Political Economy of Foreign Direct Investment: Globalized Production in the Twenty-First Century

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Abstract

This article reviews scholarly research on the political economy of foreign direct investment (FDI) over the past 20 years. FDI research during this period reflects FDI’s rapid growth, particularly in developing countries, and the emergence of intense competition among countries to attract investments. Countries have grown more open to FDI as evidenced by FDI deregulation, generous financial investment incentives, and the adoption of international agreements. Although extensive research shows that multinational corporations prefer to invest in countries with strong property rights protections, whether incentives and international agreements help countries attract FDI remains contested. Scholars can advance research by disaggregating FDI into multinational firms’ specific production activities because the scope for countries to compete for FDI and firms’ sensitivity to property rights vary widely. More generally, scholars should recast the separate study of trade and FDI into the study of global production in which trade and FDI are inextricably linked.
INTRODUCTION

Over the past 20 years, foreign direct investment (FDI) has become a central driver of global economic integration. During 1995–2000 alone, global FDI grew sevenfold, and in many subsequent years it exceeded the value of all other forms of cross-border capital flows combined (UNCTAD 2012). Of particular note, FDI has strengthened developing countries’ engagement with the world economy. Whereas these countries previously attracted little investment, by 2014 they received 55% of global FDI flows (UNCTAD 2015).

Profound economic and political transformations underlie this broad trend. Advances in communications and transport technology changed how and why multinational corporations (MNCs) engage in FDI to both produce and sell goods and services globally. Whereas before the mid-1990s MNCs’ motives for FDI were to extract natural resources or circumvent trade barriers, a growing number of MNCs fragmented production across countries to leverage lower production costs. Intrafirm trade—cross-border trade of goods and services between subsidiaries of the same MNC—is a byproduct of fragmented production and generates more than a third of total world trade (Yi 2003, Bernard et al. 2012). Simultaneously, privatization in large-scale service sectors such as telecommunications, transport, and banking provided MNCs with new opportunities to contest foreign markets for nontradable services. Services as a proportion of total FDI steadily increased over this period, such that by 2012, services accounted for 63% of world FDI stocks, more than double the FDI in manufacturing (UNCTAD 2015).

During this period, developing countries also dismantled foreign ownership restrictions and other common FDI policy barriers that prevailed in prior decades (Pandya 2014). Many developing and developed countries went a step further to actively court MNCs with financial incentives, streamlined regulations, and unprecedented legal protections. For example, bilateral investment treaties, binding agreements that codify MNCs’ legal rights vis-à-vis host country governments, nearly quadrupled during 1990–1995 (Elkins et al. 2006). To date, more than half of these treaties are between a developed and developing country (Milner 2014).

This review examines political economy research on the sources and consequences of FDI’s transformation. Whereas FDI research has evolved around discrete topics such as bilateral investment treaties (BITs) or the quality of host country institutions, I synthesize research into broader categories that highlight crosscutting themes. One strand of scholarship considers why countries have become more open to FDI inflows. These studies analyze public attitudes toward FDI and the sources of FDI policies including domestic regulations and international treaties. The second strand takes the perspective of MNCs to consider how potential host country politics and policies influence their choice of countries in which to invest.

Across several dimensions, political economy scholarship points to a more favorable environment for MNCs. Countries are more eager to attract FDI, particularly export-oriented investments, which create high-quality jobs and generate technological spillovers. MNCs, for their part, invest more in countries whose political institutions give policy makers incentives to uphold MNCs’ property rights, or restrain their ability to expropriate. Subjects of ongoing debates include FDI’s precise distributive consequences for host countries and the degree to which FDI promotion strategies such as investment incentives and international agreements help countries attract more investment.

Unpacking FDI to focus on the underlying shifts in how firms organize their global production suggests productive ways to build on existing research. FDI’s transformation reflects, in part, two fundamental changes in how MNCs organize their global production: (a) the rise of trade-FDI complementarities in the form of global production networks and (b) greater internalization of global production networks within MNCs.
Trade–FDI complementarities emerge from the dramatic reduction in trade costs. Firms increasingly fragment production across multiple countries to exploit lower production costs for distinct production phases of a single commodity. This strategy relies on low trade costs to move inputs and final products across national borders. Previously trade and FDI were more often substitutes: MNCs undertook FDI to overcome trade barriers or high transportation costs. Rather than forging a production network that spans multiple countries, MNCs would replicate the same production across multiple countries to produce and sell within the same market.

MNCs also internalized a large portion of these production networks within the firm, a trend that speaks to heightened importance of firm-specific assets in global production. Firm-specific assets are typically intellectual property like production technologies and trademarks that confer strong productivity advantages. Firms become MNCs to capture global-level scale economies associated with these assets. Firms choose to internalize global production, rather than licensing assets to arms-length suppliers, when contractual hazards are high.

Greater attention to the multiple ways of organizing multinational production and their distinctive political economy dynamics can help resolve ongoing debates and uncover new research questions. Motives for countries’ FDI openness and the salience of political restraint to MNC location decisions vary according to the content of investment.

One concrete insight is that export-oriented FDI imparts more flexibility in location choices such that MNCs can be less tolerant of poor investment climates. Export-oriented FDI’s rationale is to lower production costs using highly productive firm-specific assets. Developing countries become more attractive as lower-cost investment locations, while, at the same time, MNCs are more sensitive to these countries’ relatively weaker property rights protections. This insight provides new perspective on enduring puzzles about politics and MNC location choice. Depending on the type of FDI, MNCs can be choosier in their location decisions, and host country policy makers make different calculations about expropriation’s reputational costs.

Another insight is that the scope for FDI competition is limited. Countries have more compelling reasons to court export-oriented FDI, which creates jobs and transfers technology but does not increase product market competition. Countries not only have more to gain from export-oriented FDI but can also compete to attract these investments. By contrast, market-oriented investment, FDI to produce for the host country market, is more likely to introduce competition for local producers, and largely immutable country characteristics such as market size heavily influence MNCs’ location decisions. This insight helps make sense of variation in countries’ FDI openness.

More broadly, this nuanced approach to the political economy of FDI is an opportunity to recast the separate study of trade and FDI into a more integrated political economy theory of international production. This disaggregated approach suggests new research questions about how politics influences the scope and structure of global production, questions that are obscured when trade and FDI are studied in isolation. This approach also calls into question key stylized facts in existing political economy research.

Given this review’s emphasis on countries’ FDI openness and MNCs’ location decisions, important political economy topics in FDI research fall outside of its scope. A growing body of research evaluates FDI’s effects on democratization, governance, human rights, and income equality, among other important outcomes. This review does not catalog these sets of studies, although it touches on several concepts relevant to them. The review focuses on FDI scholarship from 2000, although it references relevant earlier research. Likewise, the review incorporates relevant research from economics but does not provide a systematic treatment.
COUNTRIES’ OPENNESS TO FOREIGN DIRECT INVESTMENT

Outcomes of interest include mass attitudes toward FDI inflows and FDI policy choices including domestic regulations and international agreements. This research parallels political economy studies of trade and portfolio capital flows, in which distributive consequences and/or symbolic resonance form the basis for attitudes and policies.

Mass Attitudes Toward FDI

Explanations for mass attitudes toward FDI build on FDI’s hypothesized effects on factor returns, particularly wages. Among the most robust empirical findings about FDI is that MNCs pay higher wages than their domestic counterparts. MNCs’ more productive technologies in turn raise labor productivity. As a consequence, MNCs demand more skilled labor than their domestic counterparts.

Political economy research identifies two labor market effects that may drive FDI attitudes: the level of labor demand and the elasticity of labor demand. MNCs’ productivity advantage translates into technological change that works to the particular advantage of skilled labor. Using multiple public opinion surveys of Latin American countries, Pandya (2010, 2014) finds FDI support increasing with skill level (proxied by education), a finding robust to controls for reported job security and nationalist sentiment. The average college-educated survey respondent is 7–10 percentage points more likely to express support for FDI inflows than the average respondent who did not complete secondary school. She takes this finding to validate a distributional model of FDI in which labor support for FDI is increasing with skill level.

MNCs may also reduce job security. Relative to host firms, MNCs can more readily adjust production activities across borders in response to changing market conditions. Scheve & Slaughter (2004) find that during the 1990s, British manufacturing workers in industries with high FDI (measured as the sum of inflows and outflows) reported less job security. A one-standard-deviation increase in industry FDI activity had a larger effect on job security than income, education, or union membership. As the authors note, demand- and elasticity-based effects are not mutually exclusive, and higher wages may compensate for greater volatility (Scheve & Slaughter 2004).

This research should delve further into the nonmaterial foundations of FDI support. In analogous survey-level research on trade attitudes, current research emphasizes the importance of nonmaterial factors such as ethnocentrism, sociotropic evaluations, and inequality aversion. Although the above studies introduce controls for some of these factors, FDI’s complex symbolic resonance calls for additional depth. Most studies of trade attitudes focus on trade in manufactured goods, but FDI encompasses a wider range of market activities including extraction of natural resources and major infrastructure (where nationalist responses are particularly common), as well as services with cultural resonance, such as media.

Another understudied dimension of FDI preferences is the attitudes of local firms toward FDI inflows. In his classic study of FDI in Brazil, Evans (1979) posits that local firms colluded with MNCs and host governments to obtain the technology necessary for industrialization. Pandya (2014) also cites local firms’ technology transfer needs to explain why countries restrict foreign ownership but typically do not enact a complete ban (see also Domínguez 1982). Aizenman (2005) theorizes that local firms are more receptive to FDI during financial crises that constrain firms’ credit access. Other possible dimensions of firms’ FDI preferences include the degree and structure of market competition and scope for productivity spillovers from MNCs.
**Domestic FDI Policies**

Domestic FDI policies include restrictions on MNCs’ market entry and operations, capital market access, and FDI promotion efforts such as tax holidays and subsidized production inputs. Over the past 20 years, countries increasingly swapped FDI restrictions for FDI incentives.

Formal FDI restrictions limit the entry and operation of MNCs in a manner analogous to capital controls, tariffs, or nontariff barriers. Some policies regulate the entry and operation of foreign-owned firms. Ownership restriction requires MNCs to form joint ventures with local firms, which retain majority ownership. Operational restrictions include local content requirements, export minimums, and mandatory local representation on boards of directors.

One set of explanations for foreign ownership regulations builds on FDI’s hypothesized distributive effects. In the mid-1970s, the median country restricted MNC ownership in more than a third of all manufacturing and service industries. By 2000, this figure had dropped to 10%, and it has continued to decline (Pandya 2014). Pandya attributes FDI liberalization in developing countries to democratization. Heightened electoral accountability makes policy makers more attentive to labor’s economic policy preferences. Analyzing foreign ownership restrictions for a global sample during 1970–2000, Pandya shows democratization coincides with the dismantling of ownership restrictions. On average, democracies restrict 6% less of their manufacturing and service industries than do nondemocracies. Additionally, she shows ownership restrictions persist in service industries, which she interprets as evidence of strong capital opposition to FDI that substitutes for trade (Pandya 2014).

By contrast, Owen (2013) emphasizes the role of job security, arguing that higher elasticity of labor demand erodes labor unions’ bargaining leverage. Analyzing US data, she finds a one-standard-deviation increase in industry unionization corresponds to a 0.168 increase in an FDI restrictions index that varies from 0 to 1. Owen argues Americans at all skill levels should oppose FDI and attributes variation in US FDI barriers to cross-industry variation in the capacity for collective action to lobby for restrictions. Contrary to Pandya, Owen finds no variation in FDI restrictions by industry skill intensity. Resolving this contradiction will likely require models that incorporate more details of cross-industry variation in MNC labor demand and how the structure of local labor markets shapes labor market mobility. In a study across 19 developed countries, Owen (2015) finds FDI restrictions are more prevalent in countries with high labor union density and concentration.

Alternatively, the institutional structure for policy making may contribute to FDI regulation patterns. Based on case studies of three US manufacturing industries—machine tools, semiconductors, and automobiles—Crystal (1998) attributes weak FDI restrictions in the United States to the absence of coherent FDI policy making, rather than to any concerted efforts by industries to lobby for FDI policies. Kang (1997) explains the creation of the Committee on Foreign Investment in the United States, the interagency group charged with evaluating the national security implications of foreign acquisitions, as the product of congressional efforts to capitalize on popular unease about foreign acquisitions but tempered by a more welfare-minded executive branch.

In recent years, domestic FDI policy controversies surround the growing number of foreign acquisitions by MNCs based in emerging markets, especially Chinese MNCs. These acquisitions raise overlapping concerns about economic and technological competitiveness, national security, and the preservation of cultural norms, and they bring renewed scrutiny to FDI screening procedures. Graham & Marchick (2006) review major US controversies including the proposed acquisition of the oil company Unocal by China’s state oil company and the transfer of US port operations to Dubai World Ports. Both acquisitions, ultimately unsuccessful, sparked debate about FDI and national security. Graham & Marchick, however, describe underlying political pressures...
to block the acquisitions based on purely commercial interests. Meunier et al. (2014) report a similar confluence of interests in response to Chinese FDI into the European Union.

More detailed studies demonstrate that opposition varies depending on local economic conditions and target firms’ industry. Meunier (2014) proposes the European sovereign debt crisis boosted Chinese FDI into the European Union by both creating more acquisitions opportunities and easing opposition to Chinese investment. She cites evidence that, during the crisis, cash-strapped EU countries more aggressively courted Chinese investors with streamlined procedures and financial incentives. Tingley et al. (2015) examine Chinese acquisitions of US firms during 1999–2014. The authors conclude opposition is higher when the target firm’s industry is security sensitive, economically distressed, or in a sector in which US MNCs face barriers to acquisition of Chinese firms. Understanding the growth of FDI from emerging markets raises many of the same challenges as parsing material and nonmaterial sources of FDI preferences, and these two areas of research will likely develop in tandem.

Although countries have long employed FDI incentives, they became more prominent as more countries actively sought FDI beginning in the 1990s. The best available evidence indicates incentives are often transfers to MNCs that do not meaningfully influence their location decisions (Oman 2000, Jensen 2012, Baccini et al. 2014). Research on FDI incentives is somewhat limited owing to the lack of transparency around these policies. Given evidence suggesting that incentives do not attract FDI, their persistence is one of the more important puzzles within the political economy of FDI openness.

A handful of studies consider policy makers’ motives to use these costly yet largely ineffective policies. Jensen et al. (2014) propose FDI incentives give voters the illusion that policy makers are proactively trying to stimulate economic growth. In an online survey experiment, the authors show subjects are more likely to support US state governors who offer tax incentives to foreign investors.

Li (2006) emphasizes the use of incentives to compensate for weak property rights. For a sample of 52 developing countries, he finds countries with strong rule of law offer MNCs lower tax breaks; democracies with strong rule of law offer even less tax relief. Consistent with this finding, Jensen (2013) shows foreign affiliates of US-based MNCs pay more taxes in democracies after controlling for firm characteristics that influence the mobility of affiliate assets. On average, firms pay 26% more in taxes in democracies relative to autocracies. Jensen attributes this pattern to democracies’ stronger incentives to police tax evasion and reduce subsidies to foreign investors.

**Accession to International Agreements**

The most-studied dimension of FDI promotion is countries’ decisions to sign bilateral investment treaties (BITs) and preferential trade agreements (PTAs). BITs specify the terms of FDI between signatory countries including, most famously, dispute-settlement procedures. PTAs not only reduce trade barriers among member countries but also increasingly address a variety of behind-the-border regulatory issues relevant to MNCs. Some PTAs incorporate BITs. Both types of agreements proliferated in the 1990s in sync with FDI’s broader transformation (for a review of FDI-related international agreements over the past two decades, see Milner 2014).

Ostensibly, these agreements reassure investors by deterring expropriation. As is the case with domestic FDI promotion strategies, the mixed evidence on BITs’ effectiveness in boosting FDI means explaining countries’ propensity to sign these agreements is of particular interest. With regard to signing PTAs, scholars consider whether countries join PTAs in order to attract more FDI.

Although BITs have been in existence since the end of World War II, their number more than quadrupled between 1990 and 2000, covering nearly 10% of all country dyads (Jandhyala et al. 2011). Developing countries, typically FDI recipients, account for many of the new BITs
signed in this period (Elkins et al. 2006). This trend coincides with the expansion of other FDI promotion activities.

Models of BIT signing compare hypothesized motives, including stiffer competition for FDI, coercion by partner countries, and diffusion processes such as learning and emulation. Elkins et al. (2006) argue heightened competition drove the recent wave of BIT signing. They find countries signed BITs when competitors—countries with similar export and infrastructure profiles—signed BITs and when the global pool of FDI expanded. Additionally, they conclude countries with greater difficulty signaling credible commitments, such as more corrupt countries and countries with civil law legal origins, more frequently sign BITs.

BIT attributes, especially the degree of constraint they impose, speak to how much sovereignty host countries are willing to forgo for the sake of FDI promotion. Allee & Peinhardt (2014) identify three traits that make BITs more constraining: binding third-party arbitration, multiple dispute-settlement venues, and arbitration by a standing body rather than an ad hoc one. They attribute patterns in BIT bindingness to the common occurrence of power disparity in dyads, in which an advanced industrialized economy is paired with a developing economy, and the power politics that gives the advanced partner more leverage during negotiations.

Haftel & Thompson (2013) model the number of months between the signing of a BIT and its entry into force as a function of executive constraints and other institutional characteristics. Countries with onerous ratification processes and constrained executives have longer delays, whereas countries with “open and predictable” (p. 362) political systems and greater government capacity ratify BITs more quickly.

Countries seem to accept more binding BIT conditions during worse economic conditions. Simmons (2014) attributes this pattern to the greater demand for FDI as a form of economic stimulus. Blake (2013) argues leaders with longer time horizons sign BITs with less binding provisions to preserve flexibility in case of future changes in economic and political circumstances. Poulsen & Aisbett (2013) argue that developing countries’ willingness to sign BITs declines once they are parties to an investment dispute, indicating they systematically underestimated the cost of disputes when signing initial agreements.

Another line of research emphasizes FDI promotion as a motive for joining PTAs. PTAs confer advantages to member-country MNCs investing in other member countries, including lower tariff barriers to facilitate trade in intermediate goods and possibly other FDI-related provisions. Baccini & Diir (2015) describe these advantages as investment discrimination and propose that the growth of PTAs reflects nonmember countries’ efforts to level the playing field. The authors find that dyads with more PTA-induced investment discrimination are more likely to sign PTAs. Tobin & Busch (2010) cite a similar dynamic that makes developed–developing dyads that share a BIT more likely to subsequently sign a PTA. They qualify this finding, noting this correlation ceases when the developing-country partner exceeds a threshold of cumulative BITs—five BITs in their sample—that erodes investment discrimination rents created by PTAs.

A related set of studies emphasizes vertical integration, identifying firms’ efforts to build multicity production networks as the main motives for joining PTAs. Vertical integration can occur via arms-length trade or FDI but nonetheless reinforces the role of trade–FDI complementarities in motivating PTA growth. Manger (2009, 2012) attributes the proliferation of developed–developing PTAs to developed countries’ efforts to support vertically integrated production networks within which firms relocate lower-value-added production activities to developing countries. His analysis of developed–developing dyads over 1995–2007 concludes dyads with a higher proportion of vertical intraindustry trade were more likely to sign PTAs. Chase (2003) finds US industries more suited to regional vertical integration were more likely to lobby Congress in support of the North American Free Trade Agreement.
Across multiple policy dimensions, countries are more open to FDI. Countries allow MNCs unfettered access to larger portions of their economies, actively court MNC investors, and join international agreements designed to strengthen MNCs’ legal protections. Points of contestation remain, however. Citizens and policy makers remain ambivalent about FDI’s distributive effects and the influence gained by geopolitical rivals. The efficacy of FDI incentives remains an open question. Developing countries pay hefty sovereignty costs to join international agreements, suggesting a somewhat reluctant openness to FDI.

**POLITICS IN MULTINATIONAL CORPORATIONS’ LOCATION CHOICE**

Political economy theories of MNC location decisions emphasize how host country political characteristics shape political risk. Political risk describes host policy makers’ propensity to expropriate from MNCs by implementing unfavorable policies ex post, such as tax increases and more onerous regulatory burdens. In extreme cases, policy makers nationalize MNC assets. This body of research coheres around the concept of an obsolescing bargain, a stylized time inconsistency problem in which host country policy makers exploit MNCs’ relationship-specific investments to extract a larger share of investment returns (Vernon 1971). More generally, the concept refers to the relative leverage of MNCs and host policy makers in shaping the host country’s investment climate. The standard account holds that once MNCs make relationship-specific investments, they are more vulnerable to host government predation. Although outright asset seizures have waned since the 1970s, several points of contention remain, including the quality of contract enforcement, entry barriers, and regulations (Hajzler 2012). Most research correlates MNCs’ location choice with these characteristics, taking observed FDI patterns as MNCs’ revealed assessment of political risk. Other lines of research explain patterns of observed expropriation and the effects of BITs and PTAs on FDI activity.

Political risk has always been a core concept in the political economy of FDI, but it became a topic of particular interest amid greater efforts by developing countries to attract FDI. On average, these countries have less stable political regimes and weaker rule of law. These countries’ extensive efforts to attract investment prompted one of the defining questions in this research: What is more important to MNCs—stable institutions or generous incentives coupled with malleable regulations? Put differently, these studies help assess whether FDI’s rapid growth produced a proverbial race to the bottom.

**Domestic Institutions**

The single most-studied research question about the politics of FDI in the last two decades concerns which types of political regimes MNCs prefer for the countries in which they invest. Most empirical tests of this question use global country samples and have FDI flows or stocks as their outcome of interest.

Democracies tend to receive more FDI, although scholars disagree why. One line of argument holds that policy makers in democracies have longer time horizons and therefore are loath to jeopardize future investments by expropriating from current investors. Jensen (2003, 2006) argues MNCs prefer to invest in democracies because policy makers’ incentives align with MNCs’ interests. In his argument, the key alignment mechanism is that, in democracies, voters punish elected leaders who breach foreign contracts. The accountability created by robust democratic institutions assures MNCs that future leaders will honor commitments and maintain stable policies. Across a series of cross-sectional and panel regressions for a sample of more than 100 countries...

The most conservative long-run estimate of the effect of democracy on FDI inflows . . . predicts that a democratic country will receive an added 0.61% as a percentage of GDP which amounts to an increase of over 45% of FDI inflows.

Li & Resnick (2003) concur that democracies receive more FDI but, disputing Jensen’s proposed mechanism, argue democracies’ high regard for property rights drives the overall correlation. In their account, democracy is potentially a double-edged sword for MNCs evaluating political risk. Democratic regimes tend to provide better property rights protection, but policy makers also face more electoral pressure to expropriate from MNCs to support greater redistribution to voters. Autocracies, by contrast, typically trade off weaker property rights protections with greater autonomy to use the power of the state to cater to MNCs, including provision of monopoly access to the local market and investment incentives (Oneal 1994). Li & Resnick’s empirical model includes separate parameters for property rights protections and democracy. Property rights have a robust correlation with FDI inflows, but holding property rights constant, democracies actually receive less FDI. Li & Resnick (2003), like Jensen (2003, 2006), control for a variety of other country characteristics that independently influence countries’ attractiveness to MNCs, such as market size and trade flows.

Building on these foundational studies, FDI scholars unpack regime type to consider specific institutional features found in both democracies and autocracies. These studies share a focus on how institutional features constrain host policy makers by limiting their motive or ability to expropriate. Li (2009) analyzes a global sample of expropriations during 1960–1990 to show that chief-executive constraints and turnover, rather than regime type per se, explain cross-country variation in the frequency of expropriations. Constrained executives in low-turnover systems (i.e., executives with longer time horizons) expropriate less frequently, irrespective of regime type. Jensen (2008) confirms the executive-constraint finding, showing that MNCs pay lower premiums to insure against political risk when host countries have tighter executive constraints. Staats & Biglaiser (2012) emphasize rule of law and strength of the judiciary as the most salient gauges of political risk because they are central features of high-quality contract enforcement. Staats & Biglaiser correlate these factors with FDI flows into Latin America. Additionally, in the authors’ survey of US-headquartered MNCs’ chief executives, respondents cite rule of law as their top criterion in FDI location decisions.

Another distinct subset of this research examines the fragmentation of policy making as a marker of political risk. If policy-making institutions have checks and balances that inhibit rapid change, leaders are necessarily more constrained, and ex post policy changes are less likely. Henisz (2000, 2002) develops a measure of the concentration of political power that captures both institutionally defined separation of powers and the divergence of preferences among policy makers. His analysis of firm-level data emphasizes the interaction of contractual and political risks. In countries with concentrated political power, he finds foreign firms that face low contractual hazards are more likely to form joint ventures with local firms in order to protect against expropriation. When both contractual and political hazards are high, MNCs are more likely to create wholly owned subsidiaries so that local partners do not collude with governments to exploit contractual risk. Henisz’s studies are notable for emphasizing that firm-level characteristics drive variation in MNCs’ optimal strategies for coping with risk. By interacting firm and host-country characteristics, he generates and tests more nuanced claims.
Host country partisanship is another type of nuance that can produce cross-sectoral variation in MNCs’ exposure to political risk. Pinto & Pinto (2008) and Pinto (2013) articulate a partisan theory of political risk in which policy makers provide a sound investment environment to MNCs whose production activities complement the factor endowments owned by their political party’s electoral base. MNCs in favored sectors perceive lower risks because their interests align with those of partisan policy makers in control of government. Analyzing sectoral FDI flows into OECD countries during 1980–2000, the authors find evidence of partisan cycles such that FDI into favored sectors increases when the aligned party controls government. The authors’ key innovation is a time- and industry-varying account of political risk.

A related line of research considers MNC characteristics that produce distinct responses to political risk. Wellhausen (2015a,b) identifies firms’ own nationality as a focal point for MNCs’ risk assessments. MNCs weigh more heavily a country’s history of expropriating conational firms’ investments. A critical mass of FDI originating from the same country provides an MNC with a “shield of nationality” because the threat of conational firm exit is more credible. She finds that countries with FDI from a wider range of countries rate higher on multiple metrics of political risk and are more likely to be in arrears to MNC suppliers to the government. Additionally, she shows that following investment arbitration, FDI from the claimant MNC’s home country declines. Johns & Wellhausen (2015) provide a variety of evidence that MNCs with supply chain links to local firms experience less expropriation.

Finally, several studies link host country political characteristics, though not political institutions per se, to the amount of FDI received. For example, Blanton & Blanton (2007) show countries with poor human rights records receive less FDI, a finding they attribute to these countries’ lower human capital levels. Leblang (2010) finds countries linked by larger migrant networks generate more investment into migrants’ country of origin. Migrant networks are information conduits and facilitate relationship-based, informal contract enforcement. Similarly, Ye (2014) credits FDI by China’s and India’s overseas diasporas with fueling their respective home countries’ booming manufacturing and software sectors.

Certain types of events and relationships influence FDI location decisions via their effects on host country constraints and credibility. Interstate conflicts dampen FDI flows, but security alliances boost flows for high-income–low-income dyads (Li & Vashchilko 2010). Foreign aid may stimulate FDI through several mechanisms, although empirical findings are mixed. Aid can reflect donors’ or lenders’ private information about relevant host country features, or it can create external constraints on policy makers that align their incentives with investors’ interests (Jensen 2004, Asiedu et al. 2009, Biglaiser & DeRouen 2010).

International Agreements

A large and distinct subset of research on MNC location decisions examines how international agreements influence FDI flows. BITs and PTAs address the obsolescing-bargain problem by enshrining openness in international law. Many BITs confer MNCs independent legal standing (i.e., independent of their home country). PTAs forestall ex post trade barrier increases that would undermine multicountry production strategies. In the event of treaty violations, countries face direct penalties and may pay an indirect reputational cost. Although a wealth of evidence shows that countries with stable and sound domestic institutions attract more FDI, the question of whether countries can compensate for weak institutions through international agreements remains contested.

One set of studies concludes that BITs, at best, complement robust domestic institutions but do not compensate for poor-quality domestic institutions. Hallward-Driemeier (2003) analyzes
bilateral FDI flows from OECD countries into developing countries during 1980–2000. She concludes that although BITs alone do not stimulate greater investment, they can complement sound domestic institutions. Her findings include a positive correlation between FDI and a BIT's/institutional-quality interaction term across several standard measures of institutions. BITs in the absence of sound domestic institutions, she argues, lack credibility. Tobin & Rose-Ackerman (2011) concur that BITs only augment the effects of sound domestic institutions, and further conclude that intensifying competition for FDI reduces the marginal return to each additional BIT signed. Neumayer & Spess (2005) counter that these findings are artifacts of small samples (few countries and years) and contrast them with their 1971–2000 sample for up to 117 countries. Their analysis correlates total FDI inflows with an FDI-weighted measure of cumulative BITs with developed countries. Neumayer & Spess find countries with more cumulative BITs receive more FDI, but they find no conclusive evidence of BITs as substitutes or complements for domestic institutions.

Kerner (2009) concludes BITs attract investment through two distinct mechanisms. They provide both a legally binding commitment to uphold investors’ property rights and a costly signal of the country’s willingness to respect investors’ property rights by demonstrating a willingness to forgo sovereignty and confront domestic opposition. He parses the two mechanisms by comparing BITs’ correlation with dyadic flows within the covered dyad, to which both mechanisms should contribute, and flows from third countries, which receive the commitment signal but receive no legal protections. He addresses possible endogeneity plaguing the first mechanism by using a moving average of neighboring countries’ BITs as an instrument. He attributes previous inconclusive results to a failure to account for endogeneity.

Asibett (2009), by contrast, critiques the quality of statistical instruments for BITs. She analyzes bilateral FDI flows between OECD members and low- to middle-income countries, using dyad characteristics and fixed effects to control for the endogeneity of BITs entry. She finds no causal effect of BITs on FDI. Her findings also cast doubt on BITs’ signaling function by showing no correlation between the number of BITs with other OECD countries and FDI inflows.

A growing number of BITs studies evaluate specific treaty features and their implications for FDI flows. Drawing a distinction between signed and ratified BITs, Haftel (2010) argues that only ratified BITs increase FDI inflows because ratification confers credibility. Drawing on precise measures of FDI, Kerner & Lawrence (2014) find US MNCs’ investments covered by BITs are more intensive in fixed capital, the type of MNC asset most vulnerable to expropriation.

The frequency and outcome of disputes under the auspices of BITs suggest that, whether or not BITs stimulate more FDI, they privilege MNCs’ interests. Simmons (2014, p. 35) documents the proliferation of investment disputes and judgments that favor investors: “Each progressive move downward through the World Bank’s income categories—upper, upper middle, lower middle, and lower—results in about a 10% chance that an arbitration panel will rule expansively, that is, in favor of investors’ rights.” Simmons also concludes that BITs are more constraining than PTAs and that BIT-based dispute settlement awards higher monetary damages than does PTA-based settlement. Allee & Peinhardt (2011) show that BITs’ stimulating effect on FDI reverses if a country is party to a dispute brought to prominent third-party arbitration venues and that a BIT dampens FDI even more if the country loses the dispute.

PTAs’ effects on FDI flows are similarly contested. Büthe & Milner (2008) document how PTAs and global FDI flows have grown in lockstep and propose that PTAs stimulate FDI by signaling a credible commitment to market-oriented policies. PTAs provide monitoring of member countries’ compliance and raise the reputational costs of violating international agreements. Büthe & Milner’s analysis of annual FDI inflows to non-OECD countries during 1970–2000 reveals a robust correlation between a country’s cumulative PTA membership and the amount of FDI.
received. Echoing key arguments in the BITs literature, they conclude that PTAs complement domestic political constraints by lowering information costs. Büthe & Milner (2014) verify that PTAs’ market size–expanding effects do not account for FDI growth and show that PTAs with relatively more stringent provisions—reflecting a stronger commitment to economic liberalization more generally—correspond to larger increases in FDI.

Peinhardt & Allee (2012) counter that US preferential economic agreements, PTAs, BITs, and other less binding types of trade and investment agreements have not stimulated sustained growth of US FDI into more than a handful of countries. Their analysis of US FDI patterns hold constant a wide range of confounding sending country effects, and they suggest the United States’s distinctive pattern of PTA signings explains the null finding.

TOWARD A POLITICAL ECONOMY OF GLOBAL PRODUCTION

Taken as a whole, the last two decades of FDI scholarship indicates an overarching shift in the politics of FDI to the advantage of MNCs. MNCs enjoy stronger legal protections, more generous incentives, and fewer regulations. Nonetheless, FDI remains controversial because of its distributive and sovereignty costs and because it is not clear the countries that bear these costs actually receive more investment.

How then should we build on existing scholarship to reconcile these contradictions and advance political economy research on FDI? In the previous section, I noted a trend in more recent studies to explain finer-grained variation in openness and political risk by disaggregating FDI by degree of contractual risk, factor content, and MNC nationality. FDI encompasses a wide range of market activities but, until recently, scholars have not explored in depth the political economy implications of this rich variation. By pursuing further research in this vein, we can more accurately identify what characteristics of FDI mitigate or exacerbate political risk or mediate FDI openness. These nuanced insights also suggest more fundamental changes in how political economy scholars organize their thinking about global economic integration.

The immediate task of building on existing findings is best accomplished by distinguishing between FDI that complements cross-border trade and FDI that substitutes for trade. Depending on the type of FDI in question, countries have qualitatively different incentives for FDI openness, as do MNCs in their location decisions. This distinction helps to make sense of seemingly contradictory findings. Many of the reviewed empirical findings are more relevant for one of these subsets than the other. By drawing this distinction, we also place sharper parameters on the scope for FDI competition.

Unpacking FDI’s Growth

FDI’s growth over the last two decades reflects, in part, two underlying changes in how firms produce and sell goods and services in the global economy: the rise of FDI–trade complementarities and the internalization of multinational production within the firm.

The emergence of FDI–trade complementarities, manifest in vertically integrated production networks, gave MNCs more flexibility in location choice and allowed countries to compete for export-oriented FDI. Previously, immutable location-specific characteristics such as market size and resource endowments drove most FDI location choices. FDI in manufacturing and services substituted for trade, allowing foreign firms to circumvent trade barriers and contest markets for nontradables. Beginning in the 1990s, a growing portion of MNCs exploited trade–FDI complementarities by fragmenting production across several countries. Declining trade barriers and transport/information costs lowered the costs of intermediate trade, prompting firms to reorganize production on a global scale to leverage differences in production costs.
Figure 1 plots the percentages of all sales of US-headquartered MNCs’ foreign affiliates that were export sales over the period 1983–2012. Exports as a percentage of total foreign affiliate sales grew by nearly ten percentage points beginning in the late 1990s. Underlying this aggregate trend are even more dramatic shifts to export-oriented production for high-value-added manufacturing industries, which can more readily fragment production. For example, during this period, foreign affiliates in the motor vehicles industries increased their export percentage of sales from 45% to 80%. The figure demonstrates that exports to third countries, suggestive of a multicountry production network, drove the overall trend.

Simultaneously, MNCs internalized more production, keeping their most productive assets within the firm while expanding the firm itself across national borders. Internalization differentiates FDI from offshore outsourcing or other types of multinational production transacted through arms-length trade. Figure 2 disaggregates US MNC affiliates’ export sales by type of trading partner. Trade with affiliated parties (i.e., foreign firms with a common owner) grew in the 1980s and continues to account for a majority of export sales. Figure 3 illustrates the growth of global production within firms. Over time, a growing proportion of affiliated-party sales were in third countries, growth that came at the cost of affiliated-party sales with the MNC’s US headquarters.

The growing internalization of production points to multicountry production networks that deploy sophisticated production technologies into more countries. MNCs arise when firms have firm-specific assets that create high scale economies but over which credible arms-length contracts cannot be readily written. Examples of these typically intangible assets include proprietary production technology, intellectual property, and production practice. These assets confer large productivity advantages, making FDI efficient despite the high fixed costs of multinational production. Helpman et al. (2004) find that multinational exporting firms are,
**Figure 2**
Affiliate versus nonaffiliate export sales, 1983–2012. This figure plots exports by foreign affiliates of US-based multinational firms disaggregated by trading partner. The solid line tracks exports to affiliated parties, typically firms with common owners and/or managers. The dashed line corresponds to exports by US affiliates to nonaffiliated parties. The figure demonstrates shares of exports to affiliated parties grew over the sample period and continue to account for a majority of affiliate exports. Data source: Annual Survey of US Direct Investment Abroad (US Bureau of Economic Analysis; see [http://www.bea.gov/international/di1usdop.htm](http://www.bea.gov/international/di1usdop.htm)).

**Figure 3**
Destination of related party sales, 1983–2012. This figure plots the geographic distribution of exports by foreign affiliates of US-based multinational firms to other affiliates of the same firm. The figure demonstrates the growth of related-party trade to third countries (solid black line) and the expense of such trade with the United States (dotted blue line). Sales to affiliates located within the same host country (dashed red line) remained constant. Data source: Annual Survey of US Direct Investment Abroad (US Bureau of Economic Analysis; see [http://www.bea.gov/international/di1usdop.htm](http://www.bea.gov/international/di1usdop.htm)).
on average, 15% more productive than nonmultinational firms that export. In market-oriented FDI, production is more contained within the host country. MNCs can cope with weak property rights by transferring older production technologies. By contrast, export-oriented FDI requires that MNCs transfer their most productive assets.

Countries’ incentives to open their economies to FDI vary depending on whether FDI complements or substitutes for trade. Export-oriented FDI is perhaps more likely to produce job insecurity because it exposes workers to global market volatility. Fluctuations in labor demand in market-oriented investments should more closely track local market condition and therefore correlate with changes in local firms’ labor demand. Alternatively, export-oriented investments could hedge against labor demand volatility by distributing risk across more markets (Alfaro & Chen 2012). FDI attitudes should vary among citizens depending on which of these effects dominate.

Countries have stronger incentives to deregulate and attract inflows of export-oriented FDI, and MNCs are less willing to accept restrictions on these investments. Export-oriented investments increase labor demand without heightened product market competition and are more likely to introduce advanced technologies that generate positive spillovers (Romer 1993). For the same reasons, FDI promotion policies tend to focus on export-oriented investments. MNCs making export-oriented investments are less tolerant of restrictions that weaken their control over firm-specific assets.

With regard to MNC location decisions, political risk should deter export-oriented investment more than market-oriented investment owing to the former’s greater location flexibility. Accordingly, to the extent that domestic institutions and international agreements signal credibility or constrain leaders, they should exert a greater effect on MNCs that have more flexibility in location choices. The distinction places FDI competition into perspective: Competition has increased but only for a subset of investment. Note in Figure 1 that approximately half of affiliate sales are local to the host country, indicating market-oriented investments. Where MNC location decisions are less flexible, standard accounts of political risk prevail.

**Measuring Multinational Production**

Careful empirical analysis of these nuances requires FDI scholars to tap into a wider range of data sources. Existing scholarship on MNC location choice relies heavily on measures of FDI’s monetary value reported in official balance-of-payments statistics. These data build on the official statistical definition of FDI as foreign equity ownership in excess of 10%. The threshold reflects the minimum level of ownership thought necessary for the foreign equity owner to exercise managerial control (International Monetary Fund 2009, p. 101).

Data quality and availability have long been binding constraints on empirical research about the political economy of FDI. MNCs’ financial strategies, such as reliance on tax havens and local borrowing to minimize exchange rate risks, distort official FDI statistics. Even accurate estimates of FDI-related capital flows are not informative without more precise knowledge about MNCs’ assets and production activities. Beugelsdijk et al. (2010) compare balance-of-payments estimates with aggregated foreign affiliate value-added measures. They find balance-of-payments measures overestimate value added for tax havens but underestimate it in countries with higher levels of financial development, volatile exchange rates, and average labor productivity. Kerner

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1Earlier FDI research makes similar points in describing variation in vulnerability to expropriation (Kobrin 1987, Frieden 1994).
(2014) raises analogous concerns specifically with regard to research on MNC location decisions. He proposes MNCs’ expenditures on fixed capital assets as a more suitable measure because they indicate investments by only majority foreign-owned firms, the type of stylized MNC assumed by existing research.

A growing number of FDI scholars draw upon more granular, firm-level measures of FDI from multiple sources. The US Bureau of Economic Analysis (BEA) conducts an annual survey of US-based MNCs and US affiliates of foreign MNCs, looking at a wide range of financial and production activities. Firms are legally required to participate in the survey. These data are exceptionally rich albeit US-centric. The BEA publishes aggregate data based on individual firm responses. Figures 1–3 and Pandya (2014) use these data to measure MNCs’ export orientation and internal vertical integration. Kerner (2014) and Kerner & Lawrence (2014) derive measures of MNCs’ physical capital investments. The BEA restricts access to the disaggregate firm-level data on privacy grounds, although scholars who are US citizens can petition for access. Jensen (2013) uses the firm-level data to measure MNCs’ tax liabilities. Jensen et al. (2013) evaluate patterns in US firms’ dumping claims using the US Census Bureau Linked/Longitudinal Firm Trade Transaction Database, a similarly rich dataset available to scholars by petition. These firm-level data allow us to observe how a single MNC modifies production decisions across different countries.


**Reorganizing the Political Economy of Trade and FDI**

More nuanced accounts of FDI’s transformation highlight that the lines between trade and FDI are more blurred than ever. If the ultimate objective of political economy research is to explain the depth and character of global economic integration, more nuanced accounts of FDI’s politics are intermediary steps to a broader reordering of theoretical categories.

Trade and FDI are different manifestations of global production. International trade is the cross-border flow of goods and services, whereas FDI is the cross-border flow of the ability to produce goods and services. A single firm makes strategic decisions about when and how to use trade and/or FDI. For example, not only does intrafirm trade account for more than a third of all trade, but MNCs also generate much of arms-length trade. In 2000, MNCs accounted for nearly 80% of all US exports and imports (Bernard et al. 2009, p. 516). In the same year the top 1% of US trading firms transacted 81% of all US trade (Bernard et al. 2009, p. 515).

Existing research does explore FDI’s consequences for trade and trade policy. The relationship between PTAs and FDI remains an active research area. Earlier FDI research considers how FDI mediates demand for tariff protection. Milner (1988) cites the nascent globalization of production to explain the absence of protectionist pressures in the United States during the 1970s. Goodman et al. (1996) show that MNCs reliant on trade for inputs are a constituency for free trade in the United States, whereas MNCs making market-oriented investments ally with local firms to lobby for protection. Bhagwati et al. (1987) argue that FDI diffuses labor’s demand for tariff protection by creating more jobs.
A more fundamental reorganization would emphasize the role of firm-specific assets as the basic building block of production. The productivity of these assets explains heterogeneity in firms' global participation (Melitz 2003). Assets also vary in the types of scale economies they produce, thus shaping firms' preference for trade or FDI. Firms whose assets have both firm- and plant-level scale economies should prefer to concentrate production and engage in arms-length trade. Firms whose assets have high firm-level scale economies but low plant-level scale economies are more likely to favor FDI. Productivity and scale economies influence several observable traits of global production, including firms' efforts to develop specific assets, the quality and variety of products they produce, and the range of countries in which they operate. Politics shapes these foundations of global production in a variety of ways. For example, firms contemplating development of new firm-specific assets may take into consideration policy barriers to the full realization of scale economies. Exogenous shocks to productivity and scale economies could easily manifest in policy preferences.

Returning to the questions of countries' FDI openness and MNC location decisions, this framework of global production suggests new approaches to existing questions. Compared to trade, FDI produces opposite cleavages between industry-specific factors. High labor specificity drives a wedge between domestic labor and capital in a given industry, the reverse of the standard Ricardo-Viner explanation for trade policy preferences (Grossman & Helpman 1996). MNCs' trade policy preferences might be more complicated than we realize. Kim (2013) finds that productive US firms that manufacture differentiated products more frequently lobby for trade openness and typically have lower tariffs. MNCs, the highest end of the productivity distribution, possibly have less at stake in US trade openness because, unlike pure exporters, MNCs have traded off the high fixed costs of establishing a multicountry production network for low variable costs. In the context of global production, MNC location choice reflects not only property rights protection but also the interaction of property rights and the choice between trade and FDI. When choosing between trade and FDI as substitutes, an MNC facing weak property rights may sometimes prefer FDI to trade because FDI provides the firm with greater control of its productive assets and less exposure to predation.

As this review attests, FDI's rapid growth has inspired a thoughtful and varied body of political economy research. We have robust accounts for why some countries, especially developing countries, are more open to FDI than others, and why MNCs choose to invest more in certain countries. The conceptual shift from FDI and trade to global production contributes greater nuance to these existing questions and provides the analytical versatility to explain the continuing evolution of global economic integration.

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