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# Decentralization and Foreign Direct Investment:

## Impact of Fiscal and Political Decentralization on FDI Inflow

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논문요약

본 논문은 지방분권이 가져오는 경제적 효과를 분석한다. 특히 지방분권의 두 측면, 재정적 분권과 정치적 분권의 상호작용이 해외직접투자에 미치는 영향을 분석함으로서, 기존연구에서 미흡했던 개헌의 경제적 효과를 살펴보는 동시에 분권의 다층적 측면을 고려했다는 점에서 그 학문적 기여가 있다. 본 논문은 지방분권은 해외직접투자를 유치하는 데에 있어 긍정적 효과가 있을 뿐 만 아니라, 재정적 분권이 가진 긍정적 효과가 정치적 분권이 진행됨에 따라 그 긍정적 효과 또한 강화됨을 주장한다. 경험적으로 81개국, 1970년에서 2010년사이의 나타난 지방분권의 현상과 해외직접투자의 관계를 분석하였다.

주제어: 해외직접투자. 재정분권, 정치분권, 지방분권, 개헌의 경제적 효과

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# I. Introduction

In 2018, the president of South Korea called for the constitutional reform by submitting his reform bill. The attempt ultimately failed. However, it was a rare opportunity to revise the Constitution which was last amended 30 years ago. It was also a rare moment for social scientists to debate constitutional reforms and their effects in South Korea. Despite the fact that there were hundreds, if not thousands, of academic conferences debating constitutional reform, political scientist focused on political effects and rarely asked how constitutional reform might shape economic phenomena. In this paper, we address the question of how the decentralization of the government, which was the main theme of recent constitutional reform proposal, affects economic outcome. In particular, we investigate how decentralization of government influences foreign direct investment.

How does decentralization affect foreign direct investment (hereafter FDI)? Previous studies have examined the relationship between a single dimension of decentralization, notably fiscal decentralization, and inward FDI. They have heavily concentrated on the fiscal aspect while disregarding the political side of decentralization when it has multifaceted effects on FDI inflow. Therefore, we consider simultaneously both fiscal and political aspects of decentralization and explore how the interaction between the two affects inward FDI.

Foreign direct investment (FDI) has become an important component of every nation's efforts toward economic growth, and it is an integral part of the global economy. Since 1970 the amount of FDI began to grow at roughly 26 percent whereas that of exports grew only at 15 percent during

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a period of 1986 to 2000.[1] In the second half of the 1990s, trade growth rate has been low at 1.9 percent in comparison to the pace of FDI growth at an overwhelmingly fast rate of 37 percent. As such, the flows of FDI have increased both in developed and developing countries, reaching a historic high of $1,979 billion in 2009 surpassing the flows of other types of investment such as portfolio and loans.[2]

Along with the growth of FDI inflow, a strong trend towards decentralization has been also observed in Europe and in developing countries at the end of the Second World War.[3] In fiscal arena, the share of subnational expenditure in total government expenditure has increased from 20 percent in 1978 to over 32 percent by 1990s. Decentralization in a political arena was even more prevalent. The proportion of countries where subnational governments have policy making authority has increased from 21 percent in 1975 to 60 percent in 1990s.[4] Moreover, over a half of regional governments in the world were directly elected through subnational elections. Direct local elections also increased from 30 percent in 1970 to 86 percent in 2000s.

Against this background, there have been numerous literatures which attempted to unveil the key determinants of large FDI inflows. They range from economic fundamentals to political institutions. Yet the combined effect of fiscal and political decentralization on FDI inflow has not received much attention. The purpose of this study is to shed light precisely on the

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1) Pinto, Pablo M., *Partisan Investment in the Global Economy: Why the Left Loves Foreign Direct Investment and FDI Loves the Left.* New York: Cambridge University Press, 2013.

2) UNCTAD, *World investment report.* Geneva: United Nations, 2009.

3) Bache, Ian and Matthew Flinders, *Multi-Level Governance,* Oxford: Oxford University Press, 2004.

4) Rodden, Jonathan, "Comparative Federalism and Decentralization: On Meaning and Measurement." *Comparative Politics,* Vol. 36, No. 4, 2004, pp. 481-500.

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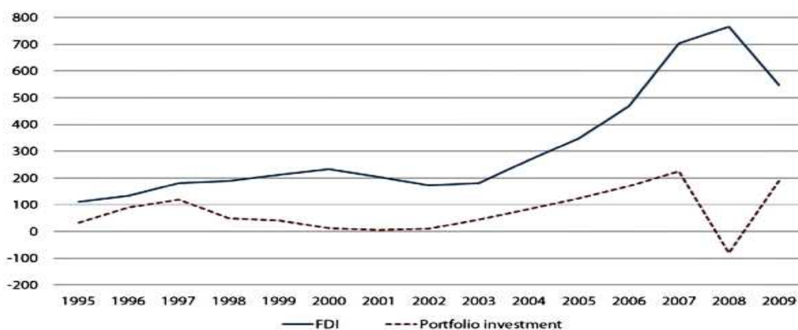
relationship between fiscal decentralization and FDI inflow contingent upon the varying degrees of political decentralization. While most existing research on the determinants for FDI inflow has been largely focused on economic factors like market size and economic development level, political factors have been much less explored.[5)] Political factors have also been limited to regime type and political institutions such as democracy and federalism, respectively. Controlling for the de jure domestic institutional veto players, this article further explores the effect of de facto fiscal and political decentralization on FDI inflow in host countries.

The rest of the article is organized as follows. Second section reviews previous literature on the relationship between FDI and decentralization. The third section establishes the definition of decentralization, and illustrates the theoretical framework and testable hypotheses. The fourth section presents empirical analysis. The last section ends with a conclusion and suggests policy implication of the findings.

Figure 1. Composition of private capital flows, US$ billions.




5) Büthe, Tim and Helen V. Milner, "The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through International Trade Agreements?" *American Journal of Political Science,* Vol. 52, No. 4, 2008, pp. 741-762.

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## Ⅱ. Literature Review

What is an investment climate more favorable in the eyes of foreign investors? There is a debate as to what makes a country attractive to foreign investors. The relationship between economic factors and FDI has received extensive attention from scholars. They studied the impact of market size, growth rate, trade, and population on the size of FDI inflow but overlooked political factors. From the foreign investors' perspective, profitability and credibility of a host country are the two most important conditions. No matter how attractive fiscal incentives may be, sudden expropriation or reversal of tax policies can deter foreign investors from investing their capital in the country. Likewise, good political institutions may provide credibility and stable political environment, but no firms would be attracted to a host country which has unfavorable investment policies. Neither of them alone is sufficient in determining which country attracts greater FDI inflows. Yet, many previous studies have focused on only one of the two dimensions—profitability and credibility—at a time while disregarding the other.

First of all, early literature on FDI had suggested that autocracies tend to attract more FDI than democracies because the former is able to suppress demand from organized labor and benefit foreign investors with lower wage than the latter.[6] However, for example, several studies empirically show that while the cost levels including wages are important factors for attracting Multinational Enterprises (MNEs), "countries like the United States can remain attractive despite a relatively high absolute level

6) Pinto, Ibid.

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of wages, because relative to the quality of the microeconomic business environment, these wages are moderate compared to other countries."[7] Hence, other scholars have overturned the argument by asserting that democracies boast greater credibility and political stability. They argue that democracies are associated with less violence or expropriation risk than autocracies thanks to availability of information, election-induced accountability, and established property rights.[8] However, not all democracies have advanced governance infrastructure which can promote the positive effects of the regime on FDI. This explanation is also limited to only democratic countries, and cannot explain variations in FDI inflow across the countries of the same regime.

Focusing the details of democratic institutions, the veto player literature, in general, claims that federal political institutions allow regional units representation or formal veto authority, whereby signaling credible constraints against policy change.[9] Reducing uncertainty is critical for MNEs because it is closely related to productivity of their investment. According to Porter et al., "[u]ncertainty can come from all dimensions of the context: it can be the result of unstable macroeconomic conditions, of an unreliable legal and political system, and of social or political tensions that have the potential to undermine the fundamental nature of institutions

7) For example, see Porter, Michael E. et al., "The Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index." In Lopez-Claros, A. et al., eds., *Global Competitiveness Report 2006-2007*(World Economic Forum). New York: Palgrave MacMillan, 2006, pp. 51~80.

8) Li, Quan, and Adam Resnick, "Democratic Institutions and Foreign Direct Investment in Flows to Developing Countries." *International Organization,* Vol. 57, No. 1, 2003, pp. 175-211; Jensen, M. Nathan, *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment.* Princeton University Press, 2006.

9) Tsebelis, George, *Veto Players: How Political Institutions Work.* Russell Sage Foundation and Princeton University Press, 2002; Jensen, Ibid; Nooruddin, Irfan, *Coalition Politics and Economic Development: Credibility and the Strength of Weak Governments.* New York: Cambridge University Press, 2011.

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or decision making."[10] This argument is reasonable in that ex post investment, host countries have incentives to renege on their initial promise if doing so renders greater benefits. This time-inconsistency problem or uncertainty can increase the operational costs of investments, which further reduce firms' productivity. Veto players, "individual or collective actors whose agreement is necessary for a change of the status quo"[11] can help minimize uncertainty resulting from the political system. As a unanimous decision of all veto players is required to change a policy or status quo, veto players may act as a credible constraint against a sudden or dramatic change, or buy time for moderation or adjustment, whereby reducing the extent of uncertainty enough to attract foreign investment.

Jensen is a strong proponent of political institutions in providing credibility to foreign investors, thus increasing FDI inflows.[12] He assumes a federal political system in which one or more veto players outside the central government share a similar preference structure with foreign corporations. In such a system, though the central government sets the agenda, veto players or local governments may have an incentive to pursue market-friendly policies in favor of multinationals, thus helping making a favorable investment climate. What the veto player literature generally claims is that the larger the number of veto players, the greater the policy credibility because they exercise veto power against a change in status quo. In contrast, Zheng argues that neither too many nor too few veto players are a favorable investment condition.[13] He suggests that a country with

10) Porter et al., Ibid, p. 115.
11) Tsebelis, Ibid, p. 19.
12) Jensen, Ibid.
13) Zheng, Yu, "Credibility and Flexibility: Political Institutions, Governance, and Foreign Direct *Investment." International Interactions: Empirical and Theoretical Research in International Relations,*

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weak institutional checks (small number of veto players) can attract more FDI if it increased credibility, whereas a country with strong institutional checks (large number of veto players) can also attract more FDI if it increased flexibility. While Jensen's veto player concept is limited to democracies, Zheng asserts that even an authoritarian country can be held accountable so long as it has more than one veto player. However, in a strongly centralized authoritarian country, emergence of veto power is hardly possible, and even if there is one, its role as a true veto player in blocking a policy change against the central government is largely limited. Zheng also provides a counterargument against Jensen in two respects: one that too many veto players can be harmful and the other that foreign investors do not always prefer democratic developing countries because though democratic institutions make political process more transparent and stable, in times of exogenous shock policy rigidity due to too many veto players may offset such benefits.

However, whether or not subnational governments have veto power in practice is questionable. We contend that federal/unitary distinction is not the most elaborate proxy for veto player with which to explain the variance in FDI inflow across countries. Although federalism and decentralization often go hand in hand, we argue that decentralization is a political process that takes place regardless of the political regime or institution. For example, the degree of decentralization varies in both unitary and federal countries.[14] Some unitary countries like China, Denmark, India, Japan, and Sweden are more decentralized in their revenue

Vol. 37, 2011, pp. 293-318.

14) Arzaghi, Mohammad, and J. Vernon Henderson, "Why Countries are Fiscally Decentralizing?" *Journal of Public Economics,* Vol. 89, No. 7, 2005, pp. 1157-1189.

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system than the average federal country.[15] Similarly, some federal countries like Belgium, Malaysia, and South Africa are more centralized than the average unitary country. Therefore, federalism is a limited proxy for the existence of multiple decision-making actors in a country. In turn, it is worth studying decentralization and its impacts on FDI inflow.

On decentralization and FDI, previous studies identified several positive effects of decentralization as follows. First, politically decentralized system reduces dogmatic policy and guidelines imposed on local governments from the center. Second, it increases the access to better information on local circumstances which helps local leaders to make rational and flexible decisions that reflect the real problems and satisfy preferences of the residents.[16] Third, better access to information in turn works to promote inter-sectoral coordination, increases accountability, and reduces inefficient policy duplication. Political decentralization also passes responsibility and accountability to local bodies which make local governments work efficiently, flexibly, and creatively by mobilizing all the available resources in their localities to fulfill the targets. Lastly, political decentralization is expected to enhance the participation of local communities in decision regarding setting goals, strategies, planning, financing, implementation, and monitoring to improve the policy outcomes at the local level.[17]

Nonetheless, political decentralization may work to deteriorate status-quo if not properly implemented. Previous literature against decentralization argues that decentralization can bear fruits only if there is a strong planning and executive capacity at local levels as decentralization

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15) Clark, William Roberts et al., eds., *Principles of Comparative Politics*. Sage Publication, 2003.

16) Oates, Wallace E., Fiscal Federalism. New York: Harcourt Brace Jovanovich, 1972.

17) Tiebout, Charles M., "A Pure Theory of Local Expenditures." *The Journal of Political Economy*, Vol. 64, No. 5, 1956, pp. 416-424.

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brings a new heavy management burden to local bodies.[18] Many developing countries may be short of qualified personnel and managers to handle the new responsibilities. Such deficiencies could undermine the competence of local bodies and render the center a better candidate to plan and execute the new tasks. In addition, if accountability and responsibility between the central and local governments are not clearly defined, there may be downsides to political decentralization like blame sharing, joint-accountability, and free-ride problems.[19]

With regard to signaling credibility, Kessing et al. argue that tacit collusion to abstain from excessive taxation among regional governments will fail to hold as the number of government increases.[20] As the number of government tier increases, the size of benefits distributed to each government gets smaller. The same applies to punishments when the governments do not cooperate. Therefore, in a largely decentralized setting, defection of one government among many has less grave spoiling effect on the whole. Therefore, decentralized governments have greater incentive to deviate from cooperating and choose defection. Likewise, they believe that vertical decentralization can weaken accountability of politicians. While Kessing et al. acknowledge that horizontal decentralization may increase accountability, they believe that the negative effects of vertical decentralization are greater. As higher and lower governments share jurisdiction of a local region, they posit that the joint responsibility and joint accountability can facilitate blame shifting and credit claiming for

18) Litvack, Jennie, and Jessica Seddon, eds., *Decentralization Briefing Notes. Washington,* DC: World Bank. 1999.

19) Kessing, S. G. et al., "Foreign Direct Investment, and the Dark Side of Decentralization." *Economic Policy,* Vol. 22, No. 49, 2007, pp. 5-70.; Rodden, Ibid.

20) Kessing et al., Ibid.

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regional economic performance.[21] To sum up, critics accord that decentralization fails to both signal commitment to foreign investors about policy stability (contracted tax rate) and to enhance government accountability due to moral hazard problem.

Although the previous research on the impacts of decentralization on FDI has generated essential insights, they suffer from some critique. First, Treisman pinpoints that Oates's and Tiebout's arguments on the positive effect of decentralization are based on flawed assumptions.[22] While the two scholars view tax competition in a decentralized country will raise subsidies to attract FDI, Treisman states that productivity of the region is dominantly more important to foreign investors and competition-induced lower tax rate are less influential. Second, when Kessing et al. argue that increasing number of government tiers obfuscates accountability and prevents coordination, they suppose that every government tier in a decentralized state is given some degree of autonomy. In reality, however, simply because a country is federal does not indicate that autonomy in a policy area is transferred to its subnational governments or vice versa. In addition, as the number of tier increases, the lower tiers tend to have much lesser degree of power. Therefore, it is doubtful that lower tiers of government are capable of incurring moral hazard problems as previously mentioned. Furthermore, while effects of individual decentralizations have been discussed by preceding authors, it remains largely unexplored as to how the interaction effect of fiscal and political decentralizations impacts FDI inflows of the host country.

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21) Rodden, Ibid.

22) Treisman, Daniel, *The Architecture of Government: Rethinking Political Decentralization.* New York: Cambridge University Press, 2007.

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## Ⅲ. Theoretical Framework

### 1. Defining Decentralization

While numerous definitions of decentralization exist in the political science literature, people often refer to countries as being more or less decentralized without specifying which aspects in particular.[23] Using multiple concepts of different scopes interchangeably arouses confusion; and thus, we rely on Treisman's definition of political and fiscal decentralization. Treisman classifies decentralization in three categories: 1) Administrative decentralization, 2) Political decentralization, and 3) Fiscal decentralization.[24] Treisman further divides the concept of political decentralization into four subcategories as follows: a) Decision-making decentralization, b) Appointment decentralization, c) Federal state, and d) Constitutional decentralization. According to Treisman, first, decision-making decentralization exists "if at least one subnational tier of government has exclusive authority to make decisions on at least one policy issue"[25] regardless of the unanimity or majority requirement. Second, appointment decentralization exists "if government officials at at least one subnational tier are selected and appointed by residents of that government's jurisdiction, independent of higher-level governments."[26]

23) Treisman, Ibid.

24) He makes a clear distinction that administrative decentralization largely differs from political decentralization in that the former emphasizes changes in organizational or administrative arrangement to achieve administrative efficiency whereas the latter emphasizes the decision-making authority given to the local governments in at least one policy issue. When a government is administratively decentralized, all agents at the subordinate level are appointed by upper governments and subnational governments do not have the veto power. Therefore our definition of political decentralization excludes administrative decentralization because the decision-making aspect is absent.

25) Treisman, Ibid, pp. 24

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Third, constitutional decentralization refers to "a system in which subnational governments or their representatives have formal rights to participate in central policy making."[27] Though it seems more complex than the simple definition used by other scholars, Treisman's elaborate classification will help greatly when analyzing the multi-faceted effects of political decentralization on FDI. Lastly, fiscal decentralization refers to giving subnational governments the power to both raise and spend fiscal resources. The more fiscally decentralized, the greater autonomy subnational governments have in setting their own tax rates and planning their public spending.[28] It is also related to decision-making aspect to an extent because subnational governments need to set goals, raise fiscal resources, and execute public policy.

Taken together, not only political and fiscal decentralizations but also each of their subcomponents is a related yet distinct concept. Therefore, it is inaccurate to unilaterally address countries more or less decentralized without further breaking down decentralization and examining each category. Moreover, it is important to understand that "decentralization is a multidimensional process that has a variety of combinations that may or may not occur simultaneously."[29] For instance, appointment decentralization can occur without constitutional decentralization. It is also possible for political decentralization to occur in the absence of fiscal decentralization. Subnational governments may have the ability to collect tax revenue yet

26) Treisman, Ibid, p. 24.
27) Treisman, Ibid, p. 25.
28) Treisman, Ibid.
29) Montero, A. P., & Samuels, D. J., eds., *Decentralization and democracy in Latin America*. Indiana: The University of Notre Dame Press, 2004, pp. 94-121.

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the center may muster and redistribute it according to its own priorities. As Wibbels warns it, centralization may be disguised in the form of 'centralization via decentralization.'[30] Hence, countries differ in their forms of decentralization; they could be decentralized selectively or in combination of multiple dimensions.

## 2. Argument

We mainly argue that the interaction effect of fiscal and political decentralization on inward FDI is positive. Fiscal decentralization is expected to be positively associated with FDI inflow by inducing tax incentives to attract MNEs. Political decentralization is also positively related to FDI inflow by increasing policy stability and improving investment climate. Taken together, when fiscal and political decentralizations interact, their interaction has a FDI inflow enhancing effect as the two complement each other.

### (1) Fiscal Decentralization and FDI

We focus on the decentralization of tax autonomy rather than of expenditure because its effects on FDI are more direct and significant than the latter.[31] Tax revenue decentralization may increase the power of

30) Wibbels, Erik, "Decentralization, Democracy, and Market Reform: on the Difficulties of Killing Two Birds with One Stone." In Montero, A. P., & Samuels, D. J. eds., *Decentralization and democracy in Latin America*. Indiana: The University of Notre Dame Press, 2004, pp. 203-234.

31) For instance, if only decentralized in spending, however, subnational governments may be easily tempted by a soft budget constraint and manage spending in a macroeconomically irresponsible manner (Wibbels 2003). They would increase spending in public goods by providing substantial benefits to their residents or spend elsewhere. Excessive spending will in turn lead to vertical fiscal imbalance where the center cannot but bail them out as a last resort, increasing national budget

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subnational governments in two ways, which help attract more FDI inflow. First, tax revenue decentralization improves regional economic environment by correcting a fiscal imbalance problem. Tax revenue decentralization encourages collecting tax at the local level, which increases local resources and decreases its dependency on the center for intergovernmental grants and transfer. Rodden and Wibbels empirically show that their sample of fifteen federations from 1978 through 1996 demonstrate a positive relationship between decentralization and smaller deficits and lower inflation rates, when the states have wide-ranging autonomy over taxation.[32] As subnational governments muster their own fiscal resources and face hard budget constraint, it is likely that they will administer finance in a more macro-economically responsible manner. In turn, tax autonomy corrects fiscal imbalance and contributes to stabilizing investment environment, which is one of the attractive factors to MNEs.

Second, tax revenue decentralization sets off competition for FDI among subnational governments by bidding lower rent on investment. Argument against the merits of tax incentive exists as such that ex post investment, host countries have incentives to renege on their initial promise if doing so renders greater benefits. However, we argue that this potential time-inconsistency problem can be resolved by the competition for FDI itself so as to signal to MNEs credibility and certainty over its peer competitors. In order to attract future FDI into host countries and increase its tax bases, it is rational of subnational governments to keep its stable tax policy rather than renege on the promise.[33] Low tax rates alone may

deficit and weakening macroeconomic stability. Instable macroeconomic climate could work to deter foreign investors from investing their capital in a host country.

32) Rodden, Jonathan, and Erik Wibbels, "Beyond the Fiction of Federalism: Macroeconomic Management in Multitiered Systems." *World Politics,* Vol. 54, 2002, pp. 494-531.

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not be sufficient to attract FDI inflow. As Pinto argue, low tax rates can fail to attract substantial amount of inward FDI just as high tax rates can hinder future FDI inflow.[34] Nonetheless, what remains certain is that corporate tax differentials do play a significant role in FDI flows. Overall, when it comes down to deciding where to invest among a handful of alternative locations, tax incentives will positively affect the foreign investors' final choice.

### (2) Political Decentralization and FDI

We consider three dimensions of political decentralization: appointment decentralization, decision-making decentralization, and constitutional decentralization. Each of them represents different aspects of political decentralization, and political decentralization may occur in various combinations of the three subcomponents. Thus it is essential to examine in detail the characteristics of each subcomponent of decentralization, and its interaction effect with fiscal decentralization on inward FDI.

#### ① Appointment Decentralization

First, appointment decentralization refers to the election of subnational representatives at the regional level. It is the most basic and fundamental form of political decentralization because subnational governments come to existence through regional elections. However, it is also superficial in its own because fiscal decentralization can occur without direct elections for

33) Qian, Yingyi, and Gerard Roland, "Federalism and the Soft Budget Constraint." *American Economic Review,* Vol. 88, No. 5, 1998, pp. 1143-1162.
34) Pinto, Ibid.

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subnational representatives; the center can appoint subnational offices and transfer tax autonomy to them.[35] However, directly elected subnational representatives without fiscal autonomy is in reality powerless. Therefore, it is the weakest element of political decentralization. Appointment decentralization without decision-making or constitutional decentralization is only superficial, analogous to just adding layers of government. It alone does not have significant effects on FDI inflow; however, it can exert positive effects when combined with other dimensions of political decentralization, particularly in countries of advanced civil society.

② Decision-making Decentralization

Regarding the relationship between decision-making decentralization and FDI, we predict that its positive impacts will prevail. Decision-making decentralization measures the extent to which subnational governments make an autonomous decision in the following policy arenas such as welfare, education, and economics. Downward transfer of decision-making power together with fiscal autonomy could improve the investment climate and attract foreign investors. If a subnational government has decision-making authority but remains fiscally centralized, it is actually a centralization of decision making via the fiscal decentralization.[36] Even if it wants to reform welfare or education policies as demanded by its constituents, it cannot actively execute the plan without its own fiscal resources. Plus spending without tax autonomy will only cause overspending and fiscal imbalance, calling for state bail out and

35) Montero and Samuels, Ibid.
36) Wibbels, Ibid

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destabilization of the regional economy. Since the central government sets tax rates unilaterally, regional fiscal competition for FDI is absent. Therefore, fiscal and decision-making decentralization must go hand in hand in order to attract inward FDI.

### ③ Constitutional Decentralization

Lastly, constitutional decentralization grants subnational governments to partake in co-determining national legislation. Constitutional decentralization disperses policymaking authority across multiple actors and provides 'safety in numbers' or 'credible constraints' by constraining the power of a single actor (Bache and Flinders 2004). Constitutional decentralization could increase the legitimacy of subnational leaders and reduce their dependence on the center, thereby limiting the power of the center.[37] As Henisz and Zelner emphasize the importance of policy stability over political stability in attracting FDI, increase in the number of veto players increase MNEs' policy stability and certainty about future investment.[38] Under a fiscally and constitutionally decentralized setting, subnational governments can offer low tax rates to MNEs thanks to its tax autonomy. Subnational governments may also exercise greater degree of political power that strains the center's monotonous decision about the country's investment policies and environments. We expect a positive relationship between constitutional decentralization and FDI inflow

37) Treisman, Ibid.
38) Henisz, Witold J., and Bennet A. Zelner, "Political Risk Management: A Strategic Perspective." *International Political Risk Management: The Brave New World*. The World Bank Group, 2003.

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### (3) Hypotheses

Taken together, we have the following hypotheses:

Hypothesis 1: An increase in the degree of fiscal decentralization of a host country has a positive effect on the size of FDI inflow.

Hypothesis 2: An increase in the degree of political decentralization of a host country has a positive effect on the size of FDI inflow.

Hypothesis 3: The interaction between the fiscal and political decentralization has a positive effect on the size of FDI inflow.

## IV. Empirical Analysis

The dataset consists of pooled time-series cross-sectional data containing 81 countries over the period of 1970-2010.[39] We employ OLS regression with panel-corrected standard errors (PCSE) in order to account for heteroskedascity and autocorrelation.

### 1. The data

#### (1) Dependent variable

We use FDI inflows measured in current US dollar. The data are obtained from the UNCTAD database from 1970 to 2010. As suggested by

39) The country sample can be found in Appendix A.

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Busse and Hefeker (2007), we take the natural log of FDI inflow using the recommended transformation formula.

$$y = \ln(x + \sqrt{(x^2 + 1)})$$

In doing so, we attempt to reduce the skewness of distribution among 81 countries which comprise of both OECD and non-OECD countries. In addition, I resolve data measurement problem where in some studies the negative observations are automatically dropped by taking the natural log. Hence, the formula helps prevent exclusion of zeros and negative values of FDI inflow, and the sample is less likely to bias the result.

### (2) Independent variable

Previously, scholarly work on decentralization has often substituted measures of fiscal decentralization or binary variables for federal structure to proxy for decentralization of various types including political and administrative decentralization.[40] Those measures, however, are limited in capturing the multiple dimensions and features of decentralization. In particular, traditional measures for fiscal decentralization has relied on the share of sub-central tax revenue (expenditure) in general government tax revenue (expenditure). This measurement is not a fine-grained proxy for what it aims to capture for the following reasons. First, although the data are made available by the OECD fiscal decentralization database, the series is short and limited to the developed countries only. Second, the ratio

40) Treisman, Ibid.

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between the subnational and the central tax revenue (expenditure) tends to distort the true extent of fiscal decentralization.[41] Conventional indicators may fail to appropriately capture the degree of autonomy, the power to autonomously decide how to raise and spend resources.[42]

In order to remedy the shortcomings of the previous literature, we use a dataset on decentralization by Hooghe, Marks, and Schakel.[43] We use fiscal autonomy dimension of their measure of decentralization for the Fiscal Decentralization variable. It refers to the extent to which a regional government can independently tax its population. It is measured on a five-point scale from 0 to 4. A score of 0 corresponds to the central government setting base and rate of all regional taxes; 1 to regional government setting the rate of minor taxes; 2 to regional government setting base and rate of minor taxes; 3 to regional government setting the rate of at least one major tax such as personal income, corporate, value added, or sales tax; and finally 4 to regional government setting base and rate of at least one major tax. In contrast to the conventional indicators, fiscal autonomy does not take into account the amount of intergovernmental transfers or grants in measuring the degree of fiscal decentralization. It is strictly committed to quantifying the regional government authority to raise fiscal resources.

The *Political decentralization* variable is also from Hooghe et al.[44] It is

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41) Tax revenue decentralization counts intergovernmental transfers or grants from the central government as part of subnational revenues when in fact they are not locally collected. In this case, larger amounts of tax revenue accrued on the local government do not necessarily mean a higher degree of fiscal decentralization. Larger amounts may simply reflect more government transfer and grants.

42) Bartolini, David, and Raffaella Santolini, "Political Yardstick Competition among Italian Municipalities on Spending Decisions." *The Annals of Regional Science,* Vol. 49, No. 1, 2012, pp. 213-235.

43) Hooghe, Liesbet et al., *A Postfunctionalist Theory of Governance Volume I: Measuring Regional Authority.* Oxford: Oxford University Press, 2015.

44) Hooghe et al., Ibid.

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operationalized in the following manner. It is a composite index that combines three aspects of decentralization: appointment, decision-making, and constitutional decentralization. First, for the appointment decentralization, we examined the extent to which a region has an independent legislature and executive, and is measured from 0 to 4.[45] Second, for decision-making decentralization, we used policy scope measure from Hooghe et al that the range of policies that a regional government is responsible for.[46] Lastly, corresponding to constitutional decentralization comes from executive control indicator of Hooghe et al.[47] It measures the extent to which a regional government co-determines national policy in intergovernmental meetings.

### (3) Control variables

We include economic control variables such as *trade, market size, and growth* that are often considered important economic determinants of FDI inflows.[48] Trade is measured as a percentage of GDP; market size is

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45) It is a composite of assembly and executive subcomponents. Assembly ranges from 0 to 2, with 0 referring to no regional assembly, 1 to indirectly elected regional assembly, and 2 to directly elected assembly. Similarly, executive ranges from 0 to 2, with 0 referring to no regional executive or appointed by central government, 1 to dual executive appointed by central government and regional assembly, and 2 to regional executive appointed by a regional assembly or is directly elected.

46) Hooghe et al. Ibid. Score 0 corresponds to very weak authoritative competencies in a) economic policy; b) cultural-educational policy; c) welfare policy; d) one of the following: residual powers, police, own institutional set-up, and local government. Score 1 corresponds to authoritative competencies in one of a), b), c) or d); score 2 corresponds to that in at least two of the four areas; score 3 corresponds to competencies in d) and at least two of a), b) or c); and finally score 4 corresponds to criteria for score 3 plus authority over immigration and citizenship.

47) Hooghe et al., Ibid. This variable is measured between 0 and 2. A score of zero refers to absence of routine meetings between central and regional governments. A score of 1 represents routine meetings between the two entities yet without legally binding authority. Lastly, a maximum score of 2 equates to routine meetings between central and regional governments with legally binding authority.

48) For example, see Jensen, Ibid.

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equivalent to GDP; and economic growth is taken from the GDP growth rate. We take the natural log of all these variables in order to reduce skewness of the distribution. The lagged dependent variable is also included in the regressions in order to account for the size of FDI inflow from a previous year affecting the size of inward FDI in the following year. In light of the existing literature, trade, market size, and growth are expected to have positive effects on FDI inflows.[49]

As for political determinants of FDI inflows, we include *Corruption, Bureaucracy Quality,* and *Government Stability.* Data for the variables are available from the Political Risks Services Group's International Country Risk Guide (ICRG) for 140 countries from 1984 to 2012. It measures each country's level of risk to international business operations by evaluating political, financial, and economic risks. We focus particularly on political risk category comprising of 12 components including Government Stability, Socioeconomic Conditions, Investment Profile, Internal Conflict, External Conflict, Corruption, Military in Politics, Religion in Politics, Law and Order, Ethnic Tensions, Democratic Accountability, and Bureaucracy Quality. However, not all of these indicators directly reflect a measure of institutional quality. Therefore, we only focus on the four stated earlier as political control variables that are most relevant to investors and in line with the previous literature on political determinants of FDI.[50]

Corruption is a threat to foreign investment because it reduces efficiency of not only government but also of business, and instable political process can, in the worst case, cause withdrawal or withholding of an investment.

49) All economic control variables are from the World Bank's World Development Indicators.

50) For example, Neumayer, Eric, and Laura Spess, "Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?" *World Development, Elsevier Ltd.* Vol. 33, No. 10, 2005, pp. 1567-1585.

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Corruption occurs in many forms such as bribes and demands for special payments with regards to import and export licenses, exchange controls, tax assessments, police protection, or loans (ICRG). In addition, the dataset takes into account other forms of corruption occurring in the political system such as excessive patronage, nepotism, job reservations, 'favor-for-favors,' secret party funding, and suspiciously close ties between politics and business (ICRG). The *Corruption* variable is measured on a six-point scale and is expected to have a negative effect on FDI.

Bureaucracy quality or institutional strength is considered a shock absorber that minimizes policy revisions when governments change. Countries with higher score are equivalent to having a strong and expert bureaucracy that has a cushioning effect against sudden or drastic changes in policy or government services. Hence, they present low risk to foreign investors because the bureaucracy is independent of political pressure or leeway. In contrast, countries with low score tend to experience a drastic change in policy, difficulty in policy formulation, and poor administrative performance. The *Bureaucracy quality* variable is measured on a four-point scale and is expected to affect FDI positively. Government stability measures the ability of the government to execute programs and stay in office. The index is made of three components of equal weight: government unity, legislative strength, and popular support. The index runs from 0 representing very high risk to 12 representing very low risk.

We also include the Tier variable which indicates layers of government as a control variable on top of what are mentioned thus far. Tier may capture political decentralization aspect to an extent that its inclusion may be redundant. Yet the way RAI country scores are calculated is by aggregating scores for each tier and individual regional governments in a

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country. Therefore, the more tiers a country has, the higher the scores of indicators. It could also be a robustness check on my three political decentralization variables.

## 2. Empirical Results

### (1) Fiscal Decentralization and Political Decentralization

First, Table 1 shows estimation results where Fiscal Decentralization and Political Decentralization, the composite index, are used. The results largely support my expectation stated earlier. Model 1 in the first column reports regression results with control variables only. As expected, control variables such as democracy, trade, growth, and population have positive signs and are statistically significant. Tier is also statistically significant and negatively associated with the FDI inflow. Corruption, however, is not statistically significant. Model 2 starts with Fiscal Decentralization to estimate its impact on FDI inflow while controlling for other factors. Fiscal Decentralization is positively related to FDI inflow and statistically significant. Next Model 3 is regressed with both Fiscal Decentralization and Political Decentralization. Political Decentralization alone is statistically significant and has a positive sign as expected. When Fiscal Decentralization and Political Decentralization interact in Model 4, the interaction term is statistically significant and positive though both constitutive terms are not significant. As a robust check, we include Bureaucracy Quality and Government Stability in Model 5. The interaction term remains statistically significant nevertheless.

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Table 1. The Impact of Fiscal and Political Decentralization on FDI Inflow

| Variable | Model 1 | Model 2 | Model 3 | Model 4 | Model 5 |
|---|---|---|---|---|---|
| Lagged FDI Inflow | 0.481** (0.049) | 0.475** (0.049) | 0.479** (0.049) | 0.470** (0.049) | 0.450** (0.052) |
| Democracy | 0.217** (0.026) | 0.208** (0.026) | 0.209** (0.027) | 0.213** (0.027) | 0.184** (0.027) |
| Corruption | 0.104 (0.065) | 0.056 (0.069) | 0.0843 (0.064) | 0.086 (0.072) | −0.0168 (0.075) |
| Tier | −0.403** (0.082) | −0.371** (0.082) | −0.406** (0.081) | −0.434** (0.079) | −0.319** (0.081) |
| Market Size | −0.0525* (0.030) | −0.0634** (0.030) | −0.0597* (0.031) | −0.0639** (0.030) | −0.0923** (0.031) |
| Growth Rate | 0.169** (0.051) | 0.177** (0.050) | 0.173** (0.050) | 0.178** (0.050) | 0.163** (0.052) |
| Trade | 0.326** (0.064) | 0.359** (0.067) | 0.342** (0.067) | 0.351** (0.067) | 0.361** (0.069) |
| Population | 0.691** (0.075) | 0.625** (0.076) | 0.629** (0.091) | 0.686** (0.094) | 0.682** (0.095) |
| *Fiscal Decentralization* | | 0.175** (0.057) | | −0.158 (0.170) | −0.0532 (0.172) |
| *Political Decentralization* | | | 0.0322* (0.019) | −0.033 (0.024) | −0.0327 (0.025) |
| *Fiscal Decentralization x Political Decentralization* | | | | 0.0291** (0.010) | 0.0203** (0.010) |
| Bureaucracy Quality | | | | | 0.310** (0.095) |
| Government Stability | | | | | 0.014 (0.035) |
| N | 1619 | 1619 | 1619 | 1619 | 1541 |
| R-sq | 0.450 | 0.452 | 0.451 | 0.454 | 0.464 |

All models use OLS with panel-corrected standard errors (PCSEs) regression. Standard errors in parentheses.
** indicates $p<0.05$, * indicates $p<0.10$.

Figure 2 shows that the marginal effect of Fiscal Decentralization is positive and significant for all values of Political Decentralization. As the degree of Political Decentralization increases, the marginal effect of Fiscal Decentralization on FDI inflow also increases. Hence, host countries in general receive more FDI inflow when they are fiscally and politically decentralized.

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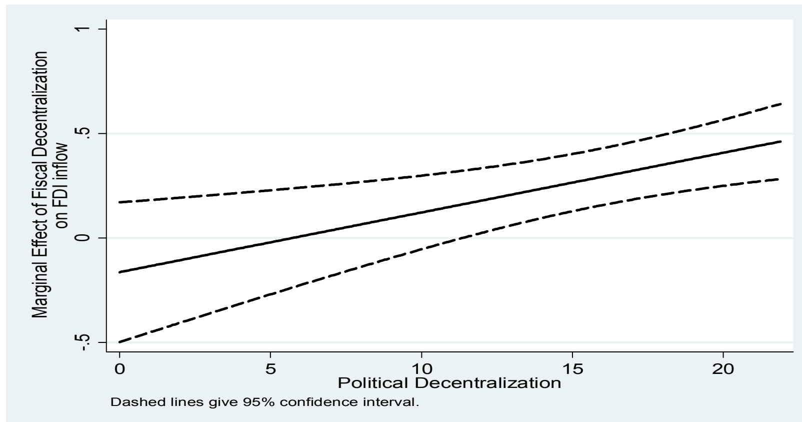
Figure 2. The Marginal Effect of Fiscal Decentralization on FDI Inflow




## (2) Robustness Check: OECD Countries.

Based on the previous estimation results, we suspect that there may be factors making a country attractive to foreign investors that are not captured by my explanatory variables such as colonial history, culture, language, climate, geographical distance to the West, and legal restrictions on inward FDI, etc.[51] We also think that the effects of various forms and the degree of decentralization on FDI inflow could vary across poor and rich countries. In order to investigate further these possibilities, we test our hypotheses using only OECD countries.

Analogous estimations results are presented in Table 2 for the OECD host countries. Control variables except for trade and growth are largely insignificant. Model 6 reports positive and significant coefficients on the interaction term of Fiscal Decentralization and Political Decentralization. As

51) Neumayer and Spess, p. 1575.

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the degree of Political Decentralization increases, the positive marginal effect of Fiscal Decentralization on FDI inflow becomes greater. Hence, both fiscally and politically decentralized OECD host countries attract more FDI inflows. Overall, the relationship between the interaction of Fiscal Decentralization and Political Decentralization is positively associated with FDI inflow.

Table 2. The Impact of Fiscal and Political Decentralizations on FDI inflow, OECD

| Variable | Model 6 |
|---|---|
| Lagged FDI Inflow | 0.229** (0.075) |
| Democracy | -0.0606 (0.170) |
| Corruption | -0.00257 (0.181) |
| Tier | 0.592 (0.391) |
| Market Size | 0.706* (0.395) |
| Growth Rate | 0.326** (0.160) |
| Trade | 1.049** (0.498) |
| Population | -0.122 (0.498) |
| Fiscal Decentralization | -0.25 (0.356) |
| Political Decentralization | -0.106** (0.043) |
| *Fiscal Decentralization x Political Decentralization* | 0.0423* (0.024) |
| N | 621 |
| R-sq | 0.150 |

All models use OLS with panel-corrected standard errors (PCSEs) regression. Standard errors in parentheses. ** indicates $p<0.05$, * indicates $p<0.10$.

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## Ⅵ. Conclusion

We investigate how two different types of decentralization may altogether affect FDI inflow outcomes. In line with our hypotheses, fiscal and political decentralization individually have a positive relationship with FDI inflow while the effect of fiscal decentralization is much more dominant. The interaction effect of the two is FDI inflow enhancing as the marginal effect of fiscal decentralization is positively conditioned upon the degree of political decentralization.

This article provides some important policy implications on the impact of fiscal and political decentralization on FDI inflow. There have been numerous advices from international organizations, recommending decentralization for developing countries in order to improve their government quality and efficiency. The empirical analysis suggests that decentralization, especially political decentralization is not a panacea, and some downsides exist on the other side of the coin. In contrast to conventional belief that decentralization conduces to better economic performance and increased accountability, our estimation results support previous findings that political decentralization can rather obscure accountability and cause buck passing and common-pool problem in developing countries due to the increased number of overlapping jurisdictions.

While both causal stories are possible, only the marginal effect of fiscal decentralization on FDI in the presence of political decentralization has been examined here. Though exact predictions on the size of FDI inflow according to the varying degrees of decentralization cannot be made, fiscal

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decentralization does help a host country attract FDI inflow. The effect of political decentralization, on the other hand, is more complicated. Political decentralization, if undertaken in a democratically immature, intuitionally weak setting, is likely to be more costly. For developed countries such as OECD countries, higher degree of decentralization in both fiscal and political arenas is recommended as the positive impacts become stronger.

## Appendix

### APPENDIX A. List of Countries Included in Sample

Albania, Australia, Austria, Belgium, Bosnia and Herzegovina, Bulgaria, Canada, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Lithuania, Luxemburg, Macedonia, Malta, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Russian Federation, Serbia and Montenegro, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States, Israel, Montenegro, Serbia, Kosovo, Indonesia, Malaysia, Philippines, Thailand, South Korea, Singapore, Brunei, East Timor, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, Uruguay, Venezuela

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## Abstract

Decentralization and Foreign Direct Investment:
Impact of Fiscal and Political Decentralization on FDI Inflow

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We examine the interactive effects of political decentralization and fiscal decentralization on foreign direct investment. We argue that the positive effect of fiscal decentralization on FDI inflow becomes stronger with the political decentralization. Empirically, we test the argument using Hooghe et al. (2015)'s original dataset on Regional Authority Index and analyze 81 countries for the period 1970 to 2010. The empirical results suggest that in general, fiscally and politically decentralized host countries receive more FDI inflow.

Keywords: Foreign Direct Investment, Fiscal Decentralization, Political Decentralization

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