

**Firm-Level Responses to Politics:
Political Institutions and the Operations of U.S. Multinationals**

Nathan M. Jensen
Assistant Professor
Department of Political Science
Washington University in St. Louis
njensen@wustl.edu

Abstract:

The existing literature linking politics and the investments of multinational corporations concludes that high levels of political risk deter investors from entering into some emerging markets. In this paper I argue that multinationals have multiple tools to manage risks (rather than simply avoiding them). Thus the risks faced by many MNCs are endogenous to the firm's operations and investment strategies. Specifically, I focus on how multinationals tailor their operations both to minimize political risks and to maximize political influence. Drawing on a confidential data set covering the complete universe of U.S. foreign direct investments abroad, I find that U.S. multinationals restrict the size of their operations in authoritarian regimes relative to democratic regimes in order to minimize the amount of assets at risk. I also find preliminary evidence that firms attempt to increase their political influence by aligning their operations with the preferences of incumbent governments. Specifically, firms increase the number of workers they employ when left-of-center governments come to power.

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1. Introduction

Countries around the world have opened their economies to foreign investors by liberalizing foreign direct investment (FDI) laws and actively promoting FDI inflows (UNCTAD 2003). Yet only a handful of countries in the developing world are attracting sizeable FDI inflows. Economists argue that the main reason for the lack of capital flowing from the capital rich north to the developing south is the potential for high levels of political risk in emerging markets.¹

Numerous studies in political science and economics have attempted to pinpoint the policies and political institutions that affect FDI flows, but most works suffer from two sets of flaws. First, many works utilize macro-level data to test micro-level theories. Theories on the relationship between political risk and multinational investment center on the decisions of individual firms while the majority of empirical analyses use aggregate levels of foreign direct investment to test these theories.

Second, many of these studies utilize an overly simplistic model of multinational investment decisions. In most cases, scholars focus on a firm's dichotomous decision of whether or not to enter a market based on the level of political risk. They then conclude that MNCs avoid investments in high risk countries. Although this is certainly one part of the multinational's decision, it ignores both the flexibility of MNC production strategies and the ability of firms to affect the political environment. In short, firms may still enter into high risk environments though they might employ different strategies. This can include making investment decisions that minimize the risks for the multinational investors, such as investing in more liquid operations that the firm can

¹ Lucas (1990). See Alfarno et al (2005) and Blonigen (2005) for a recent discussion.

easily disinvest from if the political situation worsens and actively participating in politics to affect outcomes.

My theory and preliminary empirical results suggest that MNCs make strategic decisions based on the types of political institutions in the host country. Although political risks come in numerous forms such as nationalizing firm assets, restricting a company's ability to repatriate profits, and changing tax rates, we can generalize these risks as all contract risks. Thus I differentiate political risk from the uncertainty of future policies. Political risk is the probability that governments will renege on agreements with multinational investors.

My central argument is that firms tailor their operations to different political environments. In countries with low levels of political risk, multinationals will set up operations similar to those in advanced industrialized countries. In countries that have higher levels of political risk, multinationals will structure operations that both limit the level of political risk and increase the firm's influence over domestic politics. The structure of these multinational investments will affect the wages paid, taxes collected, and other spillovers to the local economy.

2. Political Institutions and Credible Commitment to Investors

Raymond Vernon's (1971) seminal work in international business, the obsolescing bargaining model, posits that multinationals investors are exposed to tremendous risks in emerging markets. Governments actively encourage multinational investment by making promises on levels of taxation, regulation, and other policies that affect firm operations, yet these promises become "obsolete" after investment.² Once a

² Vernon (1971).

firm has invested resources, like building a multi-million dollar factory, there are considerable costs to disinvestment.

Vernon's insights have lead scholars in political science to explore how political institutions affect the risk environment for multinational investors. This scholarship focuses on the types of political institutions that allow governments to credibly commit to multinational investors. In a series of papers, Henisz and co-authors find that MNCs are responsive to the level of institutional constraints that limit the executive's ability to change policy.³ MNCs' decisions to enter emerging markets and their entrance strategies are colored by the level of political constraints. Another set of papers have debated how democratic institutions affect the risk environment for multinational investors. Although numerous scholars argue that democratic institutions can lower risks for multinational investors, the empirical literature is still unsettled. One series of articles finds that authoritarian regimes provide higher returns to investors (Oneal 1994) and non-democratic institutions attract higher levels of foreign direct investment flows (Resnick 2001, Li and Resnick 2003).⁴ Others find that democratic institutions lead to higher inflows of foreign direct investment (Busse 2004, Busse and Hefeker 2005, Harms and Ursprung 2002, Jensen 2003, 2006). Focusing exclusively on political risk, Jensen (2005) finds that the multinational investors pay lower premiums for political risk insurance coverage in democratic regimes. Büthe and Milner (2005) and Biglaiser and

³ See Henisz (2000, 2002a). For work on the relationship between political constraints and infrastructure investment see Henisz and Zelner (2001) and Henisz (2002b)

⁴ Li and Resnick (2003) find that democratic institutions lead to lower levels of foreign direct investment after controlling for property rights protections.

Brown (2006) argue that the propensity of democratic regimes to sign bilateral investment treaties complicates empirically testing the direct impact of democracy on levels of political risk. Yet most of these studies assume that multinational firms evaluate the risk environment and then simply decide whether or not to invest in the market. They then conclude that high risk locations attract less foreign investment because firms decide against entering the market at all.

These theories have underemphasized important aspects of multinational decision-making. Vernon's work focused on investments in extractive industries where firms can not easily disinvest from the country.⁵ Some industries do require illiquid investments, such as mining, oil and natural gas extraction, and infrastructure, exposing firms to risks even after the investment has been made. But a large number of multinational investments are relatively liquid, thus allowing firms to exit markets after investment has been made. For example, many textile manufacturers respond quickly to changing labor costs by closing a production facility in one location and reopening in another. With such liquid operations, firms can easily respond to political changes that negatively affect their operations by exiting the market.

Consequently the existing literature in international political economy does not focus on a realistic model of multinational operations. Most scholars overstate the costs for firms to exit the country. Some types of investment, such as investment in labor intensive production, can be quite mobile. Firms can also make choices on how to structure their operations to minimize the amount of sunk assets. This can be done

⁵ Malesky (2006).

through employing a lower ratio of sunk assets to more liquid assets, or through simply investing in smaller operations.⁶

Moreover, these studies almost completely ignore the possibility of firms engaging in political activities. Firms can lobby governments, provide campaign contributions and, in some cases, engage in illegal activities such as paying bribes to influence political outcome. Thus political risk, at least at the firm level, is endogenous to the firm's investment strategy and in the firm's activities to influence politics in the host country.

Although most scholars would accept that firms actively engage in political activities, this has been largely ignored in the literature in international political economy. However, in the field of American politics, scholars have gone further in explaining the micro-foundations of how corporations affect elections through campaign contributions and lobbying.

This literature in American politics is still far from a consensus in explaining how firms influence politics. For example, while the popular media tends to portray politicians as captured by the lobbying activities and campaign contributions of firms, numerous scholars have challenged this relationship. While there is opportunity for firms to make campaign contributions that look like better investments than investing in productive activities (rent seeking), this quid pro quo model of business-government

⁶ Sobel (1999) finds that high levels of political risk at the country level both deters international lenders from making loans to firms in the high risk country and it has an impact on the size of the loan.

relations is problematic.⁷ First, firms face a collective action problem. Many of the preferred policies (low taxes, weak regulation, etc) are public goods that affect either all firms or a subset of firms. Some of these collective action problems can be solved by either highly concentrated industries (aerospace, defense, autos) or through industry level associations.

Furthermore, campaign contributions made to politicians are unenforceable contracts (Barron 1989, McCarty and Rothenberg 1996). Firms pledge funds for a set of legislative outcomes, but after winning office, politicians may have the incentive to deviate from these pledges. This same lack of enforcement parallels the link between campaign pledges to voters and legislative outcomes. Politicians can win office on pledges of “no new taxes” and subsequently renege on these promises. What makes renegeing on these pledges both to voters and firms costly is the repeated game played over numerous electoral cycles. Politicians can be directly punished at the polls for renegeing on promises to voters, or indirectly by renegeing on promises to firms through a reduction in campaign contributions.

Ansola-behere, de Figueiredo, and Snyder (2003) review the literature on the link between campaign contributions and legislative activities, pointing out the lack of consistent results across studies. In their own empirical analysis they find little evidence for political contributions affecting political activity at the federal or state level. Equally persuasive, the authors point out the relatively small amount of resources most firms

⁷ See Barron (1989), Snyder (1990), and Grossman and Helpman (1994).

devote to campaign contributions.⁸ Firms in even the most heavily regulated industries spend more money on advertising or charitable contributions than political activities.

The literature in comparative politics and international political economy linking firms and their ability to influence politics is even thinner. A few scholars have pointed out the correlation between firm activities and political outcomes. For example, in a novel study of Vietnam, Malesky (2006a) finds that provinces that attract foreign capital are more likely to engage in “fencebreaking,” a practice that involves local politicians engaging in market-style reforms in defiance of the central government. In another study, Malesky (2006b) draws on an instrumental variables approach to explore the relationship between FDI flows and economic reform in transition countries. In both studies, Malesky finds a strong relationship between multinational investment and changing patterns of economic policy. Although these works provides interesting macro-evidence for the influence of firms, the micro-mechanisms are still an open question.

⁸ Almost 40% of fortune 500 firms and one-third of all industries did not have a representative political action committee (PAC). Of those that contributed to corporate PACs, the average amount of giving was \$1,700 in 2000 (Ansolabehere, de Figueiredo, and Snyder 2003, 106). To give a more recent example, President Bush raised \$193,088,650 for his 2004 reelection bid from a number of sources (corporations, individuals and other groups) which is roughly equivalent to the amount of money spend in 2005 by Walmart alone in charitable contributions (\$188,000,000). Money may influence politics in the United States, but link between campaign contributions and legislative outcomes is far from conclusive.

Few studies focus on the tools multinationals utilize in order to change political outcomes.

In this paper I propose a framework that incorporates insights of these seemingly diffuse studies into one project on the relationship between firms and politics.

I argue that both the theoretical mechanisms and empirical tests should focus on how political factors affect individual firms. This allows for more direct tests of the existing theoretical mechanisms linking firms with political risk and allows us to build a more realistic model of how firms operate in emerging markets. Specifically, I explore how firms make strategic choices to minimize risks and maximize political influence in emerging markets.

3. Minimizing Risk and Maximizing Influence

A better understanding of the relationship between multinational firms and domestic politics necessitates drawing on the vast research on the theory of the firm and managerial responses to different environments. In turn, this then requires the assumption that multinational firms are strategic actors who are both forward looking in their decisions on where to invest and are also capable of protecting their investments and influencing politics in the countries within which they operate. As a result, there are variations in different industries' ability to respond to political change. Yet, even within these diverse industries, there are numerous strategies that multinationals can employ to enter into a market.

In this paper I focus on how political institutions affect political risks for firms. These political risks come in a number of forms. Governments can seize firm assets through nationalizing multinationals (e.g. Iran and Cuba), or make policy changes that

affect the ownership structure or profit distribution between local firms and multinationals, such as recent disputes over oil and mining in Venezuela and Bolivia. Politicians can also make policy changes that affect the ability of firms to repatriate capital or exchange local currency for hard currency, such as the imposing of capital controls and Pesoification of assets in Argentina.

More generally, MNC investments are contractual agreements between multinational firms and governments. Prior to entry, multinational investors are often guaranteed national treatment (so that they will be treated the same as domestic firms) and negotiate agreements on taxation, ownership and regulations. Of course, sovereign nation-states can change government policy; sometimes in ways that harm multinationals (such as changing national minimum wage laws, value added taxes, etc.). However, this is simply the same policy uncertainty that exists in any political system. Unlike policy uncertainty, political risk is the systematic risk of governments renegeing on agreements made between the multinational and the government.

Obviously there are many cases of government decisions that do not clearly fall under this category of political risk. Yet market actors, such as the multi-billion dollar political risk insurance industry, have found ways to clearly differentiate between political risk and uncertainty. Political risks are 1) governments unilaterally breaking contracts with multinationals or 2) governments enacting policies directly targeted at the operations of multinational investors that violate the norms of national treatment. Thus, political risk disproportionately harms multinational investors.

Firms respond strategically to levels of political risk. This theory is based on a number of assumptions on the operations of multinational corporations.

1. MNCs are profit maximizing enterprises.
2. The decision to invest in foreign markets is driven by unobserved, parent firm level factors that provide multinational firms advantages over local firms.

Assumption (1) is a standard assumption. The second assumption may be unfamiliar to some readers but is a relatively standard assumption within the literature on the investment decisions of multinational corporations. Of course country level and industry level factors affect MNC decisions, yet most scholars find that, for example, country differences in rates of return do not adequately explain FDI decisions. Firm-specific decisions are a driving force behind FDI flows.⁹

These two assumptions allow us to build a theory on MNCs strategic responses to political risk in emerging markets. Firms will structure their operations according to their parent level attributes, economic factors in the host country, and the types of political institutions present. For example, IBM will engage in building similar production facilities in different locations with similar wages, costs of capital, and infrastructure,

In my empirical analysis I will make comparisons of firms' operations across countries. Differences in the structure of these operations will vary based on some observable economic variables, such as prevailing wages, yet I also argue that firms will tailor these operations based on the risk environment. For example, Dell Computer's operations will vary systematically according to the country-level political environment.

How does the domestic political environment affect MNCs? One central problem is the contractual relationship between the multinational firm and its host government and local firms. This issue, labeled the hold-up problem, arises when both the multinational

⁹ See Markusen (2002) for a review and clear theoretical treatment.

firm and their contractual partners (the government or local firms) either have unenforceable contracts or are unable to completely specify the details necessary to produce a complete contract.¹⁰ For example, an automobile producer can enter into a foreign market by building an automobile production facility with the stipulation that the government expand the power-production capability and contract with a local tire manufacturer to produce tires for the plant. The automobile producer is building a factory that is dedicated to the local market, the government is expanding a local power plant for the MNC, and the tire manufacturer is retooling to produce tires specifically for the MNC. There are countless scenarios where either the local government or the local tire producer could fail to live up to their promises, adversely affecting the operations of the MNC. Likewise, the MNC could cut production, which would result in the government and the local tire manufacturer to have resources that are underutilized. This is termed the “hold-up problem” because all actors will respond by under-investing in sunken assets.

I argue that this hold-up problem is especially acute in political environments where government actors are unable to credibly commit to contracts.¹¹ The form of a multinational investment is a strategic choice based on the existing political environment. In political environments that expose MNCs to these greatest risks, MNCs will enter into the market in ways that minimize firm-level risks. Consequently, the response of firms to high levels of political risk isn’t just to avoid the market altogether (even the highest risk

¹⁰ See Ethier (1986).

¹¹ See also Thomas and Worrall (1994).

countries attract some investment), but rather to tailor operations so as to minimize political risks.

Firms will achieve this by both investment in smaller production facilities, thus minimizing the assets at risk, and investment in more liquid operations. How does this affect the political risks facing a MNC? First, this allows firms to exit markets when policy or government change affects their operations. Government change, such as the election of Morales in Bolivia, could lead multinationals to quickly disinvest, ending operations in Bolivia. Secondly, it provides a credible threat of exit. This threat can provide firms some leverage over politicians and opportunistic policy changes. This leads to my first two hypotheses.

Hypothesis 1: MNCs will make smaller investments in authoritarian regimes than in democratic regimes.

Hypothesis 2: MNCs will invest in more liquid operations in authoritarian regimes than in democratic regimes.

MNCs have other sets of tools at their disposal other than exit. Many pundits, politicians and voters assume that firms wield tremendous influence over the political process in developed and developing countries yet little systematic research has been conducted on how firms influence politics in emerging markets. This is fertile ground for political scientists to contribute to this important research area.

One argument is that firms make campaign contributions and engage in lobbying to influence the political process. Other literatures focus on developing countries, exploring how corruption can be utilized by firms. In most cases corruption is a demand side issue, where firms are forced to pay bribes, often at the level of policy

implementation as opposed to formulation, rather than firms utilizing bribes as the preferred mechanisms to influence politics.¹²

I focus on how firms structure their operations to influence politicians. If MNCs can make choices about how to enter into a market, firms can enter in ways that help align the preferences of firms with those of domestic politicians. One example is how genetically modified foods producer Monsanto entered the Brazilian market by building a production facility in a relatively poor region of Brazil. Although no scholar has proved the causal relationship, the Brazilian government made major changes in the liberalization of genetically modified food production in very close temporal proximity to the announcement of the Monsanto investment. Thus Monsanto produced an entry strategy that not only lowered political risk, but also may have influenced the government decision to liberalize laws on genetically modified products.

More generally, firms can attempt to increase the spillovers of their investments by employing more workers, using local suppliers, and entering into joint ventures with local firms or state-owned enterprises. As Busch and Reinhardt (1999, 2000, 2005) show, the geographic concentration of industry affects trade policy in the United States. Politicians incorporate the interests of firms housed within their districts into their policy decisions and voting on trade policy. By doing this, politicians will have a larger vested interest in the productive operations of the firm.

¹² The literature on corruption is too vast to review in this grant, but a limited review of the relationship between corruption and MNCs can be found in Jensen 2006. See Wei (2000) for an analysis on how levels of corruption affect FDI inflows.

Changing the number of workers employed, making local purchases, and entering into joint ventures can be costly for MNCs. Thus firms will choose different entry strategies based on the types of political institutions present. In countries with a strong rule of law and hospitable investment environment, MNCs will focus on building the most efficient operations. In environments with higher levels of political risk, MNCs will be mindful of the need to protect their investments from opportunistic politicians and ensure that they have some “voice” in the policy making process. In the data section I will provide a more detailed account of how firms will manage to capture local politicians, but these details all fall under one general hypothesis:

Hypothesis 3: Firms will attempt to build operations that align with the preferences of politicians.

4. Data

Capturing the responses of individual firms to political institutions requires data that is both of high quality and disaggregated at the level of the individual firm. Ideally, we could analyze the investments of a single parent firm, say Ford Motor Company, and explore how Ford operations vary according to both economic and political factors at the country level.

The United States Bureau of Economic Analysis (BEA) collects data on the investment activities and operations of U.S. foreign affiliates every year through a survey of firm level activities for all firms above a minimum asset, sales, or net income threshold.¹³ Every five years the BEA conducts a more comprehensive survey

¹³ This reporting is mandatory under the International Investment and Trade in Services Survey Act.

including a larger number of questions and includes a larger number of firms. This survey data is believed to be of high quality since all firm-level data is confidential. The BEA aggregates this firm-level data by country and industry and releases this data to the public through a number of publications. This data may be shared with other agencies for the purpose of improving statistics, but this data is not shared with government agencies to collect taxes, enforce regulations, or make policy. Firms are required to report data to the BEA and there are stiff monetary penalties for non-compliance. Thus the BEA benchmark survey data collected every five years is the highest quality firm-level data that covers essentially the complete universe of U.S. investments abroad.

The BEA has a program that allows a limited number of academic researchers access to the firm-level data for research purposes. Access is granted (strictly at the Bureau's discretion) under a program that permits selected researchers to work on site as unpaid special sworn employees of the Bureau. To conduct this research project I was granted access to the BEA firm level data as a sworn employee of the Bureau in 2006.

I draw on the three most recent Benchmark surveys, the 1999, 1994, and 1989 Benchmark Surveys. I exclude investments made in the finance industry due to the lack of comparability of bank assets (which could include anything from buildings to bond holdings) with other foreign affiliate assets. These three years consist of a total of 54,783 foreign affiliates from 3,213 parent firms. Although data confidentiality limits the ability to discuss some aspects of the data, the 1999 U.S. Direct Investments Abroad publication provides descriptive data for that year. In 1999, a total of 2,606 U.S. parent firms had investments in 23,980 foreign affiliates, with foreign assets in excess of \$6.5 trillion and sales of \$2.6 trillion. The vast majority of these foreign affiliates (92%) are majority

owned by U.S. parent firms. Of the 23,980 foreign affiliates, most are classified as manufacturing (8,338), wholesale trade (5,154), or finance (2,342). The broad category of “other industries” comprises 4,048 foreign affiliates, includes the subcategories of management (1,627), transportation (529), and retail trade (435).

Utilizing this data and my research design strategy, I am focusing on how firms structure their operations after they make the decision to invest, and I am ignoring the MNCs initial dichotomous decision to enter the market. Modeling this first entry decision has proven difficult for most researchers who may observe a MNC choosing not to invest in a country for numerous reasons. The country could be closed to FDI, the country may not have the resources necessary for the MNC (oil, minerals, etc), the MNC may have been outbid by another MNC or local firm for the asset, or the level of political risk could have deterred the investment from taking place. In this study of political risk, how do we specify the counterfactual? If Somalia had a lower level of political risk, would it have attracted more MNC investments?

My research project is designed to overcome these problems. Rather than making counterfactual claims about which countries would have attracted more investment under different levels of political institutions, I focus on the foreign affiliates of U.S. firms. Having the complete universe of U.S. foreign affiliates abroad, I am better equipped to answer the question of how parent firms would structure their foreign affiliate operations in low risk versus high risk countries. Thus we can focus on the observable operational decisions of these investments to test the three hypotheses. I now turn to the data.

Insert Table 1

In Table 1 I present the geographic distribution of U.S. foreign affiliates in 1999. The majority of these affiliates are located with OECD countries, most of which are concentrated in Western Europe. China/Hong Kong and Mexico are the major recipients of U.S. foreign investments in the developing world. In the complete dataset, I utilize data on a maximum of the 38,738 foreign affiliates, 9,478 (24%) of which are located in non-OECD countries.

To test the impact of levels of political risk on firm level activities I employed three measures of the size of multinational operations from the BEA: log of total assets, lots of total sales, and the gross product of multinational activities. This last measure, gross product, is the BEA preferred measure of firm level production, which is the equivalent of value added at the level of the firm. All of these variables are measured at the level of the foreign affiliate.

To estimate the impact of political regimes on levels of foreign direct investment I estimate an ordinary least squares model. To measure the existence of the level of democracy, I utilize the standard Polity IV measure of regimes, which measures democracy on a 0-20 scale. I also include control variables for the log of GDP per capita (GDPPC), the log of the total population to measure the size of the domestic market (Market), and distance between the host country capital and the United States as a proxy for trade costs (Distance), and trade as a percentage of GDP as a proxy for trade openness (Trade).¹⁴ I expect that wealthy countries, large domestic markets, close geographic

¹⁴ Economic variables are from the World Bank's World Development Indicators (2005).

Geographic distance is from Blonigen and Davis (2004).

proximity to the United States, and an openness to international trade will all be associated with higher levels of multinational activities.

I also employ a large set of dummy variables for parent company, industry (of the affiliate), and year of the survey. These dummy variables are important for this research design where the tremendous heterogeneity between the activities of firms in any given industry, such as semiconductors, is vastly different from the investments in another industry, such as infrastructure. Beyond these industry differences, individual parent firms often utilize different technologies, managerial practices, and production strategies that impact the firms' operations. This dummy variable approach allows each firm and industry to have a unique intercept.¹⁵

5. Results

In Table 2 I present the results of two models of the relationship between political institutions and firm assets. In column one I estimate how the level of democracy affects the log of firm assets and in column two I estimate the same model using the total size of the investment in thousands of U.S. dollars.

Insert Table 2

In both sets of models our control variables behave as expected. Higher levels of GDP per capital, larger domestic markets, closer geographic proximity to the United States, and higher level of trade are associated with larger investments. The level of democracy, as measured by the Polity IV scores, is positively associated with firm-level

¹⁵ This dummy variable approach has been utilized by other scholars utilizing this data. See Desai, Foley, and Hines (2004, Forthcoming).

activities. Foreign affiliates in democratic regimes have higher levels of assets. These empirical results are robust to alternative specifications and empirical models. First, these results aren't sensitive to changes in the control variables and are not driven by outliers. Second, the results are similar utilizing a maximum likelihood multilevel modeling, estimating random intercepts both for the parent firms and industry. Third, these results are consistent within each year sub-sample. Estimation of these models using exclusively the 1989, 1994, or 1999 data yield similar results. Fourth, the results hold even after excluding the OECD countries from the sample. Finally, using alternative dependent variables such as the amount of foreign affiliate sales and gross product yield similar results. The conclusions drawn from Table 2 hold in all specifications.

Insert Chart 1 and Chart 2

How large of a substantive impact does the level of democracy have on the level of investment? In Charts 1 and 2 I present the results of simulations on how the levels of firm assets are affected by the level of democracy. As evidenced from Chart 1, moving from a highly authoritarian regime (-10 on the Polity Scale) to the maximum democracy score (10) increases the size of firm assets by roughly \$25 million. This amounts to increasing the size of a firm's assets 30% above the mean assets or over 150% above the median assets.

The tremendous heterogeneity between the investments of U.S. multinationals should make one skeptical of the results generated from the estimates using assets in dollars. The estimated impact of democracy on firm assets is much more modest using the log of firm assets. A move from the minimum polity score to the maximum polity

score increase the log of firm assets by roughly 2% above the mean or median. Although this impact appears small, this is the estimated impact after allowing for dummy variables for the 3,000 plus parent firms and industry dummies.

To explore how political institutions affect the liquidity of firm investments, I performed similar tests using dollars in plant, property, and equipment (PPE). Modeling the PPE/Assets proved to be difficult and alternative specifications leading to inconsistent results across models and low R-squared. I leave tests of hypothesis 2 for future research.

In hypothesis 3 I predict that firms will attempt to tailor their operations to the preferences of domestic politicians. To operationalize this I draw on the work of Pinto (2004) and Pinto and Pinto (2006) on the link between government partisanship and the preferences of politicians. Pinto and Pinto (2006) argue that some multinational operations, based on the industry of the investment, are compliments to domestic labor, generating jobs and increasing domestic wages. These types of investments are preferred by left governments, where voters supporting the political left benefit from the investments of multinationals.

I deviate from Pinto and Pinto (2006) by arguing that firms can make strategic choices on their operations. Thus firms can hire more workers, or be hesitant to fire existing workers, in political environments where leftist politicians are in power. In short, when the government is represented by labor, firms will ensure that their operations provide more generous benefits to labor.

Insert Table 3

In Table 3 I present an empirical analysis of the relationship between the partisanship of the executive and firm-level activities in OECD countries. I restrict this study to only the OECD countries due to the coding of the partisanship variable from the World Bank's Database of Political Institutions. In this dataset political parties are categorized as Right, Left, and Center parties. In OECD countries these parties map onto our intuitions on the definition of partisanship, where left governments core constituencies are labor and right governments are more likely to represent capital. In non-OECD countries, categories such as Left capture everything from Social Democrats to Communist regimes.

The empirical results are striking. Left executives have no impact on the assets, sales, gross product, or PPE of U.S. owned foreign affiliates. Left government has a negative, but statistically insignificant sign in all models. In contrast, we find that the level of employment is positively associated with more employment, and this result is significant at the 0.01 level. These results are quite preliminary, but they do point to an interesting empirical pattern. Firms employ more workers under leftist governments, lending support to Hypothesis 3.

6. Conclusions and Future Research

Multinational corporations are strategic actors, making investment and operational decisions in ways that minimize political risks. In this project I develop a theory that explores firm-level responses to political risk, and utilizes firm-level data on all U.S. foreign affiliates from 1989-1999 to test these theories.

My core empirical findings are that multinational firms structure their operations in response to the types of political institutions present in the host country. First, U.S.

multinationals make investments with more assets, higher sales, and higher value-added (gross-product) in democratic regimes than authoritarian regimes. These results provide new insights in the relationship between political regimes and multinational operations. Political institutions not only affect the aggregate amount of foreign direct investment (Jensen 2003, Li and Resnick 2003), but also the operational decisions of multinational investors. Authoritarian regimes may not completely dissuade investors from entering the market; rather firms employ risk minimizing strategies that limit the size of the investment.

Second, there is evidence that U.S. multinationals employ more labor in foreign affiliates that are located in countries controlled by leftist governments. This provides preliminary evidence for firms making strategic decisions based on the preferences of incumbent governments.

These results provide avenues for future research. First, the exclusive focus on the differentiation between democratic and authoritarian regimes ignores the nuanced institutional environments within both types of regimes. Future research should explore how electoral institutions in established democracies and different types of authoritarian regimes affect multinationals. Second, this project has not tested the dynamics of the multinational investment decisions. In future research I hope to explore how multinational operations change with changes in political institutions and government partisanship. Finally, I have established that firms tailor their operations to different institutional environments. In future research I will explore this in more detail by drawing on firm-level surveys and qualitative interviews to explore the strategic responses of multinational investors in different institutional environments.

Table 1: The Geographic Distribution U.S. Foreign Affiliates (1999)

Region/Country	Number of Foreign Affiliates
Canada	1,969
Europe	11,726
United Kingdom	2,797
Germany	1,451
France	1,269
Netherlands	1,192
Latin America	4,165
Mexico	945
Africa	571
Middle East	349
Asia and the Pacific	5,200
China/Hong Kong	1,101
Japan	942
Australia	875
Total	23,980

Source: U.S. Direct Investment Abroad (1999)

Table 2: The Determinants of Firm Level Activities 1989-1999

<i>Variable</i>	<i>Log Assets</i>	<i>Assets (\$)</i>
Regime	0.019*** (7.23)	12324.78 (3.45)
IGDPPC	0.541*** (10.30)	33011.15 (12.51)
Market	0.218*** (8.70)	10911.12 (7.16)
Distance	-0.067*** (-3.65)	-185.75 (-0.07)
Trade	0.002*** (4.15)	119.33** (2.27)
Constant	2.529*** (2.99)	-425262.40*** (-10.63)
Parent Dummies	Yes	Yes
Industry Dummies	Yes	Yes
Year Dummies	Yes	Yes
N	38332	38332
F	66.15	1.48
R-sq	0.41	0.37

Note: The dependent variable is the log of firm assets, log of firm sales, or log of gross product from the 1989, 1994, or 1999 BEA Benchmark Survey. OLS regression with robust (Huber-White) standard errors. T-statistics in parentheses.

***=p<0.01

**=p<0.05

*=p<0.10

Chart 1: Effects of Democracy on Firm Assets (Thousands of U.S. Dollars)

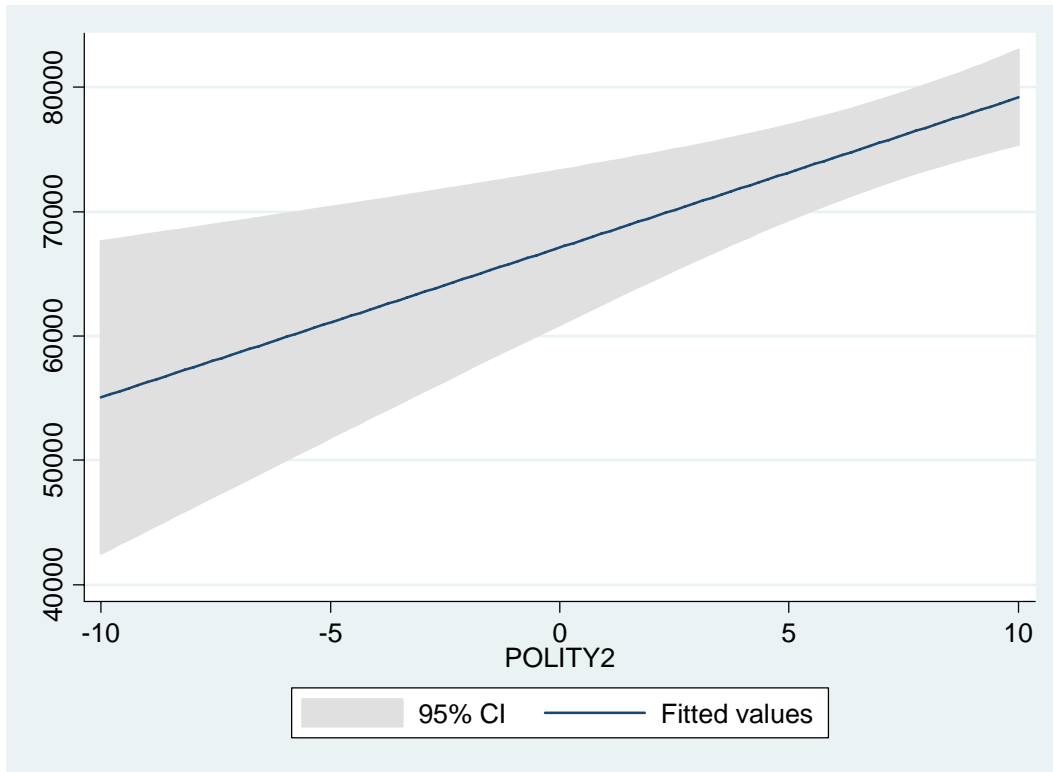


Chart 2: Effect of Democracy on the Log of Firm Assets

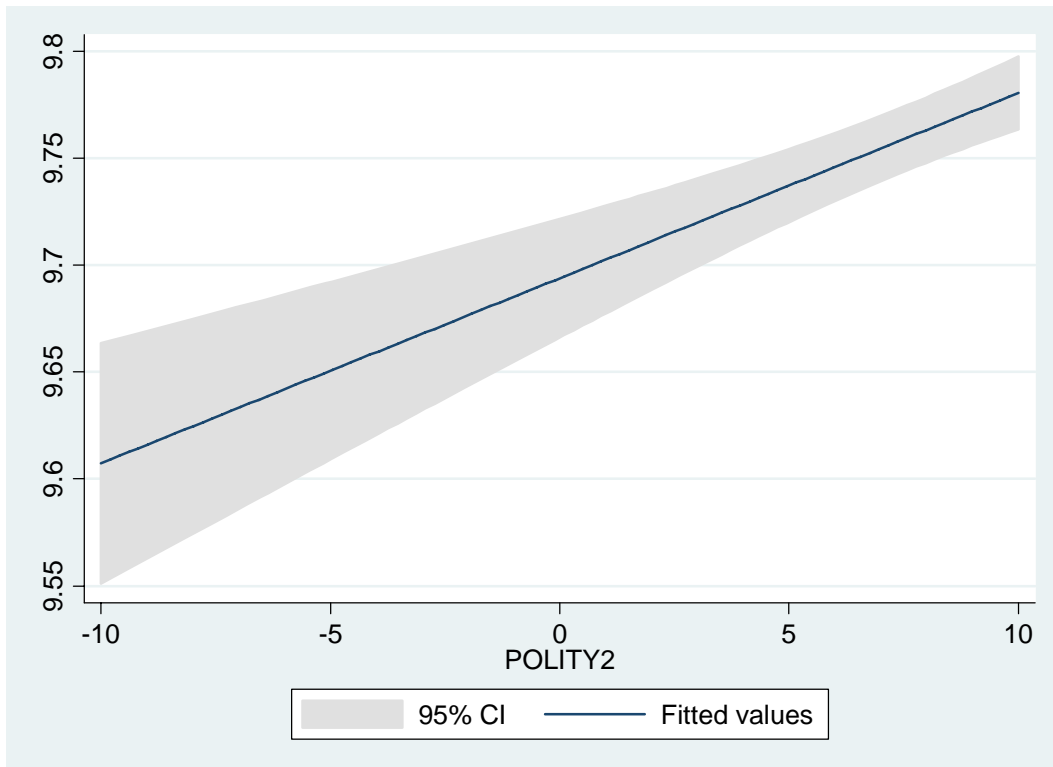


Table 3: Partisanship and Firm-Level Activities in OECD Countries, 1989-1999

<i>Variable</i>	<i>Log Assets</i>	<i>Log Sales</i>	<i>Log GP</i>	<i>Log PPE</i>	<i>Log Emp</i>
GDPPC	0.0790*** (8.46)	0.2464*** (9.86)	0.0150*** (5.41)	0.3990*** (4.52)	-0.0767 (-0.97)
Market	0.027*** (7.31)	0.1030*** (10.23)	0.0049*** (5.05)	0.1742*** (3.61)	0.1852*** (6.54)
Distance	-0.0069** (-2.41)	-0.0281*** (-4.35)	-0.0022** (-2.57)	-0.1276*** (-4.75)	-0.1706*** (-10.51)
Trade	0.0005*** (5.62)	0.0015*** (7.11)	0.0001*** (2.69)	0.0009 (0.71)	-0.0006 (-0.83)
Regime	0.0010** (1.98)	0.0061*** (4.31)	0.003*** (2.91)	0.0045 (0.88)	-0.0001 (0.02)
Left Executive	-0.0008 (-0.31)	-0.0069 (-0.86)	-0.0006 (-0.97)	-0.0353 (-1.07)	0.0801*** (4.07)
Constant	12.3862*** (99.30)	8.1962*** (24.62)	14.2714*** (401.65)	1.6334 (1.24)	3.884*** (4.21)
Parent Dummies	Yes	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes	Yes
Year Dummies	Yes	Yes	Yes	Yes	Yes
OECD Included	Yes	Yes	Yes	Yes	Yes
N	27996	27996	25592	27996	27852
F	15.24	24.95	6.78	34.34	46.88
R-sq	0.25	0.35	0.19	0.36	0.40

Note: The dependent variable is the log of firm assets, log of firm sales, or log of gross product from the 1989, 1994, or 1999 BEA Benchmark Survey. OLS regression with robust (Huber-White) standard errors. T-statistics in parentheses.

***=p<0.01

**=p<0.05

*=p<0.10

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