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**Investigating the Relationship Between Foreign Direct Investment and Democracy  
*Insights from US and Chinese Investment***

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**Investigating the Relationship Between Foreign Direct Investment and Democracy:  
Insights from US and Chinese Investment**

**Student Number:** [REDACTED]  
**Supervisor:** Stephan Lewandowsky  
**Word Count:** 10,741

## **Abstract**

This thesis investigated the relationship between foreign direct investment (FDI) and democracy, specifically examining whether investment from the United States and China is associated with a change in the level of democracy in recipient nations. To achieve this, we employed a Generalised Methods of Moments (GMM) estimator, using panel data covering a 17-year period for China and a 38-year period for the United States. For China, we detected a significant negative relationship between FDI and democracy, suggesting that an increase in Chinese FDI may be associated with a decrease in the level of democracy in recipient nations. By contrast, for the United States, no significant relationship was detected between FDI and democracy, implying that investment from the United States is not associated with changes in democratic levels in these countries. We conclude by discussing the implications of these findings and suggest directions for future research.

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## 1. General Introduction

Foreign direct investment (FDI)<sup>1</sup> is one of the most visible signs of an increasingly interconnected global economy. Indeed, prominent arguments often dictate that this globalisation undercuts autocratic regime stability (Rommel, 2023). In support of this view, some argue that globalisation increases market income, reinforcing pro-democracy attitudes among the middle class (Lipset, 1959; Rosenfeld, 2021). Others argue that globalisation shifts market income from capital to labour, creating a preference for democracy in developing countries to minimise redistributive losses (Acemoglu and Robinson, 2006; Ahlquist and Wibbels, 2012).

Yet, as of 2022, the level of democracy experienced by the average global citizen has regressed to levels last seen in 1986 while FDI has risen significantly (V-Dem Institute, 2023). Concerns have been raised over the growing influence of prominent autocratic regimes, such as China, which are often thought to be contributing to this democratic decline (Ambrosio, 2012; Gokhale, 2020; Ginsburg, 2021). Supplementing this increased prominence, many also point to the failure of Western institutions to address global democratic decline (Diamond, 2016). As to why the West may be losing influence, many cite economic downturn as a major factor, with the balance of global trade shifting in recent decades; democratic powers now control 54% of global gross domestic product (GDP), down from 70% in 1998 (Mounk and Foa, 2018; V-Dem Institute, 2023). Where once global FDI was predominantly controlled by the United States, today FDI is a far more diverse

---

<sup>1</sup> A form of cross-border investment in which one investor resides in one economy and establishes a lasting interest in an enterprise from another economy, ownership of at least ten percent of voting power is typically deemed sufficient evidence of such a relationship (OECD iLibrary, 2023; Duce and Espana, 2003).

phenomenon, extending beyond the domain of OECD countries (Goswami and Haider, 2014).

In 2023, global FDI inflows amounted to \$1.29 trillion (up from \$204.89 billion in 1990), with \$916 billion being accrued by developing countries. Approximately \$519.50 billion was invested by the United States and China (around 40.27% of total outward FDI; United Nations World Investment Report, 2023). The size of such flows, coupled with the prominent roles of both the United States and China as leading democratic and non-democratic global powers, respectively, underscores a need to better understand the impact of their investments. Accordingly, this thesis aims to investigate the political outcomes in recipient nations, focusing specifically on the relationship between investment and democracy. The paper is organised as follows: First, we examine the significance of different governance structures in attracting FDI. Next, we consider what may attract Chinese FDI, before shifting our focus to determinants of US investment. Continuing, we outline three alternative hypotheses examining the political consequences of FDI, focusing on the relationship between FDI and democracy levels in recipient nations, before concluding with an outline of the current study.

### **1.1. General Determinants of Foreign Direct Investment**

As a key driver of economic globalisation, FDI has attracted significant scholarly attention. Much of this research has focused on exploring what factors explain cross-country variation in levels of attractiveness to foreign capital. It is commonly observed that democratic governance structures tend to attract higher levels of FDI inflows than their autocratic counterparts (e.g., Jensen, 2003; Ahlquist, 2006; but see Choi and Samy, 2008). In support of this observation, Jensen (2008) notes that democratic regimes mitigate political risk for investors, reducing the premiums multinational enterprises (MNEs) have to pay for insurance

against the government. Perhaps the most common argument in favour of this view is the claim that democratic governance can credibly protect property rights for investors<sup>2</sup> (Pierpont, 2007; Nieman and Thies, 2018).

Opposing this view, others have argued that democratic institutions may limit FDI inflows by restricting MNEs from engaging in oligopolistic or monopolistic practises. Indeed, the relative value of democracy may be contingent upon the balance between risk mitigation, rights protection, and limiting MNE overreach (Li and Resnick, 2003). Although autocratic regimes may be perceived as riskier investments, this concern can be minimised through the signing of international investment treaties and by permitting some public deliberation in policymaking (Bastiaens, 2016).

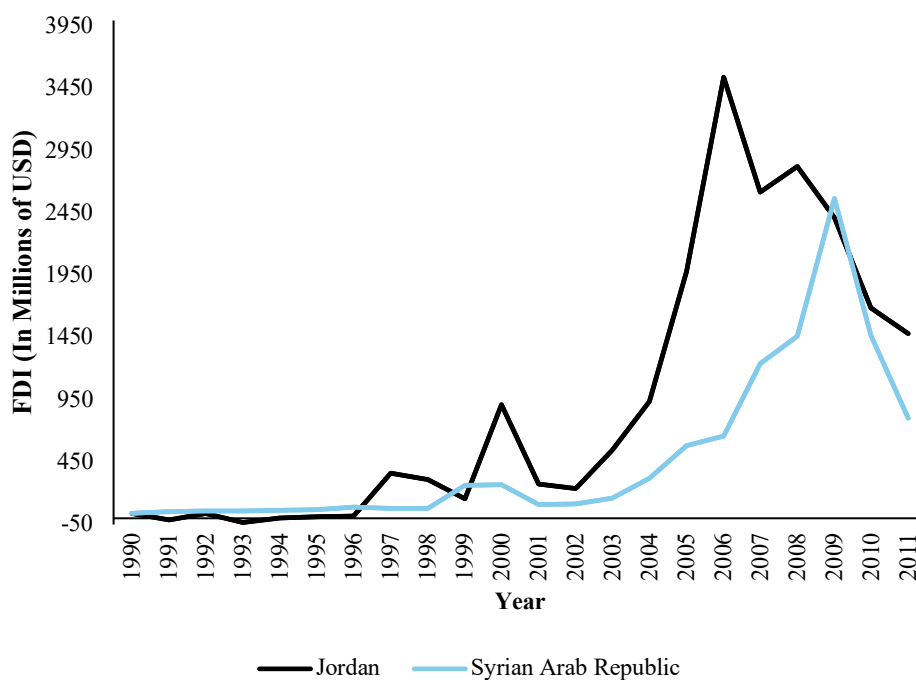
To illustrate, in the case of Jordan, adopting this strategy has seemingly proven to be effective. Not only has Jordan publicly signalled a desire to attract FDI through the signing of bilateral international treaties with an array of partners (i.e., neighbouring countries, emerging developing economies, and the developed world), but it also features local citizens in economic policymaking (Milton-Edwards and Hinchcliffe, 2009; Stevenson, 2010; Bastiaens, 2016). When contrasted with a pre-civil war Syria, a neighbouring country with a comparable life expectancy and GDP, Jordan consistently attracted more FDI than its neighbour across the prior twenty years (*See Figure 1*; World Bank, 2011<sup>3</sup>).

---

<sup>2</sup> Such an advantage is not necessarily limited to democratic regimes, however, with some positing that autocrats with long time horizons also leverage the protection of property rights to attract further investment (Moon, 2015).

<sup>3</sup> In 2007, FDI inflows into Jordan decreased by 26%. This decline is commonly attributed to political instability in the region and conflict in neighbouring Iraq; Jordan was more dependent on trade corridors through Iraq than Syria (Lasensky, 2006; Lloyds Bank, 2024).





*Figure 1:* FDI in Jordan and the Syrian Arab Republic, 1990 to 2011 (United Nations World Investment Report, 2023).

The dominant view suggests that the attractiveness of a country to FDI often hinges on the reliability of its governance structure (e.g., Globerman and Shapiro, 2002; Gani, 2007) with weak governance structures often viewed as insufficient for protecting investments (e.g., Globerman and Shapiro, 2003).

## 1.2. Determinants of Chinese Foreign Direct Investment

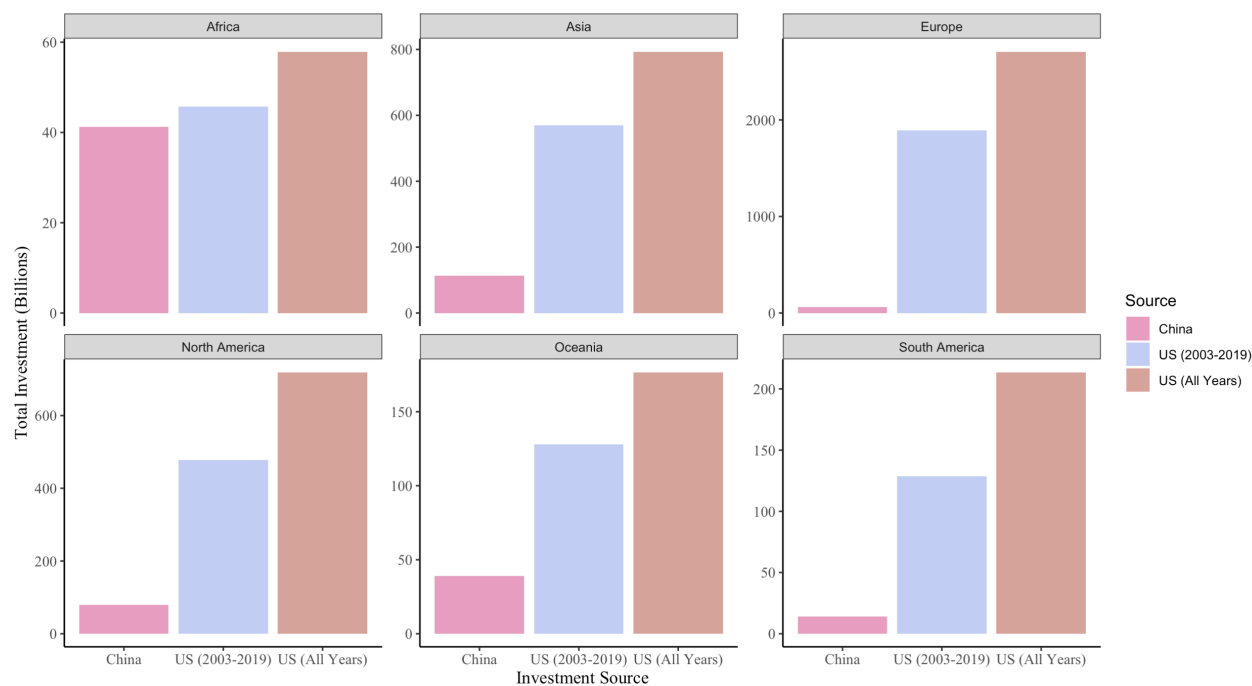
The relationship between quality of governance in recipient nations and Chinese FDI remains unclear as prior research has often yielded inconsistent findings. On the one hand, Kolstad and Wigg (2011; 2012) and Buckley et al (2010) observe that Chinese investment is often motivated by natural resource acquisition, especially in nations with poor institutions and high political risk. Child and Rodrigues (2005) even go so far as to say that Chinese firms experience a reduced liability of foreignness (i.e., the negative impact of being foreign is

lessened) when operating in more politically opaque environments. As to why Chinese investment may be attracted to countries with greater political risk, it may be that such structures are subject to low-quality, corruptible institutions that allow for greater access to the desired natural resources (e.g., Cambodia; O'Neill, 2014). Such conditions have previously been exploited by MNEs, which critics claim often undermine the sovereignty of developing countries by supporting repressive regimes (Meyer, 1998).

That said, on the other hand, Cheung and Qian (2009) and Quer et al (2012) find no significant relationship between Chinese FDI outflows and governance quality. Chen et al (2018) further note that the governance quality of African countries has no impact on Chinese FDI inflows, with Landry (2021) observing that governance quality positively influences FDI inflows (although they do observe that corruption controls have a significantly lower impact on Chinese investment relative to Western investment, but only when South Africa is excluded from their model). In practise, research related to the motivations of China, the size of her investments, and her disregard for the quality of institutions or good governance is limited (Chen et al, 2020). It is important to note, although often neglected, that Chinese investment is small relative to investment from the West, even though these investments have risen significantly in recent years (Zhang, 2022). For example, between 2003 and 2019, FDI outflows from the United States were roughly nine times larger than China (see *Figure 2*).

In addition, the growth of Chinese FDI may not be as rapid as is often suggested. While official statistics show Asia as the primary investment destination, Schüler-Zhou and Schüller (2009) observe that developed Western countries have attracted most high-value Chinese MNE investment. Many Western nations have welcomed Chinese FDI. In Europe, for instance, Germany, France, and the United Kingdom (the three largest European economies)

accounted for 57% of total Chinese FDI to the continent between 2012 and 2020 (World Bank, 2021; Zenglein and Sebastian, 2022). However, Western nations appear to be far less accepting when Chinese investment is directed towards the developing world.



*Figure 2: Outward FDI (in billions) from the United States and China for the period 2003 – 2019.*

One common Western argument is that Chinese investment is driving unsustainable debt burdens on developing countries (e.g., Schneidman and Wiegert, 2018). Indeed, the phrase ‘debt-trap diplomacy’ (i.e., excessive credit being intentionally lent to a smaller debtor country with the intention of extracting political or economic concessions in the future when the debtor defaults) has been readily attributed to China (e.g., Chellaney, 2017; Doherty, 2019). In substantiating the claim that China has an ulterior motive when investing, proponents often point to China being the largest official creditor to the developing world.

In this context, the observation that fifty percent of China's official lending to developing countries is not reported in the most widely used official debt statistics may evoke concern (Horn et al, 2021). Contrary to traditional Western lenders, Chinese loans are generally more opaque, carrying high interest rates, and are almost exclusively directed towards Belt and Road Initiative<sup>4</sup> (BRI) nations (between 2008 and 2021, China spent over \$240 billion bailing out 22 mainly BRI countries; Horn et al, 2023). Investment under the BRI has brought with it an increase in Chinese FDI into sectors aimed at addressing domestic concerns (i.e., overcapacity and pollution), with BRI nations with relatively low institutional quality being more likely to attract investment of this nature (Nugent and Lu, 2021). That said, Nugent and Lu (2021) argue that this finding does not necessarily imply that BRI-driven FDI is harmful to recipient economies. One argument in favour of this view is the observation that the pollutant intensity of investments has decreased over the past seven-years, suggesting that Chinese investments may have become more environmentally friendly, or that FDI-receiving BRI nations may have improved their regulation of FDI inflows.

### **1.3. Determinants of United States' Foreign Direct Investment**

One common finding is that market size positively correlates with US FDI, as demonstrated in Latin America (Garcia-Fuentes et al, 2016), Asia (Al Nasser, 2007), Sub-Saharan Africa (Okafor, 2015), and the European Union (Filippaios and Papanastassiou, 2008). Similar findings have also been reported for Chinese FDI (Buckley et al, 2010; Cheung and Qian, 2009; Kolstad and Wiig, 2012, Ramasamy et al, 2012; but see Quer et al, 2012). While both powers pursue larger markets, this motive appears to be more pronounced in US investment activities. Liu et al (2023) summarise this distinction by noting that US investment tends to

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<sup>4</sup> The Belt and Road Initiative is a China-led infrastructure and economic development project aimed at improving connectivity across Asia, Africa and Europe through the construction of transport and economic corridors (Hillman, 2020).

prioritise economic benefits (being more concerned with profit generation and market size), whereas China appears to adopt a more diverse approach that not only considers the size of the market, but attempts to address domestic concerns such as overcapacity and pollution, as well as resource acquisition (Casanova and Miroux, 2017; Nugent and Lu, 2021).

The economic growth rate of a recipient nation has been observed to predict US FDI (Nigh, 1985; Barrel and Pain, 1996; Billington, 1999; but see Filippaios et al, 2003). Additionally, several studies have observed that openness to trade can factor in as an important determinant in US MNE decision making; Tuman and Emmert (2003) find that this is particularly important for firms that intend to use the recipient nation as a base for intra-regional production. In addition to trade openness, Yeaple (2003) finds that labour skill can influence investment decisions; US MNEs may target skilled-labour abundant countries for high-skilled industries, while opting for countries with a less skilled workforce for lower-skilled industry work.

Adherence to rule of law and the protection of property-rights appear to be weighed heavily in US MNE decision making (Biglaiser and Staats, 2010). One exception to this appears to occur with natural resource investments, with this trend also being observed with Chinese MNEs (Biglaiser and Lu, 2021). That said, Chinese investment may be more indifferent to these aspects of poor governance than investment from the United States, with Chen et al (2018) finding that, when controlling for natural resource wealth and market size, Chinese investment tends to be larger.

The relationship between human-rights, civil liberties, and US investment is among one of the most commonly expressed concerns. Notable examples of US MNEs colluding with

autocratic powers to suppress local populations include United Fruit supporting a coup d'état in Guatemala in 1954, ITT participating in the overthrow of democratically elected Chilean President Salvador Allende in 1973, and Chevron transporting Nigerian soldiers to kill local activists in 1998 (Goodman, 1998; Spar, 1999). Tuman and Emmert (2003) even observe that, between 1979 and 1996, poor human-rights records and military coup d'états positively influenced US FDI into Latin America. Indeed, some observers argue that MNEs are not only indifferent to repression, but are reliant upon it (e.g., Hymer, 1971).

Yet, there is some evidence that democratic institutions tend to attract US FDI; in the case of Costa Rica, for example, these institutions appeared to provide a comparative advantage in attracting foreign capital (Schuler and Brown, 1999; Haq, 2001). That said, Costa Rica appears to be an outlier. Analysing the activities of US MNEs between 1980 and 1985, Oneal (1994) found that, while MNEs fared best in developed democratic nations, in the developing world they yielded a greater rate of return in authoritarian regimes.

#### **1.4. The Political Consequences of Foreign Direct Investment**

The political consequences of FDI upon the recipient nation have attracted comparatively less scholarly attention than research into determinants of FDI (Escribà-Folch, 2017). Viewed as a conduit for capital and advanced technologies, FDI is often touted as a significant driver of economic growth. As a result, developing countries often find themselves urged by international entities to dismantle obstacles to financial inflows and trade. Within the literature, the potential impact of FDI can be explored through three hypotheses: *liberalisation*, *state-capture*, and *stabilisation* (Escribà-Folch, 2017). Drawing on these hypotheses, we focus specifically upon the relationship between FDI and democracy levels in recipient nations. It is important to note that much of this research, including our own, does

not permit definitive inferences of causality between FDI and levels of democracy and should be interpreted with caution.

#### **1.4.1. The Liberalisation Hypothesis**

Colloquially referred to as the *Washington hypothesis*, advocates of this position argue that FDI is associated with reductions in the economic control of autocratic regimes and the empowerment of pro-liberalisation actors, which may increase the level of democracy in a nation. Prior research has observed that foreign capital and economic integration often positively influence the human rights practises of states (Meyer, 1996; Dutta and Roy, 2009). What's more, FDI has been linked to an increase in labour protests, empowering workers to pursue industrial action amid social dislocation and heightened expectations that arise from comparing their wages to those of better-compensated counterparts in wealthier nations (Robertson and Teitelbaum, 2011). Consistent with these findings, positive relationships between inward international capital and democratisation have been observed (Eichengreen and Leblang, 2008; Li and Reuveny, 2009).

#### **1.4.2. The State-Capture Hypothesis**

Contrary to the *liberalisation* hypothesis, this view posits that FDI is associated with instability, which may decrease the level of democracy in a nation while increasing the likelihood of an autocratic transition. Proponents of this view argue that, as the state provides the power to distribute resources, an increase in capital through FDI may provide greater incentive to seize power and enrich oneself (Wright et al 2013). Following the Second World-War, autocratic regimes have been just as likely to autocratise further as they have been to transition to democracy (Geddes et al, 2014).

### 1.4.3. The Stabilisation Hypothesis

According to this view, the level of democracy in recipient nations may remain stable following investment, with the potential to increase the level of democracy in democratic regimes, and diminish it in autocratic regimes (Armijo, 1999). In the autocratic context, the argument would follow that FDI may bring new opportunities to purchase political power and enforce state coercion, reducing the level of democracy. The mechanisms underpinning this view are underdeveloped; they broadly run as follows: FDI may serve as international validation for a regime, generate patronage rents and private benefits for acolytes and, when suppression is of mutual interest, enable collaboration between MNEs and the state to strengthen repression<sup>5</sup> (Maxfield, 1998; Desai et al, 2009; Conrad, 2011). By contrast, for democratic regimes, the argument would follow that FDI may weaken a regimes' economic control and power, disrupting cohesion among elites and their capacity to deliver patronage and benefits, resulting in an increased level of democracy (Rudra, 2005; McMann, 2006).

### 1.5. The Current Study

To summarise, in the current study, we examined the political outcomes of nations receiving foreign direct investment from the United States and China. Specifically, we investigated whether a change in the level of investment from either hegemonic power was associated with a change in the level of democracy observed in recipient nations. Adjudicating between the three hypotheses discussed above (*liberalisation*, *state-capture*, and *stabilisation*; Escribà-Folch, 2017), we consider how each aligns with our findings. It is important to note that we make no attempt to establish any causal relationship and that any results should be interpreted with caution.

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<sup>5</sup> For example, MNE's were found to report union activists to the Brazilian military during their rule (1964 – 1985; Winter, 2014)



## 2. Method

### 2.1. Overview

Our analysis examined whether a change in the level of foreign direct investment (FDI) from either the United States or China was associated with a change in the level of democracy observed in recipient nations. FDI was collected from both the Chinese Ministry of Commerce and the United States Census Bureau. Following the precedent of Busse (2003), a per capita measure (foreign direct population investment; FDPI) was derived by dividing FDI by the population of each country to account for the relative size of each country. To normalise the distribution of FDPI, a Yeo-Johnson transformation was then applied (Yeo and Johnson, 2000). To measure levels of democracy, we employed five measures of democracy from the V-Dem Institute<sup>6</sup>, each ranging from zero to one (V-Dem V10 Methodology, 2020; V-Dem Institute V11.1, 2021). Pairwise correlation coefficients between items were calculated, with a confirmatory factor analysis supporting the collapsing of these items into a single ‘Democracy’ variable.

### 2.2. Chinese Foreign Direct Investment

Chinese FDI was extracted from the 2006, 2012, and 2020 editions of the Statistical Bulletin of China’s Outward Foreign Direct Investment (Ministry of Commerce of People’s Republic of China, 2006; 2012; 2020). Available data spanned from 2003 to 2019. Using population data sourced from the United Nations a measure, foreign direct population investment (FDPI), was created to discern how much, on average, a citizen received from Chinese investment each year (United Nations, 2023). To create this measure, FDI was divided by the total population of each country, each year. The per capita measure was used to account for

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<sup>6</sup> The V-Dem (Varieties of Democracy) Institute provides a global dataset that measures various dimensions of democracy across countries; it is widely used for comparative democratic research and analysis.

the relative size of each country, following the precedent of Busse (2003). Next, a Yeo-Johnson transformation was applied to normalise the data, accommodating for the presence of negative values (Yeo and Johnson, 2000). Countries were then classified by continent, being ascribed a value between one and six, with one being Asia, two being Africa, three being Europe, four being Latin America, five being North America, and six being Oceania. Continental classification followed the precedent of the United Nations Statistics Division (2023). Due to insufficient data, 51 countries and territories were excluded. Six further nations were excluded as outliers, leaving a final sample size of 138 cross-sectional units.

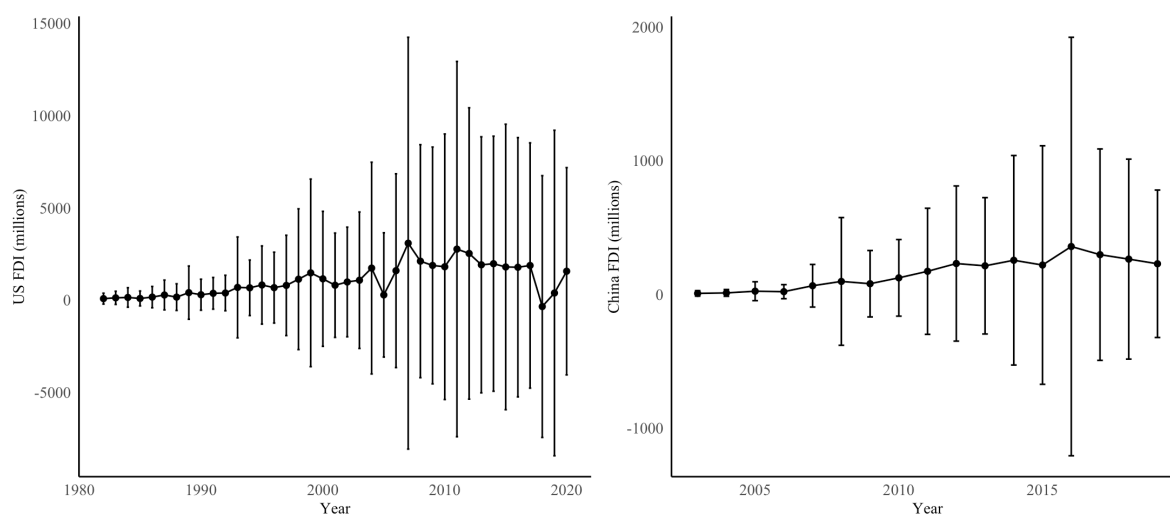
### **2.3. United States Foreign Direct Investment**

United States FDI was extracted from the United States Census Bureau (2023). Available data spanned from 1982 to 2020. Following the precedent established with Chinese FDI, an FDPI measure was calculated. Continental classification was consistent with the United Nations Statistics Division (2023). Due to insufficient data, 55 countries and territories were excluded. Two further nations were excluded as outliers, leaving a final sample size of 154 cross-sectional units.

### **2.4. Overview of the United States and Chinese Foreign Direct Investment Outflows**

Across all available years, the total FDI outflow of the United States analysed amounted to approximately four trillion, six-hundred and seventy-seven billion, one hundred and twenty-eight million USD (4,667,128,000,000). For China, this figure was approximately three-hundred forty-nine billion, seven-hundred thirty-nine million, seven hundred and seventy thousand USD (349,739,770,000). The average amount of US investment was 1117.61 million USD (SD: 5337.26), while the average amount of Chinese investment was 168.39

million USD (SD: 654.66). For a summary of average yearly investment from the United States and China, see *Figure 3*.



*Figure 3*: Average yearly FDI from the United States (left) and China (right) with error bars representing one standard deviation. See *Appendix 1* for annual aggregated investment data.

In each of the six continents analysed, across all available years, the United States provided more FDI, on average, than China (see *Table 1*). This trend was also observed across 2003 to 2019, a period selected due to the availability of comparable data for China (see *Appendix 2*).

*Table 1*: Average FDI per continent across all available years for the United States (1982 – 2020) and China (2003 – 2019).

Continent	China	United States (All Years)
Africa	57,544	58,394
Asia	173,755	637,449
Europe	144,016	2,318,483
North America	537,702	1,591,040
Oceania	494,699	1,420,179
South America	70,874	518,855

*\*Note*: For ease of interpretation, values are expressed in thousands of USD.

## 2.5. Democracy

Five democratic components, each intended to describe features of democracy at the highest level of abstraction, were extracted from the V-Dem Institute (See *Table 2*; V-Dem V10 Methodology, 2020; V-Dem Institute V11.1, 2021; V-Dem V13 Codebook, 2023). While V-Dem is one of many global democracy assessment projects, the results of these projects tend to correlate strongly (Berg-Schlusser, 2004; Graziano and Quaranta, 2024).

*Table 2: Democratic components extracted from V-Dem Institute.*

Variable Name	Description
v-polyarchy	To determine the extent to which the ideal of electoral democracy in its fullest sense is achieved
v-libdem	To determine the extent to which the idea of liberal democracy is achieved
v-egaldem	To determine the extent to which egalitarian democracy is achieved
v-partipdem	To determine the extent to which participatory democracy is achieved
v-delibdem	To determine the extent to which deliberative democracy is achieved

Each component extracted consisted of a value between zero and one. Pairwise correlation coefficients between each of the five components were calculated for each year using a dataset consisting of 6690 observations across 181 countries, spanning from 1982 to 2020.

*Table 3* presents the average correlation coefficient for each pair across all years, along with the corresponding standard deviations.

*Table 3: Pairwise correlation coefficient matrix of V-Dem democratic components.*

	v-polyarchy	v-libdem	v-egaldem	v-partipdem	v-delibdem
v-polyarchy	X	0.976	0.946	0.969	0.970
v-libdem	0.003	X	0.971	0.970	0.980
v-egaldem	0.003	0.002	X	0.947	0.959
v-partipdem	0.002	0.004	0.002	X	0.962
v-delibdem	0.003	0.003	0.003	0.005	X

\*Note: In this table, the upper half displays the average correlation coefficients for each pair across all years, while the lower half shows the standard deviations of these correlations.

Given the significant positive correlations between each of the five components, a confirmatory factor analysis was conducted with the latent variable “Democracy” assumed (See *Table 4*). As with the pairwise correlation coefficient analysis, our dataset consisted of 6690 observations across 181 countries, spanning from 1982 to 2020.

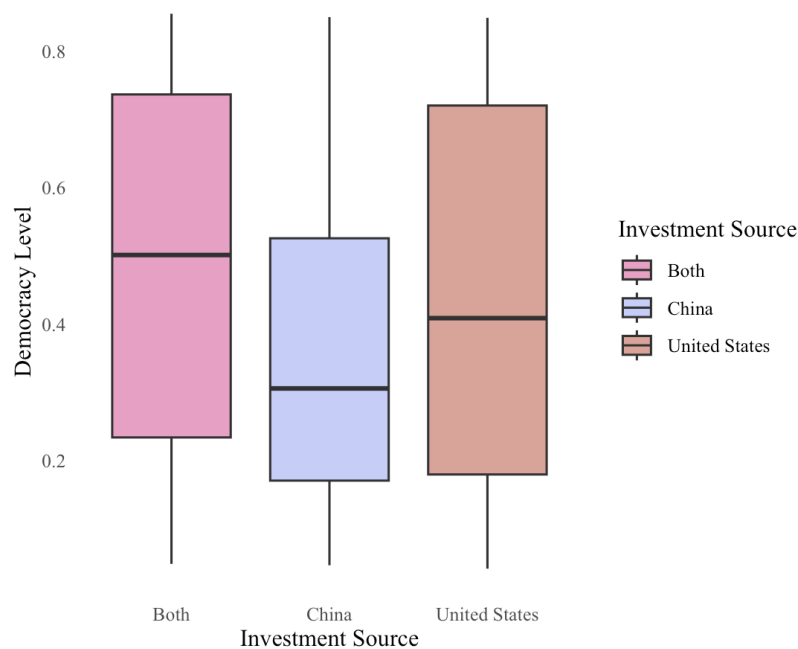
*Table 4: Results from confirmatory factor analysis conducted on the five V-Dem democratic components, with the latent variable ‘Democracy’ assumed.*

	Loading	Standard Error	z-value	p-value
v-polyarchy	0.982	0.009	111.59	<.001
v-libdem	0.994	0.009	114.35	.001
v-egaldem	0.973	0.009	109.60	.001
v-partipdem	0.978	0.009	110.63	.001
v-delibdem	0.987	0.009	112.68	.001

The loadings of this confirmatory factor analysis supported our latent variable “Democracy”. Following this, we collapsed the five democratic components into one measure. This measure

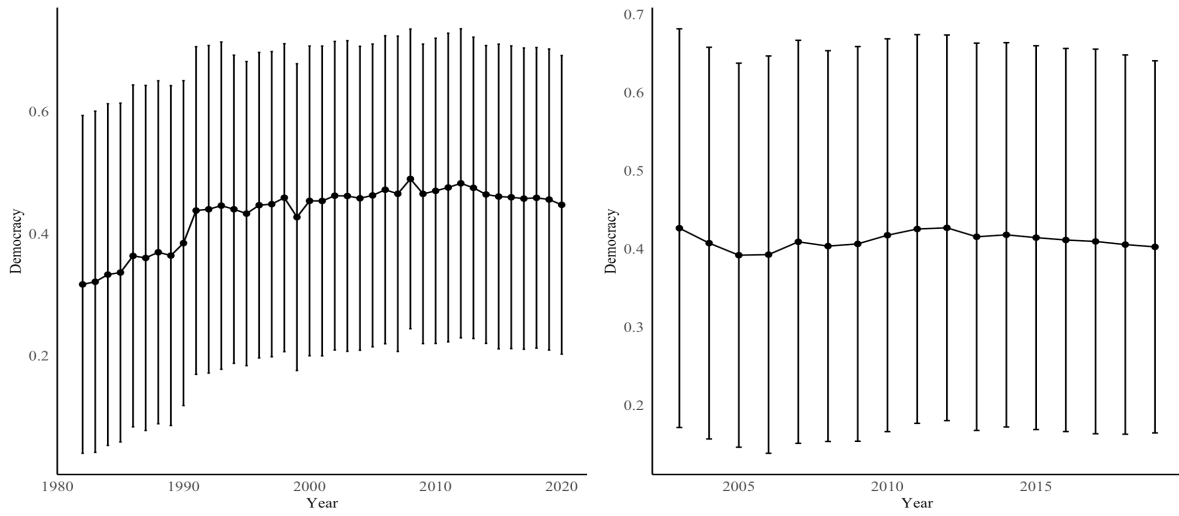
adjusted the weight of each component to accord with the value proportionate to the loading attained from the confirmatory factor analysis. Once components were re-weighted, an average across the five components was calculated; this measure was coded as ‘Democracy’.

The average level of democracy in nations receiving investment from the United States was 0.45 (SD: 0.26), while for those receiving investment from China, it was 0.42 (SD: 0.25). In instances where investment from the United States and China overlapped, the average level of democracy across recipient nations was 0.48 (SD: 0.25). When investments did not overlap, the average level of democracy in nations receiving investment from China and not the United States was 0.36 (SD: 0.22), whereas the average level of democracy for nations receiving investment from the United States and not China was 0.44 (SD: 0.26; see *Figure 4*).



*Figure 4:* The average level of democracy in recipient nations for all investments from the United States and China.

For a summary of the average democracy levels in nations receiving investments from the United States and China by year, see *Figure 5*.



*Figure 5*: The average level of democracy in nations receiving investment from the United States (left) and China (right) with error bars representing one standard deviation. *Note*: See *Appendix 3* for annual aggregated data on democracy levels.

### 3. Results

In the following analysis, we employ a Generalised Method of Moments (GMM) estimator to investigate the relationship between democracy and foreign direct population investment (FDPI) from the United States and China. We base our analysis on a panel regression approach as this allows simultaneous consideration of different countries while accommodating differences between them. Following the precedent of Arellano and Bond (1991) we used a two-step procedure for the GMM estimation. The first step of the procedure employs an initial weighting matrix to obtain a preliminary but inefficient estimator; for this matrix, we assume that the error terms are independently and identically distributed. The second step updates the weighting matrix to reflect the observed variability in the residuals, resulting in a more efficient estimator. As first-step estimates can introduce correlations between the estimator and error term that are not accounted for in basic standard error calculations, we correct for this with the technique outlined by Windmeijer (2005).

For a GMM estimator to be consistent, it requires valid instruments. To address this, we followed the precedent of Sequeira and Nunes (2008) and considered two specification tests: the first being the Hansen (1982) test of over-identifying restrictions, which examines overall instrument validity (with the null hypothesis being that the instruments are valid); and the second being the Arellano and Bond (1991) second-order autocorrelation test for the error term (with the null hypothesis that there is no autocorrelation). To account for potential issues with serial correlation, as well as individual-effects and stationarity, variables were differenced. For each model reported, both specification tests indicated that the instruments used are valid (See *Appendix 4*).



Democracy at time  $t$  in country  $i$  may not just be influenced by the level of FDPI from China or the United States at time  $t$ , but also by the level of FDPI from the previous periods; it may also depend on the level of democracy in country  $i$  in the previous periods. With this in mind, we adopted a dynamic panel model where we allow the democracy index at time  $t$  in country  $i$  to depend on the democracy index in the previous periods as well as the level of FDPI from the United States and China in the previous periods. More specifically, we initially included the lagged variables  $Dem_{i,t-1}$  to  $Dem_{i,t-5}$  and  $FDPI_{i,t}$  to  $FDPI_{i,t-5}$  on the right-hand side of the equation.

We then estimated the model for different lags of both variables and selected the model with the best fit. Our approach to assess fit used the function value of the GMM objective function. For the lags of FDPI higher than two, the goodness of fit decreased in both regressions for the United States and China. When we examined the fit for different lags of democracy, we similarly observed that the fit declined with lags higher than two. On that basis, our final model included lags of democracy up to two and FDPI up to one as they provided the best fit for both countries. We thus estimated the following equation:

$$\begin{aligned} \Delta Dem_{i,t} = & \alpha + \beta_1 \Delta Dem_{i,t-1} + \beta_2 \Delta Dem_{i,t-2} + \gamma_1 \Delta FDPI_{i,t} + \gamma_2 \Delta FDPI_{i,t-1} \\ & + \sum \delta_k \Delta Dum_{k,t} + \Delta \varepsilon_{i,t} \end{aligned}$$

where,  $\Delta Dem_{i,t}$  represents the change in democracy in country  $i$  at time  $t$ ; Coefficients  $\beta_1$  and  $\beta_2$  capture the impact of democracy change from the preceding two-years on the current value. Similarly, the coefficients  $\gamma_1$  and  $\gamma_2$  account for the effects of FDPI from both the current and previous year. To control for time-effects, time-dummies were also included in our models. Finally,  $\Delta \varepsilon_{i,t}$  is an error term that captures variations in the change of democracy that is not accounted for by FDPI.

Overall, we observed no statistically significant relationship between US FDPI and democracy. As expected, significant relationships were observed between the first and second lag of democracy and the current value of democracy (see *Table 5*).

*Table 5: Summary of two-step GMM estimation results for the United States (see Appendix 5 for summary including time-dummies).*

<b>Variable</b>	<b>Coefficient</b>	<b>Standard Error (Corrected)</b>	<b>p-value</b>
Democracy (Lag 1)	0.7796	0.0850	<.001***
Democracy (Lag 2)	-0.1429	0.0353	<.001 ***
US FDPI	< 0.0001	0.0004	0.973
US FDPI (Lag 1)	-0.0003	0.0004	0.486

\*For ease of interpretation, FDPI was divided by 1000, increasing the size of the coefficients. *Note:* \*\*\*, \*\*, and \* denotes significance at 0.1, 1, and 5% levels.

The GMM estimation results for China are available in *Table 6*. Overall, we observed a significant relationship between the current value of democracy and both its first and second lags. Significant negative relationships were observed between democracy and both current and lagged Chinese FDPI, respectively.

*Table 6: Summary of the two-step GMM estimation results for China (see Appendix 6 for a summary including time-dummies)*

<b>Variable</b>	<b>Coefficient</b>	<b>Standard Error (Corrected)</b>	<b>p-value</b>
Democracy (Lag 1)	0.8062	0.1058	<.001***
Democracy (Lag 2)	-0.2476	0.0408	<.001***
China FDPI	-0.0397	0.0180	0.027*
China FDPI (Lag 1)	-0.0458	0.0201	0.023*

\*For ease of interpretation, FDPI was divided by 1000, increasing the size of the coefficients. *Note:* \*\*\*, \*\*, and \* denotes significance at 0.1, 1, and 5% levels.

## 4. Discussion

The present thesis sought to examine the political outcomes of nations receiving foreign direct investment (FDI)<sup>7</sup> from the United States and China, focusing specifically on the relationship between investment and democracy. To achieve this, our analysis employed a generalised method of moments (GMM) estimator following a two-step procedure, as outlined by Arellano and Bond (1991). For the United States, no significant relationship between FDI and democracy was observed. By contrast, for China, a significant negative relationship was detected between democracy and both current and lagged Chinese FDI, respectively.

### 4.1. Chinese Investment: The Political Outcomes of Recipient Nations

Overall, we detected a significant negative relationship between Chinese FDI and the level of democracy in recipient nations, implying that an increase in Chinese FDI may be associated with a decrease in the level of democracy in recipient nations. Since levels of democracy historically tend to change slowly over time, significance was observed in both lags of democracy, respectively, and the current value of democracy, as expected (Capoccia and Ziblatt, 2010).

Our observation of a significant negative association between Chinese FDI and the level of democracy in recipient nations appears to be consistent with the view that FDI can create instability and reduce the level of democracy in a nation; that is, the *state-capture* hypothesis (Escribà-Folch, 2017). While we make no attempt to imply that this relationship is causal, or to establish any mechanisms that facilitate this change, it may be observed that prior literature

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<sup>7</sup> For the sake of simplicity, we will use the term foreign direct investment (FDI) throughout, whether referencing existing literature or discussing our findings.

has found results consistent with this position. For example, Po and Sims (2022) observe that China has previously supported factions with autocratic tendencies that were favourable to their interests in Cambodia and Myanmar. Chen and Chen (2023) argue that young democracies may be particularly vulnerable to Chinese influence. In Malaysia, they argue that the non-interference policy of China appeals to Malaysian leaders who often resist Western pressure for democratic reform. By providing surveillance technology to the Malaysian police, critics argue that China actively enables this resistance (Tan, 2018). Perhaps the most notable example of interference may pertain to the Chinese bailout of 1Malaysia Development Berhad (1MDB), a state-owned investment fund intended to promote global economic partnerships. Through 1MDB, over \$4.5 billion was alleged to have been embezzled, with notable beneficiaries including high-ranking Malaysian politicians and former Prime Minister Najib Razak.

While these examples highlight instances in which Chinese investment and democracy may interact, they may not reflect a broader pattern. Instead, our effect may be influenced by shifts in the global balance of trade; the proportion of global gross domestic product controlled by democratic power has decreased by 22.86% compared to 1998 (V-Dem Institute, 2023).

While China may, on average, invest in more autocratic powers than the United States, their investment may reflect an adaptation to this changing global landscape, as opposed to a strategic preference for autocracy. This view is further supported by the observation that, following the Second World War, autocratic regimes have been just as likely to autocratise further as they have been to transition to democracy; a trend that predates the economic ascent of China (Geddes et al, 2014).

As to what may be driving this trend, state-controlled Chinese firms often act in an entirely different manner to private Chinese firms (Ramasamy et al, 2012). The latter tends to be more concerned with the propitiousness of a market, whereas the former tends to be more concerned with natural resource acquisition; the outcome here being that state-controlled firms often care less about the political composition of a nation (although this is likely to remain a consideration given state-owned enterprises regularly involve the Chinese Communist Party in corporate decision making; Jin et al, 2022). Hence, while investment is often allocated to more autocratic nations, this behaviour may be driven primarily by material gain rather than an intent to promote autocratic governance.

#### **4.2. United States' Investment: The Political Outcomes of Recipient Nations**

For the United States, no significant relationship between FDI and the level of democracy in recipient nations was observed, implying that investment from the United States is not associated with changes in democratic levels in these countries. As expected, given democratic shifts tend to occur slowly, significant relationships were observed between the first and second lag of democracy and the current value of democracy.

As we did not observe a significant association between US FDI and the level of democracy in recipient nations, our result appears to be most consistent with the *stabilisation* hypothesis; that is, the view that the level of democracy in recipient nations may remain stable following investment (Escribà-Folch, 2017). Supporting this view, Teorell (2010) finds that, during the third wave of democratisation, FDI had no significant impact on democracy. Similarly, Armijo et al (1994) and Armijo (1999) doubt that foreign capital flows systematically increase the level of democracy in a country, instead arguing that foreign inflows tend to support the incumbent and stabilise the established level of democracy.

One potential explanation for our finding may pertain to market propitiousness. Our result appears consistent with the observation that US investment is often driven by the pursuit of economic benefit and fruitful markets (Al Nasser, 2007; Liu et al, 2023). Indeed, if economic considerations take precedence, it might be expected that no significant association between US investment and the level of democracy in a recipient nation is observed. Private firms are not required to exhibit ideological loyalty, with initiatives such as the *Democracy Delivers Initiative*, which has raised \$255 million in pledges thus far, providing only a modest sum relative to total US investment (United States Agency for International Development, 2023).

Our findings may also be influenced by shifts in the geopolitical landscape. Some argue that the United States is losing influence in the Global South, with China increasingly competing for dominance (Burrows and Darnal, 2022). To follow this view, the diminished influence of the United States in the Global South may correspond to a relative decline in US investment in these regions; this may shield private investment from the United States from some of the effects of democratic backsliding as fewer resources would be directed towards nations most affected by this trend (Carothers and Press, 2022). That said, it is worth noting that the United States provides significant funding to multilateral organisations such as the World Bank and International Monetary Fund, with this investment not being captured in private investment data (Carrai, 2023).

### **4.3. Limitations and Future Directions**

FDI data was collected from official government sources, namely multiple editions of the Statistical Bulletin of China's Outward Foreign Direct Investment and the United States Census Bureau. Analysing data from official government sources can be problematic.

Governments can erroneously report their data, or deliberately misreport investment; in some

instances, for political or economic reasons (Javorcik and Wei, 2009). Informal or illegal FDI, such as investments that are deliberately hidden to evade taxes or regulations, may also not be captured by official government sources. FDI of this nature is not uncommon, with between 30-50% of global FDI being funnelled through networks of offshore shell companies (Haberly and Wójcik, 2015). Offshore subnetworks are highly complex. While certain subnetworks resemble historical networks (e.g., British colonial pathways), these networks are largely inaccessible and are not well understood (Garcia-Bernardo et al, 2017).

For around 40% of foreign affiliates, the immediate direct investor is based in one country, while the ultimate source of investment, often controlled by a parent company, is located elsewhere (World Investment Report, 2016; Alabrese and Casella, 2019). As a result, the distribution of immediate investors can vary significantly from the distribution of ultimate investors, with FDI data not necessarily reflecting *real* ownership levels, but the intermediary role of conduit jurisdictions. This can lead to the underweighting of large economies as they can invest through conduit jurisdictions. For example, in 2016, the immediate direct investment into Germany from the Netherlands and Luxembourg was 41%, with the United States investing roughly 8%. However, the ultimate investment source of investment was actually 22% from the United States and 15% from the Netherlands and Luxembourg (Casella et al, 2023). One potential solution for future research would be to supplement their FDI data with ultimate investor data; although this is currently limited by the pace at which developing countries are able to produce this data relative to developed economies (Casella, 2019; Damgaard et al, 2019).

Any future research attempting to understand global democratic trends would benefit from employing a more dynamic definition of democracy. Recent research published by the V-

Dem institute has uncovered two additional dimensions of democracy that were not accounted for in our work (Wilson et al, 2023). Future research should seek to validate these additional dimensions, taking them into consideration when examining global trends or the democratic orientation of recipient nations.

#### **4.4. Conclusions**

For the United States, our GMM estimation found no significant relationship between FDI and democracy in recipient nations between 1982 and 2020, implying that FDI from the United States is not associated with changes in democratic levels in these countries. For China, we detected a significant negative relationship between FDI and the level of democracy in recipient nations, implying that an increase in Chinese FDI may be associated with a decrease in the level of democracy in recipient nations. As expected, given democratic shifts tend to occur slowly, significant relationships were observed between the first and second lag of democracy and the current value of democracy in both models.



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## Appendix

### Appendix 1:

#### 1.1. Average annual foreign direct investment from the United States and China.

Year	Average US FDI	SD of US FDI	Average China FDI	SD of China FDI
1982	77.61	295.42		
1983	121.17	357.53		
1984	142.37	528.64		
1985	87.70	404.93		
1986	160.99	576.77		
1987	275.85	807.99		
1988	160.39	722.93		
1989	402.14	1443.07		
1990	289.66	839.96		
1991	366.21	858.83		
1992	382.48	962.02		
1993	686.30	2733.94		
1994	664.55	1504.84		
1995	816.37	2118.37		
1996	673.23	1919.60		
1997	793.91	2718.63		
1998	1130.50	3815.50		
1999	1474.25	5082.64		
2000	1150.69	3657.94		
2001	804.76	2828.27		
2002	980.97	2971.54		
2003	1075.40	3698.00	7.39	20.65
2004	1733.09	5737.85	11.09	25.30
2005	278.93	3367.21	23.83	70.59
2006	1592.40	5251.36	20.38	52.58
2007	3082.03	11159.13	64.63	159.44
2008	2107.61	6313.20	96.95	477.56
2009	1876.16	6417.01	79.82	248.36
2010	1805.42	7195.70	123.71	286.44
2011	2761.50	10168.08	172.62	471.53
2012	2526.44	7894.58	230.69	580.17
2013	1910.75	6938.08	213.66	509.78
2014	1970.47	6911.79	255.09	783.23
2015	1794.15	7735.77	219.42	891.68
2016	1778.69	7025.18	357.90	1564.44
2017	1873.52	6646.81	297.07	790.47
2018	-350.65	7093.47	263.72	474.55
2019	382.64	8819.95	228.92	551.17
2020	1562.79	5616.37		

\*Note: For ease of interpretation, values are expressed in millions of USD.

## Appendix 2:

### 2.1. Average foreign direct investment Outflows (2003 – 2019) for China and the United States per continent.

Continent	China	United States (2003-2019)
Africa	57,544	105,814 <sup>8</sup>
Asia	173,755	1,019,434
Europe	144,016	3,522,536
North America	537,702	2,427,841
Oceania	494,699	2,462,520
South America	70,874	754,507

*\*Note:* For ease of interpretation, values are expressed in thousands of USD.

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<sup>8</sup> While total investment from the United States and China was comparable, the United States tended to invest in fewer countries than China over this period.

### Appendix 3:

#### 3.1. Average annual level of democracy in nations receiving foreign direct investment from the United States and China

Year	Average US Democracy	SD of US Democracy	Average China Democracy	SD of China Democracy
1982	0.33	0.27		
1983	0.36	0.29		
1984	0.33	0.29		
1985	0.37	0.30		
1986	0.42	0.30		
1987	0.45	0.30		
1988	0.42	0.29		
1989	0.37	0.28		
1990	0.41	0.27		
1991	0.46	0.27		
1992	0.46	0.26		
1993	0.45	0.27		
1994	0.44	0.25		
1995	0.46	0.25		
1996	0.47	0.25		
1997	0.47	0.25		
1998	0.48	0.26		
1999	0.45	0.25		
2000	0.47	0.26		
2001	0.47	0.26		
2002	0.51	0.26		
2003	0.46	0.26	0.42	0.25
2004	0.49	0.25	0.40	0.25
2005	0.46	0.25	0.39	0.25
2006	0.47	0.26	0.40	0.26
2007	0.48	0.27	0.42	0.26
2008	0.49	0.25	0.43	0.25
2009	0.47	0.24	0.41	0.25
2010	0.46	0.25	0.42	0.25
2011	0.48	0.25	0.43	0.25
2012	0.49	0.26	0.43	0.25
2013	0.44	0.25	0.43	0.24
2014	0.45	0.24	0.42	0.25
2015	0.48	0.25	0.42	0.24
2016	0.47	0.25	0.44	0.25
2017	0.46	0.25	0.43	0.24
2018	0.43	0.25	0.42	0.24
2019	0.44	0.24	0.44	0.24
2020	0.44	0.25		



## Appendix 4:

### 4.1. Specification tests

For a Generalised Methods of Moments (GMM) estimator to be consistent, it requires valid instruments. To address this, we considered two specification tests: the Hansen (1982) test of over-identifying restrictions, which examines overall instrument validity (with the null hypothesis being that the instruments are valid); and the Arellano and Bond (1991) second-order autocorrelation test for the error term (with the null hypothesis being that there is no autocorrelation).

For the United States, both specification tests supported the validity of the model used. The Hansen test of over-identifying restrictions observed strong evidence in favour of the null hypothesis ( $\chi^2(700) = 114.73, p = 1.00^9$ ). Similarly, the Arellano and Bond (1991) test for second-order autocorrelation in the error terms also supported the null hypothesis ( $z = -0.71, p = 0.48$ ).

For China, both specification tests supported the validity of the model used. The Hansen test of over-identifying restrictions observed strong evidence in favour of the null hypothesis ( $\chi^2(117) = 114.28, p = 0.55$ ). Similarly, the Arellano and Bond (1991) test for second-order autocorrelation in the error terms also supported the null hypothesis ( $z = -0.77, p = 0.55$ ).

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<sup>9</sup> Note: While this p-value is high, this is not uncommon for the Hansen test of overfitting; see Sequeira and Nunes (2008) where a comparable result is reported ( $\chi^2 = 82.55, p = 0.999$ ).

## Appendix 5:

### 5.1. Generalised Method of Moments (GMM) estimation results for the United States.

Variable	Coefficient	Standard Error	<i>p</i> -value
Democracy (Lag 1)	0.7796	0.0850	<.001***
Democracy (Lag 2)	-0.1429	0.0353	<.001 ***
US FDPI	< 0.0001	0.0004	0.973
US FDPI (Lag 1)	-0.0003	0.0004	0.486
1982	0.009	0.005	0.072
1983	0.014	0.006	0.018*
1984	0.012	0.006	0.055
1985	0.014	0.006	0.022*
1986	0.013	0.006	0.026*
1987	0.011	0.006	0.083
1988	0.013	0.006	0.027*
1989	0.014	0.007	0.043
1990	0.010	0.006	0.079
1991	0.014	0.006	0.031*
1992	0.013	0.006	0.048*
1994	0.006	0.005	0.236
1997	0.003	0.003	0.244
1998	0.005	0.003	0.082
1999	0.007	0.004	0.085
2000	0.013	0.007	0.046*
2001	0.017	0.007	0.013*
2002	0.015	0.007	0.053
2003	0.007	0.003	0.056
2004	0.003	0.007	0.690
2005	0.008	0.007	0.263
2006	0.007	0.007	0.303
2007	0.002	0.008	0.783
2008	-0.001	0.007	0.875
2010	-0.010	0.006	0.071
2011	-0.009	0.005	0.090
2012	-0.008	0.004	0.048*
2013	-0.009	0.004	0.021*
2014	0.008	0.004	0.030*
2015	0.008	0.004	0.048*
2016	-0.002	0.007	0.776
2017	-0.007	0.004	0.103
2018	-0.003	0.007	0.708
2019	-0.008	0.004	0.061
2020	-0.008	0.008	0.299

*Note:* \*\*\*, \*\*, and \* denotes significance at 0.1, 1, and 5% levels.

## Appendix 6:

### 6.1. Generalised Method of Moments (GMM) estimation results for China.

Variable	Coefficient	Standard Error	<i>p</i> -value
Democracy (Lag 1)	0.8062	0.1058	<.001***
Democracy (Lag 2)	-0.2476	0.0408	<.001***
China FDPI	-0.0397	0.0180	0.027*
China FDPI (Lag 1)	-0.0458	0.0201	0.023*
2004	-0.015	0.004	0.000***
2006	-0.000	0.004	0.937
2007	-0.001	0.004	0.849
2008	-0.000	0.004	0.958
2009	0.002	0.003	0.640
2010	-0.000	0.003	0.883
2011	0.002	0.003	0.571
2012	0.007	0.002	0.003**
2015	-0.001	0.004	0.793
2016	-0.003	0.003	0.367
2017	-0.006	0.004	0.090
2018	-0.009	0.004	0.026*
2019	-0.009	0.004	0.020*

*Note:* \*\*\*, \*\*, and \* denotes significance at 0.1, 1, and 5% levels.