

Do political systems affect economic outcomes?

The geography of inward FDI and its relationships with growth and inequality

Dario Maimone Ansaldo Patti*

Ram Mudambi[†]

Pietro Navarra[‡]

Abstract

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

Keywords: foreign direct investment; political competition; democracy; authoritarian regime.

* Department of Economics, University of Messina, Piazza Pugliatti 1, 98122 Messina, Italy. Email: dmaimone@unime.it

[†] Department of Management, Fox School of Business, Temple University, PA 19122, Philadelphia, USA. Email ram.mudambi@temple.edu

[‡] Department of Economics, University of Messina, Piazza Pugliatti 1, 98122 Messina, Italy. Email: navarrap@unime.it

Supplementary Material

In this document, we provide a description of the variables used in the empirical analysis of our study (Section A) and address several concerns to corroborate our main findings. Specifically, in Section B we examine the interplay between FDI inflows and trade; in Section C we take into consideration the effect of natural resources on the U-shaped relationship between regime types and FDI; and in Section D we introduce bilateral FDI as an alternative dependent variable to check the robustness of our non-linear hypothesis. Finally, in Section E, we account for institutional similarity among countries and evaluate its influence on the relationship between FDI and political competition.

A. Description of variables

In Table A1 we list all the variables used in our empirical analysis; we describe their metrics; and provide their sources. In Table A2 we present their summary statistics.

Table A1 about here

Table A2 about here

B. Trade

Moving from the proximity–concentration trade-off (Brainard, 1997), a large strand of research discusses the potential complementarity or substitutability between FDI and trade. The evidence in the literature is not uniform. While theoretical models often predict substitutability (Blonigen, 2001), a substantial body of empirical work supports complementarity (Carr & al., 2001; Ding & al., 2021). More recently, Bricongne & al. (2023) suggest the coexistence of complementarity and substitutability, depending on the type of product, the demand of the destination markets and the intensity of the investment. Similarly, Swenson (2004) argues that the inconsistency between theoretical predictions and empirical findings may stem from aggregation bias: when data are aggregated at the country level, complementarity tends to dominate.

In our estimations we control for a country’s openness — i.e., its trading capability — but we do not control for trade flows. Therefore, in this section, we re-estimate the models presented in Table 2, replacing the initial measures of openness with a country’s trade volume, drawn from the World Development Indicators database. This variable enables us to assess whether and to what extent trade flows influence FDI inflows. Our concern is that excluding trade flows from the analysis may introduce omitted variable bias, potentially affecting the validity of our main findings.

Table B1 about here

In Table B1 we show the results of our estimations. Consistent with Swenson (2004), our findings suggest the existence of complementarity between FDI and trade. More importantly, the coefficients associated with the linear and quadratic terms, along with the tests reported at the end of the table, confirm our previous results and support the presence of a U-shaped relationship between FDI and political competition.

C. Natural Resources

In the theory sections as well as in the data description we discussed asset-seeking and market-seeking motives behind MNEs foreign investment decisions. We also acknowledged

that natural resources might be an important attractive force for MNEs especially when they are scarce or costly in the source country (Dunning, 1998; Cohen, 2007).

Since natural resources are not explicitly accounted for in our main analysis, our estimates may suffer from omitted variable bias, potentially undermining the validity of our results. To address this concern, we re-estimate the models reported in Table 2, incorporating a proxy for the availability of natural resources in the host country. Specifically, we use the share of natural resource rents to GDP, drawn from the World Development Indicators database. The results are presented in Table C1.

Table C1 about here

Regression estimates are consistent with those reported in Table 2. Although the coefficient on our proxy for natural resources is positive, it is not statistically significant. More importantly, both the linear and quadratic terms of political competition keep their expected signs and significance levels. The U-shape tests at the bottom of the table confirm the presence of a U-shaped relationship, regardless of the outcome variable used. Notably, the estimated turning points are similar to those obtained in Table 2.

The lack of significance for the natural resource variable may reflect the heterogeneity of our sample, which includes both resource-dependent and non-resource-dependent countries. As Cohen (2007) notes, especially in the post-WWII period, MNEs have often invested in less developed countries that are rich in raw materials and tend to exhibit weaker institutional frameworks.

To further test the robustness of our findings, we conduct a sub-sample analysis. We define resource-dependent countries as those where fuel and/or metal exports account for at least 25% of total merchandise exports. The remaining countries form the second sub-sample. The results are reported in Table C2.

Table C2 about here

Once more, our findings confirm that the relationship between political competition and FDI inflows is non-linear and U-shaped across both sub-samples, reinforcing the robustness of our main results.

D. Bilateral FDI

In our analysis, we model FDI inflows at the country level. However, this choice may have important implications. First, aggregate FDI inflows can cover up firm-level heterogeneity, as MNEs may pursue different motivations and strategies for investing abroad. Moreover, country-level data may dilute the strategic dimensions of MNEs decision-making, including whether, when, and how much to invest.

Although the use of macro-level FDI data is common in the literature — Jha & al. (2024) is one of the most recent examples — these concerns raise questions about the extent to which external factors influence MNEs location choices. A more fine-grained measure of FDI as the dependent variable could help address these limitations.

One way to tackle this issue is to move beyond a one-sided macro approach and adopt a bilateral perspective. This methodology allows us to disaggregate at country level the dependent variable and enables us to examine whether, when, and how much MNEs from a given country invest abroad. In a word, a bilateral perspective helps us to investigate the

strategic decision-making of MNEs in relation to host country characteristics, particularly political factors.

We employ a gravity model (Bevan & Estrin, 2004; Falvey & Foster-McGregor, 2017; Amadù & al., 2018), and estimate the following equation:

$$FDI_{s,h,t} = \alpha + \beta_1 GDP_{s,t-1} + \beta_2 GDP_{h,t-1} + \gamma' X_b + \varphi' K_h + \eta_s + \eta_h + \eta_t + \varepsilon_{it} \quad (D1)$$

While it is common to estimate gravity models using a log-linear transformation, this approach can yield biased parameter estimates. Therefore, we adopt a Poisson pseudo-maximum likelihood (PPML) estimator, which offers several advantages over traditional log-linear models (Santos Silva & Tenreyro, 2006). First, PPML avoids dropping observations with zero FDI flows—values that are common in bilateral data but problematic when taking logarithms. Second, it performs better than the *ad hoc* practice of adding a small arbitrary constant to the dependent variable to solve the problem of zero values. Third, unlike standard log-linear models which can produce biased estimates under non-constant variance, PPML is robust to heteroskedasticity. Finally, the PPML estimator does not require the dependent variable to follow a Poisson distribution.

In Equation (D1), the dependent variable (FDI) is in levels and measures the flow of FDI from source country, s , to the host country, h , at time t . The GDP of both source and host countries are logged. The vector X_b includes bilateral variables such as geographic distance, shared language, legal system similarity, shared religion, the existence of regional trade agreements between countries, and a measure of social connectedness (Conte & al., 2022). The vector K_h captures host country-specific characteristics. We have, finally, controlled for source and host country effects (η_s and η_h) and time-specific shocks (η_t).

The results of our analysis are reported in Table D1. We begin by estimating a baseline model that includes only the GDP of source and host countries, along with the vector of bilateral variables. We then extend the model by incorporating host country-specific characteristics, including the level of political competition.

Table D1 about here

The coefficients associated with GDP and the bilateral variables exhibit the expected signs: FDI inflows increase when GDP of source and host countries rises; when countries share colonial ties, religion and legal systems; when have strong social connections and have signed regional trade agreements. Conversely, FDI inflows decrease with greater geographic distance between countries and—somewhat unexpectedly—when countries share a common official language.

This latter finding may be explained by the fact that sharing an official language does not necessarily imply that it is widely spoken by the population. In many cases, the official language is primarily used in government or education. For example, Luxembourg has three official languages — Luxembourgish, French, and German — but the latter two are used mainly in official documents and are not commonly spoken in daily life. In Ethiopia, Amharic is the federal official language, yet many ethnic groups speak other native languages. Similarly, in Singapore, although English is one of the official languages, many people primarily speak Mandarin, Malay, or Tamil.

In the second column of Table D1, we include host-specific variables consistent with those used in our main analysis. The results remain robust: the level of political competition in the

host country exhibits a non-linear effect. The test reported at the end of the table confirms that U-shaped relationship between political competition and FDI inflows. This suggests that MNEs FDI inflows are more likely to be associated with countries that are either strongly authoritarian or fully democratic.

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Table A1: Variables description

<i>Variable</i>	<i>Description</i>	<i>Source</i>
Per capita FDI	Per capita FDI inflow PPP adjusted	UNCTAD
Political competition	Degree of political competition ranging from 1 (low) to 10 (high)	Marshall & Gurr (2020)
Political rights	Index measuring the possibility of people to participate freely in the political process, including the right to vote freely, compete for public office, join political parties and organizations, and elect their representatives. The variable ranges from 1 (least free) to 7 (most free)	Freedom House (2024)
Gini	Logs of wealth inequality index for adult population (20+ years).	Chancel & al. (2022)
Low income countries	Dummy variable taking the value of 1 if the country is a low or medium-low income and 0 otherwise	World Bank (2025)
Corruption	Growth rate of corruption in the political system	Coppedge & al. (2025)
British legal system	Dummy variable taking the value of 1 if the country adopts a British legal system and 0 otherwise	La Porta & al. (2008)
French legal system	Dummy variable taking the value of 1 if the country adopts a French legal system and 0 otherwise	La Porta & al. (2008)
Scandinavian legal system	Dummy variable taking the value of 1 if the country adopts a Scandinavian legal system and 0 otherwise	La Porta & al. (2008)
German legal system	Dummy variable taking the value of 1 if the country adopts a German legal system and 0 otherwise	La Porta & al. (2008)

Table A1: continued

Political network	Logs of index measuring political connections in terms of number of embassies, contribution to UN peace-keeping operations and number of internationally oriented NGO in a given country. The variable ranges from 1 (poor political network) to 100 (strong political network).	Gygli & al. (2019)
Trade exposure	Logs of index measuring the amount of good and services trade in percentage of GDP. The variable ranges from 1 (poor trade exposure) to 100 (poor trade exposure).	Gygli & al. (2019)
Trade regulation	Logs of index measuring the existence of trade tariffs, taxes and regulation and the persence of regional trade agreements. The variable ranges from 1 (overwhelming regulation) to 100 (regulation beneficial for trade).	Gygli et al. (2019)
Volume of trade	Trade flows of a country measured as the sum of import and export (2015 = 100)	World Bank (2025)
Population growth rate	Population growth rate	World Bank (2025)
GDP growth rate	GDP growth rate	Feenstra & al. (2015)
Human capital	Logs of number of expected years of schooling at birth.	World Bank (2025)
Natural resources	Logs of rents from natural resources in percentage of GDP.	World Bank (2025)
Voice and accountability	Perceptions of the extent to which citizens are able to participate in selecting their government and thave freedom of expression, freedom of association, and a free media. The variable ranges from -2.5 (poor institutional quality) to 2.5 (high institutional quality)	Kaufmann & Kraay (2024)

Table A1: continued

Government effectiveness	Perceptions of the quality of public services and of the civil service and the degree of its independence from political pressures. The variable ranges from -2.5 (poor institutional quality) to 2.5 (high institutional quality)	Kaufmann & Kraay (2024)
Rule of law	Perceptions of the confidence in and respect of the rules of society, in contract enforcement, property rights, the police, and the courts. The variable ranges from -2.5 (poor institutional quality) to 2.5 (high institutional quality)	Kaufmann & Kraay (2024)
Regulation quality	Perceptions of the ability of the government to formulate and implement policies and regulations that promote private sector development. The variable ranges from -2.5 (poor institutional quality) to 2.5 (high institutional quality)	Kaufmann & Kraay (2024)
Political stability	Perceptions of the degree of political instability and/or political violence, including terrorism. The variable ranges from -2.5 (poor institutional quality) to 2.5 (high institutional quality)	Kaufmann & Kraay (2024)

Table A2. Summary Statistics

	Obs	Mean	Std. dev.	Min	Max
per capita FDI	4,108	4.42	1.95	-0.03	11.34
per capita FDI $\times$ diversity	4,004	1.89	2.84	-5.20	10.84
per capita FDI $\times$ quality	3,971	2.39	1.94	-6.11	8.90
Political Competition	4,452	6.73	3.14	1	10
Political Rights	4,659	5.98	3.23	1	10
Gini	4,592	0.58	0.09	0.31	0.78
Low income countries	4,601	0.16	0.37	0	1
Corruption	4,639	-0.10	8.44	-145.50	140.01
British legal system	4,497	0.27	0.44	0	1
French legal system	4,497	0.58	0.49	0	1
Scandinavian legal system	4,497	0.03	0.16	0	1
German legal system	4,497	0.12	0.33	0	1
Political networks	4,584	3.93	0.54	1.30	4.59
Trade exposure	4,555	3.86	0.42	1.43	4.60
Trade regulation	4,281	3.83	0.55	1.68	4.58
Volume of trade	3,753	4.88	0.61	0.91	8.03
Population growth rate	4,601	2.27	1.55	-1.13	7.25
GDP growth rate	4,430	3.45	6.52	-108.23	72.41
Human capital	4,539	2.39	0.37	0.66	3.15
Natural resources	4,486	8.21	11.58	0.00	88.59
Voice and accountability	3,234	-0.15	0.99	-2.26	1.80
Government effectiveness	3,226	-0.11	0.99	-2.44	2.47
Rule of law	3,234	-0.17	1.00	-2.59	2.12
Regulation quality	3,229	-0.09	0.99	-2.55	2.25
Political stability	3,234	-0.20	0.96	-3.31	1.76

Table B1: Testing the U-shape relationship between political competition and FDI inflows: Trade

	FDI per capita inflows	FDI inflows quality	FDI inflows diversity
	(a)	(b)	(c)
Political Competition _{t-1}	-0.161** (0.070)	-0.225*** (0.069)	-0.214** (0.084)
Political Competition ² _{t-1}	0.016*** (0.006)	0.019*** (0.006)	0.022*** (0.008)
Low income countries	-1.676*** (0.265)	-1.770*** (0.262)	-2.389*** (0.345)
Corruption _{t-1}	-0.000 (0.001)	-0.001 (0.002)	-0.001 (0.002)
British legal system	0.943*** (0.305)	1.511*** (0.315)	1.747*** (0.403)
French legal system	0.827*** (0.218)	1.406*** (0.253)	1.441*** (0.300)
Scandinavian legal system	1.619*** (0.367)	2.025*** (0.418)	3.202*** (0.497)
German legal system	1.231*** (0.312)	1.598*** (0.356)	2.345*** (0.450)
Political network _{t-1}	0.238 (0.155)	0.538** (0.222)	0.567*** (0.211)
Volume of trade _{t-1}	0.314*** (0.098)	0.182 (0.123)	0.332** (0.133)
Population growth rate _{t-1}	-0.291*** (0.084)	-0.394*** (0.087)	-0.021 (0.112)
GDP growth rate _{t-1}	0.018*** (0.005)	0.021*** (0.007)	0.023*** (0.006)
Human capital _{t-1}	1.348*** (0.281)	1.172*** (0.320)	2.208*** (0.393)
<i>U-shape test</i>			
Min	-2.22 [0.013]	-3.23 [0.001]	-2.46 [0.007]
Max	2.77 [0.003]	2.70 [0.003]	2.83 [0.002]
Overall	2.22 [0.013]	2.70 [0.003]	2.46 [0.007]
Extreme Point	4.94	5.82	4.84
Fieller Interval	[2.51; 6.14]	[4.70; 7.46]	[3.03; 6.14]
Observations	2,968	2,904	2,921
Overall significance test	4,049.900	4,678.839	9,821.816
R ²	0.523	0.490	0.636

Table C1: Testing the U-shape relationship between political competition and FDI inflows: Natural resources

	FDI per capita inflows	FDI inflows quality	FDI inflows diversity
	(a)	(b)	(c)
Political Competition _{t-1}	-0.191*** (0.069)	-0.241*** (0.089)	-0.295*** (0.091)
Political Competition ² _{t-1}	0.018*** (0.006)	0.021*** (0.008)	0.029*** (0.008)
Low income countries	-1.184*** (0.242)	-1.283*** (0.265)	-1.803*** (0.312)
Corruption _{t-1}	-0.001 (0.002)	-0.003 (0.002)	-0.002 (0.002)
British legal system	1.086*** (0.263)	1.359*** (0.301)	1.763*** (0.353)
French legal system	0.983*** (0.186)	1.251*** (0.261)	1.468*** (0.268)
Scandinavian legal system	1.807*** (0.319)	1.832*** (0.417)	3.001*** (0.448)
German legal system	1.075*** (0.287)	1.069*** (0.398)	1.966*** (0.436)
Political network _{t-1}	0.454*** (0.150)	0.881*** (0.278)	0.924*** (0.227)
Trade exposure _{t-1}	0.292** (0.133)	0.235 (0.166)	0.345** (0.173)
Trade regulation _{t-1}	0.553*** (0.146)	0.434** (0.200)	0.715*** (0.202)
Population growth rate _{t-1}	-0.265*** (0.073)	-0.396*** (0.083)	-0.048 (0.101)
GDP growth rate _{t-1}	0.020*** (0.006)	0.021*** (0.008)	0.031*** (0.008)
Human capital _{t-1}	1.271*** (0.240)	1.197*** (0.353)	2.034*** (0.348)
Natural resources rents _{t-1}	0.009 (0.006)	0.011 (0.009)	0.012* (0.007)
<i>U-shape test</i>			
Min	-2.71 [0.003]	-2.69 [0.004]	-3.18 [0.001]
Max	2.88 [0.002]	2.55 [0.005]	3.29 [0.001]
Overall	2.71 [0.003]	2.55 [0.005]	3.18 [0.001]
Extreme Point	5.22	5.66	5.12
Fieller Interval	[3.87; 6.38]	[4.40; 7.16]	[4.04; 6.16]
Observations	3,429	3,346	3,373
Overall significance test	4,488.403	5,998.977	28,592.216
R ²	0.605	0.550	0.700

Table C2: Testing the U-shape relationship between political competition and FDI inflows: Natural resources -Sub-sample analysis

	Resource-dependent countries			Other countries		
	FDI per capita inflows	FDI inflows quality	FDI inflows diversity	FDI per capita inflows	FDI inflows quality	FDI inflows diversity
	(a)	(b)	(c)	(a)	(b)	(c)
Political Competition _{t-1}	-0.234** (0.099)	-0.322** (0.125)	-0.444*** (0.130)	-0.158** (0.075)	-0.212*** (0.079)	-0.232** (0.097)
Political Competition ² _{t-1}	0.022** (0.010)	0.029*** (0.011)	0.043*** (0.012)	0.014** (0.007)	0.017** (0.007)	0.022** (0.009)
Low income countries	-0.912*** (0.245)	-1.024*** (0.319)	-1.614*** (0.320)	-1.201*** (0.257)	-1.287*** (0.260)	-1.675*** (0.335)
Corruption _{t-1}	-0.006* (0.003)	-0.009** (0.004)	-0.005 (0.004)	0.000 (0.002)	-0.001 (0.002)	-0.001 (0.002)
British legal system	0.735** (0.315)	1.007*** (0.384)	1.347*** (0.408)	0.735*** (0.278)	0.647** (0.286)	1.310*** (0.352)
French legal system	0.784*** (0.238)	1.115*** (0.348)	1.333*** (0.314)	0.647*** (0.197)	0.550** (0.235)	1.026*** (0.269)
Scandinavian legal system	1.910*** (0.422)	1.854*** (0.569)	3.594*** (0.568)	1.340*** (0.325)	1.047*** (0.381)	2.311*** (0.450)
German legal system	0.526 (0.343)	0.220 (0.500)	0.941* (0.560)	0.663** (0.290)	0.260 (0.389)	1.363*** (0.430)
Political network _{t-1}	0.331* (0.178)	0.814** (0.329)	0.636** (0.266)	0.393** (0.153)	0.680*** (0.245)	0.894*** (0.228)
Trade exposure _{t-1}	0.567*** (0.149)	0.440** (0.212)	0.670*** (0.208)	0.080 (0.166)	0.160 (0.178)	0.145 (0.207)
Trade regulation _{t-1}	0.236 (0.182)	-0.100 (0.249)	0.371 (0.236)	0.727*** (0.166)	0.744*** (0.199)	0.913*** (0.229)
Population growth rate _{t-1}	-0.240*** (0.075)	-0.351*** (0.103)	-0.036 (0.102)	-0.288*** (0.072)	-0.387*** (0.078)	-0.061 (0.097)
GDP growth rate _{t-1}	0.011* (0.006)	0.010 (0.010)	0.016* (0.009)	0.014** (0.007)	0.013* (0.007)	0.025*** (0.008)
Human capital _{t-1}	1.091*** (0.302)	1.283** (0.510)	1.386*** (0.452)	1.429*** (0.270)	1.138*** (0.319)	2.510*** (0.366)
<i>U-shape test</i>						
Min	-2.36 [0.009]	-2.55 [0.006]	-3.58 [0.000]	-2.04 [0.021]	-2.71 [0.003]	-2.33 [0.010]
Max	2.12 [0.017]	2.46 [0.007]	3.25 [0.001]	2.14 [0.016]	1.92 [0.027]	2.46 [0.007]
Overall	2.12 [0.017]	2.46 [0.007]	3.25 [0.001]	2.04 [0.021]	1.92 [0.028]	2.33 [0.010]
Extreme Point	5.26	5.47	5.16	5.45	6.16	5.22
Fieller Interval	[3.84; 8.10]	[4.13; 7.02]	[4.28; 6.15]	[2.09; 7.95]	[4.87; 10.35]	[3.07; 7.12]
Observations	1,371	1,309	1,328	2,991	2,941	2,958
Overall significance test	.	.	.	2,699.753	3,477.370	11,403.171
R ²	0.569	0.498	0.714	0.604	0.554	0.693

**Table D1: Testing the U-shape relationship
between political competition and FDI inflows:
Bilateral**

	Control Model	Full Model
	(a)	(b)
Political Competition _{t-1, h}		-0.175*** (0.029)
Political Competition ² _{t-1, h}		0.014*** (0.002)
Corruption _{t-1, h}		-0.000 (0.001)
Political network _{t-1, h}		0.007 (0.059)
Trade exposure _{t-1, h}		0.184*** (0.048)
Trade regulation _{t-1, h}		0.456*** (0.054)
Population growth rate _{t-1, h}		0.254*** (0.085)
Human capital _{t-1, h}		0.860*** (0.108)
GDP _{t-1, s}	1.789*** (0.064)	1.842*** (0.067)
GDP _{t-1, h}	0.724*** (0.043)	0.378*** (0.062)
Capital cities distance	-0.040*** (0.012)	-0.024* (0.013)
Colonial dependence	0.210*** (0.023)	0.213*** (0.023)
Common official language	-0.137*** (0.020)	-0.101*** (0.020)
Common religion index	0.495*** (0.034)	0.610*** (0.036)
Common legal origins	0.049*** (0.014)	0.036*** (0.014)
Social connectedness	0.426*** (0.009)	0.420*** (0.010)
Regional trade agreements	0.257*** (0.020)	0.225*** (0.021)
<i>U-shape test</i>		
Min		-6.03 [0.000]
Max		5.51 [0.000]
Overall		5.51 [0.000]
Extreme Point		6.41
Fieller Interval		[5.81; 7.02]
Observations	327,608	244,389
Overall significance test	10,696.196	9,752.397
Pseudo R ²	0.792	0.792