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Introduction

In today's global economy, Foreign Direct Investment (FDI) is an essential link among national economies as well as a catalyst for economic growth.[1] The benefits that FDI brings, such as capital, knowledge, technology, skills, management know-how, market access, and employment opportunities are important for development as complements to domestic resources in host countries.[2] As such, it is aggressively sought by many countries.[3] FDI does not, however, flow evenly to all. Particularly in the developing world, only a handful of countries are able to attract investments that are commensurate with their market potential. Even when the necessary firm-level incentives and host-country economic conditions are present, some countries fail to provide a welcoming investment environment in the form of policy incentives, guarantees, and stability. Why are some countries able to offer investor-friendly policies and some are not? Which political institutions produce the policies that prove beneficial

[1] FDI is an investment involving a lasting interest by a home-economy entity in an enterprise in a host economy. It is defined as involving an equity stake of 10 percent or more in a foreign enterprise. According to United Nations Conference on Trade and Development – UNCTAD (2005) – since 1993, FDI has consistently surpassed other private capital flows as well as flows of official development assistance to developing countries.

[2] According to UNCTAD (2001) empirical evidence suggests that for emerging economies a 1 percent point increase in FDI (measured as a proportion of GDP) leads, ceteris paribus, to an extra 0.8 percent increase in per capita income.

[3] UNCTAD (2005) reports that the number of countries that adopted measures intended to improve their investment climates almost tripled, from 35 in 1991 to 102 in 2004. Moreover, of the national regulatory changes that have been made to attract investment, changes that are favorable to FDI have been between 90 and 100 percent on average since 1991.

to multinational operations? Does democracy matter in attracting FDI? These are the central questions of this book.

There is an extensive literature on economic and policy determinants of FDI flows, yet much less attention has been devoted to the role of political institutions in producing a favorable investment environment to attract foreign capital.[4] Foreign companies undertake significant political risks when they invest in a host country. Conditional upon the ease with which they can withdraw their assets, they fear the risk of government interference, be it nationalization, shifting tax burdens, or new regulatory requirements. Before they invest in a country, they ascertain the nature of FDI policies and the likelihood that such policies will remain in place over the course of their involvement in the host market.

This is where political institutions come in. Investment policies are not created in a vacuum. Some groups clearly benefit from the infusion of foreign capital and the new business opportunities that are created, while others are disadvantaged by the competition and/or the various ways foreign-company operations affect taxation, job opportunities, environment, and the like in the host country. The potential losers and winners from foreign capital use the political institutions available to them to shape investment policies according to their particular interests. Political institutions not only become a platform to exert pressure on decision makers but also determine how the struggle between stakeholders plays out and how various interests are reconciled or outweighed.

Recently, scholars have started looking more systematically at the relationship between democracy and FDI.[5] Their findings, however, have been mixed and thus inconclusive about the relative merits of political regimes in attracting FDI. Some find a significant positive relationship between democracy and the ability to attract FDI, others argue that authoritarian regimes can provide better entry deals for foreign investors, and still others argue that there is no significant relationship between regime type and FDI.

I argue that the existing literature oversimplifies the relationship between FDI and regime type, and underappreciates the complexities of host country politics. The exclusive use of readily available numerical

[4] See Hymer 1960, Kindleberger 1969, Buckley and Casson 1976, Graham 1978, Rugman 1981, 1985, Schneider and Frey 1985, Crenshaw 1991, Brewer 1991, 1992, Dunning 1993, Markusen 1995.

[5] See O'Neal 1994, Henisz 2000, Harms and Ursprung 2002, Jensen 2003, 2006, Li and Resnick 2003, Busse 2003, Busse and Hefeker 2005, Li 2006, Jakobsen and De Soysa 2006.

indices and generic regime labels, oftentimes by itself, does not capture the intricacies of relations between investors and host governments. To overcome this problem, I make extensive use of both the qualitative method and the rich theoretical insights from comparative democratization literature. I analyze the decision-making process inside a number of countries to show that the institutional structure that defines and shapes the relationship between the opponents and proponents of FDI is much more complex and intriguing than previously thought.

This book contributes to the literature in two principal ways. First, I provide an in-depth analysis of a single sector of FDI – the oil sector – across a small number of cases to control for possible differences among foreign investors in terms of their sector-specific risk calculations and expectations. Of all the possible sectors, I focus on oil because it provides a hard case for the relationship between political regimes and FDI. It is generally assumed that oil investors do not have any regime preferences as long as some level of stability is attained and that the political risks they encounter depend on their relative market power and bargaining position vis-à-vis the host governments rather than the political institutions in place. According to one well-known theory (the obsolescing bargaining theory), in the early stages of the relationship between foreign oil companies and the host government, the former are in a dominant position and able to extract highly favorable terms from the latter.[6] This suggests that in the beginning oil companies face few, if any, political risks and can work with whomever is in power. As the industry matures and the host government becomes more competent, the relative bargaining power of the firm obsolesces, changing the terms of the initial agreement and increasing the degree of political risk. However, at this stage, given the large up-front expenditures they make and the strategic need for ongoing access to resources that generate high rents, investors have very few choices but to work with host governments regardless of the political regime in place. Hence, according to this logic in either stage of the relationship, political institutions do not seem to matter in investment decisions.

Similar systemic theories also assert that market fluctuations in the price of oil, more so than the intricacies of political institutions, affect the relative bargaining position of investors vis-à-vis the host governments. When the price of oil is high, potential returns from an investment

[6] See Vernon 1971, 1980, Smith and Wells 1975, Mikesell 1971, Moran 1974, Rothgeb 1990, 1991.

increase, making oil development projects more attractive. With increased competition among investors for access to oil resources, the bargaining position of the host government increases and that of the investor ebbs. Conversely, when the price of oil goes down, costs and risks of investment increase and investors gain the upper hand in setting the terms of the investment relationship. Therefore, given these persuasive theories, oil provides a hard case because if political institutions turn out to be significant for investors in this sector, it is most likely that they will have some influence on investors in other sectors as well.

Second, I refine the theoretical debate on the merits of political regimes by reclassifying them in terms of the amount of institutional constraints and competition they provide in policy making. This approach captures the political dynamics behind investment policies more systematically. Simply put, I argue that the level of executive constraints in the state as well as the degree of political competition in society determines the stability and/or flexibility of investment terms, and thus, the attractiveness of the investment environment. I operationalize and measure these two variables in terms of the strength of state-veto players and the number and organizational capacity of political parties and interest groups, respectively. I argue that the low, partial, and high levels of constraints and competition in an institutional setting produce different incentives and opportunities for the proponents and opponents of FDI as they design the terms of the relationship between investors and governments.

I discuss and empirically test the impact of these institutional variables on the ability to attract FDI into the oil sectors of three oil-rich countries: Azerbaijan, a post-communist authoritarian regime; Russia, a post-communist "hybrid" regime; and Norway, an industrialized mature democracy. Although all three countries have had similar needs and attractiveness for foreign capital, during the initial phase of their resource development Azerbaijan and Norway received significant amounts of FDI, whereas Russia received very little. The purpose of this book is to explain this empirical puzzle and formulate a broader theory in our understanding of the political conditions under which an investment environment is shaped and why investors flock to certain countries and not to others.

An in-depth comparative analysis of investment environments in these countries reveals an important rejoinder to the existing literature that finds foreign capital to be compatible with either democracy or authoritarianism. I argue that, in fact, both democracies and authoritarian regimes can be attractive to foreign investors. With high levels of executive constraints in the state and open and institutionalized competition in society, consolidated democracies tend to provide long-term policy credibility, transparency, and stability for foreign investors. On the other hand, in authoritarian regimes – assuming that the government has pro-investment preferences – a lack of institutional constraints and political competition tends to insulate decision makers from policy pressures and allows them the flexibility and adaptability to provide exceptional incentives to foreign investors in the form of tax reductions, grants, subsidized loans, market preferences, regulatory concessions, guarantees in arbitration, and the like. Given their specific institutional characteristics, both consolidated democracies and authoritarian regimes have comparative advantages in attracting FDI. The debate, then, should not be over whether FDI will favor democracy or authoritarian regimes but what the trade-offs will be for foreign companies as they invest in one as opposed to the other.

My second argument is that hybrid regimes that produce some but limited constraints and competition tend to put in place investment environments that are neither flexible nor credible but, instead, are unstable and chaotic. Compared to authoritarian regimes, hybrid regimes are characterized by increased levels of political mobilization and participation. Executives often cannot easily overcome the opposition of state veto players through exclusion and repression because the challenges tend to be both formally legal and widely perceived as legitimate. The greater access to state institutions ensured by democratization also limits the generosity of the fiscal and financial incentives host governments can offer to attract FDI. Compared to executives in consolidated democracies, on the other hand, executives in hybrid regimes have a hard time reaching policy outcomes that are acceptable to foreign investors as well as domestic groups. The conflicts of interest among state-veto players cannot be overcome because in hybrid regimes representative institutions such as political parties and interest groups tend to be weak and inchoate. Decision makers find it very difficult to build enduring coalitions and facilitate negotiation and bargaining among competing veto players. The real losers of FDI, therefore, tend to be neither consolidated democracies nor authoritarian regimes; they are the hybrid regimes.

The experiences of Azerbaijan, Russia, and Norway demonstrate that foreign investors tend to favor two polar opposites: consolidated democracies and authoritarian regimes but penalize the middle category, hybrid regimes. The in-depth case study of the oil sector that I present in this book offers a more nuanced analysis and helps to refine the existing debate in the literature. To test the generalizability of my arguments, I further provide

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a brief analysis of the investment environment in another oil producer, Kazakhstan, as well as a statistical time-series analysis of 132 countries over 34 years and for all types of FDI. These findings confirm the relationship observed in the three cases, that is the link between democracy and FDI is nonlinear. An increase in executive constraints and political competition, that is further democratization, may not always enhance a country's ability to attract FDI. Things may get worse before they get better.

Case Selection

The three oil-producing countries – Azerbaijan, Russia, and Norway – studied in this book demonstrate how different political institutions affect investment decisions and thus the levels of FDI in the oil sector. Undoubtedly, there are major differences among these three states in terms of their size, economic structure, and cultural and historical background, yet they also share several crucial characteristics. First of all, they are all major oil producers with significant oil resources. Azerbaijan, Russia, and Norway possess 0.6 percent, 6.2 percent, and 0.8 percent of the world's total proven oil reserves, respectively.[7] Their oil industries remain the focus of most foreign interest.

Second, these three countries faced similar challenges as they embarked on their energy development programs. Azerbaijan and Russia in the beginning of the 1990s and Norway in the 1970s needed significant amounts of foreign capital and expertise to extract their oil resources and generate economic development. In the case of Azerbaijan and Russia, the disintegration of the Soviet Union had led to a breakdown of the all-union Soviet market, which had negative repercussions for both countries' oil industries. Following the collapse of the Soviet Union, Russia's oil industry, which accounted for approximately 90 percent of the former Soviet Union's oil output, fell upon hard times due to decreased domestic industrial demand and a decline in drilling and domestic capital investments. From 1992 to 1998, the country's oil production plummeted 23 percent, from 7.86 million to 6.07 million barrels per day.[8] Similarly, Azerbaijan's oil production fell almost 30 percent between 1990 and 1996 as a result of continuing depletion of existing fields, poor maintenance due to lack of funds, and the limitations of outdated technology.[9]

[7] British Petroleum – BP Global 2006. Azerbaijan, Russia, and Norway are ranked as having the 18th, 7th, and 16th largest oil reserves in the world, respectively.
[8] United States Energy Information Administration – USEIA 2002.
[9] International Energy Agency 1998.

Neither Azerbaijan nor Russia, however, could domestically generate the necessary investment capital. Even though the privatized Russian oil industry could provide some of the capital, most of the Russian companies' investments were directed toward increasing production from existing fields rather than developing new fields that required extensive capital and technology. Hence, from the beginning both Azerbaijani and Russian leaders acknowledged that the long-term development of their natural resources from harsher and undeveloped oil regions in East Siberia, the Far East, and the Caspian depended on an infusion of significant amounts of FDI, especially during times of low oil prices.

Russian authorities, specifically President Boris Yeltsin himself, repeatedly emphasized the need for external capital, particularly in the form of FDI from international oil companies. In 1993, Yeltsin used a presidential decree to propose legislation to facilitate the flow of foreign capital into oil extraction and development projects. Similarly, the first democratically elected leader of Azerbaijan, Abulfez Elchibey, started in 1991 to actively promote foreign investment in the oil industry. Following his example, his successor, President Heidar Aliyev, made FDI promotion a priority for his regime and in 1994 signed the "contract of the century" with ten foreign companies.[10]

In Norway, nearly four decades ago, the need for foreign investment was also clear. Oil had come as a surprise to Norway at the end of the 1960s. With no prior experience and expertise, the domestic industry was in no position to develop these resources on its own. Considering the difficulties of drilling in the deep offshore waters of the North Sea, the Norwegian government was determined to use foreign oil companies to build national competence in oil and increase the welfare of the society. Having acknowledged the importance of foreign participation, the government passed the Royal Decree of 1965 that established the first comprehensive investment regime for exploring and producing oil from the North Sea.

Despite the importance of oil for these economies and their similar needs for FDI, these cases demonstrate a significant variation in their ability to attract foreign capital. While Azerbaijan and Norway created favorable conditions for investors to put sizable amounts of capital in their oil resources, Russia failed to establish an attractive legislative and regulatory investment framework and consequently received very little investment capital throughout the 1990s.

[10] The "contract of the century" entailed the development of three offshore fields – Chirag, Azeri, and Gunesli – with US$8 billion foreign investment over the course of 30 years.

TABLE 1.1. *FDI Statistics for Azerbaijan, Russia, and Norway*

	Total FDI[a]	World FDI Ranking[b]	FDI in Oil[c]	FDI per barrel of Oil Reserves[d]
Azerbaijan	4,488	8th	3,590	0.51
Russia	19,907	104th	3,782	0.05
Norway	22,901	60th	9,160	0.94

Notes:
[a] FDI figures are millions of US$ from 1995 to 2000. See UNCTAD (2001). Average amount of FDI per country for 1995–2000 is US$21,928. The average figure for Oil FDI per country cannot be calculated due to the unavailability of consistent sectoral data.
[b] Rankings are by FDI Performance Index, which is the ratio of a country's share in global FDI flows to its share in global GDP, from 1998 to 2000. A total of 140 countries are ranked. Available data from the early 1990s show a similar pattern: Azerbaijan 3rd (1994–96), Russia 108th (1992–94), Norway 59th (1988–90). See UNCTAD 2002a.
[c] Calculations are estimates of sector share of total FDI from 1995 to 2000 and are in millions of US$. The source for Azerbaijan is USEIA (2001a); for Russia it is UNCTAD (2003); for Norway it is United States Department of State Bureau of Economic and Business Affairs Country Commercial Guide: Norway (2001).
[d] Figures are calculated by dividing total FDI in oil from 1995 to 2000 by total proven oil reserves in that country and are in US$. Reserve figures are from BP (2006).

The overall and oil-related FDI figures clearly attest to this variation (see Table 1.1).[11] According to the FDI performance index created by the United Nations Conference on Trade and Development (UNCTAD), in terms of success in attracting FDI among 140 nations, Azerbaijan ranked the third highest during 1994–1996 and eighth highest during 1998–2000.[12] Russia, on the other hand, ranked the 108th and 104th highest among 140 nations during 1992–1994 and 1998–2000, respectively. With 6.2 percent of world's total proven oil reserves, almost ten times the

[11] It is important to note that systematic, long-term comparable data on FDI statistics, especially on sector-specific FDI statistics, is hard to locate and frequently missing. UNCTAD compiles the most systematic and comparable statistics on FDI. But, even their full dataset provides information for a limited number of countries and years. In its 2007 World Investment Report, UNCTAD discusses the complexities of accessing data on FDI in general and especially in extractive industries. It states that incomplete reporting as well as different definitions and methodologies used in data collection make it extremely difficult to interpret and compare data (UNCTAD 2007: 101).
[12] UNCTAD 2002a. UNCTAD ranking is based on the ratio of a country's share in global FDI flows to its share in global GDP. It is considered a more accurate measure than absolute values of FDI inflows because it assesses how successful a country is in attracting FDI relative to the size of its economy. Azerbaijan was ranked the highest in 2004 (UNCTAD 2006).

oil reserves of Azerbaijan, Russia received just one-tenth the FDI for each barrel of its oil reserves compared to Azerbaijan in the 1990s. Calculations based on FDI figures from UNCTAD also show that Norway received about 94 cents of foreign investment per barrel of its proven oil reserves during 1995–2000 and ranked the 59th and 60th in terms of its overall FDI levels during 1988–1990 and 1998–2000, respectively.[13]

This variation occurred despite the fact that Russia was considered one of the top potential destinations for FDI in the 1990s. For instance, it had a clear advantage over Azerbaijan in terms of more significant oil reserves, a larger domestic market, and an existing pipeline infrastructure in which to bring oil to world markets. Moreover, given the assumptions of the obsolescing bargaining theory, the initial stage of the relationship between the Russian government and foreign companies – especially during the low international oil prices of the 1990s – should have favored the latter in terms of tremendous leverage over taxation, regulatory policies, and institutional design. Yet, the Russian investment environment was significantly more challenging and hostile toward foreign investors than either the Azerbaijani investment environment throughout the 1990s or the Norwegian investment environment in the 1970s and 1980s.

Research Methodology

A comparison of these three cases is based on field work conducted in Azerbaijan in the summer of 1999, in Norway in January 2001, and in Russia in the summer of 2000 and the spring of 2001. To analyze oil-sector investment environments in these countries, I conducted a total of 75 in-depth interviews with various foreign investors, their lobbying organizations, government bureaucrats, legislators, journalists, scholars, and special analysts. In addition, I studied numerous government and private reports, documents, journal and newspaper articles, and scholarly works.

The interviews consisted of two parts. In the first part, I posed questions regarding the investment environment in each country especially during the initial interaction between foreign companies and host governments. Respondents were asked to assess the contracting or licensing

[13] These numbers certainly do not reflect the overall performance of Norway in terms of attracting FDI since the 1970s when its oil development began. The data for those decades are missing and UNCTAD reports start with late 1980 figures. The closest but imperfect figure for the years between 1971 and 1996 is a total of US$200 billion invested in exploration, construction, and operations on the Norwegian continental shelf (International Trade Administration 2001). This figure, however, most likely also includes domestic investments.

policies of each state in terms of the legal and fiscal guarantees provided for foreign investors. The technical aspects of each investment regime were studied in depth with the help of numerous documents provided by oil companies and government officials. Historical data on the evolution of investment regime in each country were also collected through an archival study of various journal and newspaper articles.

The second part of the interviews consisted of questions about the political institutions and the policymaking structure in each country as well as an assessment of political risk facing investors. Respondents were asked to discuss the different interests of societal and state actors regarding oil investment policies and then to evaluate the institutional mechanisms through which these actors interacted with each other and reached policy outcomes. Despite the methodological difficulties in comparing such a small number of cases, these three case studies made it possible to examine different models of oil agreements more closely and to expose more clearly the mechanisms that link political institutions to foreign investment. Given its increasing importance as an oil producer in Central Asia, I also included in this book a brief analysis of Kazakhstan. I relied on secondary sources of information to assess the relationship between its political regime and the investment environment.

Finally, in addition to in-depth case studies, I constructed and analyzed a time-series cross-sectional dataset to test the generalizability of my hypotheses. The data were drawn from the World Bank's World Development Indicators and POLITY IV.[14] The economic and political indicators in these datasets together provide relevant data on 132 countries from 1970 through 2004. I analyzed the dataset using both a random-effects and a fixed-effects general least squares regression with robust standard errors.

Significance and Implications

The role of political institutions in attracting FDI has been seriously understudied. This book fills the gap by mapping out the types of institutional arrangements most conducive to FDI in the oil industry and the trade-offs involved in choosing one institutional arrangement over another. It also draws attention to the analytical importance of hybrid regimes that have limited executive constraints and political competition. I stress that some countries are stuck in between authoritarian regimes

[14] World Bank 2006, Marshall and Jaggers 2004.