DEPARTMENT OF GOVERNMENT

PGT ESSAY COVERSHEET

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Registration Number:	
Module Code & Title:	**GV 907 Political Economy**
Coursework Title:	**Short Paper 5**
Assignment Number:	**5**
Module Teacher:	**Nicole Rae Baerg**
Word Count:	
Submission Date:	

Online Submission Procedures:

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Assignment Mark:

Week 14: International Finance and Capital mobility

This week's articles present ways in which countries are integrated into the world economy and how governments sell their policies not just to their voters but also to foreign investors. They focus on two kinds of actors – firms and governments, and the relationship between them. The first article talks about how countries compete for production and investment in a relatively general manner, the second one asks how domestic political institutions affect political risks for multinational investors, and the final paper focuses on the effects of government policies and institutions on stock market valuations. The first article emphasizes the importance of veto players (their similar preferences on tax issues make a country more responsive to changes in competitor countries), while the second article focuses on the chief executive (constraints on the executive reduce risks for multinationals). These papers together talk about the importance of information - access to meaningful information increase incentives to invest and information about competitor countries influences your own policy responses. The factor of information also links the literature with the previous weeks' readings.

Paper by Basinger and Hallerberg (2004)

The article starts with a saying that "good fences make good neighbors", and, in fact, those fences let governments to operate as monopolistic suppliers of services by taxing and restricting production. However, increasingly often those walls collapse, and governments start to compete for the same resources, that is where, according to the previous literature, "race to the bottom" model inserts itself – governments lower tax rates or restrictive environmental standards and their neighbors do the same to remain competitive. Although the race to the bottom model is strong in theory, the authors say that its empirical evidence is weak. A lot of ink has been spilled on trying to answer the question why race-to-the-bottom scenarios have failed to materialize. Basinger and Hallerberg came up with a new theory and new empirical tests for it. Previous scholars, like Thomas (2000) and Dehejia and Genschel (1999), discovered that tax competition between countries changes as the costs of attracting capital rise relative to the benefits. This is one of the points that the paper seems to borrow from previous literature. Their theory consists of three features: a) they can follow the effects of capital market's globalization as it allows the variation of capital flows to changes in tax policy, b) it incorporates the factor of incomplete information, especially about countries' costs of tax reform and tax reforms determining the capital location, c) it considers the role of domestic politics and institutions as there are political costs for implementing tax reforms. This article seems to develop the central point of Swank's (2002) research that emphasized the domestic political institutions and structures of interest that influence political authorities' policy responses to economic integration. However, Basinger and Hallerberg find that political costs not just reduce a country's incentive to enact reform, but they also reduce competing countries' incentives to reform. That is, the tax competition pressures that economic integration places upon one government's fiscal policies depend on the policy choices of its opponent, which creates the strategic interdependence. This model answers the question of why there is an absence of the race to the bottom. They investigate the tax policy choices in 20 OECD countries from 1980 to 1997.

As discussed, the paper disagrees with the race to the bottom model, where the competition for capital is best presented with the Prisoner's Dilemma, and claims it being too discrete. They improve the model from having two options for countries, cooperate or defeat, by introducing the incomplete information. The problem of incomplete information reminds me of the paper by

Milgrom, North, and Weingast (1990), where this issue was solved by introducing the Law Merchant as the source of information. In this article, however, there is no such body that could provide information about the other country's domestic political costs of tax reduction. The paper, in fact, introduces two reasonable forms of uncertainty, first one being unpredictability of competing country's preferences over tax reform as domestic political characteristics constantly change, and the second one that tax reform can have an uncertain affect on potential investors. This article, as previous literature, recognizes the fact that investors are sensitive to different tax burdens when deciding on the location of their investment, but it also claims that favorable tax treatment is not the only factor determining their choices. This plausible insight considers national resources, immigration laws and other factors, that can possibly be even more influential than taxation, and allows for investors to possess bias for or against investment opportunities in a country, which competing countries cannot observe. I believe it is a very realistic assumption, allowing the article to build a more superior model than the race to the bottom. Also, although the authors prove that there is a linkage between the global economic forces and political environment in a host state, they do not seem to consider that countries might be integrated differently into the global economy. Countries can have different levels of trade openness and capital market liberalization, that is addressed in the article by Mosley and Singer (2008). For instance, a crucial factor for firms investing in Europe is access to the EU Single market, which is a free trade area but also has very low non-tariff barriers because of harmonization of rules, regulations, and free movement of people. If countries differ in terms of economic openness, then free trade area might seem more attractive to multinationals, even if it has less favorable government's policies. Thus, this model might still be tested with more control variables in further study to analyze if there is a difference between countries that are Single market members and the ones that are not.

Throughout the paper the applicability of the model seems to be worrying as they apply the model only to tax reform. However, in the very end they explain how this model can be applied in any reform, such as environmental standards or labor market regulation. In fact, I imagine it being completely suitable in anything from labor skills to transport and infrastructure. Multinationals would invest more in countries with a combination of low wages, but high labor productivity and skills, and lower transport costs to get the goods onto the world market. Therefore, the factor of competition between governments to gain more investment and production can be found in most areas that they are responsible for. In terms of their methodology, when measuring the variables of this research, the article follows Clark and Hallerberg's (2000) research to measure the capital mobility, Swank and Steinmo's (2002) work to measure the tax reform, and they introduce a weighting scheme of three additional weights (GDP, FDI and FCF) that help to evaluate governments' potential competitors. Although they use strong methodological tools, I consider this paper being more theoretical than empirical as empirical part contributes to proving their hypothesis, but their theoretical contribution is more stimulating – they managed to create a very logical substitute for the race to the bottom model, that had long been a puzzle for scholars. Overall, this detailed model provides a significant implication about how country's political situation, combined with the one of its competitors, affect country's decision making in terms of competition for capital, and sets a great example of how politicians must look globally instead of just locally.

Paper by Jensen (2008)

This piece focuses on the relationship between domestic political institutions and political risks for multinational investors. We move from the governments' perspective in the previous article towards the perspective of investors. In the first paper the focus was on how governments see themselves and how they should compete with other states, here it is more about how multinationals see the governments and why they choose for or against investment in their countries. Jansen claims that previous studies capture only the minimal indirect evidence between political institutions and political risk, thus he aims to directly test this relationship. By using new political risk insurance data, he explores the mechanisms linking democratic regimes with lower levels of political risk. The paper is driven by the long-lasting debate trying to answer if democracies or autocracies attract more FDI. In his previous works Jansen (2003, 2006) claimed that democracies attract higher levels of FDI flows and he explained that autocratic regimes are more likely to be poor and more dependent on natural resources. In this article Jansen moves forward and states that the previous literature fails to address the relationship between democratic political institutions and political risk, and he tries to evaluate if this influence is positive or negative.

For the political risk variable, he uses the political risk insurance data from ONDD, the Belgian Export Credit Agency, which directly measures the risk without including other components of firms' investment strategies and is divided into different types of risk - Violence, Expropriation, and Transfer Risk. From these risks he mostly focuses on the determinants of expropriation risk as it has been analyzed the least in previous studies. However, when he explains the risks, he mentions that violence factor is more of a problem in developing and emerging markets, rather than industrialized economies. I believe that is not necessarily true as we witness increasingly more high-profile terrorist attacks and violence even in the mostly developed countries, which means that political risk determinant is important regardless of the level of development. Coming back to the main points, in the empirical part the author analyses observations from 134 countries. He uses the level of development, economic growth, and the level of democracy as independent variables to measure the expropriation risk. Democracy variable is measured according to the Polity IV dataset. However, there are many ways to measure democracy and the author should have possibly included at least one more measure of democracy (like Freedom House) and created another model to see if there is a high degree of commonality between the results. This would help to increase reliability of the results as countries could be identified as more or less democratic according to the used data. The final reading also uses Polity IV but adds political constraints measure by Henisz Witold (2002) to capture the stability of government policy. Then they see in more detail which aspects of democracy are the most crucial for market valuations, according to their results (that being voting rights in their research).

The empirical results demonstrate that democratic institutions lower the levels of political risk, detailing constraints on the chief executive. The level constraints on the executive establishes more welcoming environment for multinational operations. Jansen announces that his introduced mechanism is more specific than the ones of the previous literature on veto players. However, although constraints on the executive are important to reducing political risks for investors, democratic institutions have more features that might reduce these risks. One of the factors is the transparency of policy – transparency and predictability are crucial for foreign investors who must cope with host country's regulatory systems, cultures and administrative frameworks that might be completely different from their own. Transparency provides access to meaningful information and reduces risks and uncertainties as well as opportunities for bribery, also discourages conflicting situations and assist investors when dealing with various rules. Therefore, this research might still be incomplete as it is possible to find many other aspects of democracy that reduce political risks, and constraints of the executive might not be the strongest one.

The article also includes the aspect of natural resources, saying that they lead to higher levels of political risk for all multinational investors, even after controlling for political regime. This idea seems quite reasonable as leaders then are less concerned about their international reputation and are more likely to expropriate. However, in cases like Canada, which is one of the top countries having the most natural resources, the political risk must be low and political stability high by any standards as it receives great numbers of investment. Then maybe there is a different effect of democracy on political risk depending on the *type* of natural resources in host countries. Boschini et al. (2007) find that different types of natural resources have different effects on economic growth. Thus, a question that comes to bear is whether the type of natural resources is relevant in determining the effect of democracy on political risk. For example, if Canada produces oil and the DRC produces diamonds, there are both resources intensive countries, but do they operate under the same mechanism? Thus, it might be the case that not all resources lead to higher political risk, but just one or few kinds of them, then the applicability of the presented idea would be much lower.

The paper concludes that democratic institutions in general lead to lower levels of political risk for multinational investors. However, there might be a differentiation of the quality of democratic institutions, for instance, some might be more corrupt than others, or bureaucratic quality and impartiality of the legal systems in host countries might differ. It would be interesting to see results if we examined the variation of political risk only between different levels of democratic institutions as then the condition expands from that *democracies* reduce levels of political risk, to that *transparent democracies* reduce more political risk, compared to democracies with higher levels of corruption. Thus, the quality of institutions should also be considered in the analysis.

Paper by Mosley and Singer (2008)

This paper is an analysis of political and institutional determinants of equity market performance across countries. The article explains that previous academic works talk about the impact that political factors have on FDI and bond market behavior, but they do not seem to consider the effect on stock markets. Thus, that is what this article aims to do – examine the relationship between government policies and equity-market performance. The scholars compare the previous literature on FDI and sovereign bond markets with equity-market reactions to evaluate their differences to government policies. Their empirical contribution is an evaluation of price-to-earnings ratios in 37 countries in emerging and developed market between 1985-2004 period.

This piece has a clear structure which is very easy to follow: the authors start by explaining why equity markets are important for country's long-term economic development, then after discussing previous literature, they evaluate similarities and differences between markets of equity, FDI and bond, establish their hypothesis and results, and finally, performs the robustness checks. Although it is a quite challenging topic, the authors presented it with a very reasonable structure. The paper backs some of the claims on the previous research by Jansen (2003, 2006), for example, when it talks about the differences between foreign direct investors and equity investors, the latter being not as vulnerable to expropriation and having more ease of exit. Just like in two previous articles, information here also plays a key role. Investors with assets in multiple countries require high levels of information when allocating their assets, thus they need an open political environment to maintain good performance based on relevant information. As democracies are more likely to provide accurate information than autocracies, in this sense, equity investors are like foreign direct investors.

The discussed relationship was most likely not addressed in the previous literature as investing in stock market is not as common as investing in other types of markets. Other financial investors can easily overshadow equity investors in terms of bigger influence on government policy making. Also, most of corporations still rather take a loan from the bank rather than finance themselves with the help of equity investors. Owning stocks is very time consuming as one must research every company to determine how profitable it will be before buying stock, monitor the stock market and similar, not to mention that one can lose the entire investment if he/she buys and sells at the wrong time. Due to its risks and complications, the equity-market remains relatively underdeveloped. Therefore, the economic importance of stock markets (and the effect on government policy) might remain a question for some.

This article represents the variation in the preferences of investors across different types of financial assets. It uses two different models - TSCS model and cross-sectional analysis to test their theoretical contribution. They perform complicated empirical tests and find support for most of their hypotheses. The methodology part is very reasonable and again, detailly explained, but the sample size is smaller by around 100 countries compared to the previous article by Jansen. The larger sample size would give more reliable results with greater precision and power. However, this might come back to the fact that equity-market is not greatly developed across many countries.

Overall, the results presented in these papers are very likely to change over time as economic globalization can influence policies in an increasing number of ways and countries become involved in different kinds of capital markets. Countries relate to each other more in terms of economy, our institutions and markets are becoming increasingly similar, political activities take place at the global level, and all these similarities are most likely to develop even further. As globalization leads to interdependence between nations, for example, increasing number of members of the European Union, they rely on each other more, and have more information about one another than previously.