LESS RISKY INVESTMENT? THE IMPACT OF FEDERALISM ON THE INFLOW OF
FOREIGN DIRECT INVESTMENT

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ABSTRACT
The purpose of this paper is to theoretically outline and empirically investigate a theory linking federalism with the inflow of foreign direct investment into a country. Throughout the literature, the importance of the quality of governance is one of the most prominent factors emphasized in determining the amount of inflow of foreign direct investment into a country. This paper hypothesizes that federalism, as an important determinant of the quality of governance, should exert a significant positive effect on the inflow of foreign direct investment into a country. The causal mechanisms of this theory poses that federalism and decentralization increase the number of veto players in government policymaking thereby increasing policy stability and reducing expected costs for multinational corporations. The contribution of this paper is that it empirically assesses the impact of different dimensions of federalism on the inflow of FDI. In order to conduct this investigation, I use the data available for all countries for the period 1970-2000. I find that while administrative federalism is highly significant in its influence on the inflow of FDI into a country, though only an interactive model of fiscal federalism achieves conventional levels of statistical significance, while political federalism fails to achieve statistical significance in any of the modes. The findings of this research call into question near uniform move towards decentralization in virtually all aspects of governance and point out that in order to attract foreign direct investment, government architects need to be discerning in terms of different types of federalism.