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**Federalism and Foreign Direct Investment:
How Political Affiliation Determines the Spatial
Distribution of FDI – Evidence from India**

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Abstract

This paper links the foreign economic engagement of India's states with the literature on federalism, thereby contributing to an understanding of the political economy of FDI inflows in a parliamentary federal system. More specifically, it studies subnational governments' international engagements to attract foreign direct investment (FDI) and investigates whether the political affiliations of states' chief ministers and parliamentarians determine the spatial distribution of FDI across the Indian states, correcting for the influence of per capita income, population density, urbanisation, infrastructure, policy regime, and human development.

Although the central government plays no direct role in determining the state to which FDI goes, the centre–state relations in a federal structure play a role in creating perceptions about the relative political risk involved in different investment destinations. Employing multiple linear regressions to analyse time-series (2000–2013) cross-sectional (12 states) data using the panel procedure, the study finds that affiliated states attract relatively more FDI per capita in comparison to states ruled by opposition parties or coalition partners. However, some exceptions do result, primarily due to two phenomena: first, the presence of a strong state leadership and, second, the presence of a significant share of members of parliament belonging to the prime minister's party in the non-affiliated states. Further, states ruled by outside supporters have been most successful in attracting FDI inflows during the coalition period.

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Article Outline

1   Introduction

India's embrace of the free-market paradigm in 1991 considerably expanded the economic policymaking autonomy of subnational governments (Kennedy 2013).[1] Weak coalition governments in the 1990s further enhanced state-level incumbents' bargaining weight and the scope of their autonomous actions, unencumbered by the so-called domination of the centre

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1   This study is part of a larger project within a research group – comprising Sandra Destradi, Johannes Plagemann, and myself – that studies the impact of centre–state relations on subnational governments' international engagements in India. The paper has benefitted greatly from the detailed comments and input provided by Sandra Destradi and Johannes Plagemann.

(Nooruddin 2010; Sinha 2007). The overall impact is captured in the term "federal market economy" (Rudolph and Rudolph 2001), which is defined as the rise of the states in arenas of economic decision-making, with shared economic sovereignty and economic decentralisation as the key hallmarks. This phenomenon was unmistakably marked by the centre's diminished influence and the states' enhanced propensity and potential to seize opportunities.

Foreign economic engagement is one such area in which states have increasingly demonstrated a capability to exercise substantial autonomy, especially since the late 1990s (Jha 1999; Singla 2017; Sridharan 2003; Wyatt 2017). Within this broader domain, the scope for states' international engagement to attract foreign direct investment (FDI) is virtually unfettered (Vadlamannati 2012). This is because the union (or central) government itself has been encouraging the states to take steps to improve their business environments and attract investments (Maini 2016). The significance of FDI for a developing country such as India lies in its potential to catalyse economic development, promote employment opportunities, facilitate access to international markets, and generate technological and knowledge spillovers (OECD 2002). From a subnational perspective, foreign capital investments can boost subnational finances and revitalise local economies.

Since 2000, the phenomenon of Indian state governments sending high-level delegations to a number of countries, conducting investment summits, and holding road shows to reach out to foreign investors has been on the rise. Realising the significance of foreign investments, state governments are amending archaic central laws such as the Industrial Disputes Act, the Contract Labour Act, and the Factories Act. Overall, the frenzy to attract investment holds the potential to generate a race to the top[2] among subnational governments (Rossow 2016).

The ongoing liberalisation of FDI policy by central governments – and state governments' efforts to demonstrate impressive performance as FDI hosts – notwithstanding, the first mover in the game is the investor, who must take into account the entire gamut of economic aspects, policy benefits, and political risk factors before proposing investment in a particular location. The goal is to minimise future risks.[3] So far, the empirical literature on FDI in India has focused exclusively on its economic determinants (Kaur and Sharma 2013; Singhania and Gupta 2011); political determinants have been ignored, largely because of the challenge involved in constructing variables to capture political risks (Mukherjee 2011). The present study undertakes this task by taking on the political variables challenge, especially in

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2   A detailed case study of the Indian state of Maharashtra claims that most investors would prefer better infrastructure for industry over the government's incentive schemes (Sen 2011). In real-world situations, a "pure" race, either to the top or to the bottom, is seldom enacted. Generally, the equilibrium lies in a mixed situation, where competing jurisdictions undertake reforms to improve the business climate, while at the same time responding to "downward pressure on tax rates" (Sharma 2012).

3   Future risks or challenges can emerge in the form of contract disputes, failure to honor a sovereign guarantee, expropriation, and political violence.

terms of these variables' relation to FDI decisions. For constructing the variables, in the Indian context, the present study takes into account the complexity of intergovernmental interactions observed in the coalition period (1999–2013). In a coalition system where the national government is composed of the prime minister's party (the party in a governing coalition), the coalition partners' parties, and the outside supporters' party (a party that extends conditional support to the governing coalition), the party identities of chief ministers governing different states play an important role in determining the nature and content of centre–state relations. The states have been classified into four categories: affiliated states (where chief ministers share the prime minister's party identity), aligned states (where chief ministers belong to one of the coalition partner parties), states ruled by outside supporters' parties, and opposition states (ruled by the parties belonging to the opposition party or coalition). In a similar way, the variables capture the fact that India's states send in multiple, conflicting sets of parties to the Lok Sabha, which may or may not correspond with the parties governing those states. This leads us to capture a third factor: the interaction between the majority MP's party and the chief minister's party (which is the majority MLA's party). For further clarification see sections 3.1 and 3.2 and figures 1 and 2.

The remainder of the paper is organised as follows: Section 2 traces the politics of FDI in India, after briefly introducing the wider policy framework. The section presents case studies of FDI in Maharashtra, the richest state, and Odisha, one of the poorest states. The aim is to discover whether there is a pattern in the chain of events or the decision-making process that can then be tested using a wider dataset. Section 3 elaborates on the indicators of "FDI-friendly political situations"[4] in the specific context of coalition politics in India. Hypotheses are formulated in Section 4. Section 5 details the data, methodology, and variables. Section 6 tests the impact of the political variables on per capita FDI inflows, presents the findings, and discusses the regression results. Since the study of political determinants of FDI is relevant only under the assumption of favourable economic conditions (Lewis 1979), the regression analysis controls for several economic factors. The quantitative analysis provides a *telling demonstration* of the effects that centre–state dynamics can have on investment decisions. The study finds that (a) affiliated states receive more than opposition and aligned states (states ruled by coalition partners), except when the prime minister's (PM's) party itself controls a majority of parliamentary seats in a non-affiliated state or the chief minister (CM) is exceptionally strong, and that (b) among non-affiliated states, those with maximum bargaining power vis-à-vis the centre obtain high levels of FDI per capita. This demonstrates that the prevailing political environment plays a significant role in determining the extent to which

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4   An "investment-friendly political situation" is different from an "investment-friendly business climate." The former takes into account the dynamics of regional politics and intergovernmental relations, while the latter is a static notion focusing primarily on policies, ignoring the changing political dynamics within a state and between the state and the centre. Ideally, an investment-friendly state at any given moment will be one with both these attributes.

multinational corporate executives are able to manage governmental involvement at both central and state levels. Section 7 concludes the study.

2 Foreign Direct Investment in India: The Policy and the Politics

Since the early 1990s, India has been progressively liberalising its FDI regime.[5] In 1999, the government of India repealed the conservative and restrictive Foreign Exchange Regulation Act (FERA) of 1973 and replaced it with the more flexible Foreign Exchange Management Act (FEMA) of 1999. The FEMA (Annex B of Schedule 1 to Notification No. FEMA 20) specified all activities/sectors in which foreign investment is allowed under the automatic route – that is, without the prior approval of either the government of India or the Reserve Bank of India (RBI).

Until recently, FDI proposals for activities not covered under the automatic route were vetted by the Foreign Investment Promotion Board (FIPB), Ministry of Finance. However, to boost FDI inflow, that board was dissolved as of 5 June 2017. Thus, the 15 sectors that require prior government approval are now dealt with by the relevant central ministries or departments, in consultation with the Department of Industrial Policy and Promotion, Ministry of Commerce. Presumably, this will expedite the approval process (for an interesting case study on the political manipulation of the workings of the FIPB, see Bhatia 2015). However, this does not mean that political factors will be diluted in any way. On the contrary, the central government ministry can, in fact, be even more susceptible to seeing its counterparts in the states through the prism of party politics.[6]

Existing FDI policy provides incentive schemes for foreign investors. The central government can offer investment allowances, as well as incentives for setting up export-oriented units and units in special economic zones, national investment and manufacturing zones, and so on. Similarly, each state government can frame its incentive policy based on the amount, location, social welfare investment, and employment generation potential of a particular proposal. The incentives range from the stamp-duty exemption for land acquisition or the refunding of or exemption from value-added tax, to exemption from the payment of electricity duty.

The central government plays no direct role in determining the state to which FDI goes; this is decided by the investors. Further, given that the central government itself is encouraging states, it appears that the centre would support FDI inflows to states irrespective of polit-

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5 For an analysis of FDI policy-related issues see Nagaraj (2003), RBI (2011), and Virmani (2004). Shin (2014) showed how the institutional changes in India have influenced FDI inflows.

6 In fact, the entire process – from central government approval (if required) to the filing of an Industrial Entrepreneur's Memorandum, to obtaining various clearances, getting licenses, and other state- and central-level registrations – can be muddied with politics and bureaucratic hurdles.

ical considerations, even initiating measures to help reform laggards catch up with leaders.[7] This would seem logical because India's overall business competitiveness, as well as its macroeconomic stability, increasingly depends on reforms carried out at the subnational level. However, as discussed below, politics trump economic rationales.

Furthermore, in a country such as India, where central and subnational governments and regional parties are frequently at odds, business norms and regulations can be (to put it charitably) in a state of flux. Investors recognise that political power is a critical factor in making investment decisions, in terms of both the timing of proposals and the locations chosen – sometimes to the detriment of the centre, states, and investors (Erol 1985; Kobrin 1978). This was borne out in a survey conducted in January 2014 by the Associated Chambers of Commerce and Industry titled "Policy, Political Concerns Driving Business Anxiety." Of 1,200 corporate executives surveyed for the study, 75 per cent of potential investors considered the unfolding political direction in individual states in India, as well as at the centre, a major factor to be assessed before they made any decision.

The centre–state political dynamic can come into play in different ways. For instance, the central government can be more supportive of development initiatives in some states than in others, displaying scorn on the one hand and blatant favouritism on the other (Badrinath 2014; Hindustan Times 2016). This dynamic can also be triggered, albeit in a very different way, when locals are apprehensive about land allocation, rehabilitation, loss of livelihood and environment, or other similar issues. Because the impact of local protests is beyond the scope of this paper, I simply highlight how centre–state adversarial politics can greatly diminish the possibility of creating a win-win situation for all parties involved. For instance, it has been observed that, on the one hand, a regional wing of the national ruling party can attempt to orchestrate or inflame existing public opposition to the opposition-ruled state government's favourite development projects (for instance, the role of the Congress party in Odisha with regard to mega-FDI projects). On the other hand, a state government can use the centre's favourite projects to fan sentiments against the party in power at the centre, portraying the latter as bent upon imposing anti-people projects on the state (for example, the response of opposition-ruled states toward nuclear power projects[8] and FDI in retail[9]).

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7   Bajpai and Sachs (1999) identified Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu as reform leaders; Haryana, Orissa, and West Bengal as intermediate reformers; and Assam, Madhya Pradesh, Punjab, Rajasthan, Kerala, Bihar, and Uttar Pradesh as laggards.

8   The United Progressive Alliance (UPA II) government had proposed five nuclear energy parks, to be located in Kudankulam in Tamil Nadu, Kovvada in Andhra Pradesh, Haripur in West Bengal, Jaitapur in Maharashtra, and Chhaya Mithi Virdi in Gujarat. Congress-ruled states, such Andhra Pradesh and Maharashtra, facilitated the central government's power projects by clearing land acquisition for their establishment, despite strong protests by locals and environmentalists in both states. However, non-Congress Tamil Nadu chief minister J. Jayalalitha decided to extend her support to concerns raised by the agitators, who demanded that the proposed project be put on hold. The central government further mounted pressure on the state government to facilitate commissioning of the project. On the other hand, a strong coalitional logic was at play when the

2.1 Enron to POSCO: How Things Can Go Wrong

This subsection presents two case studies on the history of FDI in India to substantiate this paper's claim (as elaborated in the introductory section). The purpose is not to investigate allegations of crony capitalism or scandal, which are separate concerns that are outside the scope of this paper. Instead, the focus is on the intricacies of power politics in India in order to clarify the rationale on which the political variables derived for the study are based.

2.1.1 Enron's Dabhol Power Project in Maharashtra

The American energy company Enron signed a contract for the USD 3 billion Dabhol power project in Maharashtra in 1992. This project pioneered foreign investment in the country's energy sector and became the poster child of economic liberalisation in the country. At that time, the Indian National Congress (INC) was in power at the centre, as well as in the state of Maharashtra.

The INC had formed a government in the state in 1990, winning 49 per cent of the seats. The party also controlled 79 per cent of the parliamentary seats. However, a new alliance, the BJP–Shiv Sena alliance, had been on the rise in the state's politics. Embracing the typical anti-establishment role that the opposition plays in India, the BJP and the Shiv Sena vowed to scrap the controversial Enron project in Maharashtra if they came to power. For three years, the two parties propagated the view that foreign power giants were dictating how Maharashtra was governed. In the 1995 assembly election, the BJP–Shiv Sena alliance came to power in the state, winning 48 per cent of the seats. As promised, the new government cancelled the project in August 1995, and Enron went to international arbitration (Sanotra and Jain 1995).

With an opposition party now in control of the state, the centre–state political equation became adversarial. Thus, when international arbitration ruled in Enron's favour, the Congress central government refused to come to the rescue of the state government, despite having counter-guaranteed the payments due to Enron's Dabhol Power Company (DPC) in the event of a default by the government of Maharashtra. However, as of 16 May 1996, the newly formed BJP government at the centre meant that the centre–state political equation was again cordial. Unsurprisingly, negotiations were reopened, and a revised proposal was accepted on

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central government easily allowed its important ally, the Trinamool Congress, to scrap the Haripur coastal nuclear energy park.

9   There was strong opposition, particularly from traders, to the Congress-led UPA II decision to allow 51 per cent FDI in the multi-brand retail sector. Congress-ruled states such as Haryana, Maharashtra, Andhra Pradesh, Rajasthan, Assam, and Delhi welcomed the policy decision. However, non-Congress-ruled states, such as West Bengal, Uttar Pradesh, Tamil Nadu, Bihar, Orissa, Gujarat, and Kerala decided not to implement the decision. Only one non-Congress state (Punjab) supported the decision, and only one Congress-ruled state (Himachal Pradesh) opposed the policy.

28 May 1996, a few hours before the 13-day minority BJP government at the centre was voted out in parliament (Bhushan 2001).

Between June 1996 and December 1997, a 13-party United Front (UF) formed a minority government with outside support from the Congress party. This government proposed immediate action in granting greater autonomy to states in determining development priorities (*India Today* 1996).[10] However, the radical shift could not be achieved, as the government fell in December of 1997.[11] The BJP formed a coalition government on 19 March 1998, but it survived only *13 months. On 10 October 1999, the BJP-led coalition (*National Democratic Alliance [*NDA]) again formed a* government at the centre. On the other hand, on 7 October 1999, the Congress–Nationalist Congress Party (NCP) coalition formed a government in Maharashtra, winning a 46 per cent seat share. Thus, once again, the centre–state relationship became adversarial. This time, the controversy emerged due to the sharp escalation[12] of the cost of energy generated by DPC. In 2000, when the Maharashtra State Electricity Board and the state government defaulted on payments to DPC, the Union government refused to honour the counter-guarantee agreement invoked by Enron. Enron took recourse to arbitration again, criticising the Indian government for not helping Maharashtra state sell the plant's excess power (CNN 2001). Finally, the company decided to pull out of the project.

2.1.2   POSCO and Vedanta in Odisha (Orissa)

In February 2000, the central government approved 100 per cent FDI in the mining sector.[13] With this approval, various foreign companies spotted an opportunity to tap the abundant mineral resources in India's eastern states. In 2005, Odisha (Orissa) – one of India's economically poorest but most mineral-rich states – attracted huge investments from two metal companies: South Korea's POSCO and British-based Vedanta. Both signed a memorandum of understanding with the Odisha government in 2005 to invest USD 12 billion and USD 2.1 billion in the aluminium and steel sectors, respectively. At that time, POSCO's investments in aluminium promised to be the single largest foreign investment in India's history. However, neither of the two projects was really able to take off, thanks to the complicated politics of FDI in India.

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10 The UF government, with a unique 58-MP federal front within the UF, emerged as the most ardent proponent of a "strong states, soft centre" structure. Interestingly, Prime Minister Deve Gowda, as Karnataka chief minister (1994–1996), had faced the centre's apathy for power projects in the state.

11 The Congress party, as outside supporter, kept the United Front government on tenterhooks, forcing the removal of Deve Gowda as the prime minister on 30 March 1997, and then withdrawing support from I.K. Gujaral's government in December 1997.

12 The escalation was due to depreciation of the Indian rupee and an increase in the price of fuel (naphtha). For details, see Srinivasan (1996).

13 The Indian mining sector was opened up to FDI in 1993. In 1997, up to 50 per cent foreign equity participation in mining projects was permitted. In February 2000, 100 per cent FDI was allowed in exploration and mining of gold, silver, and minerals other than diamonds and precious stones.

Interestingly, since 2000 Odisha has been ruled by a regional party called Biju Janata Dal (BJD), which is not part of either of the two national alliances in India – that is, the United Progressive Alliance (UPA) and the National Democratic Alliance (NDA).[14] Thus, the political status of the state since 2004, vis-à-vis the centre, has been designated as opposition. The configuration did not change after the 2014 general elections. This makes the Orissa story a relatively straightforward example of the central government's discrimination against an opposition-ruled state (*Business Standard* 2010, 2012, 2015a; *Hindustan Times* 2004, 2016; Outlook 2015; *The Hindu* 2012; *The Telegraph* 2011).

The BJD–Congress fight over Vedanta and POSCO is well recorded in the authoritative print news media (Bose 2013; Business Standard 2010; Thomas 2013). The bitter conflict led the state's ruling party to organise a vigorous campaign called "Save Orissa" in September 2010, in reference to which the state finance minister made a stunning statement:

> The central government led by the Congress has hatched a conspiracy to block various developmental and industrial projects in the state. The Congress is shedding crocodile tears for tribals. (IANS 2010)

Throughout the UPA's term in office, Orissa CM Naveen Patnaik routinely accused the central government of adopting a "step-motherly" approach, attempting to stall his efforts to attract private investment that could assist both industrialisation and job creation in the state (DNA 2010). The CM also claimed that the Congress party – in an attempt to recreate its support base in the state – was resorting to petty politics under the guise of tribal rights and environmental concerns. He never lost an opportunity to highlight the way in which the Congress-led UPA government allowed the neighbouring Andhra Pradesh (governed by an affiliated CM) to set up a multipurpose project at Polavaram, despite similar environmental and human rights concerns. The situation did not improve after the BJP-formed government at the centre in 2014. The Orissa government's requests to expedite approvals for mining licences again fell on deaf ears.

Odisha, a non-affiliated state, governed by a strong regional leader, had received the highest FDI in the country in 2009. However, the centre–state conflict (or the Congress–BJD spat) that followed this impressive performance eventually *scared* off *potential investors, to the extent that the state's reputation as a* destination for FDI *fell from the top in 2011–2012* (The Indian Express 2012) to the bottom in 2015 (*The Pioneer* 2016).

Finally, in 2017, POSCO walked away from the plans for the steel plant and associated infrastructure in Odisha (*Livemint* 2017). Vedanta found a way to manage its refinery by sourcing bauxite from other states, such as Gujarat and Chhattisgarh – but at a reported loss of USD 14 million per month (*Business Standard* 2015b).

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14 The BJD president and Odisha chief minister Naveen Patnaik decided to break away from the NDA on 7 March 2009.

2.2 *What Can We Learn from These Case Studies?*

The case studies discussed above provide insights into intergovernmental issues vis-à-vis FDI reforms in India. They reveal that investors quite often find themselves stuck in intergovernmental disputes over the various clearances required. Note that the negotiation phase of an investment typically includes *lobbying* at different levels of government, and making financial contributions to political actors. However, in the context of intergovernmental standoffs or a lack of synergy, as evident from the case studies presented in the previous section, the negotiation period can be unduly prolonged. Moreover, the process can be disrupted by a change of *government at either level, making an investor susceptible to* renegotiation of the terms of investment. Furthermore, the imperfect enforcement of contracts amid intergovernmental power struggles ensures that the *ex ante* signing of a contract is no guarantee of *ex post* compliance. The case studies also show that a stage can come when the cost incurred in monetary assets and time can surpass the anticipated benefits, leading investors to withdraw from such projects, made unprofitable by delays. This is a no-win situation as the state (and the country as a whole) also loses credibility as an attractive investment destination.

3 The Federal Political System Meets the Coalition Party System: Investors' Dilemma of Safeguarding Investments from Political Risk

The discussion in this section, along with the preceding discussion on the politics of FDI, is intended to serve as a foundation for the construction of political variables and testable hypotheses. Figure 1 presents a bird's-eye view of the way in which India's federal parliamentary system is organised.

3.1 *India's Federal Parliamentary System*

India has 29 states, six union territories, and one National Capital Territory (Delhi). Each state is divided into parliamentary constituencies, and each parliamentary constituency is further divided into state legislative assembly constituencies. During a state assembly election, the candidate in each assembly constituency who wins the highest number of votes becomes the member of the legislative assembly (MLA) for that constituency. The leader of the political party with the most winning MLAs becomes the CM of the state. During general elections, the candidate in each parliamentary constituency who wins the highest number of votes becomes the member of the lower house of the parliament (MP) for that constituency. The leader of the political party/coalition with the most winning MPs from all states becomes the PM of the country. Each parliamentary constituency, governed by an MP, can have up to nine legislative assembly constituencies, which are governed by the MLAs (see Figure 1).

Figure 1. India's Federal Parliamentary System
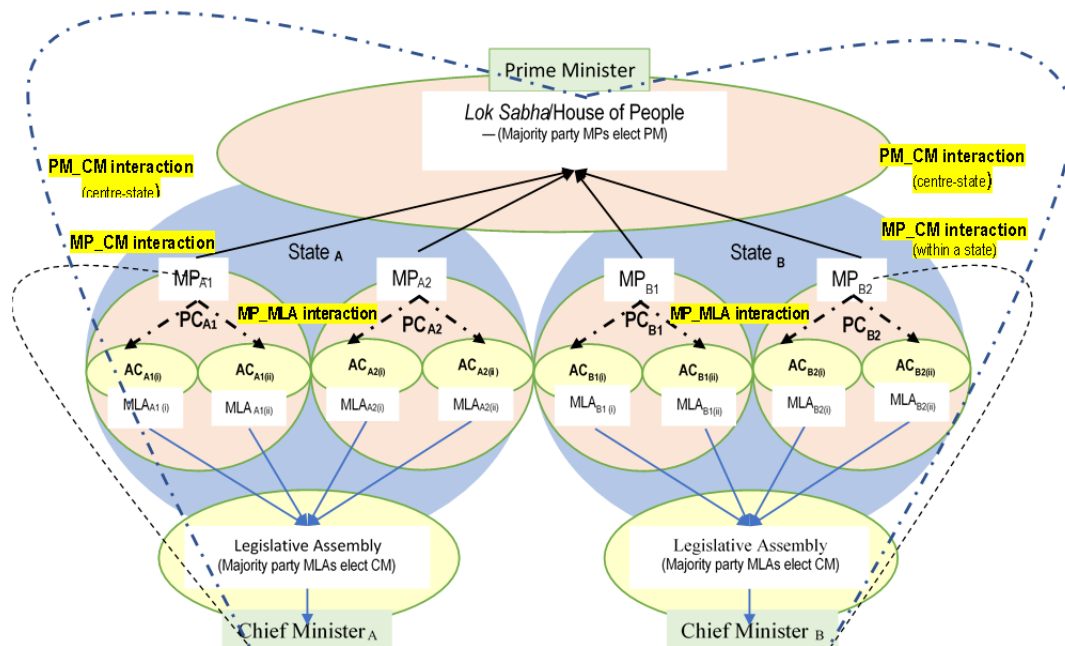
Note: This is a simple hypothetical diagram displaying two states (A and B) governed by chief ministers. Each state is shown to have two parliamentary constituencies (PCs 1 and 2) governed by MPs. Each parliamentary constituency is further shown to have two assembly constituencies (ACs (i) and (ii)) governed by MLAs. The dotted lines represent interactions between representatives. (PC: parliamentary constituency; AC: assembly constituency).

The FDI-specific point of interest here is that an MP stands to benefit from a project located in his/her parliamentary constituency. If this MP belongs to the PM's party, the investor can be sure of receiving the central government's support along with that of the state government. If this affiliated MP is also a minister, the likelihood of central government support increases all the *more*. To substantiate this logic, a recent statement made by external affairs minister Sushma Swaraj, who called for greater investments in Madhya Pradesh, is worth quoting in full:

> My parliamentary constituency, Vidisha, falls within this state, and Budhni, the assembly constituency of state's Chief Minister Shivraj Singh Chouhan, also falls within my constituency. So, those making investments here will avail *special benefits* … the ministry helps the investors going to other states, but those investing in Madhya Pradesh will get *direct assistance* from the foreign minister herself. (Zee News 2016)

3.2   The Coalition Era in Indian Politics

This paper studies the coalition period (2000–2013), which includes three governments: the NDA (1999–2003), and UPA I and II (2004–2013). During this period, state-based parties succeeded in not only forming state governments but also winning enough parliamentary seats to influence national politics (Schakel and Swenden 2016).[15] Thus, national parties seeking to

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15 Schakel and Swenden (2016) demonstrated that voters in India during the coalition era opted for state-based parties not only in state elections but also in national elections.

form governing coalitions had to bargain with state parties. The latter then used their bargaining powers as important coalition partners and outside supporters of the national ruling coalition to obtain policy benefits for their own state constituencies.[16] It has been widely observed that intergovernmental bargaining was at its peak in India during the coalition era (Rodden 2006; Sharma 2015 2017; Swenden 2016; Varshney 2013; Wibbels 2005).

During the period under study, a coalition of parties (either the NDA or the UPA) formed the national government, with the leading party being dependent on junior partners to ensure stability. Further, different parties ruled different states; some shared power at the centre (aligned), some provided outside support, and others sat in opposition. The dataset used in this study indicates that during this period only 24 per cent of state governments shared the PM's party affiliation.[17] The emergence of new categories of non-affiliated CMs and members of parliament (MPs) belonging to the coalition partners' and outside supporters' parties – in addition to those belonging to the two general categories; namely, the PM's party and the opposition party – had significant implications for India's federal market economy during this period. Figure 2 shows that there are many different ways in which CM–MP interaction can appear in a state.

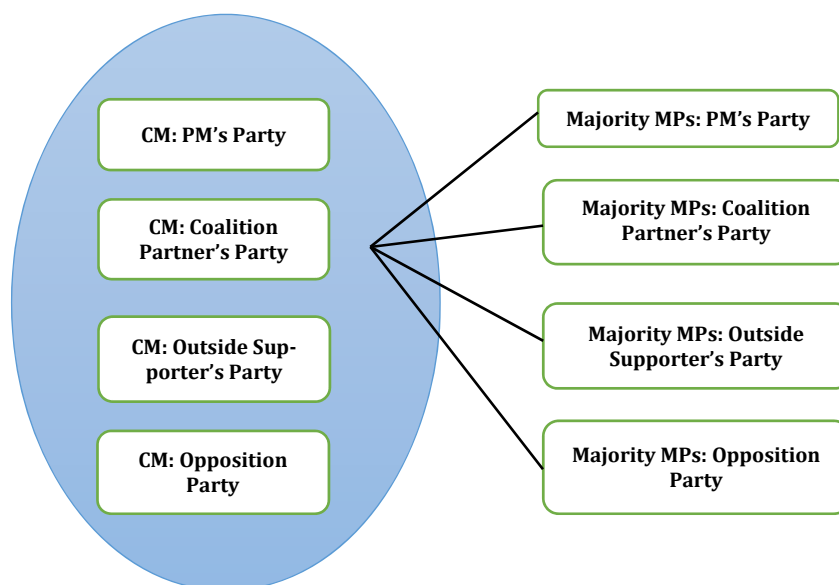**Figure 2. CM–MP Interaction during the Coalition Era**

Figure 3 shows the duration for which each of the 12 major states under study was controlled by either the affiliated party or non-affiliated parties (that is, coalition partners' parties, out-

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16 For instance, state-based parties such as Trinamool Congress, All India Anna Dravida Munnetra Kazhagam, Dravida Munnetra Kazhagam, and Telugu Desam Party (TDP) have effectively played pull-out threats to receive favours from the formateur – the account of TDP blackmailing the NDA government during the period 1999–2004 being the most famous and telling. The party, with its brigade of 28 MPs, was the outside supporter, and the TDP supremo Chandrababu Naidu often threatened to review the party's support for the NDA coalition to get his costly demands accepted.

17 The percentages have been calculated based on the dataset, which includes 14 major states only, from 1996 to 2013.

side supporters, and opposition parties) during the 14 years of coalition (2000–2013). This time period also presents an interesting phenomenon in which the majority of MPs (as a percentage of the parliamentary seats allotted to a state) and MLAs (as a percentage of seats in the legislative assembly) in a state belonged to rival parties.[18] The implications of these attributes have been factored into the political variables constructed for this study.

Figure 3. Control of Chief Ministership by Affiliated vs. Non-Affiliated Parties during the Coalition Era
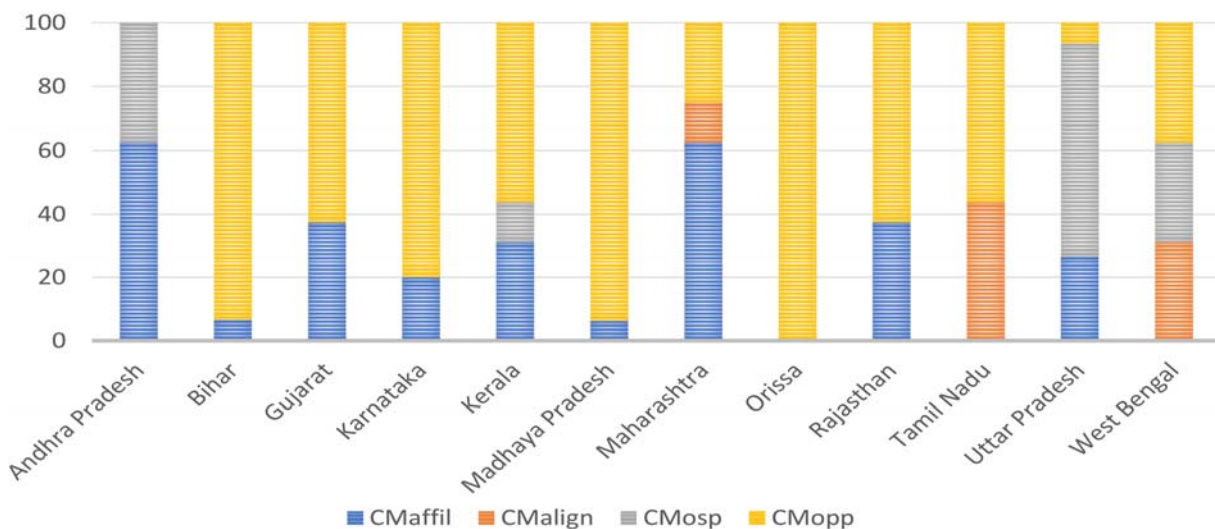
3.3 What Is "Political Risk"?

It has been argued that greater political risk – especially an unpredictable change in the political environment in which an investment decision was made – deters foreign investors. Note that political risk has been defined in the literature based on a variety of factors, such as government interference (Jiménez, Luis-Rico, and Benito-Osorio 2014), incomplete transactions leading to frequent changes in terms of agreement (Sottilotta 2015), political corruption (Osabutey and Okoro 2015), political events such as violence and terrorism (Howell 2007; Osabutey and Okoro 2015), and political instability – for example, an unexpected change in government leadership (Le and Zak 2006). Overall, political instability, measured as the probability of a change of government, has been found to be negatively and significantly correlated with FDI (Kobrin 1978; Le and Zak 2006; Lewis 1979). However, proxies such as the number of strikes, violence, person-days lost, and so forth, have given mixed results. In fact, based on how terms such as political stability and risk are defined and measured, the litera-

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18 In my sample, this phenomenon (majority MPs and majority MLAs belonging to rival parties) was evident in 71 out of 234 observations. This happens not necessarily because voters distinguish between parliamentary and assembly elections, but, in all likelihood, because the two elections are not concurrent, and swing occurs from one election to another based on the voters' assessment of their last electoral choice. However, there are also instances in which voters have voted differently despite the two elections being held close together.

ture has offered conflicting results. For instance, Schneider and Frey (1985) found an *inverse* association between the two variables, while Jaspersen, Aylward, and Knox (2000) and Hausmann and Fernandez-Arias (2000) found no correlation.

I argue that the term "political risk" is context-specific. Any attempt to arrive at a "universal" definition could be perilous. One needs to capture the factors peculiar to a country and its prevailing political situation Thus, my application of the notion of political risk here is unique to the political dynamics pertaining to politics in a federal parliamentary system. Specifically, the stated research problem is situated in the context of coalition politics in India, which has a federal system with centralising tendencies. The FDI-friendly political situation would be the one that mitigates political risks after the signing of the contract or during the construction or operation phase. The risks include a reduction or elimination of ownership of rights to the insured investment, or outright confiscation; the government's breach of a contract with the investor; or politically motivated acts of violence.

3.4 The FDI-Friendly Political Situation: Construct and Variables

Based on the lessons drawn from the case studies, I argue that, for a foreign investor, future political risk – after the signing of a contract – can emerge from above (national government) and/or from below (local civil society actors). It can also arise from a change of government at either level. At the most basic level, it appears that strong state leadership is the best safeguard against the threat from below, while the state being governed by the PM's party itself is the best safeguard against the threat from above. However, making project negotiations immune to electoral cycles is somewhat tricky. Based on my understanding of the role of federal system and coalition politics in India, I create the following continuous, categorical, and interaction variables to capture and measure several effects that might contribute to creating an "FDI-friendly political situation" in a state.

3.4.1. State Executive's Legislative Strength: The Leadership Effect

A weak CM, dependent on the support of other small-party legislators or independent MLAs, cannot implement reforms that entail considerable socio-economic upheaval in the short run. On the other hand, a CM who has a strong support base in the state is less likely to be vulnerable to such adverse reactions. The assumption is that winning a high number of seats is an indicator of a leader's charisma, which can be used to *rally people behind* a policy or a cause. The role of Gujarat's former CM Narendra Modi is a telling demonstration of this effect. Modi, having strong support in the state legislature, was able to make a series of independent decisions to address the controversies and violent protests that mired construction of the Narmada Dam (Sardar Sarovar Dam). Modi, using his uncanny ability to define and control the political narrative and sell radical changes, not only diffused the opposition but also took credit for completion of the dam (Bal 2012; *The Indian Express* 2014; Wallace and Roy 2011, p. 179). The CMs of Andhra Pradesh (*Business Standard* 2016; *The Hindu Business*

Line 2002) and Madhya Pradesh (*Times of India* 2012) also met with similar success in implementing controversial projects in their respective states. Empirically, then, I take the percentage of seat share won by a CM's party in the state as an indicator of the strength of a CM's leadership and the stability of his/her government.

3.4.2 Prime Minister's Core-Support State: Core-Affiliation Effect

Cases *such as that discussed above are* not the norm in India, making the risk of expropriation an ever-*present possibility*. Barring a few exceptional state leaders who allowed controversial projects to survive while maintaining a hold over their party, most state leaders face hurdles from central-government agencies (especially if the relation between the two is adversarial) and competition from one or more parties in the state that have a reasonably strong support base.

Investors prefer their projects to be immune from acrimonious intergovernmental *squabbles* and political interference. The centre–state political equation is significant, in that investors need to receive various clearances through the central government. Thus, a reasonable assumption is that a project with support from the PM's party, as well as the CM's party, would have the highest chances of survival and success.

It is quite logical to assume that a core-support state – where majority MLAs, as well as MPs, belong to the PM's party – would be the safest. Investing in a core-support state – where the CM belongs to the PM's party – reassures investors about policy continuity and political stability (*The Economic Times* 2017). Such perceptions play a role in determining investment locations in a federal polity. Empirically, I interact affiliated CM with the percentage of parliamentary seats occupied by the PM's party.

3.4.3 A Non-Affiliated State Providing Strong Parliamentary Support to the PM's Party: Shared-Rule Effect

Core-support states were exceptions during the study period (the coalition era). It is important to note here that during this period, 76 per cent of states were controlled by non-affiliated parties (see Figure 1 and footnote 11). As intergovernmental interactions became a function of coalition politics (during which a vast majority of states were not controlled by the PM's party), the nature of interactions depended on the types of political parties involved (coalition partners, outside supporters, opposition or affiliated parties) and the extent to which they were willing to cooperate. Thus, the question related to the coalition era is what type of non-affiliated state is safest in the eyes of potential investors?

The probable answer is that if at the time of negotiations with a non-affiliated CM the majority of parliamentary constituencies in that state are controlled by the affiliated MPs, the chances of future political hurdles are probably minimal. This situation gives investors an opportunity to bring both parties to the negotiating table simultaneously, thereby minimising the potential for future trouble. Furthermore, given that the presence of a high number of

MPs belonging to the PM's party in a non-affiliated state is also indicative of the PM's party being another credible power contender, the ex ante negotiations would not be subject to revision with the change of state government. Thus, becoming immune to electoral cycles is another benefit of investing in this type of state. Empirically, I interact non-affiliated CMs with the percentage of parliamentary seats occupied by the PM's party in their states. I label this effect "shared-rule effect" and this category of state "low-risk state" because political risk, at least theoretically, is negligible for the reasons alluded to above.

3.4.4 Chief Minister Shares the Party Affiliation of the Prime Minister: Chief Minister's Affiliation Effect

Here, I focus exclusively on the CM's affiliation, irrespective of the party identity of majority MPs. There are four groups of CMs in the coalition era: CMs belonging to the PM's party CM_{affil}, CMs belonging to the coalition partner's party CM_{align}, CMs belonging to the outside supporters' party CM_{osp}, and CMs belonging to the opposition party CM_{opp}. Of these, the state that can guarantee the necessary political safeguard, to an investor, against the eruption of centre–state conflict, would be the one where the CM shares the party affiliation of the PM. This is called "partisan favouritism," or, conversely, the discrimination thesis (Sharma 2017).

3.4.5. State Executive's Bargaining Strength vis-à-vis the Centre: The Bargaining-Power Effect

When a formateur decides to extend a purportedly unexplained bounty to a state government, s/he does so within a strategic context, with an eye to coalitional support. Thus, another relatively safe non-affiliated state for investment purposes is fairly obvious: the one with the greatest bargaining power vis-à-vis the central government. This would be a state in which the CM belongs to a party that provides support to the ruling coalition, either as a junior coalition partner (CM_{align}) or as an outside supporter (CM_{osp}).

4   Hypotheses

The overarching premise of this paper that political risk factors are an important consideration in investment decisions is apparent from the preceding discussion. In this section, I break down this presumed relationship in a way that can be tested using empirical data. The predictions are derived from existing theoretical and empirical literature and tailored to the Indian context during the coalition period.

First, strong leadership, especially in times of economic reform, appears to be a major ingredient in steering the economy toward success (Brady and Spence, 2010). Basu and Srinivasan (2002), in their case studies, found strong leadership to be an important determinant of FDI. I take the legislative strength of a state leader as a proxy for the leadership effect, as explained in the previous section.

The empirical prediction is as follows:

H1: *Leadership effect* – The greater a state CM's party's share of seats in the State Assembly, the more FDI this state will receive.

Several studies have found a negative correlation between political instability and FDI – or, conversely, a positive relationship between political stability and FDI – in their regressions (Howell and Chaddick 1994; Kobrin 1978; Lewis 1979; Sottilotta 2013). For the Indian-style federal system, I identify a variable that can safeguard against future risk arising from a change of government at either the central or the state level. This is a state where majority MPs share the PM's party affiliation but the CM belongs to one of the non-affiliated groups (affiliated MPs in a non-affiliated CM's state). I call this variable a "shared-rule effect" and take this as a proxy for political stability (see Section 3.4.3 for detailed logic behind this variable).

The empirical prediction is as follows:

H2: *Shared-Rule Effect* – The greater the proportion of affiliated MPs (belonging to the PM's party) in a state governed by a non-affiliated CM, the more FDI this state will receive.

The third set of empirical predictions tailor the majority-party-legislator hypothesis (Baron and Ferejohn 1989) to India's institutional environment. If the leading party in a coalition is biased toward its own party members, as the majority-party-legislator hypothesis articulates, then this type of state should be an attractive destination for investors.

The empirical predictions are as follows:

H3a: *Chief Minister's Affiliation Effect* – States governed by the PM's party will attract more foreign direct investment (irrespective of the affiliation of MPs).

H3b: *Core-Affiliation Effect* – The greater the proportion of affiliated MPs (belonging to the PM's party) in a state governed by an affiliated CM, the more FDI this state will receive.

Finally, if the PM's party demonstrates high vulnerability to acts of blackmail by pivotal junior partners in the legislature, as the pivotal-legislator hypothesis (Gamson 1961; Schofield 1976) articulates, then investors should also perceive the states ruled by such pivotal coalition partners as relatively safe destinations.

H4: *Bargaining-Power Effect* – States ruled by outside supporters/coalition partners will attract more foreign direct investment because they can potentially extract required clearances relatively easily, having the potential power to otherwise orchestrate the national coalition's downfall.

5 Data and Methodology

This study is based on a sample of 12 major states in India, accounting for more than 83 per cent of the Indian population. The source of the data on FDI is the RBI, which provides regional-office-level data rather than state-level data. Thus, in some cases, one regional office provides aggregate data pertaining to more than two states. For instance, the regional office

of Guwahati includes combined data for all north-eastern states (Assam, Arunachal Pradesh, Meghalaya, Mizoram, Nagaland, and Tripura), while the regional office of Chandigarh includes Chandigarh, Punjab, Haryana, and Himachal Pradesh. I have included those 12 states in my sample for which the overlap, as noted here, is negligible. I have excluded the small state of Goa, which was upgraded from Union Territory status in 1987.

The unit of analysis has two dimensions: cross-section (12 major states) and time-series (14 years of the coalition period). This study employs multiple linear regression to analyse the time-series cross-sectional data using the panel procedure. Based on the results of the Hausman specification test, I decided to use a fixed-effects estimator. Further, depending on the results of the modified Wald (group-wise heteroskedasticity) and Wooldridge (autocorrelation in panel data) tests, White's heteroskedasticity and autocorrelation consistent standard errors were employed.

The set of socio-economic control variables (see Section 5.3) comprises lagged values (the previous year's value) of six regressors. Lagging not only avoids endogeneity issues, but also factors in the lag between a foreign investment decision and its implementation. To address the issue of skewness in the dependent variable (per capita FDI), a logarithmic transformation has been used.

The general functional form of the models can be presented as:

$$Investment_{it} = C_i + \beta_1 Mkt_{it} + \beta_2 Urb_{it} + \beta_2 Infra_{it} + \beta_3 HD_{it} + Exp_{var_{it}} + \varepsilon_{it} \quad (1)$$

where $Investment_{it}$ is the investment value (FDI); Mkt_{it} represents market size, including income level and population density; Urb_{it} represents the level of urbanisation; $Infra_{it}$ represents the infrastructure; HD_{it} represents the human development indicators of the i_{th} state during the t_{th} period of time; $Exp_{var_{it}}$ are the key explanatory variables; $\beta_1, \beta_2, and \beta_3$ are corresponding coefficients of the given variables; C_i represents the state-specific individual effects; and ε_{it} is the error term.

5.1 Dependent Variable

The dependent variable in this study is FDI inflows per capita. The data also have certain limitations. They include "equity capital components" only, leaving aside other components of FDI: reinvested earnings, intra-company loans, and other capital (for details, see Srivastava 2003). However, the equity capital component is the most significant, as it represents risk capital staked by investors and is not subject to repayment. It is interesting to note that FDI began to grow only after 2004; prior to this, the magnitude of FDI was comparatively insignificant (Figure 4).

Figure 4. FDI Inflow since 1991, Total and Equity Component
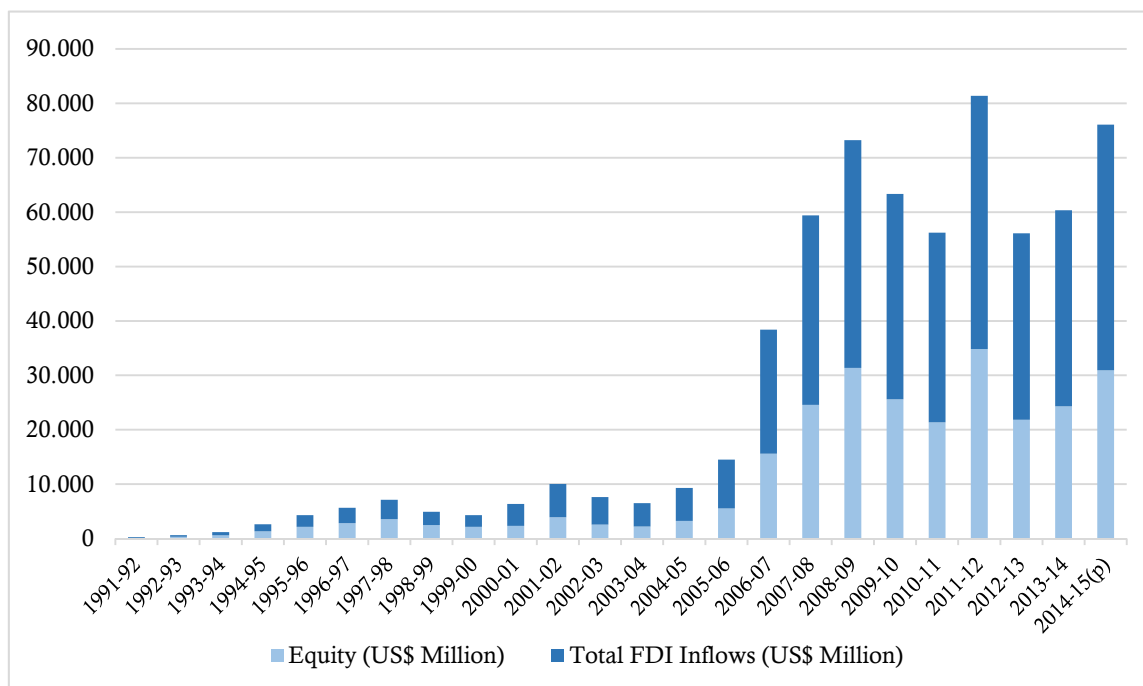
5.2 *Explanatory Variables*

The explanatory variables are derived directly from the discussion on political safeguarding. These are

a) *Leadership Effect or State Executive's Legislative Strength* ($CM_{strong_{it}}$): This variable is measured as the percentage share of seats occupied by the CM's party in the i_{th} state legislative assembly during the t_{th} period of time.

b) *Core-Affiliation Effect ($CM_{affil} * MP_{affil_{it}}$)*: This is an interaction variable where I interact the affiliated CM of the i_{th} state during the t_{th} period of time with the percentage of parliamentary seats controlled by the PM's party in that state during the same period.

c) *Shared-Rule Effect ($CM_{opp} * MP_{affil_{it}}$)*: This variable depicts a "high parliamentary support non-affiliated state." This is an interaction variable where I interact the non-affiliated CM of the i_{th} state during the t_{th} period of time with the percentage of parliamentary seats controlled by the PM's party in that state during the same period.

d) *CM's Affiliation Effect versus Bargaining-Power Effect:* I measure these two effects by creating group dummies for the party affiliation of CMs. In other words, the impact of party affiliation of CMs is estimated using the categorical variable of the CMs' party affiliation. To prevent multicollinearity, I have used CMaffil as the reference group.

5.3 *Control Variables*

The set of control variables comprises six regressors, which are as follows:

a) Log of Per Capita Net State Domestic Product (NSDP) in Constant Prices: The empirical literature on the subject has identified per capita GDP as the most robust determinant of

FDI (Asiedu 2002; Chakrabarti 2001; Schneider and Frey 1985; Tsai 1994). The high positive correlation between FDI and the per capita GDP growth implies that it is an important variable to control for (Figure 5).

b) Population Density: This variable, along with per capita income, is considered an indicator of market size. It implies the availability of a concentrated consumer and labour market (Billington 1999). However, it is relevant only in relation to high per capita income because population density in the presence of low per capita income would not deliver the intended "market size" effect (Asiedu 2002).

c) Log of the Share of Rural Population: The decline in rural population share in the total population is an indicator of urbanisation (Figure 6). In the empirical literature on FDI, this variable has been positively correlated with FDI. In India, "rural" is synonymous with a lack of basic amenities and infrastructure. Urban areas usually include better facilities, good infrastructure, and higher purchasing power capability. All this makes regions with greater expanses of urban areas and limited pockets of rural areas quite attractive to investors (Heid and Ries 1996; Henderson 2002).

d) Per Capita Availability of Electricity (in Kilowatt Hours): This variable has been used as a proxy for infrastructure (Figure 7). This is, in fact, the most effective indicator of infrastructure, which otherwise includes many dimensions, such as roads, ports, railways, and telecommunication systems. Empirical literature has shown a broad consensus that better infrastructure, especially in the developing-country context, attracts more investments (Ancharaz 2003; Asiedu 2002). However, in a country such as India, there can be other factors that attract investments into a state lacking adequate infrastructure. For instance, Odisha is an attractive investment destination due to its abundant natural resources, despite being one of India's poorest states.

e) Own Tax Revenue as a Ratio of NSDP: The impact of any one specific tax regime on FDI is uncertain,19 although empirical evidence has suggested that subnational governments respond to the high tax sensitivity of mobile tax bases by competing to offer the lowest tax rate (see Cai and Treisman 2004). In low-income countries, where some states do not have much to offer in terms of, for instance, infrastructure or human capital, tax incentives could be employed to attract investors. Back in 1999, when the FDI competition among Indian states had just begun, the West Bengal finance minister proclaimed that his new package of investment incentives was intended to win the sales-tax-rate war with other states (Mitra 1999).

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19 Some studies have reported a positive correlation (Swenson 1994), some negative (Cassou 1997; Grubert and Mutti 1991; Hartman 1994), and still others no significant correlation (Jackson and Markowski 1995; Wheeler and Mody 1992).

f) Death Rate: The FDI literature contends that human capital is an important determinant of FDI (Noorbakhsh, Paloni, and Yousef 2001). I use the death rate as an overarching variable for the quality of life and human development (Figure 6). In addition, this variable is an important indicator of the quality of health infrastructure and, in the context of a developing country such as India, captures the impact of literacy as well. Indeed, the empirical literature has found a strong, positive correlation between the literacy rates and life expectancy (decline in death rates) of a country. Even in my sample of 12 states from 2000 to 2013, the strong negative relation between the two is conspicuous (figures 8 and 9). Thus, I use only one – the death rate.

Figure 5. Per Capita Income as a Determinant of FDI in Indian States
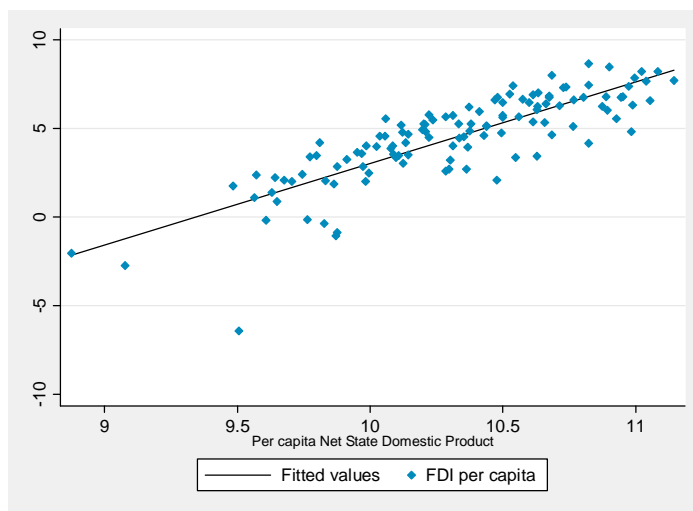
Figure 6. Share of Rural Population as a Determinant of FDI in Indian States
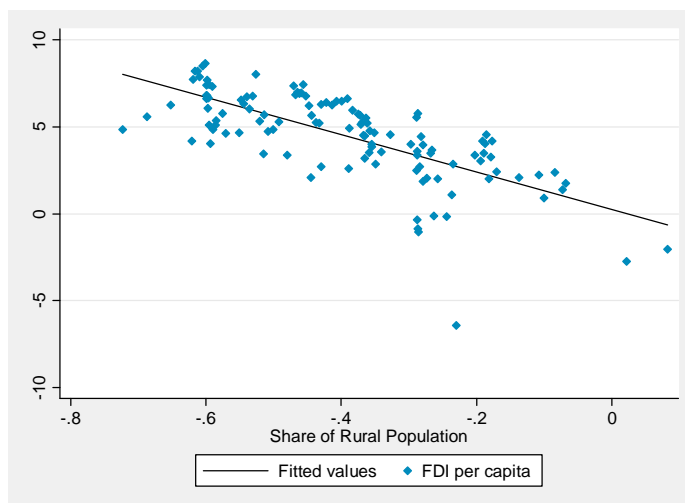
Figure 7. Availability of Electricity as a Determinant of FDI in Indian States
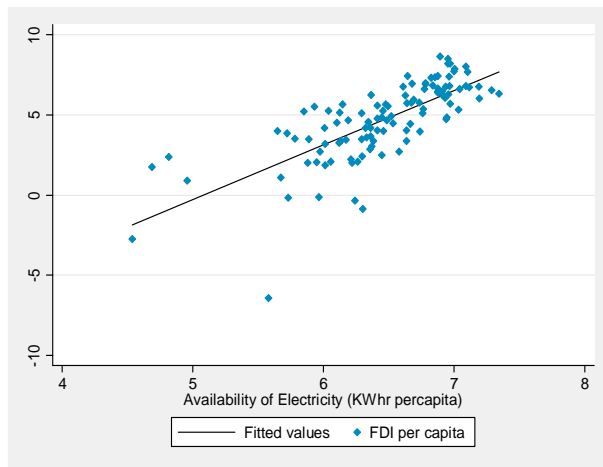
Figure 8. Human Development Indicators (Death and Literacy Rates) as Determinants of FDI in Indian States
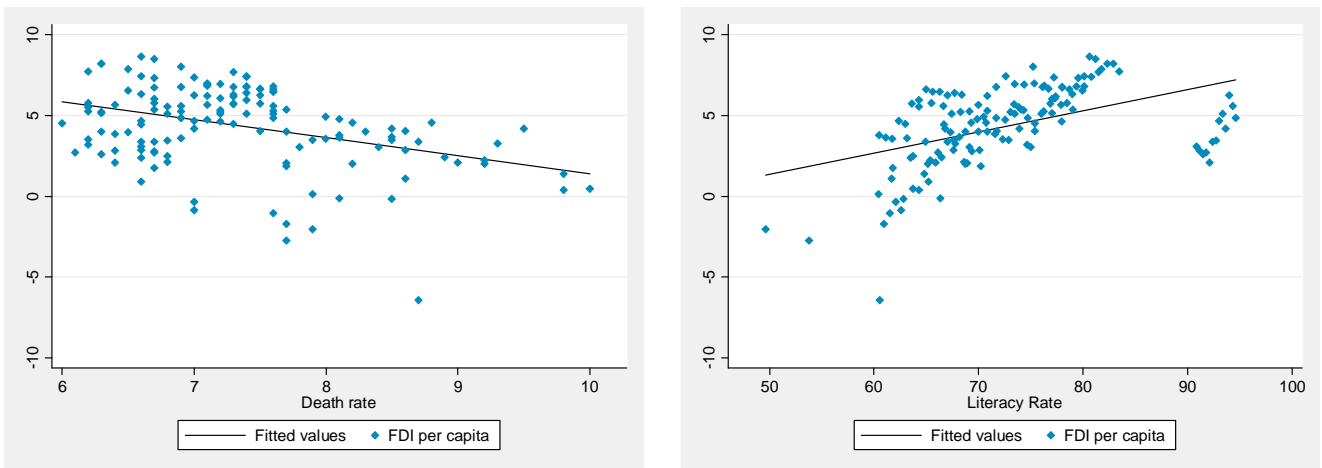
**Figure 9. Negative Correlation between Literacy Rates and Death Rates in Indian States**
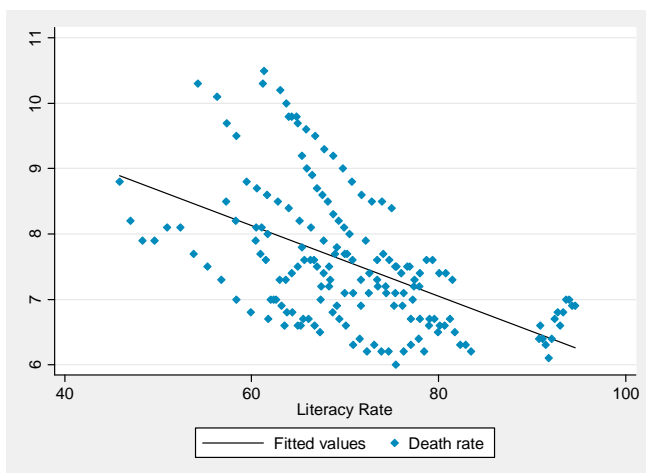
6 Findings and Discussion

It is important to note that in terms of FDI, the interstate disparity in India is huge (Figure 10). This can be attributed to variation in the key determinants of FDI themselves, as noted above. Broadly, the disparity in FDI more or less corresponds to the disparity in income (Figure 11). Controlling for such variables, in the present study I aim to obtain results that show the influence of political variables on FDI inflow.

Figure 10. Regional Disparity in FDI Inflows Per Capita
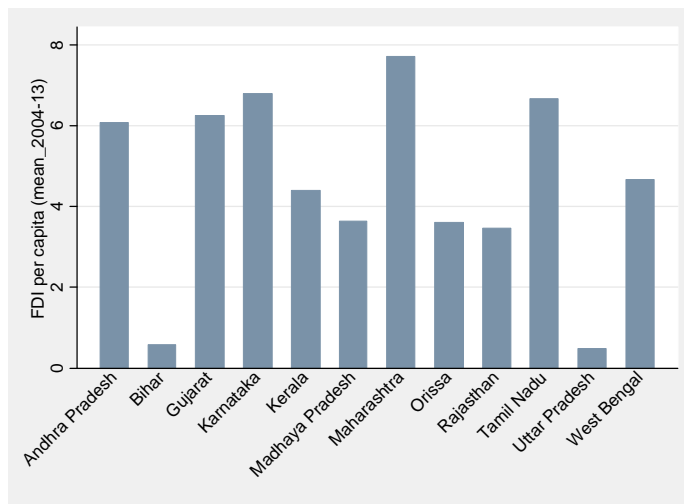
Figure 11. Regional Disparity in Per Capita Income
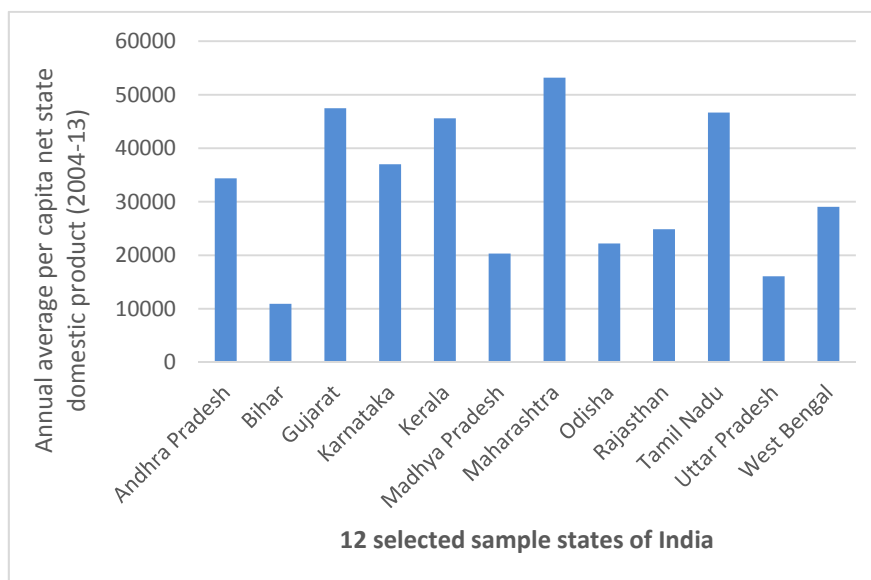
A cursory look at the data reveals that during the NDA period, especially from 2000–2003, large states such as Bihar, Odisha, and Uttar Pradesh did not receive any FDI, while overall FDI inflows to other states in my sample, except Maharashtra, were meagre at best. In fact, the

inflow of FDI picked up only after 2004. Competition among states to attract FDI had also not yet begun. Thus, it is more sensible to focus on the post-2004 period for reliable results.

However, to ensure the completeness of the study, I proceed as follows. First, I test the impact of group dummies (CM_{align}, CM_{osp}, and CM_{opp}) for the entire duration (2000–2013). Then, I test the three variables – state executive's legislative strength ($CM_{strong_{it}}$), core-state ($CM_{affil} * MP_{affil}$) and shared-rule effect or low-risk state ($CM_{not_{affil}} * MP_{affil_{it}}$) – for the UPA period, controlling for the effect of the NDA period by generating group dummies. Finally, I test all these variables for the UPA coalition period alone, while running several model specifications. Interestingly, the results are consistent across all specifications.

Table 1. Per Capita FDI (Log) during the Coalition Era (2000–2013): A Test of Hypotheses H_1, H_2, H_{3a}, H_{3b}, H_4

Model Specification 1				Model Specification 2		Model Specification 3	
Period	Variable	pc_FDI	Period	Variable	pc_FDI		pc_FDI
		b/t			b/t		b/t
NDA	NSDP per capita (log)	2.785** (2.67)	NDA	NSDP per capita (log)	2.052** (2.37)	NSDP per capita (log)	2.339** (2.41)
UPA	NSDP per capita (log)	3.039** (2.78)	UPA	NSDP per capita (log)	2.004** (2.23)	NSDP per capita (log)	2.351** (2.35)
NDA	Population density	0.018** (2.40)	NDA	Population density	0.018** (2.75)	Population density	0.019** (2.76)
UPA	Population density	0.014* (2.08)	UPA	Population density	0.016** (2.67)	Population density	0.016** (2.56)
NDA	Rural population share (log)	-2.422 (-1.50)	NDA	Rural population share (log)	-0.681 (-0.51)	Rural population share (log)	-1.765 (-1.49)
UPA	Rural population share (log)	-0.095 (-0.03)	UPA	Rural population share (log)	0.111 (0.05)	Rural population share (log)	-0.729 (-0.27)
Entire period (2000–2013)	CM_{affil}	Reference group	NDA	CM_{strong}	-0.015 (-0.79)	CM_{strong}	-0.017 (-0.88)
	CM_{align}	-0.121 (-0.50)	UPA	CM_{strong}	0.012 (1.17)	CM_{strong}	0.016+ (1.60)
	CM_{opp}	-0.113 (-0.43)	NDA	$CM_{not_{affil}} * MP_{affil_{it}}$	-0.633 (-0.82)	$CM_{affil} * MP_{affil}$	0.469 (0.97)
	CM_{osp}	0.596* (1.87)	UPA	$CM_{not_{affil}} * MP_{affil_{it}}$	1.564** (2.99)	$CM_{affil} * MP_{affil}$	0.695+ (1.60)
	Constant	-33.793*** (-4.12)		Constant	-24.909*** (-3.86)	Constant	-28.621*** (-3.78)
	R-sqr	0.642		R-sqr	0.654	R-sqr	0.645
	dfres	11		dfres	11	dfres	11
	N	147		N	147	N	147

Note: Items in bold are explanatory variables; the remainder are controls.
* p < 0.10; ** p < 0.05; *** p < 0.01 ("+" borderline case, at the edge of significance)

Table 1, Model 1 reports the regression results for the entire coalition period (2000–2013). This is aimed at testing the comparative performance of different categories of CMs. The re-

sults, as reported, show that a CM belonging to an outside supporters' party is capable of attracting maximum FDI. The effect is significant at 10 per cent. Thus, the CM_{affil} group loses out to the CM_{osp} group.

I would like to confirm that this "bargaining-power effect" observed for 2000–2013 (Table 1) is not a product of the NDA period alone (2000–2004), during which the Telugu Desam Party, with its brigade of 28 MPs, was the outside supporter, and the party supremo Chandrababu Naidu often threatened to review the party's support for the NDA coalition to have his costly demands accepted. Thus, I study this effect for the UPA government (2004–2013) alone. Table 2 reports the results. It shows that the coefficient of CM_{osp} is significant at 5 per cent in Model 1, and at 10 per cent in other models.

Table 2. Per Capita FDI (Log) during the Coalition Era (2004–2013): Robustness Check for H$_{3a}$ and H$_4$

	Model Specification 1	Model Specification 2	Model Specification 3	Model Specification 4	Model Specification 5
	pc_FDI	pc_FDI	pc_FDI	pc_FDI	pc_FDI
	b/t	b/t	b/t	b/t	b/t
NSDP per capita	4.984*** (6.95)	2.862** (2.88)	2.217* (1.88)	0.209 (0.17)	1.53 (1.15)
Population density		0.022** (2.33)	0.023** (2.38)	0.021** (2.62)	0.025** (2.58)
Rural population share			-3.746* (-2.11)	-4.058** (-2.50)	-4.895** (-2.84)
Electricity (Kwh per capita)				3.235+ (1.68)	3.513* (1.79)
Own tax revenue (as ratio of NSDP)					-1.719* (-1.89)
Death rate					(0.21) (-0.50)
CM_{affil}	*Reference group*	*Reference group*	*Reference group*	*Reference group*	*Reference group*
CM_{align}	-0.342 (-1.40)	-0.6 (-1.30)	-0.576 (-1.27)	-0.72+ (-1.61)	-0.891** (-2.24)
CM_{opp}	-0.008 (-0.03)	-0.089 (-0.27)	-0.183 (-0.54)	-0.13 (-0.57)	-0.133 (-0.49)
CM_{osp}	0.403** (2.57)	0.765* (1.70)	0.769* (1.81)	0.921* (2.10)	0.746* (1.91)
Constant	-46.941*** (-6.34)	-35.744*** (-5.13)	-30.902*** (-3.72)	-30.126*** (-3.94)	-50.120*** (-3.65)
R-sqr	0.43	0.478	0.486	0.503	0.511
dfres	11	11	11	11	11
BIC	334	329	332.1	333.1	340.6

Note: Items in bold are explanatory variables; the remainder are controls.
* p < 0.10; ** p < 0.05; *** p < 0.01 ("+" borderline case, at the edge of significance)

Note that my hypothesis (H4) that all pivotal partners (that is, coalition partners, as well as outside supporters) will attract more investments is only partially supported. The results confirm my hypothesis with regard to outside supporters, but not with regard to the coalition partners. From this we might infer that a CM belonging to an outside supporters' party has more bargaining power to secure the central government's support for his/her favourite investment projects. The reasons for this are twofold: the outside supporters' party does not participate in government – and is less hesitant to play its power card, engendering the fall of the coalition government, compared to junior coalition partners. On the other hand, coalition partners lose some of their bargaining strength as they develop a vested interest in the perks of power. With this in mind, the PM's party might not be willing to go out of its way to help internalise the costs of implementing these state governments' favourite projects.

For the remainder of the two categories – that is, CM_{align} and CM_{opp} – the sign is negative in all models (Table 1 and Table 2). This means that states ruled by the PM's party receive higher investments in comparison to states governed by either junior partners or the opposition. For instance, FDI inflow to Maharashtra grew at 0.46 per cent during the NDA period, when the CM belonged to the opposition party. However, during the UPA period, under an affiliated CM, the FDI inflow to the state grew at 0.85 per cent. Similarly, in Rajasthan between 2004 and 2008, under an opposition CM, the growth rate of FDI per capita was negative (-0.74), though from 2009 to 2013, under an affiliated CM, it grew at 0.2 per cent. Nevertheless, the lack of statistical significance means that there are some exceptional cases as well – some of the opposition-ruled states and aligned states (coalition partners) received more FDI inflow in comparison to affiliated states during this period. This will be further discussed below.

In Table 1, models 2 and 3, I compare the effect of a state executive's legislative strength ($CM_{strong_{it}}$). I find that the *coefficient* for the presence of a strong CM is positive during the UPA period, when I control for the NDA period. Testing this effect under the UPA government alone, without using period dummies (Table 3), I again find that the coefficient of $CM_{strong_{it}}$ is positive in all six specifications, and assumes statistical significance at a 10 per cent level in models 5 and 6. This confirms my expectations regarding the influence of leadership at the state level. A strong CM is an important source of security for an investor because s/he can take care of bureaucratic hurdles and handle any public resentment if or when it arises. However, the lack of statistical significance of this variable, in all models except two, implies that the numerical (seat-share-based) logic of a strong CM does not hold true at all times or in all cases. Again, the logic calls for some discussion; however, another important result must be reported *before* I can conduct this further examination.

The shared-rule-state variable ($CM_{not_{affil}} * MP_{affil_{it}}$) – also an indicator of a "low-risk state" – measures the safety of a state from an investor's perspective of providing immunity from the likelihood of being sacrificed at the altar of centre–state conflict in the near future. Table 1, Model 2 shows that the coefficient of this variable for the UPA period is positive and

highly statistically significant at a 5 per cent level. In Table 3, testing for the UPA period without using period dummies I find that the shared-rule effect (low-risk state) is significant at a 1 per cent level in models 2 and 3 and at a 5 per cent level in the remainder of the model specifications. This is consistent with the theory that investors make a "future risk assessment" before choosing investment location(s). The phase spanning from approval to actual realisation of FDI is full of uncertainty. However, successful negotiations by business executives to locate a project in a state – where the CM belongs to a non-affiliated party, while the majority of MPs belong to the PM's party – would mean support from both the central and state governments.

Note that the core-state effect ($CM_{affil} * MP_{affil_{it}}$) is neither large nor significant. Why? Firstly, the core-support states during the coalition era were few and far between. Secondly, the PM's core-state effect is conditional upon the majority of the PM's party in the Lok Sabha. In a coalition period when survival of the coalition led by the PM's party is contingent on continued legislative support from junior partners, the lack of significant effect of this variable is not surprising.

Table 3. Per Capita FDI (Log) during the Coalition Era (2004–2013): Robustness Check for H₁ and H₂

	Model Specification 1	Model Specification 2	Model Specification 3	Model Specification 4	Model Specification 5	Model Specification 6
	pc_FDI	pc_FDI	pc_FDI	pc_FDI	pc_FDI	pc_FDI
	b/t	b/t	b/t	b/t	b/t	b/t
NSDP per capita (log)	4.266***	2.254**	2.079*	1.392	2.917*	3.141**
	(7.67)	(2.28)	(2.02)	(0.96)	(1.79)	(2.44)
Population density		0.019*	0.019*	0.017*	0.018*	0.020*
		(1.87)	(1.84)	(1.75)	(1.74)	(2.00)
Rural population share (log)			-1.906	-2.327*	-3.461**	-3.674***
			(-1.29)	(-2.19)	(-2.76)	(-4.81)
Electricity (Kwh per capita)				1.2	0.993	1.412
				(0.56)	(0.46)	(0.62)
Own tax revenue (as ratio of NSDP)					-12.274*	-2.159***
					(-2.03)	(-3.56)
Death rate						-0.445
						(-1.17)
CM_{strong}	0.017	0.002	0.004	0.003	0.012*	0.010*
	(1.00)	(0.32)	(0.60)	(0.39)	(2.05)	(1.97)
$CM_{not_{affil}} * MP_{affil_{it}}$	1.356**	1.569***	1.402***	1.203**	1.344**	1.365**
	(2.71)	(3.59)	(3.67)	(2.58)	(2.77)	(2.58)
Constant	-40.878***	-28.612***	-27.433***	-27.485***	-42.002***	-50.891***
	(-6.53)	(-4.57)	(-4.07)	(-3.92)	(-3.66)	(-4.81)
R-sqr	0.44	0.472	0.474	0.476	0.486	0.49
dfres	11	11	11	11	11	11
BIC	327.4	325.5	329.8	334	336.7	340.6

Note: Items in bold are explanatory variables; the remainder are controls.
* p < 0.10; ** p < 0.05; *** p < 0.01.

In a nutshell, we can say with confidence that for the two variables – an affiliated CM (H_{3a}) and a core-support state (H_{3b}) – there is indeed a positive bias; however, the results do not approach statistical significance for the NDA period and only borderline significance during the UPA period, pointing toward exceptional cases among non-affiliated groups. The exceptions arise because a non-affiliated state will attract higher per capita FDI if it fulfils either of the two conditions – high bargaining potential vis-à-vis the centre (H_4), or the majority of MPs belonging to the PM's party (H_2). The strong leadership variable (H_1) is a borderline case. Indeed, strong state leadership has on several occasions been able to circumvent other potential constraints (for example, Gujarat under Modi's chief ministership), though on other occasions the constraints have overwhelmed even strong leadership (for example, Odisha's chief minister, Naveen Patnaik).

7 Conclusion

The analysis in this paper has revealed the intergovernmental political issues involved in the spatial distribution of FDI in India, while holding the other key determinants constant. Although the central government plays no direct role in determining the state to which FDI goes, the variable attitude of the central government toward non-affiliated states of four different types plays a role in creating perceptions about the relative political risk involved in various investment destinations. It appears that the intergovernmental bargaining thesis, as well as the discrimination thesis – the two established norms in centre–state financial relations in India – hold true for FDI inflows as well.

The paper's main findings are as follows:

1) A state's affiliation has a notable positive impact on FDI inflows. This finding supports the non-affiliated states' allegations of discrimination by central governments toward projects in their states and of keeping them dormant for many years, thereby discouraging future investors. However, there is no conclusive evidence of the finding because exceptions can result, for reasons explained in the points below.

2) The presence of strong state leadership appears to counter or suppress the impact of non-affiliation. However, the negative sign for the NDA period shows that, on certain occasions, the potential constraints can overwhelm even strong leadership.

3) A non-affiliated state becomes an attractive destination in the presence of a significant share of MPs belonging to the PM's party. This is a state in which the two largest rival parties with substantial support bases (between whom the power is expected to alternate) support investment as both stand to gain from it. This implies that investors view locations falling under the parliamentary constituencies of affiliated MPs within a non-affiliated state as secure.

4) States ruled by outside supporters have been most successful in attracting FDI inflows. This supports the widely held perception that shrewd bargainers in a coalition are treated favourably by the central government – *giving investors a compelling reason to* bet on the states governed by them.

Although it has been widely acknowledged that centre–state political dynamics are an integral part of the FDI game in a federal system, a thorough search of the relevant literature yielded no quantitative study attempting to explore this political economy phenomenon. This study offers the first analysis to reveal the precise mechanism by which domestic intergovernmental politics shapes investment decisions. The findings of this study provide broader theoretical and conceptual insights that underscore the importance of policy contexts in understanding the spatial distribution of FDI. Additionally, they bring to the fore the need to take domestic intergovernmental relations seriously in studies of subnational governments' international engagements.

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