Labour market versus FDI policies in GCC countries: A political economy approach

Louis Jaeck [i]

United Arab Emirates University, United Arab Emirates

Sehjeong Kim[ii]

United Arab Emirates University, United Arab Emirates

Abstract

Labor market policies and FDI policy liberalization do not exhibit the same pattern across GCC countries. For instance, according to data from the Fraser Institute, FDI policy liberalization tends to go hand in hand with labor market deregulation in Bahrain and Oman. This is not necessarily the case for UAE, however. This paper develops a political economy model based on a common agency model of lobbying (Grossman and Helpman, 1994) and addresses these policy developments in GCC countries. It analyzes the setting of a reform towards deregulating labor markets (ease of hiring and firing rules) as a political compromise pressured by the political influence of a multinational firm and national citizens. Adapting the common agency model of lobbying to an autocratic setting, we show that groups' influence is not distortive for a specific number of national citizens. Our political economy framework also suggests that the sponsorship system and its amendment helps explain the different patterns of regulation across GCC countries.

Keywords: FDI, political influence, labor market, common agency, autocratic state

JEL Classification: D72, J08, D83

i) Assistant Professor, College of Business and Economics, Department of Economics and Finance, United Arab Emirates University, Al Ain, United Arab Emirates. Email : louis_jaeck@uaeu.ac.ae
ii) Assistant Professor, Department of Mathematical Sciences, United Arab Emirates University, Al Ain, United Arab Emirates. Email : sehjung.kim@uaeu.ac.ae

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1 Introduction

By relying on natural resources as their main source of income, the Gulf Cooperation Council (GCC) countries have been traditionally exposed to fluctuations in world oil prices and ultimately to the depletion of these resources in the long term. Such development feature has also had institutional implications on labor markets. After the 1973 oil shock, GCC economies have massively relied on labor imports from the wider Arab world and South Asia, as national populations were too small to fill the growing need to expand infrastructure and development projects (Baldwin, 2011). Since the 60s, GCC governments have constrained migrant workers' freedom and mobility through "Kafala sponsorship" rules. The latter grant employers complete authority over their employees' labor conditions such as working hours, assignments and pay.[1] Although the oil monarchies historically promoted more flexible labor contracts, both de jure and de facto, labor laws did not protect migrant workers (Cammet and Posusnet, 2010). Figure 1 shows that GCC labor markets exhibit a high level of flexibility as far as hiring and firing regulations are concerned. Foreign employees are thus attractive because they are cheap, but also because they are more easily controlled.

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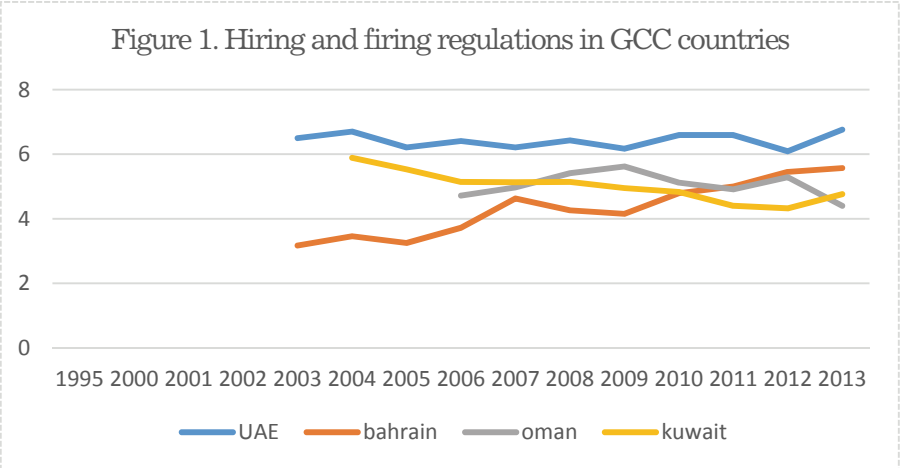
[1] Traditionally under this system, guarantors were used to enforce contracts where the individual guarantor (kafeel) was responsible for the credit, safety, and good conduct of the debtor (kafila). In modern Gulf countries, this system is a set of regulations tethering migrant workers to their employers via contracts and visas, and giving employers a substantial amount of power (Naidu et al. 2016).



Source: Authors' calculation. The data are taken from the Fraser Institute Index of economic freedom 2016. The sub indicator indicator "hiring and firing" is extracted from the indicator "labor market regulation" (Area 5B). A high score is associated with the ease to hire and fire. For some comparisons, France which is well-known for its historical record of labor market rigidities has on average a score of 2,5.

On the other hand, the sponsorship law does not apply to nationals. The latter may thus move freely on the private labor market, which makes them less attractive to businesses (Hertog, 2014). While cheap migrant workers mainly filled private labor markets, oil rents allowed GCC countries to provide well-remunerated public sector jobs to their nationals (Hertog, 2014). The latter acting as the primary transmission mechanism of the social contract in the oil-rich monarchies. As a result, GCC labor markets are segmented between the private and the public sector. The former is characterized by low-wage and unprotected expatriates, and the latter host high-wage and protected nationals (Forstenlechner and Rutledge, 2010). Due to the necessity to move away from oil-related income and ensure sustainable development, GCC countries have embarked on economic diversification through the channel of inward Foreign Direct Investment (FDI). Starting in the early 2000s, they have provided economic incentives and regulatory frameworks to attract FDI flows. These FDI-friendly policies such as those on ownership, the creation of special economic zones and lowering taxation on corporations have been widely implemented due to the competitive environment generated by globalization. Unsurprisingly, figures on inward FDI flows to the GCC

countries increase from US $ 392 million to US $ 17.9 billion between 2000 and 2016.[2]

In addition to promoting economic diversification, the strategy to rely on FDI has been justified on the grounds that it is beneficial to create job opportunities and to reduce the socially destabilizing youth unemployment problem. Indeed, attracting and sustaining FDI inflows increase the authoritarian leaders' legitimacy among the citizenry as the majority of citizens in authoritarian regimes associate FDI with growth and employment. Data from two global surveys—Pew Global Attitudes Project 2002/2007 (Pew) and Asia Europe Survey (2001) (ASES)—provide empirical evidence that the majority of citizens living in authoritarian countries support FDI inflows (Bastiaens, 2016).[3] Failure to implement FDI-friendly policies would lead to public dissatisfaction and possible unrest, threatening the survival of the authoritarian leadership (Mansfield et al., 2002; Weeks, 2008). In addition, the high unemployment level among nationals has led GCC countries to introduce command and control policies in early 2000s such as labor nationalization. The latter aim to incentivize GCC nationals to work in the private sector in the form of quota policies, subsidized (high) wages and employment protection.

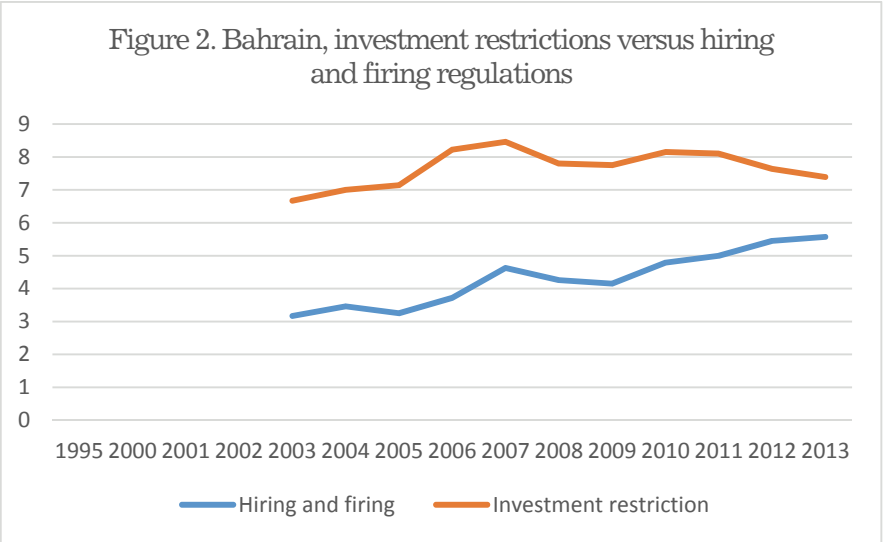
Hence, the introduction of indigenization policies that restrict flexibility on the private sector labor market in a context of an existing liberal regime aimed at attracting FDI represents a puzzle for political economists. Indeed, evidence is uncountable that FDI inflows to developing countries have been accompanied by deregulation in others sectors of their economies (Malesky, 2009). Another puzzle is observed when analyzing the trend in the regulations of FDI and private sector labor markets across GCC countries.[4] Based on data from the Fraser Institute index of economic freedom 2016, Figure 2 shows that, in Bahrain, deregulation of FDI goes hand in hand with the ease of hiring and firing.[5] This is a

[2] Authors' calculations based on UNCTAD inward FDI flows data.

[3] Respondents in authoritarian countries overwhelmingly specified that foreign companies are a good influence (68%) (Pew) and they have a lot of confidence in international big business (74%) (ASES).

[4] We have restricted our analysis to UAE, Bahrain and Oman because these countries exhibit a high level of foreign investment deregulation, which is not the case for Kuwait. Saudi Arabia and Qatar were excluded due to data limitation.

[5] The data cover the period 2003-2013. The orange line describes the evolution of foreign investment restrictions (high score means less restrictions) and the blue line describes that of hiring and firing regulations (high score means that it is easy to hire and fire). A simple



Source: Authors' calculation. The data are taken from the Fraser institute index of economic freedom database. The indicator "Investment restriction" is extracted from the Fraser institute indicator "Foreign ownership / investment restriction" (Area 4Di). The latter is based on the following two Global Competitiveness Report questions: [1] "How prevalent is foreign ownership of companies in your country? 1 = Very rare, 7 = highly prevalent." [2] "How restrictive are regulations in your country relating to international capital flows? 1 = highly restrictive, 7 = Not restrictive at all. Thus a high score shows a high level of FDI deregulation. The sub indicator "hiring and firing" is extracted from the indicator "labor market regulation" (Area 5B). A high score is associated with the ease to hire and fire.

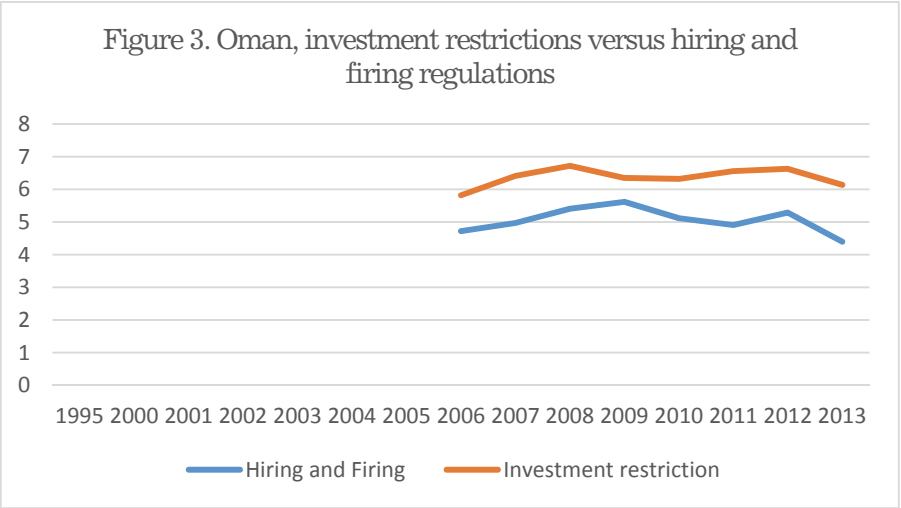
stylized fact that is in accordance with Malesky (2009)'s argument of the dynamic of deregulation.

Oman exhibits a similar pattern where a relatively strong correlation is observed (Figure 3).[6] Yet, UAE does not exhibit the same trends where FDI regulation seems unrelated to hiring and firing regulations that exhibit a constant score over the period (Figure 4).[7]

correlation indicates a correlation coefficient of 0.8 for the whole period 2003-2011.

[6] A correlation coefficient of 0.6 is observed for the period 2006-2013.

[7] A correlation coefficient of - 0.25 is observed for the period 2003-2013.



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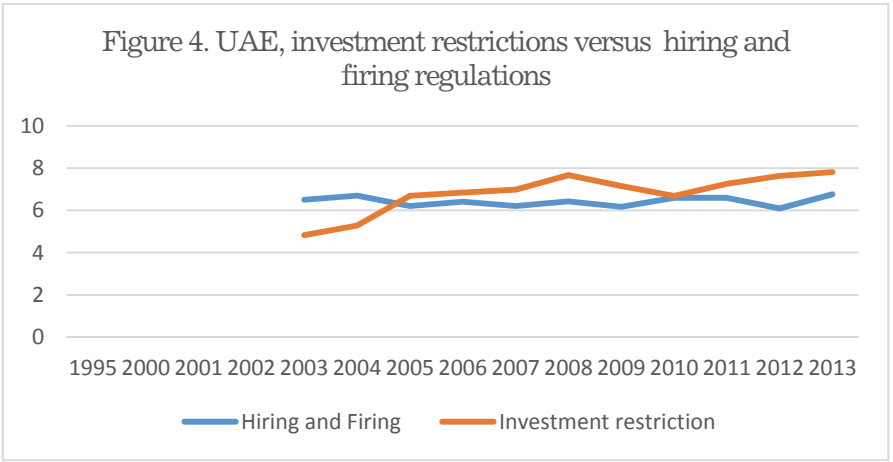

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latter is based on the following two Global Competitiveness Report questions: [1] "How prevalent is foreign ownership of companies in your country? 1 = Very rare, 7 = highly prevalent." [2] "How restrictive are regulations in your country relating to international capital flows? 1 = highly restrictive, 7 = Not restrictive at all. Thus a high score shows a high level of FDI deregulation. The indicator "hiring and firing" is extracted from the Fraser institute indicator "labor market regulation" (Area 5B). A high score is associated with the ease to hire and fire.

Addressing these puzzles suggest to focus attention on the political economy factors inherent to regulation and its dynamic in the GCC countries. This is the primary motivation of this paper. Based on a common agency model of lobbying adapted to an autocratic state setting, we develop a political economy model that analyses the interaction between FDI policies and labor market policies. To the best of our knowledge, it has not been done so far. Our main theoretical finding is that liberalization of FDI policies enhances labor market deregulation when the sponsorship system is relaxed. The underlying economic intuition is that, in a context of openness to FDI, a weakening of the sponsorship system fuels wages increase by promoting greater labor market competition. Facing higher wage costs, multinational corporations established in the host country seek to reduce their non-wage costs by increasing their lobbying efforts in favor of greater labor market deregulation.

The rest of the paper is organized as follows. Section 2 provides a brief literature review. Section 3 presents the economic framework of our model. In Section 4, we develop the model and analyze the setting of the reform on the labor market as a political compromise pressured by a multinational firm (MNF) and National citizens. These groups have opposed interests, and they both influence the government by providing political support. In Section 5, we investigate the policy distortion resulting from groups' influence by comparing the equilibrium level of reform with its socially optimal value. In Section 6, we explore how exogenous FDI policy liberalization affects the equilibrium level of labor market reform. Section 7 provides concluding remarks.

2 Literature review

In recent decades, FDI by multinational corporations (MNCs) has grown rapidly worldwide and developing countries have been the main destination. FDI is the international flow of firm-specific assets such as production technologies, managerial and organizational practices, and trademarked brands. Usually, MNCs realize FDI through the establishment of new production facilities, or the merger and acquisition of an existing firm. The literature has traditionally distinguished two motives for FDI. Resource seeking FDI refers to firms willing to reduce production costs by relocating production to foreign countries abundant in necessary inputs, such as labor or natural resources. Market seeking FDI sees firms entering countries to produce goods and services for local sales. This strategy aims at reducing the burden of trade barriers and transportation costs. During the period 1990-2013, the amount of FDI inflows have jumped from $35,000 to $77,000 million $ (UNCTAD, 2013). To explain such trend in international economic flows, the academic literature has explored a wide spectrum of factors. A first strand of literature has investigated the rationale behind the FDI decision. In particular, economic factors have been spotlighted in much of the research. Economists have examined the size and various other characteristics of the host market in order to explain individual decisions to invest abroad. The literature suggests that the size of the market in the potential host country, the level of economic development and openness to trade, and economic growth matter for FDI (Chakrabarti, 2001; Vijayakumar et al. 2010, and Zhang and Daly, 2011). The level of taxation and the quality of domestic institutions such as the rule of law have also been analyzed (Devereux and Griffith, 1998; Benassy-Quere et al., 2007). Scholars have also investigated the effect of political factors. Political instability should be deterrent to FDI since it reduces the predictability of the economic and political context (Brunetti et al. 1997; Jun and Singh, 1996). Regarding regime type, researchers have found that democracies attract FDI (Jensen, 2003). These findings contrast with the early literature on FDI that suggested that MNCs were attracted by autocratic states due to the absence of election-induced policy uncertainty (Bornschier and Chase-Dunn, 1985). A second strand of literature has focused on how governments compete to attract FDI, as the

latter has a positive effect on economic growth (Borensztein et al. 1998; De Mello, 1999) and on reduction of unemployment (Spiezia, 2004; Vacaflores, 2011). Relaxing FDI regulations such as those on ownership and lowering taxation on corporations have been widespread policies to attract FDI.[8] For instance, Kobrin (2005) showed that during the period 1992-2001, 95% of the 1086 individual policy changes either lessened restrictions on inflows of FDI or provided incentives to attract them.

In the field of political economics, the academic literature has mainly focused on the relationship between FDI decision and endogenous trade policies. It started with the seminal argument that foreign firms try to circumvent protectionist barriers that impede exports sales via setting up local production (Corden, 1974). Another formulation refers to the *quid pro quo* FDI, where the motive for foreign investment is the pre-emption barriers that might otherwise be implemented (Baghwati, 1985). [9] Dinopoulos and Wong (1991) have shown that increased FDI by foreign entities will reduce protection threats against foreign imports in the host country. *Quid pro quo* investment is thus described as "*indirect rent-seeking*" via consensual policies (Hillman and Ursprung, 1999). The *quid pro quo* investor seeks a liberal trade policy, and he will eventually be deterred if trade liberalization does not occur. For instance, Zhao (1996) has demonstrated how such investment is pre-empted if labor unions lobby a host country's government for protectionist policies. Similarly, Hillman and Ursprung (1999) argue that such foreign investment could not take place if the foreign investor acquires a domestic monopoly firm. Confronting import competition, the foreign investor supplying the domestic market may thus lobby for protection. The focus of this literature is whether the presence or threat of protection gives rise to FDI. On the other hand, other papers have studied how the presence of multinational firms affect the emergence of protection. In Hillman and Ursprung (1993)'s model, domestic and multinational firms exposed to foreign competition lobby for protection in the jurisdictions where they have plants.[10] Chari and Nandini (2008) showed that domestic firms who compete with MNCs

[8] The literature has focused on spatial econometrics to explore the extent of competition in tax, environmental standards, economic policy reforms, bilateral investment treaties and labour standards. The reader may refer to Cooray et al. (2014) for an excellent survey of this literature.

[9] See Baghwati et al. (1992) for a survey.

[10] They however show that the presence of multinational firms in an industry may encourage trade liberalization under specific conditions.

for local consumers might support FDI restrictions as a way to preserve their market shares. Empirical evidence of such behavior is found in Pandya (2014). Using an original dataset of FDI regulation covering the period between 1962–2000 over 150 countries, 57 industries and 12 specific regulations that represent the most common barriers to FDI, she found that industries in which firms invest to gain market access such as service industries are more likely to be restricted, as powerful domestic producers lobby for protection. Contrary to Hillman and Ursprung (1993), Ellingsen and Warneryd (1999) developed a model where the domestic industry lobby for less protection, as a high level of protection could attract more FDI aimed at avoiding trade barriers and thereby harming domestic firms. Foreign investors may also lobby for the changes in legislation that will affect their operations. Olarreaga (1999) models this lobbying process demonstrating that the entry of foreign investment into an economy eventually leads to greater trade liberalization.

The theoretical studies mentioned above have analyzed the political economy of FDI in interaction with trade policy. The interaction between FDI politics and labor market regulation has not been addressed however. Yet, the literature on the political economy of labor market reform has well documented that powerful interest groups such as business interests and trade unions compete to affect labor market regulations (Becker, 1983; Botero et al., 2004; Saint-Paul, 2004; 2010). Although this literature has mainly focused on democratic countries, especially European countries where trade unions are powerful, there is no reason to believe that political influence does not occur in autocratic states such as GCC countries where trade unions are prohibited. Indeed, possible unrest driven by labor market policies that reduce welfare may occur in GCC countries as welfare-enhancing policies through direct spending have historically granted rulers' legitimacy to stay in power (Heydemann, 2002).

3 The model

As modeled in Tagkalakis (2006) and Jaeck and Kim (2014), a general formulation of the unemployment equation is provided as follows:

$$u = a\ (ln\, w - ln\, \pi)\ - \delta r \tag{1}$$

where, u, is the unemployment rate, w is the nominal wage, and π is the inflation rate. Note that $\ln w - \ln \pi$ represents the real wage. It is assumed that there exists a level of reform $\bar{\theta}$ corresponding to the current level of labor market institutions (related to the current amount of distortions in the labor market) which is normalized to 1 so that its log is zero. Hence, $r = r(\theta) = ln\, \theta$ is a composite index that represents the degree of labor market deregulation with $\theta \in [1; +\infty[$ and $\frac{\partial r}{\partial \theta} > 0$. In Tagkalakis (2006), the structural reform variable, r, is a composite index that reduces labor market rigidities; it captures hiring and firing regulations. The reform process is specified as a continuous variable; the more r increases, the stronger the deregulation process is and the greater the reduction in *non-wage costs* is. Therefore the unemployment rate increases with the real wage ($\ln w - \ln \pi$) and decreases with the index r (i.e. deviation from current labor market institutions which are related to a certain amount of distortions; so if r = 0, no reform is undertaken, and distortions remain at the same level). Empirical evidences that have shown that increasing labor market flexibility reduces the unemployment rate (Di tella and Mac cullogh, 2005) support this assumption. In our model, we account for the specificity of GCC countries that are characterized by segmented labor markets. Although the concept of segmented GCC labor markets have initially fitted into the distinction public versus private labor market. Labor nationalization policies in the private sector allows for applying this concept to the private sector. We thus formulate the unemployment equation for GCC nationals, u^n as follows:

$$u^n = a\ (ln\, w_n - ln\, \pi)\ - \frac{\delta}{r}\beta v \tag{2}$$

With w_n representing nationals' nominal wage, the difference with Tagkalakis (2006)'s formulation is that deregulation on labor markets increases unemployment of nationals, as captured by the term $\frac{\delta}{r}$. Besides, r captures hiring and firing costs.[11] The assumption that more labor

[11] We do not include unions' bargaining power in the wage setting process, as Unions are not allowed in GCC countries.

market flexibility reduces unemployment is justified in a context where workers are skilled and productive. However, in the context of GCC countries, nationals are often perceived as poorly skilled and unproductive (Harry, 2007). As such, more labor market flexibility would increase nationals' unemployment.[12] The unemployment equation also accounts for the beneficial effect of FDI policy liberalization. There is a level of FDI policies $\bar{\varepsilon}$ that corresponds to the current level of FDI rules and regulations that is also normalized to 1 so that its log is zero. Therefore, $v = v(\varepsilon) = ln\,\varepsilon$ is a composite index that represents the strength of liberalization of FDI policies with $\varepsilon \in [1; +\infty[$ and $\frac{\partial v}{\partial \varepsilon} > 0$. Such index considers FDI policies that affect foreign investor's market access.[13] Similarly, the liberalization process is specified as a continuous variable; when v increases, the liberalization process becomes stronger. The parameter β measures the impact of FDI liberalization policies ($\beta > 0$). Therefore the unemployment rate of nationals decreases with the index v (i.e. deviation from the current state of rules and regulation of FDI; so if $v = 0$, no FDI liberalization policy is undertaken).[14]

The population is composed of K citizens and is divided into two types of workers. K^n represents the number of nationals, and K^e represents the number of expatriates, with $K = K^n + K^e$. Those workers are supposed to be employed in the private sector. Historically, the main labor pool for FDI remains cheap and low-skilled expatriate workers coming from south East Asia. Since the 2000s, nationals are encouraged to work in the private sector through the development of labor nationalization policies, as part of the GCC countries' strategies to promote economic diversification and provide productive jobs for their nationals.

We model a Multinational firm (MNF) established in the host country as representative of the private sector. Its profit is defined as follow:

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[12] This is the reason why GCC governments have introduced labor nationalization policies, and in particular the quota policy for nationals in the private sector, where the latter enjoy huge government protection.

[13] As an example and, building on Pandya (2014), we assume that FDI regulations subjected to the softening process are related to bans on foreign ownership, majority local ownership requirements, mandatory joint ventures, or compulsory investment pre-screening.

[14] This is an assumption that is supported by empirical evidence that has shown the positive impact of FDI in reducing unemployment rate in Latin America (Vacaflores, 2011), Central Europe (Radosevic et al. 2003), the Czech Republic (Dinga and Munich 2010) and in Italy (Spieza, 2004).

$$\pi^f = R(v) - [c^f(r) + w_n + w_e(v)] \quad (3)$$

The first term $R(v)$ represents the total revenue with $\frac{\partial R(v)}{\partial v} < 0$, capturing the idea that FDI liberalization policies reduce the MNF's profit through increased foreign competition and the loss in market shares.[15] The second term $[c^f(r) + w_n + w_e(v)]$ represents the total production costs divided into wage and non-wage costs. Non-wage costs, $c^f(r)$ are affected by labor market deregulation, with $\frac{\partial c^f}{\partial r} < 0$. Wage costs are constituted by $w_n + w_e(v)$ which represents the nominal wage of nationals and expatriates respectively. We assume that deregulation of FDI has a positive impact on expatriates' wage, with $\frac{\partial w_e}{\partial v} > 0$.[16] Given that national workers represent a tiny share of the workforce in the private sector, we do not model the impact of FDI liberalization on their wage. For methodological convenience, we thus assume that w_N is independent of v.

The representative utility function of a national worker is given by:

$$U^n = a\,(ln\,w_n - ln\,\pi) + 1 - [a\,(ln\,w_n - ln\,\pi) - \frac{\delta}{r}\beta v] \quad (4)$$

The utility of a national worker is directly affected by the real wage, $(ln\,w_n - ln\,\pi)$, and indirectly by the unemployment rate, as captured by the term $1 - [a\,(ln\,w_n - ln\,\pi) - \frac{\delta}{r}\beta v]$. When the unemployment rate increases, the utility decreases, and vice-versa. The assumption that people derive utility from the state of the economy is in line with the results of

[15] Foreign Firms pursue this strategy when trade barriers or transport costs make cross-border trade prohibitive.
For example, American restrictions on Japanese auto imports in the 1980s prompted major Japanese carmakers to establish manufacturing plants within the United States. Market-oriented FDI accounts for the majority of FDI flows. In the late 1990s, foreign subsidiaries of U.S.-based multinationals sold approximately two thirds of their output in the same host country in which they produced it (Pandya, 2014).

[16] Evidence demonstrates that foreign-owned firms pay higher wages than their domestic counterparts do in the context of both developed and less developed economies. Most studies find between a 10 and 30 percent wage premium for unskilled workers in foreign-owned manufacturing firms (Harrison 1996; Lipsey and Sjöholm 2002). Multinational firms may also pay efficiency wages to mitigate their higher labour search costs (Lipsey 2002).

Mac Culloch et al. (2001) who showed that individuals' happiness increases when the unemployment rate decreases. In the political and cultural context of GCC countries where nationals exhibit loyalty towards the regime in return for government's subsidies, this assumption seems relevant. The representative utility function of an expatriate worker is given by:

$$U^e = \ a\ (ln[w_e(v)] - ln\,\pi)\delta r \tag{5}$$

The utility of an expatriate worker is directly affected by the real wage, $(ln\,w_n - ln\,\pi)$. To account for the GCC segmented labor markets in the private sector, we assume that expatriates' real wage only is positively affected by deregulation on labor markets. The underlying assumption is that the reduction of non-wage costs benefits the firm in terms of higher productivity and competitiveness, resulting in real wage gains for expatriate workers. By opposition, deregulation on labor markets does not affect the real wage of national workers. This is because the latter are perceived to be less productive than expatriates and represent a small share of the workforce in the private sector. Thus, overall real income gains are much more significant for expatriate workers.

4 The political process

In this section, we model the political process by adapting the conventional common agency model of lobbying (Grossman and Helpman, 1994) that prevails in the literature to address the regulation process in an autocratic setting.[17] This is a methodological innovation and requirement as GCC countries are characterized by benevolent autocratic states that do not exhibit the functioning and properties of democracy. As such, the political economy setting must be amended to account for political influence through different channels. We specify that the formation of the

[17] In the conventional common agency model of lobbying (Grossman and Helpman, 1994), lobbies offer political contributions to the government. This money is for 'direct influence' as it supports the electoral campaign for the reelection of an incumbent government. As a reward, lobbies expect to obtain better access to the legislator.

reform in the labor market is subject to the influence of two groups who have opposed interests, represented by the MNF and the nationals respectively, whereas the FDI liberalization process, v, is set exogenously by the government.[18] Although these two groups cannot form conventional lobbies, we assume that they are still able to organize themselves and influence the government. Conversely, following Olson (1965), we assume that expatriate workers are too numerous to overcome the free-rider problem and influence the government.[19] Thus, we model two distinct groups j, with $j = n,f$ where n represents the nationals and f represents the MNF. Although the autocratic setting of the political system does not allow for any influence through political campaign contributions, these two groups are nonetheless assumed to influence the rulers in order to defend their interests. The timing of the political process can be described as follows. In the first stage, each group presents to the government a political support schedule, $m^j(r)$, which is contingent upon the level of labor market reform chosen by the government. In such autocratic setting specific to GCC countries, increasing political support can be alternatively interpreted in terms of decreasing political threat. For instance, when the MNF increases its political support to the government, it implicitly reduces its threat of relocating its activities elsewhere, thus strengthening the government in its ability to promote growth and employment for its own citizens. Similarly, when the nationals increase their political support, they implicitly reduce their threat of revolt for regime change. In the subsequent stage, the government determines the deregulation policy.

Before discussing the determination of the political equilibrium, we first define the aggregate welfare of each group j. The industry lobby's gross welfare function is represented by the industry profit, π^f, as described in equation (3), with $\frac{\partial \pi^f}{\partial r} = -\frac{\partial c^f}{\partial r} > 0$, capturing the idea that deregulation on the labor market increases the MNF's profit through the decrease in non-wage costs. The nationals' gross welfare function is given by:

[18] For methodological convenience and simplicity, we assume that FDI policies are supposed to be set by the government free from domestic or foreign influence.

[19] In the GCC countries, expatriates workforce represents approximately 90 % of the population. This is the reason why, nationals who represent a tiny share of the population are more likely to organize themselves into *a sort of* lobby group to influence the government.

$$W^n = K^n \; U^n = K^n\{a\,(ln\,w_n - ln\,\pi) + 1 - [a\,(ln\,w_n - ln\,\pi) - \frac{\delta}{r}\beta v]\} \quad (6)$$

Each group tailors its political support schedule to maximize its net welfare, which is the difference between the gross welfare and its political support. Then, the government chooses the policy that maximizes a weighted sum of the aggregate social welfare and the groups' political support. As in Grossman and Helpman (1994), we assume that political support schedules are globally truthful as they reflect everywhere the group's true welfare (Bernheim and Winston, 1986). With this global truthfulness assumption, the political equilibrium is the solution of a program in which the government seeks to maximize an objective function that is the sum of the aggregate social welfare W and the two groups' interests. It is such that[20]:

$$\underset{(r)}{Max\; G} = \varphi^f \pi^f + \varphi^n W^n + W \quad (7)$$

The parameter $\varphi^j \in [0,1], j = f, n$ represents the group's ability to influence the policymaker or alternatively, the weight that the government attach to the group's political support. φ^f can be either greater or lower than φ^n.The social welfare function, W, consist of two components: the expatriate workers' welfare and the nationals' net welfare:[21]

$$W = W^e + W^n \quad (8)$$

where W^e is the expatriate workers' aggregate welfare equal to :

[20] The objective function of the government without considering the global-truthfulness assumption would be as follows: $G = \varphi^f m^f + \varphi^n m^n + W$. If one considers the global-truthfulness property, the original objective function is re-written as equation (7).

[21] In a conventional common agency model of lobbying with monetary contributions offered to the government equation (8) would rewritten as follows $W = W^e + (W^n - m^n) + (m^n + m^f)$, where $(W^n - m^n)$ would represent the nationals' net welfare and $(m^n + m^f)$ would represent the monetary contributions received by the government that would be redistributed to citizens. In our formulation, nationals' political support can be proxy for instance by the "costs of generating" such political support such as convincing activists for not starting revolts. This is the reason why, theoretically, this cost of political support would be exactly offset by the welfare effects associated with the desired labour market policy. This argument justify the formulation of the social welfare in equation (8).

$$W^e = K^e U^e = K^e \{ a\ (ln[w_e(v)] - ln\,\pi)\delta r\} \quad (9)$$

Solving the maximization problem in (7) with respect to r, we obtain the first-order condition of government optimization:

$$G_r = \ \varphi^f \pi_r^f + \varphi^n W_r^n + W_r = 0 \quad (10)$$

Here, G_r measures the change in the government's objective function induced by a marginal tightening of the deregulation process r. The second-order condition requires that this variation is decreasing in r such that $G_{rr} < 0$. The relation in (10) contains a key characteristic of the model. Around the truthful equilibrium, a policy change induces a variation in each group's political support that is exactly equal to the variation in this group's gross welfare. In particular, a marginal increase in r induces variations in MNF and nationals' political support by the amount of $\pi_r^f = \frac{\partial \pi^f}{\partial r}$ and $W_r^n = \frac{\partial W^n}{\partial r}$ respectively. In what follows, we define respectively π_r^f and W_r^n as the MNF and nationals' marginal willingness to support (MWTS) for a marginal change in the reform, r. In equilibrium, $\frac{\partial \pi^f}{\partial r} = \pi_r^f = -\frac{\partial c^f}{\partial r}$ is positive, meaning that the group is willing to offer more political support in exchange for a strengthening of the deregulation on labor market. Also, $\frac{\partial W^n}{\partial r} = W_r^n = -K^n \delta \beta v \frac{1}{\theta}\, ln\theta^2$ is negative, meaning that the nationals' group is willing to decrease its political support in exchange of strengthening of the reform. These two groups have thus opposed interests. Equation (10) states that the political equilibrium level of reform is chosen as the trade-off between political support from the MNF and the nationals and the social welfare.

5 Political equilibrium policy

In this section, our primary focus is to compare the two equilibria (r°) and (r^*) . r^* is the socially optimal level of reform which corresponds to an equilibrium when there is no political influence. r° is the political equilibrium level of reform when such political influence occurs.

Analyzing the deviation between r° and r^{*} will provide us with a better understanding of the distortion resulting from groups' influence. Using (10) and rearranging, we first set out the socially optimal level of reform that is the solution of the following first-order condition:[22]

$$W_r(r^*) = W_r^e(r^*) + W_r^n(r^*) = 0 \tag{11}$$

$$\text{with } W_r^n(r^*) = -K^n \delta \beta v \frac{1}{\theta} ln\theta^2 < 0 \text{ and}$$

$$W_r^e(r^*) = K^e \frac{1}{\theta}(ln[w_e(v)] - ln\,\pi) > 0$$

The second order condition requires that $W_{rr} < 0$. This equation shows that the strengthening of the reform increases expatriates' welfare and decreases the nationals' welfare. The optimal level of reform should balance the two factors.

To compare r° and r^{*} we analyze the equation (10) for $r = r^{*}$ and given the first order condition $W_r(r^*) = 0$ we obtain:

$$G_r(r^*) = \varphi^f \pi_r^f(r^*) + \varphi^n W_r^n(r^*) \tag{12}$$

We must have $G_{rr} < 0$ as the second order condition. In equation (12), if $G_r(r^*)$ is positive (negative), the equilibrium level of reform is stricter (lower) than the social optimum. It is equal, and $r^{\circ} = r^{*}$, when $G_r(r^*) = 0$. If $\varphi^f = 0$, $\varphi^n > 0$, then $G_r(r^*) = \varphi^n W_r^n(r^*)$. When the nationals' group is the only one influencing the government, the equilibrium level of deregulation is lower than the optimal level. Indeed, we have $G_r(r^*) < 0$. Similarly If $\varphi^f > 0$, $\varphi^n = 0$, then $G_r(r^*) = \varphi^f \pi_r^f(r^*)$. When the MNF is the only one influencing the government, the equilibrium level is higher than the optimal one, with $G_r(r^*) > 0$. These results are expected.

We consider the particular case where the weight attached by the government to the groups' political support are equal such that $\varphi^f = \varphi^n$.[23] From equation (12), the following Proposition shows the

[22] When deriving the following condition, we use the relationship $m^n = W_r^n$ and $m^f = \pi_r^f$. This relationship occurs because of the global-truthfulness property of the contribution schedules.

[23] This assumption captures the fact that GCC governments value equally FDI for the purpose of

relationship between r° and r^{*} when $\varphi^{n} = \varphi^{f}$:

Proposition 1: *If the government weight equally the two groups' political support ($\varphi^{n} = \varphi^{f}$), the equilibrium level of reform is equal to the optimal one for a threshold number of national citizens $K^{n} = A$. In that case, the political influence is not socially distortive.*

From equation (12), when $\varphi^{f} = \varphi^{n}$, $G_r(r^{*}) = -\varphi^{f}\frac{\partial c^{f}}{\partial r} - \varphi^{n} K^{n} \delta\beta v \frac{1}{\theta} ln\theta^{2}$ may be either positive or negative. $G_r(r^{*}) = 0$ for a specific value of $K^{n} = \frac{-\varphi^{f}\frac{\partial c^{f}}{\partial r}}{\varphi^{n} K^{n}\delta\beta v\frac{1}{\theta} ln\theta^{2}} = A$, and $r^{\circ} = r^{*}$. In the case where $\varphi^{n} = \varphi^{f}$, when the level of reform is optimally set, $W_r(r^{*}) = 0$, the value of G_r depends on the two group MWTSs. For $K^{n} = A$, $G_r(r^{*}) = 0$ means that $|W_r^{n}(r^{*})| = \pi_r^{f}(r^{*})$, the two groups MWTSs cancel each other out. The equilibrium level of reform equals the socially optimal one. Note that the condition $W_r(r^{*}) = W_r^{n} + W_r^{e} = 0$ is fulfilled.

Corollary: *If the number of national citizens increases (decreases) above the threshold value $K^{n} = A$, the equilibrium level of deregulation is lower (higher) than the optimal level.*

From equation (12), when $\varphi^{f} = \varphi^{n}$, $G_r(r^{*}) = -\varphi^{f}\frac{\partial c^{f}}{\partial r} - \varphi^{n} K^{n} \delta\beta v \frac{1}{\theta} ln\theta^{2} < 0$ for $K^{n} > A$, and $r^{\circ} < r^{*}$. In that case, the nationals have an incentive to increase their political support for a marginal softening of the deregulation process. Influencing more the government relatively to the MNF, the equilibrium level of deregulation is lower than the optimum. Similarly, when $K^{n} < A$, the equilibrium level is higher than the socially optimal one.

economic diversification and development on the one hand, and welfare of their own people in line with their traditions and culture.

6 The effect of FDI policy liberalization

In this section, we assume that the government seeks to promote growth and employment, and thereby undertakes exogenous policies aiming at attracting FDI.[24] We investigate the exogenous effect of FDI policy liberalization on the equilibrium level of labor market policies, $\frac{dr^{\circ}}{dv}$. Since $\frac{dr^{\circ}}{dv} = \frac{-G_{rv}}{G_{rr}}$, we need to know the sign of G_{rv}.[25] With $G_{rr} < 0$, the sign of $\frac{dr^{\circ}}{dv}$ is the same as that of G_{rv}.

Differentiating G_r with respect to v yields:

$$G_{rv} = -(\varphi^n + 1)\frac{1}{\varepsilon}\ K^n \delta\beta \frac{1}{\theta}\ ln\theta^2 + \varphi^e\ K^e \frac{1}{\theta}\ \frac{\frac{\partial w_e}{\partial v}}{w_e} \tag{13}$$

We thus reach the following Proposition. It holds for any $\varphi^j \in [0,1]$.

Proposition 2: *When the impact of FDI policy liberalization on expatriate workers' wages is greater than a threshold value, F, FDI liberalization policies lead to labor market deregulation. It has no impact when it is equal to the threshold value F.*

The political effects of FDI liberalization policies on the equilibrium level of labor market deregulation depend on the impacts of relaxing FDI policies on G_r, which is the marginal benefit to the government arising from strengthening labor market deregulation. Here, G_{rv} may be either positive or negative depending on the effect of FDI deregulation on expatriates' wages, $\frac{\partial w_e}{\partial v}$. When $\frac{\partial w_e}{\partial v}$ is sufficiently high, namely when, $\frac{\partial w_e}{\partial v} > \frac{\left|-(\varphi^n+1)\frac{1}{\varepsilon}\ K^n\delta\beta\frac{1}{\theta}\ln\theta^2\right|}{\varphi^e\ K^e\frac{1}{w_e\theta}} = F$, we have $G_{rv} > 0$. The liberalization of FDI policies leads to labor market deregulation. This result has to do with the

[24] As mentioned in the introduction section, we consider FDI policies that affect foreign investors' market access.

[25] With $G_{rv} = \frac{\partial G_r}{\partial v}$ and $G_{rr} = \frac{\partial G_r}{\partial r}$, we have $dG_r = G_{rv}\ \mathrm{dv} + G_{rr}\ dr^{\circ} = 0$.

dominance of the MNF's MWTS over the nationals' one, leading to a strengthening of labor market deregulation. The intuition is that when the impact of FDI deregulation on expatriates' wages reach a threshold value, the MNF has an incentive to increase its political support for more deregulation on the labor market, as the latter would reduce non-wage costs, thus compensating for the increase in the MNF's wage costs. By the same reasoning, when $\frac{\partial w_e}{\partial v}$ is equal to a threshold value, namely when $\frac{\partial w_e}{\partial v}$ = F, we have $G_{rv} = 0$. The liberalization of FDI policies does not affect labor market deregulation. In this case, the MWTS of the MNF is such that it is equal to the nationals' one. Thus, they cancel each other out. As a result, the status quo prevails and no deregulation occurs on the labor market.

A key term in this Proposition is $\frac{\partial w_e}{\partial v}$. In the regulatory context of GCC countries, this term may capture the effect of relaxing the sponsorship system. Recall that the latter refers to a set of rules whereby employers exert complete authority over assignments, working hours, and pay of their employees. This system has often been accused of facilitating labor rights violations, thus fueling an over-importation of expatriate workers (Naidu et al., 2016). Interestingly, it also restricts labor mobility and ultimately lower migrant wages. Relaxing these labor mobility rules would enhance greater labor market competition and higher wages. Under the influence of FDI policy liberalization, the inflow of FDI generates an increase in the demand for labor and therefore higher wages. Evidence has demonstrated that foreign-owned firms pay higher wages than their domestic counterparts do in the context of both developed and less developed economies. Most studies find between a 10 and 30 percent wage premium for unskilled workers in foreign-owned manufacturing firms (Lipsey and Sjöholm, 2002). Multinational firms may also pay efficiency wages to mitigate their higher labor search costs (Lipsey, 2002). However, wage increase would occur in a context of high labor mobility only. Therefore, when $\frac{\partial w_e}{\partial v}$ is sufficiently high, it might capture the effect of a weakening of the sponsorship system. In this respect, Proposition 2 is insightful to address patterns of regulation in Bahrain and Oman. In Oman, the government has introduced a reform of the sponsorship system since late 2006. Since then, expatriates no longer need the permission of

their current employer to switch to a new job. In fact, this is mostly the case for higher-skilled expatriates who are capable of using their new mobility rights. This regulatory shift is credited to have led to an increase of the wage levels of expatriate workers (Hertog, 2014). According to figure 3, there is a clear correlation between FDI deregulation and deregulation of hiring and firing rules during the period 2006-2008. Facing higher wage costs due to the weakening of the sponsorship system, MNF increase their lobbying efforts in favor of greater labor market deregulation, thus reducing their non-wage costs. A similar pattern is observed in Bahrain. The abolition of the sponsorship system in 2008 has allowed foreign workers internal mobility in the Bahraini job market. As in Oman, this reform seems to be the driving force of wages increase for expatriates. Bahrain was the only GCC country that has exhibited wages increase above inflation in 2008 (Hertog, 2014). According to figure 2, Bahrain exhibited a constant improvement towards greater deregulation of hiring and firing rules during the period 2008-2013. This occurred in a context of a highly liberal FDI regime, as shown by the high value of the indicator of foreign investment restrictions over the period. UAE exhibits on the other hand a different pattern. According to figure 4, during the period 2003-2008, foreign investment restrictions have been greatly relaxed as shown by the indicator increase, and yet, the hiring and firing regulation indicator is constant. This is a period where the existing sponsorship system hinders labor mobility. As a result, the massive FDI inflows resulting from the easing of foreign investment restrictions have not given rise to wage increase for migrant labor. In other words, the term $\frac{\partial w_e}{\partial v}$ is equal to a threshold value F and no deregulation of hiring and firing rules occurs. However, in January 2011, UAE amended the sponsorship system. For instance, the new regulation allows transfers without the previously mandatory six-month waiting period abroad and without a "no objection certificate" if any employee is moving to a high-skilled job with a wage above certain pre-determined levels.[26] Surprisingly, figure 4 shows no significant effect on labor market deregulation after 2011. According to Hertog (2014), allowing mobility to employees with certain minimum

[26] Three others accompany such conditions. (i) the employment contract has come to an end, (ii) the employee has finished a minimum of two years of work with the employer, (iii) the employer has violated his/her duties toward the employee (Hertog, 2014).

skills and wage, creates a relative disadvantage for lower-skilled expatriates. While the new rules might help to attract higher-skilled foreign migrants, employers are likely to favor lower-skilled employees, as they remain easier to control. As a result, there is no reason to believe that the modest easing of the sponsorship system has been translated into wage increase for low-skilled workers, thus explaining the labor market status quo after 2011.

7 Conclusion

This paper has developed a theoretical political economy model aiming at addressing the interplay between deregulation of FDI and labor market regulation in the GCC countries. This question has been essentially motivated by the existence of puzzling patterns of regulation in the UAE, Bahrain and Oman. We have proposed an explanation of these dynamics of regulation by relying on the framework of a common agency model of lobbying (Grossman and Helpman, 1994). To account for the specificity of the GCC countries' political system, we have adapted the conventional framework that fits into democratic settings to a context of a benevolent autocratic government. More specifically, we have modelled a reform aimed at deregulating labor markets (ease of hiring and firing rules) that accounts for the impact of a multinational firm and national citizens. These two groups have opposite interests and compete for influencing the reform process.

In the context of given FDI policies, Proposition 1 has shown that when the two groups are active and, holding the same weight attached by the government to the group's influence, the political outcome in terms of labor market deregulation is socially optimal. This occurs for a specific threshold value of the number of national citizens. When the number of nationals increases above this value, the equilibrium level of labor market deregulation intuitively decreases below its socially optimal level. This result describes the policy development of labor nationalization that started in early 2000s in a context of growing population of GCC nationals. These policies play *de facto* against more labor market deregulation.

When labor market policies interact with FDI policies, Proposition 2

has shown that when the impact of FDI policy liberalization on expatriate workers' wages is greater than a threshold value, FDI liberalization policies lead to an easing of hiring and firing rules. It has no impact when it is equal to such threshold value. Our interpretation is that the sponsorship system that restrict foreign workers 'mobility and the degree to which it is amended, is at the heart of these results. In a context of openness to FDI, a weakening of the sponsorship system fuels wages increase by promoting greater labor market competition. Facing higher wage costs, MNCs established in the host country seek to reduce their non-wage cost by increasing their lobbying efforts in favor of greater labor market deregulation. This Proposition helps explain why Bahrain and Oman, which have relaxed their sponsorship law, have exhibited greater labor market deregulation. In contrast, such dynamic of deregulation is not observed in the UAE, as the sponsorship law has remained relatively stricter. From a normative point of view, our positive analysis suggests that GCC policymakers should go further in relaxing the sponsorship system as the latter enhances labor market deregulation through the channel of a complex political game.

Our contribution is an avenue for further research in the political economy literature of FDI. First, we have considered a general index of FDI policies that affect foreign investors' market access. Further research would consider specific policies and integrate them into the industry's profit functions. Second, analyzing how the equilibrium level of labor market reform responds to changes in the weight that the government attach to the group's political support would increase the realism of the model. Finally, we have assumed that FDI deregulation was exogenously determined and not subject to lobbying influence. Yet, there is evidence that multinational firms influence politics and help shape economic reforms in countries they seek to invest in. For instance, Lewis (2005) documented that when Volkswagen decided to buy Czechoslovakia's Skoda car plant in 1992, FDI regulations were developed in consultation between the firm and the government. Developing a model where both FDI and labor market policies are endogenously determined would account for these foreign influences in domestic politics.

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