

The Effect of Democracy on US Foreign Direct Investment

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Abstract

A growing literature shows that enforcement of property rights, lower levels of corruption, and greater stability – all advanced as advantages possessed by democracies – attract foreign investors to democratic governments. Others contend that FDI is just as likely to flow toward more authoritarian regimes. In order to extend the literature on regime type and investment inflows, we base our analysis on four baskets of host-country characteristics: macroeconomics, good governance, economic reform, and ‘follow the flag’ for US FDI between 1965 and 2002. The latter category reflects the belief that US MNCs interpret the presence of US troops as a positive signal and respond with FDI flows. We find that the direct effect of regime type is overshadowed by rival explanations once a fully-specified model is tested. In particular, regime durability, property rights, market size, ease of capital flows, previous amounts of FDI, and the presence of US troops have larger impacts on US FDI flows. The results provide reasons for optimism – young democracies attempting to secure foreign investment should realize that the attractiveness of stable regimes to US MNCs is another justification to sustain democratic institutions.

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'You've got to go where the oil is. I don't think about it [political volatility] very much.'

Dick Cheney [former CEO of Halliburton] in a 1998 speech
(originally quoted in the *Sunday Business Post*, Oct 28, 2001)

INTRODUCTION

Since the 1980s, countries worldwide have experienced a foreign direct investment (FDI) revival (Birch 1991, 149; Grosse 2001, 119). The expected political stability produced by the fall of communism and spread of democratic principles enhanced investor interest, with US MNCs at the forefront of increasing capital flows. However, US firms have not invested the same amount in all countries. Some countries attract more US capital than others do. Is democracy an important influence on US foreign investors?

In the development literature there are four areas that serve as determinants for US FDI. One area emphasizes the implementation of economic reforms to explain FDI inflows. Market-oriented reforms including trade and capital liberalization are posited as crucial for drawing in foreign investment. Market-oriented reforms signal creditworthiness and good intentions to prospective investors (Rodrik 1996, 28). Macroeconomic conditions such as economic growth rates, market size, and per capita gross domestic product (GDP) are also posited as strong predictors of foreign capital inflows (Crenshaw 1991; Oneal 1988; Pastor 1992; Rummel and Heenan 1978; Tuman and Emmert 2004). High growth rates and per capita GDP along with large market size suggest attractive host consumer markets. Alternatively, good governance in host countries is expected to promote a stable investment climate.¹ Democratic regimes that support rule of law, transparency, and other democratic principles enhance investor confidence (Jensen 2003; Li and Resnick 2003; Oneal 1994; Pastor and Hilt 1993; Tures 2003). In contrast, some contend that insular authoritarian regimes, free of pluralist pressures, hold advantages for creating a stable investment environment (Huntington 1968; Oneal 1994; Haley 1999; Tuman and Emmert 2004; Winters 1999). Still others claim that risk not connected with regime type also influences foreign investor decisions (Biglaiser and DeRouen 2006; Birch 1991; Crenshaw 1991; Haendel 1979; Levis 1979; Tuman

and Emmert 2004). Regardless of regime type, investors prefer countries with secure property rights and limited conflict to minimize FDI risk. Lastly, “follow the flag” factors also influence investment decisions. Using troop deployment as a proxy for diplomatic relations, Little and Leblang (2004) contend troops safeguard short-term investments but that long-term investments, such as FDI, render troops less necessary as FDI substitutes for troop deployment, helping to secure the US national interest.

This study tests existing theory to assess the main determinants of US FDI inflows. We provide a multivariate analysis of FDI that includes four groups of independent variables: (a) macroeconomic and host-country conditions; (b) economic reforms; (c) good governance factors; and (d) follow the flag considerations. We also combine the variables into several unified models. Controlling for macroeconomic, economic, good governance, and follow the flag factors, we test the importance of democracy to US FDI inflows. Using panel data for 196 countries from 1965 to 2002, this study shows that democracy has a relatively limited effect on US FDI inflows. Regime durability, market size, limited capital controls, protection of property rights, and US ground troops are all positive and have more significant impact than regime type on US MNC investment decisions.

Building on work by Globerman and Shapiro (2002), Grosse (1997, 148), Li and Resnick (2003), Tuman and Emmert (2004), and Biglaiser and DeRouen (2006), our results suggest the relevance of political stability and property rights for obtaining greater FDI. Consistent with Vernon (1998), foreign investors fear weak property rights, and especially asset expropriation. Minimizing nationalization risk is most relevant in developing countries that have engaged in expropriation since the 1930s. Current threats to MNCs in Latin America highlight the relevance of secure property rights for foreign investors.

Lessened expropriation fears complement political stability issues linked to increased US troop deployment, low capital controls, market size, and regime durability. The positive relationship between troop deployment and property rights enforcement makes some sense as US forces lessen appropriation

risk. Capital liberalization allows MNCs to repatriate profits, again minimizing the cost if host countries nationalize assets. We also find large market size and regime durability promote political stability. Large market size and regime durability capture the impact of more established democracies, suggesting that regime type in newer democracies has a somewhat limited effect on US FDI flows. Indeed, among the top ten countries where US MNCs invested between 1965 and 2002, eight OECD countries are almost always present: the United Kingdom, Canada, the Netherlands, Germany, France, Japan, Switzerland, and Australia. Only two developing countries, Mexico and Brazil, who have erratic histories with democracy, are regularly among the top recipients of US FDI. Support for democracy in OECD nations appeals to US investors. However, laws on the books that uphold democracy principles do not guarantee political stability and property rights enforcement. New democracies, in particular, need to show credible commitments to democratic institutions to assure investor confidence and attract US FDI.

Despite the limitations of a broad aggregate study, our findings hold important implications on the determinants of US FDI. First, the results suggest that US troops provide some security to MNCs. Reminiscent of the early 1900s, when the US followed gunboat or dollar diplomacy in the Western Hemisphere, the current situation may reflect US national security interests standing guard over US firms abroad. Second, our findings contribute to the debate on the effect of good governance on foreign investor preferences. The high costs associated with initial capital infusions make MNCs most concerned about stable property rights to insure that their investments are not lost. Building on Vernon's (1998, 65) work on the "obsolescing bargaining" between host countries and MNCs, once investors have sunk capital into projects, bargaining advantages tend to shift to the host country, enhancing appropriation risk. Because of the bargaining shift, MNCs must take into account property rights and political stability before investing. Third, and most importantly, the results should inspire new democracies to stay the course. Established democracies receive the most economic interest from US MNCs. Regime stability is

important for new democracies. Our findings provide further justification for new democracies to sustain democratic institutions.

In the first section, we discuss the possible determinants of US FDI. Issues of model specification are presented in section two. The results are presented in section three. We provide an explanation for the results in section four. Section five concludes the paper.

THE DETERMINANTS OF US FOREIGN DIRECT INVESTMENT

FDI, defined as private capital flows that provide a parent firm with some control over an enterprise outside the home country, has occurred for hundreds of years. FDI ebbs and flows as reflected in the last century when it fell in the early 1900s only to take off in the mid 1950s with US MNCs leading the way.² As FDI expanded, many countries questioned the merits of foreign ventures, and nationalist sentiments fought foreign expansion. In fact, in the 1930s - 1970s most Latin American countries expropriated US MNCs, converting these firms into state-owned enterprises (SOEs) (Torralba 2001, 62).³

Nationalization of SOEs complemented efforts away from economic interdependence, especially in the developing world. Developing countries implemented import-substitution industrialization (ISI) policies, placing high tariffs on foreign industrial goods and offering subsidies to local producers in order to promote the development of a domestic industrial base. The adoption of ISI and expropriation also provided developing countries with some autonomy from the Cold War policies between the US and USSR. Initially, success followed from ISI policies (Thorp 1998, 15). However, by the 1970s, market distortions and overpriced goods from uncompetitive domestic industries contributed to foreign exchange shortages, balance of trade and payment deficits, and capital scarcities (Edwards 1995, 117-23).⁴ Rather than attempt to attract FDI as a capital source or change economic policy course, most countries found lenders eager to offer loans in the 1970s. Developing countries borrowed excessively, until they reached

a severe credit crunch by the early 1980s.⁵ Since then, these countries have abandoned ISI policies, in many cases shifted to democratic rule, and attempted to raise capital through multinational investment.⁶

Most developed countries, too, went away from Keynesian-inspired policies of the post-World War II era to more market-oriented reforms. Democratic leaders including Margaret Thatcher of Great Britain and Ronald Reagan of the United States engineered a laissez-faire movement toward deregulation, a reduced role for the state, and greater market forces. MNCs and private enterprise fueled a free-market revolution tied to the “Washington Consensus” model.⁷ With the spread of market reforms, advance of democratic institutions, and growing capital needs, the question is where would MNCs choose to invest?⁸

The literature on FDI determinants is generally divided into four categories: (a) macroeconomic and host-country conditions; (b) economic reforms; (c) good governance factors; and (d) follow the flag considerations. Some studies suggest that certain macroeconomic conditions or host-country characteristics foster FDI interest. Tied to Dunning’s (1981) ownership, location, and internationalization framework as well as Markusen’s (1995) knowledge capital, and vertical and horizontal integration models, which focused on firm-level decisions, macroeconomic conditions in the host country as represented by economic growth rates, per capita GDP, market size, and previous experience with FDI provide varying incentives for foreign investors.⁹ Positive domestic growth rates, high per capita GDP, and larger markets indicate a potentially lucrative domestic market to sell goods as well as a vibrant economy for future sales (Brewer 1993; Tuman and Emmert 2004; Gastanaga, Nugent, and Pashamova 1998).¹⁰ On the other hand, lower per capita GDP implies reduced wage costs for employers, enhancing interest for labor-intensive businesses. MNCs are also attracted to countries with good reputations for producing competitive goods, possess large resource stocks, or have limited conflict, which provide high profit opportunities (Bollen and Jones 1982, Rummel and Heenan 1978, Levis 1979).

Economic reforms are also important determinants of FDI. Although most countries have shifted toward a market orientation, some countries have gone farther than others to support market forces. Economic reforms including trade reform and capital controls affect decision making of prospective investors. Depending on foreign investor goals, trade reform can work in opposite directions. For firms interested in producing goods in host countries for export, or to unbundle the company's production processes into smaller units for cost savings, lower tariffs are key (McKeown 1999; Agarwal, Gubitz, and Nunnenkamp 1992).¹¹ On the other hand, in larger host countries, such as China, Brazil, and India, MNCs may invest in order to avoid high trade barriers (Ellingsen and Warneryd 1999). Firms interested in tariff jumping and earning monopolistic rents may prefer host countries with protected markets. Reduced capital controls are also an incentive for potential investors. Firms desire the flexibility to move assets between countries in order to reduce costs and enhance benefits (Ramirez 2001). However, open capital markets engender a serious criticism against MNCs, namely profit repatriation. MNC opponents argue that firms investing abroad are most concerned about satisfying stockholders at home. Opponents prefer capital controls to retain profits and foster local reinvestment.

Alternatively, good governance factors such as regime type and risk considerations also affect foreign investment. A hotly contested debate in the development literature questions whether authoritarian or democratic regimes are most likely to impress investor confidence. Scholars including Huntington (1968), Oneal (1994), Haley (1999), Tuman and Emmert (2004), and Winters (1999) claim that rightist authoritarian regimes hold advantages over their democratic counterparts for promoting a stable investment environment. Because authoritarian regimes are less subject to electoral concerns, and have the capacity to use repression against protesters, these regimes possess insularity from interest group challenges. Moreover, since authoritarian regimes tend to favor more market-oriented reforms, these regimes are expected to protect foreign interests.

Tures (2003) contends the opposite, positing that international investors favor countries with democratic institutions in order to monitor and defend their capital.¹² Building on North's (1990) view that democracies protect property rights better than authoritarian regimes, Tures shows the benefits of democracies. Jensen (2003), too, argues that democratic institutions hold credibility advantages that lower political risks for foreign investors.¹³ Democracies promote stability and credibility that bolster enforcement of property rights (Biglaiser and Danis 2002; Li and Resnick 2003).¹⁴ Others also show the disadvantages of authoritarian regimes. Wintrobe (1998) contends that a lack of impartial courts or an independent media under authoritarian governments militates against FDI.¹⁵ Harms and Ursprung (2002) argue that FDI is not boosted by civil and political repression commonly tied to authoritarian regimes.

Alternatively, Biglaiser and DeRouen (2006) and Heo and DeRouen (2002) find that regime type has little effect on FDI. Instead, property rights not necessarily linked to political institutions affects investment decisions. Secure property rights that limit host country expropriation, corruption, contract repudiation, and bureaucratic interference while supporting rule of law support FDI inflows. Lehmann (1999) and Cho (2003, 3) concur, arguing that FDI is attracted to host countries that provide a predictable and stable political environment that safeguard private property and limit political risk. Crenshaw (1991) contends political upheavals and instability regardless of regime type discourage foreign investment. Regime durability, with few shifts from democratic to authoritarian rule, enhances political stability.

Lastly, foreign policy concerns also affects investor interest. Cold War politics and recent terrorist activities have inspired interest in the effect of diplomatic relations on overseas asset flows. US national security interests may attract or impede FDI inflows. Countries with high levels of US troops arguably draw in FDI, as investor worries about asset expropriation are allayed by the presence of US ground troops. In Iraq, for example, foreign investors would be reluctant to invest if not for the potential stability provided by US troops. On the other hand, the presence of many US troops abroad often

suggests political instability and risk. Little and Leblang (2004) claim that US troop deployments signal unrest to investors. Troops are important for short-term portfolio investments but MNCs are a substitute for troops that help serve long-term US national interests. Their results support the substitutability model whereby FDI comes in and supplants the need for troops.

This study develops four hypotheses to explain the determinants of US FDI. The first hypothesis claims a positive relationship between the introduction of economic reforms and foreign investment. Trade reform and fewer capital controls are expected to draw in greater FDI. The second hypothesis contends that good governance heightens foreign investment. Enhanced property rights, democratization, and regime durability are critical as investors recognize that host countries gain bargaining advantages following initial capital investments. The third hypothesis linked to follow the flag suggests that the presence of US troops attract US MNCs. Complementing good governance, US troops allay concerns about possible expropriation and support political stability. The fourth hypothesis suggests that a unified model combining macroeconomy, economic reform, good governance, and follow the flag factors is necessary to understand the determinants of FDI. Not all factors are created equal. Some measures are more important than others for attracting foreign investment.

RESEARCH DESIGN

Dependent Variable

We selected 196 countries from 1965-2002 to assess the effect of macroeconomy, economic reforms, good governance, and follow the flag on FDI. Our analysis includes all cases for which data are available, representing developed and developing countries. To measure US FDI, we use data from the Bureau of Economic Analysis (BEA) (<http://www.bea.doc.gov/bea/di/di1usdbal.htm>). The BEA

measures the holdings of US residents in long-term investments such as MNCs in US millions of dollars. In order to control for inflation, we place the data in constant dollars by using a GDP deflator.

Independent Variables

Macroeconomic and Host Country Variables

For macroeconomic and host country control variables, we use the log of real per capita GDP (development measure), log of GDP (market size), economic growth, natural resource extraction, previous experience with US FDI, and conflict (all lagged). Countries with high per capita GDP, large markets, and positive economic growth rates are expected to support future MNC sales domestically, making them attractive to foreign investment (Grosse 1997, 145). Countries with abundant natural resource stocks lure MNCs with profit prospects. Countries with a positive history in previous FDI are expected to receive renewed interest from MNCs. Lastly, conflict produced by warfare events is expected to reduce foreign investor interest. Data for the macroeconomic variables excluding previous FDI come from the World Development Indicators (2004). To measure economic growth, we use GDP growth (annual percent at market prices based on local currency in constant 1995 U.S. dollars). To measure natural resource extraction, we follow Jensen (2003) by adding fuel exports (% of merchandise exports) and ores and metals exports (% of merchandise exports) divided by GDP (constant 1995 dollars). Previous experience with US FDI comes from the BEA. To measure conflict, we use Marshall's 'Societal Effects of Warfare' Data (2002).¹⁶ Marshall categorizes and records the magnitude of the conflict based on a scale of 1 (smallest) to 10 (greatest). The numbers for each country in a given year are cumulative. Countries such as Indonesia or Burma have several ongoing conflicts at any one time and score high on this category. These data are particularly useful as they capture both internal and external conflict. Only capturing

militarized interstate disputes (MIDs) or civil wars misses important information as the former does not include conflicts with non-state actors and the latter misses interstate wars.

Economic Reforms

Economic reforms including trade reform and capital liberalization are expected to promote FDI inflows. MNCs interested in outsourcing manufactured goods for re-export favor low and uniform tariffs, a key component of trade reform (Gastanaga, Nugent, and Pashamova 1998, 1312).¹⁷ MNCs also prefer capital liberalization with few capital controls that allow profits to flow back to the home country (Gastanaga, Nugent, and Pashamova 1998, 1310). To measure trade reform, we use the sum of exports and imports of goods and services (lagged) as a share of GDP because it is the best proxy of trade openness (*World Development Indicators* 2004). Consistent with Jensen (2003), our measure takes into account tariff reduction, the elimination of quantitative restrictions, and elimination of import licenses. We use two measures from Brune, Garrett, and Guisinger (2001) to assess capital liberalization. First, we use a dichotomous measure of FDI inflow controls that codes countries with no controls as 1 and countries with controls as 0. We also employ a 9-point capital control measure, where a score of 9 indicates no capital controls with each lesser number suggesting greater controls.¹⁸

Good Governance Variables

Several good governance factors may impact US FDI. Regime type, regime durability, and property rights are factors linked to political risk and stability, important elements for longer-term foreign investors. Regime type is a controversial factor with some maintaining that democracies promote greater stability while others claim the opposite. In order to determine whether regime type affects US FDI, we use Polity IV data to operationalize democracy (Marshall and Jaggers 2002). We follow Londregan and

Poole (1996) by subtracting Polity IV's AUTOOC score from its DEMOC score, producing a measure of democracy that ranges from 10 to -10 (10 is the most "democratic" score).

Regime durability is also important for measuring political stability. If the host country is constantly shifting from presidential democracy to civilian dictatorship and then to military dictatorship, foreign investors may worry about the stability of their investments. We use a regime durability measure developed by Cheibub and Gandhi (2004), which categorizes the length of time between changes in political regime type. The six different types of political regimes are: parliamentary democracy, mixed democracy, presidential democracy, civilian dictatorship, military dictatorship, and monarchic dictatorship. We count the number of years between changes in regime category for individual countries.

Secure property rights based on risk of corruption, violations of rule of law, and worse, expropriation, generate prospective investor concern (Li and Resnick 2003). To measure property rights, we use annual data compiled by Knack from the quality of governance data of the PRS Group's International Country Risk Guide (<http://www.cidcm.umd.edu/inscr/stfail/sfdata.htm>)¹⁹ to produce a property rights variable based on five factors: expropriation, rule of law, bureaucratic quality, level of corruption, and government credibility related to contract repudiation. Expropriation and government credibility are measured on 0-10 scale and the other measures are scaled from 0-6, providing a possible 38-point measure with countries scoring highest indicating the most secure protection of property rights. The codebook for these measures is available at <http://ssdc.ucsd.edu/ssdc/iri00001.html>.

Follow the Flag

Follow the flag suggests that US national security interests affect US FDI flows. Host countries with large numbers of US troops are attractive to US MNCs, as the strong US presence assures MNCs that their investments are protected from host-government interference. This argument suggests that US

economic and security interests go hand-in-hand. Little and Leblang (2004) contend that US troops and financial flows are also correlated but in a very different way. They show that as US FDI goes up in a country, troop number goes down and they argue this is suggestive of a substitutability process. As US FDI goes into a country, the need for US troops decreases as the FDI then “promotes the national interest” as in Western Europe and Eastern Asia (Little and Leblang 2004, 17). We obtain US troop numbers in the host country from the Department of Defense (<http://web1.whs.osd.mil/mmids/military/miltop.htm>).²⁰ We test the logged version of this measure because of outliers in the data. We expect that US FDI will flow to states in the wake of troop deployments. As the US military deploys in the former Yugoslavia, Iraq, Kuwait, Panama, Haiti, Philippines and other regions, foreign investment will not be far behind.

Taken together, these independent variables represent four basic themes: macroeconomy and host country characteristics, economic reforms, good governance, and follow the flag. Summary statistics for the independent variables are presented in Table 1.

METHOD

We estimate the effect of political and economic variables on US FDI by creating models for panel data. Using OLS estimates of the standard errors in a panel setting is problematic because these estimates may be misleading as a result of panel heteroskedasticity or spatial correlation of the errors. To overcome these pitfalls, we use Beck and Katz’s (1995) panel-corrected standard error (PCSE) procedure to estimate our model. This approach is used in several previous analyses of FDI (see Biglaiser and DeRouen 2006; Jensen 2003; Li and Resnick 2003). Autocorrelation and heteroskedasticity are inherent pitfalls in panel data and OLS estimates of the standard errors may be misleading as a result of panel heteroskedasticity or spatial correlation of the errors caused by non-random data. Heteroskedasticity leads to inconsistent

standard errors. AR(1) is the most basic type of autocorrelation and means the residuals are correlated with the previous observation. We have reason to expect this type of serial autocorrelation using annual FDI data and the *xtserial* test in Stata (Drukker 2003) reveals the presence of ar1. Lagging the dependent variable is an effective means of dealing with ar1 (Beck and Katz 2004). We lag our independent variables both for theoretical reasons and to curtail possible endogeneity (see Li and Resnick 2003).

RESULTS

Results of the PCSE models are contained in Tables 2 and 3. Table 2 tests macroeconomy, good governance, and economic reform issues. The macroeconomy model reveals that previous year's FDI, natural resources, market size, conflict, and trade each affect FDI flows in the expected direction. The market-size coefficient is large but recall that this is a logged measure. Development is not significant.²¹ The two governance models test regime type, regime durability, and property rights. Only the latter two are significant. Older regimes and those that ensure property rights get more FDI from American firms. However, there is no direct effect of democracy here. The reform model generates strong support for our hypothesis that as regulations on capital flows are relaxed, FDI increases.

[Table 2 here]

Table 3 tests follow the flag and unified models. The follow the flag model results suggest that American FDI responds to troop deployments. This seems to reflect the situation in the Persian Gulf, Japan, South Korea and Western Europe, where large numbers of US soldiers are stationed and where US MNCs often invest. Unifying these models sheds more light on the question of effect of regime type. Although democracy has a direct impact in the first Unified Model, its impact is not very great.

[Table 3 here]

In order to gauge a clearer understanding of the impact of each variable, we use the two unified models to test for marginal effects of certain variables. We test several variables at their 90th percentile then we combine them to test a best-case scenario. Conflict is tested at its 10th percentile since its impact is negative. These results are contained in Table 4.

[Table 4 here]

The marginal effects reveal that the impact of regime type are much less than those of market size, capital flow regulations, age of regime, conflict, and troop deployments. In a best-case scenario, countries can expect to receive huge inflows of US FDI (\$5.5 billion more than the predicted level when all variables are set to the mean). Many OECD countries, for example, could expect these levels of US FDI as they are older regimes, have large markets and liberal capital regulations, and have little conflict. Using a different model of governance in Unified Model 2 to test marginal effects, we see that property rights have a large impact. When property rights are set to their 90th percentile, FDI increases over the baseline prediction by over \$500 million. The best-case scenario for Unified 2 sees an increase in FDI of about \$6.5 billion. These two models cover very different years as our property rights data are only for the 1982-1995 era. This helps explain some of the variation in the results, e.g., for troop deployment and conflict. But the results from both unified models suggest that countries with very young regimes, few property rights, and small markets can expect little in the way of US FDI. The larger sample that covers

1965 to 2002 also reveals the impact of conflict in the host country and the smaller sample shows that troop deployments are important.

DISCUSSION

How do we account for the pattern that emerges from the statistical estimates? First, why do US MNCs tend to invest more in countries with US troop deployments? Second, why are regime durability, market size, limited capital controls, and protection of property rights more important than regime type for fostering greater investor interest? Further investigation is required in order to systematically account for the variance in US FDI. Nevertheless, we can forward some plausible explanations that account for the strong patterns elicited in the regression analysis.

It is perhaps surprising that US troops promote US FDI. As Little and Leblang (2004) argue, troop deployments are a possible signal of political instability. However, US troops may provide a positive signal. Complementing interest in regime durability and property rights protection, MNCs are generally most concerned about expropriation risk. Troops on the ground may help address what Vernon (1998, 65) calls the “obsolescing bargaining” between host countries and MNCs. Vernon argues that foreign governments often approach MNCs to build power plants, develop transit lines, or explore offshore oil. MNCs help develop infrastructure and create jobs and new revenue streams. Projects such as these demand large initial capital infusions, and host countries, unless they possess special characteristics such as large domestic markets, are often obliged to provide generous terms such as lifting capital controls. However, once investors have sunk capital into projects, the bargaining power shifts to the host country’s advantage, weakening the MNCs position and increasing appropriation risk. The presence of US troops may reduce state expropriation and weaken the bargaining power of host countries

as long as US troops remain. US investors, such as in Iraq today, may welcome occupation by US forces to protect their firms and enhance political stability.

US occupation to serve US MNCs is not a new phenomenon. Between 1898 and 1932, an era often referred to as gunboat or dollar diplomacy, the US intervened in the Caribbean and Central America presumably to promote democratic elections but strategic protection or economic expansion motivated US actions (Drake 1991, 5). Dollar diplomacy suggested that the US would use its muscle and defense to protect and promote US MNCs. US troop deployments in developing countries as diverse as the Philippines, South Korea, Saudi Arabia, Panama, Turkey, Honduras, Indonesia, Singapore, and Egypt are perhaps once again providing security for US investors.²² During various years between 1965 and 2002, the US has sent troops to stabilize political situations (e.g., democratic transitions in South Korea, the Philippines) or for national security and/or resource needs (e.g., Saudi Arabia, Panama, Turkey, Honduras, Indonesia, and Egypt). As more troops are sent, political stability tends to advance, prompting greater interest from US MNCs. Over time, political stability reduces the need for troops, and many are reassigned but fear of expropriation is less likely with US troops on the ground.

MNC concern about political stability is not new either. Although the popular media showcases “race to the bottom” environmental and labor standards to explain much outsourcing today, US FDI since the 1960s generally flows to developed countries that maintain strict labor and environmental codes. Countries including the United Kingdom, Canada, the Netherlands, Germany, France, Japan, Switzerland, and Australia are long-time US FDI recipients. Recently, Ireland and Luxembourg have seen increased US FDI flows. These countries have the distinct advantage of regime durability based on long-standing democratic institutions, secure property rights, and relatively large domestic markets.

New democracies in the developing world should learn from the experience of established OECD countries. As developing countries pose threats to nationalize private investments and as pressures build

against democratic institutions, it is imperative that countries recognize the peril it might cause toward future US FDI. The stakes are too great for long-term US investors to ignore political stability and property rights enforcement in developing countries. Maintenance of democracy is in everyone's interest and US troops may be helpful here.

CONCLUSION

Consistent with studies by Globerman and Shapiro (2002), Grosse (1997, 148), Li and Resnick (2003), Tuman and Emmert (2004), and Biglaiser and DeRouen (2006), our results suggest the importance of political stability and property rights for obtaining more US FDI. The need for large initial capital investments compels foreign investors to assess political stability and property rights enforcement in order to reduce asset appropriation. Limiting nationalization risk is especially relevant in developing countries, which have historically engaged in expropriation.

The positive and significant correlation between US FDI and property rights enforcement, low capital controls, US ground troops, and regime durability bolsters the significance of political stability and efforts to reduce expropriation risk. Limited capital controls enable MNCs to repatriate profits, reducing costs associated with nationalization. US ground troops are perhaps relevant for safeguarding potential assets. Regime durability promotes political stability, fostering greater FDI inflows.

The importance of political stability, large markets, and property rights enforcement helps to explain why US MNCs invest most in OECD member nations. While a variety of factors including access to natural resources, labor costs, environmental regulations, achieving vertical or horizontal integration, or jumping protectionist barriers are motives for US FDI, our results suggest that political stability and property rights enforcement are the key elements. Support for democratic principles in OECD nations appeals to US investors. However, contrary to popular wisdom, the direct effect of regime

type is less important once political stability factors are taken into consideration. Like Li and Resnick (2003), we find evidence of an indirect effect of polity, where democracy has a positive impact on property rights.²³ Efforts to sustain durable democratic institutions, which US ground troops may help promote, enhance credibility with US firms. Whether US troops will help secure political stability over the long term is another question.

More comparative research on FDI inflows is needed to evaluate the effect of troop deployments and democracy on potential investors. Comparisons of US FDI with FDI from other countries might lessen the benefits of US troop deployments for attracting capital inflows. Disaggregation of property rights might also help to gain a better understanding of the specific elements that motivate foreign investors. Based on our sample, it appears that as long as countries are able to promote political stability and signal secure property rights, opportunities to attract foreign investment are attainable. New democracies have but another reason to stay the democratic course.

Table 1. Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
FDI	5351	3776.336	18104.41	-8656.992	424947.100
Development	4616	3.235	.696	1.693	4.771
Market Size	4634	10.087	1.080	-4.772	12.757
GDP Growth	4694	3.483	6.519	-51.030	106.279
Conflict	5470	.868	2.009	0	14
Polity	5200	.249	7.580	-10	10
Regime Durability	5279	23.881	25.2631	1	33
Trade	3844	.708	.489	.060	5.890
FDI Controls	3277	.196	.397	0	1
Capital Controls	3529	1.839	2.699	0	9
US Troops	5456	2.943	2.726	0	13.194
Property Rights	1520	22.183	8.068	3	38
Natural Resources	3276	25.317	31.699	.001	402.976

Table 2. Determinants of US FDI: Macroeconomy, Good Governance, and Economic Reform

Variable	Macroeconomy	Governance 1	Governance 2	Reform
FDI ₁	.956***	.945***	0.866***	0.904***
	0.051	0.534	0.105	0.081
Natural Resources	-3.298 ^a	-3.765	-2.065	0.661
	2.328	2.835	2.430	3.467
Development	168.982	-382.632	-194.573	77.896
	115.459	152.209	267.803	131.458
Conflict	-65.571*	-75.685*	4.618	-88.072*
	33.947	37.318	30.708	49.753
Market Size	1150.458**	1123.735**	1305.684*	1199.148*
	427.366	421.457	741.732	586.643
GDP Growth	-11.937	-10.470	-57.350	-31.983
	21.249	21.734	60.346	32.296
Trade	1311.160**	1159.432**	644.636	939.229 ^a
	447.469	421.777	739.508	612.903
Polity		1.766		
		10.662		
Regime Durability		23.819**	17.772 ^a	
		7.689	11.270	
Property Rights			61.142*	
			36.409	
FDI Controls				885.828*
				466.481
Capital Controls				191.374*
				103.733
Constant	-12642.320***	-11000.280**	-14268.140*	-12938.28*
	4486.640	4052.389	7919.315	6256.639
Obs	2657	2567	829	1581
R2	0.8840	0.8784	0.8515	0.8396
Wald chi2	4759.21	5685.17	6374.23	5857.42
Prob > chi2	0.0000	0.0000	0.0000	0.0000

NOTE: the dependent variable is flows of US FDI in constant 1995 millions; ^a-significant at the .10; *-significant at the .05; **- significant at the .01; ***- significant at the .001; one-tailed tests.

Table 3. Determinants of US FDI: Follow the Flag and Unified Models

Variable	Follow the Flag	Unified 1	Unified 2
FDI ₁	.956*** 0.050	.901*** 0.082	.860*** 0.107
Natural Resources	-2.520 2.349	2.690 4.037	2.070 2.537
Development	121.955 104.113	-559.565 243.047	-407.420 329.225
Conflict	-73.506* 36.575	-106.871* 54.935	-7.852 28.932
Market Size	995.993** 379.681	941.720* 483.405	893.280 ^a 618.339
GDP Growth	-12.836 21.424	-29.848 32.658	-66.171 66.587
Trade	1396.037*** 461.339	686.505 523.955	727.372 877.308
Polity		19.167 ^a 12.790	
Regime Durability		19.177* 12.790	17.611* 10.468
Property Rights			51.529* 26.756
FDI Controls		716.314* 434.609	978.936 762.961
Capital Controls		195.625* 103.917	130.850 ^a 90.944
US Troops	101.131 ^a 68.348	126.271 94.828	231.081* 139.462
Constant	-11309.37** 4049.373	-9007.24* 4749.512	-10411.81* 6666.44
Obs	2655	1574	812
R2	0.8841	0.8399	0.8522
Wald chi2	4920.37	6328.67	12239.82
Prob > chi2	0.0000	0.0000	0.0000

NOTE: the dependent variable is flows of US FDI in constant 1995 millions; ^asignificant at the .10; *-significant at the .05; **- significant at the .01; ***- significant at the .001; one-tailed tests.

Table 4. Marginal Effects

Manipulation **Effect on US FDI (\$1995 millions)**

(Based on Unified 1 model)

Market Size at 90 th ptl	+2080.35
Durability at 90 th ptl	+1987.47
Capital Controls at 90 th ptl	+1411.76
US Troops at 90 th ptl	+1139.07
Conflict at 10 th ptl	-1413.57
FDI Controls at 1	+552.94
Polity at 90 th ptl	+134.78

Best-case scenario based on the above +5510.99

(Based on Unified 2 model)

Property Rights at 90 th ptl	+511.70
<u>Best-case with Property Rights</u>	<u>+6495.39</u>

Note: the effect is measured as change from predicted value of US FDI; variables not manipulated are set to mean; insignificant variables are dropped from equations before running the models.

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ENDNOTES

¹ For details on the effects of good governance on economic choices and conditions, see Knack and Keefer (1995), Feng (2003), and Svensson (1999).

² For a thoughtful and informative history of FDI, see Wilkins (1974).

³ See Akinsanya (1980) and Vernon (1971) for details on the expropriation of foreign assets.

⁴ For the negative consequences of ISI, see Baer (1972) and Hirschman (1968).

⁵ For sources on the debt crisis, see Frieden (1991) and Stallings and Kaufman (1989).

⁶ See Armijo (1999) to understand why developing countries turned to FDI as compared to aid, loans, and portfolio investment.

⁷ See Williamson (1990), who coined the phrase “Washington Consensus,” for more details on the policies reputedly favored by international financial institutions and economists in the US.

⁸ For studies that show countries seeking FDI, see Mallampally and Sauvant (1999); Lipsey (2001).

⁹ Although Dunning (1981) and Markusen (1995) provide rich insights into FDI, according to Jensen (2003), neither framework goes far enough in explaining which countries will attract foreign investment.

¹⁰ Trade policies that protect host countries complement domestic market sales as foreign investors will market goods to wealthier consumers that are shielded from external competition (Pastor and Hilt 1993).

¹¹ MNCs may also engage in quid pro quo FDI to defuse tariffs demands in host countries (Bhagwati, Dinopoulos, and Wong 1992).

¹² See also Pastor and Hilt (1993) who argue that democracies do not impede FDI.

¹³ See Jensen (2002), which also highlights the benefits of democratic regimes.

¹⁴ On the importance of stable property rights for economic development, see de Soto (2000).

¹⁵ See also Gourevitch (1993) who argues that democracies limit lawmaker opportunism.

¹⁶ We also consulted Marshall's Center for Systemic Peace site at

<http://members.aol.com/CSPmgm/warlist.htm>.

¹⁷ In some instances, firms oppose trade reform as they set up subsidiaries in host countries to jump high tariffs and reap monopolistic rents (see Spero and Hart 2003, 131).

¹⁸ Special thanks to Nate Jensen for supplying the capital control measures.

¹⁹ See the Political Risk Service Group (www.prsgroup.com), which assesses the risk of confiscation and forced nationalization.

²⁰ There are only a few missing cases for this variable. Important exceptions include Cambodia and Laos in the early 1970s and Afghanistan since 2001.

²¹ Development is highly correlated with market size, regime durability and polity. Taking development out of the models does not significantly change the results.

²² South Korea and perhaps Turkey are considered developed countries today.

²³ Results available from authors.