

**What Attracts Foreign Investors?  
An Examination of Human Rights and Foreign Direct Investment**

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**Abstract:**

Though the prospective relationship between foreign direct investment (FDI) and human rights has long been a prominent issue within the global political economy, the linkage is empirically underdeveloped. Rather, the “conventional wisdom” regarding the association between FDI and human rights – that firms prefer the stable, compliant, inexpensive workforce produced by repressive polities – has persisted. We posit that the opposite is in fact the case; respect for human rights encourages FDI. Specifically, respect for human rights facilitates a more efficient, productive, skilled, and engaged society that makes a country a more attractive host for FDI. To examine this issue, we assess the direct effects of human rights upon FDI as well as the extent to which respect for human rights indirectly affects FDI through its impact upon human capital. We use a system of simultaneous equations to empirically probe these linkages between human rights and FDI for the years 1980 through 1997. Across all our models, we find respect for human rights to be positively, and significantly, related to FDI.

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This paper was prepared for presentation at the Annual Meeting of the Midwest Political Science Association, April 7-10, 2005, Chicago, Illinois.

## **What Attracts Foreign Investors? An Examination of Human Rights and Foreign Direct Investment\***

Foreign direct investment is a growing component of the international economy. In recent decades it has grown at almost twice the rate of either world trade or world output (Mallampally and Sauvant 1999), and FDI has surpassed official development flows as a source of capital in the developing world (Spar 1999). FDI differs from other major types of external private capital flows in that investment is motivated by long-term profit considerations based on directly controlling assets and managing production activities in host countries. To prospective host countries, FDI is particularly attractive due to the long-term spillovers that FDI can generate, as it contributes to capital formation, connotes access to international marketing networks, and provides a “means of transferring production technology, skills, innovative capacity, and organizational and managerial practices between locations” (Mallampally and Sauvant 1999:2; see also Jensen 2003). Thus, attracting FDI lies at the core of the economic development strategy of many countries. To compete for FDI, many countries make concerted efforts to improve conditions that influence the locational choices of foreign direct investors (Oman 2000; Mallampally and Sauvant, 1999).

Though there is more of a consensus on the economic benefits of FDI, the prospective relationship between FDI and human rights is a more contentious matter. The marketplace has oft been characterized as an oppressive “closet dictator,” (Greider 1993) and FDI has been associated with human rights conditions detrimental to the general population of the host country. Indeed, conventional wisdom holds that there is an inherent contradiction between FDI and respect for human rights. Along these lines, the interests of foreign capital are best served by governments that rigidly control their labor force and can secure conditions favorable for foreign investors. As Richard Falk (2002: 65) has argued, “such reasoning meant a preference for political leadership that denied elemental human rights to their citizenry.”

Recently, however, scholars have begun to argue that the relationship between human rights and foreign direct investment is more complex. Various factors have been cited that suggest an importance of human rights conditions to foreign investors. Among these are increased public awareness of human rights abuse, greater effectiveness of activists via the internet, an increasing need for well-trained labor, and a desire for access to new markets (Spar 1999). Arguably, respect for human rights creates an environment conducive to the development of human capital, with such countries generally more open, accountable, and economically efficient.

While the prospective relationship between FDI and human rights continues to be a prominent issue within the global political economy, the link between the two remains poorly understood. In this article we assess whether assumptions regarding the relationship between foreign direct investment and human rights are empirically correct. Is human rights an important precondition for attracting FDI? To answer this question, we empirically examine the aggregate relationship between human rights and FDI for the

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\* We thank Matt Baum for his helpful comments on a previous version of this paper, and Nathan Jensen for making his data available to us. We would also like to thank Betsi McGraw for her invaluable data entry assistance. All errors remain ours alone.

years 1980 through 1997. With a cross-sectional time-series design, we estimate the direct impact of human rights on the level of FDI inflows. We also probe the extent to which human capital provides a causal mechanism through which human rights affects FDI. To assess this, we empirically test the effect of human rights on human capital and explore the indirect effects of human rights on FDI.

We proceed with our analysis by first discussing the determinants of foreign direct investment inflows as supported by the current literature. Next we establish a theoretical basis for a relationship between human rights conditions and FDI. We examine the traditional understanding of the contradictory linkage between the two and consider the limitations of this approach. We then consider why foreign investors may instead be attracted to countries that respect human rights, and focus on the importance of human capital as a causal link between human rights and FDI. The research design section provides a model of FDI and discussion of the empirical techniques used. We then assess the impacts of human rights upon FDI and test its robustness across several alternative model specifications.

### **The Determinants of FDI**

The Ownership, Location, and Internalization (OLI) paradigm is generally viewed as the preeminent theoretical framework for foreign investment decisions (Dunning 1993). The OLI framework postulates that the decision to produce internationally is based on three conditions. First, a firm should possess ownership-specific advantages over firms in other countries. Possible examples include unique property rights or a broad variety of other intangible aspects, such as a product innovation or an advantage in marketing. Additionally, some location advantage must be gained by going abroad, such as a savings in transport costs, natural resources specific to the host country, proximity to a large market, or a need to get around trade barriers. Finally, a firm must desire to maintain possession of this advantage, rather than simply selling or licensing it to foreign companies. In other words, the firm must want to internalize its advantages across different markets.

The political environment of a host state can affect the ownership, locational, and internalization aspects of the OLI paradigm. Through the proper regulatory environment, a state can enhance ownership advantages by helping a firm preserve its intangible aspects or monopolistic advantage over local producers. State credibility decreases political risk and cost of internalizing production as multinationals gain confidence that the state will not adopt policies after initial investment that negatively affect their operations (Jensen 2003). Yet the role of the host state is strongest as a locational factor. Obviously, some locational criteria, such as natural resources and port access, are essentially fixed. There are, however, various ways that states can make their location more desirable, including preferential taxation policies and other financial incentives (Oman 2000). Going beyond fiscal policies, other facets of a host country may factor as locational criteria, including the political situation of the state as well as the education level of the workforce. Thus social and political factors can play an important role in FDI decisions as “host government policies create location-specific conditions that affect how well a firm can exploit its advantages” (Li and Resnick 2003: 180).

While the OLI framework serves as an important tool for understanding the motivations for investment decisions, greater insight is needed as to why some countries

are more successful than others in attracting FDI. Decisions about investing in a specific country are made at the firm-level. Yet countries differ in their ability to attract FDI (Jensen 2003). This article probes the extent to which human rights conditions function as a country-specific factor that affects FDI inflows. We posit that human rights conditions provide a locational advantage that is attractive to foreign investment. It is to the exact nature of this relationship that we now turn.

### **Human Rights and Foreign Direct Investment**

Extant work on FDI provides contrasting expectations as to the relationship between human rights and FDI. On one hand, a repressive state may connote a stable, well-controlled supply of labor. Moreover, since the rights of the local population are suppressed, the host country may have the ability to hold labor costs below the prospective market equilibrium. This controlled and relatively inexpensive labor supply can encourage FDI, particularly within the developing world. Conversely, respect for human rights creates an environment conducive to the development of human capital. Such societies tend to be more open, well-trained, and economically efficient. The “citizen voice” (Pritchett and Kaufmann 1998) that personal freedoms engender can play a key role in the economic effectiveness of a state and thus its attractiveness as a host for FDI.

### **The Traditional Understanding**

Critics have long held that there is an inherent contradiction between foreign direct investment and human rights. Lenin’s theory of imperial expansion provides a foundation for this line of thought. According to Lenin (1919), as the profitability of the home market stagnates, firms are forced abroad. Striving to maximize profits and maintain their own rates of growth, firms view countries where local populations can be exploited and controlled as desirable locations for foreign investment.

Building upon these ideas, Stephen Hymer (1971) has argued that in the quest to maintain financial dominance, multinational corporations seek to keep the world’s poorest populations under control. In order to avert protest against the inequities of the capitalist system, firms rely upon the repressive mechanisms of their host countries. Thus, foreign investors are attracted to, support, and potentially perpetuate repressive regimes.

In turn, “repressive regimes actively solicit the capital and connections associated with foreign direct investment” (Spar 1999: 58). Domestic elites reap a disproportionate benefit from foreign investment, and are often willing to compromise the good of the whole in order to attract and keep foreign investment (Maxfield 1998). Similarly, authoritarian regimes often suppress political opposition in order to secure a productive alliance with foreign firms (Evans 1979; Oneal 1994). Ultimately, human rights are sacrificed and the poor masses become a pool of cheap and pliant labor for multinational enterprises.

Anecdotal evidence attests to a preference within the international finance and business community for repressive societies. Historically, efforts to dispute the privileges of foreign investment often resulted in “intervention and the restoration of anti-labor, oppressive governments that were hostile to human rights” (Falk 2002: 64). In 1954, the United Fruit Company precipitated the CIA intervention against the economic

populism of the reformist government of Jacobo Arbenz. Likewise, International Telephone and Telegraph spurred the overthrow of Salvador Allende's populist regime in Chile in the 1970s.

More recently, the Indonesian government of President Suharto has been criticized for suppressing unions and enforcing low wages in order to attract and support foreign investment (Spar 1996). A 1995 memo from the Chase Manhattan Bank, which was intended for internal use only, bluntly addresses the Mexican government's efforts to attract FDI: "While Chiapas, in our opinion does not pose a fundamental threat to Mexican political stability, it is perceived to be so by many in the investment community. The government will need to eliminate the Zapatistas to demonstrate their effective control of the national territory and of security policy" (Graham 1995: 64).

To a potential investor, rights such as collective bargaining and the ability to protest without fear of violent retribution may represent uncertainty and risk. By denying rights such as these, repression can reduce this uncertainty by creating a controlled and constrained labor pool. The factor costs of labor can also be lowered when repressive polities restrict wages to a level below that which could be achieved in a more liberalized system (Kucera 2002; Collingsworth, Goold, and Pharis 1994). The end result is that repression allows a potential host country to "specialize" in low cost labor and become a "haven for foreign investors" (Rodrik 1996: 57). Repression can help to provide a "favorable balance of class forces," with low wages, tight control, and a minimum of class-based economic disputes (London and Ross 1995: 25; see also Ross and Trachte 1990). Within such a system, foreign capital is able to enjoy a particularly powerful role. Due to its economic power and influence with host elites, investors are able to establish an alliance with local and state capital to maintain the status quo (Evans 1979; see also Galtung 1970).

Thus, there is much to suggest that foreign firms are attracted, and contribute, to poor human rights conditions. A repressive society may produce conditions conducive to foreign direct investment.

### **An Alternative Perspective**

While conventional wisdom anticipates human rights and foreign direct investment to be at odds, multinational firms may instead be motivated to invest in countries that respect the human rights of their citizens. The traditional assumption is that the interests of the foreign investor are served through repression as it provides a means to ensure a compliant and inexpensive workforce, suppress class conflict, and maintain a status quo that protects the privileged position of the multinational. However, respect for human rights may facilitate a more efficient, productive, and skilled society and thus make a country a better host for FDI. To this end, respect for human rights engenders economic benefit by fostering the development of human capital (Kucera 2001; 2002; Feng 2001). In turn, higher levels of human capital may be linked to higher levels of FDI (Mankiw, Romer and Weil 1992; Jensen 2003).

Relatively recent developments in the scope and nature of foreign direct investment make such a relationship with human rights plausible. In the past, foreign direct investment heavily targeted primary sector industries such as mining and oil extraction. However, the composition of FDI has changed, with foreign investment increasingly going to consumer-products, manufacturing, and service and information

industries. For instance, in 1977, a third of the \$3.9 billion invested abroad by U.S. firms was in the petroleum sector (Kozlow, Rutter, and Walker 1978). However, in 1996, only \$6.1 billion of \$85.5 billion in foreign direct investment by U.S. firms went to the petroleum sector (U.S. Dept. of Commerce 1997; Spar 1999). The relative decline in importance of primary sector industries and the expansion of a wider range of industries may signal a calculus of interest that places greater value on human rights.

Arguably, primary sector industries are attracted to host countries due to the presence of natural resources and the availability of cheap and compliant labor. They are inherently limited in their choice of investment sites as they must invest in countries that possess the natural resources they wish to extract. As such, the pursuit of corporate needs may lead the firm to invest in countries that abuse human rights. Other industries, however, have far greater flexibility in selecting locations for investment. As such, they may (or may not) choose countries in which there is greater respect for human rights.

Different expectations and requirements of the workforce may further account for a relationship between human rights and foreign direct investment. Arguably, foreign investors are attracted to countries where the repressive capabilities of the state facilitate corporate efforts to lower costs by suppressing wages and regulatory standards. Under such conditions, the local population is exploited. Indeed, resource-extraction firms are the implicit focus of those who point to a compliant and cheap labor pool as a major motivation for FDI.

However, this element of the traditional understanding of the relationship between human rights and investment is questionable. With changes in the composition of FDI, labor costs have become less critical in determining production costs and investment decisions. By the late 1990s, labor costs generally comprised only 5 to 10 percent of production costs as compared to 25 percent in the 1970s (Spar 1999: 64). Furthermore, while foreign investors in non-extractive industries undoubtedly prefer cheaper labor and may even profess low wages to be a key factor in making investment decisions, there is considerable evidence that they give greater preference to the need to access and maintain a well-trained and skilled labor pool. Echoing the findings of a number of studies, a World Bank report contends that “while low wages may be desirable... perceptions of labor quality are key to attracting foreign investment” (Dasgupta, Mody and Sinha 1996; see also Spar 1999; Dunning 1993).<sup>1</sup> Such a quest for high quality labor is seen in Intel’s decision to build a semiconductor test and assembly plant in Costa Rica. The selection of Costa Rica as the location for investment was based, in part, on the ability of its educational system to produce the qualified labor pool needed for the high tech industry, as well as the lack of human rights abuse (Spar 1998).

While higher wages and skilled labor are by no means equivalent to respect for human rights, the ability of a country’s citizenry to attain an education and command a higher standard of living is more likely in an environment where human rights are respected rather than abused. Citizens who are able to express themselves without fear of government retribution are more willing to contribute their time, talents -- and more importantly, their ideas -- towards the economic good of their country (Pritchett and Kaufmann 1998). Such societal participation increases efficiency and economic effectiveness. Moreover, wide-spread respect for human rights, as individual liberty and

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<sup>1</sup> Moreover, as foreign investment in a country increases, wages will rise as the pool of potential workers becomes relatively scarcer (Feenstra and Hanson 1997; Lall 1995).

empowerment (Donnelly 1999), facilitates the ability and enhances the opportunity for the host country's citizenry to attain higher levels of education and training.

We suggest that when firms are investing abroad, they have an interest in targeting countries where repression is low and the quality of human capital is high. Though reducing wages and ensuring privileges may still be important, it is off-set by the desire for a skilled and productive workforce. If lowering labor costs is not the preeminent factor in the corporate calculus of interest, the zero-sum game implicit in the traditional understanding of foreign direct investment disappears and "success for firms no longer needs to come at the expense of the local population" (Spar 1999: 67).

Several studies provide empirical support for a positive relationship between respect for personal rights and various economic "successes." Countries with higher levels of respect for human rights have a better record of successfully completing World-Bank funded projects to build infrastructure (Isham, Kaufmann, and Pritchett 1997; Pritchett and Kaufmann 1998). Greater respect for human rights is also associated with improved rates of education of females and the reduction of infant mortality (World Bank 1991). Indeed, human rights "appear to have an instrumental value for improving a country's economic performance" (Isham, Kaufmann, and Pritchett 1997: 219). Moreover, "civil liberties at large, not for workers only, may matter more in attracting FDI" (Kucera 2002: 42). Thus, respect for human rights provides a foundation for attracting foreign direct investment to a specific location.

### **Specification and Data**

To examine the relationship between FDI and human rights, we use a time-series cross-sectional data set for the years 1980 through 1997. We include the broadest sample of countries for which data are available across any of the above years. Though complete data were not available for every variable for every year, pooling the data into an unbalanced dataset does increase the reliability of the estimates (Globerman and Shapiro 2003) by providing us with the greatest possible number of cases.

### **Dependent Variable**

We measure the dependent variable as the level of FDI net inflows, as a percentage of total GDP, which enter into a country each year. FDI refers to investments that require a lasting managerial commitment – that is, 10% or more of voting stock – in a state outside of the investor's home country. This variable can take on either positive or negative values, with the latter representing divestment. Data for this variable are obtained from the *World Development Indicators* (World Bank 2004).<sup>2</sup>

### **Human Rights**

Our substantive and empirical focus is on the impact of human rights conditions on FDI decisions. To measure such conditions, we use the Political Terror Scale (PTS). Generated by Stohl, Gibney, Poe, and their co-researchers (see Poe, Carey, and Vazquez

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<sup>2</sup> Another form of foreign economic capital, portfolio investment, occurs when foreign investors buy less than 10 percent of the stock of a company. In contrast to FDI, portfolio investment is generally a short-term commitment, does not confer ownership or management responsibilities, and is often done for speculative purposes. Given the lack of commitment implied by portfolio investment, theory does not lead us to expect human rights to be an important factor in such an investment decision.

2001; Poe, Tate and Keith 1999; Gibney and Dalton 1996; Stohl and Carleton 1985), the generously-shared PTS data focus on the amount of respect a country gives to personal integrity rights. These rights are scaled from one to five, with one indicating a low level of abuse and higher scores reflecting greater levels of repression. The specific categories, which are based on the work of Gastil (1980), are as follows:

1. “Countries... under a secure rule of law, people are not imprisoned for their views, and torture is rare or exceptional... political murders are extremely rare.”
2. “There is a limited amount of imprisonment for nonviolent political activity. However, few persons are affected, torture and beating are exceptional... political murder is rare.”
3. “There is extensive political imprisonment, or a recent history of such imprisonment. Execution or other political murders and brutality may be common. Unlimited detention, with or without trial, for political views is accepted.”
4. “The practices of (Level 3) are expanded to larger numbers. Murders, disappearances are a common part of life... In spite of its generality, on this level terror affects primarily those who interest themselves in politics or ideas.”
5. “The terrors of (Level 4) have been expanded to the whole population... The leaders of these societies place no limits on the means or thoroughness with which they pursue personal or ideological goals” (Gastil 1980, as quoted in Stohl and Carleton 1985; Poe, Tate, and Keith 1999; Poe, Carey, and Vasquez 2001)

This scale is applied, via content analysis, to yearly reports published by Amnesty International and the U.S. State Department. This produces two different, though highly related, annual measures of personal integrity rights – a PTS based on Amnesty International reports and a PTS based on the U.S. State Department *Country Reports*. Empirical analysis of these two measures has shown that they have become extremely alike over time, and that there is no substantive difference between them (Poe, Carey and Vasquez 2001; Poe, Tate, and Keith 1999). However, the annual reports by Amnesty International do not cover as many countries as those by the State Department. To maximize coverage and provide a balanced view, we combine the two PTS measures into one by taking the average of the two scores (Blanton 2000; Apodaca and Stohl 1999).<sup>3</sup>

### **Control Variables**

We also incorporate several control variables that are widely used in extant economics and business studies: market size, development, economic growth, trade openness, and capital flow restrictions. Market size is the most commonly used determinant of FDI. A country with a large market likely attracts FDI as it allows for economies of scale in terms of production and distribution. Both economic growth and development connote greater consumer demand and purchasing power, which are also attractive to FDI. Trade openness is also expected to increase FDI, as it represents an overall openness to the global economy and facilitates intrafirm trade.<sup>4</sup> Capital flow

<sup>3</sup> For observations where data were missing from one of the sources, we followed a substitution strategy with data from the alternative source used as the PTS score (see Poe, Tate, and Keith 1999).

<sup>4</sup> Host country size is operationalized in terms of GDP, expressed in terms of purchasing power parity (PPP). Economic growth is simply the percentage change in GDP over a year. We measure development in terms of GDP per capita (PPP). Trade openness is the sum of a country’s exports and imports divided by its

restrictions, on the other hand, likely inhibit FDI inflows, as they obstruct the ability of FDI to enter or leave a country (Li and Resnick 2003; Gastanaga, Nugent and Pashamova; 1998).<sup>5</sup>

A more recent addition to the literature on FDI is government consumption. Though the “conventional wisdom” on FDI posits that such investments force the state to limit its intervention into its economy, Jensen (2003; see also Romer 1990) posits that an increased role of the government in providing public goods will have positive effects on macroeconomic performance and thus encourage FDI.

Natural resource wealth can play a key role in the location criteria in making investment decisions, particularly for extractive industries. This leads to some interesting implications for the role of human rights in investment decisions. Specifically, if resource dependence is linked to repressive governance (Ross 2001) as well as increased FDI, it may be the case that much of the “conventional wisdom” about repression and FDI is due not to investor affinity for repressive governance but to the repressive nature of regimes that are rich in natural resources. Thus in assessing the prospective linkages between human rights and FDI, it is necessary to control for natural resources.<sup>6</sup>

### **Reciprocal Effects**

In this study, we focus on whether human rights influences foreign direct investment. Others have previously examined the impact of FDI in particular, and globalization in general, upon human rights (Spar 1999, Apodaca 2001; Richards, Gelleny and Sacko 2001, Milner 2002). The general argument across these works is that foreign economic capital can generate positive socio-political benefits for a society, or alternatively, that an alliance between foreign investors and the domestic elite forms which often entails the use of repression to maintain their privileged position. As there are theoretical reasons to expect that the relationship between FDI and human rights is characterized by reciprocal effects, it is important to incorporate this into our model (see Alvarez and Glasgow 2000). To this end, we use two-stage least squares regression.

We incorporate several control variables drawn from the literature on the determinants of repression (Milner 2002; Apodaca 2001; Richards, Gelleny and Sacko 2001; see also Poe, Tate, and Keith 1999). Specifically, we employ trade, democracy, economic development, economic growth, international conflict, internal conflict, and population. Though some of these same variables are also used in the primary equation, the models are sufficiently different for identification purposes. Here we focus on those variables not discussed above.

Democracy is operationalized in terms of a composite index that emphasizes the institutional dimension of democratic rule. This is different from our conceptualization of human rights in that it highlights the institutional framework for democratic governance while our human rights variable stresses individual rights. Drawn from the Polity IV

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GDP. Each of these measures is logged to correct for skewness. These variables are drawn from the *World Development Indicators* (World Bank 2004).

<sup>5</sup> The extent of capital controls is measured in terms of a 0-9 index of capital openness, ranging from 0 (no capital controls) to 9 (capital controls over nine categories of capital account transactions, including payments from exports, payments from credit operations, and proceeds from FDI). This variable is drawn from Jensen (2003), and based on Brume, Garrett, and Guisinger (2001).

<sup>6</sup> Resource wealth is operationalized as primary product exports as a percentage of GDP. Data on resource wealth were obtained from Jensen (2003; see also Sachs and Warner 1995).

database (Marshall and Jaggers 2000), the variable assesses regime type in terms of the competitiveness and regulation of political participation, competitiveness and openness of executive recruitment, and the constraints on the chief executive. The composite index is the difference between the democracy and autocracy scores for a given country. It ranges from -10, which denotes a strongly autocratic government, to +10 for a strongly democratic one.

International Conflict assesses whether a country was involved in either an international armed conflict or intervened into an internal armed conflict in another country in a given year. It indicates conflict where battle-related deaths are greater than 25 per year. Internal Conflict measures the presence or absence of involvement in internal conflict for each year, and indicates conflicts where there are at least 25 battle-related deaths per year. Data are from the Armed Conflict Dataset, version 2.0 (Gleditsch, Wallenstein, Eriksson, Sollenberg and Strand, 2002; Strand, Gleditsch and Wilhelmsen, 2003).<sup>7</sup> Data on Population is drawn from the World Bank (2004).

### **Human Rights, Human Capital, and FDI**

As explained above, we posit that respect for human rights conditions connotes a higher level of human capital, which makes for an improved climate for investment. Put another way, in addition to directly affecting FDI decisions, respect for human rights may have an indirect impact upon FDI through its impact upon the development of human capital. Thus by only modeling the direct influence of human rights, we may be underestimating its impact on FDI. It is therefore necessary to assess the potential indirect and direct impact of human rights upon investment decisions. We do this by incorporating an additional equation that estimates the determinants of human capital. Since our theory does not lead us to suspect any reciprocal effects between human capital and human rights – that is, we are not arguing that human capital causes human rights – this equation is recursive.

Following Baum and Lake (2003) we measure investments in human capital in terms of female life expectancy and female secondary school enrollment ratios. Life expectancy indicates the general health of the population and provides a basis for the ability of citizens to work and use their skills. It is measured in terms of the average female life expectancy from age zero. Secondary education reflects the acquisition of advanced skills that are likely desirable to foreign investors in non-extractive industries. Secondary education is measured as the ratio of total female secondary enrollment (irregardless of age) to the age appropriate female population for secondary school.<sup>8</sup> Female human capital indicators, as opposed to those for males, are particularly useful in this study as they are more sensitive to variations in the repressive tendencies of individual countries.

### **Empirical Analysis**

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<sup>7</sup> The Armed Conflict Dataset is available at <http://www.prio.no/jpr/datasets.asp>. For this study, we drew on data about the type and intensity of conflict.

<sup>8</sup> Data are obtained from the World Bank (2004). As this data are often not collected on a yearly basis, missing data is a problem. Along the lines of Romer (1997; see also Baum and Lake 2003), the value of each variable  $k$  is based on the values of  $k$  over the next four years. Thus  $k$  is equal to the average value across years  $t$ ,  $t+1$ ,  $t+2$ ,  $t+3$ , and  $t+4$ . The value of female life expectancy for a country in 1990, then, represents the value of that variable from years 1990 to 1994.

For our primary analysis of the direct effect of human rights on FDI, we use two-stage least squares regression to control for the potential effects of simultaneity between FDI and human rights. We incorporate fixed effects into all of the models. Adding country dummy variables to the model controls for systematic country-specific effects and spurious findings. The fixed effects estimator offers a very conservative test of the effect of human rights on FDI since the country dummy variables absorb much of the variations in FDI that might be due to other variables (Li and Resnick 2003, Green, Kim and Yoon 2001). As we have a cross-sectional time-series design, we must address potential problems posed by heteroscedasticity and serial correlation. To address serial correlation, we include yearly dummy variables in both equations (Beck and Katz 1995) and use White's (1980) estimator of robust standard errors to compensate for general conditions of heteroscedasticity.

The results of our base FDI model, shown in Table 1, provide strong support for our arguments. Even after controlling for other theoretically-based determinants of FDI, Human Rights Abuse is negatively and significantly related to FDI inflows. Thus countries with greater respect for human rights tend to attract significantly higher levels of FDI.<sup>9</sup> This suggests that in the decision calculus of foreign investors, any probable advantages of repression are outweighed by the costs that denial of individual rights portends for the business environment.

(Insert Table 1 About Here)

Results for the remaining independent variables provide further insights into the determinants of FDI. Market size is significant in the negative direction. This is probably due to two factors. First, since our dependent variable is a proportional measure (FDI as a percentage of GDP), equal amounts of FDI are proportionally larger in smaller countries, i.e. one billion dollars in FDI is proportionally larger in Togo than the United States. Moreover, it may be the case that any positive influence of size upon FDI is more country-specific and thus controlled for by the country dummy variables of the fixed effects model.<sup>10</sup> Development is positively related to FDI inflows, implying that the consumer markets and skilled labor of economically advanced markets attract FDI. Trade is also significant in the positive direction. Resource Wealth is negatively, and significantly, related to FDI. The negative relationship is consistent with broader structural changes in the investment market, which has become less centered around raw materials industries since the 1980s (Spar 1999). It may also be the case that the potential attractiveness of raw materials is outweighed by the other factors that accompany this "resource curse," including poor governance and instability (Ross 2000).

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<sup>9</sup> Data on the resource wealth measure was not as complete as was the case on the other variables. Indeed, dropping the resource variable increased the n by about 25%. However, as much of the data missing for this variable was across entire panels, rather than just country years within a panel, Romer's aforementioned procedure was of limited utility. Moreover, reviewing the raw data revealed that resource wealth was more subject to change from year to year than life expectancy or education levels i.e. many countries try to diversify their export profiles, while the discovery of resource wealth may lead to quick changes in a country's export profile. For these reasons, interpolation was a bit more problematic. We did, however, run alternate models without the resource wealth variable. Human rights was still significant, and there were no substantial changes in the remainder of the model.

<sup>10</sup> Indeed, other studies that use fixed effects models (Jensen 2003) did not find market size to be positively related to FDI.

The two-stage least squares procedure controls for possible reciprocal relationships by assessing both sides of the key causal relationship, in our case the linkage between human rights and FDI. Though we are primarily concerned with one side of the causal arrow – the impact of human rights on FDI – the other half of the equation merits explanation. For the most part, the model results, shown in Table 1, are consistent with findings of the extant literature.<sup>11</sup> Democracy, population, development, and internal conflict are significant in the expected directions. Like Apodaca (2000) and Milner (2002), but unlike Richards, Gelleny, and Sacko (2001), we find FDI to be a significant determinant of repression, as higher levels of FDI are related to lower levels of human rights abuse. However, we do not find trade to have a significant impact upon repression.

We next turn to the issues of human capital and indirect effects. As shown in Models 3 and 5 in Table 2, human rights repression is negatively and significantly related to two common indicators of human capital, female life expectancy and female secondary education. Thus countries that respect human rights are significantly more likely to have higher levels of human capital. Models 4 and 6 indicate the results when human capital measures are incorporated into our FDI model. Both human capital measures are positively related to FDI inflows, with life expectancy significant at the .05 level.<sup>12</sup> Incorporation of the human capital variables did not change the significance, or direction, of any of the control variables.

(Insert Table 2 About Here)

Thus far, we have found both human rights and human capital to be significant determinants of FDI. We have also found human rights to be significantly related to human capital. In Table 3 we assess the impact of the direct and indirect influence of human rights on FDI flows. The first column shows the magnitude of the direct effect of repression upon FDI. These effects are simply the variable coefficients multiplied by the full range of values of the given variable. Thus moving from the most abusive category (5) to the least abusive (1) would be associated with an increase in FDI equivalent to just under 1% of the GDP of the host country (.99). This represents a substantial impact upon a host country. For example, to a country the size of Bolivia, this would mean a net increase of 137 million dollars in FDI inflows from 1991 to 1992. Such a change would basically double their level of FDI, as their net inflows for 1991 were .98% of their GDP. Obviously, countries rarely make such drastic shifts over the course of a year, but this does illustrate how significant of an impact human rights can have upon FDI.

(Insert Table 3 About Here)

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<sup>11</sup> Model 1 reflects the results of the two-stage least squares procedure. However, Stata does not display the findings of the instrumented equation. The results presented in Model 2 were thus obtained with the two-stage procedure with FDI as the instrumented equation. Since ordered logit is commonly used in models with an ordinal dependent variable, it is suitable to use when modeling PTS as a dependent variable. However, Stata does not allow us to use ordered logit in a system of equations, and our primary FDI equation is better estimated by OLS. Moreover, none of the above-mentioned works control for the possible effects of simultaneity. We did, however, run the PTS model with ordered logit, and the results were essentially unchanged.

<sup>12</sup> Both of the human capital measures, life expectancy and female secondary education, were very highly related to GDP per capita (.88 and .84, respectively). However, models run without GDP per capita did not yield significantly different results in either the model (as a whole) or the human capital variables.

Ascertaining the indirect effects requires a bit more manipulation. The coefficient is obtained by multiplying the human rights coefficients in the human capital models (3 and 5) by the human capital coefficients in the FDI models (4 and 6). Since the indirect effects of human rights are produced by multiplying coefficients from different equations, the delta method is used to assess statistical significance. Per Baum and Lake (2003: 341), the standard error is derived as follows:

$$SE(\hat{G}) = \sqrt{[\beta_1^2 SE(\phi_1)^2 + SE(\beta_1)^2 \phi_1^2]}$$

Where  $\beta$  represents the coefficient on Human Rights Repression,  $\phi$  represents the coefficient on Human Capital (i.e., either life expectancy or secondary education), and  $\hat{G}$  represents the standard error of the predicted indirect effect of human rights on FDI.

As shown in Table 3, human rights has a significant indirect impact upon FDI through its influence on the measures of human capital. Though the magnitudes of the indirect effects are a good deal smaller than the direct impact of human rights or human capital, each represents a fairly substantial amount of additional FDI. Continuing with the example of Bolivia, these indirect effects would be associated with almost seven million dollars in additional FDI – over seven percent over their actual level.

Probing these indirect effects serves to provide insights into a mechanism through which human rights can influence FDI. Moreover, the presence of these effects implies that our original model, shown in Table 1, actually understates the influence of human rights upon investment decisions.

### **Alternate Specifications**

We believe our methodological approach to be the most effective way to estimate the relationship between human rights and FDI. Nevertheless, we ran our model with several other specifications in order to probe the robustness of the linkage between FDI and human rights. The results are depicted in Table 4.

(Insert Table 4 About Here)

A fixed-effects model is advantageous for our purposes as it provides a conservative test for the significance of human rights. Yet the “intrusive” nature of fixed effects models raises substantive and methodological concerns since it adds a large number of atheoretical independent variables to control for unspecified “country-specific” effects (Beck and Katz 2001). Indeed, the findings of fixed-effects models may diverge greatly from those of random-effects models, particularly when estimating economic phenomena (Resnick and Li 2003). It is thus worthwhile to test the robustness of the linkage between repression and FDI with a random effects model. As the results for Model 7 indicate, the impact of human rights repression on FDI inflows is virtually unchanged – repression remains negatively and significantly related to investment flows. Moreover, the impact of Trade on FDI is robust across both types of models. However, there are changes in most every other independent variable, thus implying that country-specific effects have a significant influence on the economic determinants of FDI. Put another way, there are significant differences in how these factors influence FDI across – as opposed to within – countries. For example, though size may be negatively related to FDI when controlling for within country differences, the broader relationship between size and FDI across countries is positive.

We also estimate our model using a lagged dependent variable. Though incorporating a lagged dependent variable is a commonly-used technique to control for

serial correlation, such a model may be troublesome particularly when estimating phenomena that change very little from year to year. Indeed, Achen (2000) posits that such models may unduly blanch out the effects of otherwise meaningful independent variables. As shown in the second column, incorporating a lagged dependent variable (instead of the yearly dummy variables) did yield some slight changes in the Economic Growth and Capital Controls variables. However, human rights remained robust.

We also test for the possible confounding effects of two related independent variables, democracy and the presence of advanced countries within our sample. Much like those who have assessed the impact of democracy on FDI (Jensen 2003; Li and Resnick 2003), we rely primarily on the traditional economic model of FDI and add in our political variable of interest. Hence, in our base model, we focus on human rights. Yet given the attention to the impact of democratic institutions on FDI, as well as the extent to which both human rights and democracy are associated with some type of empowerment – while democracy connotes the empowerment of a society, human rights focus on individual rights and liberties – it is worthwhile to test the prospective impact of democratic governance within our model.<sup>13</sup> We thus present a model that includes democracy as a potential determinant of FDI. As shown in Model 9 in Table 4, though we find democracy to be positively related to FDI, it falls short of statistical significance. While our study is not intended as a definitive test of the impact of democracy on FDI, these results do imply that the individual rights and liberties engendered by human rights may be a more relevant indicator of personal, and perhaps societal, empowerment than purely institutional measures. As Pritchett and Kaufmann (1998: 28) posit, “narrowly defined political democracy is neither necessary nor sufficient to allow full expression of the citizen’s voice.”

Finally, a great majority of FDI takes place within the advanced industrial economies. As human rights tend to enjoy greater respect within these countries, it raises the question of whether the linkage between human rights and FDI is an artifact of the presence of advanced countries within our sample. To control for this, we add a dummy variable for OECD countries. As shown in Model 10 in Table 4, though OECD countries are more attractive targets for FDI, the relationship between human rights and FDI remains robust.<sup>14</sup>

### Conclusions

While the prospective relationship between FDI and human rights has long been a prominent issue within the global political economy, the linkage is empirically underdeveloped. Rather, the “conventional wisdom” that there is a contradiction between

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<sup>13</sup> It should be noted that though there is often some degree of conceptual overlap between democracy and human rights, and there is likely a relationship between the two, democracy and human rights are substantively and empirically distinctive concepts (Donnelly 1999). Empirically, the correlation between our measures of democracy and human rights was -.35.

<sup>14</sup> As the OECD countries are primarily the wealthy nations, we also tried to isolate that income effect by running a model with an interactive term for OECD and GDP per capita. Random-effects versions of models with OECD and Democracy were also run. We found both Democracy and OECD to be positive and significant in these models, with t-scores of 3.28 and 2.25, respectively. We also ran alternate models to account for collinearity. Across our independent variables, there were two correlations above .5 – market size and development (.51) and capital controls and development (.52). To account for possible influences of this, we ran models without market size, development, and capital controls. The relationship between human rights and FDI remained significant across all of these models.

foreign direct investment and respect for human rights has persisted. We have argued that the opposite may in fact be the case -- that respect for human rights encourages FDI. Specifically, respect for human rights makes a country a more attractive host for FDI as it facilitates a more efficient, productive, skilled, and engaged society.

We use a system of three equations to assess the direct and indirect effects of human rights on FDI. We first use a simultaneous-equations model, specifically two-stage least squares, to assess the direct linkage between human rights and FDI. To assess the indirect effects of human rights on FDI, through its effect on human capital, we add a recursive equation to the system that estimates the determinants of human capital. We find that human rights has both direct and indirect effects on FDI, with repression negatively related to FDI inflows. Examining human capital as one mechanism through which human rights influences FDI, we find human rights significantly related to human capital, whether measured in terms of female life expectancy or female secondary education enrollment, and human capital positively related to FDI. Furthermore, we find that, through human capital, human rights has a significant indirect effect upon FDI.

Our results thus call into question the “conventional wisdom” regarding FDI and repression. Moreover, they suggest a fairly clear policy implication for states seeking to encourage and compete for FDI as there is not the traditionally assumed “trade off” (Donnelly 1984) between the protection of human rights and the ability to attract foreign investment. States that are able to protect the rights of their citizens are more attractive hosts for foreign capital and hence enhance their locational value as a potential site for foreign investment. More broadly, while there are many potential instances of tension between economic interests and societal norms and values, we have shown that respect for human rights is one area in which these values can actually serve to complement and reinforce the global economy.

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Table 1: Human Rights as a Determinant of FDI – A Two-Stage Analysis

<i>Variables</i>	<i>Model 1: FDI</i>	<i>Model 2: Human Rights Repression</i>
Human Rights Repression	-.198 (-3.04)***	--
FDI	--	-.035 (-2.92)**
Market Size	-3.62 (-4.44)***	--
Development	3.22 (4.49)***	-.882 (-6.35)***
Economic Growth	.023 (3.06)***	-.005 (-1.37)
Trade Openness	.019 (4.76)***	.0003 (.18)
Government Consumption	-.001 (-.07)	--
Capital Controls	.045 (1.60)	--
Resource Wealth	-.025 (-3.50)***	--
Democracy	--	-.017 (-3.00)***
Internal Conflict	--	.652 (8.09)***
External Conflict	--	-.093 (-.99)
Population	--	(.000) (5.88)***
<i>Time Dummies</i>	Yes	Yes
<i>Country Dummies</i>	Yes	Yes
<i>Observations</i>	1316	1316
<i>R<sup>2</sup></i>	.65	.66

Note: Two-stage fixed-effects regression includes robust (Huber-White) standard errors; t-statistic indicated in parentheses.  
\* indicates significance at the .1 level (two-tailed test)  
\*\* indicates significance at the .05 level (two-tailed test)  
\*\*\* indicates significance at the .01 level (two-tailed test)

Table 2: Examining the Indirect Effect of Human Rights on FDI

<i>Variables</i>	<u>FEMALE LIFE EXPECTANCY</u>		<u>FEMALE SECONDARY ENROLL</u>	
	<i>Model 3:</i> <i>DV=Life Expectancy</i>	<i>Model 4:</i> <i>DV=FDI</i>	<i>Model 5:</i> <i>DV=Secondary Ed.</i>	<i>Model 6:</i> <i>DV=FDI</i>
Human Rights Repression	-.192 (2.19)**	-.212 (-3.31)***	-.569 (-2.15)**	-.214 (-3.28)***
Female Life Expectancy	--	.033 (1.96)**	--	--
Female Secondary Enrollment	--	--	--	.008 (1.59)
GDP per capita <sub>t-1</sub>	.001 (2.15)**	--	.001 (9.18)***	--
Population	.0001 (5.58)***	--	.0001 (3.64)***	--
Market Size	--	-3.72 (-4.60)***	--	-3.25 (-3.87)***
Development	--	3.23 (4.59)***	--	2.60 (3.50)***
Economic Growth	--	.024 (3.24)***	--	.028 (3.64)***
Trade Openness	--	.019 (4.75)***	--	.018 (4.34)***
Government Consumption	--	-.003 (-.20)	--	-.008 (-.50)
Capital Controls	--	.046 (1.64)	--	.044 (1.51)
Resource Wealth	--	-.025 (-3.43)***	--	-.24 (-3.35)***
<i>Time Dummies</i>	Yes	Yes	Yes	Yes
<i>Country Dummies</i>	Yes	Yes	Yes	Yes
<i>Observations</i>	2300	1304	2170	1259
<i>R<sup>2</sup></i>	.98	.66	.97	.66

Note: FDI models are two-stage fixed-effects regression. For presentation purposes, the instrumented PTS model is not show (see Table 1). Human Capital models are OLS regression. All models include robust (Huber-White) standard errors; t-statistic indicated in parentheses.

\* indicates significance at the .1 level (two-tailed test)

\*\* indicates significance at the .05 level (two-tailed test)

\*\*\* indicates significance at the .01 level (two-tailed test)

Table 3: Direct and Indirect Effects of Human Rights Repression on FDI

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	Direct Effect	Indirect Effects	Significance Level
Human Rights Repression	.99%		.001
Human Rights Repression (through Female Life Expectancy)		.03%	.07
Human Rights Repression (through Female Secondary Education)		.02%	.10

Table 4: Alternate Specifications of the FDI Model

<i>Variables</i>	<i>Model 7</i> <i>(Lagged FDI)</i>	<i>Model 8</i> <i>(Random-Effects)</i>	<i>Model 9</i> <i>(Democracy)</i>	<i>Model 10</i> <i>(OECD)</i>
Human Rights Repression	-.141 (-2.24)**	-.239 (-5.82)***	-.195 (-3.00)***	-.185 (-2.86)***
FDI (lagged)	.393 (7.39)***	--	--	--
Market Size	-.819 (-1.74)*	.125 (3.32)***	-3.61 (-4.44)***	-3.21 (-4.21)***
Development	1.399 (2.42)**	-.095 (-1.20)	3.23 (4.44)***	3.00 (4.36)***
Economic Growth	.012 (1.51)	.030 (3.81)***	.023 (3.04)***	.022 (2.94)***
Trade Openness	.017 (4.05)***	.021 (10.52)***	.019 (4.70)***	.020 (4.88)***
Government Consumption	-.002 (-.16)	-.053 (-6.64)***	-.001 (-.09)	.001 (.05)
Capital Controls	.060 (2.84)***	.011 (.49)	.046 (1.71)*	.046 (1.64)*
Resource Wealth	-.022 (-2.98)***	-.001 (-.68)	-.025 (-3.50)***	-.025 (-3.48)***
Democracy	--	--	.005 (.42)	--
OECD	--	--	--	.706 (2.33)**
<i>Time Dummies</i>	no	yes	yes	yes
<i>Country Dummies</i>	yes	no	yes	yes
<i>Observations</i>	1307	1316	1316	1316
<i>R<sup>2</sup></i>	.69	.38	.65	.65

Note: All models include robust (Huber-White) standard errors; t-statistic indicated in parentheses. For presentation purposes, the instrumented equation (PTS) is not shown.  
\* indicates significance at the .1 level (two-tailed test)  
\*\* indicates significance at the .05 level (two-tailed test)  
\*\*\* indicates significance at the .01 level (two-tailed test)