

# Democracy, Security, and US Foreign Direct Investment

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## Abstract

A growing literature shows that property rights enforcement, reduced corruption, and greater political 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 factors: macroeconomics, economic reform, good governance, 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. Using panel data, we find that the effect of democracy is overshadowed by rival explanations including market size, trade opportunities, proximity of the host country to the US, membership in Warsaw Pact, and presence of US troops. US FDI inflows follow US troops but non-US FDI does not, perhaps suggesting that a stable investment climate, servicing of US ground forces, and even cronyism affect US FDI.

**Keywords:** FDI; democracy; security; follow the flag; economic reforms.

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## INTRODUCTION

Since the 1980s, a foreign direct investment (FDI) revival has occurred (Grosse 2001, 119). The expected political stability produced by the fall of communism and spread of democratic principles enhanced investor interest, with US multinational corporations (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 factors that serve as determinants for US FDI. One factor 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.<sup>1</sup> Democratic regimes that support the rule of law, transparency, and other democratic principles enhance investor confidence (Busse 2004; Henisz 2000; Jensen 2003; Li and Resnick 2003; 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; Crenshaw 1991; Haendel 1979; Levis 1979; Tuman and Emmert 2004). 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 unnecessary as FDI substitutes for troop deployment, helping to secure the US national interest.

This research note tests existing theory to assess the main determinants of US FDI inflows. We provide a multivariate analysis of FDI based on the following groups of independent variables: (a) macroeconomic conditions and proximity to the US; (b) economic reforms; (c) good governance factors; and (d) follow the flag considerations. Controlling for macroeconomic, economic, good governance, and follow the flag factors, we test the importance of democracy on US FDI inflows. Using panel data for 135 developing countries from 1965 to 2002, this note shows that democracy has limited effect on US FDI inflows. Market size, trade opportunities, proximity to the US, membership in the Warsaw Pact, and the presence of US ground troops has more significant impact than regime type on US MNC investment.

The findings that larger markets and trade opportunities enhance US FDI, while the further the country is from the US, the less likely US firms will invest are not unexpected results. Given the expansion of trade and interdependence under a more global economic environment and the costs economically and politically of maintaining factories and shipping goods from far distances, market size, export/outsourcing opportunities, and geographical closeness to the US is predictable. Similarly, it is not surprising that US firms invested less in Warsaw Pact countries as US MNCs received cautions from both the Soviet Union and US government during the Cold War era.

More interesting is the finding that the presence of US ground troops attracts US FDI, while troops have little effect in promoting inflows from non-US MNCs. We speculate that investment stability, military outsourcing, and perhaps cronyism are the reasons why troop deployment affects investors differently. US troops stationed abroad signal credible positive relations between the US and host countries, enhancing investment stability for US FDI (Jones and Kane 2005). Additionally, with the increased outsourcing of US military activities to private companies, US defense contractors are investing

more in host countries to service ground troops. The fact that such contracting sometimes involves non-competitive bidding hints that cronyism may also be an element in US FDI. With firms such as Halliburton, its subsidiary Kellogg Brown & Root, and Bechtel, earning millions if not billions of dollars in contracts, US ground troops provide secure and lucrative investment opportunities for US firms overseas to rebuild host countries.

Despite the limitations of a broad aggregate study, our findings hold important implications on the determinants of US FDI. First and most importantly, our findings contribute to the debate on the effects of democracy on foreign investor preferences. Regime type appears to have little impact on US foreign investors. Although established OECD democracies continue to receive the most interest from US MNCs, in the developing world, regime type is a less crucial indicator of US investor preferences. Second, the results suggest that investment stability provided by US deployed troops are an important example that economic and security goals are not necessarily mutually exclusive. US troops not only support a stable investment climate for US FDI but through the outsourcing of military functions to private contractors offer profitable opportunities available mostly to US firms.

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 over 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.<sup>2</sup> 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).<sup>3</sup>

Nationalization of SOEs complemented efforts away from economic interdependence. Many 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. 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).<sup>4</sup> 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 and debt crisis in the 1980s.<sup>5</sup> Since the mid-1980s, developing countries have abandoned ISI policies, in many cases shifted to democratic rule, and attempted to raise capital through multinational investment, all part of the free-market revolution tied to the “Washington Consensus” model.<sup>6</sup> With the spread of market reforms, advance of democratic institutions, and growing capital needs, the question is where would US MNCs choose to invest?<sup>7</sup>

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 provide varying incentives for foreign investors.<sup>8</sup> 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). On the other hand, lower per capita GDP implies reduced wage costs for employers, enhancing interest for labor-intensive businesses.<sup>9</sup> MNCs are also attracted to countries located closer to home that reduce shipping costs and may provide MNCs with greater control over the enterprise.

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).<sup>10</sup> 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).

Alternatively, good governance factors such as regime type and risk considerations also affect foreign investment. A debate in the development literature questions whether authoritarian or democratic regimes are most likely to impress investor confidence. Scholars including Huntington (1968), O Neal (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. 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.<sup>11</sup> Democracies promote stability and credibility that bolster enforcement of property rights (Biglaiser and Danis 2002; Li and Resnick 2003).<sup>12</sup> 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.<sup>13</sup> 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, stability based on factors such as regime durability without major political upheavals provides a predictable and stable political environment that safeguards private property and limits political risk (Lehmann 1999; Crenshaw 1991).

Lastly, follow the flag concerns also affects investor interest.<sup>14</sup> 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 a large US troop presence draw in FDI, as the troops provide security against asset expropriation. 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, as Little and Leblang (2004) claim, 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. Similarity of United Nations (SUN) votes between the United States and host countries are another potential sign of political stability for US investors. Consistent voting with the US promotes investor confidence that the host country will not take action, such as asset expropriation, opposed by the US government. Whether the country was a member of the Warsaw Pact also is expected to have debilitating effects on US FDI, as not only did the Soviet Union often proscribe US investment but so too did the US government.

This study develops three 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. Factors such as enhanced democratization or regime durability are critical as investors seek political stability to reduce investment risk. The third hypothesis suggests that follow the flag considerations attract US MNCs. Factors that include the presence of US troops or similar UN voting patterns allay concerns about possible expropriation and support political stability.

## **RESEARCH DESIGN**

### *Dependent Variable*

We selected 135 countries from 1965-2002 to assess the effect of macroeconomy, economic reforms, good governance, and follow the flag on US FDI. Our analysis includes all cases for which data are available, representing a good cross section of developing countries.<sup>15</sup> 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 millions of US dollars. In order to control for inflation, we place the data in constant dollars by using a GDP deflator. These data

are also logged.<sup>16</sup> An important consideration concerning these data is that the BEA suppresses country data for some years. The reason for this is to avoid the possibility that certain FDI can be traced back to specific investors. Following Rosecrance and Thompson (2003) and Little and Leblang (2004), we exclude these years in our analysis.

### *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 (all lagged), and geographical distance from the US (distance between capitals). 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 located closer to the US reduce transportation costs and may make it easier to control investments or respond more quickly to changing trends, such as in the toy and clothing industries. Data for the macroeconomic variables 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). The distance from the US variable comes from Gleditsch (2005).

#### 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).<sup>17</sup> 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 (*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 employ a 9-point capital control measure developed by Brune, Garrett, and Guisinger (2001) to assess capital liberalization, where a score of 9 indicates no capital controls with each lesser number suggesting greater controls.<sup>18</sup>

### Good Governance Variables

Several good governance factors may impact US FDI. Regime type, regime durability, and conflict 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 AUTOC 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 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) that 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.

Lastly, conflict produced by warfare events is expected to reduce foreign investor interest. To measure conflict, we use Marshall's 'Societal Effects of Warfare' Data (2002).<sup>19</sup> 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 (Myanmar) 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.

### Follow the Flag Variables

Presence of US troops, similarity in UN voting between the US and possible host countries, and membership in the Warsaw Pact suggest 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 they show that as US FDI goes up in a country, troop numbers go down in a substitutability process. The need for US troops decreases as FDI substitutes for troops to promote the national interest, with Western Europe and Eastern Asia serving as examples (Little and Leblang 2004, 17). We obtain US troop numbers in the host country from the Department of Defense (<http://web1.whs.osd.mil/mmid/military/miltop.htm>).<sup>20</sup> We test the logged version of this measure because of outliers in the data (Jones and Kane 2005). We expect that as the US military deploys troops overseas, foreign investment will not be far behind. We obtain congruence figures for UN voting between the US and developing countries from Gartzke, Jo, and Tucker (1999). We use a dummy variable to distinguish Warsaw Pact country years.

We also include net global FDI to differentiate between US and non-US MNCs. Follow the flag factors linked to security may affect US MNCs but not necessarily firms outside the US. To measure world FDI, we use the average net FDI inflows as a percentage of GDP from the *World Development Indicators* (2004). Unlike overall net FDI flows that subtract foreign capital inflows from domestic

capital outflows, net FDI inflows measure a change in the position of foreign investors in a country (Jensen 2003). Although US MNCs are included in the net FDI inflows, MNCs from all over the world also make up the dataset.

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

[Table 1 here]

## **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.<sup>21</sup> 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 in each of our models. Stata uses Prais-Winsten regression in the presence of AR1 in a panel setting.

## RESULTS

Results of the PCSE models are shown in Table 2. The first model contains host country attributes and economic indicators while the second model adds international factors. Without looking any further, much of the variation in US FDI can be accounted for by market size and distance from the US.<sup>22</sup> The reform hypothesis is partially supported, as trade reform but not capital controls is significant in each model. The second hypothesis based on governance factors is not supported. Regime type, regime durability, and conflict are each in the expected direction but not significant. American firms do not seem to be intimidated by conflict, young governments, or low levels of democracy in the developing world. The third hypothesis that American FDI responds to troop deployments appears significant and positive. This holds even after controlling for net global FDI (not significant), foreign policy affinity (not significant), and Warsaw Pact countries (negative and significant).<sup>23</sup>

[Table 2 here]

In order to gain a clearer understanding of the impact of each variable, we use the second model to gauge marginal effects of certain variables. We test several variables at their 90<sup>th</sup> percentile then we combine them to test a best-case scenario. Distance is tested at its 10<sup>th</sup> percentile since its impact is negative. These results are contained in Table 3. When market size is at its 90<sup>th</sup> percentile, the predicted US FDI increases a great deal over the baseline prediction (all variables set to mean). Distance also has a relatively large impact. In the best-case scenario, predicted US FDI is exceptionally higher than the baseline. Countries closer to the US, with open trade, large markets, and higher numbers of US troops, such as in Latin America (e.g., Mexico, Panama, and Brazil), can expect greater levels of US FDI. In the worst-case scenario, small markets, distance, illiberal trade policies, and no US troops spell exceptionally low levels of US FDI. There are many African (e.g., Cameroon, Liberia, Tanzania, Mali, Malawi, Chad,

Madagascar, Sierra Leone, Burundi, Burkina Faso, and Mozambique) and Asian (Cambodia, Laos, Nepal, Fiji, and Sri Lanka) countries that exhibit the worst-scenario qualities and receive minimal US FDI.

[Table 3 here]

## **DISCUSSION**

How do we account for the pattern that emerges from the statistical estimates? First, why are market size, trade opportunities, proximity to the US, and membership in the Warsaw Pact more significant than regime type on US MNC investment? Second, why do US MNCs tend to invest more in countries with US troop deployments? 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.

The importance of market size, trade openness, closeness to the US, and non-membership in the Warsaw Pact, and lower relevance of regime type makes sense with a closer evaluation of the data. For the past forty years, much of US FDI has flowed to OECD countries including the United Kingdom, Canada, the Netherlands, Germany, France, Japan, Switzerland, and Australia. Only a few developing countries have consistently received US investor interest, and those countries are all in Latin America: Mexico, Brazil, Panama,<sup>24</sup> Argentina, and Venezuela.

What distinguishes these countries from other developing countries is large markets (with the exception of Panama), significant trade openness reinforced by the relatively close proximity to the US, and non-membership in the Warsaw Pact. The benefits of large markets are well established because of opportunities to satisfy domestic consumers as well as potentially reduced labor costs based on a sizable population. Export opportunities are also enhanced based on their geographical location. The growth and development of maquiladoras in Mexico, the signing of the North American Free Trade Agreement, and the goal of creating not only a Central American Free Trade Agreement but also a Free Trade Area of the

Americas for the Western Hemisphere reinforce the importance of outsourcing opportunities and proximity to the US for investors. The Warsaw Pact nations not only were far from the US border hampering trade but they also played into Cold War politics. As early as the late 1940s, the Soviets created COMECON, a rival organization to the Bretton Woods institutions, to shield countries in the Soviet orbit away from capitalist influence. US investors also received little encouragement from the US government who favored allies linked to the North Atlantic Treaty Organization.

In contrast, regime type carried little influence in the US investment decisions in the five Latin American countries. With the exception of Venezuela, which despite President Hugo Chavez' recent actions, has remained democratic since the 1960s, the others shifted between authoritarianism and democracy. US investment fell and climbed in these countries with little consideration of regime type. In Argentina, for example, the serious economic crisis that began in 2001 slowed US FDI, but regime type had little effect on the decision, as democratic rule continued. In Venezuela, investment fell in the mid-1970s not because of a regime change but because of the nationalization of US oil assets.

More instructive is the finding that the presence of US ground troops attracts US FDI. It might be argued that US troops promote stability for investors in developing countries. Consistent with the work by Globerman and Shapiro (2002), Grosse (1997, 148), Li and Resnick (2003), Tuman and Emmert (2004), and Biglaiser and DeRouen (2006), political stability and expropriation fears are important factors that affect investment decisions, and ground troops lessen risk in developing countries. The high costs associated with initial capital infusions make MNCs most concerned about stable property rights. Building on Vernon's (1998, 65) work on the "obsolescing bargain" 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. If ground troops promote political stability and reduce

investor risk, we would expect not only US MNCs but also firms outside the US to be attracted by US ground troops. However, we find that ground troops only draw in US firms.

Part of the explanation perhaps involves the credibility signal US troops provide for US MNCs when they are stationed in host countries. US troops are often stationed abroad to conduct regular training exercises with local military forces, staff bases, and engage in activities that include drug interdiction and peace-keeping efforts. Frequent deployments and joint military exercises during peace time in the past in Morocco, the Philippines, and Thailand, and currently in Egypt, Panama, Saudi Arabia, Singapore, South Korea, Turkey, and the United Arab Emirates indicate positive relations and in some cases formal and informal alliances between the US and host countries. Such hospitality can spill over into cooperation and stability for US MNCs, prompting greater US investor interest.<sup>25</sup> As Jones and Kane (2005, 6) argue, “The security guarantee of U.S. troops is a powerful signal to foreign investors, perhaps even a deciding factor for firms choosing where to locate new factories.”

Similarly, the aligning of the US and Colombia and Peru in drug interdiction efforts that have brought US troops to train local military and police forces may also enhance the investment climate for US investors. Although today it is very rare for US troops to become directly involved in the domestic political affairs of the countries they are stationed in (this is one thing the Pentagon is still willing to leave to the CIA), or to act to directly protect US FDI, the willingness of potential FDI host countries to accommodate an American troop presence, even if only on a temporary basis, may be an important signal to US MNCs of a more positive political environment for US FDI in a particular country.<sup>26</sup> In other words, the presence of US troops indicates a political relationship between the host country and the US government that greatly reduces the chances of the host country interfering with US investments.

Thus, US troops are likely to be an important indicator to American investors of the relative security of their investments in any particular country. This may also extend to situations involving

considerable political instability and/or regime change. Even if the US troops play no role in the local political situation, so long as they do not themselves become an issue in the local political unrest American investors may see this as an important signal that their investments will also not suffer from the political conflict. And in cases of actual regime change the attitude of the new government to a pre-existing US military presence may also be taken as an important indicator of how that government will treat American investments. The point then is not that the presence of US troops is important to American investors because of any expectation that the troops themselves will take an active role in defending American investments, but rather as an indicator of the overall hospitality of any particular country and regime toward any form of American presence in the country, be it military or economic. On the other hand, the lack of military presence is not necessarily a sign of an inhospitable climate to US investors. In fact, there are a great many cases where the US investors are doing extremely well in countries with little or no US presence at all. The argument is simply that the presence of US troops can act as a barometer of the potential friendliness to US investors.

Of course when US troops are deployed into actual combat operations this would likely have the opposite effect. Few US MNCs are likely to be very interested in investing anywhere so politically unstable as to require the involvement of US troops in combat. So a clear and obvious exception to this argument would be cases such as Vietnam, Iraq, Afghanistan, etc., where the US forces are actually engaged in extensive and long-term combat.

However, changes in the support structure for the military may also raise US FDI even in cases of combat. Since the end of the draft in 1973 and the advent of the all-volunteer military, military outsourcing to private firms has provided jobs ranging from cooking and cleaning duties to hiring civilian specialists to maintain and repair the services' sophisticated weapons systems (Pan 2004). Hailed as a means to save tax dollars, military outsourcing and the downsizing of professional armies expanded in the

1990s with the end of the Cold War and the ideological trend toward the privatization of many government functions (Singer 2005). The process of contracting out to mainly US private firms, tasks that used to be performed by military personnel, shows that situations of actual combat with large troop deployments will also almost certainly lead to an increase in some forms of US FDI, but most, if not all of this, will involve support for the military operations themselves, rather than traditional forms of FDI. As the recent contracting in Iraq attests, US private firms have received a large portion of outsourced contracts to support for the US troop presence itself. Although a less common and maybe more short-term effect, privatization of military services supports the positive impact of US ground troops on US FDI.

Non-competitive bidding, a controversial contracting process used in Iraq, also supplements US FDI in host countries with US troops deployed. As Republican and Democratic members of Congress debate the no-bid contracts and over-charging by Halliburton, and its subsidiary Kellogg Brown & Root (KBR), claims of cronyism appear (Eckholm 2005, A-10). The contracting director of the Army Corps of Engineers, Bunnatine H. Greenhouse, contends that the Corps turned “too readily and too generously” to Halliburton, a company formerly headed by Vice President Dick Cheney, with one of the biggest single contracts of the war (Eckholm 2004, A-10). The fact that Halliburton and its subsidiary KBR is the biggest private contractor for American forces in Iraq worth some \$11 billion dollars has not prevented questions about favoritism (Mayer 2004, 80). In addition, the Center for Public Integrity reports that since 1998, “[m]ore than 40 percent of the Pentagon's \$900 billion in prime contracts during the past six years have been awarded without competitive bidding” (Merle 2004, E-1). The Pentagon's largest contractors, including US corporations such as Lockheed Martin and General Dynamics, received most of their defense revenue through no-bid contracts (Merle 2004, E-1).<sup>27</sup> Regardless of the outcome of

congressional inquiries, private military firms have received lucrative US government contracts and invested substantial monies to rebuild host countries occupied by US ground troops.

## **CONCLUSION**

A large debate exists in the FDI literature over the effect of regime in attracting investment capital. Our work adds to the debate by showing that regime type appears to have little effect in drawing in US FDI. Instead, we find that market size, trade opportunities, proximity of the host country to the US, membership in Warsaw Pact, and the presence of US troops are more important in attracting US foreign investment than the type of government in office. The positive and significant correlation between US FDI and market size, trade opportunities, and proximity of the host country to the US are expected and consistent with the literature. So, too, is the negative effect of membership in the Warsaw Pact.

The more novel result is the positive effect of US troops in attracting US capital inflows. At first blush, the finding suggests the relevance of political stability stemming from ground troops. However, since only US MNCs are apparently drawn to invest in host countries occupied by US troops, it is debatable why political stability would not also attract FDI from non-US MNCs. We speculate that US troops stationed in host countries credibly signal investment stability that only US firms experience. US deployed troops signal positive relations and possibly alliances between the US and host countries that spill over into a friendlier investment climate for US MNCs. Additionally, the privatization of military duties is responsible for the correlation between US FDI and US troops. Military outsourcing to private firms mainly from the US has stimulated significant investment in host countries with US ground troops. Non-competitive contracts that in some cases stir up charges of cronyism only add to the monies available for private US contractors to rebuild host countries occupied by US forces.

More comparative research on FDI inflows is needed to evaluate the effect of troop deployments and democracy on potential investors. Specifically, qualitative work is recommended to determine if stability, outsourcing, or cronyism are the most important factors for the increased US FDI in countries with US troops deployed. Efforts to capture the various elements of political stability are also warranted. Not only are risk assessments needed to evaluate property rights and the probability of expropriation or contract renegotiation, often a key concern for investors, but other measures that capture property rights enforcement are also desired. In addition, work on institutional microfoundations might provide clues that demonstrate how domestic political factors influence FDI inflows. Democracy disaggregated might show that certain political institutions are more important than others in attracting US FDI. Based on our sample, regime type appears to have little impact on US FDI. Security oriented goals along with economic factors are most effective in drawing in US investors.

**Table 1. Summary Statistics**

<b>Variable</b>	<b>Obs</b>	<b>Mean</b>	<b>SD</b>	<b>Min</b>	<b>Max</b>
FDI	3916	3.844	3.099	-2	10.889
Market	3762	9.820	.970	-4.772	12.082
Development	3744	2.995	.529	1.693	4.615
GDP growth	3816	3.529	7.103	-51.030	106.279
Distance	4623	8.563	.488	6.919	9.228
Polity	4286	-1.624	6.881	-10	10
Conflict	4489	1.005	2.157	0	14
Durability	4325	16.949	16.325	1	133
Capital Controls	2926	1.590	2.549	0	9
Trade	3009	.738	.507	.060	5.890
SUN	3455	-.145	.282	-.667	1
US Troops	4475	2.407	2.258	0	13.194
Warsaw Pact	4623	.030	.170	0	1
Net FDI	3178	1.780	4.385	-82.873	72.254
Conflict*Troops	4475	2.494	7.771	0	92.361

**Table 2. Determinants of US FDI**

<b>Variable</b>	<b>Host Country</b>	<b>Follow the Flag</b>
Development	.227	.135
	.300	.347
Market Size	2.401***	2.297***
	.210	.226
GDP Growth	-.00007	.003
	.004	.004
Distance	-1.606***	-1.483***
	.186	.226
Trade	.372 <sup>a</sup>	.453*
	.243	.260
Capital Controls	.020	.016
	.027	.030
Conflict	-.004	-.013
	.038	.042
Polity	.007	.001
	.010	.011
Regime Durability	.0003	-.002
	.006	.007
SUN		.089
		.235
US Troops		.130*
		.055
Net FDI		.003
		.015
Warsaw Pact		-2.129*
		.998
Constant	-7.074**	-7.052***
	2.458	2.091
Obs	1873	1514
R <sup>2</sup>	.242	.309
Wald chi <sup>2</sup>	542.48	529.02
Prob > chi <sup>2</sup>	.0000	.0000

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

**Table 3. Marginal Effects**

<b>Manipulation</b>	<b>Predicted USFDI (log 1995 millions)</b>
Baseline (all at mean)	4.11
Market size at 90 <sup>th</sup> ptl	6.57
Distance at 10 <sup>th</sup> ptl	5.35
Troops at 90 <sup>th</sup> ptl	4.40
Trade at 90 <sup>th</sup> ptl	4.39
Best-case scenario (all of the above and Warsaw Pact=0)	8.38
<u>Worst-case scenario (above at 10<sup>th</sup> ptl; log distance at 90<sup>th</sup> ptl, Warsaw=1)</u>	<u>-1.65</u>

Note: based on follow the flag model; variables not manipulated are set to mean;

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## ENDNOTES

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

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

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

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

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

<sup>6</sup> See Armijo (1999) to understand why developing countries turned to FDI as compared to aid, loans, and portfolio investment. See Williamson (1990), who coined the phrase “Washington Consensus,” for details on the policies reputedly favored by international financial institutions and economists in the US.

<sup>7</sup> For studies that show countries seeking FDI, see Mallampally and Sauvart (1999); Lipsey (2001).

<sup>8</sup> 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.

<sup>9</sup> See Neumayer and de Soysa (2004) for the effect of labor standards on FDI.

<sup>10</sup> MNCs may also engage in quid pro quo FDI to defuse tariffs demands in host countries (Bhagwati, Dinopoulos, and Wong 1992).

<sup>11</sup> See Jensen (2003), which also highlights the benefits of democratic regimes.

<sup>12</sup> On the importance of stable property rights for economic development, see de Soto (2000).

<sup>13</sup> See also Gourevitch (1993) who argues that democracies limit lawmaker opportunism.

<sup>14</sup> For other studies that assess the effects of follow the flag strategies, see Pollins (1989).

<sup>15</sup> We do not include OECD countries because, as Bloningen and Wang (2004) note, most FDI inflows into OECD countries are motivated by horizontal integration goals while FDI inflows into developing

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countries are normally of a vertical variety. We also do not include North Korea and Cuba in our sample because of data limitations.

<sup>16</sup> There are approximately 145 cases of negative FDI (i.e., divestment). The impact of these observations is minimal because of missing values for other variables. In any case, these data cannot be logged. We follow Jakobsen and de Soysa and convert negative values to a \$10,000 or .01 millions. Logging .01 gives -2. Thus we can still capture the negative intent of divestment. Removing these negative observations yields essentially the same results.

<sup>17</sup> 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).

<sup>18</sup> Special thanks to Nate Jensen for supplying the capital control measure.

<sup>19</sup> We also consulted Marshall's Center for Systemic Peace site at <http://members.aol.com/CSPmgm/warlist.htm>.

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

<sup>21</sup> Generalized least squares (GLS) yielded almost identical results. Beck and Katz (1995) argue that in many cases GLS produces overly optimistic standard errors. Further, PCSE is prescribed when the number of panels approaches 20 as in this case.

<sup>22</sup> Development is highly correlated with market size, regime durability, and polity. Taking development out of the models does not significantly change the results.

<sup>23</sup> We also specified and tested an interaction between troops and conflict. We considered it a strong possibility that the presence of US troops would not compensate for widespread unrest in a host country (e.g., present-day Iraq or Afghanistan). We expected the interaction and conflict to be negative, and troops to be positive. However, only the variable for troops was significant (positive).

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<sup>24</sup> The Canal Zone is a crucial part of US FDI in Panama.

<sup>25</sup> South Korea and maybe Turkey are developed countries today. We considered the possibility that US long-term troop presence in Turkey and South Korea could be driving our results. Taking these countries out of the sample did not change the results. Nor did including a dummy variable for Turkey and South Korea. This dummy was negative and significant while logtroops had a slightly bigger impact.

<sup>26</sup> Unlike the gunboat of dollar diplomacy period of the late nineteenth and early twentieth centuries, when US firms favored military occupation to protect and promote their overseas investments (Drake 1991, 5), the current environment suggests the importance of friendly relations fostered by US ground troops to promote a stable investment climate. Moreover, the fact that both military and economic aid are correlated with the stationing of US troops also fuels positive relations that benefits US investors. See also Jones and Kane (2005, 6), who contend that American-guaranteed security lowers the risk premium on interest rates helping to spur FDI.

<sup>27</sup> As a *New York Times* editorial (2003, A-12) wrote in the awarding of a nearly \$680 million contract to the Bechtel Group, in which only a few American companies competed, “[this] can only add to the impression that the United States seeks to profit from the war it waged.”