

Security, Property Rights, and US Foreign Direct Investment

11-21-05

Glen Biglaiser
Texas Tech University
Department of Political Science
Box 41015
Lubbock, TX 79409
gbiglais@yahoo.com

Karl DeRouen, Jr
The University of Alabama
Department of Political Science
Tuscaloosa, AL 35487
kderouen@bama.ua.edu

Abstract

Since the end of the cold war, the effects of security factors on foreign direct investment (FDI) have received limited scrutiny. 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. Using panel data for 126 countries between 1966 and 2002, we find that the effect of democracy on US FDI is overshadowed by rival explanations including defense pacts with the US, economic development, trade opportunities, expropriation risk, and a post-cold war effect. These results demonstrate that economic and security goals are not necessarily mutually exclusive.

The authors would like to acknowledge the helpful comments of participants at the Political Economy of MNE Conference at Washington University, St. Louis where an earlier version of this manuscript was presented in June 2005. We wish to thank Matthias Busse, Nate Jensen, Quan Li, Edmund Malesky, Guillermo Rosas, and Andy Sobel. We are especially indebted to the keen insights of David D'Lugo.

INTRODUCTION

Since the fall of communism in the late 1980s, there has been a foreign direct investment (FDI) revival, with United States multinational corporations (MNCs) at the forefront (Grosse 2001, 119). The end of the cold war is expected to make US investors less worried about national security issues. Whereas in the cold war era, pressures from the US government and host countries not allied to the US dissuaded investments in some countries, in the post-cold war era security concerns and country alliances should play a less immediate role in investor decisions. Do security issues affect US FDI inflows?

Security factors as determinants for FDI inflows have received limited interest in the development literature. Most scholars posit that the implementation of market-oriented reforms (Rodrik 1996, 28), positive macroeconomic conditions (Crenshaw 1991; Oneal 1988; Pastor 1992; Rummel and Heenan 1978; Tuman and Emmert 2004), and good governance factors such as regime type and political risk help explain FDI inflows (Busse 2004; Crenshaw 1991; Henisz 2000; Huntington 1968; Jensen 2003; Li and Resnick 2003; Oneal 1994; Tuman and Emmert 2004; Tures 2003).¹ Among security explanations, Little and Leblang (2004) contend that “follow the flag” factors influence investment decisions. Using troop deployment as a proxy for diplomatic relations, Little and Leblang argue that 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. In the trade literature, Long and Leeds (forthcoming) find that nations that sign economic and security agreements facilitate economic interdependence. Kane and Jones (2005) statistically show that US troops lead to greater growth in host countries. They argue that the mechanism is that US troops lead to a safer investment environment. To our knowledge, there are no studies that directly assess the effect of US defense alliances on US FDI inflows.

This essay provides a multivariate analysis to test the effect of defense alliances on US FDI. In other words, “FDI follows the flag.” We control for the following groups of independent variables: (a)

macroeconomic conditions and proximity to the US; (b) economic reforms; (c) good governance factors; and (d) other security-related considerations. Using panel data for 126 developing countries from 1965 to 2002, this essay shows that host country alliances with the US, economic development, trade, expropriation risk, and post-cold war years have significant impact on US MNC investment.

The findings that higher GDP/capita (development), enforcement of property rights, and trade openness enhance US FDI, while the most recent years have witnessed greater levels of US FDI are not unexpected results. Given the expansion of trade and interdependence under a more global economic environment, the end of the cold war with investment opportunities especially in Eastern Europe, concern about foreign investment regulation, expropriation, or taxation, and the enhanced human capital associated with higher per capita GDP, export/outsourcing opportunities, development, more secure property rights, and a warmer post-cold war political climate predictably attract US FDI inflows.

More interesting is the finding that defensive alliances between the US and host countries attract US FDI. Political factors influence US investor decisions but it has less to do with the type of regime in power and more to do with the linkages between the US and host country. We argue that investment stability and US security goals connected to alliances help support US FDI. If hegemony is characterized by an ability to use resources and military strength to exploit global economic opportunities, there should be tangible evidence of how this power is wielded (DeRouen and Heo 2004). A connection between US alliance structure and American MNC expansion would be a manifestation of the linkage between American military and economic strength. Kane and Jones (2005) assert that this connection can be advantageous to the host country if American military power is measured with troop deployment. We argue that long-term alliance agreements are more likely to underpin the security-investment nexus.

Consistent with work by Globerman and Shapiro (2002), Grosse (1997, 148), Li and Resnick (2003), and Tuman and Emmert (2004) that claim that secure property rights positively affect investment

decisions, we posit that defensive alliances between the US and host countries enhance investment stability for US FDI (Jones and Kane 2005). The risks involved in foreign investment make such cooperation useful for attracting FDI. Because of the high sunk capital costs associated with initial investments, investors fear nationalization.² Efforts to minimize expropriation risk are germane to Latin America, a region known for nationalizing foreign investments. Defensive alliances, many of which are between the US and Latin America, may provide a credible commitment that the host country cooperates with its alliance partner and respects foreign assets. MNCs reap the benefits of military pacts as defense cooperation between the governments strengthens the alliance, promoting greater economic security (Long and Leeds forthcoming).

Additionally, the US government has taken action to lessen the risk of investing in developing countries that back US foreign policy goals. In 1969, the US government created the Overseas Private Investment Corporation (OPIC) through an amendment to the Foreign Assistance Act. OPIC provides risk insurance to US investors overseas against political risks such as expropriation (Moran and Bergsten 2003). Signing a defense alliance with the US is a strong signal that the host country upholds US security interests. Moreover, US officials that operate OPIC steer investment monies to countries that supports US security goals (<http://www.opic.gov/>). OPIC offers guaranteed bank loans and bonds, and other incentives that promote investment in US-allied countries. Defense alliances with the US provide a seal of approval that reduces interest rates on loans abroad not only from OPIC but also from financial institutions. With financing and risk insurance flowing to countries supportive of US goals, US firms have another reason to invest in US-allied countries.

Despite the limitations of a broad aggregate study, our findings hold important implications on the determinants of US FDI. First, the results suggest that investment stability provided by US alliances are an important example that economic and security goals are not necessarily mutually exclusive. Alliances

not only support a stable investment climate for US FDI but through US government agencies such as OPIC, offer risk insurance and other incentives to US firms that support US foreign policy goals. Troops are more likely to be in response to acute-crises and do not foster American investment (see also Little and Leblang 2004). Second, the linkage between alliances and FDI is a timely topic and our findings have direct relevance to the current situation in Eastern Europe. On March 29, 2004, Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovakia, and Slovenia officially became members of NATO and therefore defense allies of the US. As NATO studies show, the expectation is that expansion will lead to enhanced stability and therefore greater US FDI in Eastern Europe (Sapronas 2000). US capital is likely to be increasingly drawn to its new allies due to the combination of security and free market potential.

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.³ 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).⁴

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).⁵ 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.⁶ 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.⁷ With the spread of market reforms, advance of democratic institutions, and growing capital needs, the question is where would US MNCs choose to invest?⁸

The literature on FDI determinants is generally divided into four categories: (a) macroeconomic and host-country conditions; (b) economic reforms; (c) good governance factors; and (d) ‘follow the flag’ considerations. Some studies suggest that certain macroeconomic conditions or host-country characteristics foster FDI interest. Tied to Dunning’s (1981) ownership, location, and internationalization framework as well as Markusen’s (1995) knowledge capital, and vertical and horizontal integration models, which focused on firm-level decisions, macroeconomic conditions provide varying incentives for foreign investors.⁹ Positive domestic growth rates, high per capita GDP, and larger markets indicate a potentially lucrative domestic market to sell goods and a vibrant economy for future sales (Brewer 1993; Tuman and Emmert 2004; Gastanaga, Nugent, and Pashamova 1998). Higher per capita GDP also suggests a more skilled labor force that is potentially attractive to firms requiring more sophisticated workers as well as financial and insurance service providers. On the other hand, lower per capita GDP implies reduced wage costs for employers, enhancing interest for labor-intensive businesses.¹⁰ 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).¹¹ On the other hand, in larger host countries, such as China, Brazil, and India, MNCs may invest in order to avoid high trade barriers (Ellingsen and Warneryd 1999). Firms interested in tariff jumping and earning monopolistic rents may prefer host countries with protected markets. Reduced capital controls are also an incentive for potential investors. Firms desire the flexibility to move assets between countries in order to reduce costs and enhance benefits (Ramirez 2001).

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), Oneal (1994), Haley (1999), Tuman and Emmert (2004), and Winters (1999) claim that rightist authoritarian regimes hold advantages over their democratic counterparts for promoting a stable investment environment. Because authoritarian regimes are less subject to electoral concerns, and have the capacity to use repression against protesters, these regimes possess insularity from interest group challenges. Moreover, since authoritarian regimes tend to favor more market-oriented reforms, these regimes are expected to protect foreign interests.

Tures (2003) contends the opposite positing that international investors favor countries with democratic institutions in order to monitor and defend their capital. 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.¹² Democracies promote stability and credibility that bolster enforcement of property rights (author; Li and Resnick 2003).¹³ 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.¹⁴ Harms and Ursprung (2002) argue that FDI is not boosted by civil and political repression commonly tied to authoritarian regimes.

Alternatively, 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 affect investor interest.¹⁵ 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. One 'follow the flag' explanation suggests that countries with a large US troop presence draw in FDI (Jones and Kane 2005). Given the military's privatization of many government functions since 1973 (Singer 2005) and outsourcing of jobs ranging from cooking and cleaning duties to hiring civilian specialists to maintain and repair the services' sophisticated weapons systems (Pan 2004), it is expected that US troops attract US FDI. US troops also provide security against asset expropriation. In a slight twist, Little and Leblang (2004) claim that countries with a large US troop presence draw in short-term portfolio investments, but long term US troop

deployments signal unrest to investors. MNCs are a substitute for troops that help serve long-term US national interests.

A second and less recognized 'follow the flag' consideration is alliances between the United States and host countries. Consistent with Long & Leeds (forthcoming) who contend that defense alliances affect trade, alliances also may promote stability and property safeguards for investors. Defensive alliances indicate a political relationship between the host country and US government that is viewed as credibility signal to American investors of the relative security of their investments. US defensive allies also receive perks from the US government that encourage US FDI. The Overseas Private Investment Corporation (OPIC), a development agency created by the US government, provides political risk insurance to US firms that invest in countries sympathetic with US foreign policy goals. OPIC also issues guaranteed bank loans and bonds, and other incentives that promote investment in US-allied countries. Defense alliances combined with OPIC reduce political risk and enhance US FDI.

Based on this discussion, this study develops three hypotheses to explain the determinants of US FDI, with security issues at the forefront. The first hypothesis claims that alliances between the US and host countries promote greater US FDI inflows, as alliances allay concerns about possible host country actions against foreign investors and support political stability. Complementing the development literature, we also consider the effects of economic reforms and good governance on US FDI. The second 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 third 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.

RESEARCH DESIGN

Dependent Variable

We selected 126 developing countries from 1965-2002 to assess the effect of defense alliances and other factors on US FDI. Our analysis includes all cases for which data are available, representing a good cross section of developing countries.¹⁶ 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. To control for inflation, we place the data in constant dollars by using a GDP deflator. These data are also logged.¹⁷ An important consideration concerning these data is that the BEA suppresses country data for some years. The BEA does this 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).¹⁸ 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). Moreover, per capita GDP also reflects the level of human capital. Higher income is indicative of a more skilled work force. Geographical distance is also relevant as 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).¹⁹ 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 absolute value of US imports (lagged) from the foreign country. We obtained the data from the International Monetary Fund (several years). We also tested alternative trade measures (all lagged) including the sum of exports and imports of goods and services as a share of GDP (*World Development Indicators* 2004), total bilateral trade (IMF several years), and the log of real imports of the US from the foreign country (IMF several years). We found consistent results regardless of the trade measure used. 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.²⁰

Good Governance Variables

Several good governance factors may impact US FDI. Regime type, regime durability, property rights, 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 the Polity2 variable contained within the Polity IV data to operationalize democracy (Marshall and

Jagers 2002). This measure ranges from 10 to -10 (10 is the most democratic) and is specially designed for use in time-series as it compensates for interregnum and transition years.

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.

Secure property rights to reduce expropriation risk are also relevant to FDI in developing countries. In the 1930s - 1970s, many MNCs saw their investments in Latin America, Africa, and elsewhere expropriated with little or no compensation (Vernon 1971). To measure property rights, we use expropriation risk data compiled by Stephen Knack from the quality of governance data of the PRS Group's International Country Risk Guide project.²¹ Risk of expropriation is measured on a 10-point scale, with ten providing the best protection of property rights.²² Many observations are lost with these data as they only cover 1982-1995.

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).²³ 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 and the cumulative scores are comparable across country years. Only capturing militarized interstate disputes (MIDs) or civil wars will overlook 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 a defense alliance, US troops, Warsaw Pact membership, and cold war effects suggest that US national security interests affect US FDI flows. Defense alliances suggest that US FDI flows are attracted to host countries that have alliances with the US, showing that the US's economic and security interests go hand-in-hand. Unlike an entente or neutrality pacts, where the agreement entails a promise not to attack, a defense alliance is more meaningful for investors. A defense alliance is a commitment by the US to come to the aid of a country, and provide defenses to protect a country from external attack. Such an alliance sends a stronger signal to investors relative to ententes or neutrality pacts. As a defense alliance, NATO enlargement sends a message to American MNCs that the government is committed to the region. We obtain alliance data from Leeds et al. (2002). We create a dummy variable for alliances, coded 1 if a defensive alliance exists between the US and host countries, and 0 otherwise. We also specify an interaction between alliance and troops to capture any possible effect from long-standing alliances and troop deployments in places like South Korea and the Philippines.

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. 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. We obtain US troop numbers in the host country from the Department of Defense (<http://web1.whs.osd.mil/mmid/military/miltop.htm>).²⁴ We test the logged version of this measure because of outliers in the data. We expect that as the US

military deploys troops overseas, foreign investment will not be far behind. We use a dummy variable to distinguish Warsaw Pact country years.

Because our data covers the cold war period as well as more than a decade after the fall of the Soviet Union, we test to determine if there is a difference in US investment before and after the cold war. During the cold war, the US may have tolerated or befriended dictators because of anti-communist positions held by the ruler. In addition, the Soviet Union placed many obstacles against US investments in Eastern Europe, as did the US government. To take into account investment climate changes, we incorporate a post-cold war dummy variable, measured 1 after 1989, and 0 between 1965 and 1989.

Taken together, these independent variables represent four basic themes: macroeconomic and host country characteristics, economic reforms, good governance, and security. 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. This approach is used in several previous analyses of FDI (see author; Jensen 2003; Li and Resnick 2003). Failing to note country effects in these data will lead to biased estimates therefore we conduct Hausman tests (StataCorp 2003) to determine whether random effects are appropriate. As we report below, we obtain different results when switching from random effects to fixed effects. The null hypothesis is rejected in the Hausman test thus indicating that the random effects model is not appropriate (StataCorp 2003, 202). While the Hausman test is not conclusive, we err on the side of caution and report fixed effects results. Failing to account for country effects can lead to biased estimates. The Wooldridge

test (Drukker 2003) indicated autocorrelation in all of the US FDI models. We take AR1 and fixed effects into account using Stata's *xtregar* command with the fixed effects option.

RESULTS

Results from six models are reported in Table 2. The baseline model is specified with host country attributes and basic economic indicators. Here the only significant determinant is logged development. Indeed, this variable carries much of the load in each of the models. The security variables are entered into the 'follow the flag' model in the second column. As hypothesized, alliance is significant in each of the models. It appears that defense alliances with the US indeed have a positive impact on US FDI in the ally.²⁵ This central finding is robust even with the addition of cold war, trade, capital controls, and property rights in the final four columns. American firms do not seem to be intimidated by conflict or low levels of democracy in the developing world.²⁶

Besides alliances and development, regime durability is the most consistently significant baseline variable though only at the .10 level. Democracy and Warsaw Pact are significant in the expected direction but not consistently across each specification and then only in the final two models with their smaller sample sizes. Furthermore, the coefficient on democracy is quite small. Trade is significant in the expected direction.²⁷ As expected, property rights also lead to greater US FDI. Market size (log GDP) and growth are almost never significant at the .05 level but they are negative, a direction somewhat unexpected. However, with the increased use of developing countries not for local consumer markets but for stages to outsource and re-export goods to the US market, the result is not completely surprising. The presence of American troops does not increase US FDI. This result is not surprising when we consider that many deployments are into hostile situations (e.g., Iraq, Kuwait, Afghanistan, Colombia).²⁸

[Table 2 here]

In order to gain a clearer understanding of the impact of each variable, we use the cold war model to gauge marginal effects of certain variables. These results are contained in Table 3. The baseline predicted US FDI is about \$121 million. This goes up to \$230 million for allies. This is not an insignificant amount. In a 'best-case' scenario, FDI is predicted to jump to over \$1 billion. Countries that score higher on the positive factors (allies, higher levels of development, older regimes) include Argentina, Brazil, the Czech Republic, Hungary, South Korea, Poland, and Trinidad and Tobago. In the 'worst-case' US FDI is expected to be only \$18 million. Countries that often score particularly low on the key factors include pre-alliance Guyana, Angola, Bosnia, and many other African and Asian countries. Table 3 also contains predictions for several new NATO members using the most recent data in the sample (2002 or 2003) and the coding of alliance as 1. The model predicts an increase of \$466 million for Slovakia, \$220 million for Bulgaria, and \$184 million for Romania. While not definitive owing to the use of previous year's data, these estimates represent significant capital inflows.

[Table 3 here]

DISCUSSION

Countries with defense alliances with the US attract more US FDI. Other 'follow the flag' factors are less important. Consistent with work by Little and Leblang (2004), US troops are not a big draw for US FDI. Despite changes in the military support structure that promote military outsourcing to private firms, and non-competitive bidding on military contracting that favors US firms where US troops deployed (Eckholm 2005, A-10; Mayer 2004, 80; Merle 2004, E-1),²⁹ US troops at best play at best a temporary and not significant role in attracting US FDI. Defense alliances, on the other hand, are long-term commitments. Most countries that require US troops for long stays are indicative of political

instability, something MNCs oppose as they are concerned about the long-term stability of their investments.

Building on research that finds that defense alliances affect trade (Long & Leeds forthcoming), we argue that alliances also promote stability and property safeguards for investors in developing countries. Defensive alliances provide a credibility signal for investors. Such alliances may signal a more positive political environment for US FDI in a particular. A defensive alliance 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. Defensive alliances 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. The point then is that the alliance is important to American investors as a barometer of the overall hospitality of any particular country and regime toward US economic interests. Among the top developing country recipients of US FDI, all the Latin American cases as well as South Korea, the Philippines, Hungary, and Poland hold defense alliances with the US. As discussed, new alliances in Eastern Europe portend increases in US FDI to the region.

US foreign policy goals also complement efforts to promote US FDI in strategically important areas. In 1969, the US government created the Overseas Private Investment Corporation (OPIC), a development agency that offered selective incentives or political risk insurance to US firms. Prior to OPIC's founding, "insurance coverage against the variety of political risks encountered by international companies was virtually nonexistent" (Moran and Bergsten 2003, 2). US firms rightly feared investing in developing countries. OPIC helped to reduce such fears. According to OPIC (<http://www.opic.gov/>), "OPIC helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, complements the private sector in managing the risks associated with foreign direct investment,

and supports U.S. foreign policy.” Foreign policy goals are a fundamental component of OPIC’s mission that has supported more than 3,100 projects (and nearly \$145 billion worth of investments) in the developing world between 1971 and 2003 (<http://www.opic.gov/>). Host countries that have signed defensive alliances with the US meet fundamental US security interests. Although there are now private-sector political risk insurers helping foreign investors to operate in developing markets, that does not negate OPICs history of supplying political risk insurance to US firms that invest in countries that support US foreign policy.

Lastly, defense alliances with the US affect capital concerns. An important issue for US MNCs is the interest rates they pay on capital overseas. Investments in developing countries are often seen as risky and higher interest rates are expected on such loans. However, OPIC also offers guaranteed bank loans and bonds, and other incentives that stimulate investment in US-allied countries. According to Jones and Kane (2005, 6), American-guaranteed security lowers the risk premium on interest rates helping to spur FDI. Defense alliances with the US provide a seal of approval that reduces interest rates on loans abroad not only from OPIC but also from financial institutions.

Besides defense alliances, development, trade openness, and post-cold war years are important determinants of US FDI. Regime type seems to play a weak role at best. These findings make sense upon 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 small number of developing countries have consistently received US investor interest, and those countries include: Mexico, Singapore, Brazil, Panama, Argentina, Chile, South Korea, China, Indonesia, Malaysia, Venezuela, and the Philippines. More recently, Poland and Hungary have also garnered significant US FDI inflows.

What distinguishes these countries from other developing countries is relatively high GDP per capita compared to other developing nations, significant trade openness, in many instances reinforced by their close proximity to the US, protection of property rights, and the expansion of globalization since the end of the cold war. The benefits of high per capita GDP enables firms in higher end service industries to tap into a wealthier customer base that can afford products from insurance and financial companies. It is also important for firms that need higher-skilled labor such as in IT areas. Outsourcing is not always an attempt to farm out less human capital-intensive stages of the production process to lower income countries. Developing countries that receive much of the US FDI conduct work that demands a skilled labor force such as in data processing and software programming.³⁰

Another common attribute among the top recipient countries is their trade openness and greater use as outsourcing markets, especially since the 1990s.³¹ Outsourcing and trade pacts are common in the Western Hemisphere. The growth and development of maquiladoras in Mexico, the signing of the North American Free Trade Agreement in 1993 and US-Chile Free Trade Agreement in 2004, the recent US commitment to a Central American Free Trade Agreement, and the hope for a Free Trade Area of the Americas reinforce the importance of outsourcing opportunities for US investors. Such trade linkages are also seen in many other developing countries including Singapore (the US-Singapore Free Trade Agreement signed in 2004), the signing of the ASEAN Free Trade Agreement in 1993, and of course membership in the World Trade Organization. These agreements have further cemented trade openness that began in the latter 1980s and early 1990s that helped foster US FDI inflows.

Secure property rights are expected to draw attention given the long history of nationalization in the developing world. Complementing studies by Globerman and Shapiro (2002), Grosse (1997, 148), Li and Resnick (2003), and Tuman and Emmert (2004), expropriation fears affect investor decisions. 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. MNCs must take into account property rights before investing. Although the risk of nationalization has fallen, the vast monies required for upgrading and enhancing many industries, particularly in infrastructure, make risk minimizing strategies important. Recent threats against foreign firms in Bolivia, Ecuador, Venezuela, and Russia suggest the continued relevance of property rights for investors (Forero 2005). Host country changes of regulations and tax policies on already agreed to contracts also demonstrates the importance of secure contracts.

In contrast, regime type carried little influence among the top recipients of US FDI inflows. With the exception of Venezuela, which despite President Hugo Chavez' recent actions, has remained democratic since the 1960s, the other Latin American cases that received significant US FDI 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. Regime type has also not played a compelling role in the Asian countries either. While South Korea, the Philippines, and even Indonesia have received greater inflows as their countries became more democratic, Singapore, China, and Malaysia attracted monies under stable but generally not highly democratic governments.

CONCLUSION

In the post-cold war era much of the FDI literature has stressed the importance of regime type rather than national security concerns in attracting investment capital. Our work adds to the regime type debate and

is consistent with much of the literature about the positive and significant correlation between US FDI and development, trade opportunities, secure property rights, and the period since the 1990s. The more novel result is the positive effect of defense alliances in attracting US capital inflows. The finding suggests the relevance of political stability and reduced expropriation risk stemming from friendly relations between the US and host countries. We argue that alliances credibly signal investment stability for US firms. Defense alliances signal positive relations between the US and host countries that spill over into a friendlier investment climate for US MNCs. Additionally, incentives, guaranteed bank loans and bonds, and political risk coverage provided for more than 35 years by OPIC, with part of its mission devoted to supporting US foreign policy goals, also fosters investment by US investors to strategic allies.

More comparative research on FDI inflows is needed to evaluate the effect of defense alliances and democracy on potential investors. Specifically, qualitative work is recommended to determine if political stability, defense alliances, or expropriation risk are the most important factors for increased US FDI. 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, 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. Based on our sample, security oriented goals along with economic factors are most effective in drawing in US investors.

Table 1. Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
FDI	3329	1202.442	3647.116	0	53582.99
Conflict	4296	1.034683	2.188223	0	14
Polity	4256	-1.706297	6.836016	-10	10
Market Size	3708	9.833269	.9696041	-4.772138	12.08237
Regime Durability	4266	17.02368	16.39686	1	133
Development	3690	2.984086	.5233658	1.69305	4.61576
GDP growth	3763	3.529786	7.112431	-51.03086	106.2798
Warsaw	4428	.0313911	.1743921	0	1
Troops (log)	4284	2.406002	2.267344	0	13.19446
Defense Alliance	4428	.2319332	.4221142	0	1
Alliance*Troops	4284	.9974763	2.17127	0	11.10544
Cold War	4428	.3848238	.4866086	0	1
US Imports	4100	1452.421	6977.765	0	136144
Total Bilat. Trade	4079	2424.865	11109.06	0	243831
Imports (real, log)	3908	18.84307	2.49893	11.47657	25.54771
Exp+Imp/GDP	2983	.7349463	.5083308	.0607544	5.890707
Capital Controls	2875	1.617739	2.562978	0	9
Expropriation	1238	6.32084	2.08854	.5	10
Prop. rights index	1242	18.67564	8.45652	1	38
Population (log)	4291	15.8328	1.549237	11.71178	20.97044
Polity*Conflict	4256	-2.519032	15.38723	-126	88
Alliance*Conflict	4296	.1831937	.8803675	0	9

Table 2. Determinants of US FDI, 1965-2003: Pooled Time-Series with Fixed Effects

Variable	Baseline	Follow the Flag	Cold War	Trade	Capital Controls	Property Rights
Polity	.0088 .007	.0088 .007	.0042 .007	.0104 .019	.0178* .009	.0156 ^a .012
Market Size (log)	-.2427 .161	-.2505 .159	-.3081 ^a .158	-.4179* .162	-.3460 ^a .187	-.2893 .246
Development (log)	2.121*** .520	2.100*** .515	2.215*** .510	2.721*** .531	2.385*** .614	1.951* .782
GDP Growth	-.0010 .002	-.0010 .002	-.0010 .002	-.0022 .002	-.0007 .003	-.0096 .006
Warsaw Pact	-.5304 .480	-.5102 .479	-.5440 .478	-.6561 .479	-1.158 ^a .618	-1.276* .502
Conflict	.0197 .019	.0225 .019	.0210 .019	.0259 .019	.3516 .026	.0407 .037
Regime Durability	.0054 ^a .003	.0058 ^a .003	.0049 .003	.0062 ^a .003	.0080* .004	.0047 .005
US Troops (log)		.0114 .033	.0058 .033	.0197 .034	.0276 .043	.0231 .088
Alliance		.9753* .339	.9525* .338	1.004* .338	1.560*** .438	2.441** .879
Alliance*Troops		-.0181 .050	-.0123 .049	-.0236 .050	-.0515 .065	-.0282 .117
Cold War			.2436** .081			
Trade				.00002*** .0000007		
Capital Controls					.0286 .027	
Property Rights						.1278*** .032
Constant	.737*** .099	.529*** .101	.6715*** .102	.3042*** .110	.1938 .147	-.0485 .315
Obs	2719	2719	2719	2631	1957	862
R ² overall	.1760	.2810	.2544	.2681	.2647	.3126
F Test	17.67	13.71	13.63	15.94	11.35	9.36
Prob > F	.0000	.0000	.0000	.0000	.0000	.0000

NOTE: the dependent variable is logged flows of US FDI in constant 1995 millions; main entries are OLS coefficients from pooled time-series regression; numbers below main entries are standard errors; all models include correction for AR1 and fixed effects using Stata *xtregar* command and *fe* option; ^a-significant at .10; *-significant at .05; **- significant at .01; ***- significant at .001; two-tailed tests.

Table 3. Marginal Effects

<u>Manipulation</u>	<u>Predicted USFDI (1995 millions)</u>
Baseline (all at mean)	121.51
Alliance set to 1	230.44
Best-case scenario (post-Cold War, allies; development and durability at 90 th ptl)	1085.72
<u>Worst-case scenario (Cold War, not allied; development and durability at 10th ptl.)</u>	<u>17.99</u>

Note: based on cold war model in Table 2; variables not manipulated are set to the mean.

Effect of 2003 Defense Treaty Signed with US on US FDI (Predicted Values)

Slovak Republic: increase of \$466 million

Bulgaria: increase of \$220 million

Romania: increase of \$184 million

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ENDNOTES

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

² Investors are also wary of changes in host country regulation or tax terms that reduce investment profitability.

³ For a thoughtful and informative history of FDI, see Wilkins (1974).

⁴ See Akinsanya (1980) and Vernon (1971) for details on the expropriation of foreign assets.

⁵ For the negative consequences of ISI, see Baer (1972) and Hirschman (1968).

⁶ For sources on the debt crisis, see Frieden (1991) and Stallings and Kaufman (1989).

⁷ 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.

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

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

¹⁰ See Neumayer and de Soysa (2004) for the effect of labor standards on FDI.

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

¹² See Jensen (2003), which also highlights the benefits of democratic regimes.

¹³ On the importance of stable property rights for economic development, see de Soto (2000).

¹⁴ See also Gourevitch (1993) who argues that democracies limit lawmaker opportunism.

¹⁵ For other studies that assess the effects of follow the flag strategies, see Pollins (1989).

¹⁶ 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 countries are normally of a vertical variety. We also do not include North Korea and Cuba in our sample because of data limitations.

¹⁷ We add a one to the many zeroes in the data before logging so that zeroes remain zeroes after conversions. There are approximately 154 cases of negative FDI (i.e., divestment). The impact of these observations is minimal because of missing values for other variables. Of these cases, only one involved a military ally: Guyana in 1985. In any case, these negative values cannot be logged. Therefore we convert these cases to -.01 in the final version of the dependent variable so that we can still capture the negative flow. Jakobsen and de Soysa (2005) take a somewhat similar approach. Changing the 154 cases to zeroes does not change the results.

¹⁸ Since we use the fixed effects estimator, distance is dropped from the model as it does not vary over time. In sensitivity tests using the random effects estimator, distance is negative and significant.

¹⁹ 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).

²⁰ Special thanks to Nate Jensen for supplying the capital control measure.

²¹ See the Political Risk Service Group (www.prsgroup.com), which assesses the risk of confiscation and forced nationalization. We accessed the data at: <http://www.cidcm.umd.edu/inscr/stfail/sfdata.htm>.

²² Following Li and Resnick (2003, 190), we also tested property rights by using five variables from Knack: risk of expropriation, contract repudiation risk, bureaucratic quality, government corruption, and rule of law. The results remain virtually the same except that the property rights measure is no longer significant and the magnitude of the alliance coefficient jumps to 2.66. We argue that the risk of

expropriation by itself is a better measure as investors are more concerned about asset expropriation than bureaucratic quality, government corruption, and other measures. Results are available from the authors.

²³ We also consulted Marshall's Center for Systemic Peace site at <http://members.aol.com/CSPmgm/warlist.htm>.

²⁴ There are only a few missing cases for this variable (e.g., Cambodia and Laos in the early 1970s). We also consult Jones and Kane (2005) on troop data.

²⁵ The presence of US troops does not appear to be significant. However, when a random effects estimator is used troops is positive and significant. Alliance is also positive, significant, and has greater impact with random effects. For clarity, we do not report random effects findings.

²⁶ We carried out a variety of sensitivity tests. The alliance finding is robust to the inclusion of logged population, several other versions of trade (total bilateral trade, real imports logged, and the sum of exports and imports of goods and services as a share of GDP), a polity*conflict interaction, an alliance*conflict interaction, and the removal of Latin America from the sample. The findings are also robust to 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. Neither was significant in the fixed effects models.

²⁷ Since trade may not be strictly exogenous in the model, this finding should be interpreted with due caution.

²⁸ Dependency theory would suggest that troops or alliances might follow American investment rather than the sequence we test here. While this is not the focus of the paper, we recognize that modeling issue that arises. We specify and test a model (n=3029) with troops as the dependent variable and alliance and US FDI on the right hand side. Neither variable is significant (results available).

²⁹ 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.”

³⁰ See Nunnenkamp (2002, 28), who argues “booming FDI in developing countries in the 1990s was largely because of FDI in services.”

³¹ See Gastanaga, Nugent, and Pashamova (1998, 1312), who contend that trade liberalization has become an important motive for FDI.