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The Political Economy of Foreign Direct Investment: Government Policies, Political Institutions and Foreign Direct Investment Flows

A Dissertation
Presented to the Faculty of the Graduate School
of
Yale University
in Candidacy for the Degree of
Doctor of Philosophy

By
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Dissertation Advisor: Geoffrey Garrett

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Abstract:

The Political Economy of Foreign Direct Investment:
Government Policies, Political Institutions and Foreign Direct Investment Flows
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In this dissertation I argue that the fiscal competition among governments to attract multinational investors has been grossly exaggerated, and that fixation on the "race to the bottom" has diverted attention from what are, in fact, the major political determinants of FDI flows. Foreign direct investment, by definition, entails a substantial and lasting ownership stake in a host country. Perceptions about future conditions in the host inform investment decisions today. I argue that three political factors have a marked impact on these decisions: whether a country is democratic, whether it has a politically federal system and whether it owes the IMF money.

In a number of cross-national empirical tests I show that: 1) levels of government taxation and spending do not have large effects on FDI inflows in 15 OECD countries, 2) Democratic institutions are associated with higher levels of FDI inflows, 3) Politically federal institutions can increase FDI inflows while fiscal federalism has no effect, and 4) IMF agreements are associated with lower levels of FDI inflows for recipient countries.

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The Political Economy of Foreign Direct Investment

Chapter 1: Introduction

Multinational corporations are major actors in the global economy. By most estimates production by multinational enterprises now accounts for over one-fourth of the world's production and one-third of world trade. The investments of multinationals, commonly known as foreign direct investment, are generally believed to have beneficial effects on economic growth, transferring technology and managerial expertise as well as providing capital where it is needed. There is a large literature on firm level decisions about FDI, but much less rigorous attention has been paid to the national level – what is it about certain countries that makes them more attractive to multinational firms? It is a widely believed, but rarely tested, stylized fact that countries attract multinationals by lowering levels of taxation. This is seen to result in invidious fiscal competition-the race to the bottom thesis, as it is commonly known.

In this study I show that the fiscal competition among governments to attract FDI has been grossly exaggerated, and that fixation on the race to the bottom has diverted attention from what are, in fact, the major political determinants of FDI flows. Foreign direct investment, by definition, entails a substantial and lasting ownership stake in a host country. Perceptions about future conditions in the host inform investment decisions today. I argue that three political factors have a marked impact on these decisions: whether a country is democratic, whether it has a politically federal system and whether it owes the IMF money.

I demonstrate that democracy and federalism both strongly attract FDI. In contrast, even controlling for factors that affect the probability that a country will owe the

IMF money in the first place, countries that participate in IMF agreements attract less FDI. These three political factors are important because they affect a country's credibility with the markets in general, and with would be foreign direct investors in particular. For example, investors are unlikely to react favorably if they believe that governments may try to nationalize their assets or expropriate their profits, repudiate contracts, or act in other ways that undermine stable property rights, both in terms of ownership and income streams.

All three of these political institutions affect both the stability of policy and its content. For democracies and countries with federal political structures, patterns of political accountability lead to policies that are conducive to multinationals. For countries under IMF agreements, I argue that the policies promoted under the auspices of IMF conditionality, government's may be forced into a policy equilibrium that harms multinationals both direct, by decreasing spending on market promoting public goods or increasing taxes on corporations or foreign trade, or indirectly, through worsened macroeconomic performance.

In this dissertation I demonstrate that democratic systems attract 60% more FDI than authoritarian regimes. The literature on the democratic peace points to a number of causal mechanisms linking democratic institutions to higher levels of credibility in the international system. Many of the same mechanisms also translate into higher levels of credibility when dealing with multinational firms. The institutional checks and balances associated with democratic systems decrease the likelihood of policy reversal, providing multinationals with a de facto commitment to policy stability. This policy stability allows multinationals to more accurately forecast budgeting needs according to future

macroeconomic conditions and tax schedules, to hedge against currency risks, and generally to make managerial decisions in response to the predicted macroeconomic environment. In general, policy stability provides multinationals with greater assurances that the conditions that promoted entry into the market in the first place will persist.

Although this stability of policy is important to multinationals, democratic institutions also create incentives for governments to pursue policies that are favorable to multinationals. I argue that the "audience costs" associated with democratic governance provide political leaders with the proper incentives to tailor policy towards multinationals. The logic is as follows.

In response to any negative policy change, multinationals can threaten political leaders that have harmed multinationals operations by refusing further investment in the country, or by pulling out existing investments. This is possible in both types of political systems, authoritarian or democratic. In democratic systems, in contrast to authoritarian regimes, citizens have the incentive to replace leaders with tarnished reputations through electoral mechanisms. Citizens that want to reap the benefits of future FDI will choose candidates with the best reputations on election day. Political leaders must be wary of developing bad reputations, leading them to avoid policies that hamper multinationals operations. This does not guarantee market friendly policies, but in democratic systems policies that are unfavorable to multinationals nonetheless generate substantial political costs for leaders – because the political position of multinationals is even more "privileged" (in Lindblom's (1977) terms) than is the case for domestic businesses.

My second major finding is that politically federal institutions attract roughly 50% more FDI than authoritarian regimes, whereas fiscally federal institution have no

impact on multinationals' investment decisions. Politically federal institutions increase the number of veto players in a political system, and hence promote the kind of policy stability that multinationals like. Policy change is more difficult as subnational governments become involved in national policy either through representation of one or both houses of a legislature or through the existence of formal veto authority.

Moreover, political federalism tends to produce policies that are quite market friendly. Unlike Weingast's "market promoting federalism" argument, I do not argue that it is competition among subnational units that leads to market friendly policies; rather what matters are the differing incentives of subnational units from the central government regarding the treatment of multinational corporations. Central governments have incentives to renegotiate policies with multinationals after investment takes place, such as rates of taxation, or to change macroeconomic policy without regard to the effects on multinationals. In unitary systems, the national government must weigh the benefits of policy change accruing to the central government against the negative reputation effects.

In federal systems the incentive structure is slightly different. Although FDI benefits national economies in aggregate, many of the specific goods are local – such as employment creation and the spillovers on the local economy, which are important to subnational governments. I argue that these localized benefits are dependent on the productive operation of the multinational firm. Thus, subnational units have both the incentive and the ability to veto legislation that would hamper the operations of the multinational, leading multinationals to prefer to invest in these systems.

Finally, I also demonstrate that countries under International Monetary Fund agreements attract 30% less FDI, even when controlling for the macroeconomic factors

that lead these countries to seek IMF support. On the surface this result may seem counterintuitive. One might think that IMF conditionality should help lock governments into a specific, market friendly, policy equilibrium, leading to higher levels of policy stability. This policy stability could lead governments under IMF programs to attract higher levels of FDI.

I argue, however, that while IMF agreements do promote policy stability, they promote policies that are not attractive to multinationals. The IMF prescribes a similar "one size fits all" set of economic policies for most countries, highlighting fiscal austerity among other things. This often leads to decreased spending on market promoting public goods such as education and infrastructure-both of which are important to multinationals.[1] IMF conditions may increase political instability and social unrest by prescribing austerity policies in low and middle-income countries. These policies can create a societal backlash that may lead to escalating levels of protests and violence, along with electoral instability as incumbent governments are swept from office. On balance, the IMF loans, and the conditionality associated with these funds, may increase levels of policy stability but are perceived as negative by multinationals due to the political and economic effects of the content of policies.

These results provide some clear leverage over what has become a dense research thicket in recent years-the effects of political institutions on growth. There is no consensus, for example, on whether democracy, federalism and IMF programs are good

[1] The importance of public goods to multinationals is examined in my discussion of the extensive literature on the determinants of FDI inflows in Chapter II.

for growth.[2] Perhaps this is because they have different effects on different parts of the growth equation. If FDI is an important driver of growth, my results have powerful implications for the policy choices of national governments and for the behavior of international institutions such as the IMF.

The Conventional Wisdom: The Race to the Bottom Thesis

The myth of perfect capital mobility has hindered our ability to understand FDI flows. Much of the literature often assumes that multinational corporations are perfectly mobile in their investment decisions. According to this perspective, multinationals search the world for investment opportunities, playing governments against one another, entering and exiting domestic markets at will in an attempt to obtain higher returns. I argue that this view of perfect capital mobility – of frictionless investment across national borders - is inconsistent with decades of research on FDI that has focused on *imperfect* market approaches to the study of multinational firms.

The race to the bottom thesis is based on this myth of perfect capital mobility. This perspective argues that domestic governments must pander to multinational corporations, attracting them with the only viable tools at their disposal: regulation and fiscal policy. Domestic governments are forced to lower levels of environmental protection, loosen labor standards, and most importantly alter patterns of government fiscal policy. Governments must attract multinationals by lowering levels of capital

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[2] For an extensive discussion of the links between democracy and economic growth and development see Przeworski et.al. (2000), for federalism and economic performance see Oats (1999) and Rodden and Rose-Ackerman (1997) and IMF programs and economic performance Przeworski and Vreeland (2000) and Vreeland (2002).

taxation, leading either to lower levels of government spending or a shifting of the burden of taxation from capital to labor.

In reality, multinational investments, while relatively liquid ex ante, are much more illiquid ex post.[3] Once a multinational corporation has committed resources to an investment location, the investment is relatively immobile. Although multinationals may have considerable bargaining power prior to investment, a large degree of power shifts to the host government once the investment has been made.

This ex post immobility of multinationals forces firms to try to predict the future policies of host governments. Politicians may make attempt to make assurances on future policies, but governments have the incentive to change policy once a multinational has committed substantial resources to the project.[4] Government's that can credibly commit to a specific policy equilibrium, ensuring policy stability, should attract higher levels of FDI by lowering political risks for multinationals. More importantly, governments that can commit to market friendly policies can assure multinationals of a favorable policy environment for their operations. This ability to provide multinationals assurances on future policy is central to attracting FDI.

By ignoring the complexity of investment decisions the race to the bottom thesis over emphasizes the importance of fiscal competition for FDI and downplays the

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[3] Even this assumption that multinationals are liquid ex ante is questionable. The study of MNEs has focused on imperfect market approaches. See Chapter II.

[4] This time inconsistency of government policy as originally theorized by Kydland and Prescott (1977) is discussed in more detail in chapter two.

importance of the political factors that affect government policy. In the next sections I will discuss the importance of political institutions on FDI inflows.

Democratic Institutions and FDI: Theory

One important topic seriously understudied is the effects of democratic political institutions on foreign direct investment. Many scholars and pundits assume that multinational prefer to invest in dictatorships.[5] Dictators are not responsible to an electorate, giving authoritarian leaders more room to maneuver and negotiate with multinationals. Although this may be a logically persuasive line of argument, this view on the preferences of multinational enterprises for authoritarian regimes is little more than an assumption. Few studies have actually examined the links between political regimes and multinational corporations.

Given the tremendous literature on the effects of democracy on economic performance and international relations, these links between multinational corporations and political regimes remain glaringly underdeveloped. Even if one assumes the argument that multinationals may prefer to bargain with authoritarian leaders, there are a number of other channels through which democracy could affect FDI inflows.[6]

Profit-maximizing multinational enterprises will weight the varying factors that impact operations in host countries. Contrary to the pessimism about the link between authoritarian regimes and foreign direct investment, in this dissertation I identify three mechanisms, information, representation, and economic policy, through which democratic institutions would be the preferred institutional structure for their

[5] Oneal (1994), Jessup (1999).

[6] A further discussion of the preferences of multinationals is discussed in Chapter III.

investments, and argue that the last of these mechanisms, the role of political institutions on government policy, have large influences on FDI inflows. These three mechanisms are:

Information: Multinationals are attracted to democratic countries because of the better information available on government policy and current political and economic conditions. A large literature on the democratic peace in international relations has highlighted the role of information and democratic governance.[7] Democracies are more transparent, both in their economic and political affairs. In democracies, commitments to external actors are still produced through domestic political processes (Gaubatz 1996, Bennett 1997). These domestic political processes provide information to investors, which have intrinsic value, and allow multinational firms to react to proposed changes in government policy before they are enacted.

Representation: Foreign investors may find avenues to pursue favorable policies, either directly, or indirectly. Foreign investors can directly lobby government officials for their preferred legislative outcomes in democracies that aren't possible in autocracies. Hansen and Mitchell (2000) find that foreign firms in the US are just as likely to engage in lobbying activity as domestic firms. As Hillman and Ursprung (1988) state, "under representative democracy, foreign participation in domestic politics can take the form of campaign contributions, or other transfers directly at influencing the trade-policy position taken by a political candidate"[8] The difficulties of influencing policy in authoritarian regimes recently has a negative effect on overall FDI inflows.[9]

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[7] For a review of the most recent literature see Schultz (1999).

[8] Hillman and Ursprung (1988) page 730.

Even more importantly, MNC's may find vested interests in democratic systems already in place. A foreign MNC, once it has sunk capital into a country, shares many of the same preferences as domestic producers.[10] If these democratic systems take the interests of these domestic producers into account, the government will be providing legislation favorable to the domestic producers and foreign investors.

This is not to say that authoritarian regimes do not provide businesses with the opportunity to influence policy decisions. Much of the non-academic literature on multinationals assumes that firms prefer to bargain with authoritarian regimes, where authoritarian leaders are willing to offer firms substantial influence over government policy. According to this theory, authoritarian regimes would attract higher levels of investment.

Although this argument is logically compelling, there is little empirical support that multinationals prefer to influence policy through these channels. For example, Wei (2000) finds that multinational corporations are reluctant to invest in political systems with high levels of corruption. Multinationals may be more than willing to engage in corrupt deals with authoritarian leaders, it is by no means the preferred mechanism of influencing policy.

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[9] One example of the difficulties in influencing policy in authoritarian regimes is the experiences of multinationals in China.

[10] This is theoretically in line with the work done by Frieden (1991) where he distinguishes between different types of capital based on their mobility. Milner (1988) argues that companies with an international focus share similar preferences on trade protection policy.

Economic Policy: Stability and Content: Although the effects of democracy on information and representation are important, this dissertation stresses the policy enhancing nature of democracy. As highlighted earlier, multinational face large political risks in their investments. Government's, or more specifically political institutions, that can help to decrease these political risks will attract higher levels of FDI, all else being equal.

Democratic governments are credible in making agreements with other nation-states (Cowhey 1993, Fearon 1994, Gaubatz 1996, McGillivray and Smith 1998, and Leeds 1999). These explanations range from the institutional checks and balances within democratic systems to the "audience costs" generated by elected leaders. Logically following from this large literature, democratic governments may also be more credible in their dealings directly with multinationals for these same reasons. These institutional features of democracies lead to higher levels of FDI inflows.

One mechanism that leads democratic governments to higher levels of credibility in terms of economic policy is based on the number of veto points in a democratic political system. Tsebelis (1995) argues that the existence of these veto points can increase policy stability. These veto players can include chambers of the legislature, a supreme court, separation of the executive and legislative branches of government, or federal actors.[11] Democratic governments have these institutional constraints in place, making the possibility of policy reversal more difficult. Multinationals investing in large

[11] Heinsz (2000) argues that foreign firms change their entrance strategies into domestic markets in response to the number of veto players.

illiquid projects will prefer to invest in countries where there is a lower probability of policy reversal once the investment has been made.

Even more important for multinationals, democratic institutions provide multinationals benefits through the existence of "audience costs". International relations theorists find that democratic leaders are held accountable for their actions, including reneging on a promise or threat. These audience costs can also be important for multinational investors. If governments make agreements with multinational firms and renege on the contracts after the investment has been made, democratic leaders may suffer electoral costs. The potential for these electoral backlashes may constrain democratic leaders.

Some scholars would be quick to point out that democracies are associated with higher levels of leadership turnover, which could have a negative impact on policy stability and ultimately country credibility. In a recent article, McGillivray and Smith (2000) point to way in which leadership turnover could be associated with higher levels of credibility. They argue that political leaders play an "Agent Specific Grimm Trigger Strategy" where political leaders refuse to cooperate with other political leaders that have "defected" in the past. Multinationals can also play this strategy with governments that institute legislation or reverse policy in ways that negatively affect multinational corporations. Essentially, firms can hold individual leaders politically accountable for policy and refuse to cooperate (invest) in the future. In democracies, citizens that value the benefits of multinational production have the incentive and the opportunity to replace leaders with tarnished reputations through electoral mechanisms.

Given the effects of democracy on policy stability and content, I predict that the overall effect of democratic institutions should be positive. Democracies should be associated with higher inflows of FDI. Also, given the importance of these policies on the profitability of multinationals, the effects of these institutions should be comparatively large. The empirical results discussed later confirm both of these predictions.

Federal Institutions and FDI: Theory

This dissertation also examines the role of federal political institutions in attracting multinational corporations. Federal institutions can provide benefits to multinationals by enhancing policy stability and providing multinational friendly policies. Subnational actors can potentially provide veto points within the political system that enhances the credibility of host governments. The value of these "veto points" depends on the exact type of federal institutions.

There is an important theoretical distinction between political federalism and fiscal federalism that must be untangled to understand the independent effects of these institutions on multinational production. Before embarking on a discussion of *political* federalism and *political* decentralization, it is important to contrast these political arrangements with the growing literature on *fiscal* federalism/decentralization. Early scholars such as Tiebout (1956) and Oats (1972) have constructed the foundation for the study of fiscal decentralization on economic performance. Fiscal federalism and fiscal decentralization entail a degree of fiscal autonomy of regional governments from the central government in both taxing and spending. Although these works on fiscal

decentralization have been important academic contributions, they have missed an important institutional element of federal systems.

Weingast (1995) amends the literature on fiscal federalism, arguing that for states to be "market-preserving" federal countries, five conditions must be met:

1. A *hierarchy* of governments with a clear scope of authority.
2. The *autonomy* of each government is assured through some set of institutions.
3. The subnational governments are the primary agents responsible for *regulation* of the economy.
4. A *common market* of free trade between subnational units is guaranteed.
5. Subnational units face a *hard budget* constraint.

Weingast stresses that while the first two conditions may ensure a politically federal system as envisioned by Riker (1964), the final three conditions are necessary to give the subnational units enough autonomy to constrain the central government.

The definition of politically federal systems employed in this analysis is based on political relationships between the central government and local/regional governments. Contrasting from Watt's (1999) definition of federalism as a combination of "shared-rule and regional self-rule", the working definition of political federalism is based solely on the first dimension.[12] Specifically, political systems where regional actors affect *national* policies are considered politically federal systems.

Political federalism contrasts with political decentralization, where decentralization encompasses Watt's second part of his definition, self-rule. Regional units are often given functional authority over certain policy areas. This includes

[12] Watts (1996) page 6.

"autonomous regions" within a polity that are given some degree of political autonomy, but have no real effect on the crafting of national policy.

The working definitions of these three concepts are summarized as:

1. Fiscal Federalism: Subnational units are given primary responsibility of spending and raising revenue. These units have primary responsibility of regulating economic activity within their subnational territorial area.
2. Political Federalism: Subnational units do not have the primary responsibility of taxing and raising their own revenue but do have a hand in crafting national policy. Subnational units are involved (in ways that will be described later) in legislation at the national level.
3. Political Decentralization: Subnational units are given autonomy over policy within their subnational territorial unit, short of taxing and spending their own revenue. Subnational units have no role in the crafting of national policy.

These differing conceptions of federalism have potentially different effects on FDI inflows. Although most studies have focused on the market enhancing nature of fiscally federal systems, political federalism could provide substantial benefits to multinational investors. Essentially in politically federal systems, subnational units can provide a de facto veto on central government legislation.

This increase in the number of veto players provides higher levels of policy stability in a Tsebelis style framework. More importantly, I argue that these veto players in federal systems have the incentives and the power to protect the operations of multinational firms. The logic is as follows.

Multinational investments provide benefits to the nation as a whole (the central government) and benefits that are localized (concentrated in one or more subnational unit). These national benefits include increased tax revenues, technology transfer, and foreign exchange. An example of a localized good is employment creation. These localized goods are dependent on the profitable operation of the multinational firm.

In a simple model constructed in Chapter IV, I show that these differing incentives of the central government and subnational governments can provide multinationals with a credible commitment to market friendly policies. This "market preserving federalism" only occurs with system where the power of taxation is left to the central government and subnational units have some degree of political power. Only *politically* federal systems provide commitments to market promoting polices. These political systems attract higher levels of FDI

International Monetary Funds Agreements and FDI: Theory

Although domestic political institutions can have major effects on government policy, and ultimately FDI, international institutions can also affect policy in ways that affect FDI inflows. In chapter VI I explore the effects of signing agreements with the International Monetary Fund on FDI inflows. Countries in severe economic crisis turn to the IMF for "lender of last resort" funds. These funds are often provided with explicit IMF conditionality, where disbursements of IMF funds are contingent on specific macroeconomic reforms.

The signing of a loan agreement with the International Monetary Fund can provide international investors with a limited credible commitment to a specific package of future economic policies. Countries signing IMF agreements face more than just

reputation costs, they will incur actual fiscal costs in terms of lower levels of funding from the IMF for reversing policy. IMF packages should decrease the level of policy instability.

Unlike democratic institutions and federal institutions, IMF packages, while decreasing policy instability, do not ensure market friendly policies. Although the policies associated with IMF conditions are generally believed to be market promoting, the effect of IMF agreements is strictly an empirical question. Financial markets, in this case FDI flows, should provide the answer as to if foreign investors value these reforms. Economic reforms that will stabilize the economy and provide the foundation for robust future macroeconomic performance should be valuable to multinational corporations. Countries that sign IMF agreements should then be associated with higher FDI inflows.

At the same time there is the possibility that IMF programs could have a detrimental effect on multinational investors. Signing of IMF agreements could also lock governments into an inefficient policy equilibrium. If the conditionality associated with IMF loans is worse than the current economic policies, foreign investors will react negatively to IMF agreements.

Although, on the surface this explanation may sound farfetched, there is some reason to believe that the negative impact of IMF polices is a distinct possibility. IMF conditional often prescribes austerity packages that may impose political and economic costs on domestic economies, and multinational corporations.[13] For example, IMF conditionality may impose spending constraints on domestic governments. Governments

[13] In a recent work Przeworski and Vreeland (2000) found that IMF policies lead to lower levels of long-run economic growth for countries.

must slash government spending to conform to agreed upon budget deficit levels. This decrease in spending can translate into a lower provision of public goods, such as decreased spending on education and physical infrastructure. If IMF conditionality forces governments to provide lower levels of market enhancing public goods, multinationals may react negatively by refusing to invest in these countries.

Given this relationship there are no a priori reasons why one should assume that the macroeconomic reforms prescribed by the IMF would attract foreign investors. They may provide credibly commitments to a specific policy equilibrium, but the value of this equilibrium to foreign investors is unknown. The overall effect of IMF agreements on FDI is strictly an empirical question. The empirical results discussed below find a strong negative relationship between IMF programs and FDI inflows.

The Race to the Bottom and FDI: Empirical Results

In Chapter III I test the effects of government fiscal policy decisions on FDI inflows. In an analysis of 15 OECD countries from 1970-1993 test the race to the bottom thesis by estimating the impact of levels of taxation and spending on FDI inflows. Contrary to the race to the bottom thesis, I find no support that levels of capital taxation, labor taxation, or social security transfers negatively affect FDI inflows. I also find that there is no obvious relationship between partisan composition and the levels of FDI inflows.

The only support I find for the race to the bottom thesis is that levels of government spending do affect FDI inflows, but not in the way that most scholars suggest. I find that the overall level of government consumption across countries has no impact on FDI inflows. On the other hand, there does seem to be evidence that firms

respond to the lowering of levels of government spending within a country. I conclude that firms are responsive to levels of government consumption, but that there is not real pressure for the highest consumption (and tax) countries to conform to the policies of the lowest consumption (and tax) countries. In conclusion, I find very overall support for the race to the bottom thesis.

Democratic Institutions and FDI: Empirical Results

This dissertation empirically examines the relationship between FDI and democratic institutions using a number of OLS regressions. The first set of regressions utilizes cross-sectional data for 80 countries on the determinants of FDI in the 1990s. These regressions find that democratic political institutions are associated with as much as 60% more FDI flows than authoritarian regimes. These results are robust when other political factors are controlled for.

The second set of regressions utilizes panel data to explore the effects of democratic institutions on FDI inflows from 1970-1998 for over 100 countries. In this set of tests I construct a number of Ordinary Least Squares regressions with robust standard errors using annual FDI inflows as a percentage of GDP as the dependent variable. As with the cross-sectional results, these panel regressions find that democratic institutions have a positive and statistically significant affect on FDI inflows. The magnitude of these flows is massive, democratic institutions attract almost 70% of FDI as a percentage of GDP. The cumulated effect of democratic institutions after 10 years of continuous democracy amounts to an added stock of FDI of roughly 20% of GDP.

The third set of empirical tests corrects for the selection bias in democratic institutions by utilizing a modified Heckman selection model. As pointed out by

Przeworski et. al. (2000), the study of the economic effects of political regimes suffers from a selection bias. Democratic institutions in low-income countries seldom survive, collapsing into authoritarian regimes leaving us with few observations of democracies in these low-income countries. Since theses lower income countries often attract high levels of FDI as a percentage of GDP, the standard OLS regressions are biased against democratic institutions.

When a selection corrected Heckman model is employed, we do indeed find that the OLS regressions were biased and that the effects of democratic institutions on FDI are vastly underestimated. The selection corrected estimates of the effects of democracy are roughly three times larger than the OLS results. Democratic institutions have an even more massive positive effect on FDI inflows than originally estimated.

The final set of empirical tests explores the credibility enhancing nature of democratic institutions by exploring the effects of democracy on country sovereign debt ratings for 80 countries from 1980-1998. This is not a direct test of the credibility improving character of democratic institutions for multinational investors, but is does help us to more clearly examine the causal mechanism. The ex-post/ex-ante bargaining nature of FDI is similar to the dilemma faced by political leaders attempting to obtain loans from foreign lenders. Governments make promises on the repayment of loan, but once the loan is disbursed, these conditions may not be met. There are reputational costs for default, but often the short-run political and economic incentives outweigh these reputation costs.[14] Creditors must attempt to predict the potential of default, by examining the country's economic conditions and political institutions along with future

[14] Rosenthal (1991), Bulow and Rogoff (1989)

world macroeconomic conditions. The empirical results find a strong positive and statistically significant effect of democracy on sovereign debt ratings.

Federal Institutions and FDI: Empirical Results

To untangle the effects of political and fiscal federalism on FDI inflows, I utilize a number of OLS panel regressions similar to the tests on the effects of democracy on FDI. To test the independent effects of fiscal federalism and political federalism on foreign direct investment I have constructed two key independent variables. I operationalize fiscal federalism as the local government's share of revenue as a percentage of GDP from IMF sources. For political federalism, I have constructed a measure ordinal measure of federalism from a number of sources for over 100 countries from 1975-1995.

The estimated effects of political federalism on FDI are positive and statistically significant. Politically federal countries attract higher levels of FDI, even when other political and economic factors are controlled for. The effects on fiscal federalism are neither consistently positive nor are they statistically significant.

These findings on the positive effects of political federalism and the null result on fiscal federalism have academic importance beyond the study of FDI flows. These results show that the economic effects of federalism are contingent on the definition of federalism used. The lack of attention paid to these differing conceptions of federalism could help explain the lack of consensus on the overall effects of federalism on macroeconomic performance.

International Monetary Fund Agreements and FDI: Empirical Results

To test the effects of International Monetary Fund agreements on the FDI this dissertation empirically examines the affects of IMF programs on FDI inflows for 100 countries from 1970-1996 using a number of time-series-cross-sectional regressions. Standard OLS regressions on this topic suffer from obvious selection effects; only countries in economic crisis sign IMF agreements. To correct for these selection effects I utilize a Heckman selection model. This model utilizes annual observations of FDI inflows and corrects for the selection bias of countries under IMF programs by predicting IMF participation through a number of economic control variables.

The empirical results find that the selection corrected effects of IMF programs are negative and statistically significant. Countries that sign IMF agreements attract lower levels of FDI. The magnitude of this effect is large. Countries that turn to the IMF, ceteris paribus, attract 25% less FDI inflows than other countries. These results remain robust under a number of alternative specifications.

Conclusions

The findings in this dissertation, when they are incorporated with the existing work on FDI, provide a comprehensive explanation of the distribution of foreign direct investment across countries. The empirical results point to the importance of political institutions on the political risks associated with foreign direct investment. These political institutions have massive effects on inflows of foreign direct investment. Understanding these political factors is central to understanding the investments from Multinationals. From a public policy perspective this dissertation maps out the types of institutional arrangements that are the most conducive to FDI.

These findings, while cumulatively adding to our general understanding of FDI flows, also debunks some of the myths on the effects of political institutions on FDI. One of these myths that are prevalent in public policy debates and the public attitudes is the relationship between multinationals and authoritarian regimes. Although the logic that multinationals prefer to bargain with dictators may have some conceptual appeal, there a number of reasons whey multinationals would prefer to investment in democratic regimes. Empirically the results are rather conclusive, democracies attract more FDI.

Another myth relates to the market preserving nature of federal institutions. As academic scholars debate the positive and benefits of fiscal decentralization, and the World Bank pushes for fiscal decentralization in the developing would, the importance of more clearly understanding the effects of federalism on macroeconomic performance becomes even more important. This dissertation stresses that the exact definition of federalism is the central element to more clearly understanding these effects. More specifically, the extensive focus on fiscal federalism and fiscal decentralization has overlooked the importance of political federalism.

Lastly, and perhaps most timely in terms of public policy, is the role of the International Monetary Fund on macroeconomic performance. Recent debates have examined the effects of the IMF on long-run economic growth. Other scholars have examined the effects of IMF programs on short-term, portfolio capital flows. This study examines the effects of IMF programs on long-term, FDI inflows. These FDI inflows are important mechanisms for economic development, and serve as an important barometer on the future of the economy. Essentially by understanding how firms react to the singing of IMF agreements, we can examine how firms perceive the future of the

economy. The empirical results in this dissertation find that IMF programs are associated with lower levels of FDI inflows.

Dissertation Outline

The remainder of this dissertation is as follows. Chapter II will discuss the political and economic importance of FDI, and examine the existing work on the determinants of FDI. Chapter III tests the race to the bottom thesis in the OECD. Chapter IV will focus on the relationship between democracy and FDI across the globe. Chapter V focuses on the effects of political and fiscal federalism on FDI. Chapter VI examines the link between IMF programs and multinational's investment decisions. Chapter VII concludes.

The Political Economy of Foreign Direct Investment

Chapter II: Multinational Firms and Domestic Governments

I. Introduction

The focus of this project is on the most stable and economically important of the international capital flows, foreign direct investment (FDI).[15] Foreign direct investments are defined as private capital flows from a parent firm to a location outside of the parent firm's host nation. These investments consist of equity capital, intercompany debt, and reinvested earnings. An investment is considered foreign *direct* investment, as opposed to portfolio investment, if the investment is large enough to give the parent firm some amount of control over the management of the enterprise, usually over 10% of the firm.[16] FDI, unlike portfolio investments, have long time horizons and is generally not done for speculative purposes, but rather to serve domestic markets, exploit natural resources, or provide platforms to serve world markets through exports.

The most common form of FDI in developing countries is "greenfield investment", where multinational corporations construct subsidiaries from the ground up in foreign markets. Multinational firms choose between locations across the globe, providing the financial capital and managerial know-how to establish a subsidiary. These greenfield investments can made in virtually any industry, from manufacturing, to agriculture, to mining, to services.

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[15] See Lipsey (1999) for a discussion of the stability of FDI flows relative to other investment flows.

[16] These are the statistical rules used by the IMF. See IFC (1997) page 9.

One example of a manufacturing Greenfield investment was medical technology producer Medtronic's decision to construct a production facility in Tolochenaz, Switzerland in 1995. Medtronic, the leading pacemaker producer in the world, had established a presence in Europe since the mid-1960s and wanted to expand their production capacity beyond the existing production facilities. Fourteen months after Medtronic made the decision to invest in Switzerland, the final production facility was financed, designed, and completed.

A second form of FDI, very common in the developed countries, is described as "brownfield" investments. These investments are made in existing firms, through mergers and acquisitions, or through privatization programs. This form of FDI is traditionally more common in developed nations, where large multinationals gain access to foreign markets by purchasing existing companies. More recently, a number of middle income countries have attracted this form of FDI due to the privatization programs of former communist economies and countries in Latin America.

In many countries, both types of multinational investments have been on the rise. In Eastern Europe, for example, foreign automotive producers have flocked to both invest in existing state-run enterprises and to establish new production facilities. Auto giant Volkswagon, for example, attempted to both greatly expand auto production for Eastern European consumers, and to take advantage of the potential to use Eastern European production to help supply world demand for autos. In the early 1990s, VW acquired the giant Czech auto firm Skoda and constructed an Audi factory in Hungary.

II. Invitations to Multinationals

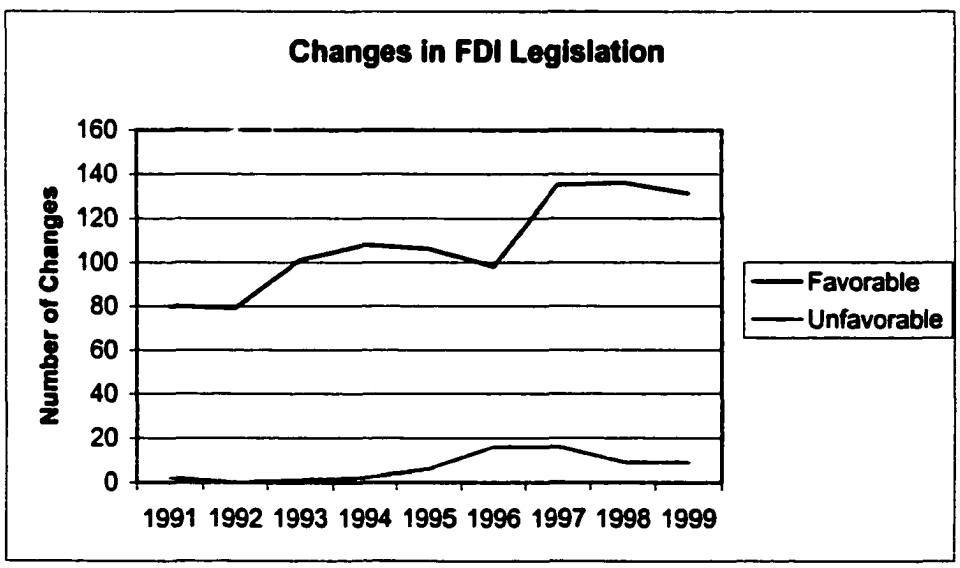
FDI promotion strategies, in any form, have become a central aspect of the economic development strategies of countries of all levels of economic development. The enthusiasm to attract investment is evident in the rise of government sponsored marketing campaigns to attract multinationals. In the period between 1991 and 1998 alone, over 58 countries initiated investment promotion programs, joining the 48 already utilizing these tactics (Moran 1998; 37).

One example is the Invest in Sweden Agency (ISA). This agency answers directly to the Swedish Ministry of Foreign Affairs and is responsible for attracting international investors to Sweden. The agency focuses on special marketing programs in the sectors the agency believes Sweden can offer the best opportunities to foreign investors, currently: automotive, call center, direct marketing, food, health care, information technology, microelectronics/software, mineral exploration, and wood processing. Although the primary responsibility of the agency is to disseminate information on business opportunities in Sweden, the agency also provides free legal assistance and even introduces executives to government officials and business associations.

Some of these investment promotion programs, such as the Austrian Business Agency, have moved from passively attempting to contact interested investors to actively recruiting companies. These recruitment tactics stem from advertising in magazines such as the Economist to more targeted individual contact between investment agencies and multinationals that could potentially provide FDI.

Countries have also taken bold steps in the liberalization of the investment regimes, allowing for further penetration of multinationals into domestic markets. The United Nations documented 1,035 worldwide changes in laws governing FDI from 1991-1999, where 94% of these created a more favorable environment for multinationals. The annual number of positive changed is staggering, as exhibited in Figure 2.1. Many of these changes have been in response to international agreements on FDI liberalization as mandated in the EU, NAFTA, WTO and other regional agreements. No matter what impetus is for these changes, the growing consensus is that an economy open to FDI is a necessary in the 21st century.

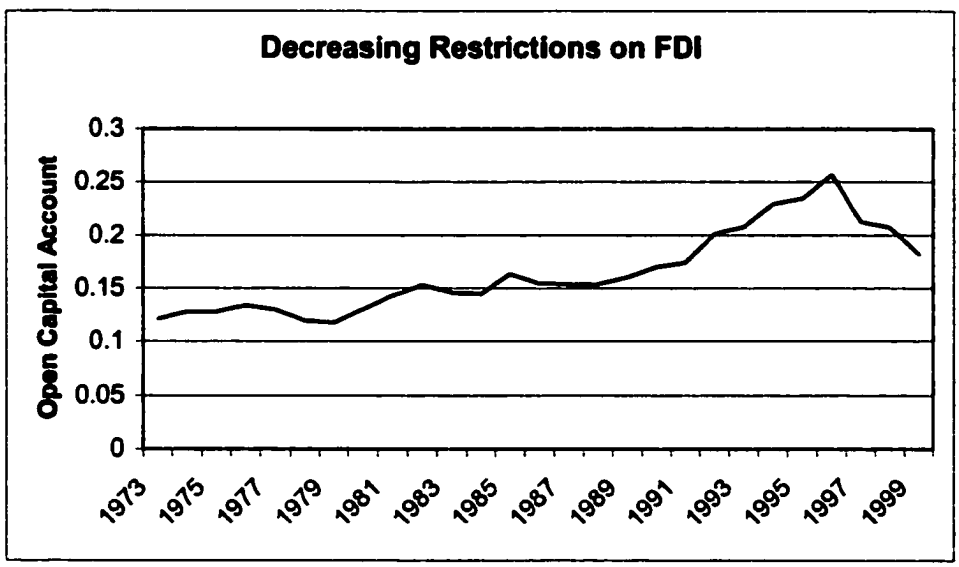
Figure I



The forms of FDI liberalization vary across countries. Countries have decreased the use of capital controls on FDI inflows, increasingly allowed multinationals into sectors often reserved for domestic firms, opened up privatization programs to foreign firms, and generally enacted laws allowing multinationals treatment more similar to that of domestic firms.

The importance of liberal entry conditions has become the most important change in FDI laws. The increasing trend in allowing multinationals greater participation in foreign markets can be seen through the decreased use of capital controls on FDI inflows. Figure II shows the increasing capital account openness of countries around the globe. Since 1973 the average number of countries with a completely open capital account has more than doubled, only to decrease slightly in the wake of the East Asian financial crisis.

Figure II



This focus on attracting multinational corporations has spread to countries around the globe. In sub-Saharan Africa, an area known for nationalization of multinationals in

the 1960s and 1970s, the mood towards FDI has shifted from hostility to accommodation.

According to one scholar:

> During the last decade, most SSA governments have made concerted attempts to improve the investment climate for transnational corporations and other foreign investors. New investment codes have been promulgated that have swept aside many of the restrictions and impediments that had limited FDI in the past, replacing them with a variety of investment incentives and guarantees. These include the freedom to remit profits, the removal of limits on the level of foreign equity, and the granting of work permits for all necessary expatriate personnel. Foreign investors are now actively wooed by senior politicians and government officials. High profile investment conferences are regularly held both in-country and overseas.[17]

In Argentina, the path towards accommodating multinationals has been more of a smooth one:

> Regulations on FDI were established as early as 1976 to provide equality of rights and obligations with local investors. The regulations permitted incorporation of used capital goods, capitalization of intangibles, profit remittance, and unlimited capital repatriation. Beginning in 1989, prior official approval was not longer required for FDI in the computer industry, telecommunications and electronics. But authorization was still required for FDI in the defense and national security sectors, energy, the communications media, education, insurance, and finance except banks. Meanwhile, the state reform law established the legal framework for the process of privatization of public enterprises through external debt conversion, and it authorized the entry of foreign capital into the program of privatization of sanitation, electricity, gas, telecommunications and postal services.
>
> In September 1993, a new text was approved for the Foreign Investment Law incorporating all these modifications. The new law established no requirement or conditions for profit remittance (and also exempted profit from any specific tax) or capital repatriation. It deregulated various activities still under the prior authorization regimen, authorizing grants of licenses for the exploration of mines and gas and oil fields (without changing the regimen of government ownership), and deregulated the domestic and foreign marketing of crude oils and fuels.[18]

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[17] Bennell (1997) pages 133-134.

[18] Chudnovsky et. al. (1995) pages 41-42.

In Hungary, the socialist government in the 1980s partially opened the doors for multinational production. The limiting condition was that the central government attempted to control their balance of payments by requiring firms to acquire "export credits" in order to import raw materials. What this meant was that the multinational was forced to offset the value of any imported goods with exports of final products.[19] For Ford in Hungary, in the early 1980s, this meant establishing one plant that provided electronic components for export to other Eastern European markets, and another that would import semi-finished goods to produce automobiles for the domestic market. These policies were dropped in the early 1990s, paving the wave for even more multinational investment in Hungary.

Although the forms of policy change towards multinational corporations vary, the direction is the same. Most countries have increasingly opened their doors to multinationals, attempting to establish policies and institutions conducive to multinationals. Many countries in the developed and developing world have begun the use of incentives. In Ireland, for example, companies are eligible for grants toward start-up costs and grants towards research and development.

The growing consensus on the need for attracting FDI inflows is due to the increasing supply of FDI flows in the global economy, and a general consensus by

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[19] The GATT provisions concerning National Treatment (Article III), reaffirmed by the Agreement on Trade-Related Investment Matters (TRIMs), explicitly prohibits these trade balancing requirements.

economists on the importance of FDI for economic development. Both of these issues will be discussed further in the following two sections.

III. Multinationals and Multinational Investments

Multinational corporations are the major players in the world economy. Today over 63,000 multinational corporations own almost 700,000 foreign affiliates in virtually every nation on the globe. The current value of the stock of world FDI is valued at well over $5 trillion and produces an estimated $3 trillion in goods and services. When all multinationals are taken together, both the parent firms and the foreign affiliates, multinationals account for one quarter of the world's GDP (UNCTAD 2000). The importance of multinationals, and multinational investments (FDI), is obvious.

The direct importance of foreign direct investment on capital accumulation, the driver of economic growth in neoclassical economics, is large and growing. International capital flows have increasingly become dominated by flows of private capital. In 1990 44% of all international capital flows were private, by 1996 85% were private, and FDI was the largest single type of flow.[20]

Foreign direct investment has generally outpaced international trade, where FDI grew at an average rate of 13% per year from 1980-97, as compared to an annual 7% growth rate for exports.[21] The sales of the affiliates of multinational corporations were more than twice the level of global exports in 1999. This trend of FDI outpacing exports is further widening; in 1998 and 1999 FDI flows grew at an explosive rate of 25% and 28% respectively.

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[20] IFC (1997) page 14

[21] Mallampally and Sauvant (1999).

This comparison between multinational production and world trade isn't exactly fair. Most analysts estimate that a full 30% of world trade is actually trade within firms (Markusen 1995). When Ford imports components from a subsidiary in Germany, these statistics are counted as Germany exports and United States imports. The point is that FDI not only has been growing faster than international trade, but it is also interlocked with trade, and may even be one of the drivers of the growth of trade.

Even in all of its dynamic growth, foreign direct investment remains one of the most stable of all private capital flows. In the wake of the East Asian crisis international capital flows plunged over 14%, decreasing the total capital flows to emerging markets from 11% of world capital flows in 1997 to 4.5% by 1999 (Global Finance Report 2000; 21-22). During this same time period FDI flows to developing countries remained relatively stable and showed some increases in 1999 and 2000. The total share of developing country FDI increased from 21% in 1991 to 36% in 1997, dipping back to 25% in 1998. This decline in the total share of FDI was not due to decreased FDI flows in developing countries, rather it was attributed to increased FDI flows between the developed countries in the merger mania of the late 1990s (Global Development Finance 2000).

Even with the relative stability of FDI, there are some interesting FDI trends over time. Figure III presents the average levels of FDI as a percentage of GDP for high-income countries, middle income countries, low-income countries, and all countries averaged. For all sets of countries FDI has showed solid growth since the early 1980s, only to explode in the early 1990s. The high income countries, both the main recipients and the main suppliers of global FDI have followed the world average, averaging FDI

inflows of roughly 0.5% of GDP in the early 1970s, surging to 1% in the 1980s, and topping off over 2% at the end of the 1990s.

Middle income countries have followed a similar trend, only with higher levels of FDI. These countries started attracting FDI flows at a higher level than the high-income countries (as a percentage of GDP) in the 1970s, and separated even further from the high-income countries by the 1990s. By the end of the 1990s these middle income countries (which ones) attracted FDI flows at a magnitude of over 3% of GDP.

Most startling has been the growth of FDI inflows to the low-income countries of the world. Many of these countries were not even counted in official FDI statistics in the early 1970s, and only really began attracting significant amounts since the 1980s. In the early 1990s, FDI flows exploded, increasing from well less than 1% of GDP in 1990 to around 3% of GDP by 1995.

Figure III

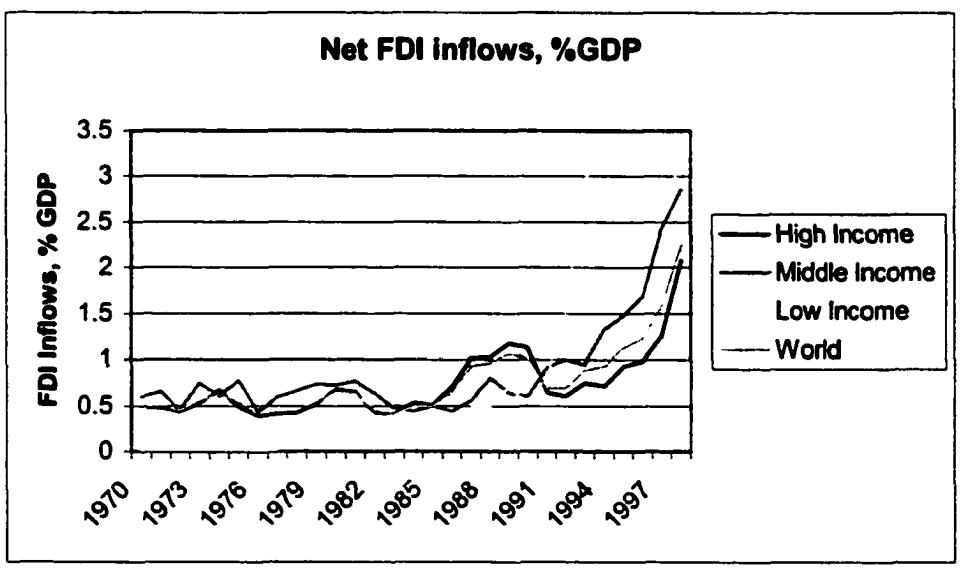
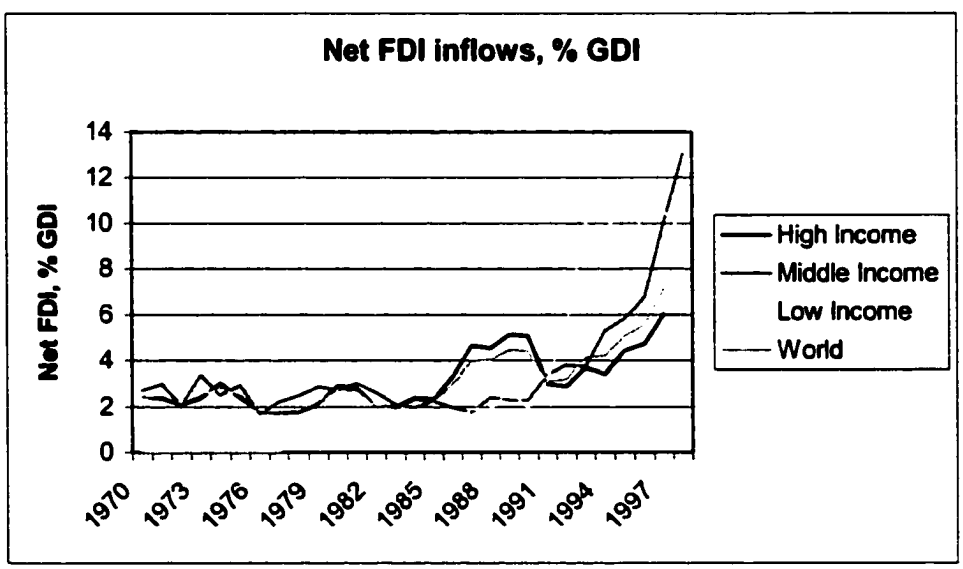


Figure IV presents the contribution of FDI to gross domestic investment, the driver of economic growth. For most groups, unsurprisingly, FDI as a percent of GDI

follows a similar pattern as FDI as a percentage of GDP. The high income countries once again mirror the world average and show significant increases since the 1970s. For the low-income countries and the middle income countries the surge in investment in the early 1990s contributed to multinationals making a larger contribution to the domestic capital stock.

FDI flows have not only grown, they have outpaced domestic savings. By the end of the 1990s FDI flows accounted for a full 7% of investment in most countries. For the low and middle-income countries the sheer magnitude is startling. Investments from multinationals now account for roughly 10% of investment in low income countries and are approaching 14% in middle-income countries. FDI has clearly made a tremendous impact on all countries.

Figure IV



Although FDI has become increasingly important for both developed and developing countries alike, large differences remain in the actual distribution of FDI

between countries. This study explores have political institutions help explain these cross-country variations in FDI inflows. Before we examine these political institutions we should have a better understanding of the significance of foreign direct investment.

IV. The Positive Effects of Multinationals

Technology

These figures on the magnitude of FDI obscure an even more important element of FDI flows-the role of multinational production in transferring technology. The potential for technological transfer is obvious if one examines the characteristics of most multinational firms. "Multinationals tend to be important in industries and firms with four characteristics: high levels of R&D relative to sales; a large share of professional and technical workers in their workforce; products that are new and/or technically complex; and high levels of product differentiation and advertising. These characteristics appear in many studies, and I have never seen any of them contradicted in any study".[22] Investments by these technologically advanced firms translate directly into growth promoting technical advances for the host nation.[23]

In a review of the literature on the affects of FDI on host countries, Blomstrom and Kokko argue that multinational corporations transfer of technology formal mechanisms than can be either passive or active. Formal active mechanism such as joint ventures or licensing agreements often have explicit technology sharing agreements, or at least entail the multinational introducing new technologies used in joint production. Formal passive mechanisms, such as the establishment of linkages between firms and

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[22] Markusen (1995) page 172

[23] See, Wang (1990) and Grossman and Helpman (1991).

individuals with technological know-how are less obvious. Blomstrom and Kokko (1997, 4) explain:

> For instance, linkage effects can take place between firms in different countries, like when exporters learn from the feedback they receive from their multinational customers abroad, but perhaps even stronger when they arise between local firms and MNC affiliates operating in the same country (as will be seen in the ensuing discussion of spillovers). Similarly, many informal transfers where MNCs have a passive role- those that come about as a result of any kind of personal contact with people who know about MNC's technologies- are obviously facilitated by the presence of foreign affiliates.

Empirical studies have attempted to examine the actual role of FDI in technology transfer. A study by Barrel and Pain (1999) find that for 4 industrialized European countries, a one-percentage increase in FDI, increased technological progress by 0.18%. In another study, Luiz R. de Mello, Jr. (1999) uses panel data for 15 OECD countries and 17 non-OECD countries from the period 1970-90 and finds that FDI does increase growth, but the gross enhancing effects are dependent on the level of technological backwardness. For the backward countries, FDI is more productive than domestic investment.

Exports

Although the direct effects of FDI on capital accumulation and technological transfers are economically the most important, other economic and political effects of FDI should not be overlooked. FDI is most often concentrated in export sectors, generating foreign exchange for the host nation.

This link between trade and FDI deserves closer examination. The pillar of the theory of international trade, the Heckscher-Olin-Samuelson model, predicts that

international trade and capital will serve as perfect substitutes.[24] Numerous authors have attacked the assumptions of this model, generating substantially different results. In many of these new models, there is a positive link between the level of international investment and trade (Kemp 1966, Jones 1967, Purvis 1972, Markusen 1983, Svensson 1984, and Markusen and Svensson 1985). A number of empirical tests have validated the link, however complex, between higher levels of investment and trade (Goldberg and Klein 1998 and Goldberg and Klein 1999).

The largest advances in this field have been by recent models described as "new trade theory". These models increasingly abandon the simplistic assumptions of the earlier models, allowing for a more rich analysis of international trade. Recent contributions, such as Markusen and Ethier (1996) examine more generally the mode of entry of multinationals, be it through international trade, FDI, or licensing agreements. As Ethier and Markusen (1996, 2) state: "...the new trade theory emphasizes just those features that appear to be central to multinationals: economies of scale, imperfect competition, strategic considerations, and technological change and diffusion".

Along with these theoretical and empirical studies, casual observation also leads us to a mixed and complex view on the role of FDI in increasing exports. In a recent study on FDI in Latin America, FDI had very different affects on the export position of Mexico, Argentina, Chile, and Columbia.[25] In Mexico, FDI was concentrated in manufacturing industries designed for export, such as the automotive industry, and local

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[24] This model has helped generate a tremendous amount of theoretical and empirical analysis of the relationship between trade and investment.

[25] Agosin (1995).

firms were used to supply these industries. Although FDI had a major impact on the export position of Mexico, this effect, although positive, was more modest in Argentina. A large quantity of FDI investment was made to serve the domestic market, having no impact on the export position of the country. In Chile and Columbia, FDI has flooded into natural resources: mining in Chile and oil and mining in Columbia. Although these industries do generate exports, there is little reason to believe that the purchase of these resources by multinationals have greatly increased the volume of exports beyond that of what local owners would have exported.

In most of these studies there is little evidence that multinational production serves as a substitute for international trade.[26] At the same time, FDI is not across the board always associated with higher levels of country exports. Multinationals attempting to serve the domestic market often do not impact country exports, while multinational production in the natural resource sector is mixed. Multinationals can often just take over existing operations of firms already utilizing natural resources or may be associated with large capital investments in natural resource industries, leading to booms in natural resource production and natural resource exports.[27] In any case, multinationals have the ability, in many circumstances, to greatly increase exports for the host country.

Employment

[26] There is some evidence that increased trade barriers may be related to increased "tariff-jumping" FDI. See Bhagwati (1985) and Barrell and Pain (1999).

[27] One recent example of increases in oil production due to multinational investments can be found in Equatorial Guinea.

FDI provides jobs for host countries. Multinational enterprises are estimated to employ 70 million workers, 22 million of these jobs are located in foreign subsidiaries (OECD 1994; 10). In the OECD, FDI accounts for roughly 2% of total employment (OECD 1994, 12). FDI is also a means of generating employment through the indirect effects on the economy, such as domestic industries emerging to compliment the new foreign firms (OECD 1994, Markusen and Venables 1999).

This employment creation component is often regionally concentrated. Multinationals invest in production facilities in specific locations, generating employment in the surrounding community. National governments have recognized this and have attempted to use investment incentives to channel multinational investment into areas that are economical less developed.

Economic Growth

These individual positive effects of FDI all translate in higher levels of economic growth, especially when interacted with other domestic conditions. The most obvious mechanism is through the expansion and deepening of a nations capital stock, leading to economic growth based on neoclassical growth models.[28] In these models the value of FDI is bounded by constant returns to scale production functions, meaning that capital accumulation (domestic or foreign) results in diminishing returns to capital. In capital abundant countries, FDI should have only a small impact on economic growth.

Romer (1986) proposed a deeper model of the role of capital on economic growth, arguing that capital should be viewed as more than simply a factor of production, but as

[28] This view of capital accumulation began with Harrod (1939), culminating into the famous Solow growth model. See, Solow (1956).

"knowledge". In Romer's theory, firms invest in private capital (knowledge), inadvertently leading to an increase in the public pool of knowledge. Under this theory, capital could lead to increasing returns to scale, where rich, technologically advanced countries can continue to sustain high levels of economic growth.

The most promising research has explored how FDI interacts with existing domestic conditions and institutions. Balasubramanyam, Salisu, and Sapsford (1996) find that FDI has the strongest contribution to growth in countries following export promotion strategies.[29] Balasubramanyam, Salisu, and Sapsford (1999) find that FDI has a large positive effect on FDI inflows, especially strong in countries with a minimum level of human capital. Many of these studies are very recent and leave many questions unanswered, but they do point to the need for a closer examination of how the affects of the flows of foreign capital are partially contingent on domestic political and economic factors.

Balasubramanyam, Salisu, and Sapsford (1999) summarize this vast literature on FDI and economic growth noting:

> Although there is no consensus, the following appear to be the factors identified in the literature on FDI.
>
> (a) FDI is a composite bundle of capital, know-how and technology.
> (b) Its main contribution to growth is through technology transfer and technology and skill diffusion in the countries importing FDI.
> (c) The effectiveness of FDI in promoting growth is, amongst other things, a function of the type of trade regime in place in the host country. FDI in the presence of a protectionist regime is likely to immizerize growth, whereas a liberal trade regime is likely to promote growth.

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[29] The original theory on the effects of export promotion policies on the efficiency of FDI has been attributed to Bhagwati (1978).

(d) Most empirical studies suggest that foreign-owned firms in comparable industry groups exhibit superior productive efficiency relative to that of locally owned firms, on most criteria of efficiency. But whether or not the social rate of return to FDI is on par with the private rate of return is a matter of dispute.[30]

One illustrative example of the potential impact of FDI projects on national economies can be seen by Intel's investment in microchip processing facility in Costa Rica in the mid-1990s. Intel, a company that boasted sales in 1996 that were three times larger than Costa Rica's GDP, originally promised a $300 million investment that grew to an estimated $500 million by 1998.[31] At full capacity, this plant promised to produce microchip exports that would equal, or exceed, total exports from Costa Rica. By 1999, production from Intel's plant accounted for over half of the total growth of the Costa Rican economy![32]

V. The Critics View of FDI

Although there is a growing consensus that FDI flows have positive effects on the national economy, multinationals and their investments aren't often portrayed as positive elements of the global economy. The criticisms can be placed in two camps, one on the direct negative effects of FDI and the other on the negative effects of the competition between countries for FDI.

Dependency theorists have long argued that FDI has serious negative political and economic consequences. Early versions of dependency theory originally focused exclusively on the lack of bargaining power of developing countries vis-à-vis multinational corporations. These early theories were viewed as overly simplistic,

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[30] Balasubramanyam, Salisu, and Sapsford (1999) page 28.

[31] IFC (1997) page 51.

[32] http://www.svtc.org/listserv/leter12a.htm

forcing a recasting of dependency theory to account for the variations in success of developing countries in economic development.

Peter Evan's (1979) contribution focused on the potential alliances between local political and economic elites and foreign capital. This "triple alliance" was mixed with cooperation and conflict, as each set of actors leveraged their power to gain the most from the alliance. Not included in this alliance, and suffering greatly from the distorted policies by this system, were the citizens in developing countries.

Other scholars within the dependency theory literature focus on the process of "denationalization", where local assets are absorbed by foreign capital. Foreign firms exploit profit-making opportunities in developing countries, but expatriate the profits to the wealthy host countries. Even worse, some scholars such as Gereffi (1983) argue that these multinationals also preempt the development of indigenous industries and firms, although this claim is difficult to test in reality.

Scholars in economic and political science have harshly criticized the dependency literature. Casual observation shows that multinational corporations have been utilized in East Asian countries' development strategies, producing dramatic levels of economic growth. The countries that have fared so poorly may be attributable to failure of development strategies, not the negatives of FDI. As Haggard (1989) states: "Virtually all of the major works in the vein have been draw from import-substituting manufacturing". Although some of the arguments of dependency do have their merits, these works do not lead us to the conclusion that FDI, in all cases, has negative political and economic consequences.

More recently, scholars have begun to focus on the effects of the competition for international capital and domestic governance. Scholars now generally recognize that the existence of multinational corporations can have positive effects on the economy (for the reasons stated above) but that the process of attracting FDI can produce a number of substantial costs on governments and their populations.

Scholars have highlighted the tensions between government macroeconomic policy and capital mobility.[33] One strand of the literature focuses on the "efficiency" constraints of governments. Governments that want to attract multinationals in today's global economy must slash government spending and taxation in a race for the neoliberal bottom.[34] This theory has moved from academic debates to public policy circles to mass-market books. In the words of a popular best-seller on globalization, "In a world in which capital is mobile, you cannot adopt rates of taxation that are far from the rates that prevail in other countries and when labor is mobile you can't also be out of line with others wages" (Friedman 1999, 108).

Chapter III of this dissertation more closely examines this race to the bottom perspective. The central theoretical point made in this chapter is that the race to the bottom thesis assumes a degree of capital mobility that is complete unrealistic when applied to FDI. The study of FDI has been focused on the study of imperfect markets (as highlighted below) while the race to the bottom thesis utilizes an analogy based on perfect markets. Empirically there has been little support for the race to the bottom

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[33] An excellent analysis of this literature can be found in Drezner (2001).

[34] Andrews (1994), Cerny (1990), Kurzner (1993). See Garrett (1998) for a discussion of the literature.

thesis. Chapter 3 finds practically no relationship between government spending and taxation and FDI.

VI. Determinants of FDI

The growth in the magnitude and importance of FDI flows (either positive or negative) has not been matched with an increased understanding of the actual determinants of these flows. Although few broad, systematic studies on the determinants of FDI exist, the OECD's simple distinction between the 'push' and the 'pull' factors is an excellent starting point (OECD 1998). Push factors are foreign firm's motivations for investing capital in production facilities abroad. These factors help explain the surges in FDI flows, such as the role of decreasing communication and transportation costs that made international multistage production feasible.

Stephen Hymer, in a 1960 dissertation, first published in 1976 was one of the first scholars to separate FDI from portfolio investment. Investment theory in the neoclassical tradition focused on the behavior of investments in perfect markets, positing that firms invest abroad simply in response to higher returns. Hymer noted that investment flows did not conform to the predictions of the neoclassical models and argued that firms' investments that sought to control (FDI) should be separated from other investment (portfolio capital flows). Contrary to neoclassical theory, Hymer argued that FDI was a response to "imperfect markets".

The following boom in academic scholarship on FDI in response to imperfect markets is far too extensive to review in its entirety here, thus I will only focus on a few of the pinnacle works. Kindleberger (1969) focuses on discussing the forms of market imperfections that make FDI possible. These include:

1. Departures from perfect competition in goods markets, including product differentiation, special market skills, retail price maintenance, and administered pricing.

2. Departures for perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, and of difference in skills of managers organized into firms rather than hired in competitive markets.

3. Internal and external economies of scale, the latter being taken advantage of by vertical integration.

4. Government limitations on output and entry. (Kindberger 1969, 14).

Although there was considerable debate within the literature, the works of Caves (1971), Aliber (1971), and Dunning (1971) all focused on this general imperfect markets approach.[35]

John Dunning's OLI framework is generally considered the paradigmatic theory of the multinational firm's investment decisions, where MNE's invest internationally for reasons of ownership, location, and internalization.[36] Firm's have *ownership advantages* when they have access to some asset or process that provides leverage over existing firms

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[35] Other notable contributions include Vernon's (1966) product life cycle, Buckley and Casson (1976) on internalization, Magee (1977) and information, Rugman (1979) and international diversification, Lamfalussy (1961) on defensive FDI, and Williamson (1975) on transaction costs.

[36] Dunning 1981. For an interesting discussion on the OLI framework and recent work done in relation to it, see Markusen (1995).

in the foreign market. These can be physical in the sense of patented products or production processes, or more intangible, such as global brand name recognition. Multination firms invest abroad to exploit these firm specific advantages in foreign markets to secure higher returns.

Firms may also be motivated to invest abroad because of *locational advantages.* Firms may invest in production facilities in foreign markets because transportation costs are too high to serve these markets through exports. This could either be directly related to the actual nature of the good, either being a high bulk item or a service that needs to be provided on site, or due to policy factors such as tariff rates, import restrictions, or issues of market access that makes physical investment advantageous over serving the market through exports. Also, the locational advantage could be related to the actual endowments of the host location, either a rich source of natural resources or a high quality, low-cost labor force.

The third, and most complex factor is the *internalization advantage.* While the other two OLI factors highlights reasons while firms would move production to a foreign location, it does not give any reason as to why a firm simply wouldn't license a foreign producer to make the item for the parent firm. A multinational could simply provide the technology needed for the production process and the blueprints for the product to a local firm. This concept of internalization advantages captures the firm specific motivations for a firm choosing to produce the product within the organization itself in a foreign location.

Closely related to Dunning's work, other scholars have developed a number of theoretical models to explain firm's decisions to invest abroad. These models can be

roughly classified as theories based on "vertical" firms, "horizontal firms, and the "knowledge capital model" of multinational firms.[37] Vertical firms separate production activities by the level of capital intensity, producing different goods and services at different production physical locations (Helpman 1984). Although an important contribution to the understanding of multinationals' investment decisions, theories based on vertical multinationals failed to account for the existence of firms replicating the production of the same goods and services in different physical locations.

Markusen (1984) explained this pattern of replicating production by creating a model of "horizontal firms" with firm-level economies of scale that integrate horizontally across national borders.[38] These horizontal models have been integrated into the existing vertical models of multinational firms into Markusen's (1997) "knowledge-capital model". In this model, multinational firms can produce the same product or service in multiple locations (horizontal) or geographically separate the firm's headquarters from the production location (vertical).

Although the OLI framework and the horizontal/vertical/knowledge-capital models of multinationals all remain strong tools to understand the motivations for MNE foreign investment, they still doesn't go far enough in answering one of the more important questions of international development: which *countries* attract foreign direct investment? Foreign direct investment remains a firm level decision, but countries have differed in their abilities to attract FDI. The question remains, what are these country specific factors that affect FDI inflows?

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[37] See Markusen and Maskus (1999a), (1999b).

[38] For a review of the literature see Markusen and Maskus (1999a).

Although most of the attention on FDI determinants has been focused on economic decisions at the firm level, economic and political analysis at a macro level has not been completely left out.[39] Some theoretical and empirical work has been done on the relationship between economic policy and foreign direct investment, especially in terms of trade and tariff policy (Bhagawati et al 1992; Blonigen and Fennstra 1996; Ellingsen and Warneryd 1999).[40] Heinsz (2000) argues that multinational corporations choose their entrance strategy in order to minimize political risks. In countries with a high number of veto players firms are more confident in the stability of government policy. In systems with smaller numbers of veto players firms are open to government actions targeted at expropriating the firms' assets or income streams. To minimize these political risks firms choose to enter these markets via joint ventures. Similarly, a recent work by Jensen and McGillivrary (2000) explore the relationship between federal political institutions and FDI inflows.[41]

Another area of research that has obtained more attention lately is tax rates and

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[39] Brewer (1993) reviews much of the existing literature on the political determinants of FDI flows in developing countries.

[40] The debate on FDI investment and trade policy as focused on international trade as complements or as substitutes for FDI. The consensus has shifted towards FDI as a complement to international trade.

[41] Jensen and McGillivray (2000) find that politically federal institutions have positive effects on FDI inflows in authoritarian countries.

international capital, arguing that capital mobility forces governments to lower their rates of capital taxation to attract foreign investors.[42] The empirical literature on this topic remains divided, with some theorists arguing that corporations are now more sensitive to tax rates in their investment decisions (Alshuler 2000) while others find that tax rates have no significant effect on international investment.[43]

Other studies have highlighted the effects of direct labor costs[44], political stability[45], and host country legislation that affect FDI.[46] These studies have generally

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[42] Martain and Velazquez (1997) also found that 'endowments of transport and human capital infrastructure' have a positive effect on FDI inflow. These factors have begun to find themselves within the FDI models of economic theorists, where Zhang and Markusen (1999) develop a theoretical model that argues that MNE's need skilled labor, and public and private services (telecom, laws, etc.) drives FDI flows.

[43] For a brief review, see Markusen (1995). For interesting work on the level of tax rates under conditions of capital mobility, see Swank (1998), Garrett and Mitchell (2001).

[44] For a review, see Brewer (1993)

[45] Ibid. For an examination of contract risks and MNE activities see Lehmann 1999 and Heinsz (2000).

[46] UNCTC (1991) examines 46 countries from 1977 to 1987 found that government policy had an effect on FDI inflows, but these policies alone are not enough to attract FDI. Markets and economic conditions matter more. Ganesan (1998) argues that "while an MAI (multilateral agreement on investment) may contribute to an improvement in the investment climate of a country, it will not be the dominant factor in directing FDI flows to developing countries'.

either found that these factors are not of central importance to FDI flows, or they have failed to integrate these theories into the existing work done on FDI.

This paper attempts to link the empirical and theoretical scholarship on the determinants of FDI and incorporate the role democratic governance into this body of work.

VII. Political Risk and FDI

Vernon (1971) identified the "obsoleseing bargaining" nature of FDI, where FDI is mobile ex ante, yet relative immobile ex post. Governments have the incentive to make promises to multinationals, but once the multinationals have sunk their investment, governments have the incentive to renege on the contracts. Governments may attempt to renegotiate contracts with multinationals (Gatignon and Anderson 1988, Williamson 1996, more) or to unilaterally expropriate assets or income streams (Kobrin 1989). These political risks are central to multinationals investment decisions.

Much of the literature on the determinants of FDI flows focuses on the actual decisions of individual firms. Unfortunately, this literature has not been incorporated into the literature on political risk; a literature that has a long and rich history in the business and economics.[47] Understanding political risk is central to understanding foreign direct investment.

Definitions of political risk vary greatly, but the simplest definition would focus on how social or political factors affect the profitability of a multinational investment. In common usage, political risk refers to when government policy, political institutions, or any other political factor has a negative impact on multinational ownership or operations.

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[47] See Harms (2000) for a review of the political risk literature.

These political risks are not to be confused with political instability or government action. Political risk has a probabilistic element, where countries with high levels of political risks have greater expectations of political factors adversely affecting the profitability of an investment. Countries with high levels of political instability can have low levels of political risk if this instability does not threaten the operations of foreign firms. Conversely, nations with little or no political instability can have high political risks if there is a high future probability of some type of political factor that could negatively affect multinationals.

What are these political factors that could negatively affect multinationals? While nationalization and expropriation are major elements of political risk, political risk encompasses much more. Kobrin (1982) identifies that political risk can be a result of major shifts in power (such as in Iran in 1979), but also can be stem from ordinary policy making. Robock (1971) classifies these risks as either macro or micro risks. Macro risks are associated with risks to all foreign firms and micro risks, risks that are associated with specific firms or industries.

Within these sets of micro and macro risks there are differentiations between risks that affect ownership and risks that affect operations (Kobrin 1982). The threat of mass expropriation of all foreign firms is a macro ownership risk, while the treat of expropriation of an industry is a micro ownership risk. Examples of operations risks, such as imposing capital controls (macro) and enacting legislation affecting an industry (micro) are also important.

While the nationalizations of the 60s and 70s are often associated with the risks of international investment, these are far from the most common risks. Kobrin (1985)

argues that only in the period from 1968 to 1975 was expropriation common. Most political risks today aren't dramatic changes in ownership, from foreign firms to host governments, they are policy changes that affect operations of a multinational firm.

These changes in the policy environment that adversely affects multinationals has been referred to as "creeping expropriation".[48] Governments today seldom directly nationalize industries, but often they make attempts to wrestle control or capture income streams from the corporation.

Part of this creeping expropriation is the very difficulty of specifying complete contracts. In technology joint-ventures, for example, multinationals are wary of how technological leakages or inadequate enforcement of property rights could threaten an investment. These contracts, even if there are fully enforced, are difficult to specify given the difficulty of writing a contract about assets that have yet to be created and the pace and scope of technological innovation is uncertain (Freeman 1982, Mowery and Rosenberg 1989, Oxley 1997). Multinational have to do more than predict if contracts are enforced, but also in which ways disputes over the unspecified elements of the contract are resolved.

Kenneth David (1985) argues that political risk assessment often is based on an American-centric view of world business. David argues that serious political risks can be generated by the interaction between competing firms and government ministries. In a study of Indian and Korean service industries David finds that the nature and character of this relationships with government ministries has a serious impact on firm performance.

[48] See Oseghale (1993) for more on creeping expropriation.

Political risk, and 'creeping expropriation' can be stem from different levels of government.

Not all scholars have argued that political instability and political risks always have negative consequences on multinational corporations. Kobrin argues that political instability may actually lessen the probability of political risk. Kobrin gives an example:

> After the Peronist regime was overthrown in Argentina, the government's attitude toward foreign direct investment became more positive; in fact, previously expropriated firms were returned to their owners. Similar policy shifts occurred after the demise of Sukarno in Indonesia and the violent overthrow of Allende in Chile. (Kobrin 1982, 37).

In an interesting study, Fynas (1998) finds that Shell Oil Corporations adapted to high levels of political risk in Nigeria, providing high returns on their investment, although this was due to increased entry barriers for multinationals. Perhaps even more striking, Fynas finds that political has been beneficial to Shell by both limiting new entrants into the Nigerian Oil Industry and using political instability, specifically terrorists attacks, to limit their liabilities for a number of oil spills in Nigeria.

Although these cases of political risks seem to have some validity, the general consensus is that political risks have serious negative effects on multinational investments.

Numerous studies have found that higher political risks lead are associated with lower returns on equity investments.[49] Higher political risks also affect the types of entry decisions of multinational firms, be they wholly owned subsidiaries, licensing agreements, or joint ventures (Gatignon and Anderson 1988, Murtha 1991, Oxley 1997, and Heinsz 2000). Lastly, and most relevant for this study, Wheeler and Moody (1992) find that high political risks are associated with lower levels of FDI inflows.

VIII. Government Credibility and FDI Flows

This project examines how political institutions can affect a government's credibility with multinational investors. Political institutions can provide guarantees, or at least mitigate these political risks for foreign investors. Specifically, this project examines how democratic institutions, federalism and decentralization, and agreements with the International Monetary Fund affect a governments' ability to attract multinational investments. The chapters IV, V, and VI more closely explain the effects of these three political institutions on FDI inflows.

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[49] For example see, Erb et. al. (1996).

The Political Economy of Foreign Direct Investment

Chapter III: The Race to the Bottom Thesis and FDI

I. Introduction

Most of the attention on the political determinants of FDI has focused on government fiscal policy. Scholars have long debated the reactions of footloose capital to the level and growth of government taxation and spending. The now almost cliché view of the "race to the bottom" thesis argues that multinational firms force governments into tax competition, lowering levels of corporate taxation and spending to attract mobile factors of production.

Although a number of scholars have examined the relationship between capital account openness and spending, few studies to date have actually examined the determinants of international capital flows in terms of patterns of government spending and taxation. Does international capital flow to countries with lower levels of government spending and taxation?

This chapter attempts to answer at least part of that question. In this study I will empirically examine the flows of foreign direct investment (FDI) to 15 OECD countries from 1960-1993. The empirical tests are designed to illuminate the link between government fiscal policy and multinational investments and attempt to fill a gapping hole in the literature by answering the question: Do multinationals prefer to invest in countries with low levels of spending and taxation?

This analysis admittedly ignores the question of the determinants of portfolio capital flows or flows of international debt. Also, this analysis only examines the determinants of FDI to OECD countries. Although this is not directly generalizable

beyond this set of countries, my conjecture is that there is also little support for this thesis beyond the OECD. This chapter, while limited, is unique in its empirical examination of the relationship between multinational firms investment decisions and a range of host governments' fiscal policies in the OECD using foreign direct investment as a the dependent variable.

The empirical results in this analysis find that the pessimism about the role of government fiscal policy in attracting foreign direct investment is greatly over exaggerated, directing our attention away from the institutional determinants of FDI. There is little support that levels of government spending or taxation have a negative affect on foreign direct investment inflows. Government spending on social security, often characterized as economically unproductive market intervention, does not deter multinational investments. More generally, there is no support that left wing governments suffer from lower levels of FDI inflows. In sum, multinational corporations' investment decisions have not seriously challenged government fiscal policy autonomy. The focus on fiscal policy determinants of FDI inflows has directed our attention away from the other important determinants of FDI inflows. Chapters IV, V, and VI will explore how political institutions affect FDI inflows.

This chapter proceeds as follows. Section II examines the recent growth in FDI flows into the OECD. Section III discusses the political ramifications of these flows and reviews the existing theory on the links between government fiscal policy and FDI. Section IV and V discuss the empirical methodology, the data, and the empirical results of the effects of fiscal policy on FDI flows. Section VI concludes.

II. Foreign Direct Investment: Importance and Trends within the OECD

The attraction of foreign direct investment has become a policy goal for most countries within the OECD. Virtually every OECD country has lowered barriers to multinational entry, either unilaterally or through negotiated agreements. Most OECD countries now have at least one agency devoted to the attraction of foreign direct investment, providing information, contacts, and legal support for foreign corporations.[50]

One explanation for this increased interest in attracting multinational investments is purely economic. There is a growing consensus that FDI has positive effects on macroeconomic performance.[51] The most obvious mechanism is through an increase in the domestic capital stock through multinational investments. Capital accumulation is the driver of economic growth in the neoclassical growth model, thus FDI should have a direct positive impact on economic growth.[52]

Although the impact of FDI on the capital stock in the OECD is economically important, the largest economic benefit of FDI to the OECD is through the diffusion of technology. The potential for technological transfer is obvious if one examines the characteristics of most multinational firms. Multinationals tend to produce technologically complex products that require large R&D investments and employ large numbers of professional and technical workers.[53]

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[50] This trend towards investment promotion programs has been extended to developing countries also. See, Moran (1998).

[51] See Chapter II.

[52] Solow (1956).

[53] Markusen (1995).

Insert Chart I

The growing interest in FDI has also been a reaction to the increase in the sheer magnitude of multinational investments over time. Chart I shows the growth of FDI as a percentage of GDP since the 1970s. In the 1970s FDI flows were roughly 2% of GDP, jumping to over 4% in the late 1980s and early 1990s. With the merger mania of the late 1980s fading, FDI slipped back to roughly 3% of GDP in 1992 and has grown steadily to over 6% of GDP by 1998. These dramatic increases in FDI flows have sparked a large discussion on the impact of FDI on host governments.

III. Foreign Direct Investment and Domestic Politics

Scholars have highlighted the tensions between government macroeconomic policy and capital mobility.[54] One strand of the literature focuses on the "efficiency" constraints of governments. Governments that want to attract multinationals in today's global economy must slash government spending and taxation in a race for the neoliberal bottom.[55] This theory has migrated from academic debates to public policy circles to mass-market books. In the words of a popular best-seller on globalization, "In a world in which capital is mobile, you cannot adopt rates of taxation that are far from the rates that prevail in other countries and when labor is mobile you can't also be out of line with others wages" (Friedman 1999, 108). The race to the bottom theory has become almost cliché.

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[54] An excellent analysis of this literature can be found in Drezner (2001).

[55] Andrews (1994), Cerny (1990), Kurzner (1993). See Garrett (1998) for a discussion of the literature.

The second strand focuses on the domestic political pressures for "compensation" from the losers of globalization.[56] Governments under conditions of high levels of trade and capital mobility are pressured by their citizens to provide higher levels of protection in the face of growing levels of economic insecurity in a dynamic global economy.[57] These works remind us that politicians respond to electoral pressures, not just market pressures.[58]

Although the compensation hypothesis seems to have some strong empirical and theoretical validity, this article takes one step back and focuses on the actual market pressures on patterns of government policy. Before we ask the question of whether governments choose to listen to markets over voters or vice versa, we must first understand what the markets actually want. Is there systematic evidence that multinationals actually prefer low levels of government spending and taxation? To answer this question we must have a deeper understanding the details for the "efficiency hypothesis".

The efficiency hypothesis actually contains two interrelated theories. One, often called the "race to the bottom" thesis, argues that governments are in a constant competition for international investment. Governments must act and react to the world policy environment, bidding against other countries by lowering levels of spending and taxation, loosening labor and environmental legislation, and generally providing a more hospitable environment for foreign investors.

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[56] Cameron (1978), Garrett (1998).

[57] Rodrik (1997).

[58] Rodden and Rose-Ackerman (1997).

In the strongest form, capital is mobile and governments are little more than commodities. Global corporations search the world for countries willing to offer the most attractive opportunities for their investments. Potential host governments can do little more than to continually bend to the whims of multinationals, offering these firms extremely lucrative investment opportunities and policy environments. Governments are forced to throw out their domestic environmental legislation, to lower levels of corporate taxation, and eventually alter their patterns of spending. Democratic decision-making is inhibited as footloose capital makes its voice heard loud and clear as firms "vote with their feet".[59] In essence, domestic governments must give up the ability to control their taxing and spending decisions.

Theoretically, there are serious flaws in this race to the bottom perspective. This theory assumes a degree of capital mobility and perfect markets that isn't supported by economic theory or casual observation. As Goodman (1976, 68) clearly states: "The perfect competition model fails to take into account the complexity of the firm's environment". Decades of research on foreign direct investment have been centered on the study of *imperfect* markets.

Hymer (1976) revolutionized the study of FDI by separating it from portfolio capital flows and focused on the reactions of multinationals in imperfect markets. Kindleberger (1969, 13) in his pathbreaking analysis of multinationals lists the specific market imperfections that give rise to multinational investments:

1. Departures from perfect competition in goods markets, including product

[59] Tiebout (1956).

differentiation, special market skills, retail price maintenance, and administered pricing.

2. Departures from perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, and of difference in skills of managers organized into firms rather than hired in competitive markets.

3. Internal and external economies of scale, the latter being taken advantage of by vertical integration.

4. Government limitation on output or entry.

For Dunning (1977, 1981), market imperfections were also central to understanding multinational production. To study this, Dunning constructed the OLI paradigm, which explained multinational firms' decisions to invest abroad for three reasons:

1. Ownership-Firms have some advantage in owning a physical plant rather than serving the market through export or licensing agreements.

2. Location-Firms have advantages of locating a facility in a specific geographic location, such as access to raw materials, proximity to a market for the good or service, or to utilize low cost labor.

3. Internalization-Firms have some advantage in keeping operations internal, such as a patented product or process.

For all of these theories, and a number to follows, imperfect markets are more than an interesting side note on multinational production; they are the drivers of FDI.

These imperfect market approaches cast some serious doubt on the "race to the bottom" thesis. If multinational investment decisions are made on grounds much more

complex than simply the levels of government taxation and spending then the competition between governments for investment through taxation and spending may be much more muted than generally acknowledged. Multinationals do care about levels of taxation and spending, but there are a number of important decision factors involved. The race to the bottom thesis is based on an analogy of perfect competition that is questionable when applied to FDI.

Empirically, the race to the bottom thesis has also been harshly criticized. There simply is little evidence to support any convergence towards the neoliberal bottom in terms of government spending. Most recently, Garrett (2001) finds that capital mobility has no effect on government spending patterns in over 100 hundred countries from 1970-1995. Drezner (2001, 75) summarizes the vast literature on the race to the bottom, concluding:

> The lack of support for the RTB (race to the bottom) argument is striking. This absence of supporting evidence continues if one looks at other issue areas. Most economic studies show that increased capital mobility has not constrained the ability of states to tax capital. One comes to a similar conclusion with regard to the regulation of consumer health and safety. Even in macroeconomic policy, an area commonly thought to provide the strongest support for the RTB hypothesis, the empirical evidence is debatable. Repeated studies have showed that domestic institutions, interests, and political parties have a significant effect on fiscal and monetary policies. This sort of variation is inconsistent with a race to the bottom.

With such weak theoretical and empirical support the race to the bottom thesis rests on very shaky ground. The empirical section of this analysis finds no support for the race to the bottom thesis.

A second, and more realistic, sub-theory within the efficiency hypothesis isn't directly related to policy competition between countries, rather firms have a preference for "lean government" irregardless of the level of policy competition. In this theory, multinationals obviously prefer to pay less tax than more tax, but multinationals do not jump from country to country solely based on rates of taxation and spending.

Multinationals choose production locations based on a number of criteria, one of these criteria being the level of government spending and taxation.[60]

Governments can lower their levels of taxation to attract more multinationals, but there is not a direct competition between all countries for multinational investment. Countries offer multinationals different bundles of costs and benefits that are related not only to the level of government spending, but also the uses of government spending.[61] Countries are always under pressure to find new ways to make government "leaner" but there is no pressure for the Scandinavian countries to follow the Anglo-Saxon model. Countries can lower government spending and rates of taxation to attract higher levels of FDI.

These two variants of the efficiency hypothesis make very different predictions on the effects of government activity on FDI inflows. The race to the bottom thesis would predict that we should see systematic relationships between high levels of FDI and low levels of spending and taxation *across* countries. Alternatively, the lean government thesis would argue that we should see a systematic negative relationship between spending and taxation *within* countries.[62] The empirical results presented in the next

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[60] Multinationals also make choices on the levels of investment and the forms of entry into foreign markets. For an interesting examination of multinational entry decisions see Henisz (2000).

[61] This corresponds to the works in New Growth Theory. See, Lucas (1988), Barro (1990), and Romer (1990).

[62] In many ways these theories are compatible with each other. The race to the bottom thesis could be seen as the "lean government" thesis plus competition between countries.

section find that neither theory does an adequate job in explaining patterns of FDI over time.

IV. Methodology

The empirical technique used to examine this relationship is a series of ordinary least squares regressions for a panel of 15 OECD countries from 1960-1993. All observations are annual, and all independent variables are lagged one year. I also employ the Beck and Katz (1995) recommended panel corrected standard errors to control for the possible bias in the standard errors generated by OLS.[63]

All regressions include a lagged dependent variable as recommended by Beck and Katz (1995). The lagged dependent variable also serves as an important control for the "self perpetuating" nature of FDI. Countries that attracted higher levels of FDI in the past are expected to lure more investment through multinationals reinvesting earnings, further investments in existing facilities, and the "learning" about the market that the multinational has experienced. All regressions also include a trend variable to capture the increasing values of FDI over time.

For each set of regressions I estimate the same model using both random and fixed effects. The random effects model (with no country dummies) examines the relationship between the independent variables and FDI across countries. All country years are pooled to examine the affects of levels of government spending and taxation on FDI flows. This set of tests examines if countries with lower levels of spending and taxation attract higher levels of FDI.

[63] For all regressions Stata 6.0 was used with the xtpcse option.

The fixed effect regressions include dummies for all 15 OECD countries. For these regressions all countries have a unique intercept, allowing each country to have its own baseline level of FDI. These regressions examine how variations within countries over time are related to FDI inflows. This set of regressions also captures country specific factors, such as the size of the domestic market or geographic location. Once these country specific factors are controlled for, the relationship between government spending and taxation within countries can be more closely examined.

The data utilized for this analysis comes from Garrett and Mitchell (2001). Foreign direct investments are defined as private capital flows from a parent firm to a location outside of the parent firm's host nation. These investments consist of equity capital, intercompany debt, and reinvested earnings. An investment is considered foreign *direct* investment, as opposed to portfolio investment, if the investment is large enough to give the parent firm some amount of control over the management of the enterprise, usually over 10% of the firm.[64] The dependent variable, FDI inflows, is total FDI inflows as a percentage of GDP from the IMF's balance of payments statistics.

I utilize a number of control variables including the level of trade (exports+imports/GDP), the level of economic development (GDP per capita in constant $), and economic growth (GDP per capita growth). Higher values for all of these control variables have been found to be associated with higher levels of FDI flows.[65] The original sources and descriptive statistics for all of these variables can be found in the appendix.

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[64] These are the statistical rules used by the IMF. See IFC (1997) page 9.

[65] See, Markusen (1998a), (1998b); Markusen and Maskus (1999a), (1999b).

V. Results

Government Consumption

Many scholars point out that the effects of capital mobility are felt directly on a government's ability to tax and spend. High levels of government spending are often financed by short-term borrowing which leads to higher interest rates and eventually lead to higher levels of taxation. This dynamic can lead to an appreciation in the exchange rate, making investments by multinationals more costly. Proponents of the race to the bottom thesis argue that the need to attract capital forces governments into a competition for foreign investors. Governments must cut spending and taxation in order to provide environments conducive for multinationals.[66]

The efficiency hypothesis would argue that governments are pressured to provide an environment conducive to multinationals. Similar to the race to the bottom thesis, each government has the incentive to reduce the level of government spending and taxation to induce more multinational investment. Contrary to the race to the bottom thesis, governments are not pressured to converge to the lowest levels of consumption and taxation. Countries such as Sweden, for example, are not expected to mirror spending patterns in low consumption/tax countries such as Ireland.

Insert Table I

Table I presents an empirical examination on the determinants of foreign direct investment in the OECD. The independent variable, GOVERNMENT CONSUMPTION is general government consumption as a percentage of GDP from the OECD. Column

[66] Kruzner (1993) argues that financial markets punish states enacting social welfare polices and public spending expansion.

one examines the relationship between government spending and FDI inflows by utilizing an OLS random effects regression. Levels of government spending have no statistically significant relationship on the levels of FDI inflows. This result agrees with previous work that found no systematic relationship between capital mobility (measured in terms of capital account openness) and government consumption (Garrett 2001). Taken with the existing studies that find a positive relationship between capital mobility and government spending (Quinn 1997, Swank 1998), these results generate serious doubts on the validity of the race to the bottom thesis.

Model two examines the same regressions using fixed effects (country dummies). These regressions generate a separate constant for each country, allowing us to examine how changes in the levels of government spending affect levels of FDI inflows. Unlike the earlier random effects regression, the coefficient on government spending is negative and weakly statistically significant, lending limited support to the efficiency hypothesis. This results is also relatively small, where a one standard deviation increase in government consumption (an increase of 4.15% of GDP) leads to an only a 0.19 standard deviation decrease in FDI flows (a subtraction of 0.0016% of GDP).

Social Security

One of the most important future challenges to governments in the OECD is the growing strain on national social security systems. The graying of the "baby boomer" segment of the population and the advances of medical technology has increased the percentage of the population nearing or at retirement age. This demographic reality has to the potential for an economic crisis, as social security systems, already strained in

many countries, will be forced to fund more retirees with less people paying contributions.

Some scholars argue that this demographic crisis is compounded by the globalization of multinational production. Even if one accepts the tenants of new growth theory, that government consumption can be market enhancing, few scholars would argue that social security contributions provide many direct benefits to multinationals. As countries look for ways to trim government spending to attract multinationals the future of social security seems even less promising.

Politicians may be tempted to slash social security spending, or curb its growth, to attract more multinational corporations. At the same time these politicians may be under intense pressures to "compensate" both the losers from economic globalization and provide adequate benefits to those living in retirement. Are politicians in a no-win situation?

These doomsday predictions could be real, but to date there have been no direct tests of the effects of social security transfers on multinational investments. Are social security transfers a drag on the economy, providing multinationals with few benefits are high costs? Conversely, are these social security expenditures part of the social fabric that allows for low levels of political unrests, union cooperation, and perhaps even higher levels of worker productivity?

Insert Table II

This analysis makes no claim at independently sorting out the answers to these questions; rather I focus on the overall empirical relationship between social security transfers and FDI inflows. Table II presents this relationship using social security

transfers as a percentage of GDP from the OECD as the key independent variable and examining the affects on these transfers on FDI inflows. In both the random effects and the fixed effects models, there is no evidence that the cutting of social security transfers have any affect on the level of foreign direct investment flowing into the economy. The doomsday predictions may have a plausible theory, but the empirical evidence to date does not support it.

Capital Taxation

A more direct test of the constraints posed by capital mobility is an examination of the reactions of multinationals to levels of capital taxation. The race to the bottom thesis often cites the tax wars between countries as evidence of the dire situation of host governments (Oman 2000). Gropp and Kostial (2001, 2) state:

> Tax competition for foreign direct investment (FDI) can have adverse effects on corporate tax revenue. In fact, these effects may have already become evident in the sharp decline in corporate tax revenue in some member countries of the Organization for Economic Cooperation and Development (OECD). It is interesting that the countries experiencing revenue declines also offer the least attractive corporate tax regimes within the OECD. Although part of the decline can be attributed to business-cycle variations or changes in tax codes, its extent and persistence suggest that additional factors may be at work, including the direction and size of FDI flows.

For a country to attract high levels of multinational investment the country must provide a tax environment that is competitive to other nation-states.

Insert Table III

Table III examines the links between multinational investment and the effective level of capital taxation from Mendoza 1997. Model 5, the random effects model finds a *positive* and weakly statistically significant relationship between high levels of capital taxation and FDI. One conjecture could lend support to the recent contributions to new growth theory, where countries can tax corporations and provide market enhancing public

goods; goods that lead to higher levels of multinational investment. In any case, this evidence allows us to reject the race to the bottom thesis.

Model 6 examines the same regression with fixed effects. As predicted by the lean government hypothesis, the coefficient on capital taxation has a negative sign, but is far from statistically significant. Essentially, there is no significant evidence that capital mobility forces governments to slash levels of taxation to attract more multinationals.

On the surface these results may be startling. One of the central arguments of many of the doomsday predictions on the effects of capital mobility makes the assumption that firms prefer low tax environments. This assumption is simply not empirically validated. In the abstract, firms obviously prefer lower taxation to high taxation, all else being equal. In reality, the 200 plus countries of the world have a tremendous amount of variation in their geographic locations, market characteristics, levels of economic and social development, and government policies relating to monetary and fiscal policy. Countries provide unique bundles of benefits and costs to multinationals; and the level of taxation is only one of many of the elements.

In a survey of the literature on multinational production in the global economy, James Markusen summarizes these links between taxation and FDI: "There is little support for the idea that risk diversification or tax avoidance are important motives for direct foreign investment (Morck and Yeung 1991, Wheeler and Mody 1992). Apparently, most firms first choose foreign production locations, and then instruct their tax departments to minimize taxes." (Markusen 1995, 171). The negative relationship between capital taxation and FDI has at the very least been over emphasized, at the most, it is completely wrong.

Taxation of Labor

A second related test examines the links between FDI and the level of labor taxation. Many scholars highlight that the burdens of taxation fall onto the shoulders of labor.[67] Firms may choose to invest in countries with high levels of public good provision, but they surely would prefer not to pay for these goods.[68] Footloose capital will pressure governments to shift taxation from capital to labor.

Insert Table IV

Table IV presents the empirical results on the relationship between the levels of labor taxation and FDI inflows.[69] Model 7 finds a slightly significant and *negative* relationship on the levels of labor taxation and FDI inflows. There is limited evidence that countries that have the lowest level of taxes on labor, contra the race to the bottom thesis, attract higher levels of FDI. Model 8 examines this same relationship with country dummies and finds that labor taxation is positive, as predicted by the lean government hypothesis, but is not statistically significant.

Once again, the predictions of the race to the bottom and the lean government hypothesis do not stand up to the empirical tests. There is no empirical support that shifting taxation to labor has any significant impact on attracting multinational corporations. Conversely, there is limited evidence that countries with low levels of labor taxation attract higher levels of FDI.

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[67] See Gravelle and Smetters (2001) for a review of the literature and a theoretical examination of the burden of taxation in a simple open-economy model.

[68] This is a classical free-rider problem. See Olsen (1965).

[69] Labor taxation is the effective labor tax rate from Mendoza (1997).

Social Democratic Governments

The race to the bottom thesis and the lean government thesis make predictions that are pessimistic social democratic governments. Social democracy is built on the foundation of market intervention and economic protection for the citizenry. Has capital mobility has destroyed the "left" alternative offered by social democratic governments?

Insert Table V

Table V provides a crude test of this question. If social democracy is really an economically inefficient political arrangement, market forces should punish these governments with lower levels of capital inflows. Government of the left would signal a commitment to costly market intervention, decreasing the attractiveness of the country to multinational corporations. The independent variable, LEFT GOVERNMENTS, is the percentage of left cabinet portfolios from Swank 1998.

The empirical results presented in table V clearly do not support this pessimism. In both model 9 and model 10 left governments have no statistically significant affect on patterns of foreign direct investment over time.[70] There is simply no systematic relationship between partisanship and FDI inflows.

Insert Table VI

This null result isn't surprising given the results on spending and taxation. Table VI summarizes the general findings on the relationship between government fiscal policy and FDI inflows. There is no systematic evidence to support the race to the bottom thesis; there is simply no relationship between countries with low levels of taxation and

[70] The variable, left governments, is operationalized as the percentage of cabinet seats for left parties from Swank (1998).

spending and higher FDI inflows. Similarly, there is little support for the "lean government hypothesis". Only the level of government consumption has a negative affect on FDI inflows, although this relationship is only weakly statistically significant and quantitatively very small. For both the race to the bottom thesis and the lean government thesis, there simply is little empirical support for either.

VI. Conclusion

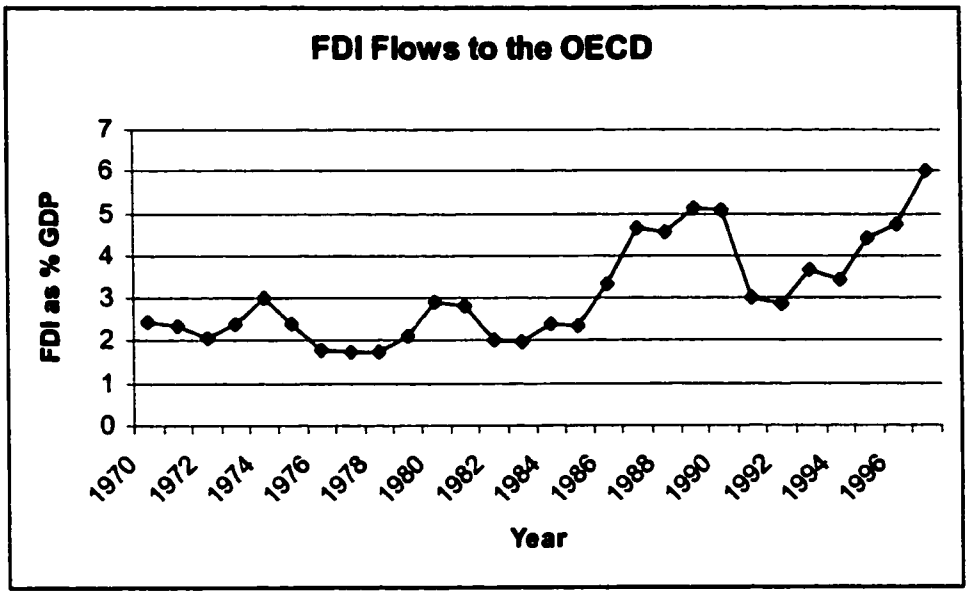
This chapter has attempted to contribute to the debate on the affects of capital mobility on government policy by isolating the relationship between government fiscal policy and foreign direct investment inflows. The question this paper sought to answer was: "Do multinationals prefer to invest in countries with lower levels of government spending and taxation"?

Based on the analogy of country competition for international investment, the answer may seem obvious. Multinationals search the globe for investment opportunities, pitting governments against one another, forcing political leaders to decide between fiscal policy autonomy and attracting foreign direct investment.

The theoretical literature highlighted in this paper argues that this pessimism may be overemphasized. The existing literature in business and economics stresses that the decision of multinationals to invest abroad is driven by imperfect markets. An analogy based on perfect markets, such as employed in the race to the bottom thesis, isn't appropriate to the study of FDI. Only through a careful empirical test can we examine the real relationship between government fiscal policy and multinationals investment choices.

Contrary to the pessimistic views on the ability of governments to spend and tax in a world of capital mobility, the empirical results presented in this paper highlight the weak relationships between these variables. Only in government consumption do I find any negative relationship between government intervention and lower levels of FDI inflows. Even this relationship is weak and very small. In the following chapters I will explore how political institutions, rather than government fiscal policy, are the central determinants of FDI inflows.

Figure I: FDI Flows as a Percentage of GDP



Source: World Development Indicators 1999

Table I: Government Consumption and FDI

	Model 1	Model 2
Lagged FDI inflows	0.811***	0.623***
	(16.569)	(9.470)
Trade	0.004***	0.005
	(3.338)	(1.166)
Level of Development	0.000	-0.000
	(1.367)	(-1.541)
Economic Growth	0.012	0.021**
	(1.183)	(2.103)
Government Consumption	-0.004	-0.038*
	(-0.638)	(-1.955)
Trend Variable	Yes	Yes
Number of Observations	420	420
Number of Countries	15	15
R-sq	0.73	0.75

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table II: Social Security Transfers and FDI

	Model 3	Model 4
Lagged FDI inflows	0.815***	0.658***
	(16.982)	(10.540)
Trade	0.004***	0.005
	(3.416)	(1.193)
Level of Development	0.000	-0.0000
	(0.769)	(-1.347)
Economic Growth	0.013	0.027***
	(1.394)	(2.654)
Social Security Transfers	-0.005	-0.001
	(-0.973)	(-0.059)
Trend Variable	Yes	Yes
Number of Observations	416	416
Number of Countries	15	15
R-sq	0.73	0.76

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table III: Capital Taxation and FDI

	Model 5	Model 6
Lagged FDI inflows	0.786***	0.569***
	(11.645)	(6.887)
Trade	0.004***	0.002
	(3.297)	(0.444)
Level of Development	0.000	-0.000*
	(0.664)	(-1.879)
Economic Growth	0.019*	0.028**
	(1.789)	(2.327)
Capital Taxation	0.005*	-0.003
	(1.836)	(-0.449)
Trend Variable	Yes	Yes
Number of Observations	334	334
Number of Countries	15	15
R-sq	0.70	0.74

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table IV: Labor Taxation and FDI

	Model 7	Model 8
Lagged FDI inflows	0.773***	0.574***
	(11.738)	(7.017)
Trade	0.006***	0.001
	(3.664)	(0.226)
Level of Development	0.000	-0.000**
	(1.190)	(-2.000)
Economic Growth	0.011	0.032***
	(0.983)	(2.868)
Labor Taxation	-0.008*	0.010
	(-1.917)	(0.635)
Trend Variable	Yes	Yes
Number of Observations	334	334
Number of Countries	15	15
R-sq	0.70	0.74

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table V: Left Governments and FDI

	Model 9	Model 10
Lagged FDI inflows	0.815***	0.654***
	(16.632)	(10.551)
Trade	0.004***	0.003
	(3.313)	(0.828)
Level of Development	0.000	-0.000
	(1.045)	(-1.216)
Economic Growth	0.014	0.027***
	(1.512)	(2.757)
Left Government	-0.000	0.0000
	(-0.618)	(0.942)
Trend Variable	Yes	Yes
Number of Observations	420	420
Number of Countries		
R-sq		

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table VI: Summary

	Support for: Race to the Bottom Thesis	Support for: Lean Government Thesis
Government Spending	No	Yes
Social Security Transfers	No	No
Capital Taxation	No (Opposite Relationship)	No
Labor Taxation	No (Opposite Relationship)	No
Left Governments	No	No

Appendix

Data Sources

Variable	Definition	Original Source
FDI Flows	FDI inflows/GDP (%)	IMF BOP
Trade	X+M/GDP (%)	OECD 6094
Level of Development	GDP per capita in constant $	OECD 6094
Economic Growth	GDP per capita growth	OECD 6094
Government Spending	Government consumption/GDP	OECD 6094
Social Security Transfers	social security transfers/GDP (%)	OECD 6094
Capital Taxation	effective capital tax rate	Mendoza 1997
Labor Taxation	effective labor tax rate	Mendoza 1997
Left Governments	% left cabinet portfolios7	Swank 1998

Descriptive Stats

Variable	Obs	Mean	SD	Min	Max
FDI	464	0.655	0.835	0	5.3
Trade	612	57.10	27.446	9.4	156.3
GDPPC	476	11309.68	2531.804	4491	18095
Growth	612	2.593	2.477	-7.9	11.6
Gov Cons	612	16.906	4.147	7.3	29.6
Soc Sec	654	13.692	5.429	3.7	28.9
Cap Tax	372	35.719	11.721	13.942	74.332
Lab Tax	372	31.767	10.091	10.96	53.581
Left Gov	612	30.428	37.307	0	100

The Political Economy of Foreign Direct Investment

Chapter IV: Democracy and FDI

I. Introduction

Although few scholars dispute the aggregate economic benefits of FDI, critics argue that the benefits of multinational production come with substantial costs for governments and their citizens. The need to attract FDI pressures governments to provide a climate more hospitable to foreign corporations, potentially altering patterns of domestic economic policy, possibly even challenging the de facto sovereignty of the nation state and the capacity for democratic governance.[71] Democracy is often seen as an inefficient institutional structure in the global economy.[72]

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[71] Jessup (1999) argues that authoritarian regimes in developing countries attract more international investment. Oneal (1994) finds that authoritarian regimes provide investors with higher returns in developing countries, although overall investment flows are not related to regime type.

[72] Although a large number of definitions of democracy exist. Robert Dahl (1971), one of the most influential democratic theorists of our time, defines democracies as countries where: 1) Citizens can vote, 2) The government comes to power in a freely contested election where two or more parties compete, and 3) The executive is held either directly accountable through direct elections (Presidential systems) or indirectly by being accountable to the legislature (parliamentary systems).

A more minimalist theory of democracy, employed by Przeworski, Alvarez, Cheibub, and Limongi (2000), is to distinguish between " 1) regimes that allow some, even limited, regularized competition among conflicting visions and interests and 2) regimes in which

This paper empirically assesses these predictions about the political preconditions for attracting FDI using both cross-sectional and panel regression analysis for up to 116 countries. The cross-sectional regressions estimate the effects of economic conditions, policy decisions, and democratic political institutions in the 1980s on the level of FDI inflows in the 1990s. The panel regressions explore how changes in changes in economic policies and political institutions affect changes in FDI inflows in the period from 1970-1997. Next I utilize a Heckman selection model to explore the robustness of the relationship between democratic governance and FDI. Lastly, I explore the causal link between democracy and FDI by empirically assessing the affects democratic governance on country credibility. In this section I test the affects democratic institutions on country sovereign debt ratings for 79 countries from 1980 to 1998.

My results show the importance of democratic institutions as a determinant of FDI inflows, but are inconsistent with the dire predictions on the effects of the competition for FDI on domestic politics. Democratic political institutions are associated with higher levels of FDI inflows. Democratic governments, even when controlling for other political and economic factors, attract as much as 70% more FDI as a percentage of GDP than their authoritarian counterparts. This result is robust under different model specifications and types of empirical tests.

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some values or interests enjoy a monopoly buttressed by the threat or the actual use of force. Thus democracy, for us, is a regime in which those who govern are selected through contested elections." (Przeworski et. al. 2000 ; 15). The central feature that most definitions of democracy share is that of "accountability".

The remainder of this paper is organized as follows. Section II presents some descriptive statistics on FDI flows. Section III examines the existing work on the determinants of FDI flows and provides the theoretical links between economic policy, political institutions, and FDI inflows. Section IV discusses the causal links between democracy and higher levels of FDI inflows. Section V provides a brief overview of the empirical tests. The following two sections construct empirical tests of the determinants of FDI flows, examining the levels of FDI using cross-sectional data (section VI), changes utilizing panel data including a Heckman selection model (section VII). Section VIII examines the link between democracy and credibility by empirically examining the effects of democratic institutions on country sovereign debt ratings. Section IX concludes.

II. Development, Growth, Conflict and FDI

The debate on the relationship between political institutions and economic performance has generally been framed in terms of democracy and economic development. Standard econometric studies, and causal observation, find a positive association between democratic institutions and higher levels of economic development. Almost all of the economically developed nations are democratic regimes, while few full democracies exist in less developed countries. Although most scholars recognize this relationship, a considerable amount of controversy remains on the causal relationship between democracy and economic development.

Modernization theory, usually attributed to Lipset (1959), argues that democratic institutions are the end of a long process of economic and political development. Most recently, Przeworski, Alvarez, Cheibub and Limongi (2000) argue that a process of

modernization does not explain the correlations between economic development and democracy. The "endogenous" theory forwarded by modernization theorists assume that higher levels of economic development create democratic institutions. Therborn (1977) argues that many European countries democratized following wars. The democratic waves felt in Africa and Eastern Europe are often linked to the end of the cold war, far from the causal mechanism of modernization theory.

The path-breaking work of Przeworski, Alvarez, Cheibub and Limongi (2000) forwards a theory of regime dynamics contrary to modernization theory. They argue that theories of regime transition must examine patters of democratization and breakdowns of democratic rule. Only by understanding these regime transitions can scholars make any meaningful link between democratic governance and economic development. To understand the relationship between development and democracy we must have theories on the transitions from authoritarian rule to democracy and democracy to authoritarian rule.

Using a number of advanced statistical models, Przeworski et. al. find that democratic governments, although fragile in developing countries, are intractable in the most developed countries. The richest democratic regime ever to collapse was Argentina in 1975 at a level of GDP per capita of $6, 055 (page 98). No country with a higher level of GDP per capita has experienced a democratic breakdown. Their final conclusion, a compelling one, argues that the correlations between economic development and democratic institutions are based on the "survival" of democracies.

The literature on the link between democracy and economic growth remains equally divided. Early theorists speculated that democratic institutions may spark

popular demands for government consumption, lowering economic growth (Huntington 1968). More recently, theorists have argued that some degree of democracy can be growth enhancing (Barro 1990, Barro 1996)

Most recently, Przeworski et. al. 2000 argue that there is no difference in the levels of economic growth between democracies and dictatorships. In poor countries, there is no difference in the rates of investment, growth of the labor force, or returns on capital or labor. In richer countries, democracies tend to pay higher wages, have lower levels of investment but have higher returns to capital. The dictatorships exploit low wage labor, obtain higher levels of investment, but have lower returns on capital and labor. In the end, both political regimes grow at roughly the same rate. Although this contribution of provides a rich analysis of the relationship between political institutions and economic growth, there exists no strong consensus on the relationship between democracy and economic growth.

This lack of consensus is in stark contrast with the generally accepted link between democracy and lack of international conflict. Dating back to Immaniel Kant, international relations scholars have long theorized on the affects of democratic institutions on conflict between nations. In empirical literature, pioneered by the works of Bruce Russett, theorists have examined the link between democratic institutions and the lack of military conflict between nations. Prima facie, the case seems rather compelling: no two democratic nations have ever fought each other. Like the link between democracy and development, this relationship has generated a tremendous amount of controversy in international relations.

In an early work Small and Singer (1976) found that democratic states are just as prone to military conflict as authoritarian states. This finding has been refuted by a number of more recent studies (Bremer 1992, Russett and Oneal 2001). Even more powerful, a number of statistical analyses find that when two nations are democratic, this is "virtually a sufficient condition for peace between countries" (Russett and Oneal 2001, 48). Democratic states are also less likely to initiate conflict against any type of states, authoritarian or democratic (Rousseau 1996, Rosseau et. Al. 1996, Rioux 1998).

This empirical finding has not gone unchallenged, where some scholars have argued that common interests, not democratic institutions explain the lack of conflict between nations. Farber and Gowa (1995, 1997a) argue that the empirical link between democratic institutions and the lessened probability of conflict is spurious. Historically, democratic states had common interests, such as the democratic states of Britain, the US and France all confronting Germany in the World Wars. These common interests, in line with realist theory, explain these patterns of conflict.

Other scholars have examined how changes in democratization affect the prospects for peace, perhaps in ways contrary to the "democratic peace". Mansfield and Snyder (1995) argue that although established democracies have enjoyed relative peace, democratizing states are more war prone than either democratic or authoritarian states. Ward and Gleditsch (1998) find that large increases in democracy significantly decrease the probability of conflict, small moves of liberation can increase this probability. Gleditsch and Ward (2000) find that large swings between democracy and authoritarianism raise the risk of conflict. Lastly, a number of recent studies (Roussea

1997, Oneal and Russett 1997, Russett and Oneal 2001) find that democratization does not affect the probability of conflict.

Although considerable controversy remains within this democratic peace literature, the general finding, that democratic states do not fight each other, is compelling and has approached general acceptance in the discipline. The realist critiques of the democratic peace argue that common interests, not common institutions explain the period of peace between democracies. As Russett and Oneal (2001) point out, the larger question is why democratic states perceive their interests to be common. To explain this finding, democratic peace scholars have focused on cultural and structural explanations.

The two major explanations for the relative peace between democratic states are either cultural or structural. Cultural arguments, dating back to Kant, focus on "shared democratic principles, perceptions, and expectations of behavior".[73] Democratic states are therefore more likely to settle disputes through peaceful means and abhor war with groups of individuals sharing similar values.

Structural arguments, focus on the unique institutional structures of democratic systems, usually focusing on the institutional constraints imposed on policy makers. As pointed out originally by Kant and then most recently by Russett and Oneal (2001), these sets of explanations are complementary and may involve a "virtuous circle" were democratic institutions foster democratic norms and democratic norms strengthen democratic institutions.

Russett and Oneal (2001) are careful to argue that the peace between democracies is "over identified" and that the exact causal mechanism can't be pinned down. The

[73] Russett (2001) page 53.

debates on the structural or cultural aspects of the democratic peace are difficult to test. More importantly, they argue that these two explanations are complementary in that both of these factors have independent and mutually reinforcing affects on the prospects for peace.[74]

This well developed literature on the democratic peace is helpful in helping us understand the potential benefits of democratic governance structures for foreign investors. Beyond the obvious benefit of democratic states avoiding conflict with other democracies (which are often other large, economically developed countries) and winning the conflicts that they engage authoritarian states in, multinationals may have preferences for investing in democracies. If democratic political institutions allow higher levels of cooperation between states, they may also allow for higher levels of cooperation between states and multinational corporations.

III. Three Theories on Democracy and FDI.

Few empirical studies have examined the relationship between democratic political institutions and FDI flows. The empirically work that directly explores this issue, while very thin, finds that FDI flows are either not response to political regimes (Oneal 1994, Alesina and Dollar 1998) or that democratic political institutions are associated with lower levels of FDI inflows (Jessup 1999). Given these recent findings, there is little support in the literature for linking democratic political regimes to higher FDI flows.

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[74] One comprehensive game-theoretic study by Bueno de Mesquita and Lalman (1992) incorporate both of these concepts into one model.

The vast and growing literature on the democratic peace does find that political regimes influence relationships between national-states. This well developed literature on the democratic peace is helpful in understanding the potential benefits of democratic governance structures for foreign investors. Beyond the obvious benefit of democratic states avoiding conflict with other democracies and winning the conflicts that they engage authoritarian states in, multinationals may have preferences for investing in democracies. If democratic political institutions allow higher levels of cooperation between states, they may also allow for higher levels of cooperation between states and multinational corporations. There are three interrelated reasons why democratic systems might attract higher levels of FDI.

The first reason is one of *information.* Much of the literature on the democratic peace in international relations has highlighted the role of information and democratic governance.[75] Democracies are more transparent, both in their economic and political affairs. For politicians to be held accountable to voters, democratic systems must provide information on the decisions and actions taken by the ruling elite. This includes a general openness of the decision-making processes and general support for a free press.

In democracies, commitments to external actors are still produced through these same domestic political processes (Gaubatz 1996, Bennett 1997b from Russett and Oneal 2001). One illustrative example of the difficulties of investing in authoritarian governments in terms of market information comes from a recent volume from Rosen (2001) on the experiences of foreign executives in China. Rosen cites four areas of concern regarding obtaining information in China.

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[75] For a review of the most recent literature see Schultz (1999).

> First, Chinese statistical data at all levels-local, provincial, and central-are subject to both intentional and unintentional biases. For example, production might be overstated to attract investors, or understated to avoid taxes: because the inaccuracies have so many causes, it is difficult to adjust for them.
>
> Second, until recently private reporting on economic matters-which can help fill the gaps left by uncertain state statistics-was discouraged, and even prohibited. Seemingly mundane statistics were treated as state secrets, and reporters were threatened or occasionally imprisoned for violating national security when they provided basic economic information to mainstream media. Obviously, in such an environment good sources of market and economic analysis were hard to come by.
>
> Third, in response to the growing demand for better economic information, the central government proposed to loosen its tight hold-but only to the extent of giving the state-run Xinhua New Service a monopoly to disseminate official data. This idea did not go over well with the foreign community or with domestic businesses, long accustomed as they were to Chinese media that lied about even the weather...
>
> Fourth, the interviews for this study suggest that much of the information that firms depend on-to get approvals, learn about contracts, resolve disputes, appeal a customs duty rate and the like-is gleaned from inside or "informal sources". (Rosen 2001, 31).

Given the importance of information in international economic relations, specifically long-term investments, this information advantage of democratic systems could attract higher levels of investment. Foreign firms have more knowledge of the workings of the political system and have the available information to make predictions on future policy.

Also, the free press that is often associated with democratic systems can provide spillovers for foreign investors. This includes critical analysis of government policy, unbiased (or less biased) information on both economic and political affairs. In a famous work, Dreze and Sen (1989) find that no democratic nation has ever experienced a major famine, which is attributed to the information proved by the press and the political opposition. Citing Mao after the Chinese famine of 1962, that a "free press and an active political opposition constitute the best early warning system that a country threatened by famine can possess". Democracies clearly provide better information. (Cited from Przeworski et. al. 2000; 144).

Chart I provides some limited evidence on the link between information and democracy. On the x-axis I present the average Polity III democracy score (0-20) where a 20 represents a fully democratic country and a 0 represents an authoritarian regime. On the y-axis I include a measure of transparency from a survey conducted by Price-Waterhouse-Coopers on the level of transparency. This measure of transparency, opacity is ranges from the lowest level of transparency of 87 to the highest of 29.[76] In an econometric study of FDI flow, Price Waterhouse Coopers (2001) found that higher levels of opacity were associated with lower levels of FDI inflows.

Chart I: Information and Democracy

A second possible reason, *representation*, stems from democratic theory. Foreign investors may find avenues to purse favorable policies, either directly, or indirectly. Foreign investors can directly lobby government officials for their preferred legislative outcomes in democracies that aren't possible in autocracies. This isn't to say that some form of lobbying activity isn't possible in authoritarian regimes, only that lobbying activity is often institutionalized and as transparent in these systems.

There is considerable evidence that foreign firms do in fact lobby national governments. According to a study by Hansen and Mitchell (2000), reign firms in the US are just as likely to engage in lobbying activity as domestic firms. As Hillman and Ursprung (1988) state, "under representative democracy, foreign participation in domestic politics can take the form of campaign contributions, or other transfers directly at influencing the trade-policy position taken by a political candidate"[77]

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[76] A detailed descriptive of this index is located in the appendix.

[77] Hillman and Ursprung (1988) page 730.

The difficulty of lobbying a government for preferred policy is obvious in authoritarian countries. For example, in a recent article in the *Economist*, the difficulties of lobbying in China are documented and discussed. Unlike most democratic nations, lobbyists in China have no formal mechanisms for influencing policy (such as campaign contributions) and have difficulty in even identifying the decision-makers that the firms should be targeting. Even the threat of disinvesting large FDI projects has little effect, "the lobbyists sigh that China is still an authoritarian government, and economic clout (of multinationals) remains limited".[78] The difficulty of influencing policy in authoritarian regimes has a negative effect on overall FDI inflows.

Even more importantly, MNC's may find vested interests in democratic systems already in place. A foreign MNC, once it has sunk capital into a country, shares many of the same preferences as domestic producers.[79] If these democratic systems take the interests of these domestic producers into account, the government will be providing legislation favorable to the domestic producers and foreign investors.

One possible criticism of this representation theory is that firms may simply find other mechanisms in which to manipulate government policy in authoritarian regimes. One example is the use of bribery or other forms of corruption to influence central or local governments. Multinational investors may prefer to invest in dictatorships where

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[78] *The Economist* Feb 17, 2001; 43.

[79] This is theoretically in line with the work done by Frieden (1991) where he distinguishes between different types of capital based on their mobility. Milner (1988) argues that companies with an international focus share similar preferences on trade protection policy.

there is less media scrutiny and authoritarian decision-makers aren't constrained by the citizenry in the deals they can strike with multinational corporations.

The empirical evidence strongly points to the contrary. In a comprehensive study of large sample of countries, Wei (2000) finds that higher levels of corruption is associated with lower levels of FDI inflows. Even if there are means of influencing policy in authoritarian regimes, it seems as though corruption is far from the preferred form of policy influence for multinational corporations.

Even with the informational and representational elements of democratic institutions, the conventional wisdom is that multinationals prefer to invest in authoritarian regimes. Authoritarian leaders can provide multinational firms with better entry deals, due to the lack of popular pressure from below, and repressing labor unions to drive down wages. This relationship leads to higher levels of FDI inflows to authoritarian countries.

The second of these arguments, on the role of authoritarian regimes in providing a lower cost workforce, does have some support in the literature (Rodrik 1998). The real question is, does this translate into higher levels of FDI inflows? Most scholars on FDI argue that the impact of low wages has been overemphasized as a determinant of FDI and that the wage rate is just one of many decision factors for multinational firms (Markusen 1995). I will argue later that the impact of lower wages is offset by the positive impact of democratic institutions for multinationals.

The other argument, on the role of authoritarian regimes in bargaining with firms, also has been greatly exaggerated. Most scholars assume that the lack of constraints for authoritarian regimes leads to a more generous situation for multinationals. As Putnam

(1988) showed, the logic of a two level game provides both constraints and leverage to political leaders. Although the democratic constraints imposed on leaders may limit the amount of discretion in offering multinationals deals, this lack of discretion can also provide beneficial to multinational firms.

More specifically, most scholars fail to consider the possibility that the constraints imposed on political leaders within democratic systems could translate into a beneficial situation for MNEs. I argue that these constraints lead to higher levels of policy stability and more favorable policies towards multinationals.

Conversely, the extensive and growing literature on the democratic peace in international relations argues that political regimes influence relationships between national-states. This literature on the democratic peace is helpful in understanding the potential benefits of democratic governance structures for foreign investors. Beyond the obvious benefit of democratic states avoiding conflict with other democracies and winning the conflicts that they engage authoritarian states in, multinationals may have preferences for investing in democracies.[80] If democratic political institutions allow higher levels of cooperation between states, they may also allow for higher levels of cooperation between states and multinational corporations. This paper highlights two mechanisms through which democratic institutions could attract higher levels of FDI inflows.

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[80] Bruce Russet pioneered a large part of the literature on the democratic peace. See Russett and Oneal (2001) for a review of the literature and a number of relevant empirical tests.

In this paper I argue that the main advantage of democratic institutions to multinational investors is *credibility*. Foreign direct investment, while mobile ex ante, is relatively illiquid ex post (Vernon 1971). Once foreign capital is invested in a country, the firm is subject to policy change or reversal by the central government. Once multinational investments have been made, there are considerable political risks in the investment.

These political risks come in a number of forms. The most obvious political risks, nationalization and expropriation, involve the loss of ownership by multinationals of their investments but are now relatively uncommon. Even with the decreasing incidences of nationalizations multinationals still face considerable political risks in terms of the expropriation of revenue streams.[81] Governments can renegotiate tax rates, depreciations schedules, tariff rates, and a host of other policies that directly affecting multinational operations. Other indirect factors, such as the imposing of capital controls, devaluations, or other macroeconomic decisions not targeted specifically at multinational firms, but affecting the profitability of the investment are also important. Multinational corporations are attracted to governments that can help minimize these political risks.

Democratic institutions can be a mechanism to decrease these political risks. Democratic governments have been found to be more credible in making agreements in the international arena (Cowhey 1993, Fearon 1994, Gaubatz 1996, McGillivray and Smith 1998, and Leeds 1999). These explanations range from the institutional checks and balances within democratic systems to the "audience costs" generated by elected

[81] This is often referred to as "creeping expropriation".

leaders. Logically following from this large literature, democratic governments may also be more credible in their dealings directly with multinationals.[82]

One specific mechanism that leads democratic governments to higher levels of credibility is based on the number of *veto points* in a democratic political system. Tsebelis (1995) argues that the existence of these veto points can increase policy stability. These veto players can include chambers of the legislature, a supreme court, separation of the executive and legislative branches of government, or federal actors. Heinsz (2000) argues that foreign firms change their entrance strategies into domestic markets conditioned on the number of veto players. Democratic governments have these institutional constraints in place, making the possibility of policy reversal more difficult. Multinationals that enter foreign markets can be reasonably confident that the government policies that were in place when the firm entered the country will continue over time.

A second potential reason for the credibility of democratic systems, perhaps even stronger than the veto point argument, can be found in the *audience cost* literature. While the veto points in a political system generate higher levels of policy stability, an even more important component of credibility is a government's commitment to market friendly policies in the future. International relations theories find that democratic leaders are held accountable for their actions, including reneging on a promise or threat. These audience costs can also be important for multinational investors. If governments make agreements with multinational firms and renege on the contracts after the

[82] Preliminary support for this is found in Jensen (2000).

investment has been made, democratic leaders may suffer electoral costs. The potential for these electoral backlashes may constrain democratic leaders.

In a recent article, McGillivray and Smith (2000) argue that political leaders play an "Agent Specific Grimm Trigger Strategy" where political leaders in one country refuse to cooperate with other political leaders in another country that have "defected" in the past. Multinationals can also play this strategy with governments that institute legislation or reverse policy in ways that negatively effect multinational corporations. Essentially, firms can hold individual leaders politically accountable for policy and refuse to cooperate (invest) in the future. In democracies citizens have the incentive and the opportunity to replace leaders with tarnished reputations through electoral mechanisms. Thus, the leadership turnover in democratic systems (or the potential for leadership turnover) can be associated with more market friendly policies for multinationals.

This argument on the role of leadership turnover in ensuring more market friendly policies obviously ignores the potential political benefits of expropriation for leaders. In both democratic and authoritarian countries, there may be some immediate benefits to "expropriation".[83] Political leaders may use the assets or income streams from policy changes to essentially "buy-off" key support groups. My argument is that this holds for both authoritarian and democratic systems. In both types of regimes, political leaders have a key support group, the "selectorate", which must be appeased for political

[83] For an interesting discussion of expropriation see, Thomas and Worrall (1994).

survival.[84] There is little reason to believe that democratic regimes are more likely to expropriate than authoritarian regimes.

All three of these links between democratic institutions and FDI inflows points to one conclusion: democratic institutions help countries attract higher levels of FDI inflows This analysis makes no further attempt to disentangle the causal link between democratic institutions and FDI inflows, rather focusing on establishing the general relationship between democracy and FDI inflows. The central question that the empirical analysis is attempting to answer is if there is a significant positive link between democracy and FDI inflows.

V. Empirical Tests-Overview

This paper explores the relationship between foreign direct investment and democracy in four sets of empirical tests. The first set of tests will estimate the effects of democratic institutions on FDI inflows in a cross-section of countries in the 1990s. These tests will examine the general relationship and the robustness of the findings on the effects of democracy on FDI inflows. The second set of empirical tests will test the relationship by utilizing panel analysis with both random and fixed effects. The third set of empirical tests will employ a Heckman selection bias model to further examine the

[84] See, Bueno de Mesquita et. al. (1999). The most logical extension of their theory would be that expropriation would be more likely in systems with smaller selectorates (authoritarian regimes). In systems with large selectorates (democracies) political leaders would have to spread the benefits of expropriation over a larger percentage of the citizenry, a making expropriation a less viable option.

robustness of the relationship. The final set of empirical tests examines the causal mechanism linking democracy and FDI by examining the effects of democracy institutions on sovereign debt ratings. The first three sets of tests confirm the hypothesis that democratic institutions are associated with higher levels of FDI inflows and the final test highlights the link between democracy and credibility.

VI. Empirical Analysis-Cross Sectional Results

Although many of the studies highlighted provide either a theoretical motivation for investment or limited empirical tests, these studies leave us unable to fully understand the determinants of FDI inflows. The core analysis is cross-sectional ordinary least squares regressions for 49 to 79 countries using White's correction for heteroscedasticity.[85] In order to mitigate problems of reverse causality, all independent variables are lagged, either using averages for the 1980s for most of the economic variables, or a 1990 measure for most of the political variables.

The cross-sectional regression equation is:

$$\text{NET FDI INFLOWS}_{1990\text{-}97} = \alpha + \beta_i(\text{INDEPENDENT VARIABLES}_{1980\text{-}89}) + \varepsilon_i$$

The dependent variable, the average net foreign direct investment inflows as a percentage of GDP from 1990-1997, is from the World Bank's World Development Indicators 1999. Net foreign direct investment *inflows* should not be confused with overall net foreign direct investment *flows*. Net foreign direct investment *flows* are total FDI inflows of foreign capital minus total FDI outflows of domestic capital. The theoretical work cited in this paper only makes reference to a country's ability to attract

[85] Transition economies are not included in this sample.

foreign capital, not in the policies or institutions that influence domestic investors to move capital abroad. The dependent variable, net foreign direct investment *inflows*, is a measure in the change in the position of foreign investors in a country. A country with a positive FDI inflow position is attracting new FDI investment, while a country with a negative position is experiencing an outflow of foreign capital. This net inflows measure of FDI is the best measure to examine a country's ability to attract foreign direct investment.

The econometric work on FDI inflows in the economics literature provides a baseline model to begin our exploration of the political determinants of FDI flows. These studies find that market size, investment and trade costs, and the relative skilled-labor abundance of the parent country are all important factors (Markusen 1998a, 1998b; Markusen and Maskus 1999a, 1999b).

Unfortunately, data limitations for a number of developing countries constrain the possible empirical tests. Dyadic FDI figures, information on the country source and country destination of FDI, are generally not available for most developing countries. Given this limitation, I include economic control variables that are grounded in existing economic and business school theories, including: the LEVEL OF DEVELOPMENT, TRADE, and MARKET SIZE.[86] Trade is measured as exports plus imports divided by GDP. The level of development is measured as the log of GDP per capita and market size is the log of GDP. Both of these variables, and trade as a percentage of GDP, are expected to have a positive effect on FDI inflows.

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[86] All control variables are from the World Bank's World Development Indicators (1999) unless otherwise noted.

To test and examine the effects of political regime type of FDI performance, I use a standard measure of democracy. The variable used in these regressions, DEMOCRACY, is a measure of political regime averages for 1990 from the Polity III data set by Jaggers and Gurr (1998).[87] This variable provides an ordinal ranking of political regimes on a scale of 10 to −10 (democracy to authoritarian regimes) that I have rescaled to a 0-20 scale for easier interpretation where a 20 constitutes the highest democracy score.[88]

I have also included control variables for the level of NATURAL RESOURCE DEPENDENENCE and the rate of ECONOMIC GROWTH. Natural resources are exogenous economic factors that may help a country attract higher levels of FDI that are independent of political institutions and government policies.[89] Economic growth rates have an effect on the domestic market, where countries with expanding domestic markets should attract higher levels of FDI.

The failure to control for natural resources in previous studies could account for the perceived negative relationship between democracy and FDI inflows. A number of

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[87] Given the democratizations in the 1990s, the 1990 measure of democracy is a more representative measure of political institutions during the period of FDI investment (the 1990s). As an alternative specification I also tested all models with the average level of democracy in the 1980s. These results were slightly weaker.

[88] The correlation between the Polity III democracy measure and the Alvarez et. al. (1996) democracy score is 0.92.

[89] Natural resources are operationalized as primary exports as a percentage of GDP from Sachs and Warner (1995).

scholars have highlighted the positive correlation between natural resource dependent economies and authoritarian regimes.[90] If natural resources are correlated with authoritarian regimes, and natural resources are likewise correlated with higher FDI, any empirical study may find a spurious causation between authoritarian regimes and higher FDI inflows. Only by properly controlling for the level of natural resources can we examine the true effects of democracy on FDI.[91]

Another important control variable is the level of GOVERNMENT CONSUMPTION since the level of government consumption is possibly correlated with the type of political regime. This variable is all of interest beyond that of simply a control variable. While economists have found negative effects of government intervention on economic growth rates[92], little work has been done on the size of government and FDI. Proponents of the 'race to the bottom' thesis argue that governments in a world of capital mobility are forced to roll back the state and limit intervention into the economy to a minimum role.[93] More recent scholarship on new growth theory have stressed the potential positive role of governments in providing public goods that are under supplied by the market, which will have positive effects on

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[90] For some examples of the effects of natural resources on political institutions see Wantchekon (1999) and Ross (2000). For an application to Africa, see Wantchekon and Jensen (2000).

[91] The panel analysis in the next section will more directly test the effects of democracy on individual countries by utilizing fixed effects regressions.

[92] Barro (1996).

[93] See Garrett (1998) for a review of the literature.

macroeconomic performance.[94] To test this, I employ the variable GOVERNMENT CONSUMPTION from the World Bank's World Development Indicators 1999, which is the average general government consumption as a percentage of GDP for 1980-1990. The prediction that stems from the theoretical work of neoclassical economics and from the empirical work done on economic growth suggests that government consumption should have a negative effect on FDI inflows.

Most literature on international financial transactions highlights the negative effects of government deficits on macroeconomic performance. High deficits have been linked to poorer long-run economic performance, while high deficits also have immediate negative effects on interest rates and exchange rates. In international capital markets, budget deficits can be financed by inflows of foreign capital. Foreign direct investment flows may be attracted to countries with high budget deficits. I control for this by using BUDGET DEFICIT, overall general government deficit as a percentage of GDP averaged for the period 1980-1990.[95]

The role of human capital in macroeconomic performance has gained tremendous attention recently by economists and political scientists. The concept of human capital has become a buzzword in the economics literature, linking higher levels of human capital to higher growth rates and directly to higher levels of FDI.[96] I have employed the Barro and Lee (1993) measure for HUMAN CAPITAL, which is defined as the average

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[94] See Lucas (1988); Romer (1990), and Barro (1990).

[95] All empirical results on democracy are generally unchanged when this variable is dropped.

[96] Mankiw, Romer, and Weil (1992).

number of years of school of the workforce for the 1980s. The clear prediction is that higher levels of human capital should have a positive effect on a nation's ability to attract foreign direct investment.

Controls of inflows and outflows of foreign capital can have dramatic effects on FDI inflows. Countries with controls of inflows may seriously limit the aggregate amount of FDI inflows. Countries with controls on outflows of retained earnings of foreign firms could potentially increase FDI inflows through these added retained earnings, and potentially decrease the attractiveness of investments in the country. The measure of controls on foreign direct investment inflows, FDI INFLOWS CONTROLS, is from Brune, Garrett, Guisinger, and Sorens (2001). This variable is a dichotomous measure of controls on FDI inflows that codes countries with no controls on FDI inflows as 1 and countries with countries as 0.

The OLS empirical results are presented in Table II where the first number refers to the coefficient and the second the T-statistic. The core econometric model from column one supports much of the theoretical work done on foreign direct investment and on economic growth more generally. Trade is a complement to FDI, where countries that tend to be more open to trade, attract higher levels of foreign direct investment. This could be a direct causation, or there is a possibility that the some other latent factors that increase a country's ability to export products overseas and its ability to attract foreign direct investment are present, such as a country's policy towards trade and FDI could be linked. Not surprisingly, countries with higher levels of natural resources also attract higher levels of FDI flows.

Government consumption has a small negative effect on a country's ability to attract FDI, consistent with other works that find government consumption having a negative effect on economic growth (Barro 1990). This result is only statistically significant in the first two models. The empirical result on the effects of budget deficits on FDI performance confirms the prior hypothesis. Countries with higher budget deficits (large negative numbers in the data) attract higher levels of FDI.

Surprisingly, DEVELOPMENT LEVEL seems to have no consistent statistically significant effect, which can be interpreted as finding that international capital, even when other domestic factors are controlled for, does not flow from the rich countries to the poorer countries of the world. Much of the work on economic growth done by Robert Barro argues for 'conditional convergence' where when other domestic factors are controlled for, the less developed countries grow at faster rates than more developed countries.[97] This empirical finding produces one microfoundational flaw in this argument where growth promoting FDI flows are not attracted at any higher rate to the developing countries than the developed countries.

The result for economic growth is the opposite of what most economic literature would expect. Countries with higher levels of economic growth generally attract lower levels of FDI. A number of potential theories could explain this result, but the most obvious would be the 'scaling effect' mentioned earlier, where countries that have growth rates that exceed the growth in FDI have a decrease in FDI as a percentage of GDP. Another alternative explanation would be the result of business cycles, specifically in that

[97] The basis of the concept of convergence comes from the Solow (1956). See Barro (1996) for a discussion of conditional convergence and empirical results.

during the 1980s (the period of the independent variables) a number of the industrialized countries were in recession. This business cycle explanation is confirmed in Section V using panel analysis.

Models 3 and 4 include the measure of capital controls on FDI inflows. Countries are coded as a 1 if there are no controls on FDI inflows, and a 0 if there are controls. While the addition of this variable as a control has no significant effect on the other variables, the result is interesting in itself. Countries with restrictions on FDI inflows actually attract higher levels of FDI inflows than countries with no FDI restrictions. This is not to say that capital controls have the opposite effect to which they are intended, but rather there are a number of serious selection issues. Simply, countries that will not attract FDI flows will not employ capital controls while countries that attract high levels of FDI may find a political or economic need to control these inflows.

The empirical results in Table II provided solid evidence of the positive effect of democracy on foreign direct investment inflows. There is an obvious linear positive relationship between democracy and a country's ability to attract foreign direct investment. This result is robust both under different model specifications and even a different measure of democracy.[98] These results are robust under a number of specifications.

The substantive effects of different levels of democracy on FDI inflows are large. Countries that move from one standard deviation below the mean to the mean level of democracy, a change in the democracy score from 3.03 to 10.9, increases FDI inflows an

[98] The empirical results are essentially unchanged under different measures of democracy. See the Table VI.

added 0.47% of GDP. A move to full democracy would increase FDI as a percentage of GDP by 1.2%. The magnitude of these swings is quite remarkable, where the average level of FDI for the sample is 1.96% of GDP. A move from an authoritarian regime to a democratic regime increases FDI inflows by 60%.

These positive results on the effects of democracy on FDI inflows remain extremely robust under multiple specifications. To test the robustness of the democracy result I have included a number of variables from the William Easterly Data set, including Government Reputation, Expropriation, Corruption, Rule of Law, and Bureaucratic Quality.[99] The empirical results are reported in Table III. None of these variables had any significant effect on the democracy variable's standard error or coefficient.

INSERT TABLE III

VII. Time-Series-Cross-Sectional Results

Cross-sectional empirical analysis often is criticized for its static nature. To explore how domestic variables affect FDI inflows over time, I have constructed a time-series cross-sectional data set for 114 countries from 1970 to 1997. The methodology employed is an OLS regression with panel corrected standard errors as recommended by Beck and Katz (1996). All regressions were run with both random and fixed effects and with decade dummies. The unit of observation for the dependent variable is annual FDI inflows as a percentage of GDP as defined earlier. The independent variables GROWTH, LEVEL of DEVELOPMENT, MARKET SIZE, TRADE, GOVERNMENT CONSUMPTION, BUDGET DEFICITS and DEMOCRACY are the same as used in

[99] Easterly (1999).

earlier regressions. I have also included two measures of capital controls from Brune, Garrett, Guisinger, and Sorens (2001). Overall capital controls is a 9 point measure of the controls of inflows and outflows of capital, where a country is coded as a 9 if there are no controls on any capital flows. FDI INFLOWS is the same variable used in the earlier regressions. All independent variables are lagged one year and I have included a lagged dependent variable.[100] The time-series-cross-sectional econometric equation is:

$$\text{NET FDI INFLOWS}_t = \text{FDI}_{t-1} + \beta_i(\text{INDEPENDENT VARIABLES}_{t-1}) + \varepsilon_i$$

The empirical results presented in table IV support many of the findings from the cross-section regressions earlier. The random effects models (models 10-12) show positive and statistically significant effects of trade and past foreign direct investment flows on current FDI inflows. Not surprisingly, in the fixed effects models (models 13-15) trade is no longer statistically significant.[101] The level of development, when other factors are controlled for, has no statistically significant effects in most models.

INSERT TABLE IV

The picture on economic growth also has changed dramatically from the cross-sectional regressions. Growth is highly significant and positively associated with higher levels of FDI as a percentage of GDP for both random effects and fixed effects models. The difference in this result and the cross-sectional results earlier is most likely attributed

[100] I have also tested this result without a lagged dependent variable, but with AR1 correlations. The results are essentially unchanged.

[101] Given the stability of international trade as a percentage of GDP over time, this result is not surprising.

to business cycles. When a longer timer period is included, it becomes obvious that countries with higher growth rates attract higher levels of FDI.

Interestingly, government consumption is highly statistically significant in the fixed effects models, but only slightly significant in random effects models. In other words, increases in government consumption has a negative effect on FDI inflows within a country, but this effect of levels of government consumption is not nearly as strong across countries. The interpretation of this result is that while governments are constrained in their spending, there are other unmeasured compensating factors that allow some countries to have higher levels of government consumption than others. These results confirm the conclusions and conjectures from Chapter III.

DEMOCRACY remains positive and statistically significant in all models. This result is especially interesting given these are fixed-effects regressions, where even when we hold all country attributes fixed, countries that increase their level of democracy will also increase their level of FDI inflows. These results are very similar to the cross-sectional results. Fully democratic governments (scores of 20) attract and added 0.4% more FDI flows as a percentage of GDP than fully autocratic countries (scores of 0). Considering that countries over this time period have an average level of FDI flows of 1.3% of GDP, democratic political regimes have an enormous effect on FDI inflows.

This effect is even larger when one examines the cumulative effects of democratic institutions on FDI. The empirical framework of this paper analyzes the effects of democratic political institutions on FDI *flows*. These flows contribute to the *stock* of foreign capital in the country, where democratic political systems would accumulate a larger capital stock over time than their authoritarian counterparts. The most

conservative long-run estimate of the effect of democracy on FDI inflows (the lowest coefficient on democracy from the first random effects model) predicts that a democratic country will attract an added 0.61% as a percentage of GDP, which amounts to an increase of over 45% of FDI inflows. Using the first fixed effects model, this estimate jumps to an added 0.98% of GDP, or an increase of over 73%.[102] After ten years of democracy, these states will have an added *stock* of FDI that amounts to 18% of GDP and 22% of GDP respectively. Under any estimate, democratic political institutions have an enormous positive impact on FDI inflows.

These empirical results are robust under a number of different model specifications.[103] One potential criticism of these empirical results is that the advanced democratic countries in the OECD may drive the positive link between democracy and FDI. Models 16 and 17 show that these empirical relationships between democracy and FDI are still significant when the OECD countries are dropped from the sample. A second potential objective is that the independent variables MARKET SIZE and DEVELOPMENT LEVEL may be highly correlated and may be biasing the empirical

[102] This estimate converges to 0.6 after 7 years of democratic governance. Long run estimates are generated by the formula for calculating the present value of perpetuity: (Democracy Coefficient*Democracy Score)/(1- Coefficient on the Lagged FDI).

[103] I thank an anonymous reviewer for a number of suggestions on potential robustness tests.

results.[104] Models 18-21 examine this by dropping one of the two variables. Again, the empirical results on democracy remain unchanged.

Another potentially serious criticism is that these results may be driven by a particular "measurement" of the democracy. Although the Polity measure of political regimes remains largely the standard measure of democracy employed in most empirical studies, it is essentially a subject measure. Unfortunately all measure of democracy have some degree of subjectivity.

Theoretically, the strongest measure of political regimes comes from Alvarez, Cheibub, Limongi, and Przeworski (1996). This variable codes democracies as a 0 and authoritarian regimes a 1. This measure is in many ways less subjective measure than the Polity III variable since it uses a stricter, more minimalist definition of democracy, and it is a based solely on observables.[105] Although this measures is highly correlated with the Polity variable in my sample (-0.87), it is at a minimum an important robustness test of the link between democracy and FDI.

Insert Table VI

Table VI presents the empirical results of replacing the Polity III measure of democracy with the ACLP measure of political regimes in the most conservative regressions-a lagged dependent variable OLS panel corrected standard errors with fixed

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[104] I have also checked the robustness of the empirical results by individually dropping each independent variable. The results on democracy are unchanged.

[105] See Alvarez et. al. (1996) and Przeworski et. al. (2000) for a more detailed discussion of the variable.

effects. The empirical results are unaffected by this change in measures of democracy. Democracies attract higher levels of FDI.

The final set of empirical tests on the determinants of FDI examines the potential selection effects of democracy on FDI inflows. Przeworski, et. al. (2000) find that very few poor democracies survive adverse economic conditions, leading to fewer observations of democratic governments in poor countries. Empirical tests that do not account for this dynamic may suffer from a potential selection bias, in our case biasing our results on the effects of democratic governance on FDI inflows.

To control for these selection effects, I utilize a Heckman selection model. To estimate the selection corrected effects of democracy, I use the level of GDP per capita and the number of past democratic breakdowns to generate probit estimates of the existence of a democratic regimes and then used this predicted result in a standard OLS regression with country and time dummies.[106]

Insert Table VII

For this regression all variables are the same employed earlier, except that I have substituted the Polity III measure of democracy with a dichotomous measure of dictatorship from Alvarez et. al. (1996), because of the need for a dichotomous measure of democracy to employ this empirical technique. The standard OLS estimates are presented in the first column and the selection corrected estimates are presented in the second column. The standard OLS regression yields very similar results as in table V,

[106] This is the similar empirical technique employed by Przeworski et. al. (2000). They find that the level of economic development and the number of transition from authoritarian rule correctly classify 77.7% the political regimes from 1950-1990.

democratic regimes attract roughly 0.37% more FDI as a percentage of GDP than their authoritarian counterparts. When the selection model is employed, we find that a significant selection bias in the OLS results.[107] In our case, we have vastly *underestimated* the effects of democratic governance on FDI inflows. When these selection effects are taken into account, democratic governments attract almost a full 1% more FDI as a percentage of GDP per year!

These selection effects are explained by the size of FDI inflows to developing countries. Although the majority of FDI is between developed countries, when measured as a percentage of GDP, developing countries attract the highest amount of FDI in the sample. These developing countries also tend to be authoritarian, or at least more authoritarian than the developed countries in this sample. This can lead us to a spurious correlation between authoritarian regimes and high levels of FDI inflows, when in actuality it is lower levels of economic development that explains the high levels of FDI as a percentage of GDP.

Essentially, the standard OLS regressions have understated the effects of democracy on FDI. The OLS regressions ignore the fact that poor countries attract more FDI as a percentage of GDP, and that poor countries also tend to be authoritarian. When these selection effects are controlled using a standard Heckman selection model we find that the true positive affects of democratic institutions on FDI inflows are even more massive than reported in the OLS estimates.

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[107] Both Lambda and the LR test confirm the significance of the selection model. See Table VII.

VIII. Democracy and Sovereign Debt Risk

Although this paper argues that the informational and representational characteristics of democratic systems have positive effects on FDI inflows, the greatest benefit is how democratic systems increase the credibility of political leaders. This section attempts to empirically examine the effects of democratic institutions on levels of political risk. According to my theory, democratic institutions should decrease the potential risks of government leaders choosing policies that negatively affect multinational operations.

To empirically address this relationship I would like to examine the link between democracy and government credibility by examining how democratic institutions affect the sovereign debt ratings of governments. Granted, this is not a direct test of the credibility improving character of democratic institutions for multinational investors, but is does help us to more clearly examine the causal mechanism. The ex-post/ex-ante bargaining nature of FDI is similar to the dilemma faced by political leaders attempting to obtain loans from foreign lenders. Governments make promises on the repayment of loan, but once the loan is disbursed, these conditions may not be met. There are reputational costs for default, but often the short-run political and economic incentives outweigh these reputation costs.[108] Creditors must attempt to predict the potential of default, by examining the country's economic conditions and political institutions along with future world macroeconomic conditions.

Are democratic governments less likely to renege on foreign debtors? More specifically, are democratic governments less risky debtors in terms of sovereign debt

[108] Rosenthal (1991), Bulow and Rogoff (1989)

risk? To answer this question I have constructed a number of empirical tests of the effects of democratic institutions on country risk ratings.

Table VIII presents a series of OLS regressions with panel corrected standard errors that examine the determinants of sovereign risk ratings. For these regressions I use both the Institutional Investor credit ratings and Euromoney as the dependent variables. The Euromoney credit rating score are constructed by a panel of experts who assign countries values in a number of economic and political categories and generate an aggregate measure of country risk using weighted averages. The Euromoney credit risk ratings come from a survey of roughly 100 international banks on the probability of default. Sticking to convention, I use the standard logarithmic transformation of both ratings.[109]

A number of empirical studies have examined the economic determinants of country risk ratings.[110] These studies have found that the level of economic development, the government current account balance, and the level of country debt all are significant determinants of country risk. The baseline model in column 1 reconstructs the economic determinants of country risk using data on the level of development (GDP per capita), debt (central government debt/GDP), and current account balance (current account/GDP) all from the World Bank's World Development Indicators.

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[109] This is the standard transformation used by Feder and Uy (1985), followed by Cosset and Roy (1990) and Lee (1993). The formula for the transformation is Dependent variable=ln[R/(1-R)] where R represents the Institutional Investor or Euromoney Rating divided by 100.

[110] See, Feder ad Uy (1985), Cosset and Roy (1990), and Lee(1993),.

Insert Table VIII

Table VIII present a simple OLS panel regression for 73-79 countries from 1980-1998 using the Institutional Investor and Euromoney risk ratings as the dependent variable. As expected, in all models the level of economic development has a positive and statistically significant affect on country risk ratings, while the level of country debt has a negative affect. The current account deficit does not have a statistically significant effect on country risk, while GDP growth has a positive, although not statistically significant effect. All models were also tested using controls for levels of inflation or exchange rate variations.[111]

In both of the random effects models, democratic institutions are associated with higher country sovereign debt ratings. In the first fixed effects model, the model using the Institutional Investor scores as the dependent variable, democracy is positive and highly statistically significant. In the final model, the fixed effect Euromoney regression, I find no relationship between Euromoney ratings and political regimes. This last finding is not surprising, given the stability of Euromoney ratings over time. Essentially the fixed effects, country dummies, do most of the work in this regression. Other important controls that do not vary much over time, such as the level of economic development, are only weakly statistically significant.

In summary, democratic institutions, when all other economic factors are controlled for, are associated with lower levels of political risk in terms of sovereign default risk. This result sheds some light on the earlier finding that democratic

[111] I tested all models with controls for the average annual consumer price inflation and the real effect exchange rate using World Bank World Development Indicators data.

governments attract higher levels of FDI. As stated earlier, the political risks involved with multinationals' investment decisions are similar to those faced by multinational corporations investing in foreign markets. Although this is not a direct test of the causal mechanism, they do provide a foundation for the credibility enhancing nature of democratic institutions.

IX. Conclusion

The empirical analysis in this paper develops a number of models of FDI inflows, checking the robustness of the link between democratic governance and FDI by changing the model specifications and empirical tests. The evidence on political regimes is relatively conclusive; democratic governments attract higher levels of FDI. These results are robust across empirical tests and model specifications. Democratic institutions have a large positive effect on FDI inflows. These results become even stronger when the selection effects of the lack of democracies in developing countries are controlled for. In sum, all of these empirical tests find that democracies attract higher levels of FDI.

The results on sovereign debt risk point to one possible link between democracy and higher levels of foreign direct investment. Democratic governments, when all other economic conditions are accounted for, are associated with lower country risk. These risks associated with debt risk are similar to the risks faced by multinationals investing in foreign locations. One logical conjecture stemming from this result is that democracy lowers country risk, for both lenders and multinational investors.

Taken as a whole these empirical results cast serious doubt on the doomsday prediction on the link between democratic political institutions and foreign direct investment. Democratic institutions are not inefficient institutions in terms of attracting

multinational corporations. There is simply no empirical evidence that multinationals prefer to invest in dictatorships over democratic regimes. On the contrary, the empirical evidence in this paper suggests that democratic regimes attract as much as 70% more FDI as a percentage of GDP as authoritarian regimes.

Table I: Democracy and Information

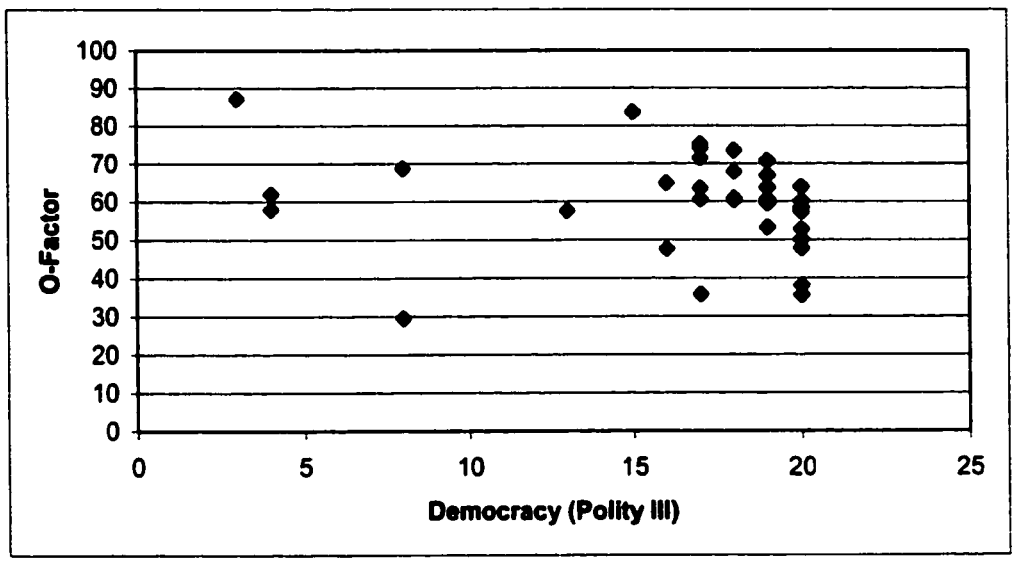

Table II. The Economic and Political Determinants of FDI (Cross-Section)

	Model 1	*Model 2*	*Model 3*	*Model 4*
Market Size	0.200 (1.463)	0.183 (1.198)	0.268* (1.705)	0.259 (1.629)
Development Level	0.088 (0.351)	-0.124 (-0.340)	-0.358 (-0.945)	-0.336 (-0.874)
Growth	-0.2857*** (-2.857)	-0.266** (-2.465)	-0.321*** (-3.243)	-0.317*** (-3.176)
Trade	0.030*** (7.151)	0.031*** (6.673)	0.034*** (10.048)	0.034*** (8.883)
Natural Resources	6.623*** (3.114)	6.365*** (2.792)	5.217*** (2.701)	5.234*** (2.731)
Government Consumption	-0.076** (-2.441)	-0.091*** (-2.797	-0.044 (-1.189)	-0.043 (-1.145)
Budget Deficits	-0.116** (-2.111)	-0.125** (-2.267)	-0.117** (-2.428)	-0.118** (-2.399)
Democracy	**0.057** (2.208)**	**0.053*** **(1.902)**	**0.060** (2.156)**	**0.100** **(0.804)**
Human Capital		0.149 (1.289)	0.203* (1.893)	0.205* (1.880)
Democracy Squared				-0.002 (-0.339)
FDI Inflows Controls			-1.839*** (-3.597)	-1.798*** (-3.357)
Constant	-6.857** (-2.500)	-5.305 (-1.511)	-6.316** (-2.014)	-6.374*** (-2.014)
N	78	71	68	68
R-sq	0.68	0.70	0.75	0.75

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table III: Robustness of Democracy and FDI (Cross-Section)

	Model 5	*Model 6*	*Model 7*	*Model 8*	*Model 9*
Market Size	0.243	0.246	0.185	0.260	0.219
	(1.445)	(1.521)	(1.162)	(1.514)	(1.344)
Development Level	-0.271	-0.173	0.160	-0.135	0.033
	(-0.764)	(-0.493)	(0.517)	(-0.389)	(0.117)
Growth	-0.361***	-0.338***	-0.277***	-0.307***	-0.293***
	(-3.561)	(-3.329)	(-3.205)	(-3.296)	(-3.149)
Trade	0.033***	0.034***	0.033***	0.034***	0.033***
	(11.363)	(11.389)	(10.886)	(11.053)	(11.139)
Natural Resources	5.861***	6.130***	6.025***	6.255***	6.137***
	(3.352)	(3.382)	(3.171)	(3.208)	(3.100)
Government Consumption	-0.040**	-0.042	-0.257	-0.038	-0.036
	(-1.134)	(-1.167)	(-0.734)	(-1.043)	(-0.916)
Budget Deficits	-0.114**	-0.111**	-0.112**	-0.120**	-0.115**
	(-2.523)	(-2.413)	(-2.430)	(-2.493)	(-2.329)
Democracy	**0.076*** **	**0.068*** **	**0.084*** **	**0.080*** **	**0.080*** **
	(3.536)	**(2.922)**	**(3.669)**	**(3.488)**	**(3.454)**
Government Reputation	0.198				
	(1.552)				
Expropriation		0.165			
		(1.210)			
Corruption			-0.159		
			(-1.288)		
Rule of Law				0.106	
				(0.836)	
Bureaucratic Quality					-0.017
					(-0.128)
FDI Inflows Controls	-1.816***	-1.918***	-1.840***	-1.813***	-1.841***
	(-3.943)	(-3.643)	(-3.504)	(-3.583)	(-3.579)
N	69	69	69	69	69
R-sq	0.76	0.76	0.76	0.75	0.75

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table IV: Panel Analysis

	Model 10	*Model 11*	*Model 12*	*Model 13*	*Model 14*	*Model 15*
Lagged FDI	0.575***	0.574***	0.567***	0.364***	0.358***	0.361***
	(8.660)	(8.578)	(8.425)	(5.059)	(4.952)	(5.006)
Market Size	-0.006	-0.006	-0.011	-0.554	-0.206	-0.516
	(-0.501)	(-0.465)	(-0.870)	(-1.236)	(-0.438)	(-1.121)
Development Level	0.011	0.012	0.021	0.834*	0.419	0.803*
	(0.209)	(0.224)	(0.402)	(1.868)	(0.886)	(1.762)
Growth	0.025***	0.024***	0.025***	0.024***	0.024***	0.024***
	(3.148)	(3.028)	(3.075)	(2.961)	(2.897)	(2.867)
Trade	0.009***	0.009***	0.009***	0.006	0.006	0.006
	(4.832)	(4.796)	(4.837)	(1.249)	(1.402)	(1.330)
Budget Deficits	0.004	0.004	0.004	-0.023**	-0.024**	-0.024**
	(0.403)	(0.389)	(0.395)	(-2.187)	(-2.272)	(-2.261)
Government Consumption	-0.014*	-0.015*	-0.011	-0.039**	-0.041**	-0.042**
	(-1.675)	(-1.686)	(-1.236)	(-2.357)	(-2.444)	(-2.508)
Capital Controls		-0.001			0.054**	
		(-0.058)			(2.441)	
FDI Inflows Controls			-0.278***			0.002
			(-3.045)			(0.014)
Democracy	**0.013*** **	**0.013*** **	**0.014*** **	**0.021*** **	**0.021*** **	**0.019** **
	(2.631)	**(2.590)**	**(2.653)**	**(2.606)**	**(2.358)**	**(2.224)**
Time Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Country Dummies	No	No	No	Yes	Yes	Yes
Observations	1630	1609	1609	1630	1609	1609
Countries	114	113	113	114	113	113
R-sq	0.67	0.67	0.67	0.72	0.72	0.72

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table V: Robustness Tests (Panel)

	Model 16	*Model 17*	*Model 18*	*Model 19*	*Model 20*	*Model 21*
Lagged FDI	0.552***	0.354***	0.575***	0.367***	0.575***	0.369***
	(7.837)	(4.738)	(8.684)	(5.119)	(8.686)	(5.166)
Market Size	-0.017	-0.382			-0.004	0.119
	(-0.955)	(-0.630)	Dropped	Dropped	(-0.707)	(0.574)
Development Level	0.054	0.509	-0.011	0.219		
	(0.786)	(0.810)	(-0.553)	(0.981)	Dropped	Dropped
Growth	0.026***	0.024***	0.024***	0.025***	0.025***	0.026***
	(3.186)	(2.819)	(3.096)	(3.048)	(3.113)	(3.147)
Trade	0.009***	0.006	0.009***	0.005	0.009***	0.005
	(4.353)	(1.166)	(4.915)	(1.235)	(4.881)	(1.228)
Budget Deficits	0.002	-0.024**	0.004	-0.023**	0.004	-0.023**
	(0.226)	(-2.009)	(0.521)	(-2.196)	(0.488)	(-2.142)
Government Consumption	-0.017	-0.039**	-0.014*	-0.037**	-0.014*	-0.037**
	(-1.625)	(-2.243)	(-1.692)	(-2.288)	(-1.884)	(-2.263)
Democracy	**0.015*** **	**0.020** **	**0.014*** **	**0.019** **	**0.014*** **	**0.019** **
	(2.700)	**(2.307)**	**(2.994)**	**(2.503)**	**(3.140)**	**(2.447)**
Time Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Country Dummies	No	Yes	No	Yes	No	Yes
OECD Included	No	No	Yes	Yes	Yes	Yes
Observations	1223	1223	1630	1630	1630	1630
Countries	93	93	114	114	114	114
R-sq	0.66	0.71	0.67	0.72	0.67	0.72

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table VI: Alternative Democracy Measure (Panel)

	Model 22	*Model 23*	*Model 24*	*Model 25*
Lagged FDI	0.379***	0.309***	0.305***	0.308***
	(4.633)	(3.977)	(3.922)	(3.962)
Market Size	-0.689	-0.614	-0.234	-0.608
	(-1.505)	(-1.330)	(-0.493)	(-1.278)
Development Level	1.151**	0.947**	0.472	0.939**
	(2.543)	(2.138)	(1.022)	(2.055)
Growth	0.021***	0.023***	0.023***	0.023***
	(2.685)	(2.710)	(2.778)	(2.688)
Trade	0.002	0.007	0.008*	0.007
	(0.317)	(1.550)	(1.662)	(1.550)
Budget Deficits	-0.033***	-0.024**	-0.024**	-0.024**
	(-3.017)	(2.160)	(-2.128)	(-2.170)
Government Consumption	-0.061***	-0.045**	-0.043**	-0.045**
	(-3.012)	(-2.446)	(-2.340)	(-2.440)
Capital Controls			0.061***	
			(2.755)	
FDI Inflows Controls				-0.037
				(-0.267)
Dictatorship		**-0.380*** **	**-0.379*** **	**-0.369*** **
		(-3.988)	**(-3.945)**	**(-3.800)**
Time Dummies	Yes	Yes	Yes	Yes
Country Dummies	Yes	Yes	Yes	Yes
Observations	1823	1584	1568	1568
Countries	128	104	104	104
R-sq	0.72	0.71	0.71	0.71

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table VII: Selection Models of Democracy and FDI

	Standard OLS	Selection OLS
Lagged FDI	0.308***	0.310***
	(3.962)	(14.533)
Market Size	-0.608	-0.626
	(-1.278)	(-1.387)
Development Level	0.023***	0.023***
	(2.688)	(3.101)
Growth	0.939**	0.796
	(2.055)	(1.485)
Trade	0.007	0.007**
	(1.550)	(2.350)
Budget Deficits	-0.025**	-0.024***
	(-2.171)	(-2.954)
Government Consumption	-0.045**	-0.046***
	(-2.440)	(-3.298)
FDI Inflows Controls	-0.037	-0.025
	(-0.267)	(-0.129)
Dictatorship	**-0.369*** **	**-0.964*** **
	(-3.800)	**(-2.891)**
Time Dummies	Yes	Yes
Country Dummies	Yes	Yes
Observations	1568	1568
Countries	104	104
Rho		0.531***
		(7.923)
Sigma		1.479***
		(37.253)
Lamda		0.786***
		(6.787)
LR Test, Chi-sq (Probability)		11.28*** (0.0008)

***=99% confidence level, **=95% confidence level, *=90% confidence level

Table VIII: Democracy and Sovereign Debt Ratings

Variable	*II*	*II*	*EM*	*EM*
Development Level	0.809***	0.149*	0.874***	0.250*
	(29.317)	(1.898)	(16.296)	(1.821)
Democracy	**0.031*** **	**0.011*** **	**0.027*** **	**-0.000**
	(9.173)	**(3.772)**	**(6.974)**	**(-0.006)**
Current Account	0.014***	-0.003	0.008	0.005
	(-8.014)	(-1.074)	(1.215)	(1.040)
Debt	-0.004***	-0.003***	-0.002***	-0.004***
	(-8.014)	(-7.467)	(-3.732)	(-5.821)
GDP Growth	0.024***	0.009***	0.026***	0.020***
	(3.304)	(2.735)	(3.071)	(4.187)
Time Dummies	Yes	Yes	Yes	Yes
Cntry Dummies	No	Yes	No	Yes
No. Countries	73	73	79	79
No. Obs	695	695	705	705
R-sq	0.70	0.96	0.63	0.90

***=99% confidence level, **=95% confidence level, *=90% confidence level

Appendix: Descriptive Statistics

Descriptive Statistics: Cross-Section Variables

Variable	Obs	Mean	SD	Min	Max
FDI inflows	165	1.96	2.68	-11.03	13.59
Wealth	111	7.95	1.07	5.99	9.8
Exports	156	33.72	24.48	3.38	189.07
Taxes on Trade	130	21.05	17.29	0	68.29
Natural Resources	120	0.24	0.4	0	3.74
Growth	105	0.201	2.33	-6.35	6.6
Government Consumption	163	16.9	7.71	2.36	58.31
Budget Deficit	126	-4.4	6.1	-39.61	24.51
Human Capital	102	4.86	2.88	0.54	12.039
Income Inequality	102	39.2	9.99	21.19	60.95
FDI Laws	93	2.6	0.87	1	5
Democracy	130	10.9	7.87	0	20
Effective Party Control	118	1.49	0.97	0	4.885
Reputation	123	5.81	2.34	1	10
Expropriation	123	6.55	2.22	1	10
Corruption	123	3.3	1.48	0	6
Rule of Law	123	2.98	1.63	0	6
Bureaucratic Quality	123	3.19	1.55	1	6

Descriptive Statistics: Panel Variables

Variable	Obs	Mean	SD	Min	Max
FDI inflows	3519	1.34	2.93	-30.33	39.21
Wealth	3141	7.99	1.08	5.44	10.32
Exports	3808	34.21	24.65	0.89	215.38
Taxes on Trade	2639	18.9	17	0	76.51
Growth	3833	3.37	7.46	-52.3	181.15
Government Consumption	3772	16.02	7.22	0.9	76.22
Budget Deficit	2521	-3.64	5.96	-61.14	58.71
Democracy	3727	9.69	7.78	0	20
Capital Controls	4247	0.19	0.39	0	1
Exchange Rates	1420	116.58	66	37.1	921.42

The Political Economy of Foreign Direct Investment

Chapter V: Political Federalism, Fiscal Federalism, and FDI

I. Introduction

In chapter IV I demonstrated that democratic institutions provide multinational investors with policy stability and credible commitments to market friendly policies, leading to higher levels of FDI inflows. In this chapter I examine the role of federal institutions in providing these same two benefits to multinational investors. These results add to the findings in Chapter IV.

This chapter also contributes to a deeper understanding of the economic effects of federal institutions on macroeconomic performance. Generally, there is a growing interest in the study of federalism. Theorists have revived old debates on the effects of federal institutions on economic performance and have generated a number of new theories that are supported by formal models and empirical results. Unfortunately, to date no consensus has emerged in either the theoretical or the empirical analysis of the effects of federalism on the economic performance

Part of the reason for this theoretical and empirical confusion is the complexity of the concept of federalism. I argue that there are serious conceptual distinctions between different forms of federalism that affects economic performance. More precisely, this chapter explores the effects of federalism on the ability of countries to attract foreign direct investment by differentiating between three types of federalism: 1) fiscal federalism, 2) political federalism, and 3) political decentralization.

Using this conceptual distinction as a guide, we can more clearly examine the affects of federal political institutions on multinational investments. I empirically test

the differing effects of fiscal federalism and political federalism on foreign direct investment (FDI) inflows for 124 countries from 1975-1995.[112] The central finding of this chapter is that politically federal institutions are associated with higher inflows of foreign direct investment, while fiscal federalism has no statistically significant effect.

This chapter proceeds as follows. Section II will briefly discuss some of the recent literature on federalism and economic performance. Section III makes the conceptual distinction between fiscal federalism, political federalism, and political decentralization. Section IV discusses theoretical differences of these institutional arrangements in regards to FDI. Section V further highlights this distinction by using the example of the taxation of multinational corporations. Section VI explains the construction of the data set on political federalism. Section VII presents the empirical tests and the results. Section VIII concludes.

II. Federalism and Economic Performance

Although a complete review of the literature on the effects of federalism on economic performance is beyond the scope of this chapter, a number of notable scholars have examined the benefits of federal institutions on economic performance. One literature argues that state actors are more knowledgeable about local tastes and business costs than the central government in a unitary state (Oates 1999). The "laboratory of federalism" concept stresses the role of federalism in finding innovative solutions to problems by allowing different states to experiment with different policy solutions,

[112] There is little reason to believe political decentralization will have any effect on FDI inflows. I focus on political federalism and fiscal federalism.

although Rose-Ackerman (1980) argues that this could lead to free-riding by states.[113] Brennen and Buchanan (1980) argue that fiscal decentralization can help control public expenditures, although Oates (1985) finds no evidence for this. Lastly, federal institutions can provide competition for mobile factors between subnational units (Tiebout 1956). If mobile factors can "vote with their feet", subnational units will be forced competition that will be market enhancing, such as investments in growth-promoting infrastructure (Qian and Roland 1998).

Federal institutions can also have political advantages that lead to better macroeconomic performance. Most notably, Weingast (1995) argues that federal institutions ensure limited government, allowing nation-states to credibly committee to ensuring property rights. This idea is explored in a series of papers that examine the role of federal institutions in promoting economic development (North and Weingast 1989, Montinola et. al. 1995).

Other theorists have stressed the potential negative affects of federalism on economic performance. Subnational units may be more susceptible to corruption, particularly problematic in developing countries. (Prud'homme 1995, Rodden and Rose-Ackerman 1997, Bardhan and Mookherjee 2000). Treisman (1998) argues that political and fiscal decentralization in developing countries can lead to higher levels of inflation. More recently, Treisman (2000) shows that decentralization can lock countries into an inflation equilibrium, resulting in continued levels of low inflation in some decentralized countries and persistently high levels in other decentralized countries. Wibbles (2000)

[113] See Oats (1999) for a review of this literature.

finds empirical evidence that politically federal institutions inhibit macroeconomic performance and economic reform.

These differing theories and empirical results on the role of federalism in macroeconomic performance are partially attributable to the complexity of federal institutions. Some recent works have attempted to disaggregate the conceptual differences between different forms of federalism and empirically test these effects.[114] Before this is possible in our case, it is important to examine the different concepts of federalism.

III. Political Federalism, Political Decentralization, and Fiscal Federalism

In the study of comparative politics we are forced to compare, contrast, and classify institutional arrangements across countries. As scholars we readily recognize the minute differences that make each nation's political institutions unique, but to gain analytical leverage in explaining the general causes and effects of these institutions we must find commonalities between these systems. One set of institutional structures that have received a tremendous amount of attention is the effects of federalism on both politics and economic performance. Unfortunately much of the existing literature fails to distinguish between political federalism, political decentralization, and fiscal decentralization. This paper attempts to clearly separate these three concepts.

Before embarking on a discussion of *political* federalism and *political* decentralization, it is important to contrast these political arrangements with the growing literature on *fiscal* federalism/decentralization. Early scholars such as Tiebout (1956) and Oats (1972) have constructed the foundation for the study of fiscal decentralization on

[114] See Treisman (2001).

economic performance. Fiscal federalism and fiscal decentralization entail a degree of fiscal autonomy of regional governments from the central government in both taxing and spending. Although these works on fiscal decentralization have been important academic contributions, they have missed an important institutional element of federal systems.

Weingast (1995) amends the literature on fiscal federalism, arguing that for states to be "market-preserving" federal countries, five conditions must be met:

1. A *hierarchy* of governments with a clear scope of authority.
2. The *autonomy* of each government is assured through some set of institutions.
3. The subnational governments are the primary agents responsible for *regulation* of the economy.
4. A *common market* of free trade between subnational units is guaranteed.
5. Subnational units face a *hard budget* constraint.

Weingast stresses that while the first two conditions may ensure a politically federal system as envisioned by Riker (1964), the final three conditions are necessary to give the subnational units enough autonomy to constrain the central government.

This concept of market preserving federalism has not gone without criticism. Rodden and Rose-Ackerman (1997) stress that not only do almost all federal systems fail to meet this standard, this theory fails to address the other political and electoral pressures within a political system. As Wibbles (2000) suggests, this literature has, "...failed to account for the differences in political incentives facing subnational leaders in federal and unitary nations...The difficulty with this perspective is that if fails to account for the crucial role of political accountability".[115]

[115] Wibbles (2000) page 690.

Moving away from fiscal federalism, the study of politically federal institutions is an important element in understanding the relationships of political accountability between the central government and regional governments. These political relationships are difficult to separate and classify. Daniel Elazar identifies a number of politically federal institutional arrangements including: federations, confederations, unions, constitutionally decentralized unions, federacies, associated statehood, condominiums, leagues and joint functional authorities.[116] For Lijphart (1999), these distinctions can be broken down into two dimensions: federal-unitary and decentralized-centralized.[117] These two dimensions clearly point out that, at the very least, politically federal systems are not synonymous with politically decentralized systems.

The definition of politically federal systems employed in this analysis is based on political relationships between the central government and local/regional governments. Contrasting from Watt's (1999) definition of federalism as a combination of "shared-rule and regional self-rule", the working definition of political federalism is based solely on the first dimension.[118] Specifically, political systems where regional actors affect *national* policy are politically federal systems.

Political federalism contrasts with political decentralization, where decentralization encompasses Watt's second part of his definition, self-rule. Regional units are often given functional authority over certain policy areas. This includes

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[116] Elazar (1994).

[117] Lijphart (1999) page 185

[118] Watts (1996) page 6.

"autonomous regions" within a polity that are given some degree of political autonomy, but have no real effect on the crafting of national policy.

The working definitions of these three concepts are summarized as:

1. Fiscal Federalism: Subnational units are given primary responsibility of spending and raising revenue. These units have primary responsibility of regulating economic activity within their subnational territorial area.
2. Political Federalism: Subnational units do not have the primary responsibility of taxing and raising their own revenue but do have a hand in crafting national policy. Subnational units are involved (in ways that will be described later) in legislation at the national level.
3. Political Decentralization: Subnational units are given autonomy over policy within their subnational territorial unit, short of taxing and spending their own revenue. Subnational units have no role in the crafting of national policy.

The debate on the effects of federalism on macroeconomic performance has centered around the first two concepts. Few theorists argue that political decentralization has an important impact on economic relationships. For this study, I exclude further examination of political decentralization and focus on fiscal federalism and political federalism. These two conceptions of federalism have different theoretical affects on flows of foreign direct investment.

III. Federalism and Foreign Direct Investment

As highlighted in Chapter II, foreign direct investment is an important element of economic development. Countries attempt to attract foreign corporations to increase the capital stock, encourage technology transfer, generate employment, and increase tax

revenues. The attraction of FDI has become perhaps the central element of economic development for both low and middle-income countries.

Although the benefits of investing in foreign production facilities may be substantial, multinational corporations face high levels of risk in these investments. FDI projects are relatively liquid ex ante; companies can make the decision to invest essentially anywhere in the world. Ex post, once the initial investment is made, production facilities are constructed, machinery imported, all fixed costs sunk, multinationals investments quickly come illiquid.

Numerous scholars have identified federal institutions as a veto point within the political system. These institutions, such as a legislature that represents regional units, can block the passage of new legislation. Tsebelis (1995) argues that the existence of a larger number of veto points increases the probability of policy stability. From this logic, one could make the argument that federal systems increase the number of veto points in the political system, thus providing a more stabile environment for FDI. Heinsz (2000) constructs a measure of the number of veto points, including federal institutions, and argues that this affects the type of entry decision made by a multinational. Within this framework federal institutions are just another barrier to policy change, just as are supreme courts, the number of houses of the legislature, and presidential systems.

While federal institutions undoubtedly increase the number of veto points within the political system, the potential importance of federal institutions is much richer and varied. As Oates (1972) points out, federal political systems can be viewed within the principle-agent framework, where the central government and the regional government

represent different sets of agents.[119] These agents will have different preferences that can greatly affect policies towards multinational corporations.

Federalism becomes a meaningful concept if we can begin to specify the preferences of the actors of the regional and central governments. If the preferences of these actors diverge, then in the language of Tsebelis (1995), the size of the win set decreases and policy stability increases. If the preferences of the subnational units coincide perfectly with that of the central government, federalism will have less of an effect on policy stability. Most importantly, if subnational actors have similar preferences to multinationals, subnational units have the incentive to provide market-promoting policies favored by multinationals.

Specifying these preferences is essential to understanding the role of federalism in attracting FDI, and more generally the effects of federalism on macroeconomic performance. The preference structure of the actors within a federal system is dependent on the formal institutional arrangement of the system. Subnational units that are dependent on the central government for tax revenue may have very different preferences than if these subnational units raised there own revenue. This same logic applies to spending decisions, the ability to regulate firms, and numerous other responsibilities that can be shifted between the central government and subnational units. The structural differences between the three types of federalism explored in this paper, political

[119] In democratic systems the regional units represent the citizens of the region and the central government the whole country. In authoritarian countries the different principles are the central and the regional elites.

federalism, political decentralization and fiscal federalism, entail very different preferences for subnational units.

To highlight these different preference structures in the context of FDI, let us explore a simple example of multinational investment. Multinational investments provide countries with numerous benefits, these benefits range from having national (economy wide) effects to more localized effects. An excellent example of a purely national effect is the use of multinational exports to improve the trade balance of the country and generate foreign exchange.

One of most important local benefits of FDI is job creation provided by multinational investment. Multinationals create new jobs and may countries pay wages that are higher than domestic firms.[120] This creation of jobs has a relatively small impact on the national economy, but creates a large pocket of employment that is localized. These jobs opportunities increase as multinationals expand operations, reinvest earnings, and contract with local providers for inputs and services.

By examining the distribution of these benefits, in terms of national and localized benefits, and specifying the institutional structure of the federal system we can make predictions on the degree of policy stability and the content of the policies. The next section will use the example of the taxation of multinational corporations to highlight the important distinctions between different institutional structures.

IV. Unitary, Political Federal, Fiscally Federal Systems and the issue of Taxation

[120] Discussion of the relative wages of workers employed by multinationals is a complex topic that is beyond the scope of this chapter.

One of the most politically salient issues concerning multinational investment is the issue of taxation. Multinationals often negotiate rates of taxation, levels of exemptions, depreciation schedules, and tax holidays with host governments before investment has been made. Once the investment has been made, as highlighted earlier, firms are susceptible to host governments changing their policies towards taxation. This can entail a renegotiation of the original tax agreement, or may entail a more subtle change in government policy on which assets are eligible for more favorable depreciation schedules or if specific requirements are being meet that allow for lower rates of taxation (such as export requirements).

In a unitary political system, the central government makes all decisions regarding the treatment of the multinational. In these unitary political systems, the government will obvious care about benefits that are both localized and national in nature, but may have a strong preference towards maximizing the national benefits at the expense of localized benefits.

In both politically and fiscally federal systems, on the other hand, actors with much stronger preferences on the maximization of localized benefits of FDI will have some degree of power. In its ideal type, fiscally federal subnational units would be fiscally autonomous from the central government, raising and spending their own revenue. These subnational units would bargain directly with multination corporations and have the ability to renegotiate with these firms once the initial investment has been made.

In politically federal systems, negotiations on the levels of taxation are made between the central government and the multinational firms. Subnational units have no

direct role in negotiations, but they do have a tremendous amount of political power in influencing the central government's policies. These subnational units can propose or stall legislation[121], provide suspensive vetoes[122], or veto legislation completely[123]. This institutional organization is similar to a system of checks and balances between an executive and a legislature, requiring both bodies to agree on policy or legislation (Persson, Roland, and Tabellini 1997).

The important distinction between fiscally federal systems and political federal systems is that many of the national benefits of FDI *become localized* in fiscally federal systems. In both systems pockets of employment benefit the sub-national governments, but in the fiscally federal system the benefits of taxation accrue to the sub-national government. Subnational governments in fiscally federal systems will attempt to maximize the total benefits of employment and taxes from multinationals.

In many ways, a subnational unit within a fiscally federal system begins to look like a unitary state. Throughout the world, unitary states tax their citizens and spend their own revenue. While scholars often argue that the "hard-budget constraints" of subnational units within fiscally federal nationals force subnational units into better behavior, it is important to highlight that unitary nation-states also face hard budget constraints. The competition between states within a federal system for international

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[121] Most federal systems have bicameral legislatures with at least one house representing the territorial units.

[122] Malaysia is an example of this type of system.

[123] This could be the case in authoritarian federal systems such as the United Arab Emirates.

investment is similar to the competition between nation-states for international investment within the international systems. In essence, since the degree of competition between states already is high, the potential benefits of fiscal federalism in a world of capital mobility are small.

This is obviously an idealized conception of a fiscally federal system. In reality, no subnational government is completely unconstrained in their dealing with multinational corporations. This is beside the point, the important distinction is the degree in which the incentives structures of the subnational units diverge from the incentives from the national government. In fiscally federal systems, in their less ideal type, subnational units generate tax revenue from multinational corporations. These subnational units will have preferences that are similar to the national government, or at least more similar than that of a politically federal nation-state.

Political federalism, on the other hand, could provide some benefits to multinational investors. The central difference between fiscal federalism and political federalism is the agency that negotiates and collects taxes from foreign investors. In politically federal systems, sub-national units receive relatively few benefits from the taxation of multinational corporations. In these systems, tax revenues are a national benefit that the central government attempts to maximize.

Subnational units have little incentive to behave opportunistically in terms of renegotiating tax deals with multinational corporations. Subnational units want to maximize the localized benefits of multinational investment. Sub-national units would at the very least be indifferent to the central government's interest in renegotiating a tax ex-post. If the process of renegotiation entails some costs, either the credibility of the

country, or the relations with the existing multinationals that may affect localized benefits, then subnational units will attempt to block policy changes.

This argument on the taxation of multinationals is just one of many examples of the potential role of subnational actors constraining the central government from enacting polices that would harm multinationals. Similar arguments could be made for the imposition of capital controls, changing legislation regarding business regulations, exchange rate decisions, or any host of policies that would be important to multinational corporations. Politically federal institutions can be advantageous to foreign investors because of the shared power between the central and sub-national governments. From these simply theories we can deduce a number of empirically testable hypotheses.

H1: Politically federal systems will attract higher levels of FDI than unitary political systems.

H2: Fiscally federal systems will have little affect on FDI inflows.

The following section will present the data used to test these hypotheses.

V. The Data

The terms, fiscal decentralization, political decentralization, and fiscal federalism are logically distinct from political federalism. While there may be considerable overlap between these systems, they are by no means synonymous. Since these analytical differences entail different underlying patterns of relationships, authority and responsibility, we, as social scientists, must strive to create measures that capture these distinctions in our empirical tests. Although a number of scholars have begun to separate these important features between political decentralization and fiscal decentralization and

create corresponding measures, little work has been done to create variables that capture the important distinctions between political federalism and the other alternatives.

One illustrative example of a politically decentralized system that should not be confused with a politically federal system is the recent devolution of power to Scotland within the United Kingdom. Although the creation of a Scottish parliament has delegated Scotland a number of powers, this assembly has little or no power over national policy. This highlights the distinction between decentralization and the operationalization of 'Political Federalism' in this data set.

The variable, Political Federalism, is an attempt to measure the political relationship between sub-national units and central governments. In a federal political system sub-national actors are involved in shaping *national* policy. By this definition countries with autonomous or semi-autonomous units are not federal unless these autonomous units play a role in policies that affect the nation as a whole. In political systems where sub-national actors play a role in national politics they are classified as federal.

A number of institutional features were examined to classify these political regimes. First and foremost, countries with bicameral legislatures with a "strong federal chamber" are classified as federal.[124] In most cases, this consists of a upper house representing territorial units, although in some countries this federal dimension is institutionalized in the lower house. A second important feature is a formal federal constitution. Third, and most often ignored in the federalism literature, is the ability of

[124] Lijphart (1999) page 187.

regional actors to veto or suspend legislation. For example, in Malaysia regional elites have the power to suspend central government legislation for 30 days.

This definition allows for the existence of federal systems in authoritarian or semi-democratic regimes. In both democratic and authoritarian systems, the ruling elite needs to maintain the support of some groups within society, be it the majority of the electorate, the military, or some other subset of the population.[125]

Given the heterogeneity of federal political systems, no better formulaic explanation of the construction of the variable can be given. The variable, "Political Federalism", is an ordinal variable taken on the values of 0, 1 and 2 from the least federal to the most federal. While much finer gradations of federalism are apparent in the world, the use of this simple measure helps to limit to degree the subjectivity of this measure.

The time frame of this data set spans from 1975 to 1995. Some countries encountered institutional change within this time period. For countries with institutional change in the first half of the year, this changed was coded as occurring in that year. For countries where institutional changed happened in the second half of the year, the institutional change was recorded in the following year. Appendix A describes all 30 federal systems and the timing of any institutional changes.

A large number of sources were used in the construction of this variable including: *The Political Handbook of the World*, *Political Systems of the World*, Watt's *Comparing Federal Systems* (1999), The World Bank's Database of Political Institutions, Lijphart's *Patterns of Democracy* (1999) and Wibbles (2000). It is important to mention that Wibbles (2000) proved a tremendously informative source for the classifying a

[125] This group has been termed the selectorate by Bueno de Mesquita et. al. (1999).

number of developing countries. For a number of these countries there is a complete overlap between this data set and Wibbles (2000), for which he should be given credit for the country classification. This data set includes annual observations for 124 countries from both the developed and developing world from 1975-1995.[126]

In the presentation of this data set I have attempted to limit both Type I and Type II errors. Type II error, the possibility of classifying a system as Federal that is not federal, is minimized by giving detailed descriptions of all federal systems in Appendix A. Given the small universe of federal systems (30 countries), these descriptions allow scholars to examine the institutional structure of these federal systems. Type I error, classifying a system as unitary when it is in fact federal, is slightly more difficult. Although it is impossible to examine every political system and explain the institutional features, appendix B presents the coding for all 124 countries.

VI. Empirical Analysis

The empirical analysis of this paper examines the effects of federal institutions on annual inflows of foreign direct investment. The empirical technique employed is a time-series-cross-sectional regression analysis from 1975-1995 for 124 countries, using the same specifications as Chapter III. As recommended by Beck and Katz (1996), I perform an OLS regression with panel corrected standard errors and a lagged dependent variable. All regressions include regional dummies and decade dummies. All independent variables are lagged one year.

The regressions equation is:

$$\text{Net FDI Inflows}_t=\alpha + \beta_i(\text{Net FDI}_{t-1})+\beta_j(\text{Independent Varables}_{t-1})+\beta_k(\text{Controls})+ \varepsilon$$

[126] I am in the process of extending this data set from 1945-2000.

The dependent variable, foreign direct investment, is FDI inflows as a percentage of GDP from the World Bank's World Development Indicators 1999. This variable measures to the total change in foreign direct investment inflows for a country in a given year. I use standard control variables from the previous chapter. Market size (log of GDP), level of economic development (log of GDP per capita), and the level of trade (exports+imports/GDP) are all used as control variables, as informed by theoretical and empirical studies on FDI.[127] All control variables come from the World Bank World Development Indicators 1999.

To test the robustness of the results, I include variables including the level of democracy, the number of veto points in the political system, and a measure of natural resources. In the previous chapter I argued that democratic regimes attract higher levels of FDI. If federal systems are more likely to occur within democratic regimes, then spurious correlation could lead us to associate federal regimes with higher levels of FDI. To control for this I include a standard measure of democracy from the Polity III dataset from Jaggers and Gurr (1996). This measure classifies political regimes on a scale from 0 (authoritarian) to 20 (democratic).

A second robustness check includes a measure of the number of "veto players" in the political system from the World Bank's *Database of Political Institutions*.[128] Including this variable illuminates the relationship between federalism and the number of veto points in the political system. The theoretical section of this paper stresses that

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[127] See, Markusen (1995) for a review of the literature.

[128] See Beck et. al. (2000) for a discussion of the project. I used the recommended veto player variable, Checks2a.

political federalism is a richer concept than just the number of veto points it adds. This is empirically tested in Table II.

Some countries will attract higher levels of FDI due to their natural resource endowments, independent of their political institutions. To control for this I include a measure of natural resources in table II. The measure is the total amount of mineral and fuel exports as a percentage of merchandise exports from the World Bank's World Development Indicators 1999. The expectation is that countries with higher natural resource endowments attract higher levels of FDI.

To examine the effects of federal institutions on FDI inflows I utilize the constructed measure of political federalism and a measure of fiscal decentralization from the IMF's World Financial Statistics yearbook.[129] The chosen measure of fiscal decentralization is state and local revenue as a percentage of total revenue.[130] This variable proxies for state and local ability to tax multinational corporations.

Table I presents the empirical results of the basic model. Only the controls for trade, economic growth, and the lagged dependent variable were statistically significant in most models. Model 2 includes the variable, Political Federalism, which is positive and statistically significant. The effects of federal institutions are substantial; a move from a unitary state to a federal state increases FDI inflows by 0.4% of GDP. Given the average level of FDI inflows for the sample is 1.3% of GDP this amounts to a substantial increase.

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[129] I thank Jonathan Rodden for this data.

[130] Using state expenditures as a percentage of GDP produces similar results.

Model 3 includes the variable, Fiscal Federalism, defined as subnational revenues as a percentage of GDP. Unfortunately this decreases the sample size from 124 countries to 63. Fiscal federalism has no statistically significant effect on FDI inflows. Finally, in model 4 I test political and fiscal federalism jointly. As predicted, political federalism remains positive and (weakly) significant while fiscal federalism has no statistical significance on FDI inflows.

Table II examines the robustness of these findings by including measures of democracy, veto points, and natural resources. These regressions are attempts to explore the robustness of the results on federalism, not to provide a complete test of the role of democracy, veto points, or natural resources on FDI inflows. Models 5 and 8 include a measure of democracy on FDI inflows. Models 6 and 9 examine if federal systems simply have more veto points, which attributes to higher levels of FDI inflows. Lastly, in models 7 and 10 I examine if the effects of higher inflows of FDI in federal countries is attributable to their endowments of natural resources.

Insert Table II

In all models, the findings in Table I hold up to the robustness test. Political Federalism remains strongly statistically significant in all models, while no empirical relationship is found between Fiscal Federalism and FDI inflows.

These empirical results are not a direct test of the causal mechanism linking federalism to higher levels of FDI inflows. Federal institutions enable governments to provide credible commitments to multinational corporations, essentially providing environments that entail lower levels of political risk for corporations. By making these credible commitments countries with federal institutions attract higher levels of FDI. The

robust results on the ability of federal countries to attract higher levels of FDI are consistent with this story, but not a direct test.

I employ the same method used in the previous chapter by exploring the effects of federalism on sovereign debt ratings. Granted this is not a direct test of the credibility improving character of federal institutions, but is a helpful test in exploring how federalism contributes to increasing the credibility of governments in dealing with investors, multinationals or lenders.

As noted in the last chapter, the obsolescing bargaining nature of FDI is similar to the dilemma faced by international lenders. Governments make promises on the repayment of loan, but once the loan is disbursed, these conditions may not be met. There are reputational costs for default, but often the short-run political and economic incentives outweigh these reputation costs.[131] Creditors must attempt to predict the potential of default, by examining the countries economic conditions and political institutions along with future world macroeconomic conditions.

Table III presents a series of OLS regressions that examine the determinants of sovereign risk ratings. For these regressions I use both the Institutional Investor credit ratings and Euromoney as the independent variables. The Euromoney credit rating score are constructed by a panel of experts who assign countries values in a number of economic and political categories and generate an aggregate measure of country risk using weighted averages. The Euromoney credit risk ratings come from a survey of roughly 100 international banks on the probability of default. A more detailed

[131] Rosenthal (1991), Bulow and Rogoff (1989)

description of both of these variables is included in the appendix. Sticking to convention, I use the logistic transformation of both ratings.[132]

Tables III and IV present a simple OLS panel regression for 73-81 countries from 1980-1999 countries using the Institutional Investor (Table III) and Euromoney (Table IV) risk ratings as the dependent variable.[133] As predicted, Political Federalism is positive and statistically significant in all regressions except for model 18 in table IV. The variable, veto points, is not statistically significant in any of the regressions. Interestingly, fiscal federalism, contrary to the earlier FDI results, is positive and statistically significant in all regressions. Political federalism and fiscal federalism is associated with higher sovereign risk ratings (lower default risk).

VII. Conclusion

This chapter argues that the existing literature on federalism generally fails to make careful distinctions on the structure of political and economic relationships within a federal system. These conceptual distinctions are important in understanding the affect of federal institutions on economic performance. This study specifically concludes that while politically federal institutions can have positive effects on FDI inflows, the same is not true for fiscal federalism. The benefits of federalism in attracting multinational corporations is due to the political relationships between the national government and subnational units, not on fiscal relationships. Once again, political institutions have an

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[132] The formula for the transformation is Dependent variable=ln[R/(1-R)] where R represents the Institutional Investor or Euromoney Rating divided by 100.

[133] All independent variables are lagged one year.

enormous impact on FDI inflows. The following chapter will explore how international institutions can also affect FDI inflows.

Table I: Federalism and FDI

Variables	*Model 1*	*Model 2*	*Model 3*	*Model 4*
Past FDI	0.591***	0.496***	0.667***	0.629***
	(8.616)	(7.183)	(7.567)	(6.942)
Market Size	-0.048	-0.024	0.031	0.006
	(-1.394)	(-0.658)	(0.877)	(0.160)
Growth	0.009	0.0184***	0.032***	0.045***
	(1.350)	(2.633)	(0.2790)	(3.868)
Development	-0.034	-0.113*	-0.021	-0.027
	(-0.452)	(-1.693)	(-0.159)	(-0.219)
Trade	0.008***	0.010***	0.005**	0.005*
	(4.893)	(6.416)	(2.022)	(1.810)
Political Fed		0.200***		0.153*
		(3.799)		(1.894)
Fiscal Fed			0.367	-0.340
			(0.398)	(-0.342)
R-Sq	0.63	0.60	0.76	0.76
Countries	151	124	63	56
Observations	2552	2267	646	608

Note: For all regressions are estimated using OLS with panel corrected standard errors and a lagged dependent variable (Past FDI), regional dummies, and decade dummies.
***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Table II: Robustness

Variable	*Model 5*	*Model 6*	*Model 7*	*Model 8*	*Model 9*	*Model 10*
Past FDI	0.502***	0.496***	0.538***	0.652***	0.672***	0.764***
	(6.491)	(7.155)	(7.479)	(7.448)	(7.703)	(12.094)
Market Size	0.014	-0.026	0.055*	0.027	0.032	0.024
	(0.400)	(-0.715)	(1.662)	(0.712)	(0.909)	(0.803)
Growth	0.022***	0.020***	0.007	0.036***	0.036***	0.023***
	(2.736)	(2.840)	(1.105)	(3.166)	(3.447)	(2.590)
Development	-0.100	-0.102	0.114***	-0.042	-0.039	0.001
	(-1.341)	(-1.496)	(-3.042)	(-0.265)	(-0.296)	(0.006)
Trade	0.011***	0.010***	0.009***	0.005**	0.005**	0.004*
	(5.794)	(6.313)	(4.840)	(1.974)	(1.986)	(1.847)
Political Fed	0.132**	0.194***	0.115***			
	(2.558)	(3.821)	(2.654)			
Fiscal Fed				-0.142	0.303	0.343
				(-0.150)	(0.338)	(0.503)
Democracy	0.006			0.022**		
	(0.988)			(2.427)		
Veto Points		0.010			0.034	
		(0.566)			(1.264)	
Resources			-0.001			0.001
			(-0.148)			(0.335)
R-Sq	0.60	0.60	0.72	0.76	0.76	0.82
Countries	111	123	109	62	62	58
Observations	1989	2245	1619	632	641	587

Note: For all regressions are estimated using OLS with panel corrected standard errors and a lagged dependent variable (Past FDI), regional dummies, and decade dummies.
***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Table III: Federalism and Institutional Investors Credit Ratings

Variable	*Model 11*	*Model 12*	Model 13	*Model 14*
Development Level	0.877*** (19.937)	0.665*** (13.461)	0.944*** (19.222)	0.645*** (13.873)
Current Account	0.001 (0.486)	0.005 (0.669)	0.001 (0.623)	0.005 (0.744)
Debt	-0.002*** (-3.767)	-0.001*** (-2.731)	-0.001*** (-2.797)	-0.002*** (-2.858)
Political Federalism	0.389*** (5.403)			0.224*** (2.779)
Fiscal Federalism		6.187*** (14.543)		5.294*** (8.539)
Veto Points			0.004 (0.434)	-0.008 (-0.745)
Countries	73	45	78	42
Observations	680	339	738	327
R-sq	0.59	0.53	0.54	0.55

Note: For all regressions are estimated using OLS with panel corrected standard errors with an AR1 correction and decade dummies.
***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Table IV: Federalism and Euromoney Credit Ratings

Variable	*Model 15*	*Model 16*	*Model 17*	*Model 18*
Development Level	0.914*** (10.781)	0.619*** (5.755)	0.979*** (10.695)	0.602*** (5.827)
Current Account	0.003 (0.625)	0.022* (1.955)	0.004 (0.865)	0.214** (1.968)
Debt	-0.002*** (-3.051)	-0.003** (-2.477)	-0.002** (-2.495)	-0.003*** (-2.855)
Political Federalism	0.378*** (4.640)			0.088 (0.983)
Fiscal Federalism		7.873*** (5.352)		7.384*** (4.865)
Veto Points			0.002 (0.082)	0.034 (1.311)
Countries	83	46	88	43
Observations	718	322	778	310
R-sq	0.43	0.44	0.36	0.46

Note: For all regressions are estimated using OLS with panel corrected standard errors with an AR1 correction and decade dummies.
***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Table V: Federalism, Democracy and Institutional Investor Ratings

Variable	*Model 19*	*Model 20*	*Model 21*	*Model 22*
Development Level	0.847***	0.639***	0.897***	0.619***
	(22.147)	(12.651)	(21.241)	(13.039)
Current Account	0.001	0.005	0.002	0.006
	(0.424)	(0.746)	(0.629)	(0.811)
Debt	-0.002***	-0.002***	-0.002***	-0.002***
	(-4.017)	(-2.649)	(-3.185)	(-2.778)
Political Federalism	0.349***			0.206**
	(4.918)			(2.519)
Fiscal Federalism		6.153***		5.314***
		(21.161)		(9.784)
Veto Points			0.002	-0.007
			(0.238)	(-0.639)
Democracy	0.010**	0.008	0.014***	0.009
	(1.999)	(0.787)	(3.161)	(0.800)
Countries	70	44	74	41
Obs.	646	332	699	320
R-sq	0.61	0.55	0.58	0.58

***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Table VI: Federalism, Democracy, and Euromoney Ratings

Variable	*Model 23*	*Model 24*	*Model 25*	*Model 26*
Development Level	0.874***	0.547***	0.926***	0.520***
	(9.108)	(4.976)	(9.208)	(4.939)
Current Account	0.004	0.022*	0.004	0.021*
	(0.769)	(1.845)	(0.833)	(1.835)
Debt	-0.003***	-0.003***	-0.002***	-0.003***
	(-3.477)	(-2.936)	(-2.972)	(3.445)
Political Federalism	0.294***			0.065
	(3.498)			(0.715)
Fiscal Federalism		7.196***		6.739***
		(4.971)		(4.660)
Veto Points			-0.010	0.034
			(-0.440)	(1.319)
Democracy	0.019***	0.028*	0.022***	0.032**
	(3.162)	(1.946)	(3.589)	(2.199)
Countries	76	45	80	41
Obs.	656	316	709	320
R-sq	0.46	0.46	0.42	0.58

***= significance at 0.01
**= significance at 0.05
*= significance at 0.10

Appendix A

Argentina (1975-1981 Mixed; 1982-1995 Federal)

Argentina is classified as a mixed political systems from 1975-1982 during the period of authoritarian rule. Argentina became a federal system after 1983 where the 29 provinces are represented in a 69-member upper house with each provincial assembly nominating 2 members and a third member representing minorities.

Australia (1975-1995 Federal).

Provinces are represented in the 76 member Senate (12 seats for each of the 6 states, two for the Northern Territory, and two for the Australian Capital Territory).

Austria (1975-1995 Mixed)

Lander are represented in the 64 member Bundesrat. The state assemblies elect candidates. Each Lander provides a chair for the Bundesrat for a six-month term.

Belgium: (Mixed 1975-1995)

The 71 member Senate consists of 40 directly elected members (15 from Wallonia and 25 from Flanders), 21 indirectly elected (10 by the Flemish Council, 10 by the French Council, and 1 by the German council), and 10 appointed by the elected Senators. Some institutional changes were made in 1993 giving regions more autonomy, although this is not a major change in the role of regions in central government legislation.

Brazil (Mixed 1975-1981; Federal 1982-1995)

The 26 states and the district of Brasilia are represented in the upper house. Candidates were chosen from 1975-1981 through partially fair elections, and from 1982-1988 by the state legislators. The 1988 Constitution further strengthened the federal system maintaining the election of Senators (1 per state) and Chamber of Deputies (by population and 1 deputy representing each state).

Canada (Federal 1975-1995).

The 10 provinces are represented in the 104 member Senate.

Columbia (Mixed 1975-1990; Federal 1991-1995)

From 1975-1990 the 114 member Senate was elected by the 23 national departments. A new constitution was ratified in July 1991 which included a bicameral legislature that is directly elected. The 163 member House of Representatives includes two representatives from each of the 23 national departments.

Ethiopia (1975-1993 Unitary; 1994-1995 Federal)

Ethiopia was a federal system from 1952 until it returned to unitary status in 1962. It is coded as a unitary system until 1994. The new 1994 Constitutions returned Ethiopia to federal status by granting the 9 states a number of powers, including the right to secede through referendum. Ethiopia is coded as a federal system for 1994 and 1995.

Gambia (Unitary 1975-1981; Mixed 1982-1989; Unitary 1990-1995)

Gambia is a unitary system expect in the period of 1982-1989 during the period of the Senegambian Confederation, the merger of Senegal and Gambia. This confederation was dissolved on September 30, 1989.

Germany (1975-1995 Federal).

The Lander (10 prior to unification, 16 since unification) are represented in the 68 member Bundesrat, holding 3 to 6 seats (according to population).

India (1975-1995 Federal)

The 25 states are represented in the 245 member Council of States (Rajya Sabha). The state assemblies choose members. The central government has the ability to impose "Presidential Rule" on the states during periods of turmoil, although this is quite uncommon.

Malaysia (1975-1995 Federal)

Malaysia is coded as a federal system from 1975-1995. The states are represented in the Senate. Sixty percent of the candidates are chosen by state assemblies, which are chosen by election. The remaining 40% of the seats are reserved for minorities. The states also have a suspensive veto (six months) over central government legislation.

Mexico (Federal 1975-1995)

Mexico is coded as a federal system from 1975-1995. The states are represented in the 128 member Senate.

Netherlands (Unitary 1975-1982; Mixed 1983-1995)

Constitutional change in 1983 specified that members of the first chamber are elected by representatives of 12 provincial councils

Nigeria (1975-1977 Mixed; 1978-1983 Federal; 1984-1989 Mixed; 1990-1993 Federal; 1994-1995 Mixed)

Constitutional change in 1978 stated that Senate was elected by the states, until the military government suspended the federal constitution from 1984-1989. In late 1993 the government suspended the parliament.

Pakistan (1975-1984 Mixed; 1985-1995 Federal)

Pakistan is classified as a mixed political system when the federal constitution was suspended from 1973-1984. In 1985 the original constitution was restored where the upper house is indirectly elected by the provinces.

Papua New Guinea (1975 Unitary; 1976-1995 Mixed)

Papua New Guinea is classified as a mixed political system after constitutional change in September 1975. The single-camber parliament, the National Assembly, consists of 80 local, single member constituencies, and 20 provincial constituencies. Each elector has one vote for the local seat and one vote for the provincial seat.

South Africa (1975-1993 Unitary; 1994-1995 Federal)

In 1994 Constitution specifies that the Senate consist of 10 members from each of the 9 regional legislatures.

Spain (Unitary 1975-1978; Mixed 1979-1995)

The 1978 Constitution specifies that 49 of the 257 Senators represent the regions.

Sudan (Mixed 1975-1995)

Sudan formally has a federal constitution that has been changed and suspended from 1975-1995. The size and composition of the unicamerial legislator varied from 1975 to 1985.

Switzerland (Federal 1975-1995)

Switzerland is a federation of 26 cantons. The cantons of a tremendous amount of influence in the central government, indirectly through the Nationalrat, and directly through the use of referenda which can veto central government legislation.

United Arab Emirates (Federal 1975-1995)

This is a federal system of seven sheikhdoms which grant the sheikh heredity rule over his own emirate.

United States (Federal 1975-1995)

The 50 States are represented in the Senate by 2 Senators per state, appointed through direct election.

Venezuela (Federal 1975-1995)

Venezuela is a federal system with each of the 23 states and the Federal District appoints 2 members to the Senate.

Appendix B

Country	System	Entry	Exit
Afganistan	unitary	1975	1995
Albania	unitary	1975	1995
Algeria	unitary	1975	1995
Angola	unitary	1975	1995
Argentina	mixed	1975	1981
	federal	1982	1995
Australia	federal	1975	1995
Austria	mixed	1975	1995
Bahamas	unitary	1975	1995
Bahrain	unitary	1975	1995
Bangladesh	unitary	1975	1995
Barbados	unitary	1975	1995
Belgium	mixed	1975	1995
Belize	unitary	1975	1995
Benin	unitary	1975	1995
Bhutan	unitary	1975	1995
Bolivia	unitary	1975	1995
Botswana	unitary	1975	1995
Brazil	mixed	1975	1981
	federal	1982	1995
Brunei	unitary	1975	1995
Burkina Faso	unitary	1975	1995
Burundi	unitary	1975	1995
Cape Verde	unitary	1975	1995
Cambodia	unitary	1975	1995
Cameroon	unitary	1975	1995
Canada	federal	1975	1995
Central African Republic	unitary	1975	1995
Chad	unitary	1975	1995
Chile	unitary	1975	1995
Colombia	mixed	1975	1990
	federal	1991	1995
Congo, Rep	unitary	1975	1995
Costa Rica	unitary	1975	1995
Cote d'Ivoire	unitary	1975	1995
Cuba	unitary	1975	1995
Denmark	unitary	1975	1995
Djibouti	unitary	1975	1995
Dominican Republic	unitary	1975	1995
Ecuador	unitary	1975	1995
El Salvador	unitary	1975	1995
Egypt	unitary	1975	1995

Ethiopia	unitary	1975	1993
	federal	1994	1995
Fiji	unitary	1975	1995
Finland	unitary	1975	1995
France	unitary	1975	1995
Gabon	unitary	1975	1995
Gambia	unitary	1975	1981
	mixed	1982	1989
	unitary	1990	1995
Germany	federal	1975	1995
Ghana	unitary	1975	1995
Greece	unitary	1975	1995
Grenada	unitary	1975	1995
Guatemala	unitary	1975	1995
Guinea	unitary	1975	1995
Guinea-Bissau	unitary	1975	1995
Guyana	unitary	1975	1995
Haiti	unitary	1975	1995
Honduras	unitary	1975	1995
Hungary	unitary	1975	1995
Iceland	unitary	1975	1995
India	federal	1975	1995
Indonesia	unitary	1975	1995
Iran	unitary	1975	1995
Iraq	unitary	1975	1995
Ireland	unitary	1975	1995
Israel	unitary	1975	1995
Italy	unitary	1975	1995
Jamaica	unitary	1975	1995
Japan	unitary	1975	1995
Jordan	unitary	1975	1995
Kenya	unitary	1975	1995
Korea, Rep	unitary	1975	1995
Kuwait	unitary	1975	1995
Laos	unitary	1975	1995
Lebanon	unitary	1975	1995
Lesotho	unitary	1975	1995
Liberia	unitary	1975	1995
Libya	unitary	1975	1995
Luxembourg	unitary	1975	1995
Madagascar	unitary	1975	1995
Malawi	unitary	1975	1995
Malaysia	federal	1975	1995
Maldives	unitary	1975	1995
Mali	unitary	1975	1995
Malta	unitary	1975	1995

Mauritania	unitary	1975	1995
Mauritius	unitary	1975	1995
Mexico	federal	1975	1995
Mongolia	unitary	1975	1995
Morocco	unitary	1975	1995
Mozambique	unitary	1975	1995
Myanmar	unitary	1975	1995
Namibia	unitary	1975	1995
Nepal	unitary	1975	1995
Netherlands	unitary	1975	1982
	mixed	1983	1995
New Zealand	unitary	1975	1995
Nicaragua	unitary	1975	1995
Niger	unitary	1975	1995
Nigeria	mixed	1975	1977
	federal	1978	1983
	mixed	1984	1989
	federal	1990	1993
	mixed	1994	1995
Norway	unitary	1975	1995
Oman	unitary	1975	1995
Pakistan	mixed	1975	1984
	federal	1985	1995
Panama	unitary	1975	1995
Paraguay	unitary	1975	1995
Papua New Guinea	unitary	1975	1975
	mixed	1976	1995
Peru	unitary	1975	1995
Philippines	unitary	1975	1995
Poland	unitary	1975	1995
Portugal	unitary	1975	1995
Qatar	unitary	1975	1995
Rwanda	unitary	1975	1995
Saudi Arabia	unitary	1975	1995
Senegal	unitary	1975	1995
Sierra Leon	unitary	1975	1995
Singapore	unitary	1975	1995
South Africa	unitary	1975	1993
	federal	1994	1995
Solomon Islands	unitary	1975	1995
Spain	unitary	1975	1978
	mixed	1979	1995
Sri Lanka	unitary	1975	1995
St. Lucia	unitary	1975	1995
Sudan	mixed	1975	1995
Swaziland	unitary	1975	1995

Sweden	unitary	1975	1995
Switzerland	federal	1975	1995
Syria	unitary	1975	1995
Taiwan	unitary	1975	1995
Tanzania	unitary	1975	1995
Thailand	unitary	1975	1995
Togo	unitary	1975	1995
Trinidad and Tobago	unitary	1975	1995
Tunisia	unitary	1975	1995
Turkey	unitary	1975	1995
United Arab Emirates	federal	1975	1995
Uganda	unitary	1975	1995
United Kingdom	unitary	1975	1995
United States	federal	1975	1995
Uruguay	unitary	1975	1995
Vanuatu	unitary	1975	1995
Venezuela	federal	1975	1995
Vietnam	unitary	1975	1995
Yemen	unitary	1975	1995
Zaire	unitary	1975	1995
Zambia	unitary	1975	1995
Zimbabwe	unitary	1975	1995

The Political Economy of Foreign Direct Investment

Chapter 6: The International Monetary Fund and FDI Inflows

I. Introduction

In chapters four and five I demonstrate that domestic political institutions have massive effects on flows of foreign direct investment. This chapter explores how international institutions, specifically the International Monetary Fund, affects inflows of FDI. International and domestic political institutions affect a country's ability to credibly commit to a specific policy equilibrium. In this chapter I argue that IMF agreements lead governments into taking policy positions that are not conducive to multinational investments, culminating in lower levels of FDI inflows. This deeper understanding of the role of the IMF on multinational corporations is the last key element of understanding the political determinants of FDI inflows.

This study on the IMF's effect on FDI inflows can also contribute to a deeper understanding of the IMF's impact on developing countries. There is a proliferation of work on the effects of International Monetary Fund programs on macroeconomic performance. This work has focused almost exclusively on the effects of IMF programs on economic growth, balance of payments, inflation, or in some cases portfolio capital flows. Few studies to date examine the impact of IMF programs on FDI. Does the IMF generate higher levels of confidence in a host government once an agreement has been signed? This question has obvious academic and public policy ramifications.

Most scholars would argue that IMF programs, and IMF conditionality, have a positive effect on FDI inflows. Ceteris paribus, countries in financial crisis improve their ability to attract FDI inflows by signing IMF agreements. These agreements provide

badly needed capital, and more importantly a commitment to market promoting economic reform. Conventional wisdom would lead us to believe that IMF programs should be associated with higher inflows of FDI, when we control for the factors that lead countries to seek financing from the IMF.

In this chapter I argue that there are a number of strong theoretical reasons why IMF programs could have a negative impact on FDI inflows. In essence, although IMF conditionality undoubtedly entails a commitment to a specific package of economic reforms, the value of these reforms to multinationals is debatable. IMF agreements, and IMF conditions, may have negative consequences on multinational investors.

First, these reforms may have a negative impact on overall macroeconomic conditions. Economic reforms imposed by the IMF can harm the domestic economy, leading to lower levels of economic growth and a higher potential for economic crisis in the future. Essentially, countries signing IMF agreements may be locking themselves into an inefficient policy equilibrium.

Secondly, IMF conditions may impose costs directly on multinational corporations. In many cases, IMF conditionality could lead to lower levels of market promoting public goods as countries attempt to meet spending and deficit requirements by reducing spending on education and infrastructure. IMF conditions could also lead to an increase in rates of capital taxation or tariff duties. In either case, IMF programs could generate conditions that harm multinational corporations beyond the effect on the domestic market.

With these multiple channels though which IMF programs could affect the attractiveness of countries to multinationals, I argue that the overall relationship is an

empirical question. In section IV I test the effects of IMF programs on FDI inflows by utilizing a Heckman selection model for 68 countries from 1970-1998. I find that IMF programs are associated with lower levels of FDI inflow.

This chapter is outlined as follows. Section II will very briefly outline the history of the IMF and discuss IMF conditionality. In Section III I explore the potential impact of IMF programs and conditions on flows of foreign direct investment. I construct a series of empirical tests of the effects of IMF programs on FDI inflows in Section IV. Finally, Section V concludes.

II. The IMF: Structure, History, and Conditionality

The IMF, and its sister institution, the World Bank, were created as part of the Bretton Woods agreement at the end of the Second World War. The World Bank was designed as an institution to funnel economic assistance into developing countries, specifically by making project finance available to countries unable to attract capital through market mechanisms.[134] The IMF, on the other hand, was originally envisioned as an institution to oversee the fixed exchange rate arrangements between countries and to provide short-term capital for balance of payment crises.[135]

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[134] De Gregorio et. al. (1999) argue that with the availability of capital to most middle income countries, the role of World Bank has shrunk considerably in recent years.

[135] Throughout this chapter I admittedly ignore the complex governance structure of the IMF, instead simply discussing the IMF as a single international organization. In reality the mechanism for governance of the IMF is relatively complex. Oversight of the IMF is done by the Interim Committee, but the final authority rests with the Board of Governors, which consists of the 182 finance ministers and leaders of central banks. Most regular

The collapse of the Bretton Woods exchange rate mechanism, coupled with the largely unforeseen explosion in world capital markets, threw the IMF into uncharted territory. The seemingly automatic role of the IMF slipped further into the realm of the subjective after the end of the system of fixed exchange rates. The IMF continued to function as the "lender of last resort", but the role was fundamentally altered under the complex web of fixed and floating exchange rates post 1971. This necessitated a fundamental shift from the management of fixed exchange rates to the "firm surveillance" of countries' exchange rate policies (James 1996, 592).

Originally the role of IMF was viewed as almost an automatic response mechanism in the management of fixed exchange rates. With a fixed exchange rate system, "inappropriate policies" would trigger balance of payments deficits (James 1996, 588). Domestic governments would be pressured (both by markets and the IMF) to alter policies to fix these imbalances. IMF funding would then provide short-term support for these fiscal imbalances.

With the end of the era of fixed exchange rates, the IMF continued to function as the lender of last resort, but this role become exceeding difficult and complex. Countries

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activities of the fund are done through the Executive Board, which uses of systems of weighted voting to make decisions. This system of weighted voting allocates votes to countries according to their economic size, renegotiated every 5 years. Since most major decisions are made through votes that necessitate 85% of all votes, the economic superpowers have tremendous leverage in stalling any proposed measures. The United States alone, with over 15% of the votes, has the ability to unilaterally defeat any proposal.

in the new financial system would often run current account deficits, but it became imperative for the IMF to distinguish if these deficits were due to short-term fluctuations or misguided economic policies. The IMF had to shift from loaning countries capital to managing short-term imbalances, to examining the economic policies of host countries to determine 1) if the shortage of capital were due to fluctuations or policy, and 2) what type of policies would ensure economic recovery. Thus the organization's concerns shifted from simply current account deficits to overall macroeconomic performance.

With this shift in organizational focus came a shift in IMF conditionality. IMF conditionality is simply the set of policies or "conditions" that the IMF requires in exchange for funding.[136] If these conditions are not met, future disbursements of IMF funds may be withheld. In terms of assuring repayment of the loan, conditionality can serve an important function. In private lending markets, creditors require some form of collateral to ensure that the loan is paid off. For obvious reasons the IMF does not require collateral, rather it requires the government seeking financing to take actions to correct macroeconomic imbalances, thus increasing the probability that the loan will be repaid.[137] In this regard, macroeconomic reforms serve as "collateral" for IMF loans.

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[136] IMF conditionality became part of the IMF's lending scheme in 1952 (Sidell 1988), later being codified in the charter in 1968. After the 1976 Annual Meeting, the concept of conditionality further evolved and was defined in the 1979 IMF Guidelines on Conditionality, it was called "strict conditionality" (James 1996, 322-323). These conditions became more detailed in the 1960s and 1970s.

[137] See Khan and Sharma (2001).

Conditionality is a complex and changing concept. There is a growing consensus that the balance of payments position of a country is strongly related to the overall macroeconomic environment. Recognizing this, the IMF has broadened the concept of conditionality to include macroeconomic reforms that are not directly related to the balance of payments position. Killick (1995, 25) argues this has lead to a dramatic shift to "structural conditionality" in recent years and that three main objectives of IMF conditionality have emerged:[138]

1. To increase the role of markets and private enterprises relative to the public sector and to improve incentive structures.
2. To improve the efficiency of the public sector.
3. To mobilize additional domestic resources.

Conditionality is practically enforced through the Fund's "standby arrangements" and "extended fund facility"- essentially loans that were meant for longer terms of support. Thus the IMF ties the meeting of specific conditions with future disbursements of the agreed upon loan. In the words of the IMF, "If the executive directors are satisfied that the reforms will solve the problem, the loan is disbursed in installments (usually over one to three years) tied to the member's progress in putting the reforms into effect. If all goes well, the loan will be repaid on time, and the member, with necessary reforms now in place, will come out of the experience economically stronger" (IMF 1998, 19).

The IMF maintains that conditionality is not a set of ridged criteria, but rather is guided by a set of general conditions. The IMF executive board's criteria are as follows:

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[138] Other scholars argue for a greater differentiation in the level of conditionality. See Dell (1982) and Williamson (1983).

- Encourage members to adopt corrective measures at an early stage.
- Stress that the IMF pay due regard to members' domestic social and political objectives, as well as economic priorities and circumstances.
- Permit flexibility in determining the number and content of performance criteria.
- Emphasize that IMF arrangements are decisions of the IMF that set out—in consultation with members—the conditions for its financial assistance. (IMF 1999b, 68).

In practice, the IMF focuses on a number of specific macroeconomic policies. Although the conditionality of Fund lending is generally not made publicly available, the general consensus is that the Fund focuses on control the size of the budget deficit. This leaves the politically sensitive issues of cutting spending or raising taxes to domestic governments (Kruger 1988). The IMF has been specific about their criteria in other areas beyond the budget deficit, such as their insistence on trade reform and liberalization.

These conditions, along with the funds made available through the IMF, can potentially have major effects on domestic economies. The next section examines the impact of IMF programs affect foreign investors.

III. The International Monetary Fund and FDI

To date there are no studies of the effects of IMF programs on foreign direct investment. This omission in the literature is striking, given the vast econometric literature on the importance of FDI for developing countries, and the growing literature on the effects of IMF programs on economic growth. Understanding the effects of IMF programs on FDI inflows is an important public policy question, as countries in economic crisis attempt to calm foreign investors. Equally important, by understanding firms'

responses to IMF programs, we might have more insight as to the overall effects of IMF programs on macroeconomic performance. Do firms perceive IMF programs as increasing the attractiveness of a host country's market and business climate?

There a number of mechanisms through which IMF programs could affect FDI inflows. These mechanisms span from indirect effects through macroeconomic conditions, to more specific effects such as stability of policy towards multinational corporations.[139] These mechanisms are discussed in the section below.

Overall Macroeconomic Performance

The first obvious link between FDI and IMF programs is the role of the IMF in stabilizing countries in crises. Multinationals want to invest in stable economies for production either for the domestic market or export. In both cases an economy with a stable economy and a growing domestic market are preferred.[140]

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[139] Another possibility is that signing of IMF agreements signals the desperation of both the government and the IMF. As showed by Frankel and Schmukler (1996), information cascades explains why international investors carefully watch the reactions of domestic investors. By this same logic, international investors can also watch the actions of the host governments as a predictor of the future macroeconomic environment. The signing of an IMF agreement could signal that the host government predicts a future economic crisis.

[140] One case of economic instability increasing FDI inflows is the case of "fireside FDI" after a currency devaluation. See, Krugman (2000).

The most obvious link between IMF loans and macroeconomic performance is the effect of IMF programs on the current account balance and overall balance of payments. In a comprehensive survey Haque and Khan (1998) find that in most studies the IMF helped improve both of these variables. Przeworski and Vreeland (2000) find more mixed results, sighting the work of Reichmann and Stillson (1978) and Connors (1979) as examples of studies that find IMF programs have no effect on the balance of payments.

Even less clear is the impact of IMF programs on economic growth. The most recent contribution on the subject can be found in Vreeland (2002). Using a dynamic bivariate probit model with partial observability, Vreeland finds that when both observed and unobserved selection factors are controlled for, IMF programs are associated with lower levels of economic growth.[141] This result confirms the early result from Vreeland and Przeworski (2000) on the negative impact of IMF participation on economic growth.[142]

One compelling argument on the link between IMF programs and weak macroeconomic performance is that IMF simply gets the prescriptions wrong. The IMF

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[141] This model uses a version of a dynamic probit model to predict IMF participation. In this dynamic, bivariate probit, Vreeland controls for selection both 1) the types of countries that seek IMF support and 2) the types of countries that receive support. In the real world we only observe when a country is either under an IMF agreement (both condition 1 and condition 2 are satisfied) or when a country is not under an agreement (either one or both conditions have not been fulfilled).

[142] Even some IMF research showed programs could have a negative impact on output (Kahn et. al. 1986, Vines 1990)

is an international organization that attempts to monitor the economic conditions of over 180 countries with a modest budget and staff. James (1996) argues that the Western educated elites at the IMF could be unfamiliar with local economic conditions, cultures, and environments.

Jeffrey Sachs provides an interesting example of the IMF's inability to predict the Asian Financial Crisis:

> Consider what the fund said about Korea just three months ago (September 1997) in its 1997 annual report. 'Directors welcomed Korea's continued impressive macroeconomic performance and praised the authorities for their enviable fiscal record.' Three months ago there was not a hint of alarm, only a call for further financial sector reform—incidentally without mentioning the *chaebols* (conglomerates) or the issue of foreign ownership of banks or banking supervisions that now figure so prominently in the IMF's Korea Program.
>
> In the same report, the IMF had this to say about Thailand, at the moment on the edge of the financial abyss. "Directors strongly praised Thailand's remarkable economic performance and the authorities' consistent record of sound macroeconomic policies."
>
> With a straight face, Michel Camdessus, the IMF managing director, now blames Asian governments for the deep failures of macroeconomic and financial policies that the IMF has discovered. It would have been more useful, instead, for the IMF to ponder why the situation looked so much better three months ago, for therein lies a basic truth about the situation in Asia. (Sachs 1999: 116-117)

This lack of understanding of this financial crisis ultimately led to bad public policy prescriptions, such as pushing for a fiscal policies that were "too tight" (Lane et. al. 1999).

The G-24 summarizes their view of the effects of IMF programs:

> The experience of developing countries that have undertaken Fund supported adjustment programs has not generally been satisfactory. The Fund approach to adjustment has had severe economic costs for many of these countries in terms of declines in the levels of outputs and growth rates, reductions in employment and adverse effects on income distribution. A typical Fund program prescribes measures that require excessive compression of domestic demand, cuts in real wages, and reductions in government expenditures; these are frequently accompanied by sharp exchange rate depreciation and import liberalization measures, with due regard to their potentially disruptive effects on the domestic economy. (G-24 1987, 9)

At best, there is no conclusive evidence that IMF programs have a major positive impact on macroeconomic performance. At worst, IMF programs are associated with worse macroeconomic performance.

Political Stability

Another potential argument is that signing of IMF agreements with conditionality may entail political costs for domestic governments. In exchange for IMF funds recipient governments are essentially sacrificing policy autonomy. The contractionary policies prescribed by the IMF can cause political costs for host governments.[143] Citizens may take to the streets or punish governments at the polls. The signing of IMF agreements may trade an increase in economic stability with a potential increase in political instability. This overall relationship is complex, in some cases IMF loans can stabilize economies and provide citizens with an improved economic environment, in other cases the IMF imposed conditions can cause political instability.

One possible scenario is that a developing country may have a sustainable fiscal deficit, but IMF conditionality forces a lowering of the real urban wage (via devaluation) that may cause political protects (Bird 1995). This is in line with Pastor (1987) and Vreeland's (2002) findings that IMF programs are associated with a decline in labor's share of national income. Given this relationship, Sidell (1988) surprisingly finds little effects of IMF programs on political stability from 1976-85.

Political stability is not the same as political risk. Even if IMF programs do not generate large street riots, they may have political consequences that are perceived as

[143] The political costs to reform can be extremely high in countries with a high debt overhand. See, Sachs (1989) and Krugman (1988).

negative my multinational investors. One distinct possibility is that IMF programs could increase the level of leadership turnover as political leaders are replaced in electoral backlashes against the prescribed IMF conditions.[144] There is little support in the empirical literature to support this higher leadership turnover position. Killick (1995) argues that in more cases than not, IMF programs helped existing governments to maintain in office than to increase the slide out of power. A similar conclusion was drawn by Sidell (1988). Overall there seems little conclusive evidence that IMF programs are political destabilizing.

Country Credibility

Although many believe IMF policies are generally believed to be market promoting, the effects of IMF agreements are strictly an empirical question. Financial markets, in this case FDI flows, should provide the answer as to if these reforms are valued by foreign investors. Economic reforms that will stabilize the economy and provide the foundation for robust future macroeconomic performance should be valuable to multinational corporations. Countries that sign IMF agreements should then be associated with higher FDI inflows.

Alternatively, IMF programs could be associated with worse overall macroeconomic performance or may directly have a negative impact on multinational

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[144] This leadership turnover has been mentioned as an important component of economic reform. Stanley Fisher, the first deputy manager of the IMF during the Asian Financial Crisis once stated, "It is worth noting, that our programs in Asia—in Indonesia, Korea, and Thailand—only took hold after there was a change in government". (Quoted in Sanger 1999).

firms. Although, on the surface this explanation may sound farfetched, there is some reason to believe that the negative impact of IMF polices is a distinct possibility. IMF programs are designed for fiscal solvency, not for attracting FDI inflows. IMF conditional often prescribes austerity packages that may impose political and economic costs on domestic economies, and multinational corporations.[145]

For example, IMF conditionality may impose spending constraints on domestic governments. Governments must slash government spending to conform to agreed upon budget deficit levels. The IMF has even become active in discussing the composition of government spending, even in areas as politically sensitive as military spending (Killick 1995, 20). This decrease in spending can translate into a lower provision of public goods, such as decreased spending on education and physical infrastructure. These public goods are valuable to multinationals operations, and to the domestic market generally.

Alternatively, the controlling of budget deficits could be done through increased levels of taxation, such as in the IMF lobbying for increases in the value-added tax under Argentina's Menem administration (Bandow 1994).[146] In both cases, IMF conditionality could lead to policies that would have a negative impact on firms.

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[145] In a recent work Przeworski and Vreeland (2000) found that IMF policies lead to lower levels of long-run economic growth for countries.

[146] Another possibility is that developing countries dependent on tariffs for government revenue may see a marked decease in revenues during a devaluation. Government deficits will rise further or the burden of taxation must be shifted to another source.

Overall Effects on FDI

If IMF programs are market promoting, multinational corporations should prefer to invest in countries under IMF agreements, holding all political and economic factors equal. IMF agreements could then produce "catalytic effects" on financial markets, where IMF could restore confidence and lead to higher levels of FDI inflows.[147] Conversely, IMF could lead to lower levels of FDI inflows by either imposing costs directly on multinationals or by indirectly effecting multinationals by worsening the macroeconomic performance of the country.

Although no studies to date empirically test the effects of IMF programs on FDI inflows, a number of empirical tests provide some insights on the effects of IMF programs on financial markets. Hajivassiliou (1987) and Faini et. al. (1991) find either a negative or no relationship between IMF programs and flows of private debt. In essence, the IMF programs did not restore the credibility of these countries in the eyes of international lending markets.

This chapter empirically assesses the impact of IMF programs on FDI inflows in 68 countries from 1970-2000. Any empirical test on the effects of IMF programs suffers from a number of potential empirical pitfalls. The most important of these issues, best documented by Vreeland (2002) is the selection bias of participation in IMF programs. Obviously not all countries request (and obtain) IMF funds, only countries facing specific macroeconomic problems are able to obtain IMF funding. These selection issues must be incorporated into any serious economic study of the effects of IMF programs.

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[147] Bird and Rowlands (1997), Krueger (1998), and Rodrik (1996) are all critical of these catalytic effects.

The preferred method of controlling for this selection bias is a Heckman selection model. I draw extensively from the work of Przeworski and Vreeland (2000) and Vreeland (2002) on the proper method of correction for this selection bias. The major contribution of this chapter is the application of the selection method to the problems of explaining flows of foreign direct investment. The central question tackled in this chapter is: What are the affects of IMF programs on FDI inflows?

IV. Empirical Analysis

Although the policies prescribed by the IMF are assumed to be market promoting, the effect of IMF agreements is strictly an empirical question. Financial markets, in this case FDI flows, should provide the answer as to if IMF reforms are valued by foreign investors. Economic reforms that will stabilize the economy and provide the foundation for robust future macroeconomic performance should be valuable to multinational corporations. Countries that sign IMF agreements should then be associated with higher FDI inflows.

To test the effects of IMF programs on FDI inflows I add a simple measure of a countries involvement with the IMF to the baseline regressions from Chapter IV. This variable, IMF Participation, simply measures if a country is currently under an IMF agreement at any time during the year. This variable was constructed by Vreeland (2002) and provides a dichotomous measure of IMF participation for 183 countries from 1970-2000.

I make no attempt to differentiate between different types of IMF agreements or the actual conditions imposed. As a first cut I simply examine the relationship between IMF participation and net FDI inflows. In Table I, I present a standard OLS with panel

corrected standard errors regression using the same baseline, random effects model as I used in Chapter 4.

Due to data limitations on IMF participation, the number of countries in the sample has been reduced drastically. For some variables, such as the level of democracy, the signs remain the same as the earlier regressions, but they are no longer significant.[148] For our important variable, IMF participation, I find that countries under IMF agreements attract lower levels of FDI inflows.

Insert Table I

The findings using a standard Ordinary Lease Squares regression are not surprising. There is a tremendous selection bias in the countries that participate in IMF programs. Not all countries are equally likely to participate in IMF programs. For example, Bird (1995) argues that poor counties are much more likely to seek IMF funding, where these poor countries often hold lower percentages of foreign reserves, are more likely to have balance of payment deficits, and generally have higher foreign debts.

Even more importantly, countries in serious financial crises, those with adverse conditions for foreign investors, are also more likely to seek IMF support. If this IMF variable is simply a proxy for "financial crises" then the standard OLS regressions do not accurately portray the effects of IMF programs on FDI inflows. Only by properly controlling for these selection effects can we explore the real relationship between IMF flows and multinationals investment decisions.

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[148] This result is explained by the decreased number of observations and the lessened variation in the measure of democracy in countries that seek IMF funding.

To control for these selection effects, I build upon the empirical techniques used by Przeworski, Alvarez, Cheibub, Limongi (2000) and Vreeland (2002). Most similar to this problem, Vreeland (2002) uses a number of advanced Heckman models to control for the selection effects of participation in IMF programs.

I use the simplest variant of this family of models, a static Heckman selection model that predicts participation in IMF programs using a recipient country's economic performance and political institutions. Essentially I construct a probit model using IMF participation as the dependent variable, generate a predicted IMF participation variable, and use this variable to examine the selection corrected effects of IMF participation on FDI inflows.

Insert Table II

Table II presents a probit analysis of the determinants of IMF participation for 68 countries from 1970-2000. The dependent variable is participation in IMF programs and all independent variables are lagged one year. The strongest predictor of IMF participation is past participation in IMF programs. Countries that already are under IMF agreements are more likely to continue or sign onto two agreements. One important reason is that a country that has entered into an IMF agreement may continue with the IMF agreement since economic conditions may not have improved. The conditions that drove the country to seek IMF funding may still persist.

Another explanation is forwarded by Vreeland (2002). Vreeland argues that signing IMF agreements entail sovereignty costs for the domestic government. By agreeing to IMF financing, the country has bowed to a number of IMF conditions. The country is now constrained in their macroeconomic policies. Once a government has

already paid these sovereignty costs (by singing an agreement last year) the marginal cost of another IMF agreement, and set of conditions, is relatively low.

Beyond recidivism I find that the total debt burden of the government and the level of foreign exchange reserves are important predictors of IMF participation. Countries with low levels of foreign exchange reserves and high debt burden are more likely to seek and obtain IMF financing.

Similar to Vreeland (2002), I find that the level of economic development and inflation are not significant determinants of IMF participation. Contrary to Vreeland (2002) I find the levels of economic growth is a significant determinant of IMF participation. Countries with lower levels of economic growth are more likely to obtain IMF funding.

Interestingly, I find that political regimes, the existence of democracy, does not affect IMF participation, contrary to Vreeland (2002). This difference can be explained by the different regression model employed. Vreeland (2002) argues that the sovereignty costs of signing IMF agreements are especially high for democratic leaders, leading democratic countries to be less likely to seek IMF funding. But, Vreeland argues that political regimes are not a significant factor in the continuation of IMF programs and that only economic factors explain a countries continuation in IMF agreements

In Table III I present the predicted values of country participation in IMF programs for 916 observations using the model in Table II. The model does a reasonably job in predicting participation in IMF programs. Out of the 464 observations of IMF agreements, this model accurately predicts participation in 374 of these cases. In the 453 countries years of non-participation in IMF programs, this model accurately predicts 393

of these cases. Overall, this model accurately predicts over 83% of the cases in the sample.

Insert Table III

Next I produce a Heckman selection model using the selection equation from Table II and the standard FDI determinant equation from Chapter III. This model uses predicted values of IMF participation to find the true effect of IMF agreements on FDI inflows. Table IV presents the empirical results.

Insert Table IV

In these regressions, most of the results on the control variables remain unchanged. Using the predicted IMF participation variable, I find that the OLS results are indeed biased and have understated the true impact of IMF programs on FDI inflows. IMF participation, when I control for selection, is both negatively and statistically significant.

These results are substantially large. The average level of FDI inflows in this sample is roughly 1.3% of GDP. The estimated difference in FDI inflows between countries under IMF agreements versus those countries not under roughly amounts to a difference of 0.35% of GDP. Countries under IMF agreements, ceteris paribus attract over 25% less FDI than countries that opt not to seek IMF financing. IMF programs agreements lead to substantially lower levels of FDI inflows.

Conclusions

International organizations ranging from regional trade agreements such as NAFTA, to more integrated regional economic and political organizations such as the European Union, to international trade associations such as the World Trade Organization

can have dramatic effects on domestic economies and international flows of goods, services, and capital. Understanding the impact of these institutions on macroeconomic performance has important academic and public policy ramifications.

In this chapter I explore the effects of International Monetary Fund Programs on inflows of foreign direct investment. Theoretically there are distinct arguments that could both link IMF programs to either higher or lower levels of FDI inflows. On one hand, IMF programs may prescribe economic reform packages that are conducive to multinational investors, leading to higher levels of economic stability and strong macroeconomic performance. Conversely, these IMF reform packages could lead to worse macroeconomic performance and higher levels of economic and political instability. Most specific to multinationals, IMF conditionality could lead to an under provision of market enhancing public goods.

In the empirical section of this chapter, after controlling for selection, I find strong evidence linking IMF participation to lower levels of FDI inflows. Countries in economic crisis that turn to IMF support inhibit their ability to attract multinational investors. These results help illuminate a new set of challenges for countries in financial crisis that are attempting to calm foreign investors. IMF support, sometimes essentially to crisis prevention and alleviation, leads to policies that decrease inflows of foreign direct investment.

Table I: The Effects of IMF Programs on FDI Inflows

Variable	Coefficient (T-Stat)
Lagged FDI	0.543***
	(18.005)
Development Level	0.179*
	(1.911)
Market Size	-0.044
	(-0.943)
GDP Growth	0.042***
	(3.833)
Trade	0.007***
	(3.266)
Regime	0.004
	(0.481)
Budget Deficit	0.001
	(0.076)
Government Consumption	-0.015
	(-1.190)
IMF Participation	-0.119
	(-1.068)
Time Dummies	Yes
Number of Countries	68
Number of Observations	796

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table II: The Determinants of IMF Participation

Variable	Coefficient (T-Stat)
Lagged IMF Participation	1.947***
	(18.221)
Political Regime	0.007
	(0.765)
GDP Per Capita	0.014
	(0.179)
GDP Growth	-0.024**
	(2.117)
Budget Deficit	-0.004
	(-0.381)
Central Government Debt	0.016***
	(3.759)
Market Size	-0.675
	(-0.499)
Inflation	-0.580
	(0.562)
Domestic Investment	-0.010
	(0.218)
Foreign Reserves (Months of Exports)	-0.0826***
	(-3.762)
Constant	-0.242
	(-0.264)
Number of Countries	69
Number of Observations	916

***=99% confidence level
**=95% confidence level
*=90% confidence level

Table III: Actual Participation vs. Predicted Participation in IMF Programs

	Actual			Total
		Yes	No	
Predicted	Yes	374	60	434
	No	90	393	483
		464	453	

Table IV: The Effects of IMF Programs on FDI Inflows

Variable	*OLS*	*Heckman*
Past FDI	0.543***	0.540***
	(18.005)	(18.086)
Development Level	0.179*	0.177*
	(1.911)	(1.903)
Market Size	-0.044	-0.050
	(-0.943)	(-1.072)
GDP Growth	0.042***	0.042***
	(3.833)	(3.857)
Trade	0.007***	0.007***
	(3.266)	(3.177)
Regime	0.004	0.004
	(0.481)	(0.504)
Deficit	0.001	-0.003
	(0.076)	(-0.221)
Government Consumption	-0.015	-0.017
	(-1.190)	(-1.329)
IMF Participation	-0.119	-0.356**
	(-1.068)	(-2.120)
Time Dummies	Yes	Yes
Number of Countries	68	68
Number of Observations	796	796

Note: Rho 0.168 (0.088), Sigma 1.492 (0.0378), Lambda 0.250 (0.132)

***=99% confidence level
**=95% confidence level
*=90% confidence level

Chapter 7: Conclusion

I. Introduction

This dissertation has focused on the economic, political, and policy factors that influence foreign direct investment across countries. Understanding these determinants of FDI are important in understanding how to attract capital flows, capital flows that have become associated with higher levels of economic growth, employment creation, and technology transfer. As countries in the developed and developing world embrace foreign investment promotion strategies as part of a larger strategy of macroeconomic development, an understanding of the determinants of FDI inflows has important academic and public policy ramifications.

These capital flows also serve as a barometer of firms' perceptions of domestic governments' policies and institutions. By exploring how capital flows react to policies and institutions we can develop a greater understanding of how politics and policy affect macroeconomic performance generally.

Finally, and perhaps most timely, as protestors and citizens have become increasingly disenchanted with the activities and actions of multinational corporations abroad, a deeper understanding of multinationals and their investment decisions becomes increasingly important. Only by understanding multinationals and their investments can we learn how to maximize the benefits of multinational production and to minimize the adverse effects.

In this study I generated four sets of empirical tests of the determinants of FDI inflows. First I explore the fiscal policy determinants of FDI, then three chapters on the

institutional determinants of FDI inflows. The results are discussed in the following sections.

II. Economic Policy: Race to the Bottom

According to the "race to the bottom" perspective, multinationals search the world for investment opportunities, playing governments against one another, entering and exiting domestic markets at will in an attempt to obtain higher returns. I argue in Chapter II and Chapter III that this view of perfect capital mobility -- of frictionless investment across national borders -- is inconsistent with decades of research on FDI that has focused on *imperfect* market approaches to the study of multinational firms. The race to the bottom thesis is based on this myth of perfect capital mobility.

In Chapter III, I explore the fiscal competition between 15 OECD countries and the impact of these policies on FDI inflows. My results are as follows:

- Levels of government consumption *across* countries has no impact on FDI inflows, while here is some evidence that a decreasing of the level of government consumption, *within* a country, can increase FDI inflows.
- The level of social security transfers has no impact on FDI inflows.
- Levels of capital taxation have little impact on FDI inflows.
- There is no evidence that FDI flows react positively to a shift in taxation from capital to labor.
- There is no evidence that left governments decrease inflows of FDI.

In summary, this dissertation finds practically no support for the race to the bottom thesis.

III. Political Institutions as a Commitment Mechanism

As I outlined in Chapter II, multinational investments, while relatively liquid ex ante, are much more illiquid ex post.[149] Once a multinational corporation has committed resources to an investment location, the investment is relatively immobile. Although multinationals may have considerable bargaining power prior to investment, a large degree of power shifts to the host government once the investment has been made.

This ex post immobility of multinationals forces firms to try to predict the future policies of host governments. Politicians may make attempt to make assurances on future policies, but governments have the incentive to change policy once a multinational has committed substantial resources to the project. Governments that can credibly commit to a specific policy equilibrium, ensuring policy stability, should attract higher levels of FDI by lowering political risks for multinationals. More importantly, governments that can commit to market friendly policies can assure multinationals of a favorable policy environment for their operations. This ability to provide multinationals assurances on future policy is central to attracting FDI. Political institutions can serve as these commitment mechanisms. I identify three sets of institutions that could affect FDI inflows: democratic institutions, federal institutions, and the International Monetary Fund.

IV. Democratic Institutions

Scholars and pundits assume that multinational prefer to invest in dictatorships. They argue that dictators are not responsible to an electorate, allowing authoritarian

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[149] Even this assumption that multinationals are liquid ex ante is questionable. The study of MNEs has focused on imperfect market approaches. See Chapter II.

leaders more room to maneuver and negotiate with multinationals. Even if one assumes the argument that multinationals may prefer to bargain with authoritarian leaders, there are a number of other channels through which democracy could affect FDI inflows.

Profit-maximizing multinational enterprises will weight the varying factors that impact operations in host countries. Contrary to the pessimism about the link between authoritarian regimes and foreign direct investment, in this dissertation I identify three mechanisms, information, representation, and policy credibility, through which democratic institutions would be the preferred institutional structure for their investments, and argue that the last of these mechanisms, the role of political institutions on government policy, have large influences on FDI inflows. These three mechanisms are:

Information: Multinationals are attracted to democratic countries because of the better information available on government policy and current political and economic conditions.

Representation: Foreign investors can more easily influence policy in democracies through institutionalized mechanisms than in authoritarian regimes. MNC's may find vested interests in democratic systems already in place.

Policy Credibility: Commitment to Stability and Policy Content: Although the effects of democracy on information and representation are important, this dissertation stresses the policy enhancing nature of democracy. Two sub-mechanisms provide multinationals with market-promoting policies.

1. One mechanism that leads democratic governments to higher levels of credibility in terms of economic policy is based on the number of veto

points in a democratic political system. Democratic governments have these institutional constraints in place, making the possibility of policy reversal more difficult. Multinationals investing in large illiquid projects will prefer to invest in countries where there is a lower probability of policy reversal once the investment has been made.

2. Even more important for multinationals, democratic institutions provide multinationals benefits through the existence of "audience costs". If governments make agreements with multinational firms and renege on the contracts after the investment has been made, democratic leaders suffer electoral costs. The potential for these electoral backlashes constrain democratic leaders in their policies toward multinational corporations. Democratic governments may provide more market friendly policies.

Given the market promoting nature of democratic institutions I predict that democratic nations will attract higher levels of FDI than their authoritarian counterparts. I test this theory in Chapter IV using cross-sectional, time-series-cross-sectional, and Heckman selection regressions on the determinants of FDI inflows.

- The first set of regressions utilizes cross-sectional data for 80 countries on the determinants of FDI in the 1990s. These regressions find that democratic political institutions are associated with as much as 60% more FDI flows than authoritarian regimes. These results are robust when other political factors are controlled for.
- The second set of regressions utilizes panel data to explore the effects of democratic institutions on FDI inflows from 1970-1998 for over 100

countries. In this set of tests I construct a number of Ordinary Least Squares regressions with robust standard errors using annual FDI inflows as a percentage of GDP as the dependent variable. As with the cross-sectional results, these panel regressions find that democratic institutions have a positive and statistically significant affect on FDI inflows. The magnitude of these flows is massive, democratic institutions attract almost 70% of FDI as a percentage of GDP. The cumulated effect of democratic institutions after 10 years of continuous democracy amounts to an added stock of FDI of roughly 20% of GDP.

- The third set of empirical tests corrects for the selection bias in democratic institutions by utilizing a modified Heckman selection model, controlling for the limited number of observations of democracies in these low-income countries. I find that the OLS regressions were biased and that the effects of democratic institutions on FDI are vastly underestimated. The selection corrected estimates of the effects of democracy are roughly three times larger than the OLS results. Democratic institutions have an even more massive positive effect on FDI inflows than originally estimated.

In a final set of empirical tests I explore the credibility enhancing nature of democratic institutions by exploring the effects of democracy on country sovereign debt ratings for 80 countries from 1980-1998. The empirical results find a strong positive and statistically significant effect of democracy on sovereign debt ratings. In summary democratic institutions are associated with higher levels of FDI inflows and lower levels of sovereign debt risk.

V. Political Federal Institutions

I established in Chapter IV that federal institutions can be associated with higher flows of FDI. Federal institutions can provide benefits to multinationals by enhancing policy stability and providing multinational friendly policies. Subnational actors can potentially provide veto points within the political system that enhances the credibility of host governments. The value of these "veto points" depends on the exact type of federal institutions.

I argued that a careful theoretical distinction between political federalism, political decentralization, and fiscal federalism that must be developed to understand the independent effects of these institutions on multinational production.

The working definitions of these three concepts are summarized as:

1. Fiscal Federalism: Subnational units are given primary responsibility of spending and raising revenue. These units have primary responsibility of regulating economic activity within their subnational territorial area.
2. Political Federalism: Subnational units do not have the primary responsibility of taxing and raising their own revenue but do have a hand in crafting national policy. Subnational units are involved (in ways that will be described later) in legislation at the national level.
3. Political Decentralization: Subnational units are given autonomy over policy within their subnational territorial unit, short of taxing and spending their own revenue. Subnational units have no role in the crafting of national policy.

I argue that in politically federal systems, subnational units can provide a de facto veto on central government legislation. This increase in the number of veto players

provides higher levels of policy stability in a Tsebelis style framework. More importantly, I argue that these veto players in federal systems have the incentives and the power to protect the operations of multinational firms. .

In a simple model constructed in Chapter IV, I show that these differing incentives of the central government and subnational governments can provide multinationals with a credible commitment to market friendly policies. This "market preserving federalism" only occurs with system where the power of taxation is left to the central government and subnational units have some degree of political power. Only *politically* federal systems provide commitments to market promoting polices. These political systems attract higher levels of FDI

Empirically I find strong evidence that the effects of political federalism on FDI are positive and statistically significant. Politically federal countries attract higher levels of FDI, even when other political and economic factors are controlled for. The effects on fiscal federalism are neither consistently positive nor are they statistically significant. In a test of sovereign debt ratings I find that both political and fiscal federalism are associated with higher sovereign debt ratings.

VI. The International Monetary Fund

Although domestic political institutions can have major effects on government policy, and ultimately FDI, international institutions can also affect policy in ways that affect FDI inflows. In chapter VI I explore the effects of signing agreements with the International Monetary Fund on FDI inflows. Countries in severe economic crisis turn to the IMF for "lender of last resort" funds. These funds are often provided with explicit

IMF conditionality, where disbursements of IMF funds are contingent on specific macroeconomic reforms.

The signing of a loan agreement with the International Monetary Fund can provide international investors with a limited credible commitment to a specific package of future economic policies. Countries signing IMF agreements face more than just reputation costs, they will incur actual fiscal costs in terms of lower levels of funding from the IMF for reversing policy. IMF packages should decrease the level of policy instability.

Unlike democratic institutions and federal institutions, IMF packages, while decreasing policy instability, do not ensure market friendly policies. Although the policies associated with IMF conditions are generally believed to be market promoting, the effect of IMF agreements is strictly an empirical question. Financial markets, in this case FDI flows, should provide the answer as to if foreign investors value these reforms. Economic reforms that will stabilize the economy and provide the foundation for robust future macroeconomic performance should be valuable to multinational corporations. Countries that sign IMF agreements should then be associated with higher FDI inflows.

At the same time there is the possibility that IMF programs could have a detrimental effect on multinational investors. Signing of IMF agreements could also lock governments into an inefficient policy equilibrium. If the conditionality associated with IMF loans is worse than the current economic policies, foreign investors will react negatively to IMF agreements.

Using a Heckman selection model to control for the factors that lead countries to be under IMF agreements, I find that IMF programs do not help restore the confidence of

multinationals during an economic crisis. In fact, I find that IMF programs are associated with a significant reduction in FDI inflows for a host country. Countries that sign agreements, even after controlling for selection, attract 25% less FDI that countries that do not obtain IMF support. This leads to the conjecture that IMF conditions, usually austerity policies, are viewed unfavorably by multinational corporations.

VII. Summary

In summary, the empirical chapters of this book find that the public policy factors related to FDI, such as levels of government spending and taxation have been overemphasized as important determinants of FDI inflows. Alternatively, political institutions, in our case levels of democracy, forms of federal institutions, and agreements with the International Monetary Fund all have massive effects on FDI inflows. Understanding the impact of these political institutions are necessary to understand the investments of multinational corporations across the globe.

VIII. Public Policy Ramifications

This dissertation, while academic in focus, generates four public policy prescriptions directly from the four empirical chapters.

1. Countries should not simply cut levels of government spending and taxation in an attempt to attract foreign capital.

Countries in developed and developing countries that are attempting to attract multinationals should focus on the crafting of broad institutions that are conducive to strong macroeconomic performance rather than narrow focus on fiscal policy to induce investment.

2. There is no tension between democracy and the attraction of FDI inflows.

Although there may be a number of cases that can be made on the tensions between democracy and economic development, this study finds no evidence that multinational corporations prefer to investment in authoritarian regimes. In fact, this study finds that democratic institutions can provide important benefits to multinational corporations, specifically in lowering levels of political risk for investors.

In parts of the world that have been plagued with low levels of FDI, such as Sub-Saharan Africa the importance these institutions as central to attracting FDI inflows can no be overemphasized. For these countries fundamental economic and political reforms are a necessary condition in attracting FDI. Specifically, the consolidation and maintenance of democratic institutions are an important economic development strategy, not to mention a potential mechanism for dealing with civil conflict and govern natural resources endowments.[150] Political reform should be the first priority for these countries.

In other areas of the globe that have been more successful in attracting FDI, such as the post-Communist states of Eastern and Central Europe along with the former Soviet Union, this study illuminates the dangers of executive discretion in a world of global capital markets. Political leaders in a number of countries, such as Slovakia and Russia, wield tremendous influence in their countries' domestic policy and international relationships. This executive discursion is not only dangerous to the democratic process; it may also entail serious economic costs.

3. Relationships between actors within a nation-state can affect a country's ability to attract multinational corporations.

[150] Wantchekon and Jensen (2000).

In this dissertation I stress that the patterns of political accountability between central and subnational governments can lead to higher levels of FDI inflows. More generally, governance relationships between actors within nation-states can help provide a more conducive environment for multinationals. A careful consideration of political relationships between the executive and other political actors (legislatures, courts, etc) can be an important component of economic development strategies for developing countries. Getting "institutions right", both domestic and international, has become more important in a world of multinational production.

4. IMF Programs do not restore the confidence of multinational investors.

IMF lending, and IMF conditions in their present form, do not have a positive impact on FDI inflows. The fact that forward looking investors do not consider IMF programs valuable to countries in economic crisis, leads us to doubt the overall value of IMF programs and conditions. Reform of the IMF and IMF conditionality should be in the interest of governments, citizens, and multinational corporations.

IX. Caveats

This dissertation, while attempting to remain objective and empirical, generates results that speak to both academic and public policy debates. Taken at face value they may seem optimistic.

- Governments' fiscal policies are not constrained by capital mobility.
- Democracy is not under threat by foreign markets; markets only strengthen the case for democratic institutions.
- Certain types of federal systems may provide even more benefits to domestic governments by lowering levels of political risk.

- IMF Reforms that would most likely be less draconian in the eyes of the populace would also most likely be more conducive to multinational investors. The austerity packages promoted by the IMF, so often opposed by the citizenry, are indeed not market promoting.

Have the critics of multinationals, the opponents of globalization, the pessimists about the race to the bottom, and the supporters of the IMF got it all wrong? Not exactly.

First, it is important to note that while this study finds that multinationals do not challenge economic policy autonomy or democratic governance, I am by no means advocating that MNEs can not, or do not, have negative impacts on government. In this dissertation I simply assume that MNEs are profit-maximizing enterprises, neither demons nor angels, only firms that answer to investors. Thankfully, there are economic benefits to democratic institutions, and there seem to be little economic consequences to government fiscal autonomy. Unfortunately there are a number of areas where some pessimism is in order.

Perhaps the greatest challenge to domestic governments in a world of free trade and multinational production is to foster economic development, free trade, and the protection of property without further damaging the physical environment. Environmental protection, a textbook example of a public good, is generally underprovided through market mechanisms. Environmental protection, a benefit to consumers and citizens, has little value to multinational investors. Countries in the developing and developed world may lower standards on the protection of the environment in order to attract multinationals that are hampered by high environmental standards.

Sadly, many of the international institutions, regional trade associations, and international agreements have not only failed to adequately protect the environment in the face of these pressures, they have made the domestic regulation of environmental standards even more difficult. One glaring example is Chapter 11 of the NAFTA agreement that has been used by multinationals to challenge domestic environmental legislation and standards. Similar examples can be found in the WTO, EU, and the proposed (and failed) Multilateral Agreement on Investment. Multinational investment, and international financial flows generally, can pose real and serious challenges to the environment .

Second, the findings on the impact of federal political systems on FDI inflows stresses that specific institutional arrangements can produce lower levels of political risk and increase FDI inflows. Unfortunately, both few federal systems meet these criteria in the real world and federal institutional arrangements can have serious effects on other aspects of economic policy and the political process. This dissertation attempts to sort out part of the confusion on the effects of federalism on macroeconomic performance by differentiating between different types of federalism. I am not in the position to advocate unitary systems in developing countries to adopt politically federal constitutions.

More importantly, the fiscal reforms most recently promoted by the World Bank in developing countries do not fit into this set of "market promoting institutions". In Chapter V I find some evidence that fiscal federalism may be associated with lower levels of political risk, but I find no evidence that fiscal federalism is associated with higher levels of FDI inflows. Coupled with the existing literature on the potential negative effects of fiscal federalism on macroeconomic performance, the World Bank's

emphasis on fiscal federalism seems less appropriate for fostering economic development.

Lastly, in Chapter VI, I showed the negative impact of IMF agreements on multinational corporations. There is also a growing literature on the negative impact of IMF programs on economic performance and domestic societies. At the same time I think one can make a strong case can be made for a larger, better funded IMF. The true problem with the current IMF is its form, not its function. In my opinion the existence of an international lender of last resort in a world of massive capital flows has become more important in recent years.

With the end of the gold standard and fixed exchange rates the complexity of responsibilities of the IMF increased without an increase in resources. Many of the criticisms of the IMF, and many of their policy mistakes, have their roots in the lack of resources at the disposal of the IMF. To make informed decisions and provide adequate support for countries in economic crisis the IMF needs more staff and resources.

The IMF also needs a fundamental transformation in the role and form of conditionality in the lending process. IMF conditions can be linked to a number of negative economic consequences. At the same time, the funds provided by the IMF can help save countries in economic crisis and more generally promote world economic stability. In short, the IMF must get out of the economic growth business, but not out of the lending business altogether.

X. Summary

In sum, multinational corporations still pose tremendous possibilities and enormous challenges to governments and citizens. This dissertation has made a serious

attempt to understand multinational corporations and their investment decisions. The main point of this dissertation is that political institutions, both domestic and international, have major effects on multinational investors. This understanding can serve as a foundation for both enabling and regulating multinationals to serve the needs of governments and citizens in countries across the globe.

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