

TYING HANDS VS. EXCHANGING HOSTAGES
DOMESTIC COALITIONS, POLITICAL CONSTRAINTS AND FDI

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ABSTRACT: This paper explores the link between domestic politics and foreign direct investment flows. I argue that FDI flows will be larger when labor is more influential, and smaller when capital owners are. Following the trade-theoretic literature I derive actors' preferences from their position in the economy. A formal model explores the conditions under which labor will take a position that is pro-foreign capital, while domestic capital would oppose. The relative influence of labor in domestic politics may work as a reassurance to foreign investors. In the empirical section I try to assess whether the conditions described in the model are generalizable. Tests conducted on a cross section of 34 developing and developed countries show that partisan effects might be at play: left-right orientation of the chief executive in the host country has a statistically significant effect on the amount of FDI that flows into the country. Countries ruled by the left appear to receive more FDI. Additional tests on a panel of 14 OECD countries over a 22-year span seemingly confirm these predictions: FDI flows are larger in countries and years where the left is in power.

DOMESTIC COALITIONS AND THE POLITICAL ECONOMY OF FDI

INTRODUCTION

While in some countries foreign direct investment (FDI) has become an important source of government revenue, employment and foreign exchange, there is significant variation across countries and along time in policies toward FDI. Cross-country comparisons show that governments have chosen very different policies towards foreign investors (Caves 1996).¹ Japan and South Korea, for example, which are associated with business friendly economic policies, have been highly restrictive towards foreign investors. Within countries, policies and outcomes vary over time as well: economies that had historically looked closed to investors –such as Argentina, Brazil, and even South Korea, among others- have liberalized their foreign investment policies in recent years.²

There is also large variance in terms of the levels of foreign investment flows, which is reflected in the difference between FDI potential and FDI performance indices created by UNCTAD (2002). This variance is not fully explained by policy regimes, investment climate or even traditional variables such as size, endowment, distance, or common features such as language, legal system or colonial links.

I argue that part of this unexplained cross-country and temporal variance in outcomes is related to differences in domestic political alignments in the host country. Applying direct Heckscher-Ohlin assumptions inflows of capital that alter the relative ratio of factor endowments are likely to have distributive consequences on the returns to

¹ In recent years countries have embarked in promotional campaigns to attract FDI. They have adjusted their trade and investment regimes, designed tax packages –including import duty exemptions, tax breaks and income tax holidays-, granted special subsidies and accounting rules, and built infrastructure to lure investors in (See Caves 1996; UNCTAD 2001, 2002).

² In my dissertation I have developed a measure of investment restrictions derived from a gravity model of investment. Indices developed by ECLAC (Morley et al. 1999), UNCTAD (2002), Heritage Foundation (2003) among others show a similar trend: countries liberalizing to foreign investment. The change towards regimes that are friendlier to foreign investors varies across countries (See Morley et al. 1999, OECD 1998). In the 1970s most developing countries, particularly those in Latin America, place heavy controls on capital transactions both for citizens and foreigners alike. Many countries limited the sectors that were open to foreign investors and placed ceilings on the repatriation of interest and dividends. Liberalization did not pick up speed till after the debt crisis. Argentina liberalized its investment regime in 1991. In South Korea, the Foreign Investment Promotion Act of November 1998 and other reforms substantially opened the South Korean economy to foreign investment (Yun 2003).

domestic factors of production.³ Labor is likely to benefit from inflows of investment while capital is likely to hurt.⁴ Governments whose political support base is built around labor will offer conditions that are more favorable to foreign investors, while governments who draw their support mostly from capital owners will be less favorable. As a result, inflows of foreign direct investment will be larger under pro-labor/left leaning governments, than under pro-capital/right leaning governments, all else equal.

Note that I do not intend to explain where foreign investment goes. There is a vast body of literature in economics reviewed below that tries to explain the main determinants of capital flows. I argue that when the conditions for investment are present, when foreign investors could potentially gain from investing in the host country, politics can have an important effect on investment decisions. This analysis has been overlooked in the extant literature in political science.

This paper is organized as follows. The first section briefly summarizes the literature on multinational activity, its determinants and its connection politics. Next I describe a simple model about the relationship between governments and foreign investors, from which I derive testable hypotheses. Later I discuss operationalization of concepts and methodological issues to assess the empirical validity of those hypotheses. The last two sections present the results and discuss the findings, which suggest that, at a minimum, the theory presented in this paper is plausible: FDI flows are larger in countries where a pro-labor party is in power.

FDI AND POLITICS IN THE LITERATURE

The literature on FDI and multinational activity is as extensive as it is controversial.⁵ In theory there are two main explanations of the determinants of multinational activity. On

³ In order to have this effect, investment inflows should have the potential to affect the stock of capital in the host country.

⁴ These predictions follow the classic Stolper-Samuelson (1941) theorem. See Dutt & Mitra (2002) for a review of the literature in economics. In political science Rogowski (1989) offers an application of the Stolper Samuelson theorem to political conflict and partisan alignments. See also Scheve & Slaughter (1999) on labor market competition and individual preferences over immigration policy.

⁵ FDI involves the transfer of capital and technology from one country to another. This transfer usually takes place in order to arbitrage differential returns on capital between countries where its marginal product differs. Traditionally trade and investment are considered substitutes: factor price equalization occurs through trade, or through factor movement when trade is inhibited. Robert Mundell (1957) is responsible for a formal elaboration of this proposition. However, FDI is not about capital arbitrage alone. A vast body of literature shows that rate of return differentials do not suffice to explain foreign investment,

one hand we find factor proportions explanations, those that stress that investment flows are driven by differences in endowments.⁶ On the other hand, the decision to become multinational reflects a trade off between proximity to consumption markets and economies of scale that investors face when deciding to supply consumers located at home and abroad.⁷ Yet theoretically and empirically explanations on why companies become multinational do not give the impression of being enough to explain where capital goes. Variables traditionally associated with factor proportions or scale economies, such as capital, labor and skill endowment, market size, distance, language, legal systems among others leave a large part of the variance in FDI performance unexplained.⁸

Empirical approaches have adopted different methodologies to analyze the flow of investment capital. Findings are difficult to compare due to lack of correspondence in the universe of cases, sample size, model specification and choice of controls.⁹ This results in a lack of consensus about the factors that should be considered as determinants of multinational activity, and/or the sign attributed to them (Chakrabarti 1997).

Although the literature on the determinants of capital flows is profuse, the link between foreign direct investment and domestic politics has gone virtually ignored. There are limited examples in the literature that look at the link between FDI flows and political regimes. Oneal (1994), for instance, argues that autocracies are better hosts of multinational activity. On the contrary Jensen (2001) suggests that democratic regimes make them more credible environments for FDI.

Henisz & Williamson (1999) argues that institutional constraints help governments overcome the time-consistency problems they face when they cannot otherwise commit ex-ante to a policy schedule that is sub-optimal ex-post.¹⁰ Institutional design may provide the type of reassurance demanded by foreign investors: increasing

FDI is not randomly distributed across industries, and corporations rather than financial intermediaries conduct most FDI. Hymer (1976). Here's where the distinction between types of FDI becomes relevant.

⁶ Factor proportions explanations are associated with Helpman (1984, 1985), Markusen (1984), Helpman and Krugman (1985).

⁷ See Horstmann & Markusen (1992), and Brainard (1993a). Factor proportions relates to vertical FDI, while vertical FDI can be identified with the proximity/scales economy explanation (Markusen 1995).

⁸ UNCTAD (2002).

⁹ The most 'successful' empirical approaches are probably those based on gravity specifications. See Blonigen & Davies (2000). But gravity techniques, which are good at capturing vertical and horizontal models of FDI, cannot account for the knowledge-capital model of multinational activity. Carr, Markusen & Maskus (2000); Markusen & Maskus (1999a, 1999b).

¹⁰ Henisz & Williamson (1999); Henisz (2000). See Williamson (1985).

the number of political actors that are required to change the status quo will result in policy stability. Yet, when veto gates are aligned, the only reassurance possible is given by the political preferences of those holding the levers of the policy-making process.

In general, the link between regime type, political institutions and FDI friendly policies is oversimplified, and more often than not lacks micro-foundations. They tend to overlook the distributive effects created by factor flows. In addition, as contradictory findings seem to indicate, predictions from this tradition have limited empirical support, if any at all.

What explains, then, variation in policy toward FDI? Not much has been done on this specifically, and there is no evidence of any clear pattern in the data. Moreover the bundle of policies adopted by governments to respond to FDI has changed over time, and so have academic debates.

In the 1970s and early 1980s, for example, a wave of dependency theorists denounced the triple alliance between governments, domestic and foreign capital to exploit the popular sectors. According to this argument, local capital shares similar preferences with foreign capital along several policy dimensions, such as suppressing labor organization and standards, reducing taxes on capital, and eliminating environmental regulations.

This whole literature has several shortcomings. Theoretically, it lacks micro-foundations; it fails to explain why labor would oppose and capital support those policies. Empirically, there have been no good tests; in fact, case studies suggest that the alliance between domestic and foreign capital is likely to be unstable and short-lived even when it exists. The inflow of foreign capital creates a distributive rift, affecting the return to domestic capital, and ultimately trumping their purportedly shared preferences.

This has led to the analysis of the conditions that affect labor's attitude towards MNCs that has begun to develop in the labor relations literature. Guillen (2000) argues that labor may adopt responses to foreign multinationals that range from hostility to active partnership. Labor's attitude towards MNC is affected by two factors that link foreign investment to development. One factor is the relationship between FDI and trade –whether import substituting or export promoting- and the other factor is the stance

adopted by the state –permissive or restrictive.¹¹ While the first concern is a sensible one, the second condition points to the main shortcoming of this body of literature: the assumption that labor reacts rather than participates in the determination of government behavior.

An example of this limitation may help clarify this point. It is uncontested that organized labor has been the backbone of the Peronist movement.¹² Yet when trying to explain the policies adopted towards foreign investors by Menem in the early 1990s –or even Peron in the early 1950s- most of the literature fails to account for labor’s preferences.¹³ Hence, when experts see policy change they conclude that either labor has either grudgingly acquiesced for loyalty reasons, or that labor’s ideology has changed.¹⁴ I argue that without a theory of policy preferences, it is impossible to predict ex-ante how labor or capital will react.

GOVERNMENTS AND INVESTORS: A FORMAL MODEL

In this section I introduce a simple model to support the logic, namely that investment regimes will be pro-foreign investors when labor is more influential, and less so when domestic capital is. This would result in higher levels of investment under left-leaning governments, and lower levels under right-leaning governments, all else equal. My argument borrows on the endogenous policy-formation literature in that its outcomes are the result of interest group behavior, and that behavior is driven by actors’ preferences over policy outcomes. Actors’ preferences are derived from their material interests, and those interests depend on their relative endowment of factors of production.

The model starts with two actors: a *host government*, and a *foreign investor*. These actors receive a payoff from their interaction that takes the form of tax revenue (τ), in the case of *government*, and return to investment in the host country to the *foreign investor*. The foreign investor has two options: she can invest at *home* (rest of the world),

¹¹ Gereffi (1989) and Haggard (1990).

¹² Guillen (2000)

¹³ Peron reformed the foreign investment regime in 1952, reversing the wave of nationalization started by the previous military regime -of which Peron himself was a visible member. Menem established a liberal foreign investment regime in 1989. In both circumstances scholars and pundits alike tend to conclude that labor was betrayed, trumped or bought off. See Fuchs (1981); Monteon (1987); Murillo (2001).

¹⁴ Rock (1987), Monteon (1987), Fuchs (1981).

action for which she would receive a return r (net of home taxes), or she can invest abroad, receiving a return to her investment, which we will call R . Let K^F be the amount invested by foreign investors in the host country, while K^D is the amount invested in this market by domestic capital. The total amount invested in the host country by foreign and domestic investors is K , where:

$$K = K^F + K^D$$

The indirect utility function of the host government is:

$$U^G = \tau(K) \quad (1)$$

Assume, for simplicity, that domestic capital is (relatively) inelastic to taxes:

$$K^D = \bar{K}$$

Output (y) is produced according to a standard constant returns to scale Cobb-Douglas production function, where:

$$y = f(K, L) = A K^\alpha L^{1-\alpha}$$

Assume, for simplicity, that $A=1$, $L=1$ (or $k=K/L$) and $\alpha \in (0,1)$. The marginal product of capital is:

$$f_k(K) = \alpha(K^F + \bar{K})^{\alpha-1} \quad (2)$$

In addition, assume competitive factor markets, i.e.: factors are paid according to their marginal contribution to output. The return (R) to a foreign investor in the host country would be:

$$R \equiv f_k(K) - t$$

Where t is a tax raised on foreign investment. R must be at least equal to r , for the foreign investor to invest in the host country. This condition is:

$$R \equiv f_k(K) - t = r \Rightarrow f_k(\bar{K} + K^F) - t = r \quad (3)$$

Then, equation (3) becomes:

$$\alpha(K^F + \bar{K})^{\alpha-1} - t = r \quad (4)$$

From equation (4) we can derive the amount of foreign investment (K^F) that flows into the host country:

$$K^F = \left(\frac{r+t}{\alpha} \right)^{1/(\alpha-1)} - \bar{K} \quad (5)$$

Then, from (5) we can see how t affects investment:

$$K^F(t), \text{ or } K(t) = K^F(t) + K^D = K^F(t) + \bar{K}$$

$$\text{Note that: } \frac{dK}{dt} = \frac{dK^F}{dt}$$

Hence, from (3) we obtain:

$$f_{kk} \frac{dK^F}{dt} dt - dt = 0 \Rightarrow \frac{dK^F}{dt} = \frac{1}{f_{kk}}$$

By assumption (concavity of f_k), we know that $f_{kk} < 0 \Rightarrow$

$$\Rightarrow \frac{dK^F}{dt} = \frac{1}{f_{kk}} < 0 \Rightarrow \frac{dK^F}{dt} < 0 \quad (6)$$

Next, assume that $\tau(K)$ takes the following functional form: $\tau(K) = t K(t)$. The host government's maximization problem becomes:

$$\max_t t K^F(t) \quad (7)$$

The First Order Condition (FOC) to this maximization problem is: $\tau' = 0$

$$t: K^F + t \frac{dK^F}{dt} = 0$$

The Second Order Condition (SOC) is: $\tau'' < 0$

$$\frac{dK^F}{dt} + \frac{dK^F}{dt} + t \frac{d^2K^F}{dt^2} < 0$$

From (6) we know that the first two terms are negative: $dK^F/dt = (f_{kk})^{-1} < 0$, and d^2K^F/dt^2 can be derived from the functional form of the production function.¹⁵ The SOC to the government's maximization problem is:

$$t < \frac{2 \alpha (\alpha - 1)}{(\alpha - 2)} K$$

The optimal tax rate (t^*) that maximizes the government's utility function, provided that the first and second order conditions are fulfilled, is:

$$t^* = \frac{-K^F}{\frac{dK^F}{dt}} \quad (8)$$

¹⁵ Note that $f_{kk} = \alpha(\alpha - 1) K^{\alpha-2}$ and $f_{kkk} = \alpha(\alpha - 1)(\alpha - 2) K^{\alpha-3}$

FOREIGN INVESTMENT AND DISTRIBUTIVE CONCERNS:

What would happen when the host government is accountable to domestic actors?

Following Hillmann (1982), I model a political support function, where government not only cares about revenue but looks after the fate of two types of domestic actors: workers and owners of capital.¹⁶ In the political support function used below, the government's objective function contains an indirect utility derived from the weighted average of the welfare of domestic labor and capital, and a direct utility derived from increased revenue through taxes levied on foreign capital, as in the model described above.¹⁷

Political support in the case of capital flows results from the value domestic actors place on the distributive effects associated with factor flows.¹⁸ Utility of domestic actors is affected by the investment decision of the foreign investor (K^F). An inflow of capital changes the relative endowment of labor and capital in the host country, hence affecting the marginal productivity of these factors of production. Assuming that factor markets are competitive, the entry of capital affects the return to labor positively and that of capital negatively. There additional actors that have the potential to affect government: labor (L) and capital (K), whose utility functions are, respectively:

$$U^L = U(x)$$

$$U^K = U(z)$$

Where:

$$x = w = f(K) - f_k(K) K$$

In this model host governments are partisan; they weigh the support of labor and capital differently:

$$U^G = \tau(K) + \beta U^L + (1-\beta) U^K \quad (9)$$

Government partisanship is captured by the parameter $\beta \in [0,1]$ in (9). A higher value of β reflects a government that leans towards the left, one that values the support of domestic labor, while a lower value implies that the government is right-leaning, one that

¹⁶ The political support function model used by Hillman (1982, 1989) to assess the effects of protectionism is derived from the Stigler-Peltzman model of regulation (Stigler 1971; Peltzman 1976).

¹⁷ Grossman and Helpman (1994a; 2001) adopt a broader form of this political support function originally developed by Hillman, where government's selection of policy outputs result from a trade-off of domestic welfare for political contributions. It also differs from the function used by Dutt & Mitra (2002).

¹⁸ As derived from the Mundell equivalence proposition and the Stolper-Samuelson theorem.

pays more attention to the preferences of domestic capital. Replacing x and z from above, the host government's utility function is:

$$\begin{aligned} U^G &= t K^F + \beta U(x) + (1-\beta) U(z) \\ U^G &= t K^F(t) + \beta U(x) + (1-\beta) U(f_k(K) K^D) \\ U^G &= t K^F(t) + \beta U(f(K(t)) - f_k(K(t))K(t)) + (1-\beta) U(f_k(K) K^D) \end{aligned} \quad (10)$$

The maximization problem becomes:

$$\max_t t K^F(t) + \beta U[f(K(t)) - f_k(K(t))K(t)] + (1-\beta) f_k(K(t)) \bar{K}$$

First Order condition (FOC): $\tau' = 0$

$$\begin{aligned} t : K^F + t \frac{dK^F}{dt} + \beta U_x \left[f_k \frac{dK^F}{dt} - f_{kk} \frac{dK^F}{dt} K - f_k \frac{dK^F}{dt} \right] + (1-\beta) f_{kk} \frac{dK^F}{dt} \bar{K} &= 0 \Rightarrow \\ K^F + t \frac{dK^F}{dt} + \beta U_x \left[f_{kk} \frac{dK^F}{dt} K \right] + (1-\beta) f_{kk} \frac{dK^F}{dt} \bar{K} &= 0 \end{aligned}$$

Second Order Conditions (SOC): $\tau'' < 0$

$$\begin{aligned} \frac{dK^F}{dt} + \frac{dK^F}{dt} + t \frac{d^2 K^F}{dt^2} - \beta \left[U_{xx} \left(-f_{kk} \frac{dK^F}{dt} K \right) \left(f_{kk} \frac{dK^F}{dt} \right) + U_x \left(f_{kkk} \frac{dK^F}{dt} \frac{dK^F}{dt} + f_{kk} \frac{d^2 K^F}{dt^2} \right) \right] + \\ + (1-\beta) \bar{K} \left(f_{kkk} \frac{dK^F}{dt} + f_{kk} \frac{d^2 K^F}{dt^2} \right) < 0 \end{aligned}$$

This gives a solution (as long as the SOC are satisfied) and other parameters of the model:

$$t^p = - \frac{K^F}{\frac{dK^F}{dt}} - \beta \frac{U_x \left(-f_{kk} \frac{dK^F}{dt} K \right)}{\frac{dK^F}{dt}} - (1-\beta) \frac{f_{kk} \frac{dK^F}{dt} \bar{K}}{\frac{dK^F}{dt}}$$

Which can be further simplified to:

$$t^p = - \frac{K^F}{\frac{dK^F}{dt}} - \beta \left[U_x (-f_{kk} K) \right] - (1-\beta) f_{kk} \bar{K} \quad (11)$$

Comparing (8) and (11), it becomes apparent that the level of t^p varies with β .¹⁹ The first term on the right hand side of equation (11) is identical to the right hand side of equation

¹⁹ In reduced form: $t^p = \tau(\beta)$

(8), and we have seen that it has a positive sign. The level of t^p is thus contingent upon the signs and levels of the terms that follow β and $(1-\beta)$.

We know that K , \bar{K} , U_x are positive, while f_{kk} and dK^F/dt are both negative.²⁰ Through a comparative statics exercise we can assess the effect of a change in pro-labor orientation of government (β). From (11) it becomes apparent that: $dt/d\beta < 0$.²¹

Consider the two extreme cases:

a) When $\beta=1$, the first term in (11) is identical to the right hand side term in (8), while the second term is negative:

$$-U_x (-f_{kk}K) < 0$$

If we label this case as t_L^p , we can infer that $t_L^p < t^*$.

b) When $\beta=0$, the first term in (11) is identical to the right hand side term in (8), while the second term is positive: $-(f_{kk}\bar{K}) > 0$

Labeling this case as t_K^p , to distinguish it from t_L^p we may infer that $t_K^p > t^*$. Hence given on the assumptions of the model and the SOC, by transitivity we find that $t_K^p > t^* > t_L^p$.

Movements towards each of the extreme cases result in a weighted average of these:

$$t^* + \beta t_L^p + (1-\beta)t_K^p$$

The behavior by government affects domestic constituents in different ways, in line with the effects that FDI has on different types of individuals in the host country. This section shows that as investment inflows change the relative endowment of labor and capital, owners of capital will be hurt, while labor should benefit. Translating the previous comparative statics exercise into words allows me to derive the following proposition:

Proposition 1: *the larger the value that government agents place on the political support of labor, the lower the tax schedule offered to foreign investors, all else equal.*

²⁰ U_x is positive by definition: labor's utility is an increasing function of x .

²¹ Based on the functional form of the production function, all these terms could be expressed in terms of $f(K)$, and its different order derivatives. For now finding the direction of the likely effect of changes in β suffices.

From $dt/d\beta$, recently discussed, and dK^F/dt , which we know from (6), we may derive the following proposition as well:

Proposition 2: *the larger the value that government agents place on the political support of labor the higher the level of foreign investment, all else equal.*

PARTISAN GOVERNMENT, TAXES AND INVESTMENT

The previous framework can be trivially modified to incorporate alternative conditions, usually associated with ideological variation in the assessment of higher taxes, as a proxy for government intervention in the economy. For example, domestic actors may accrue benefits (losses) not only from the effect of the inflow of capital on their returns, but from revenue as well: they may receive a share of g .²²

The model described above assumed that labor and capital valued the income they obtained from participation in the market. But labor is also likely to prefer to receive a form of social insurance, resulting in higher taxes, all else equal. Higher (lower) taxes lead to lower (higher) foreign (and overall) investment, which reduces (increases) labor's income from the market. I extend the model to account for labor's preference in this dimension. Labor now faces a tradeoff between the utility of income obtained from participation in the market, with the utility obtained from goods produced with the extra taxes collected.

Government raises taxes but can only keep to himself proportion δ of the revenue obtained, where $\delta \in [0,1]$, and uses the rest to provide a good g .²³ Assume, also, that only labor values a higher level of government expenditure, g , while capital is indifferent. The utility functions of labor (L) and domestic capital (K) are:

$$U^L = U(x, g)$$

$$U^K = U(z)$$

where $g = (1-\delta) t K^F$

Government has the following utility function:

²² An alternative would be to change weights on the objective function, making revenue more valuable to government than the indirect utility of the government's constituents.

²³ $1-\delta$ captures the weight placed on g by different types of government. A decrease in δ would reflect the fact that an extra \$ in revenue is valued more heavily by a left government. When $\delta = 1$ we are back in the model discussed in the previous section.

$$U^G = \delta t K + \beta U^L + (1-\beta) U^K$$

$$U^G = \delta t K^F + \beta U(x, g) + (1-\beta) U(z)$$

$$U^G = \delta t K^F(t) + \beta U(x, (1-\delta)g) + (1-\beta) U(f_k(K) K^D)$$

$$U^G = \delta t K^F(t) + \beta U[f(K(t)) - f_k(K(t))K(t), (1-\delta) t K^F(t)] + (1-\beta) U(f_k(K) K^D) \quad (12)$$

Government's maximization problem becomes:

$$\max_t \delta t K^F(t) + \beta U[f(K(t)) - f_k(K(t))K(t), (1-\delta)t K^F(t)] + (1-\beta) f_k(K(t)) \bar{K}$$

The first order condition (FOC)²⁴ to this maximization problem is:

$$\text{FOC: } \tau' = 0$$

$$t : \delta K^F + \delta t \frac{dK^F}{dt} + \beta U_x \left[f_k \frac{dK^F}{dt} - f_{kk} \frac{dK^F}{dt} K - f_k \frac{dK^F}{dt} \right] + \beta U_g \left[(1-\delta) K^F + (1-\delta) t \frac{dK^F}{dt} \right] \\ + (1-\beta) f_{kk} \frac{dK^F}{dt} \bar{K} = 0 \Rightarrow$$

$$\Rightarrow \delta \left[K^F + t \frac{dK^F}{dt} \right] + \beta U_x \left[-f_{kk} \frac{dK^F}{dt} K \right] + \beta U_g (1-\delta) \left[K^F + t \frac{dK^F}{dt} \right] + (1-\beta) f_{kk} \frac{dK^F}{dt} \bar{K} = 0$$

The solution is a function of β , δ :

$$t^* = \frac{-\beta U_x \left(-f_{kk} \frac{dK^F}{dt} K \right) - (1-\beta) f_{kk} \frac{dK^F}{dt} \bar{K}}{(\delta + \beta U_g (1-\delta)) \frac{dK^F}{dt}} - \frac{K^F}{\frac{dK^F}{dt}} \Rightarrow \\ t^* = -\frac{\beta U_x (-f_{kk} K)}{(\delta + \beta U_g (1-\delta))} - \frac{(1-\beta) f_{kk} \bar{K}}{(\delta + \beta U_g (1-\delta))} - \frac{K^F}{\frac{dK^F}{dt}} \quad (13)$$

When $\delta=1$, the solution is identical to the one discussed in the previous model, where the level of t^* depends on the values of β . Most action occurs when δ approaches zero, i.e.: when government values less the direct effect of additional revenue, taxes on foreign investment will be lower under when β increases. Under these conditions, when $\beta=0$, the effect of inflows of capital on domestic capital's income is magnified. We know

²⁴ In order to save space the second order condition ($\tau'' < 0$) is not reproduced here.

that the first argument in the right hand side of equation is negative (13), but we need more structure to predict whether t will be different from the t_L^p case.²⁵

DISCUSSION:

The model discussed in the previous sections is based on very simple assumptions about the production function, and interactions between governments and investors.²⁶ It also relies on very simple assumptions about actors' preferences. This results in a rather simplistic objective function. Simple as it is the model allows us to make predictions about the expected sign of the investment regime that host governments would offer to foreign investors, and ultimately the level of investment in the host country.

FDI will flow to countries where labor is more influential, or shun countries where capital is more influential. The null hypothesis is that there is no relationship between foreign direct investment flows and labor influence in politics. The empirical section explores an additional implication this hypothesis: the effect of ideological position of the chief executive in the host country on the levels of inbound foreign direct investment (FDI) flows.²⁷

RESEARCH DESIGN

I conduct two different sets of statistical tests on two different samples of countries. The different tests try to overcome problems related to data availability and research design, particularly on the latter the inability to assign randomly observations to treatment (changes in the independent variable) and control. The cross-sectional test averaging values for a larger sample of countries over a ten-year interval reduces the missing data problem and allows for independence of observations. An additional problem with this design is that we cannot get pre and post-treatment observations of the units. Another important challenge to the empirical tests of the argument is data availability. The TSCS

²⁵ We could even assume a different functional form for $U(x, g)$; it could be: $x = w + g$ if g is an in-cash transfer.

²⁶ Of these assumptions the constant returns to scale production function is perhaps the most problematic when dealing with multinational activities, especially under the Horstmann & Markusen (1992), and Brainard (1993a) model where the decision to invest abroad is driven by the proximity/economies of scale trade-off.

²⁷ In my dissertation I explore the relationship between domestic coalitions and investment regimes, using a measure of investment restrictions derived from a gravity model of investment.

panel design partially solves the second part of the problem; there is still no random assignment yet units are observed before and after treatment. However, the design is more intensive in data, which so far I could only obtain for a limited set of countries and years.²⁸

I discuss additional issues related with the research design and model specification in the sections that report the results obtained for each model.²⁹ It should be noted that the tests performed do not truly establish causality. They must be interpreted as observational studies that simply point to the plausibility of the argument.

TESTABLE HYPOTHESIS

I argued earlier that responsiveness of government to foreign investors is a function of the relative power of labor -its potential to influence on the policy-making process- and the receptiveness of politicians to labor's demand. It is possible that labor would prefer an overall higher level of taxes on capital, which would make investors more likely to shun these countries. Yet taxes on foreign capital are likely to be lower than those under a government where domestic business interests are central. If these predictions are right we should expect higher levels of foreign direct investment in countries where governments are more responsive to labor.

One way to assess responsiveness to labor demands is to look at the ideological orientation of the party in government. Left-leaning parties are more likely to respond to labor's interests and to react more favorably to labor's demands. The reasoning is the following: governments on the left side of the political spectrum tend to cater to labor for political support, and place more emphasis on issues such as unemployment and income distribution. Right-leaning parties tend to be more business-oriented, assign high priority to price and stability, and usually clash with labor on issues such as unemployment and income distribution.

The main testable hypothesis is, thus:

²⁸ The ideal design would require a more disaggregated measure of labor influence and of FDI policy. The unit of analysis should be industry/year, in the tradition of the endogenous tariff literature, and industries/sectors within countries should be chosen randomly. Because obtaining this data for a large number of countries is costly and time consuming I limit this analysis to the case studies on Argentina and Korea.

²⁹ Appendix 1 describes the variables used and sources of data, while Tables 1 and 2 present summary statistics for each model.

Partisan Hypothesis: *foreign direct investment flows will be larger to countries where the left is in power.*

An alternative hypothesis is derived from the institutional constraints literature:

Veto-Gates hypothesis: *foreign direct investment flows will be larger to countries where government is institutionally constrained.*³⁰

Cox & McCubbins (2001) argue that a polity's ability to commit to policy depends not only on the institutional configuration, but also on the effective number of vetoes in political decision-making, which is a function of the number of political actors that possess can veto a policy change (institutional veto), and the conflict of interest between those actors (partisan veto). The tests should look at both dimensions.

DEPENDENT VARIABLE

Foreign direct investment is a net inflow of investment to acquire a lasting management interest in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. The variable used in the tests is FDI net inflows in US\$.³¹ The measurement used is total net inflows in the reporting. In the TSCS tests I use the natural log of FDI net inflows instead.³²

EXPLANATORY VARIABLE:

Labor/Capital influence in politics: The concept to be operationalized is the ability of domestic actors to affect policy, i.e.: labor/capital relative influence. I have identified several measures that could be used as proxy for this concept: labor/capital shares of income; union density; centralization of wage bargaining; ideological orientation of government. Following Dutt & Mitra (2002), the measure of labor influence used is

³⁰ A general framework on veto-gates and their effect on politics was developed by George Tsebelis (1995, 1999, 2002). Henisz (2002) applies the logic to investment under conditions associated with high transaction costs.

³¹ FDI inflows in current US\$ are converted to constant 1996 US\$ using a GDP deflator obtained from WDI (2001).

³² The variable is transformed in the following way: negative values of FDI inflows (which reflect repatriation of capital) are converted to zero. In order to preserve the information from those observations now recorded as zeros, and reduce the risk of bias in the estimates, the log is taken after adding \$1 to the dollar amount of FDI inflows: $\ln FDI_{it} = \ln(FDI_{it}+1)$.

ideological position of the party or the ruler in power, as coded in the Database of political institutions (Beck et al. 2001).³³

The ideological position assigned to each country corresponds to the orientation of the chief executive for political systems classified as presidential in the database, and that of the majority or largest government party for systems classified as parliamentary. A higher value on this scale represents a more leftist orientation of the chief executive.³⁴ In the TSCS tests I replace Ideology with a dummy variable labeled *Left* that takes the value of 1 if Ideology is “Left” and 0 otherwise.

Political Constraints: proxy for institutional constraints on policy-making, i.e.: institutional and partisan veto gates. Relying on a simple spatial model of political interaction Henisz (2002) derives a measure of how constrained the chief executive is in her choice of policies. It is a measure of the likelihood of change in policy given the structure of political institutions –the number of veto points- and the preferences of the actors that hold each of these points –the partisan alignment of various veto points and the heterogeneity or homogeneity of the preferences within each branch-. Possible scores for the final measure of political constraints range from zero (most hazardous) to one (most constrained).

CONTROLS

From the extensive and diverse literature on the determinants of FDI the main variables that appear to be consistently related with FDI flows are factor endowment, market size and trade orientation.³⁵

³³ For robustness checks I use an alternative measure of labor influence: centralization of wage bargaining, which is available for the subset of 14 OECD countries.

³⁴ The partisan ideology variable is an index coded 1 for a right leaning party, 2 for a centre party, and 3 for a left party. The data on political orientation are obtained from the Database of Political Institutions (DPI) (Beck et al, 2001). I detected several problems in the DPI dataset that are likely to affect the results in systematic ways. First, their classification of party on the left-right dimension is based on the party names, where such distinction is possible. They later look at the party’s affiliation with international organization of parties. In the case of Argentina, for instance, there is a change over time in their classification of the Peronist party, which they code as left leaning in the 1970s and as right leaning in the 1990s. The purported change in the policy orientation of the party that grants such change has not affected its relationship to organized labor in the country, though, which still identifies with the party. Second, they code as 0 those years when military regimes are in power. Even in the Western Hemisphere, where most of the military regimes have leaned towards the right, there are major exceptions such as Velazco Alvarado’s tenure in Peru.

³⁵ Language and distance should be included on the list when estimating gravity models of investment.

In the statistical tests I use variables that proxy for market size (GDP in constant US\$, and in purchasing power parity), relative endowment of capital (GDP per capita in constant US\$, and labor share of income), trade orientation (openness), to control for those determinants that stand out in the literature. One of the main assumptions in the model is that domestic and foreign capital are substitutes. To control for this substitution effect I add savings in the host country as one of the regressors. The cross-sectional models that comprise units that are more heterogeneous also include variables such as schooling (to control for differences in the human capital endowments) and protection of civil rights.³⁶ In the TSCS models all control variables are in natural log form.

Factor endowment: comparable measures of capital stock and labor endowment across countries are notoriously limited in coverage, measurement error, and hence seriously flawed.³⁷ For practical reasons in the tests reported below I use per capita GDP instead. Per capita GDP is a coarse proxy for endowment of capital. To the extent that it captures relative endowment of capital the coefficient on GDP per capita is expected to return a negative sign. Yet GDP per capita may also signal larger consumption potential in the host economy, or similarity of consumption preferences or complementarities between home and host countries, all leading to higher investment, in which case the expected sign would be positive.

Gross Domestic Product: GDP is a proxy for size. Larger countries are likely to attract more FDI. The expected sign is positive.³⁸

Savings: Gross domestic savings are calculated as GDP less final consumption expenditure, including private and public consumption. To the extent that domestic and foreign investment are substitutes as assumed in the model –i.e.: that there is a crowding out effect- the expected sign on this variable is negative.

Property rights: according to a profuse body of literature protection of property rights is one of the main determinants of investment –including domestic investment- and growth.³⁹ Yet the transaction costs theory of MNCs developed by Caves (1996) argues

³⁶ Other variables used in the empirical literature include competitiveness, domestic investment, growth, government intervention, infrastructure, privatization, and trade balance (Wheeler and Mody 1992).

³⁷ Dutt & Mitra (2002).

³⁸ Market size usually returns a positive result, which probably reflects the presence of economies of scale (Wheeler and Mody 1992).

³⁹ North and Weingast (1987); North (1991).

that firms are more likely to internalize transactions within a hierarchic organization where the existence of proprietary assets make arms' length transactions riskier. I use the Gastil index of civil rights as a proxy for property rights protection. An environment where violation of property rights is pervasive may have two contrary effects on foreign investment flows. On one hand it may inhibit investment altogether. On the other hand, to the extent that investment takes place, it will take the form of FDI. The expected effect is, hence, indeterminate.

Trade: Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product. The expected sign is negative if trade and factor flows are substitutes, or positive if they are complements.

Labor Share: labor's share of income. This variable is constructed as the economy-wide aggregate measure of sectoral share of labor compensation to sectoral output. The expected sign is positive.

CROSS SECTION RESULTS

I conducted series of tests on a sample of 34 countries, developing and developed. To concentrate on the cross-country variation values of the relevant variables are averaged for a 10-year interval (1980-1989). I tested the partisan and the political constraints hypothesis side by side.

The results show that policy orientation of the government has a positive and statistically significant effect on average FDI flows for the ten-year period under scrutiny.⁴⁰ Though significant the results are relatively small when compared to the variance in the sample: a one-point movement in the Right to Left lead to an additional US\$ 3.2 billion in FDI net inflows, slightly less than a standard deviation of the observed value of the dependent variable. A full movement from right to left orientation of government is associated with over US\$ 6 billions on average. This result is statistically significant beyond the 99% level.

The political constraints index, on the other hand, returned a positive coefficient, with significance at the 90% level of confidence, suggesting that more constrained governments attract more FDI flows.

⁴⁰ Even though in the tests reported I treated the variable as cardinal, I have conducted robustness checks using dummies for Left, Right or Center respectively. Results, available from the author, are consistent to those reported here.

The rest of the variables included are highly significant in most specifications and return the expected sign: FDI inflows seem to be positively related to trade, size of the economy, years of schooling, and negatively related to endowment of capital (proxied for by GDP per capita), savings and taxes. The positive result on the civil rights protection variable should not be surprising. Recall that this variable takes a higher value in cases where there is less freedom. The positive and significant result is consistent with Caves (1996) theory of MNCs.

TIME-SERIES CROSS-SECTION DATA (OECD 14, 1975-1996):

I run a final set of tests on a subset of OECD countries for the period 1975-1996. The test takes the form of a factorial design, where we examine several different values of the treatment.

As units are non-randomly selected into the sample, I measure the dependent variable before and after episodes of treatment, which in this case are changes in political coalitions and their influence on the policy-making process. All cases are advanced democracies members of the OECD, with relatively similar levels of development. They show changes in composition of ruling coalitions and in political regimes and partisan cycles, which resulted in variation on the relative influence of labor and capital influence. There is also variance in political institutions across countries and along time. The sample includes cases from more than one region of the world, allowing for intra and inter-regional variance. Stratification of the sample and introduction of appropriate controls and econometric techniques allows holding constant the residual variation in terms of development, political institutions and endowments.

Due to the time-series cross-section structure of the data –repeated observations over fixed units- I run a linear regression model with standard errors corrected for panel effects on a rectangular matrix of 14 countries over 22 years for a total of 308 observations. Beck and Katz (1995) find that the panel corrected standard errors estimator performs well when the data has a time-series cross-section structure, as is the case here. All models include a one-period lag of the dependent variable on the right-hand side to

control for serial correlation, as recommended by the same authors (Beck & Katz 1996).⁴¹ The inclusion of one lag of the dependent variable seems to correct for serial correlation in the data.⁴² The model in column 7 also includes year dummies to control for latent temporal breaks in the series.

RESULTS

Results of different specifications of this model are reproduced on Table 3. From these results we may see that the coefficient on Left is positive and significant beyond conventional levels of confidence in all models reported. The effect is not quite substantive, though, particularly when compared to the whole sample. A movement to the left is associated with an increase in the dependent variable (log of FDI) of close to one-third of a standard deviation of the DV. For example, taking model 5 as a benchmark, a movement from right to left would result in roughly \$1.5 billion increase in FDI inflows for an average country/year in the sample.⁴³

Regarding the control variables, the lagged DV is highly significant, suggesting that there is more variance across units than within countries, which is not surprising. GDP is positively associated with inflows, probably indicating the influence of market size.⁴⁴ Savings, which enters the equation in log form, returns a negative coefficient, consistent with the crowding out effect. This coefficient is never significantly different from zero, though.

In models 6 and 7 I control for the relative share of factors of production in the economy using a variable labeled as labor share.⁴⁵ This variable is constructed as the economy-wide aggregate measure of sectoral share of labor compensation in

⁴¹ Similar results are obtained using method of generalized estimating equations (GEE) and the Arellano-Bond generalized method of moments (GMM) estimator. Regression results using GEE and GMM are available from the author.

⁴² The original dataset comprised 322 observations, but 14 observations are lost due to the inclusion of the lagged dependent variable. The use panel of corrected standard errors in conjunction with ordinary least squares estimates corrects for heteroskedasticity and contemporaneous correlation in the data (Beck & Katz 1995, 1996).

⁴³ For a country like the US in 1991, for instance, the model would predict that a change from right to left would result in somewhere between \$13 billion to \$26 billions extra inflows of FDI. But we should be careful when constructing these counterfactuals for several reasons: first, the variance explained by the model is low, as reflected in the R-square for each model. Second, most of the action is across rather than within countries, as reflected by the coefficient on the lagged dependent variable.

⁴⁴ The log form may also reflect relationship between foreign investment and growth.

⁴⁵ A coarse proxy $1-\alpha$ in the models discussed above.

manufacturing to sectoral output. The variable is a measure of either relative endowment, if technology is identical across units and time, or technological change that determines a different combination of labor and capital across countries or along time.⁴⁶ Labor share is positively related to the log of FDI inflows but its coefficient is never significant.⁴⁷

The findings are robust to alternative specifications and controls. The inclusion of the following variables does not affect the relationship found between left orientation of government and the log of FDI flows: arable land, exports of fuel and exports of food as proxies for endowment of natural resources, international capital mobility proxied for by the log of world FDI outflows.⁴⁸ To ensure that no individual country was driving the relationship found in the models discussed above, I re-run the test on different samples of the data by sequentially dropping observations for individual countries.⁴⁹ Results remain robust to these adjustments as well.

CONCLUSION:

In this paper I explore the link between domestic politics and foreign direct investment flows. I argued that FDI flows are larger when labor is more influential, and smaller when capital owners are. Simple assumptions about actors' preferences that parallel those in the trade-theoretic literature allow me to derive the conditions under which labor will take a position that is pro-foreign capital, while domestic capital would oppose.

In the empirical section of the paper I try to assess whether the conditions described in the model are generalizable. I conducted a series of statistical tests on the hypothesis that left leaning governments are more likely to attract higher levels of FDI, finding preliminary evidence that supports the core hypothesis.

The findings in the sample of developing and developed countries are consistent with the predictions derived from proposition 2, namely that pro-labor governments attract more FDI. The results also find partial support to the institutional constraints hypothesis. The last set of tests conducted on a TSCS panel of 14 OECD countries takes

⁴⁶ Note that it could also reflect the ability of labor to claim a higher share of output.

⁴⁷ Similar results are obtained when centralization of wage bargaining is entered in place of labor share. It is worth noting that labor share is relatively constant within countries; most of the variance comes from cross-country comparisons.

⁴⁸ Results available from author.

⁴⁹ Similar tests were conducting by systematically eliminating years from the sample, with no substantial change in the findings reported above.

advantage of longitudinal variance of the data. I find strong support to the partisan hypothesis: FDI flows are larger in countries where a pro-labor party is in power.

These results should not be taken as conclusive evidence. The theory is about preferences of domestic actors derived from their position in the economy and policy outcomes which are assumed rather than tested. I use measures of variables that are but poor proxies that do not fully map onto the main concepts in the theory, while several of the relevant political and economic variables are only measured indirectly. Ideology is a coarse measure of the propensity of governments to respond to labor demands in this particular dimension. It places parties on a left-right scale which usually taps into the party's preferences with respect to government intervention in the economy, or higher taxation of capital, two conditions that may actually create a disincentive to invest in the country. However, the fact that they capture a direct relationship between partisan orientation of government and foreign investment using aggregate data, where the ratio of signal to noise is likely to be low, and a coarse measure of the main explanatory variable is quite noteworthy.

These statistical tests need to be complemented by within countries longitudinal. The within countries studies allow for a more disaggregate measure of FDI policy, labor organization, variance in labor market institutions and influence in the fashion of the endogenous policy tradition. The unit of analysis here is industry/year, in the endogenous policy tradition. This alternative design provides more units of analysis, and allows for random selection of units (industries/sectors within countries) providing for more internal validity of the conclusions.

Caveats notwithstanding, the results presented suggest that the theory advanced in this paper is plausible. To the extent that they are partisan governments need not be institutionally constrained to attract foreign direct investment. This solution brings forth the 'mutual exchange of hostages' analogy. Investment will be secure when government's attempts to target investors hurt domestic actors that the government cannot afford to ignore; i.e.: when investors can take a pivotal domestic actor hostage. Preferential treatment to foreign investors is a ransom that political leaders are usually willing to pay to prevent pivotal domestic actors from being harmed. What kind of hostages do investors take? Those that have motive and opportunity to affect government

behavior. They must be influential, and they must potentially benefit from FDI inflows. To the extent that domestic and foreign capital are substitutes, labor interests become congruent to those of foreign capital.

Beyond the statistical findings reported here, there is abundant qualitative data that also seems to support the argument.⁵⁰ In the case of post-war Argentina, for instance, foreign investment flew back into Argentina under Peron in the 1950s, even though the country's leader seemed institutionally unconstrained, and made no effort to tone down an anti-capitalist rhetoric. In 1951, Peron unveiled a new plan for the economy. One of the key elements of this plan was deepening import substitution and encouraging export promotion by courting foreign investors.⁵¹ At the time that Peron announced that his government would ease long standing restrictions on foreign investment, he promised to place higher controls on imports, and threaten to expropriate equipment, machinery and inputs that according to the government had not been imported for production.⁵² This harsh rhetoric by a leader who had recently nationalized public utilities made the prospect of investing in the country hardly appealing at all. Yet foreign investment position in the country remained stable, and by 1953 there was a net inflow of FDI, reversing the negative trend of disinvestment and expropriations that had characterized the previous two decades.⁵³

⁵⁰ In my dissertation I conduct two in-depth case studies of foreign investment regimes in Argentina and South Korea.

⁵¹ In 1948 an executive decree (3347/48) signed by Peron established a regulatory framework for foreign investment and created a government agency, the Comisión Nacional de Radicación de Industrias (CNRI), to oversee foreign investment initiatives. The regime, and consequently the agency, would promote selective location of foreign investment projects especially in the manufacturing sector. By 1953 the government had already realized the importance of creating an environment conducive to lure foreign investment (Altamir, Santamaria & Sourrouille 1967). For the first time in Argentine history the government adopted a comprehensive regime that would unambiguously regulate foreign investment in Argentina. The regime established by Congress under Law 14,222, created a National Registry of Foreign Investment (Registro Nacional de Inversiones Extranjeras) and granted certain privileges (tax breaks and access to foreign exchange) to foreign investment projects that received government's approval, but limited annual remittances to an 8% of the total investment in the country (Altamir, Santamaria & Sourrouille 1967, 371).

⁵² In his February 18 1952 televised speech to the Argentine population, "El Plan Económico para 1952", Peron described the policy package adopted by his government to overcome the hard times faced by the country, resulting from domestic conditions (fiscal and foreign exchange glut) and external conditions (the Korean War, a decline in export prices, the exclusion of Argentina from the list of exporting countries to Europe under the Marshall Plan, and Britain declaring the end of the free convertibility of the pound). This document is available at: <http://www.depeco.econo.unlp.edu.ar/docpolit/polit1.pdf>

⁵³ While since 1934 net flows of investment had been negative, following nationalization of railways, public utilities and services, by the early 1950s foreign investment inflows turned positive again, rising to

(Table 4 about here)

It is precisely the link between Peron and organized labor what made these regimes credible. The relevant counterfactual here is what would have happened had capital been more influential. The closest example to this counterfactual is, probably, South Korea. Facing similar external constraints to those of Argentina under Peron, in the form of balance-of-payment problems, in South Korea where labor was repressed and politics dominated by a ruling coalition centered around domestic capital interests, policy towards foreign investment was restrictive. The outcome was hardly any foreign investment at all, especially when compared to other Asian NIEs.⁵⁴ More recently, South Korea started to open up to foreign investment, especially after the exchange rate crisis of 1997.⁵⁵ It is likely that democratization and the collapse of the *chaebols* opened the door to this liberalization.

US\$58 millions in 1953 (Altamir, Santamaría & Sourrouille 1967, 371). See Table 1. Note that the sharp decrease in foreign capital stock between 1945 and 1949 maps almost directly to the amounts paid by the Argentine government for the formerly British owned railways. All other forms of investment in the country increased in the same period.

⁵⁴ Haggard (1990).

⁵⁵ See Yun (2003).

**TABLE 1: DESCRIPTIVE STATISTICS
MODEL 1: SELECTED COUNTRIES (1980-1989 AVERAGES)**

Variable	Unit	Obs	Mean	Std. Dev.	Min	Max
<i>FDI Net Inflows</i>	<i>US\$ Millions</i>	34	-242	3897	-14254	14271
<i>Trade/GDP</i>	<i>Percentage</i>	34	55.5	27.1	15.2	138.6
<i>GDP PPP</i>	<i>Billion Int. \$</i>	34	350	772	9	4260
<i>GDP Constant</i>	<i>US\$ (Billions)</i>	34	486	1130	5	5560
<i>GDP per Capita</i>	<i>US\$</i>	34	13755	10882	868	41,789
<i>Schooling</i>	<i>Years</i>	34	7.3	2.4	3.3	12.0
<i>Political Constraints</i>	<i>Index (0-1)</i>	34	0.4	0.2	0	0.7
<i>Ideology of Chief Executive</i>	<i>Index (1: Right; 3: Left)</i>	34	1.8	0.7	1	3
<i>Civil Rights</i>	<i>Index (1-7)</i>	34	2.3	1.5	1	5

MODEL 2: OECD 14 (1975-1997) - DESCRIPTIVE STATISTICS

Variable	Unit	Obs	Mean	Std. Dev.	Min	Max
<i>FDI Net Inflows</i>	<i>US\$ Millions</i>	308	6348	12387	-1038	106035
<i>Left</i>	<i>Dummy</i>	308	0.38	0.49	0	1
<i>GDP (PPP)</i>	<i>US\$ (Billions)</i>	308	839	1350	27	8150
<i>GDP per Capita</i>	<i>US\$ (1995)</i>	308	23550	5841	12718	43483
<i>Trade/GDP</i>	<i>%</i>	308	59.06	30.47	15.92	149.41
<i>Savings/GDP</i>	<i>%</i>	293	23.63	4.42	14.84	35.74
<i>Political Constraints</i>	<i>0-1</i>	308	0.49	0.10	0.23	0.74

TABLE 2: CROSS SECTION OF SELECTED COUNTRIES (1980-1989)
MODEL 1: LEAST SQUARES REGRESSION

Independent Variables	Dependent Variable: Average FDI Net inflows (1980-1989)		
	1	2	3
Trade/GDP	83.13 ** (34.92)	87.85 ** (34.92)	77.50 ** (36.12)
GDP	2.24 *** (0.75)	2.26 *** (0.75)	2.38 *** (0.75)
GDP Per Capita	-0.48 *** (0.12)	-0.45 *** (0.12)	-0.48 *** (0.12)
Schooling	1252 *** (377)	1176 *** (377)	1308 *** (396)
Civil Rights	1599 ** (633)	1677 *** (633)	1311 * (718)
Political Constraints	8773 * (4935)	8543 * (4935)	8663 * (4922)
Partisan Ideology	3222 *** (961)	3302 *** (961)	3147 *** (969)
Savings/GDP		-117 (104)	-88 (108)
Taxes/GDP			-48.10 *** (44.83)
Constant	-20172 *** (5703)	-17721 *** (5703)	-16126 (5877)
N	34	34	34
R²	0.5049	0.5288	0.5503
Adj R²	0.3716	0.3780	0.3817

Significance levels: * p < .10; ** p < .05; *** p < .01

TABLE 3: PANEL OF 14 OECD COUNTRIES (1975-1996)
MODEL: OLS WITH PANEL CORRECTED STANDARD ERRORS (PCSEs)

Independent Variables	Dependent Variable: Log FDI Net Inflows						
	1	2	3	4	5	6	7
Log FDI (n-1)	0.26 ^{***} (0.09)	0.26 ^{***} (0.09)	0.26 ^{***} (0.09)	0.26 ^{***} (0.09)	0.26 ^{***} (0.09)	0.23 ^{***} (0.09)	0.23 ^{***} (0.09)
Log GDP per Capita	-1.76 ^{**} (0.83)	-1.98 ^{**} (0.93)	-1.56 [*] (0.92)	-1.83 [*] (1.04)	-1.85 [*] (0.99)	-3.47 ^{****} (0.94)	-2.30 ^{**} (1.06)
Log GDP (PPP)	1.30 ^{****} (0.22)	1.34 ^{****} (0.23)	1.53 ^{**} (0.77)	1.51 ^{**} (0.77)	1.51 ^{**} (0.74)	1.16 ^{****} (0.24)	2.30 ^{***} (0.80)
Log Trade/GDP	2.04 ^{****} (0.37)	2.06 ^{****} (0.37)	1.98 ^{****} (0.38)	2.01 ^{****} (0.38)	2.02 ^{****} (0.39)	1.50 ^{****} (0.32)	1.33 ^{****} (0.31)
Political Constraints		1.73 (1.25)		1.68 (1.28)	1.67 (1.34)	2.58 [*] (1.48)	2.15 (1.33)
Log Savings/GDP			-0.27 (0.84)	-0.20 (0.84)	-0.19 (0.85)		-1.38 (0.79)
Left	0.89 ^{***} (0.35)	0.99 ^{***} (0.38)	0.89 ^{**} (0.35)	0.99 ^{***} (0.38)	1.00 ^{***} (0.37)	0.85 ^{**} (0.35)	0.79 ^{**} (0.36)
Labor Share					0.55 (4.09)	3.95 (4.24)	
Constant	-20.08 ^{**} (8.88)	-19.90 ^{**} (8.97)	-21.12 ^{**} (9.16)	-20.68 ^{**} (9.31)	-21.12 ^{**} (9.62)	1.42 (8.21)	-4.94 (9.05)
Observations	308	308	308	308	306	306	308
Groups	14	14	14	14	14	14	14
R-squared	0.3006	0.3028	0.3009	0.3029	0.3032	0.4142	0.4175
Wald chi²	113.01	126.12	113.44	126.64	150.27	318.84	329.63
Prob > Chi²	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Year Dummies	No	No	No	No	No	No	Yes

**TABLE 4: FOREIGN CAPITAL STOCK AND INVESTMENT
(ARGENTINA 1900-1955)**

Year	Foreign Capital Stock	Foreign Investment
	(US\$ millions)	
1900	1,120	--
1909	2,176	1,056
1913	3,136	950
1917	3,233	97
1920	3,040	-193
1923	3,088	48
1927	3,474	386
1931	3,661	187
1934	3,485	-76
1940	3,164	-321
1945	2,651	-513
1949	1,255	-1,396
1953	1,487	232
1955	1,537	50

Source: Altamir, Santamaría & Sourrouille (1967, p. 367)

APPENDIX 1: DATA DESCRIPTION:

Model 1: Cross-section of 34 countries (1980-1989). Unless otherwise stated variables are averages for the period. *Countries:* Argentina, Australia, Austria, Belgium, Bolivia, Canada, Chile, Colombia, Costa Rica, Denmark, Ecuador, Finland, France, Greece, Ireland, Israel, Italy, Japan, Mexico, The Netherlands, New Zealand, Norway, Paraguay, Peru, Portugal, Spain, Sweden, Switzerland, Thailand, Turkey, United Kingdom, United States, Uruguay, and Venezuela.

Model 2: TSCS panel of 14 OECD countries for the time period 1975-1996. *Countries:* Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, The Netherlands, Norway, Sweden, United Kingdom, and United States.

Dependent variable:

FDI net inflows (current US\$): Foreign direct investment is net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows total net, that is, net FDI in the reporting economy less net FDI by the reporting economy. Data are in current U.S. dollars. Source: World Development Indicators (2001).

Log FDI: Natural log of FDI net inflows

Explanatory Variables:

Ideology: The data on political orientation are obtained from the Database of Political Institutions (DPI) (Beck et al, 2001). The authors have created a large cross-country database of political institutions that covers 177 countries over 21 years, 1971-1995. The database lists the political orientation of the chief executive and of the majority party in the legislature as 'Left', 'Center' or 'Right'. From ideology I construct dummy variable that takes the value of 1 if Ideology is "Left" and 0 otherwise.

Political Constraints: proxy for institutional constraints on policy-making (institutional and partisan veto gates). Henisz (2002) builds an index of Political Constraints (POLCONIII). Relying on a simple spatial model of political interaction he derives a measure of how constrained the chief executive is in her choice of policies.⁵⁶ It is a measure of the likelihood of change in policy given the structure of political institutions (the number of veto points) and the preferences of the actors that hold each of these points (the partisan alignment of various veto points and the heterogeneity or homogeneity of the preferences within each branch). Possible scores for the final measure of political constraints range from zero (most hazardous) to one (most constrained).

Controls:

Civil rights: The Gastil index for civil rights provides a subjective classification of countries on a scale of 1 to 7 on political rights, with higher ratings signifying less freedom. Gastil (2001)

⁵⁶ He identifies the number of independent branches of government with veto power over policy change in each country.

GDP, PPP (current international \$): PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over GDP as the U.S. dollar has in the United States. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current international dollars. WDI (2001)

GDP (current US\$): GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates. For a few countries where the official exchange rate does not reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used. WDI (2001)

GDP per capita (constant 1995 US\$): GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in constant U.S. dollars. WDI (2001)

GDP per capita, PPP (current international \$): GDP per capita based on purchasing power parity (PPP). PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates. WDI (2001)

Labor Share: labor's share of income. This variable is constructed as the economy-wide aggregate measure of sectoral share of labor compensation to sectoral output. The original data comes from OECD's International Sectoral Database, which is available for a limited number of countries.⁵⁷

Savings (% of GDP): Gross domestic savings are calculated as GDP less final consumption expenditure (total consumption). WDI (2001)

Schooling: is the average number of schooling years in total population over the age of 25. WDI (2001).

Trade/GDP (%): Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product. WDI (2001).

⁵⁷ Labor Compensation includes all payments made by employers to their employees, in cash and in kind, in the form of salaries and wages, plus contributions to social security, private pensions and insurance.