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Doorways to Development: Foreign Direct Investment Policies in Developing Countries

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Doorways to Development: Foreign Direct Investment Policies in Developing Countries

A Dissertation

Submitted to the Graduate Faculty of the
University of New Orleans
in partial fulfillment of the
requirements for the degree of

Doctor of Philosophy
in
Political Science

By

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May, 2008

To Megan,
for your unfailing support and love.
You are the pillar upon which this work leans
and I am extremely grateful.

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Abstract

Foreign direct investment (FDI) is a key option for economic growth in most, if not all, developing countries. However, not all developing countries are equally open to foreign investment. Some restrict foreign equity, while others encourage multinational corporations to enter their markets. Because FDI involves outsiders entering national markets and profits, it is very political. FDI can bring economic benefits, such as jobs and new technology, but it may also entail economic costs, such as increased competition for national businesses. FDI may also bring political costs, as governments that open to foreign equity may see a popular backlash.

Most governments have policies to control FDI's entry into their markets. These policies have been inadequately explored in quantitative studies of FDI because of a lack of available data. This study seeks to rectify that problem by introducing a new set of data: The Foreign Equity Index. I develop a theory and model of FDI in developing countries framed by the logic of two-level games. FDI requires agreement between developing states and international firms, and therefore agreements are reached with influence from domestic-level political and economic factors, as well as international-level factors. FDI policies are an indication of developing countries win-sets, or range of agreements they are willing to accept when dealing with foreign multinational corporations.

I test this theory quantitatively using the Foreign Equity Index, which covers 55 developing countries from 1976-2004. I first estimate the international and domestic factors that influence the degree of openness to FDI indicated by FDI equity policies in developing countries. I then test the effect these policies have on FDI inflows. I find that both domestic and international factors affect developing countries' FDI policies, and in turn, policies are a significant factor determining the flow of FDI into national markets. I also explore the ways in which FDI policies have played a role in economic development strategies of El Salvador and Nicaragua. This research and the Foreign Equity Index should aid in a better understanding of foreign direct investment and growth in developing countries in general.

Keywords: foreign direct investment, FDI, policy, policies, developing countries, Foreign Equity Index, development, modernization, dependency, corporation, multinational

Chapter One

Introduction

Since 1976, Niger, Gabon and Swaziland appeared to be doing the right thing to attract foreign direct investment. Niger, one of the poorest countries in the world, has maintained a very open policy toward foreign equity, and puts few restrictions on the entrance of foreign investment into its market. This developing country has participated in workshops and talks on investment agreements in the international arena, and has highlighted its efforts to improve education and literacy and create jobs for its population (States News Service 2007, US Fed News 2007). Yet this country has gained very little for its efforts. From 1976 to 2004, Niger has only averaged about \$22 million a year in foreign investment, or 0.59 percent of its GDP. Compare this to its neighbor, Nigeria, which averaged \$1.07 billion, or 2.64 percent of its GDP, a year in foreign investment during that same time. Yet Nigeria had more restrictive FDI equity policies. Similarly, Chad has maintained more restrictive policies, but FDI flows have been greater and FDI makes up 5.33 percent of its GDP. Even Algeria and Cameroon have gained more FDI inflows, though it makes up a smaller share of the GDP in those countries than in Niger.¹

Gabon had limited restrictions until 1998, when it opened up its economy almost completely to foreign equity. Yet Gabon only averaged about \$26 million a year in foreign direct investment between 1976 and 2004, despite the fact that India has invested over \$100 million in oil development projects there (Walker 2007). Gabon has

¹ The main source of statistics on foreign direct investment throughout this dissertation is the World Development Indicators, compiled by the World Bank. Both the subscription version and the online version of these statistics were used. The online version can be found at <http://www.worldbank.org>.

averaged less in the past thirty years than Cameroon (\$64 million per year, 0.49 percent of GDP) and even the war-torn Democratic Republic of Congo (\$61million dollars, 0.39 percent of GDP).

Swaziland, nestled between Mozambique and economic giant South Africa, should be doing well with foreign investment by all accounts. From 1976 to 2004, it maintained an open foreign equity policy with very few restrictions. Yet Swaziland only averages about \$56 million (5.06 percent of GDP) a year in foreign direct investment inflows. Lesotho averaged more than Swaziland over that period, pulling in \$69 million dollars (7.48 percent of GDP) in FDI even while maintaining more restrictions on foreign investment. Even South Africa, despite a flight of investment during the apartheid years, still managed to average ten times as much investment than Swaziland during those years, though FDI's percent of GDP in South Africa was a miniscule 0.49 percent.

On the other side of the coin, Brazil, China and Mexico appear to acting contrary to conventional wisdom, and yet for all intents and purposes they are better off for it. They all receive large amounts of foreign investment despite the fact that they have relatively restrictive policies on foreign investment equity. Brazil allows 100 percent foreign ownership, but it restricts a large number of industries to national investment, thus limiting the industries in which foreign investment can take part. From 1976 – 2004 it has a more restrictive attitude toward foreign investment when compared with other countries in its region, and yet it managed to pull in an average of almost \$9 billion (1.55 percent of GDP) in foreign investment yearly during that time.

China's record toward foreign investment has been even worse, comparatively. From 1976 to 1984 China did not allow foreign investors to fully own a company.

Foreign investors had to find local partners, and take a minority position. In 1985 it opened its markets to 100% foreign ownership, but on a very restricted level. Yet China has averaged \$19 billion dollars a year (2.09 percent of GDP) in foreign investment between 1976 and 2004 despite its restrictive policies.

Among these three countries, Mexico's attitude toward foreign investment was probably the most restrictive. Mexico allowed foreign investment only in partnership with local capital in its national markets in the period from 1976 to 1988. Companies that could be 100% owned by foreign interests were restricted to special border zones. In 1989, Mexico opened its markets to 100% ownership while reserving significant chunks of its industrial sectors for national capital. Yet Mexico has managed to pull in \$7.7 billion (1.77 percent of GDP) yearly in foreign investment equity despite these restrictions.

At first glance, one could classify these countries and their different situations on size and region. After all, Niger, Gabon and Swaziland are located in Africa and are small. Mexico is located next to the United States, China is in the booming Asian economic zone, and Brazil is the largest country in the economically vibrant Latin American region. These facts probably play a part in explaining their contrasting situations, but the main point still stands out. In the game of globalization, Niger, Gabon, and Swaziland appear to be doing what is expected of them. They have maintained few restrictions on foreign direct investment equity in their markets, but they are not rewarded by the international economic community for their efforts. On the other hand, China, Brazil and Mexico flaunt restrictions on foreign equity, and yet investment keeps pouring in.

What is the explanation for these apparent contradictions? Why do developing countries want foreign investment? Why should some developing countries maintain open policies toward FDI if they do not get rewarded? Why shouldn't developing countries simply restrict FDI as they see fit – after all, if China, Mexico and Brazil can do it and receive billions of dollars in investment, while other countries go out of their way to make themselves attractive to potential investors and get very little, what is the point? Why do countries bother with policies on foreign direct investment? What influences the attitudes on foreign investment that are reflected in policies? Do these policies make any difference at all when it comes to FDI inflows?

I will explore these questions by investigating this phenomenon of globalization – foreign direct investment (FDI).² In particular, I examine the creation of foreign direct investment policies in developing countries and how those policies affect actual foreign direct investment inflows. I develop a multi-level model of FDI policies and inflows in which a combination of international and domestic politics intertwine to not only influence FDI policies in developing countries, but also influence the eventual agreements between developing states and foreign investors. I test this model using two time-series cross-sectional quantitative analysis of 55 developing countries over a period of twenty-nine years, from 1976 to 2004. In the first analysis, I develop a model of FDI policy based on domestic and international political factors, demand for FDI, and anticipated FDI inflows. In addition, I evaluate the relationship between policy and FDI inflows through a second analysis based on policy outcomes and international and domestic economic factors. Finally, I follow up these two quantitative analyses with a

² The Organization for Economic Cooperation and Development (OECD) defines foreign direct investment as “a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise).”

separate qualitative study of policymaking and FDI outcomes in two Caribbean Basin states: El Salvador and Nicaragua

Globalization is a concept that sparks fierce debates among politicians, academics and even the general public. Business leaders and policymakers, the practitioners of globalization, argue that open markets and free trade will create new economic opportunities for all. In truth, developed countries in the global North have benefited for decades from globalization in all its forms and account for the lion's share of the world's economic trade and investment. Their message to the developing countries in the global South has taken the following form: Open your economies to market forces, and you will achieve greater development than is possible on your own. Developing countries, after trying and then rejecting liberalization in the 1960s, embarked on campaigns of economic self-sufficiency. They were initially slow to embrace the new message of globalization. However, eager to advance their economies and afraid of being left out of the promised economic boom, developing countries have lined up to liberalize their trade and open their markets in the 1990s and the early 21st century.

Attracting investment from foreign companies has been an important economic strategy amongst developing countries. They have seen the continued growth of the developed economies and have come to believe that such interconnecting economic links can bring greater development. They have watched international firms from the United States invest in Europe and Japan throughout the last half of the 20th century, and European and Japanese firms invest in the United States in turn. In particular, developing countries look to such foreign direct investment (FDI) from developed

nations because it promises jobs, technology, management skills, infrastructure and a host of other improvements. Many developing countries also believe that FDI will increase their foreign exchange holdings, tax receipts and boost their international economic standing by improving their balance of trade and payments.

To set the stage for FDI in their markets, developing countries create policies establishing their level of openness to foreign firms and their activities. These policies are delineated by three types. The first category of policies governs foreign firms' entry into the market. These policies generally outline what restrictions, if any, foreign firms face when they set up business in the country. The second category of policies is incentives – the types of fiscal and financial inducements offered directly to the firm if it decides to set up business. The third category is regulation, or what laws foreign firms will have to obey in order to continue doing legal business in the country. Altogether, these three types of policies serve an important function for developing economies. They allow developing countries to control the flow of FDI into their markets, they allow for developing countries to compete against other developing countries for FDI, and they allow the state to maintain control over and set boundaries for foreign firm activity once the firms are establishing themselves in the market. These sets of policies also serve as signals to foreign firms. They indicate how open a country is to new FDI, what kinds of agreements they may be willing to make to beat out the competition, and what kind of freedoms firms will or will not have if they set up business there.

At first glance, these policies seem very important in the process that makes FDI an integral facet of globalization. As one of the manifestations and engines of globalization, FDI is an accepted, and popular, means for economic development. FDI

has seen tremendous growth in the last half century. Since the 1970s, developing countries have increasingly courted multinational corporations (MNCs) in efforts to attract more FDI within their borders. On a larger level, FDI is a tangible symbol of interpenetration that attracts both praise and criticism from politicians and academics alike. However, the story of FDI policy and its contribution to the FDI process has not been adequately told, in large part because there have been no adequate and reliable indicators of FDI policy that can be used in systematic large-scale research. Theories about FDI policy have thus been inadequately tested except in case studies which give us a limited picture on how they relate to the overall FDI process.³ Research has been able to bridge this gap by focusing on other indicators of FDI – most often FDI flows and stocks.⁴ However, these indicators only indirectly, if at all, illuminate the role of policies, which in turn illuminate the key role of the state in the FDI process.

Why are developing states' policies relating to FDI so important? First, in an era of global integration, where some see an erosion of economic boundaries and the decline of the nation-state relative to non-governmental entities in the international marketplace, I argue that nation-states still have means to control their economic destinies. Perhaps a future world will make the nation-state obsolete, but for the present, nation-states still make choices that restrict or enhance the flow of investment into their markets. Second, these choices may be dictated in part by characteristics of the host polity, and in part by the international system. These choices are inherently political, actively chosen by nation-states in the process that leads to the creation of their policies. Third, I argue that these policies may have ramifications on the

³ For example, see Fletcher (2002), Besley (1995) and Laney (1991).

⁴ For some recent examples utilizing flows, see Egger and Winner (2006), Jensen (2003), Li and Resnick (2003), Bandelj (2002). For a recent example utilizing FDI stocks, see Kentor and Boswell (2003).

investment that flows into the host state, and on the gains that accrue to the host state. Fourth, the inadequate amount of rigorous study on developing states' FDI policies has meant that some important research questions have not been answered satisfactorily. Why do developing states set their policies as they do? Why have some developing countries chosen to promote FDI with few restrictions, while others regulate and restrict it to a greater extent? Through research, we have gained a good understanding of the effects of FDI on states' political and economic processes, and we have made strides in understanding some effects of FDI inflows, but there is very little systematic and quantitative research that explores why developing countries are more or less open toward FDI and whether this level of openness has any effect on their FDI inflows. This dissertation fills the gap in research by developing a model of foreign direct investment that includes FDI policymaking, and tests it through quantitative and case study analysis. The tests will answer questions about the determinants of FDI policies and the effectiveness of FDI policies on FDI inflows.

This study focuses on the political and economic factors that lie at the heart of FDI policy and its role in the FDI process by presenting and testing three main hypotheses. First, I argue that FDI follows the same framework of two-level games established by Putnam (1988). In this sense, FDI ultimately involves an agreement between two entities: developing states and international firms. States develop their policies on FDI in order to control the flow of FDI into their markets, and these policies are influenced by domestic politics and the realities of the domestic market. However, international factors introduced by the globalization of trade and investment also

influence policymaking, and these factors are usually more friendly to international firms.

Secondly, the creation of FDI policy is only part of the full story of FDI. These policies become the basis for future agreements between states and firms, with domestic factors influencing how states can bargain with firms and whether firms will invest in developing markets, and international political and economic factors providing further influences on decisions by firms to invest. Once FDI policies have been completed and the stage is set for FDI, I argue that those policies in turn influence actual FDI inflows into each developing country's domestic market because they set a level of openness to FDI. Combined with characteristics of the investment market in each country, and the economic characteristics that are unique to each state, FDI policies should exert a profound influence over the actual flows of FDI.

In general, I argue that FDI policies follow a pattern generally as depicted in Table 1-1: with policies and outcomes relating from low openness to FDI and low inflows to high openness to FDI and high inflows. While my model predicts that most developing countries' FDI policies and inflows follow a direct and positive relationship, indicating that policy is important in the FDI bargaining process, there are some countries that will fall outside these expectations.

Those countries that fall in cells II and III of the table will be interesting to examine, because they will help determine whether policy really matters or whether there are other factors that are more important to FDI inflows. Unfortunately, prior to this research no reliable and direct measure of FDI policy appears to exist, which is an extreme obstacle to these arguments. To test these hypotheses, this dissertation

Table 1-1: Predicted Relationships Between FDI Policies and Flows			
		Policies: FDI Openness	
		Low	High
Outcomes: FDI Flows	Low	I	II
	High	III	IV

therefore develops an important new measure of FDI policy. This new index will be a valuable addition and resource to future researchers of FDI and FDI policy.

Why does this dissertation only concentrate on developing state policies, and not generalize to all states? First, FDI involving firms investing in developed states may be very different than FDI involving firms in developing states. Enough key factors differ between the developed nations and the developing nations, as well as the fact that FDI to developed states is still greater than FDI to developing nations, that addition of developed nations to the sample may cause a loss of significance in those factors that truly affect developing states' FDI processes.

Second, until recently a lack of available data from developing nations has hampered the study of FDI in the developing world. While some research has been done with developing nations, more studies have been performed on FDI in the developed world.⁵ However, greater amounts of data coming from developing nations and compiled by world institutional bodies have made greater study involving developing nations possible.

Third and foremost, developing countries contain the bulk of the world's population, and the bulk of the world's poverty. The developing world, for the most part,

⁵ This has been true from Hymer's (1976) first research on foreign direct investment in the 1960s to today. For more examples, see Vernon (1966), Kindleberger (1974), Barrell and Pain (1997).

has, for better or for worse, chosen to utilize FDI as a cornerstone of their development strategies. Since the struggles of developing states to achieve greater living standards for their citizens has been a key concern of the developing and developed world alike, any research that helps shed light on their development processes is extremely important and may serve not only as an academic exercise, but also as a policymaking aid.

Recent Trends in Foreign Direct Investment

The amount of FDI capital inflows and outflows around the world rose sharply starting in the early 1980s, peaked in the year 2000, and since has suffered a precipitous decline. Table 1-2, reproduced from UNCTAD, illustrates these trends.

Figure 1-1 graphs the trends for FDI inflows and outflows of capital. The reason for the recent decline was blamed by the World Investment Report on slow economic growth around the world and a decline in cross-border mergers and acquisitions (UNCTAD 2003). Despite the declines, the amount of foreign direct investment in 2002 throughout the world, both inflows and outflows, remained over 200 times greater than in 1970, and around 4.5 times greater than in 1992.

Where does this foreign investment go? By and large one characteristic of foreign investment is that the bulk flows to and from the developed world. From 1970 to 2002, the developed world has received an average of 72 percent of the inflows of FDI capital. Developing countries, on the other hand, that have made foreign direct investment a key part of their development strategies, have averaged far less. Figure 1-2 gives a graphical representation of developing countries' inflows, and their share of

Table 1-2: Selected World Indicators of FDI, 1982-2002

Item	Value at 2000 prices (billions of US dollars)			Annual growth rate (Percent)						
	1982	1990	2002	1988-90	1990-95	1995-00	1999	2000	2001	2002
Inflows	33	159	677	18.5	15.4	36.7	60.6	33.1	-39.1	-20.2
Outflows	16	184	673	23.1	12.7	31.4	63.9	21.9	-39.0	-8.1

Source: World Investment Report 2003 (<http://www.unctad.org>)

world inflows (UNCTAD 2003). In 1982, developing countries hit their highest percent of world FDI inflows, at nearly 46 percent. Developing countries captured over 40 percent of world inflows two other times, in 1994 and 1997. In 2002, they captured only about 25 percent, over a percentage point less than their share at the beginning of the 1970s.⁶

Nor is FDI distributed evenly among the developing nations. A number of researchers single out Brazil, Indonesia, Malaysia, Mexico and Singapore as those developing countries that capture a large percentage of FDI from the developed world (Moran 1986, Cable and Mukherjee 1986, Cable and Persaud 1987, Page 1987). Recently, China has grabbed more and more of the FDI available from the developed world. In 2003, among the top 20 recipients of FDI, China ranked second to Luxembourg with receipt of \$53 billion, Singapore grabbed about \$16 billion for 14th place, Mexico ranked 15th with receipts of about \$15 billion, and Brazil ranked 16th with receipts of about \$13 billion.⁷ China and India also stand out as desirable locations for new investment. In 2004, one survey showed that for the first time, global company

⁶ Data gathered from the United Nations Conference on Trade and Development (UNCTAD). Their website, <http://www.unctad.org>, contains statistics on FDI available for viewing and downloading.

⁷ World Development Report, 2004.

Figure 1-1: World Foreign Direct Investment (1970-2003)

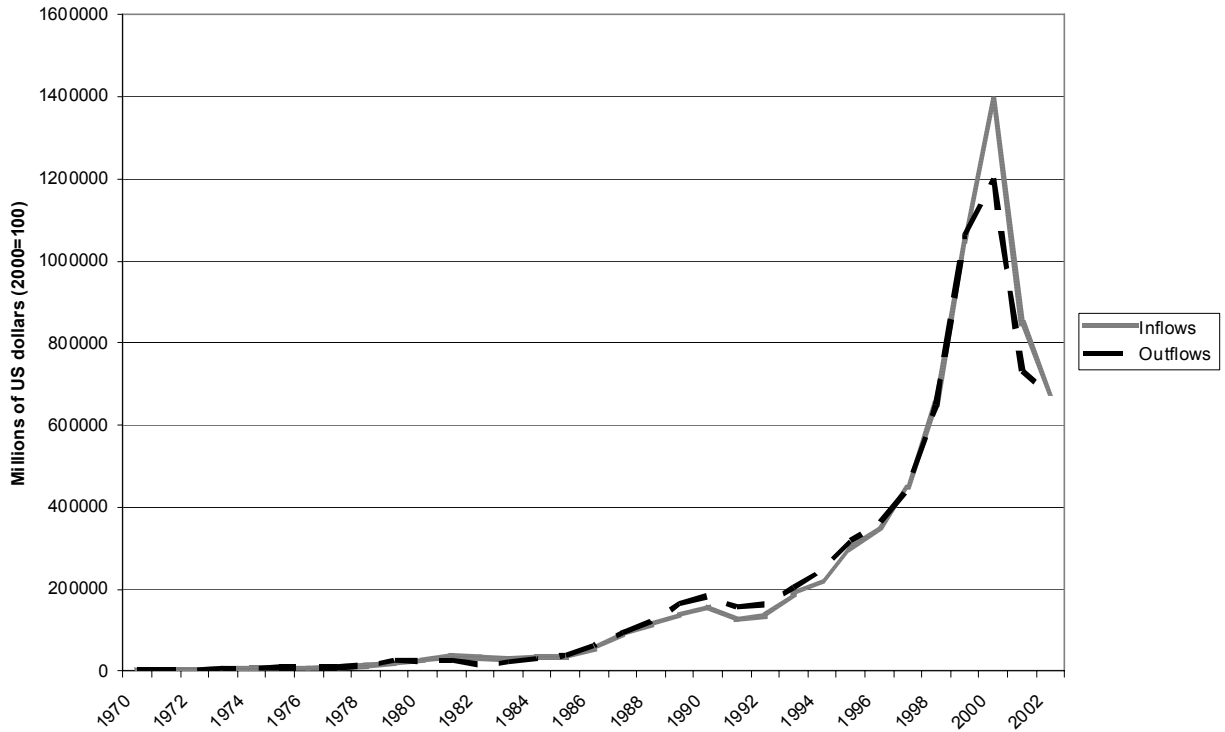
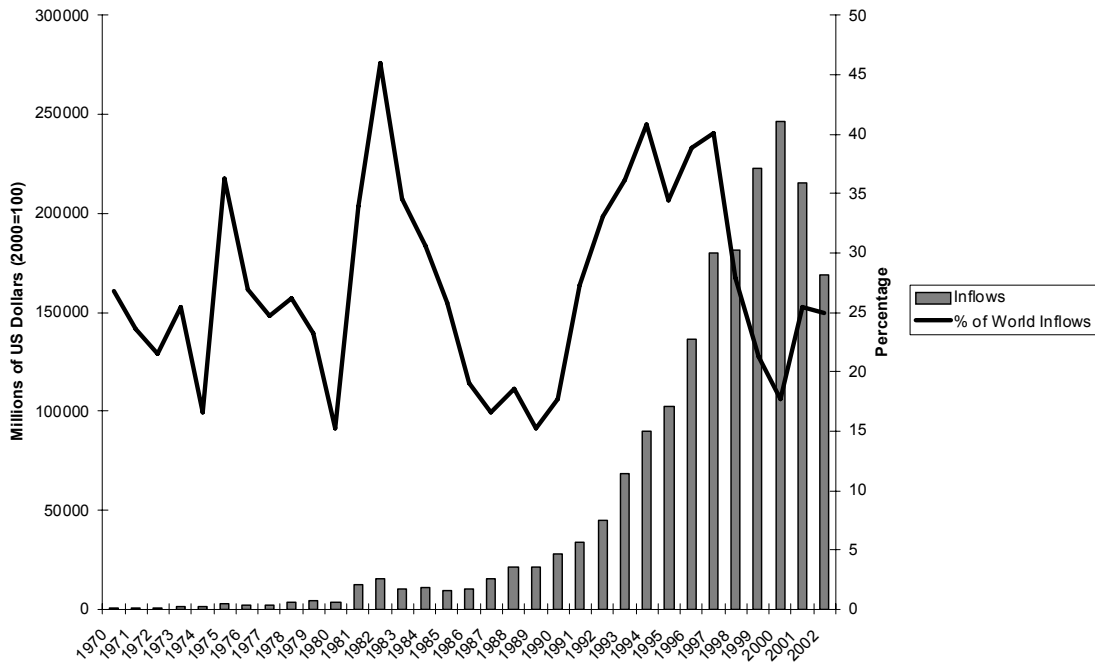


Figure 1-2: FDI in Developing Countries (1970-2002)



executives ranked China higher than the United States as a destination for investment, with India as the third most attractive location. The report states that "...China and India dominate the top two positions for most positive investor outlook, likely first-time investments, and most preferred offshore investment locations for business processing functions and IT services."⁸

Brief Outline of the Dissertation

Having introduced a rationale for a new study of FDI, the remainder of this chapter will discuss the structure of the rest of this dissertation. Chapter Two will draw specific elements of economic and political science literature together to create a model of FDI. I first revisit these questions: What accounts for the variation of FDI policies in developing countries? Do policies have an effect on FDI flows? I argue that individual developing countries policies are indicative of a blend of wariness and openness toward FDI, partly due to economic outlooks at various points in time that reflected pessimistic or optimistic views of industrialization. Modernization theory and dependency theory are discussed as emblematic of these two viewpoints. I then introduce the main actors in the FDI story, multinational firms and developing states, and discuss their motivations for participating in the FDI process by reviewing a number of theories on FDI from both the firm and state perspective. Following that discussion, I introduce the logic of two-level games. I argue that it best explains the FDI process because it incorporates both the international and domestic level influences on policymaking and agreements between firms and states.

⁸ AT Kearney. 2004. <http://www.atkearney.com/main.taf?p=1,5,1,151>.

At the end of Chapter Two I develop a model of FDI. FDI policy is theorized to be influenced by both domestic and international political and economic factors in a larger multi-level process. FDI policy establishes each country's openness or restrictiveness to FDI. These policies are subject to domestic level political factors such as regime type, nationalism, ideology, and domestic economic realities, such as the availability of alternatives to FDI. However, international political and economic factors, such as pressure from international institutions and proximity to developed countries, also have an effect on domestic FDI policies.

Once the level of openness to FDI is determined through policy, it becomes a factor in determining FDI inflows. Policies establish a baseline for agreement between developing states and firms. Developing states with open policies have a larger range of agreement possibilities, whereas those with restrictive policies have a smaller range of agreement. These policies combine with other domestic and international economic and political factors, such as international and domestic political stability, characteristics of the investment market, wage structure, presence of corruption, and property rights, to create an environment in which international firms decide whether or not to invest. The type of investment opportunity (sectoral) will be particular to each state. I further argue that FDI policies and FDI inflows have mutual dependence on each other, with each exerting influence over the other.

Chapter Three subjects the theory presented in Chapter Two to empirical statistical tests. Drawing on publicly available data published by international institutions, I created a paneled time series dataset encompassing 55 countries and 29 years (1975-2004). In addition, I drew on the Exporter's Encyclopedia, published by Dun

and Bradstreet, to create an important new indicator of FDI policy: a 4-point index which measures the relative openness and restrictiveness of each developing country toward FDI. This indicator is the first of its kind, and should create opportunities for additional research on FDI policy per se. I test the influences on FDI policy by using a general linear, latent, and mixed model process and discuss the results. I find positive associations between developing countries' openness to FDI and democracy, membership in international institutions, proximity to developed countries, external debt, and past experience with FDI. I find negative associations between FDI policies and nationalism and savings rates. Chapter Four extends the model to FDI inflows. I specifically propose that FDI inflows are positively associated with open FDI policies, and I find that is the case. FDI inflows are also positively associated with degree of democracy.

Chapter Five presents case studies of two developing countries: El Salvador and Nicaragua. El Salvador and Nicaragua offer interesting similarities and differences for comparison. Each country has had a similar history in Spanish colonialization and independence, and each has had a history of political and economic dominance from a handful of elites. In El Salvador, a small coterie of influential land-owning families has virtually controlled the political and economic landscape of that country. In Nicaragua, most of the 20th century political and economic history of the country was dominated by the Somoza family. However, many differences remain. El Salvador maintained a nominal democratic government, dominated by right-wing groups, while Nicaragua was ruled by the Somoza family dictatorship. Both countries faced violence and repression, and both suffered from civil conflict. In El Salvador, the conflict ended in stalemate,

leaving the country ruled by centrist and then rightist forces. In Nicaragua, however, the conflict turned into a victory for leftist forces, followed by a continued and protracted civil war.

In addition, both countries have had differing relations with the United States. In Nicaragua, the Somoza regime largely retained the support of the United States, with some exceptions when the dictatorship went too far with human rights abuses and corrupt practices. The later success of the Sandinistas in Nicaragua led to increased U.S. involvement in military efforts to overturn the government, which helped culminate in the 1990 election that turned out the Sandinistas and ushered in the Chamorro government. In El Salvador, U.S. military support for the government helped keep the country from turning left politically, though at the cost of civil unrest. Economically, both countries have also had differing histories in the 20th century. While El Salvador's governments embraced free-market capitalism and experienced some growth in the industrial sectors in the 1970s, largely due to foreign investment, the 1980s brought an economic downturn due to the ongoing civil conflict. In contrast, Nicaragua's small industrial sector was geared toward domestic consumption and never really competed with coffee and other agro-industrial exports. The Chamorro government brought in economic reforms in the 1990s hoping to attract further aid and investment, but these never really materialized.

To test the theory of FDI offered in this dissertation, I will examine their histories of domestic and international politics and their economic openness. I will also pay close attention to FDI and FDI policies. I include interviews with El Salvadoran government and academic elites who know the policy process relating to FDI and its ultimate effects

on the FDI bottom line. These interviews will help complete the overall picture that I establish with my theory and model.

I will follow the case study chapters with a short review in Chapter Six of the research presented in this dissertation, and some conclusions. I will also provide some possible directions for future research based upon my findings. I hope that the addition of a new measure for FDI policy, a quantitative test using that measure, and comprehensive case studies will significantly add to the previous valuable research on foreign direct investment.

The Path to a New Model of Foreign Direct Investment

In the following chapter I will begin by focusing on attitudes toward foreign investment established by modernization and dependency theories and then concentrate on the relationship between states and firms. While the multinational corporation pursues strategies toward greater profit, the state or groups within the state pursue strategies toward greater development. These development strategies are represented by state policies including those dealing with foreign direct investment. I argue that developing states create policies that constitute a basis for eventual agreement with international firms. These policies can be classified as incentives or restrictions. The more open (restrictive) the policies, the easier (harder) the bargain the state will drive. In turn these FDI policies influence the level of FDI inflows that enter developing countries, since along with other factors they provide some level of inducement for international firms to invest. The entire dance of FDI takes place within

a complex web of interactions between domestic political and economic activities and the international political and economic environment, which I will discuss further.

Chapter Two

Toward a Theory of Foreign Direct Investment Policy

Arriving at a theory of foreign direct investment (FDI) policy is a bit like staging a play. There are actors, both primary and secondary, encounters among those actors, and outcomes from those encounters. However, there are also motivations, desires and strategies that drive the actions of each of the actors. These characteristics are specified in an overall narrative, which creates the conditions for what happens on the stage. In this chapter, I will lay out the narrative, identify the actors, especially the main actor or actors, highlight their characteristics and describe their encounters and the outcomes of those encounters. The following pages will illuminate the drama that is being played out in the foreign direct investment story. The goal is to identify why developing countries pass policies on FDI, and why those policies vary from more restrictive to more open. A second goal is to determine if developing countries' FDI policies have an effect on the amount of FDI that flows into their markets.

The first part of the chapter will set the stage for why developing countries restrict or demonstrate openness to FDI. I will examine two main theoretical frameworks which I argue have influenced developing countries' attitudes toward FDI over the past half century. I will then introduce our main actors of interests, developing states, and their motivations. I will also introduce and briefly touch on another primary actor, multinational corporations, without which the FDI story would not occur. I will explain the web of domestic and international factors that influence agreements, and tie

everything back to the main goal of explaining FDI policies and their effects on FDI flows. I will conclude the chapter by defining a model of FDI that includes FDI policy.

I assume, throughout this dissertation, that all developing states have a desire to better their economic development at various points in time. Regardless of whether they put their development plans on hold for a period of time, they will have pursued or will pursue development at other points in their history. I believe this is a reasonable assumption because the history of states is dynamic, not static. Governments, economic situations, world politics and other aspects of states change, and so do their goals.

I also assume, for the sake of simplicity, that investment agreements are between one firm and one state. Of course, developing states most likely engage multiple firms and also compete against other states. However, I argue that each agreement process between a developing state and multinational corporation follows similar dynamics, and therefore simplification to a one-state, one-firm scenario helps explain all such situations.

Setting the Scene

As explained in Chapter One, FDI has been a growing and important part of the globalization of the international economy. In the latter half of the twentieth century, FDI has been a vital component in the development strategies of underdeveloped countries. FDI has been at the center of a convergence of desires between the developed and the developing world. By and large, the developing world has desperately wanted to industrialize to enjoy the benefits experienced by the already industrialized developed

world. However, industrialization not only provides benefits, but also costs. For this reason, I will argue that developing countries are of two minds about FDI. On one hand, they want investment, capital, job opportunities, managerial and technological advances, and additional revenues. On the other hand, allowing foreign investment potentially brings about a whole host of problems for host governments, including partial loss of economic decision-making control, local opposition by interest groups, and greater international scrutiny of their policies toward business and the economy in general. Thus, each developing country weighs the benefits against the costs of FDI, and decides how wide to open its doors to foreign capital. Some countries will be more wary about this path to development and restrict foreign investment to a greater degree based on a multitude of factors such as their internal political situation, their position in the international community, the availability of alternative ways to development, and their own past history with FDI. Other developing countries, based on the same factors, will take a more positive view of foreign direct investment, and open the door wider.

For those in the developed world, the benefits of industrializing the underdeveloped countries have largely outweighed the costs. At the very least, developing countries hold the potential of new markets, cheap labor and manufacturing, and can possibly serve as a new source of profits for multinational firms. For the more utopian-minded, the prospect of a fully modernized and industrialized world creates the prospect for a high standard of living for all, harmony and peace among nations, and an opportunity for humanity to engage in higher pursuits. The idea that humanity can rise above its petty conflicts, harmonize its interests in the pursuit of rational ideas, and live in prosperity was first proposed during the Enlightenment in Europe. Over the

centuries, various incarnations of this philosophy have flourished and waned. The hope of a more rationalized, modernized world influences the narrative I am constructing in the 1950s, just after the bloodiest war in history and in the middle of the Cold War between the United States and the Soviet Union. Modernization theory emerged from academia in the United States partly as a way to entice developing and newly liberated states away from the umbrella of the Soviets (Latham 2003). The message was simple. The industrialized countries in Europe and the United States were all once developing states themselves. Through a progression from agriculturally-based societies to industrialized societies, each of the industrialized nations advanced until they reached modernity. The developing countries are on the same path, modernization theory argued, maybe starting at a later point in time or moving at a slower pace but all advancing inexorably forward. In order to help the process, the acceptance of Western values such as capitalism and democracy was seen as key to leaping ahead of the countries (the Soviet Union and its allies) that had turned their back on Western modernity to pursue a socialist form of industrialization.

One widely accepted version of this theory was proposed by Walt Rostow (1960). Rostow argued that modernization proceeded in a linear set of stages. Basing his arguments on observations of European cases, Rostow contended that all countries first begin in what he labeled the *traditional* stage. At this stage, the state is rudimentary or non-existent, and the market consists of low-technology production and subsistence agriculture. As the nation-state begins to centralize, the *preconditions for take-off* begin to appear. The growing nation-state fosters private entrepreneurship, which in turn leads to advances in technology and the beginnings of industrial production. These

advances create changes in the economic, political and social environment. The state pushes greater development by passing laws favoring production over agriculture. The overcoming of obstacles and groups opposed to economic development puts the nation-state in the *takeoff* stage.

Rostow maintains that nation-states that continue a long process of economic development by extending modern industrial production techniques throughout society advance through a stage called the *drive to maturity*. After about 40 years, the stage of *high mass consumption* occurs, in which a state's economy has become sufficiently diversified and more service-oriented. Industrial production concentrates on durable goods rather than non-durables.

Another articulation of modernization theory was provided by Lipset (1959), who proposed that various socioeconomic factors, such as education, industrialization, urbanization and wealth, along with the effectiveness and legitimacy of the political systems, were the keys to political and economic modernization, particularly sustaining democracy.

This linear and somewhat deterministic theory seemed to not only explain how the European nations developed, but how other nations, particularly the developing countries in the global South, could develop as well. State actions that promoted private entrepreneurship and free markets assumed primary importance. However, many developing nations that followed U.S. prescriptions for development, regardless of what types of policies they put together, did not seem to develop as predicted through the 1950s and 1960s. From the modernization viewpoint, this lack of development was explained by inadequate investment in the local economy and bad government policies.

Modernization theorists, particularly Rostow, proposed advancing foreign aid from the industrialized world, most notably the United States, to help finance development in underdeveloped regions. They argued that such aid would create appreciation for capitalism, and create aspirations for democracy in recipient countries (Haefele 2003). Most notably, it was argued that such aid would keep such states from falling into the Soviet orbit, which was advancing its own form of modernization with its command economy model. More recently, Boix and Stokes (2003) find, statistically, that economic development leads to democracy, especially when per capita income exceeds \$12,000 per year.

Modernization theory has been under scrutiny since it was articulated. Some critiques have to do with the factors that push modernization. For example, does modernization in developing countries arise from endogenous factors or exogenous factors? Migdal (1974) looks at what he calls “culture contact” or exposure to a wider cultural environment (perhaps akin to globalization), and finds it insufficient to explain modernization. He argues that the breakdown of old traditions and institutions within societies, if they occur, is another explanation for modernization. Similarly, Pye (1979), in a critique of the development of modernization theory, points to local cultural factors and its effects on the pace of economic and political development within different societies.

Other criticisms arise from modernization theorists’ predictions of democracy given greater economic development. Some theorists, such as Barrington Moore (1966), though sympathetic to the idea that development of a middle class could allow a country to politically modernize, disputed that the Western model would lead to one

outcome. He argued that differences in class development could easily lead to modernization under non-democratic conditions. More recently, Przeworski and Limongi (1997) challenged the prediction that countries that economically develop become democratic, citing data that show that some dictatorships are wealthy and reach stability under greater development. In their view, democracies thrive due to political actors, and because they are modern. Similarly, a study of the military-led modernization efforts in Latin America found that increased military spending thwarts modernization (DeRouen, Jr. and Heo 2001). Since many Latin American countries have histories of military rule during modernization attempts, modernization may not have been the impetus behind their recent political development into democracies. In that vein, modernization may not have contributed to democracy in Thailand (Englehart 2003).

Other theorists took aim at the argument that modernization was inevitable. Notably the dependency school, beginning with Andre Gunder Frank and continuing with Immanuel Wallerstein, argued that the results of industrialization on the Western model were conditioned by the structure of the world economy, which was based on colonization and exploitation (Gilman 2003). Developed nations and their former colonies were locked in a relationship of dependency, where developing countries gained somewhat, but the core developed countries gained more because the world economic system limited the economic capacities of the developing world.

Different approaches to dependency theory developed, all concentrating on the systemic nature of the international economic environment (Fry 1983). One, Marxist in character, focuses on the effects of socio-economic class and investment on national

welfare. It argues that the capitalist class in industrial countries uses FDI to dominate the lesser-developed countries. Investments are made in commodities and raw materials, which are exported out of the host country and manufactured into industrial products that are imported back to the developing countries. Thus, developing countries are victims of a type of economic colonialism, continually dependent on the industrialized countries for consumer goods, made from developing states' own resources, at high prices.

A non-Marxist strain of the theory softens the language of economic colonialism, but argues that the net effect of the dependent relationship over time is a continued loss of economic ground to developed countries. In other words, this softer dependency theory does not necessarily accept the thesis of economic colonialism, but argues that the inherent bias of the international economic system leads to similar effects.

In both strains of dependency theory, the world is seen in dichotomous terms. The international arena is divided into areas called the "core" and the "periphery." The core is made up of industrial states concentrated mostly in the global north. These states have set up a system based on economic openness, especially with each other. Trade and investment pass relatively easily between them. Because they are industrialized, they have a wide variety of materials that can be used to trade with other nations for comparative advantage. The periphery is made up of all other nations. These nations range from some industrialization to little industrialization. They have relatively few resources or products to trade for comparative advantage.

Some periphery countries, like Mexico, Brazil and the newly industrializing countries of Asia, managed to make some advances in industrialization that was not

accounted for in dependency theory. To explain these countries, Peter Evans (1979) advanced a version of dependency theory that he labeled dependent development. In his formulation of dependency theory, some countries were able to advance from the periphery to a semi-peripheral state based on a tripartite alliance of international capital, local capital and the developing state. These countries are able to industrialize to a point, and even gain control over some non-critical sectors of the economy. However, conditions always dictated that local capital would be at a disadvantage. The developing state plays local capital against foreign capital, and left out of the process is the mass population of the developing country which is not allowed to participate or make decisions about economic growth.

Resources that developing countries offer are raw materials and abundant labor. Because they are under-industrialized, however, they lack the ability to exploit these resources efficiently and must choose to try to industrialize by themselves, or to invite help from outside. The first choice is often economically more expensive than they can handle, but may be popular socially and politically. The second choice may be less expensive economically and gain developing countries' world credibility, but governments opening up to the global system and inviting agents of industrialization from outside to enter their economies may pay a political and social price. Once there is a leak in the economic dike, the flow of outside capital, including foreign direct investment, becomes difficult to stop.

Developing nations are affected by their reliance on the world economic system to develop through FDI, argues dependency theory. While this is not the main focus of this dissertation, it is interesting to review because it foreshadows later arguments on

the agreement process between states and firms. In general, industrialized countries and their agents, the multinational corporations (MNCs), continue to draw upon resources primarily from the developing host countries, leaving developing countries in a permanent state of under-development.

The costs of industrialization are painstakingly tallied by dependency theory. First, it is argued that MNCs do not bring much new capital into host countries; instead they borrow locally and spirit capital back to the industrialized countries through transfer pricing and profit repatriation (Fry 1983, Moran 1986, Billet 1993). Second, FDI allows MNCs to maintain a monopolistic advantage in developing countries' markets, stifling local competition, creating technology dependence, stripping resources from the country and leading to MNC domination of key sectors (Evans 1979). Third, MNCs bring inappropriate, capital intensive technology into host developing countries which do not make the best use of their abundant labor resources. Inequality problems are exacerbated by the formation of a labor elite and the development of enclave economies (Evans 1979, Moran 1986, Grieco 1986). Fourth, FDI brings inappropriate products into host country markets, which can be of little social value and in turn, exacerbate social inequalities by fostering a consumer culture (Vernon 1977, Fry 1983). Fifth, the penetration of developing countries by MNCs leads to dependent and asymmetric relationships with the industrialized countries, increasing the power of MNCs (Fry 1983) and possibly leading to MNC interference in host state politics and policy (Apter 1976).

In many ways, classical dependency theory is as deterministic as modernization theory. It points to world capitalism as the main cause of underdevelopment in

developing countries (Bratton 1982). For our purposes, the importance of dependency theory lies not in its arguments about the potential effects of capitalism and FDI on political and economic development prospects. Instead, the theory is important because of its view on state roles and state policy. Dependency theory argues strongly that states should be active participants in the economy, and it had a significant impact on the way that many nations approached FDI and FDI policy, especially in the 1960s and 1970s. Many developing nations, following the tenets of dependency theory, severely restricted the amount of FDI unless it nurtured home-grown industries with an emphasis on greater exports and replacing expensive imports. Foreign firms were required to localize production, to varying degrees of success, in many countries including Korea, Malaysia, Thailand, the Philippines and Indonesia (Doner 1992). The primary goal for many developing nations was to become less dependent on foreign-made products by encouraging local manufactures, and to gain greater economic wealth by exporting these manufactures abroad. Many developing countries took a direct role in their economies by establishing and strengthening state-owned corporations and parastatals (Evans 1979).

The 1970s saw a number of developing countries adopt policies based on the tenets of dependency theories. Export-oriented industrialization policies, combined with greater regulations on foreign corporations, restriction on the participation of foreign corporations in developing markets, and import substitution policies to reduce reliance on foreign products were supposed to allow developing states to drive a harder bargain with foreign companies. Such policies were not without their critics. Mahler (1981) made an early argument against dependency theorists' tendency to blame all

developing country ills on capitalism in his study of the world sugar agreement. Rather than quit cultivating sugar because of perceptions that the market is controlled by firms and advanced countries, he suggested more coordinated strategies among developing countries. Ahiakpor's (1985, 546) case study of Ghana showed how policies influenced by dependency theories could go wrong. He argued that such policies led to "poverty and misery." By the 1990s, after disappointing economic results and many economic crises, many developing countries began to reduce government participation in the economy, loosen regulations and restrictions, and privatize government-owned industries. In 2002, one critic declared dependency theory dead (Velasco 2002).

Ideas of modernization began, in one way or another, to gain credence again. Neoliberal economics argued that developing states had meddled too much in the economy, and must scale back and allow free market policies in order to modernize. Western neoconservatives, on the other hand, merely hoped for stability and order among developing countries, rather than modernity (Gilman 2003, 71). They criticized previous neoliberal views that modernization could be imposed or encouraged, but backed invasion of an autocratic, developing Iraq in an attempt to introduce democracy to the Middle East, arguing that toppling the Iraqi government would bring the Middle East eventually closer to modern Western values. This cyclical movement of development prescription is noted by Paul Krugman (1995), who describes the movement from free-market and state privatization policy recommendations in the 1930s to those of state intervention and activism in the markets in the 1960s and 1970s, and back to Washington Consensus recommendations of free-markets and privatization in the 1980s and 1990s.

I argue that the result, for developing countries, is a mixture of acceptance of the international economy and its promise, and a wariness of the methods of the international economy. Many developing countries implemented import-substitution-industrialization policies in the 1970s, hoping to reduce their reliance on imports from the developed world and to foster their own industrial capabilities. Many countries allowed restricted foreign investment, and regulated it. Massive state spending and establishment of state-owned-industries, fueled by recycled petro-dollars, led to equally massive debt-crises in the 1980s, and prescriptions of structural readjustment by international lending institutions as a remedy to put developing countries back on the right track. FDI policies in many developing countries become less restrictive, though some countries, such as China, were able to restrict investment more than others.

FDI policies serve as one indication to firms of the investment climate in developing markets, and their potential of profitability. Therefore, policies directly affect the amount of FDI that flows into the developing market. Developing countries' attitudes, reflected in their policies, consist of unique combinations of acceptance and wariness based on past experiences and future promises.

Foreign Direct Investment Defined

To this point, we have discussed the environment which allows developing countries to set policies of foreign direct investment. What is FDI and why do developing countries, on one hand, look to it as a path of development and on the other hand, treat it cautiously?

Foreign direct investment occurs when a firm in one country invests directly in facilities in another country for the purpose of producing a product, buys an enterprise in a another country, or sets up a direct subsidiary. While this concept is relatively straightforward, it still creates difficulties for researchers that wish to measure FDI and use it for study. A comprehensive FDI glossary compiled by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) defines direct investment as “a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise).”⁹ In addition, both the IMF and the OECD define a direct investment enterprise as one “in which a foreign investor owns 10 percent or more of the ordinary shares or voting power for an incorporated enterprise or an unincorporated enterprise in which a foreign investor has equivalent ownership.”¹⁰ Direct investment, according to these definitions, can include subsidiaries, branches, and associate companies in which non-resident investors own 10 percent or more of the enterprise. The World Bank follows a similar guideline when categorizing FDI.

The main agents of foreign direct investment are firms investing abroad. Labeled as transnational corporations (TNCs), multinational corporations (MNCs), or multinational enterprises (MNEs), such firms share common attributes. MNCs tend to be large and diverse, both geographically and in the products they offer. They are controlled from a central point in a home country with subsidiaries in various host nations (Vernon 1977). Home countries for MNCs are predominantly in industrialized

⁹ Organization for Economic Cooperation and Development. www.oecd.org/dataoecd/56/1/2487495.pdf

¹⁰ Ibid.

countries, though the number of MNCs based in developing countries has been rising. MNCs treat the entire world as their operational area, and all units of MNCs have the same objective as communicated from the center operations. The most commonly assumed objective of MNCs are continued profits.

FDI should be distinguished from other types of foreign capital that flow around the world. Capital can flow into countries through foreign investment, foreign aid, or by borrowing from international financial institutions. The utility of the different types of flows has undergone an evolutionary process. FDI replaced foreign aid as the most dominant form of capital flow in the 1960s and 1970s. The late 1970s and early 1980s saw the recycling of petrodollars, in which oil money from the Middle East flooded into financial institutions in developed countries and then became loans to the developing world. A ballooning of external debt forced many developing nations to undergo fiscal belt-tightening, and FDI has come back into prominence in the 1990s as the capital-generation mechanism of choice for developing countries (Billet 1993).

FDI must also be distinguished from portfolio investment, which is conducted through economic transactions in the securities markets. Hymer (1976), in a seminal study of FDI, called for a theory of FDI separate from portfolio investment because examination into the behavior of each revealed more differences than similarities, sometimes in contradiction to each other. Unlike portfolio investment, FDI is conducted specifically by firms usually over a longer term. Hymer felt that applying existing theories of portfolio investment to FDI did not make sense, and argued that the missing factor separating FDI from portfolio investment is the concept of control. Firms investing in foreign countries want control of the investment in order to maximize profits, ensure

investment security, remove competition from other international or local competitors, and appropriate full returns on skills and capabilities in the host economy. In contrast, portfolio investment tends to be of shorter duration and concentrates on quick profits. While portfolio investors in corporations with subsidiaries in foreign countries can often vote on company direction, voting does not necessarily allow control. Direct investment is, in other words, controlling investment, where the parent corporation directly controls what the subsidiary does.

This idea of control emerges from various definitions as “lasting interest” and the idea that 10 percent or more ownership constitutes an “effective voice” in the operations of the firm. However, the 10 percent floor has been challenged by some researchers who question its accuracy despite widespread acceptance (Graham and Krugman 1993). What truly constitutes a controlling interest? Lall and Streeten (1977) argue that control can be exercised with relatively low equity share, and can be exerted without direct management. Regardless of the debates about control, this concept separates FDI from other forms of international investment. However, Moosa (2002) points out that 10 percent interest does not constitute an actual controlling interest but a potential controlling interest, and that control is more evident when firms have a substantial amount of shares, and shift part of their assets, production and/or sales to the host country.

FDI creates many measurement issues as well. One of the greatest problems is the lack of available or complete data. Some countries do not publish FDI data on a frequent basis. Others employ differing standards to delineate FDI. One section of the World Investment Report 2003 is devoted to individual country reports regarding their

FDI, and parts of those reports consist of explaining each country's unique standard of FDI. Two commonly used forms of measurement for FDI are flows and stocks of capital. FDI flows are amounts invested over a set period of time, and stocks are the cumulative amounts invested over time in a country. Furthermore, flows and stocks of FDI are often divided into inward FDI and outward FDI, each measuring differing aspects of FDI. Inward FDI is stocks or capital of FDI that enters a host country from abroad. Negative inflows indicate capital leaving a host country because of government policy, profit or capital repatriation or export of goods. Outward FDI, on the other hand, consists of resources that are sent overseas by firms in the home country – outflows can also be negative for the same reasons as inflows. Researchers investigating FDI use either inflows or outflows of stock or capital depending on their research questions.

The Developing State

With this understanding of FDI, we must now define the main actors in this drama. In the world of FDI, the state is one of many actors that influences where the current of FDI flows. However, the focus of this dissertation is on the eventual action of developing states as revealed through their policies. In the narrative of this story I am describing, the developing state has a blend of openness and wariness about FDI. Therefore, it is incumbent that we appreciate the state and learn why it is important, and what motivates its actions in the FDI story.

There are a number of perspectives on the state and foreign direct investment, as well as the development of policy in general. The state can be viewed as an arena in which various societal and economic groups cooperate and compete and where policy

is created that predominantly reflects the interest of the most dominant groups. It is important to acknowledge that various groups and classes may have some effect on the creation of policies for foreign direct investment in developing countries. At the same time, the creation of FDI policy regularly pits the interests of multinational corporations against the interests of a “state” which may or may not reflect the interests of economic or social groups within it. When a developing country passes laws that restrict or enhance investment entry, or establishes regulations on MNC activity within its borders, it sends a signal to potential investors about its “friendliness” towards direct investment in general, sometimes in consensus with and sometimes against societal groups.

The “state” has not always been considered to be an important player in the political arena. Until the late 1970s, many political theories revolved around various economic and social groups within the state, arguing that such groups use the state as an arena in which to cooperate and compete in order to further their economic, social and political interests. Studies in political economy have more or less acknowledged the existence of the state, with some that give the state a greater role and responsibility and assigning various roles to it. For example, in classical political economy as articulated by Smith and Ricardo and their followers, the state plays a minimal role. The working of the market is presented as a seamless system, where individuals that act as both buyers and sellers of products and labor pursue the means to meet their subsistence levels. Public welfare is met if the market is free to operate according to its own rules; though hardship is inevitable for individuals for periods of time, the laws of supply and demand serve the public good overall. The state is relegated to protecting life, property and providing public goods that the market cannot provide.

Neoclassical political economy similarly downplays the role of the state. The neoclassical perspective argues that public welfare is maintained if all people are allowed to maximize their satisfaction. In maximizing satisfaction, people pursue consumption, thereby entering into exchange with others who are equally trying to maximize their own utilities. Neoclassical theories argue that a perfect market with plenty of competition features maximum group welfare if individuals are allowed to pursue their satisfaction without interference. Unfortunately, markets are not perfect and there are problems of externalities – the effects that transactions between two parties have on others who are not part of the transaction. Thus, neoclassical theories also see a role for the state in the absence of perfect markets, because the state can intervene to create more competition by breaking up monopolies and preventing collusion, and use fines, subsidies and regulation to limit externalities.

The Marxian perspective perceives the state in a very different way. Like Smith and Ricardo, Marx argued that the market system creates a social division of labor, which separates upon class lines. The most simple and important class division is that between workers and producers, or in other terms, labor and capital. Marx argued that labor and capital are diametrically opposed to each other because of conflict over surpluses created by the market. These surpluses are coveted by capitalists as profit, and by workers wishing to move beyond subsistence and to gain other social welfare benefits. Because capitalists always want more profit, they attempt to make production more efficient at the expense of labor. However, whereas workers may achieve class consciousness and unite, Marx argues that capitalists are not very cohesive as a class because they are in competition with each other and weaker capital is constantly

subsumed by stronger capital. Thus, the Marxian perspective sees the state arising for two different purposes. The state exists to keep social order because of the conflict between labor and capital, and to represent the interests of the capitalist class. This does not mean that the state acts at the behest of the capitalist class, but simply in capital's interest.

More academic interest has focused on how the state acts not only as an arena for political conflict, but also as an autonomous actor in the political process affecting political outcomes even as it is affected by them. Part of this "upsurge" in interest in the state, as Skocpol (1985) described it, was the realization that the state often took actions that either went beyond or went against the wishes of the dominant societal or economic groups. In addition, the fact that states cooperate and compete with each other in an international political and economic environment, and the assumptions already inherent in these relationships that states act in an internally cohesive manner by serving as an arena for compromise among their constituent units, helps to give the concept of "state as actor" more credibility.

Researchers, beginning in the 1970s, began to take the state into account in their studies. As Duvall and Freeman (1981) succinctly write:

"In capitalist societies of the twentieth century, the state is deeply and directly involved in the processes of economic growth, not only through benign facilitation, *but through active promotion and direction*. Partly through Keynesian demand management, and partly through intervention into the sphere of production, the capitalist state plays an important role in shaping the course of the economy. It influences patterns of distribution and consumption, affects savings and investment rates, *devises and executes development programs (albeit sometimes haphazardly and unwittingly)*, and contributes to the national creation and maintenance of industrial sectors by participating in the financing and even ownership of the means of production. Indeed, capital accumulation is so directly and thoroughly affected by the state that it becomes increasingly difficult conceptually to distinguish the "public" from the "private" in analyzing the

dynamics of accumulation. The capitalist spheres of production and exchange and the capitalist state are inextricably bound together.”¹¹

Evans (1979) argued that the rapid industrialization that occurred in Brazil from 1950 through the 1970s would not be possible without an activist state whose interests were sometimes allied with and sometimes opposed to multinational corporations and local elites. Caporaso (1982), in addressing the industrialization of Brazil, Mexico, Taiwan, Singapore and South Korea, found that one common characteristic among them was an active state that aggressively entered the economy and promoted the industrialization process, often by mobilizing both domestic and foreign finance. Campbell and Lindberg (1990) argue that both the state as actor and the state as a collection of institutions influence their economies by shaping, defining, and redefining property rights. The research suggests that the state can be perceived as an actor that cannot be dismissed in political economy, and serious consideration of the state should be taken into account in any discussion of FDI, especially FDI policy.

What does it mean for a state to be an actor? According to Skocpol (1985), states are considered actors if they formulate and pursue their own goals. This independent action may come about because of states' linkages into the international economic and political environment, and because of their need to maintain order domestically. States are made up of collectivities of actors implementing established policies in an organizationally coherent fashion over a long period of time. The organizational resources states can bring to bear are very important. In particular, state autonomy and capacity become crucial if the state is to be successful in reaching its economic goals. Autonomy refers to the separation the state can maintain from

¹¹ Italics are mine.

dominant groups, and capacity refers to the resources the state can bring to bear. In many cases, capacity not only refers to financial resources, but human resources as well, such as the skill and loyalty of state officials. Autonomy and capacity are not constant, but may vary across policy areas.

States value autonomy and capacity because of the opportunity it gives them to maximize various goals. What are these goals? Four possible goals of the state in the international economic arena have been defined as aggregate national income, political power, social stability, and economic growth (Krasner 1976). Krasner argued that these goals apply to all states in the international system, regardless of size and level of development. Even though Krasner was exploring the question of states' openness in the international trading sphere, these goals also apply to foreign direct investment, and are especially important in developing countries, where distortions of the market make state autonomy and capacity very important in order to achieve these goals.

Reuschmeyer and Evans (1985) argue that one goal of states is to promote economic development by stimulating and disciplining entrepreneurship in markets that are less than competitive. In some cases, the state inserts itself into the economy in the form of state-owned enterprises, ostensibly to replace the lack of private capital in certain problematic sectors. In other cases, it may offer incentives for local and/or foreign capital. Another goal of the state is to try new methods of achieving economic growth. Amsden (1985) offers a case study of Taiwan in which the state managed to move the economy from import-substitution to export-led growth, overcoming the influence of the military and its interest of continued defense spending. Regardless, the state's ability to affect the economy seems relatively clear.

As discussed above, state autonomy is important, but some see state autonomy as being clearly dependent on a number of important factors. A long-standing traditional political science framework for influences on the state has been pluralism, or the degree of strength and competition between interest groups within society. Traditional pluralism as applied to the United States held that interest groups competed in a “free market” of politics. It was argued that the existence of many points of access in the federal U.S. political system allowed ample ways for groups to influence government. Competition between groups checked the monopolization of one or a few groups (Truman 1951, Dahl 1967). According to Keehn (1976), pluralism relegates government to the task of night watchman, acting as a referee and balancing the competing interests. Policy is created by government after weighing competing proposals from groups. Corporate pluralism held that interest groups do not compete freely in American politics, but that individual groups or small collectivities of interest groups “capture” governmental institutions and literally write governmental policy because government has given them sovereignty in certain areas (Lowi 1967, 1979). Subsequent refinements of pluralism include the more complex models of policy subsystems, such as subgovernments consisting of Congressional committees, administrative agencies and interest groups, and the more complex model proposed by Hecló (1978) which proposed the existence of issue networks within which subgovernments operate. As issues become more complex, the federal government finds it more difficult to address them comprehensively through public policy. New networks form from a rapidly increasing pool of new groups, as well as federal, state and local governmental agencies. The representatives of these groups and agencies

are more politically and technologically savvy about the issues their groups and agencies represent, and more tightly focused policymaking occurs as a result.

The concept of pluralism has been argued to more or less describe the federal U.S. system, though it has been criticized as not capturing the essence of the American political system. (Keehn 1976). Pluralism is also a much less compelling argument in other parts of the world, but the existence of groups in developing countries and their relationships to the state, in some cases reducing state autonomy and capacity, have been noted. For example, it has been documented that African states regularly intervene in agricultural markets at the behest of interest groups with a stake in agricultural prices (Bates 1988). Migdal (1988) argues that in weak developing states such as Sierra Leone, central governments have been hampered by local strongmen and their followers who were empowered by previous colonial governments. The implication, however, is that pluralism does not necessarily indicate a vibrant state. For instance, it has been argued that “pluralism by default” has been the process by which developing states in the former Soviet Union have progressed politically, based not on strong civil society or democratic institutions but in the breakdown of autocratic control (Way 2005).

Many modern European democratic systems were built partly through interest groups operating in close alliance with governments. These groups did not capture government agencies but were officially sanctioned by governments. This type of system has been labeled corporatism, and has been defined as a system in which “strategic actors are given a permanent role in policymaking in those sectors that are relevant to their interest” in exchange for “politics of moderation characterized by a

willingness to compromise with each other and with the state” (Magagna 1988, 422). In Europe, corporatism seems to be associated with consensus democracies, while pluralism tends to concentrate in majoritarian democracies (Lijphart and Crepaz 1991) However, this is not necessarily the case in developing countries. In Latin America, for example, majoritarian systems such as Mexico and Brazil have at times been corporatist. In such countries we see similar situations in which governments sanction official interest groups and leave independent groups on the margins. Corporatist systems allow government elites to define the scope of civil society through inducements and constraints and maintain more control over the policymaking process. Groups that are officially sanctioned receive organizational benefits, such as official recognition and subsidies that give them significant advantages over groups that claim to represent the same members of the public. In addition, official recognition may allow the government to penetrate and dominate officially sanctioned groups, which then respond to the government’s wishes more readily than the needs of their constituents (Collier and Collier 1979).

So far, the developing state in a corporatist scenario seems to have relative autonomy from interest groups. However, this is not entirely the case. First, the support of interest groups does not come for free for governments in developing states; they must provide some reason to win the initial cooperation of the groups. Often this may involve acceding to certain demands. The stronger the interest groups in question, the more inducements the state must offer to win them over. Second, a developing state under the corporatist model cannot always fully silence non-sanctioned groups unless it reverts to a more oppressive system. This is not to say that corporatist states

do not repress non-official groups; they often do, especially when the state is strong enough to dictate high constraints and offer low inducements (Collier and Collier 1979). However, there is some latitude for non-official groups to operate. In other words, even an authoritarian state's policies will still reflect a certain amount of deference to official groups, and even to some issues from strong non-official groups.

In the case of FDI and FDI policy, domestic interest groups may line up for or against FDI, and dominant groups within the society may exert more or less influence, based on whether these groups are open or wary of this form of economic development. Yet the state must, whether it is legitimately representing its entire population or even a small portion thereof, set policy and use that initial stance to bargain with multinationals in order to attract investment. Therefore, whether policies reflect the interests of strong interest groups or the interests of an autonomous state, they still indicate a set of preferences. Regardless of whether these preferences reflect narrow interests or a majority of the population, they are what developing states bring to the bargaining table with firms and indicate the initial stance of these developing states toward FDI.

Multinational Corporations

Multinational corporations (MNCs), sometimes referred to in this dissertation as firms, are the second actor in the FDI story. As I have explained, developing states form attitudes about FDI, which influence their preferences about how open they will be toward this avenue of development. Their policies toward FDI, either more restrictive or more open, are an indication of their initial preferences.

The MNC plays a key role in the story of FDI. Understanding their role as entities that enable FDI is essential, because they serve as agents of development. In doing so, firms act in their own interest and therefore are independent entities in the process. Nevertheless, their preferences and motivations must be taken into account, because the results of developing states' interactions with them can also affect those states' FDI policies.

MNCs are distinguished from strictly national firms by their large size, the complex character of their organization, the diversity of their business interests, and their geographical dispersion (Vernon 1977, 1998). Because MNCs operate on a global scale in the pursuit of profit, they are not as concerned about their effects in local markets as their hosts are. Since they make direct investments, they also control the actions of their subsidiaries in developing countries through their hierarchical structures. These traits, argues Vernon, tend to bring firms into conflict with host nations which have desires and preferences of their own based on local conditions. Thus, firm and host country desires will sometimes clash with the global preferences of firms.

Even though this study does not approach FDI from the firm perspective, I argue that firms play a major role in providing an impetus for foreign direct investment policy. With their investments, firms provide a shopping list of benefits that developing countries lack and desire, such as resources, expertise, know-how and efficiency. MNCs also offer a way for developing countries to exploit valuable resources, whether those resources are natural or human, which they may not have been able to exploit before.

Theories of the firm tell us about firm preferences that lead them to invest in developing countries. These preferences indirectly influence FDI policies and should be briefly touched on. Hymer (1976) articulated perhaps the first firm theory devoted to FDI where he argued that FDI could be differentiated from portfolio investment because of its long-term nature and the characteristic of MNC control over its nature for its duration. Firms engaging in FDI want control in order to ensure the safety of the investment, to remove competition between themselves and other international or local competitors, and to fully take advantage of any returns on skills and abilities acquired in the investment.

Firms have a variety of motivations to engage in FDI. MNCs gain advantages, such as such as acquiring lower-cost factors of production, gaining knowledge or control of more efficient production functions, obtaining better distribution facilities, increasing the differentiation of their products and reducing risk by diversifying globally (Hymer 1976). They may also gain monopolistic or oligopolistic advantages by investing in other countries. They gain such advantages by competing and driving out local business or exploiting imperfect market conditions. Their sheer size gives them the ability to exploit economies of scale and diverse resources and affords them many advantages in lesser-developed countries. They also provide benefits to host countries, including increased exports and a boost in the host country's economic capabilities (Grieco 1986).

Firm theories focus on the reasons MNCs choose to directly invest abroad. One variant focuses on market imperfections that create opportunities for firms to engage in oligopolistic behavior. Companies prefer to directly invest in foreign markets in order to

overcome the disadvantages of distance, communication, culture and imperfect information. In addition, other draws include low costs of production and generous individual country policies. Marketing advantages also play a role in firms' decision to invest. This theory argues that firms seek opportunities to gain an advantage over their competitors internationally through their investments and must possess advantages over local competitors when they enter foreign markets (Caves 1996).

Another widely referenced theory of firm foreign direct investment involves the product cycle. Firms that create products at home may venture to market in other similarly industrialized countries. High demand may lead firms to decide to invest in manufacturing capabilities in those countries, thereby cutting costs by manufacturing the product in the same market. Eventually, production may shift down the income scale to less-developed countries where the product can be produced and exported back to high-income countries more cheaply than the costs of production in high-income countries allow (Vernon 1966). In Europe's industrial development, for instance, textile production in Britain led to saturation of that market. Britain marketed textiles in other European countries, which not only helped spur a wave of industrialization but also spilled over into other industrial sectors. Later Latin American development was also spurred by investment from European countries when economic conditions such as inflation demanded new action, and industrial capital looked for new, stable and cheaper markets (Kurth 1979).

MNCs may also engage in FDI as a mechanism to get around state trade barriers such as high tariffs (Blonigen 2006). Tariffs are meant to shield domestic firms at the expense of foreign firms, effectively protecting domestic businesses against

waves of cheap foreign imports, though this simple relationship is not so straightforward. Goodman, Spar and Yoffie (1996) argue that differences between import-complementing and import-substituting investment create different coalitions. For example, import-complementing investment, or investment that competes directly with local firms, causes locally-producing U.S. domestic firms to line up in favor of protection and foreign firms that import goods into the United States to join together in favor of free trade. Import-substituting investment, or investment where the foreign firm replaces imports with products manufactured by its local affiliate, causes a different alignment. This type of investment will ally both foreign and domestic firms against protection. However, Blonigen labels the notion of tariff-jumping, or investing in a foreign country to bypass tariffs, “folk wisdom” among economists. He argues that tariff-jumping occurs, but only among firms that have experience in international markets (Blonigen 2002).

Finally, firm decisions to invest abroad can be determined by considerations of the advantages of ownership, location and firm internalization (Dunning 1980). By taking direct ownership in foreign countries, firms can gain additional advantages such as international transfer pricing, the ability to shift assets to different currencies in order to create profits, capabilities to diversify investment portfolios and opportunities to create parallel production capacity in different countries to protect against slowdowns or labor unrest. Simmons and Elkins (2004) echo Dunning when they point out that firms weigh the competition and will see countries that offer similar policies on the free movement of capital as similar risks for investment. Market structure, natural resources, labor, proximity to market, legal and commercial environments, and government policy

provide locational advantages. MNC internalization of capital, technology, and management through direct control in their subsidiaries, rather than leaving control to local partners, giving local subsidiaries free rein, or engaging in risky and uncontrolled portfolio investment may also factor into firms' decisions to invest abroad.

Firm and State Agreement

In the progression of the FDI story, we have met two actors, each with unique sets of motivations and preferences in how to reach their goals. These preferences sometimes harmonize and sometimes clash with each other. Developing countries, hoping for progress through greater foreign direct investment but also with some degree of wariness, weigh alternatives and make decisions on how much they will rely on FDI. These decisions are realized through the political process and become policies. Firms, looking to earn greater profits, make decisions on whether to invest in developing countries based on the advantages they see by doing so. Firms and developing countries must come to agreement over FDI and the conditions that will allow the investment into the host country market.

The firm-state agreement process is an important part of the story that is told in this study. Developing countries bring existing explicit or implicit policies on FDI to the table. These policies are a gate, where the width of the opening serves as a screening function. Some firms will rule out investment based on the policies they see. Those firms that can live with host country policies may enter into agreement with a developing state. Developing countries' FDI policies, in essence, are their opening gambit in the

bargain. They set the tone for the conditions of investment, and upon conclusion of the agreement, these policies influence both future FDI policies and future FDI flows.

The first and foremost goal of firms is profit, and MNCs are not driven by altruistic motives to help developing countries exploit their resources or develop their economies. MNCs want to make sure that their investments in developing countries will yield more benefits than costs. If profit is firms' primary goal, how can they go about reaching that goal in the most efficient manner? How can they squeeze the most possible profit they can out of their foreign investment? Internally, they can take a number of measures, such as making best use of their organization. The internal workings of the MNC do not necessarily concern us. However, the external conditions that MNCs must confront point toward Hymer's initial identification of control as a key preference. MNCs want to control as much of the FDI process as they can. MNCs try to establish this control in a number of ways. First, they find imperfect markets that allow them to corner a sector, either by themselves or with a small number of other firms, which gives them greater control over pricing. Second, they seek to make use of peculiarities of domestic and international markets that allow them to move assets and finances quickly and cheaply in order to create greater profit. Third, they seek stable markets in countries with low wage bases and few regulations and restrictions in order to keep costs down as they exploit resources. In other words, MNCs invest in developing countries as long as they can keep costs low and profits high, and as long as economic and political realities favor continued business there.

Developing state preferences are a little more complex. Developing states look upon incoming FDI as a way that they can meet development goals, maintain state

legitimacy in the eyes of powerful segments of the population, maintain legitimacy in the eyes of other nations, and participate in the world economy. These countries also want to achieve a maximum amount of rents and control over the timing and the amount of flows of investment for their own particular social and political purposes. In order to achieve their goals, they must insist on taxes, restrictions and regulations and give away as little as possible. In addition, the priority they put on their preferences and goals is tempered by the emphasis they put on the participation of FDI against wariness over allowing foreign capital and corporations to play a part in their national economies.

FDI agreements occur because both firm and state feel they are better off with the agreement. Should the firm not feel it benefits from the potential agreement, it will walk away before the deal is made. Should developing states not be happy with the proposed terms of the agreement, they will call off the process if the terms cannot be adjusted. Yet there is some reason to question whether firms and developing states are equally matched at the start of the agreement process, and whether their position in the bargain remains unchanged after the agreement is reached.

For example, the basis of the relationship between MNC and state may be characterized as a bilateral monopoly (see Kindlberger 1969, Kobrin 1987). The host has resources that it cannot exploit but control over access and conditions for operation, and the firm has the technology, capital and other means to extract the resources. In this type of relationship, characterized by one buyer and one seller, the bargaining that takes place between the state and MNC is over the monopoly rents that accrue from the investment. Within this framework, the outcome of the agreement depends upon the relative bargaining strength of the firm and the host country. Both firm and state each

have specific behavior patterns that they follow in such relationships. The firm often behaves according to the state of the industry in which it produces. The state, on the other hand, behaves according to its economic and political bases.

Thomas and Worrall (1994) offer a test of the bilateral monopoly framework in terms of expropriation, or in other words, a host country taking control over the operations of a foreign firm within its borders. They argue that a one-shot bargaining process is not sufficient to account for why firms and host countries enter agreements. Their rationale is that if bargaining was a one-shot deal, firms would know that countries would eventually expropriate and therefore not invest. However, if the agreement process is over infinite repetitions, then contracts become self-enforcing because each side realizes it has something to lose by breaking the agreement. The firm withholds maximum investment and payments to forestall expropriation, but must increase investment and payments over time. The contract thus evolves, "ratchet-like," toward greater levels of efficiency. If the contract remains below optimum efficiency, the state expropriates; otherwise an efficient level of investment is reached.

Also in this infinite bargaining period, the state's power in the agreement process may get stronger relative to the firm. This "obsolescing bargain" was first proposed by Kindlberger (1969) and articulated by Vernon (1971). As host countries become more knowledgeable and the firm's costs become more tied to the host country, the host country can begin to exert pressure and get better terms. For example, the erosion of the bargaining power of foreign copper firms in Chile, along with domestic political factors, played a role in the nationalization of the copper industry in that country (Moran 1974).

Shapiro (1991) studies another case in which the Brazilian government was able to use its bargaining power to manipulate foreign firms. In the 1950s and 1960s Brazil put in motion a set of economic policies designed to pressure foreign automakers to increase the domestic content of their manufactures in Brazil. The goal of the Brazilian government was to create a domestic Brazilian car industry. The foreign automakers responded tepidly to initial requests by members of the Brazilian administration. They did not feel that the Brazilian automobile market was large enough to sustain local production. The administration of Kubitschek then put into place policies constricting foreign exchange for firms unless they created new products using at least fifty percent local content, and rising over five years to 95 percent local content. These constrictive policies were supplemented by generous financial incentives offered to companies that agreed to abide by the new regulations. The use of these policies were partly responsible for the development of the Brazilian car industry, which was the first of its kind in Latin America and served as the basis for later government policies in Argentina and Mexico.

Kubitschek's initial impetus was political; he wanted to create a national policy that would be successful and would survive beyond his presidential tenure. There was also intense popular support for home-grown industry, and the policies were meant to not only prop up Brazilian capital invested in smaller local auto and truck manufacturers, but also to create spillover effects to suppliers. In addition, local labor would benefit. However, his policies also gained from the condition of the auto industry at the time. Volkswagen was at a point in its history where it was willing to try overseas manufacturing for the first time. This coincided with slowed demand at home for U.S.

and European carmakers after an initial burst of post-war car sales, and increased demand in Brazil due to a rising economy. Volkswagen's willingness to enter the market under Brazil's policies led other U.S. and European firms to follow suit to protect their positions in the market.¹²

As companies petitioned to enter the Brazilian market, the administration set up an agency, GEIA, to oversee the process and to rule on applications. This agency was criticized by many automotive officials for, in their perception, impeding the process and ruling arbitrarily. Government officials preferred that GM and Ford lead the Brazilian automotive industry; landing one or both of them would ensure credibility to the program and the architects of the Brazilian policies assumed that some of the smaller participants would eventually be driven out or subsumed.¹³ GEIA, which was also intensely aware of showing favoritism, worked cooperatively with all companies that submitted proposals. However, GEIA hardened its position, particularly with Ford, when it perceived through the application process that the companies were trying to get around regulations. GEIA could only accomplish its job with relative insulation from the administration and from pressure groups, such as local industrial concerns.

Shapiro insists that neither theories of the firm, nor theories that put the state and its policies to the front, can completely explain the Brazilian case. There is considerable overlap; states react not only to their economic and political bases but also to the conditions of industry, and MNCs react not only to their industries but conditions within the state. In addition, states and MNCs may find their interests to be convergent if

¹² Except for Ford and GM. Ford held out against the regulations in its truck division and only entered the car market after the military coup. By this time, however, Volkswagen had captured the passenger car market and Ford executives lamented that they had missed an opportunity. GM never did enter the auto market, but did comply in its truck assembly plants.

¹³ In fact, this did happen after the initial wave of entrants. However, among the casualties were the car and truck makers that had majority Brazilian control.

those political and economic conditions in the state correlate favorably with conditions in the industry, which Shapiro argues was clearly happening in the Brazilian case.

However, despite convergent interests, Ford held out for years despite intense pressure and almost walked away altogether.

What is clear from Shapiro's account is that the Kubitschek administration used its restrictive foreign exchange regulations and the financial incentives policies to encourage foreign automakers to invest new technology and production processes in Brazil. These policies set up the initial conditions by which Brazil could then, company by company, reach agreement on its initial goals of increasing local content in automotive manufacturing, and on the long-term goal of creating a stand-alone Brazilian automotive industry through new investment.

Stopford and Strange (1991) take the bargaining scenario one step further, arguing that firm and state bargaining is part of a more complex scenario that pits states against firms, states against other states, and firms against firms. In their study of firm and state policy in the face of FDI, they argue that the bargaining that takes place between firms and states are conditioned by the competitive structure of the market, for example, if the firm is entering a global market, is trying to enter a local market, or if the firm is trying to exploit natural resources. It is also conditioned by the national policy intent of the host state, such as whether the host state is looking toward import substitution or exporting in a dependent or independent relationship with the rest of the world. They contend that the problem with existing economic models, except perhaps for Vernon's product-cycle model, is that they are static and do not adequately explain the changing economic and political environment that firms and countries face.

Governments in particular face excruciatingly difficult decisions. Should they liberalize or restrict investment? Should they or should they not utilize monetary policy to control capital? Should they promote trade, and if so, what kinds of restrictions are appropriate? Should they privatize their state-owned firms and open up to market forces, and if so, do they put any restrictions at all on private ownership and foreign firms? What differences across sectors should they take into account? Stopford and Strange argue that as governments design policy, the dynamic political and economic environment ensures that governments often have multiple, conflicting and shifting objectives, and their decisions lead to political consequences.

FDI Policies

In the process of telling the FDI story, I have thus far introduced two different views, openness and wariness, of FDI which inform developing states' impressions of FDI and thus, influence their FDI policies. These views I derived from paradigms established by modernization theory and its descendents, and dependency theory. I have established two main actors in the FDI story, developing states and multinational corporations, and explored their motivations. Generally, firms look for conditions of investment that will improve their ability to make profits, and developing states look to investment to increase their economic abilities. Both actors hope to be able to control aspects of investment that put them at odds on many of their goals, and therefore a bargaining situation arises. Developing states' policies provide a starting point for negotiations, and agreements reached provide one influence on developing states' future FDI policies.

In this section, I will look at two possible ways to examine FDI policies. The first way is by comparing FDI policies to tax incentives policies. Tax incentives policies are used to encourage or discourage investment in certain regions, sectors or industries in local economies (Biger and Pepe 1986). As such, tax incentives policies can be targeted at both local and international capital. Tax incentives policies, their causes and effects on FDI may have similarities to FDI policies. I will also examine another possible theoretical perspective on FDI policies which argues that FDI policies are influenced on two levels, the domestic and the international.

Economists took the lead in examining tax incentives and their effects on FDI. Taxation, or more precisely effective rates of taxation, are central to the study of investment incentives (Birla Institute of Scientific Research 1985). The theory of optimal taxation, one of the core theories of investment incentives, argues that governments aim for an optimal tax that increases both revenue and welfare. To take the extremes, if governments do not tax firms, they get nothing. Similarly, if governments tax firms fully, they will also get nothing because no goods will be produced within their borders. Governments therefore tax at rates that ensure that they will receive an appropriate amount of revenue while simultaneously allowing firms to make a profit. In other words, there is a window of possible tax rates for governments. Governments that set tax rates higher than this optimal area will get less tax revenue because firms will leave the country. Governments that set tax rates lower than this optimal area will find it difficult to maintain revenues because they are not taxing enough. Why wouldn't firms flock to states that set inordinately low tax rates? If we take into account that international markets are not perfectly competitive, then we must accept that many industries are

oligopolistic on the international stage, therefore limiting the number of firms that will enter foreign markets. This theory is weighted by standard assumptions; consumers maximize utilities, all goods can be taxed, and income can be perfectly observed. However, at its core it still suggests that firms and countries are engaged in a delicate balancing act, trying to work out a range of possibilities that will be useful and beneficial to each while also keeping an eye on their competition.

Tax incentives are one of the mechanisms used by states to indicate the level of their seriousness in drawing FDI (Li 2006). Incentives affect the allocation of scarce financial resources, influence government revenues, favor particular groups at the expense of others, reduce market competition, and often cause rent-seeking behaviors in host countries. Governments pick winners and losers in the market, leading them to discriminate against small and local firms, and design programs through backchannel negotiations. Incentives can strengthen MNC competitiveness internationally, but also enhance their ability to monopolize the local market. Tax incentive policies have distributive consequences, pitting groups within the society for or against foreign competition, and against each other.

Research has shown that taxation can have a deleterious effect on investment. Taxes raise the costs of capital, which disadvantages companies in high taxation markets and therefore discourages them from investing. High taxes can impede local research and development if the R&D is complementary to imported technology – although it can encourage local R&D if it substitutes for imported technology (Hines 1995). Cummins and Hubbard (1995) find that a one percent rise in the cost of capital leads to a one to two percent decrease in annual rates of investment. Hines (2001)

finds that tax sparing agreements, which grant credits in order to get rid of contradictions between home and host country tax policies, can lead to much higher levels of FDI and lower tax rates on FDI.

Research has also been conducted on the effects of globalization on tax-rate policies. Some theories speculate that increased participation in world markets and increased trade integration maximizes the power of the market at the expense of countries' policy options and creates a greater need for countries to be economically efficient in order to effectively compete (Garrett 1995, Owens and Whitehouse 1996). These conditions lead to policies that favor lower taxes, reduce the welfare state, and increase labor flexibility.

However, another theoretical strand argues that globalization does not threaten national sovereignty and is not a new phenomenon. This view argues that corporations face obstacles that keep them from leaving markets once they invest (Spar and Yoffie 1999), that country characteristics offer enticement to corporations (Garrett 1995, Caves 1996), that political institutions can provide stability that may hold long-term attractiveness to corporations (Hall 1997) and that countries can use these leverages to continue to approve taxation policies. Gelleny and McCoy (2001) find that education levels significantly enhance government abilities to tax, that left-leaning governments are more likely to tax than centrist or right leaning governments, and that openness to trade actually increases the likelihood of higher taxes. They speculate that pressures on societal groups resulting from greater openness lead governments to tax more highly in order to offset some groups' losses. Li (2006) echoes this view, arguing that

democratic governments and governments associated with rule of law tend to be less generous in their tax incentive policies.

The Organization for Economic Cooperation and Development (OECD) spells out some of the elements of this balancing act in its paper advising governments on taxation in a global economy (OECD 1991). While arguing that countries tax because 1) they use taxes as an instrument of social policy and 2) they want to exercise their right to tax, the OECD cautions that taxes are often market distorting but should not be. One reason for the distorting effects of taxes is that there is always the potential for double taxation, in which a firm is levied taxes both in home and host countries. The cures for such distortions, such as exemptions, credits and deductions, may be distorting in themselves in that they may favor international firms over local firms. In addition to market distorting effects, there are also issues caused by companies attempting to avoid or evade taxation, fair distribution of taxes, and administrative problems. Not all nations are inclined to tax in the same way, so nations must decide whether to tax incomes of resident companies and affiliates or source companies, to tax international equity, or if domestic rates or some other rates apply.

States use incentives because, as Stopford and Strange argued, states are also pitted against other states for investment. Chudnowsky and Lopez (2002) point out that when business leaders are questioned in surveys, incentives don't appear to be as important as other factors, such as host market size, a country's rate of growth, physical and communications infrastructure, and the quality of human resources. However, they argue that incentives are important on the margins, when MNCs have a number of different countries that they can choose from in making investment decisions. They

point to Ireland as an example, which used incentives to separate itself from the crowd in Europe. These incentives included grants for research and development facilities, and were part of Ireland's set of policies designed to attract higher value-added industries, create specialized industrial clusters, and promote links with domestic firms. Ultimately, Ireland's targeted investment policies were helpful in landing a number of high-tech companies, which fueled a boom that transformed the country from European economic backwater to economic engine in just a couple of decades.

Like tax incentives policies, it can be argued that all FDI policies also provide an indication about the environment for FDI. The effects of FDI policies, including favoring particular groups and reducing competition, are very similar. Open policies may provide a basis for competition against other states, but the level of openness must always be balanced with potential domestic political costs. Globalization demands may influence more open policies, but openness is tempered by the extent of the need to rely on FDI versus other avenues of development. Like taxation policies, many factors make it certain that FDI policies are a balancing act. The balance must be configured between the degree of openness to FDI and domestic political needs, domestic economic goals, world pressure, demand for FDI, and past experience with FDI including past bargaining scenarios and past policies.

Once policies are enacted, they play a major role in firm decision-making, which directly affects inflows of FDI into developing states. States that are wary of FDI will enact more restrictive FDI policies. Firms that can still find advantages in states that restrict investment will invest regardless of the policies, but there will be fewer of them than in countries that are more open to FDI. Thus, firms examine policies before

entering agreements with developing states. In this way, developing states set the tone for any future agreements, and exert some control over the flow of FDI into their markets.

Another way to look at FDI policies is by examining the environment in which they are created. The weakness of using existing theory on tax incentives policies is that while they examine both domestic and international effects on tax incentives, they do not take into account the dual influences together, nor do these primarily economic perspectives allow for political influences. Policies may not simply be a case of either demands of the domestic markets or demands of the international markets. They may be a function of both together. Add domestic political and international political influences into the mix, and a much more complex picture emerges.

In this vein, FDI policies can be examined as a function of games occurring on two levels. The use of games and game theory to shed light on bargaining scenarios has yielded much academic research. In a seminal game-theoretic paper on bargaining, Nash (1950) sets up a theory of bargaining in which he outlines a two-person non-zero sum game. He assumes that each player is rational, able to communicate desires, has equal bargaining skill, and has full knowledge of the other's tastes and preferences. In this idealized environment, Nash creates a utility function for each player, based on the anticipation each has for what he or she can get in the bargain. He goes on to prove that if these utility preferences are known, there is a bargaining solution in which each player can gain a deal which is satisfactory and leaves both better off.

Harsanyi (1956) later combines elements of Nash's game theory on bargaining, Nash's theory of optimal threats, and other bargaining approaches to round out bargaining theory. The theory of optimal threats argues that each bargainer may use a threat as long as it will hurt the threatened party more than the party making the threat. However, each party may be prepared to make threats that will cause self-harm if the agreement fails in the hopes of getting a better agreement. Thus, according to Harsanyi, bargainers will gain better terms if they are willing to take greater risks than their opponents. In addition, Harsanyi argues that the bargaining outcome also depends upon the ease of transfer of goods or money between the two parties, and the likely effect of present behavior on future bargains between the parties (strategic thinking).

While game theory on bargaining as envisioned by Nash provides a basis for explanation, it does not adequately explain all bargaining situations, especially when there are many possible agreeable contracts and multiple rounds of bargaining. Rubinstein (1982) proves that with many possible Pareto optimal outcomes (outcomes which make neither player worse off and make at least one player better off), players come to an equilibrium agreement among the optimal outcomes. In the presence of fixed costs, the weaker player is always disadvantaged and does not come out of the bargain as well off as the stronger player. In the presence of fixed discounting factors (how the players value the utility of the future), the player that makes the first move will always be at an advantage.

The need for game theories to reach equilibrium agreements concerns Sebenius (1992). He notes that game theory, while invaluable in constructing and offering

explanations for bargaining situations, makes several troubling assumptions including full rationality and perfect information, and attempts to relax these assumptions have been problematic. He observes that game theory views cooperation and conflict as a binary construct with possible solutions located along the Pareto frontier. However, he argues that cooperation and conflict are often both present in negotiation, and that the relaxation of assumptions of full rationality and perfect information allow for a more useful explanation of bargaining behavior. In essence, the area between no agreement and Pareto-optimum solutions encompass an area of possible agreement. Bargainers that assume that their opponents are rational but hampered by imperfect information may end up with solutions that are not Pareto-optimal but are the best that is possible given the circumstances. Subsequent negotiations with greater information expand the zone of possible agreement. Sebenius argues that the existence of epistemic communities on either side of the issue greatly helps this process, as they bring in new ideas that also create new possibilities for solutions. In other words, the more information each side has, the more likely a solution.

Game theory has had tremendous practical applications in international relations (see Snidal 1985, Maoz and Felsenthal 1987, Powell (1991), Bueno de Mesquita and Lalman 1992, Niou and Ordeshook 1994, Powell 1996, Allan and Dupont 1999, Signorino 1999, Bennett and Stam 2000), Putnam (1988) addressed the complexity of negotiations given international and domestic constraints by introducing the logic of two-level games. Explicitly, Putnam argued that international negotiations are best explained by bargaining on two levels. On the international level (Level I), negotiations between states are more open or constrained by policies and politics on the domestic

level (Level II). However, negotiations on Level I can also create conditions for policies on Level II. The two levels operate concurrently over iterations of bargaining, until an agreement on the international level is reached or lost. Of importance is the size of the bargainers' win-sets, or the range of agreements each party is willing to consider because it feels it has gained. A larger win-set at the international level widens the range of possible agreements, but leaves the state in weaker bargaining position. However, a smaller win-set at the international level lowers the range of possible agreements, but can give negotiators bargaining power by claiming domestic opposition.

McGinnis and Williams (1993) provide support to Putnam from the social choice perspective by introducing the concept of the correlated equilibrium to the two-level game framework. They argue that the idea of a unitary-rational state is not logical, given that states are collectivities of institutions and actors. However, each state exhibits regularized behavior. In their models, the individual collectivities that make up the state reach coordinated equilibrium on their expectations by drawing from the same pool of information from their environments. Iida (1993) extends the analysis to conditions of uncertain information, and determines that in these situations domestic constraints may still impede agreements.

Two-level games, since Putnam's theory was formulated, have been used to explain U.S. trade pressure on Japan (Schoppa 1993), United States-Soviet strategic negotiations (Knopf 1993), trade negotiations between the United States and Taiwan (Li 1994), ethnic conflict (Carment and James 1996), and the peace process in Northern Ireland (Trumbore 1998). Perhaps tangentially related to this analysis, Goldstein (1996)

looks at the logic of two level games in determining how domestic politics might encourage nations to join international trade institutions. Goldstein's thesis is that Canada used free-trade agreements as a mechanism to alter what it considered unfair U.S. trade laws. The U.S. administration had some sympathy toward this view, and saw agreeing to international arbitration panels under the agreements as a way to thwart opponents of free-trade. The new institutions created by the agreements effectively changed the way that the United States administered its own trade laws.

The logic of these games assumes state-to-state negotiations. However, if we follow the reasoning of Stopford and Strange, we can't simply assume that states are the only entities on the world stage, and that states do not make deals with other entities. States make agreements with multinational firms over foreign investment constantly, and like in international negotiations, whether a state gets foreign investment or not depends on the willingness of groups within the state and the credibility of the state to "seal the deal" on the international stage. The next section will try to extend a form of two-level games framework to FDI policy.

The Logic of Two-Level Games and FDI

The logic of two-level games proposed by Putnam and reviewed above is a theory of how domestic policy and international agreement interact and intertwine. As such, it assumes, on the international level, two or more countries trying to reach agreement. However, as noted above, some scholars have taken a more expansive view of the international environment. In this larger milieu, firms also inhabit the environment and enter into agreements with states on foreign direct investment.

If firms can be considered part of the international environment, we must fit them into a framework that will explain not only the nature and character of policies of foreign direct investment in developing countries, but also how those policies then affect the amount of capital flowing into each country through direct investment.

Let us look at the stories of FDI we have laid out so far. We have identified two actors in the FDI process that are important to understanding FDI policies, states and multinational firms. Focusing for one moment on firms, we have looked at a range of explanations of firm motivations clustered under the label of firm theories. These theories, which put their focus on the multinational corporation and its role in the FDI process, have shown that firms play an indispensable role in bringing FDI to foreign markets and the reasons for their interest in FDI. Firms have their own set of motives and desires in engaging in FDI. They look to open up new markets, gain advantages over competitors, diversify, capitalize on market imperfections, exploit advantages in local markets and reduce disadvantages of distance. They often follow a cycle of production where a new manifestation of the cycle leads to foreign production. They hope to get around trade and other barriers. They also may want to gain other advantages available to them by expanding abroad. All of these motivations are in the pursuit of greater profits. Governments that consider allowing foreign firms into their markets must therefore pass policies in order to control the pace and timing of entry and to ensure that the state accrues gains. However, firm theories, in their specific focus on what drives firm investment, treat as extraneous economic and political factors, and do not account for state behavior. These theories thus lack the ability to account for FDI in the context of state policies.

If theories of the firm are not adequate to the explanation of FDI policies, then perhaps conceptions of the state and its various roles will help us. After all, it is within the state that policies are formulated and refined. Elsewhere, I argued that the state presents a united front to foreign corporations in its stance toward investment. However, this unified stance conceals the fact that even as states present their offerings to corporations, a lot of political negotiations, along with other political and economic realities, influence what they bring to the table. State theories, in their examinations of state power and weakness, have provided us with an opportunity to envision a state with a unified vision and strategy when facing a bargaining scenario with corporations. Still unresolved, however, is how states make policies for the specific purpose of dealing with other entities, as international relations theories do. However, accepting the state as a unitary-rational actor, as many studies in the international relations discipline, simply accepts that policies exist, and does not consider the influences of the internal workings of the political process on those policies. However, pluralism also fails to provide a complete picture, for it relegates the state to its constituent units and institutions. The state with any reasonable amount of independence does not exist. Finally, a theory based on tax policies, discussed above, might be an answer. However, theories of tax policies simply deal with the economic interaction, bargaining and agreement between firm and state, but do not account for various domestic factors that affect policymaking, nor do they account for international influences on the entire process.

What is needed is a theory or framework that allows for a state-firm interaction that allows the state to follow a cohesive and stable policy, but also acknowledges the

importance both domestic and international influences in policies of FDI and in the practice of FDI. If we accept the proposition that the state, while not precisely a unitary actor but one made up of constituent groups and institutions that can create consistent and stable domestic policies and represent them in negotiations with other entities on an international level, then we can set the stage for using the logic of two-level games in the creation of policy and in the eventual agreement between state and firm.

Consider Putnam's argument that international agreements are the result of political bargaining on two levels. With an expanded environment that allows firms, the reasoning of two-level games can be modified to include state-firm agreements. In such a scenario, states face twin dilemmas. On the domestic front, leaders for the state need to hammer out policies on foreign investment that are acceptable to home constituencies. Policies are subject to a political process that must take the ideals, opinions, and values of powerful coalitions into account. FDI policies are influenced by these political processes as well as the realities of the domestic economy, and are designed to work to the benefit of the state. With these policies, states can enter into agreements with foreign corporations.

We can fit this scenario into Putnam's two-level framework so that we can categorize the process of agreement between firm and state as Level I, and Level II as the domestic policymaking process leading to FDI policies. In Putnam's model, the process of agreement between firm and state at the international level begins the game, and domestic policymaking follows. In our model, the process will work in reverse. In other words, domestic policymaking at Level I starts the process toward agreement on FDI, and states' agreements with firms follow at Level II. I argue that this makes logical

sense, for states' policies serve as the basis and starting points for agreement. If a state's policies are too restrictive for firms, they may not invest. If policies are open, firms may be more likely to invest.

What determines the restrictiveness or openness of a state's policies on investment? Domestic politics and economic characteristics at Level II account for some of the variation of state policies. Through the policymaking process, groups and institutions within the political environment work out a cohesive set of policies reflecting the dominant preferences and economic realities within the state. These policies are presented at Level I, the international level, during the agreement process. Putnam's model focused on the win-sets of various states as determined by domestic politics. The win-set is defined as the range of agreements a side is willing to accept in making an agreement. Each side has a win-set, and where the two win-sets overlap agreement can be reached. The concept works similarly here and demonstrates the importance of domestic political realities. Restrictive policies are a reflection of the wariness toward FDI demonstrated by important constituent units within the state, such as interest groups, parties, and governmental officials and institutions. These smaller win-sets limit the range of agreements that the state can accept and leave states with less room for bargaining with firms at the agreement level because going outside the win-set leaves the government vulnerable to political sanction at home. However, as Putnam suggests, this may work to state advantage especially if the state is large or otherwise an attractive market. In such cases firms may be willing to live with a more restrictive set of choices and invest. Open policies, on the other hand, indicate the openness of important groups, parties, state institutions and leaders to FDI and indicate that those

states have larger win-sets. Paradoxically, openness also weakens a state's bargaining power since firms can push for the best possible outcomes for themselves and be reasonably sure that they will reach agreement.

For simplicity's sake, my models will assume one firm and one developing country, and one step of the agreement process. State creates policy, policy is presented during negotiations with firm, agreement with firm is reached (or not). In reality there may be more iterations, and more countries or firms involved in the process of agreement. In addition, the negotiations on the international level may influence future domestic policymaking. Putnam's theory covered this as he included in his theory the possibility for multiple iterations in the process of negotiations between states. In the models presented here, a dynamic element to the process of firm-state agreement is modeled by the inclusion of international level factors (along with domestic factors) as potential influences on domestic FDI policies, the inclusion of both domestic and international factors as influences on the results of firm-state agreements (inward FDI), and an accounting for the dynamic nature of the process over time.

The model as presented here does not explore in detail the firm side of the agreement process. While I will assume a rational firm presenting a cohesive face, in reality firms are more complex and there certainly is disagreement that must be worked out within each firm's leadership before an action is agreed upon. I will also assume that all information is known to both parties, though information uncertainty is more likely especially given that there may be multiple iterations of the agreement process in reality, and that in developing countries domestic political situations at Level II could change quickly.

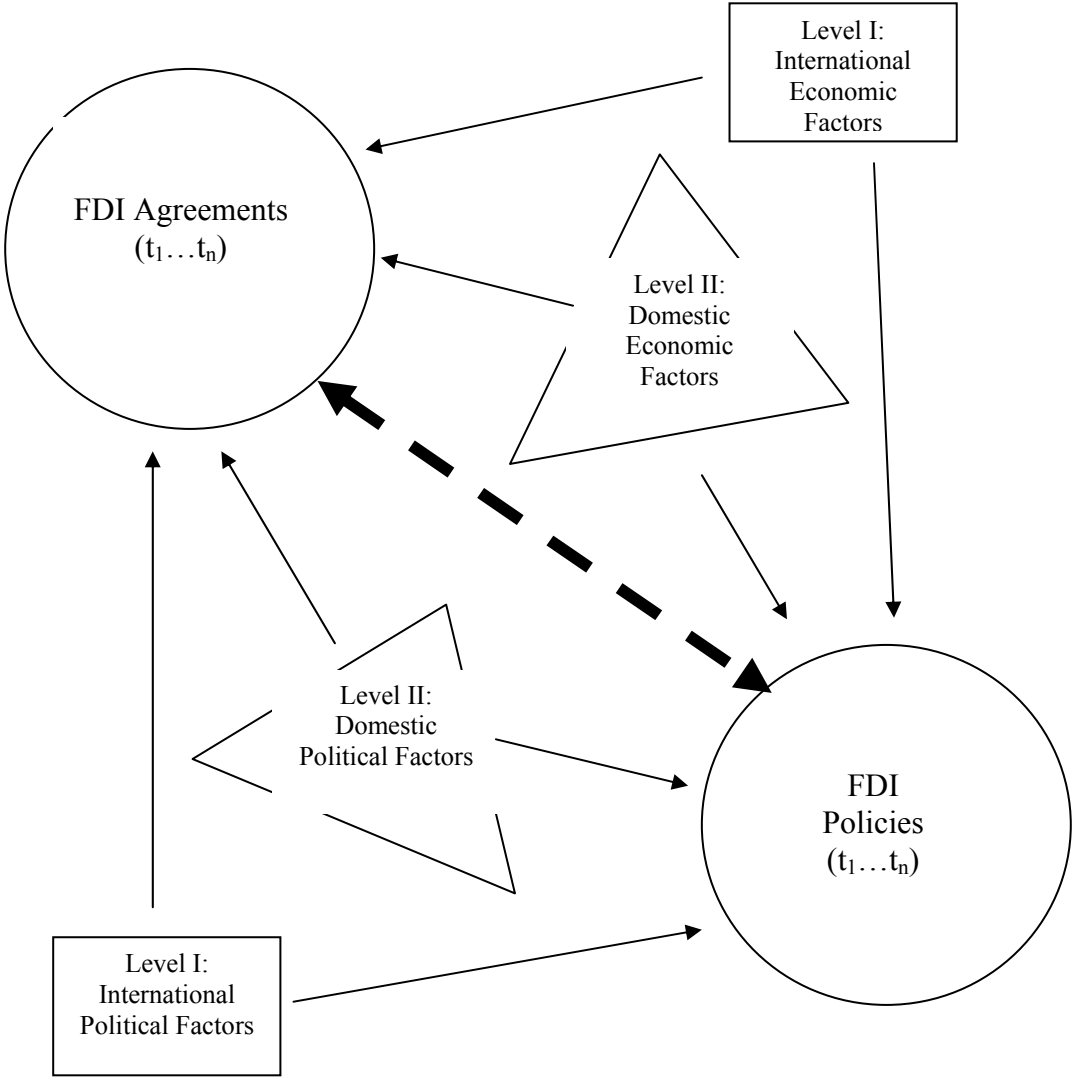
The model using a two-level scenario modeling such dynamics is depicted in Figure 2-1. Domestic politics at Level II starts the process and policies are created within the state through political negotiation between interest groups, parties, state institutions and leaders. These policies are also influenced by domestic economic realities, and international economic and political factors. FDI policies are brought by states and their leadership to negotiations with firms at Level I during the agreement process. Restrictive policies at Level II reduce the win-set for states, leading to less chance of agreement at Level I but allowing greater bargaining leverage to the state.

Open policies lead to a greater chance of agreement at Level I but reduce the state's bargaining power. The agreements are reflected by inward FDI, which is influenced over time by policies and by domestic and international economic and political factors. Agreements between firm and state ultimately affect future policies, adding to the complexity and the dynamism of the model.

A Model of FDI

To this point, I have introduced foreign direct investment as a concept, and have outlined the main actors in the FDI story. MNCs and states, both realizing the benefits of FDI, must come to terms with conflict over the benefits of FDI. Firms seek to establish operations overseas for a variety of secondary reasons that support their main goal, increased profits. Developing states seek to entice firms to invest in order to gain access to means of development, and to increase revenues. While it seems that each has reasons to engage in FDI, they differ over the amount of control each will have and how the benefits will be shared. Firms want control in order to gain more profits and to

Figure 2-1: Levels and FDI Policies



distribute them as they wish. States want control in order to expand industrialization, keep profits in the local economy, and maintain revenues. Both must balance their preferences with each other in order to make a working agreement. Firms must be guaranteed a minimum amount of profit that makes the agreement worthwhile and profitable for them, while states must be guaranteed that the benefits of FDI outweigh a host of potential costs in allowing FDI into their markets.

The model created above shows the complexity of the FDI process, particularly for developing states. States must think locally and must take domestic politics into account. They must have in mind the interests of the main local groups that support them. They must weigh other options to development against FDI, and they must take into account past experience with FDI. These concerns, shaped by their internal and domestic experiences and realities, do not necessarily coincide with firm self-interests, which are measured on a global scale. Thus states must also take into account international factors and of other influences on the international stage that may be supportive of firm preferences.

Given the supposed benefits of FDI, and the fact that most developing states appear to desire foreign investment, why do some developing states pass policies limiting or restricting FDI while others pass policies that encourage FDI? I argue that policies are shaped by a number of domestic and international factors that affect developing states, including domestic politics, international pressure, demand for FDI, and past experience with FDI. These policies provide developing states with a way of satisfying diverse sources of pressure on them. They also serve as an indication to potential investors of the initial bargaining position of the developing state. I have also

argued that two development theories that had a great influence on the development policies of third-world states, dependency and modernization theories, introduced a blend of openness and wariness regarding the benefits and costs of FDI. I explored the motivations of both firms and states in the FDI process. I also introduced the logic of two-level games and discussed the context of influences on state FDI policies and the role of those policies in reaching agreement with firms over foreign direct investment. Finally, I forwarded a theory of FDI that includes the role of FDI policies.

The presentation of a testable model of FDI is the next step in the development of this story. My model synthesizes the concepts of FDI discussed above, and includes FDI policies as an integral part of the FDI process. I present the model in two tests. In the first test I explain the factors that influence FDI policies in developing states. These factors express the mix of attitudes of openness and wariness that make up FDI policies, and are divided into the international and domestic influences described previously. These domestic and international influences take the form of domestic political factors, international pressures, domestic demand for FDI, and past experience with FDI. In the second test, I will demonstrate that international and domestic influences on FDI inflows, such as domestic politics, domestic investment market characteristics, and the international political environment, affect flows of FDI to those states. I will highlight in the second test the role of FDI policies in the flow of inward FDI.

Determinants of FDI Policies

What influences the policies that states make? The logic of two-level games argues that international and domestic political factors are the major influences on

policies, and I argue that economic factors also play a role. There are four general factors that affect developing states' openness to FDI: political and ideological costs, international pressure, demand for FDI, and strategic thinking. I will discuss each of these influences more specifically in the following sections.

Domestic politics and ideologies. Stokes (1997), in a case study of Peruvian president Alberto Fujimori's campaign promises versus actual economic policies as president, explores the concept of responsiveness. Her article makes three points. First, politicians in democracies do not necessarily keep their campaign promises, especially in developing countries. They may be motivated to break their promises by new information upon taking office, a desire to say what voters want even though they know the voters are misguided, or a desire to mislead voters for personal gain. Second, politicians may still be considered responsive to the electorate even if they break their campaign promises. Third, it is difficult to determine whether politicians that break their promises are being responsive or unresponsive.

Stokes' arguments are in reference to democratic governments, but she brings up a germane point. Governments are going to be more or less affected by popular pressure. FDI is one issue that can feed popular sentiment for better or worse, and many governments must take the costs and benefits of FDI into account.

Domestic politics and ideology affect FDI policy. Strong interest groups, if present, may have an interest in the FDI question, and may or may not be in favor of FDI. There are two levels of politics that we can explore. The first centers on the type of regime, democratic or authoritarian, present in the developing country. The second

centers on the ideology of the government, and specifically whether the government is leftist, centrist or rightist.

There has been quite a bit of theoretical and empirical study on the regime-type and FDI which is relevant to this study. Lipset (1959) wrote a seminal paper addressing the relationship between democracy and development concluding that democracy leads directly to development. It has been generally noted that democracies tend to have safer environments for investments, with less chance that the government will confiscate or expropriate, and even less probability that the government will compete with private entrepreneurship (Freeman 1982). Theory suggests that democracies provide more protections for private property rights, and provide institutional means of resolving disputes between parties which authoritarian governments lack (Olson 1993). However, many scholars, particularly those from the dependency school, have argued that autocratic governments also offer advantages to investors, such as relaxing unfavorable laws, using strong tactics to intimidate labor unions and other potential opposition to investment, and putting favorable policies in place faster than democracies (Evans 1979; O'Donnell 1988).

The effects of regime type on FDI have been empirically mixed. O'Neal (1994) shows that democratic governments create overall better rates of return for multinationals, but that multinationals investing in developing states with authoritarian regimes still manage to come out ahead. Burkhart and Lewis-Beck (1994) also find this association. Guillen (2000) in case studies of Argentina, Spain, and South Korea, finds that authoritarian and democratic governments stimulate different responses from labor unions toward FDI. He finds that populist labor unions under authoritarian governments

tend to see multinational corporations as villains, whereas in democracies, populist labor unions support import-substitution models and adopt a “necessary evil” approach toward FDI. Modernizing labor unions, on the other hand, collaborate with FDI at arms’ length in authoritarian countries, while adopting a partnership attitude in democracies.

Most theoretical work generalizes the concept of “development,” while quantitative work tends to focus more specifically on actual flows of FDI, rather than on the policies of FDI. Democracy has been the subject of many studies about its relationship to FDI flows, and in a broader sense, democracy has been tested for relationships to free trade, open markets, and most recently globalization. Reactions by developing countries to free trade pressures and globalization lead to policy choices that have substantial effects on FDI.

Teune (2002), for example, writes “it took most of the 1990s to grasp that without democracy, globalization could not continue in a peaceful, orderly fashion....,” and that “...Democracy at the national level became the political environment most open and receptive to processes of globalization.” Mansfield, Milner and Rosendorff (2000, 2002a, 2002b) argue that democracies, with free and fair elections, create greater economic gains for leaders through trade agreements, which encourage them to pursue greater economic cooperation with other states and signal to the population that their leaders are open to more transparency in their decisions. They find that democracies are more likely to conclude trade agreements, are more likely to conclude preferential trading agreements with one another, and generally set lower tariff barriers with one another regardless. Milner (1998) suggests that ideas help define states’ policy actions,

and certainly democracy brings expectations of greater openness and transparency with it.

An oft-debated concept in international relations, the democratic peace theory, argues that democratic regimes are less likely to go to war with each other, partly because of the economic links they forge (Maoz and Russett 1993). One study has shown that democracy and economic interdependence exist in a relationship that brings greater peace and stability to the international arena, particularly when states are contiguous with each other (Oneal, Oneal, Maoz and Russett 1996).

The above theoretical arguments give an indication that the preferences of democracies and autocracies are different when it comes to economic openness. Democracies generally are more open economically and likely to establish more open policies toward FDI, while autocracies want greater control over their economies and therefore set restrictive FDI policies. Given this theorized and empirically supported relationship, and the fact that economic policy is an outcome of nations' political regimes, it can be expected that democracies should be more open toward FDI and autocracies being less open.

A second measure of political and ideological costs indicates what people in a country believe about the role of government in their economic and social lives. Running along a left to right spectrum, with those on the left advocating a greater role for government in the economy and society, and those on the right generally advocating for a smaller government role, these ideologies permeate political structures and provide a platform upon which the political process creates winners and losers. In other words, we can predict policies based on the ideologies driving governments.

When it comes to foreign direct investment, the issue would seem to be pretty well cut and dried. Past research has noted the presence of differing views on economic development within the domestic polity. Vandeveld (1998) spells out the differences between economic nationalism, which is descended from the writings of Hobbes and Machiavelli and which prescribes wealth redistribution, state intervention in the economy and economic protection, versus economic liberalism, which has its roots in Locke, Smith and Ricardo and espouses wealth creation, free markets and limited government intervention. Economic nationalists, he writes, are more likely to call for restrictions on trade and FDI, whereas economic liberals call for free trade and free movement of capital across borders.

There are plenty of scholars who find that traditional relationships hold. Ornstein and Stevenson (1984), in a study of elite attitudes in Canada, generally described right-oriented elites as those favoring the status quo, cutting back on social welfare, and opposing government economic intervention (though this last point breaks down between the big business-small business divide). Those on the left had high identification with labor unions and favored nationalization of some major enterprises, redistribution of income, and strengthening labor rights. Similarly, the so-called “Washington Consensus,” a series of economically liberal prescriptions that were adopted by many developing countries, particularly in Latin America, held that developing countries could prosper by curtailing government intervention, lifting barriers on imports, exports, foreign investment, and financial transactions (Naím 2000).

Empirical work trying to relate these ideologies to economic outcomes has been mixed. OECD countries with strong leftist governments are associated with more

corporate taxes, larger interest rates, and increased public spending despite the fact that globalization would predict a weakening of their ability to implement such policies (Garrett 1995, 1998). Oatley (1999) finds that partisan macroeconomic policies exist, despite the hypothesis that globalization has reduced the ability of parties to follow their own agendas. He observes that leftist governments, under fixed exchange rates, impose more capital controls. However, Gelleny and McCoy (2001) find that leftist governments do not necessarily tax more than other types of governments, and attribute this finding to one of two things: either leftist governments are nervous about creating an “anti-investment” climate, or they have accepted neo-liberal economic policies. Nielson (2003) found the presence of leftist governments an unreliable predictor for the level of collected tariffs, a potential investment-discouraging policy. Pinto (2005) examines the hypothesis that labor is generally more favorable to FDI than capital because the entry of foreign capital alters the traditional returns to domestic labor and capital. His empirical results on 18 developed countries uphold his hypothesis.

We might generally expect that governments oriented to the right would generally be in favor of foreign direct investment. For such governments, most of the opposition to FDI will come from leftist groups concerned about wages, social welfare and worker representation. Such groups also tend to be distrustful of multinational corporations. However, right-oriented governments may also face some opposition from elements on the right, such as owners of smaller local businesses that will be hurt by foreign competition. Because the right expects opposition from the left, it is prepared to deal with its opponents through various means (using anything from compromise to

repression). Right-oriented governments are able to discount costs of their actions, having expected such opposition, and the other costs are relatively negligible.

For leftist governments that consider opening to FDI, however, the costs may be greater. Consider a leftist government that has been elected to power on the expectation that it will carry out a populist agenda. As economic realities convince the leaders that they must consider opening to FDI, they must also consider the costs of doing so. Leftist interest groups, particularly workers groups, might be upset at a shift away from the domestic economic agenda that was promised in the campaigns, and the costs to these groups of bringing in foreign investment may be grievous in terms of lower wages, the decreased power of unions and the potential loss of jobs due to competition.

Some empirical findings indicate that left-oriented governments may not be as hostile to FDI as it may seem, especially if they are broken down along regime type. Guillen's and Pinto's work suggest left accommodation, and the fact that Pinto's work takes place in developed countries suggest that the effect takes place in democracies.

It is expected that leftist governments will be hostile to greater openness to foreign equity, given that they must answer to groups that stand to be hurt by foreign investment. Rightist governments, which stand to benefit given their support by groups that stand to gain through foreign investment, should favor FDI openness. I could find little information about how centrist governments should behave when it comes to FDI, and therefore it is difficult to predict a definite relationship.

Most discussion of nationalism in political economy appears to equate it with protectionism, economic autarky, and closing the state to external economic interests

(Shulman 2000). Indeed, the idea of nationalist protection of the economy in writings of political economy has a long history. For example, Robert Gilpin (1975) described three models of the future for the international economy. One of them, mercantilism, described an economic nationalism of nation-states competing for scarce resources and eventually, organizing into regional economic blocs to protect themselves. Johnston (1985), arguing that Canadian trade unions represented a more nationalist and protectionist position economically, found that Canadian trade union elites did not favor foreign investment as much as corporate elites, and were strongly in favor of nationalization. He also found that Canadian representatives of local capital favored more regulation on foreign firms than representatives of international capital. Beinun (1999) chronicles the turn of Middle Eastern Arab regimes away from economic nationalist state-led industrialization and import substitution policies to policies of free trade and global economic integration beginning in the 1970s. Nayar (2000) points out that the Hindu nationalist Bharatiya Janata Party's economic program, while not greatly different from the Congress Party that preceded it, took issue with the Congress Party's opening of the economy to foreign capital and promoted an India-first model of development in which foreign direct investment would play a supplementary role to local capital. Berend (2000) describes the economic nationalism of Central and Eastern Europe after World War One, which encouraged import substitution policies in an attempt to separate itself from Western Europe.

Indeed, while nationalism cannot be equated with dependency theory, both appear to have sprung out of some similar concerns about globalization. Both appear to focus attention on the potential harms to local economies and workers as foreign

capital become increasingly present, and both have encouraged affected nations to institute some closing-off of the economy to world forces in order to counteract these perceived harms. It is therefore very likely that countries with a more nationalist orientation would be more wary of foreign investment and more likely to have policies restricting FDI.

International political pressure. One force that may make a great impact on the openness of FDI policies is the overt and implied political pressure put onto states by other international actors. As trends continue to move nations toward greater economic openness, developing countries under greater international political pressure are more likely to be pushed in that direction, which includes greater openness toward FDI.

Multinational corporations, as potential beneficiaries of FDI, are at the forefront of this international political pressure. However, their efforts are supported by other international actors. Some scholars have argued that under the onslaught of non-state actors, the sovereign state is becoming one of many international players, rather than the only international player (Strange 1982, Stopford, Strange and Henley 1991, Strange 1996). Developed states, whose multinational corporations provide the lion's share of FDI, are one additional source of international political pressure. Another source of pressure is international opinion and mores. A good example of such consensus of opinion is the promotion and widespread acceptance of the economics of the "Washington Consensus" by the international community beginning in the 1980s.

Other sources of political pressure are international organizations which often make their membership and benefits contingent on greater economic openness. While developing countries do not need to be members of these organizations, most join

because of the perceived benefits and to gain a greater voice in international matters. International organizations are important for a variety of reasons. They allow member states to share information on the actions of other states, share and reduce the costs of agreement negotiation, and to bring to light and sanction other nations for agreement violations (Milner 1998). Martin and Simmons (1998) indicate that there is a long history of research that indicates that international institutions affect state behavior and their domestic policies. While Matecki (1956) argued early in the post-war period that institutions could be places where inspiration and ideas could be fostered, later scholars such as Cox (1969) showed how international institutions, through their executive leaderships, could influence domestic policy through building support with domestic interest groups. Various interest groups and entities can even push for some policies to be removed from national decision-making entities and put into the hands of international institutions if it meets their needs. Goldstein (1996) explores why the United States allowed for trade disputes within NAFTA to be removed from its national courts to an international body when doing so clearly weakened its abilities to rule in favor of its own citizens and businesses. Goldstein argues that disputes between the president and Congress over free trade and protectionism led the executive branch to favor the international body. However, Congress ratified this move, possibly partly due to political pressure from constituents concerned about the trade imbalance. Other aspects of international institutions that may affect domestic policy outlined by Martin and Simmons include promotion of transparency in international policy, forcing democratic nations to live up to their ideals on the world stage, providing a vehicle for nations to solve collective action problems and help nations coordinate more efficient

policy responses (though efficient policies are not always a result!), and establishing rules and norms for international behavior.

There are a number of international institutions, such as the World Bank, the World Trade Organization, and others that focus on world economic issues, including openness to investment and standardization of international regulations on investment. Given that membership in such institutions increases transparency, standardizes policy outcomes, sets rules for compliance and provides some punishment for contrary behaviors, it can be expected that membership in international institutions leads to greater openness in policies of foreign direct investment.

Developing countries that border on or are within the sphere of influence of developed countries may be subject to greater pressures toward economic openness. The case of Mexico is all too apparent, bordering as it does on the giant United States' economy. Haggard and Maxfield (1996), for example, write that Mexico's proximity to the United States limits its ability to put governmental currency controls in place. Hanson (1997, 114) writes "...For Mexico, the proximity and size of the United States make trade liberalization tantamount to integration with its northern neighbor." Middle Eastern and North African nations, particularly after the collapse of the Soviet Union, have been forced to seek greater economic integration with Europe, leading to increased pressures to open their economies further. The northern African nations of Libya, Tunisia, Morocco, Algeria and Mauritania formed the Arab Maghrib Union for this specific purpose. Owen (1993, 5) writes "...hence, the European Community seems to have had the freedom to demand integration as a prior condition to serious negotiations if and when it suits its own interest."

Given the pressure that can be brought to bear by developed nations on developing nations all over the world, and considering that some developing nations' proximity to the developed world gives them an interest in putting policies in place that will make them attractive to capital from their wealthier neighbors, it can be expected that this proximity leads to greater openness in FDI policies.

Demand for FDI. The demand for FDI is another combination of factors that affect the openness of FDI policies in developing countries. The demand for FDI can be summed up as the relative importance of FDI in development strategies versus other options for development. States are not simply limited to one avenue of development. They can have access to alternative sources of capital, and may gain development funding from international lending institutions, overseas aid, exports (which increase cash flow), and domestic savings. States can put themselves at a disadvantage by relying too heavily on one form of development. States that rely primarily on loans, for instance, place a great amount of control in the hands of their creditors, the international lending institutions. Often states cannot rely too heavily on overseas aid due to uncertainty about whether the funding will remain in place or at the same levels year after year. In the case of FDI, states that rely too heavily on foreign investment capital face the same problems as outlined in the previous chapter. By relying on FDI, they enter a bargain with multinational corporations. Access to other options not only strengthens countries' bargaining strength with MNCs, it also reduces their reliance on FDI.

Domestic savings, the first component of demand for FDI, follows a simple maxim: savings equals investment. Greater amounts of domestic savings create more homegrown capital for local entrepreneurs. Sengupta (1968) establishes the

relationship between domestic savings and investment by showing that the difference between exports and imports equals the difference between gross domestic savings and gross domestic investment. Countries can therefore invest more than they save if the shortfall in savings is met by the same amount in increases in imports. Krause (1989) links the high development growth of Pacific Rim Asian countries with high domestic savings rates, leading to a lack of dependence on foreign capital. Graham (1991) writes of the low gross domestic savings rate in the United States, and how that has fueled a greater dependence on foreign investment to drive an economy that continually performs at mediocre levels. This does not just apply to the United States. Mongolia has relied on foreign investment to make up for a shortfall in gross domestic savings as well (Goyal 1999). In terms of policies, those countries that establish greater restrictions on FDI may be relying on higher savings rates to fuel development. Conversely, those countries that are more open to foreign capital may be trying to make up for a perceived shortfall in domestic savings. We would expect savings to show an inverse relationship with countries' policies on foreign direct investment, because greater amounts of foreign direct investment is commonly associated with a low domestic savings rate.

Foreign aid, the next component of demand for FDI, is financial assistance given by developed countries to developing countries. Research has established a relationship between foreign aid and foreign direct investment, though the relationship seems to run in different directions depending on the study. Sometimes, the relationship seems to enhance, rather than replace, foreign direct investment prospects. Jodice (1980) finds that greater reliance on foreign aid reduces the number of

expropriations in developing countries, though the relationship is weaker than expected, and Bandelj (2002) found that foreign aid had a significant and positive relationship on logged-FDI flows between dyadic pairs.

However, other studies find that foreign aid supports development as an alternative to foreign direct investment. For example, Kamath (1990) attributes China's post-Maoist "Open Door Policy" for foreign direct investment to three factors: the impossibility of China raising the resources for development domestically due to its Mao-era economic troubles; as an alternative to foreign borrowing, which China did not trust and pursued with a wary eye; and China's isolation from multilateral aid agencies and a desire to not become dependent on bilateral aid. In addition, China needed the foreign technology that comes with FDI. Another study attributes the growth in FDI in developing countries to the slowdown in U.S. foreign aid (Summary and Summary 1998).

While funding from developed countries is supposed to enhance the development options of developing countries, we might expect that, despite the uncertainty of its availability, countries have reasons to want to receive foreign aid as an alternative to other forms of development, and that a loss of foreign aid would lead countries to make up the shortfall elsewhere. In developing countries, where over the past 30 years domestic savings have not lead to significant investment, and where foreign borrowing has often led to debt crises, foreign aid might be a reasonable alternative. Therefore, it can be expected that larger levels of foreign aid will lead to more restrictive FDI policies.

International loans are another potential variable that may have an effect on the demand for FDI. There is substantial scholarship to support this idea. Some researchers indicate that external debt and foreign investment compete with each other. In developing countries with a large public sector, as in Brazil and Mexico, foreign borrowing was a direct result of import substitution policies and provided funding for massive new state investments in the economy. By the mid-1970s, this foreign borrowing crowded out foreign investment in many sectors (Alarcon and McKinley 1992). Frieden (1983) relates that a net result of such borrowing was that such countries increased their industrial and exporting capacities. He goes on to argue that foreign borrowing is simply another form of foreign investment, albeit an indirect form, and presents statistics demonstrating that throughout the 1960s and 1970s an increase in the share of foreign capital inflows into developing countries held by private international financiers was accompanied by a decrease in the share of inflows held by multinationals.

However, there are some contrary indications that foreign loans affect the demand for FDI. In particular, China has benefited from both borrowing and foreign direct investment, using the two simultaneously to fund its development (Lardy 1995). The issue may be one of causality. If countries have racked up great amounts of external debt, would they be more inclined to seek capital to pay off their debt? Might another way to gain capital consist of the promotion of foreign direct investment? A temporal element may also be in effect, as countries developing over time may reach a threshold where they cannot, or will not, borrow any more. However, since foreign

borrowing constitutes a possible alternative to FDI, it is expected that countries that rely more upon international lending will have more restrictive FDI policies.

The trade balance may be a force that influences FDI policies. Sengupta, as noted above, set the trade balance equal to the difference between gross domestic savings and gross domestic investment:

$$\text{Exports} - \text{Imports} = \text{Domestic Savings} - \text{Domestic Investment}$$

This simple equation suggests that the trade balance is linked with investment, and particularly that a trade deficit will lead to a savings deficit which opens the door to foreign capital. Lipsey (1991) argues that direct investment in the United States is part of a web of interrelationships involving imports, exports, market shares and component and materials sourcing, though he doubts the relationship leads to much effect on the U.S. trade balance. The trade balance is also nested with other possible variables, including exchange rates, which affect whether investment will be domestic or foreign. In any case, Lipsey and Sengupta serve to show that trade and foreign direct investments are interrelated. For example, in the United States, larger trade deficits have helped turn the United States into a debtor nation with a greater reliance on foreign direct investment, though some argue that this state of affairs is not all bad (Dornbusch 1990). If trade balance is indeed related to foreign direct investment, then trade surpluses affect the demand for FDI, and will result in more restrictive FDI policies, while trade deficits will lead to more open FDI policies.

Because the demand for FDI is inversely related to the availability of other sorts of development funding, we should see that these four factors – domestic savings, foreign aid, foreign loans and the trade balance – are negatively related to the openness

of FDI policies. Alternatively, it is possible that general openness to FDI directly influences the demand for FDI. For example, developing countries that have greater openness to FDI may gain a positive reputation that justifies greater trust from international lending and aid institutions and decreases the amount of domestic savings as the economy develops and more local resources are tapped. In other words, openness to FDI may precede demand for FDI, in which case we would not see these relationships develop as the theory predicts. Should the theory be correct, then developing countries that maintain trade surpluses and rely on greater amounts of foreign loans, overseas aid, domestic savings will rely less on FDI, and therefore may be expected to be more restrictive in their FDI policies.

Past experience with FDI. Finally, developing countries look to past experience in developing their policies. By looking at past experience with FDI, states can anticipate their needs, and therefore past performance becomes part of the agreement process. I argue that developing countries take advantage of their attributes, which will be explained more fully in the test of Model Two, to exert control over the FDI process. Developing countries have no exact idea what they can expect in terms of FDI inflows from year to year. While they can make a prediction based on past performance, current negotiations with firms, and other tangible and intangible factors, they will not know the exact level of FDI inflows until those inflows are accounted for. In addition, in order to have a modicum of control over the FDI process, developing states may want to keep their FDI policies as restrictive as they possibly can while maintaining inflow levels at an acceptable level. For example, assume that the government of a developing state believes that it is attractive to investors for a variety of reasons, such

as natural resources, infrastructure, abundant labor, a large market, and a stable political system. This government believes that investors are more disposed to invest in the state than not. Should political and economic realities mean the state has restrictive policies, it enters the agreement phase with firms in a good bargaining position. If firms agree, the various constituencies within the state might favor restrictive FDI policies in the future based on the anticipation that the state will still receive an acceptable level of FDI.

On the other hand, assume that a state has not been attractive to investors, and has experienced a stagnant flow or decline of FDI in the recent past. If the constituencies of this state have agreed to open FDI policies in the political process, the state may find itself in a weaker bargaining position so that the investment it does get works to a greater benefit for firms and a lesser benefit for states.

If states review past performance, where do they get their information in order to make reasonable estimates? States will look at past FDI figures as well as their assets, liabilities and negotiating positions and try to anticipate and predict future FDI. On a basic level, if states see that past inflows have been declining and economic performance is down, governments may be compelled to open to FDI. States that have rising FDI may act in various ways given other economic and political factors.

Determinants of FDI Inflows

All of the factors described in the previous section influence current FDI policies, which indicates the extent of developing countries' openness to FDI. In this model, I argue that FDI policies have a strong influence on inflows of FDI into developing countries. In addition to FDI policy, other influences on FDI inflows include

characteristics of the investment market, political characteristics of the state, and state economic characteristics. All of these factors combine to determine the levels of developing countries' overall total of FDI inflows. I discuss the influences on FDI inflows in greater detail in the next sections.

FDI policies. Now that FDI policies and the factors that influence developing countries' level of openness to foreign investment have been established, FDI policies become an important influence on FDI, and their level of openness should have a strong impact on FDI inflows. FDI policies serve as one basis for agreement between developing countries and international firms over investment, as well as delineating each developing country's win-set, or range of possible agreements that they can make with firms. Multinational corporations' responses to developing country policies are therefore indicated by the amount of investment that flows into developing markets from foreign sources. Policies that are more open increase the number of possible agreements with foreign firms that developing countries can accept, and should lead to a greater amount of FDI inflows, while restrictive policies reduce the range of agreements and should therefore decrease FDI inflows.

State political characteristics. The political character of the state does not just affect FDI policy. It also affects the flow of FDI in and out of the domestic economy. This effect is partly because the political makeup signals to potential investors what types of policies are in place in the host market, what the initial bargaining position of the host state will be, whether the state will be more inclined toward regulation, control, and expropriation or toward market freedom, whether the state will protect property rights, and so on. In developing countries, where governmental structures may not be as

advanced or as stable as in the industrialized world, the political characteristic of the state can make a difference in the importance of foreign direct investment in its economy. The political characteristics that have the greatest impact on foreign direct investment are regime type, ideology, and political stability.

Regime type has many theoretical and empirical associations with foreign direct investment. While most of the discussion on this concept for the first stage of the model is still pertinent in Model Two, there have been some specific quantitative studies utilizing regime type as an independent variable where the effects of regime type on FDI inflows have been generally favored democracy for greater inflows, with a few exceptions. One exception has been reported by Resnick (2001), who finds a negative association between FDI and democracy in his study of FDI in nineteen developing countries, and Li and Resnick (2003) come to a similar finding on foreign direct investment and democracy in a study of 53 developing countries. Property rights protections seem to mitigate this effect because they are stronger in democracies and suggest that developing countries may gain greater foreign investment by making incremental improvements in the protection of the rights of property owners.

However, Feng (2001) finds that political freedom (usually associated with democracy) enhances private investment. Jensen (2003) argues that findings that downplay democracy's effect on FDI are in error because they do not account for the fact that most developing countries are more authoritarian than developed countries, and all developing countries depend on FDI as a greater share of their GDP than developed countries. In tests on cross-sectional and time-series cross-sectional models he finds that democracies are 70 percent more likely to attract FDI than non-

democracies. He concludes that democracies are considered low-risk, which makes them attractive to international investors.

In the face of much theoretical and empirical support, it is likely that countries that are more democratic will be more likely to receive the benefits of FDI over countries that are not, although there is a possibility that, given the mixed findings, political stability matters more than regime type and therefore stable authoritarian and democratic regimes are considered attractive to investors.

Ideology should also play a role in determining the amount of foreign direct investment inflows. Ideology matters for numerous reasons, explained in Model One, and which serve as the basis for hypotheses. If left-leaning governments are more likely to restrict FDI than right-leaning governments, then there should be less FDI in left-leaning developing countries than in right-leaning ones.

Unfortunately, few existing studies use ideology as a variable to predict FDI. A very recent study that uses ideology was written by Jakobsen and de Soysa (2006) in response to an earlier study by Li and Resnick, cited earlier. They take issue with Li and Resnick's findings that democracy and FDI inflows have a negative association when controlling for property rights. By increasing the sample size to 114 countries from 1984 to 2001, they find that property rights become insignificant. Developing democracies gain higher inflows of FDI, and governments under the control of leftist political parties gain more FDI than governments under centrist and rightist control. They argue that leftist governments prefer FDI because it will help labor. In turn, labor is less likely to engage in internal struggles over policy change, which offers potential investors credible guarantees against policy reversals. Leftist democratic governments

are also more likely to fund public goods and engage in human capital formation which would be attractive to foreign investors.

In the paucity of quantitative evidence about ideology and FDI it is hard to predict an outcome. Certainly leftist governments should be more guarded about FDI as reflected in their policies, but does this translate to inflows? Are MNCs attracted to supposedly capital-friendly right-oriented countries as opposed to capital-unfriendly left-oriented countries? It is expected that the traditional relationships will hold, but it is also quite possible that left-leaning developing democracies may be different, as Jakobsen and de Soysa suggest.

Political stability and its relationship to FDI have been well-researched. While it is possible that political instability inhibits FDI, the evidence has been decidedly mixed. Early research tended to equate democracy and political stability, but Bollen and Jackman (1985) make a good empirical case for not making such an assumption, and encourage researchers to test stability as a concept separate from democracy. Bollen and Jones (1982) find a negative and insignificant correlation between political instability, defined as armed attacks, riots, deaths from political violence and assassinations, and domestic auto production (which, as they argue, involves significant foreign investment from the auto-producing corporations) in 84 countries. Crenshaw (1991) also finds political instability, defined similarly to Bollen and Jones, to be an insignificant determinant of FDI in 69 developing countries. Feng (2001) finds that usual indicators of political instability (strikes, revolutions, coups d'état, and riots) have little effect on private investment. Perhaps these findings are due to the fact that strikes and

riots are limited instances of instability and should not be grouped with larger, more disruptive instances of instability, such as wars, civil insurrection, and revolution.

Political instability can also be measured by the rate of change of government. The more change that governments undergo, the fewer guarantees investors have in terms of protections and policy certainty. Root and Ahmed (1979) find that frequent changes in government deter non-extractive foreign direct investment. Feng, cited earlier, finds that government changeability and policy uncertainty have negative effects on FDI. Li and Resnick (2003) find a positive correlation between regime durability and foreign direct investment, while Jakobsen and de Soysa (2006) discover that the association disappears when they increase sample size.

Political stability in a country can often depend on whether it is in conflict externally or internally. Internal conflict, such as civil unrest or civil war, is related to the concept of political instability as defined by strikes, revolutions, riots and coups d'état. Civil war can be an extension of those occurrences, and is perhaps the next, more violent step of political instability. External warfare, on the other hand, consists of government sponsored violence against another country. External war can create political instability in all parties to the war, and most especially in the nation that fares badly.

As one indicator of the domestic political environment, we can expect that greater political instability hinders, not enhances, FDI prospects in developing nations. Given that developing nations are perceived to be less stable than the developed nations, and that theoretical links have been proposed linking greater FDI to greater stability, all aspects of political instability should correlate negatively with FDI.

Characteristics of the investment market. Characteristics of states' investment markets may affect foreign direct investment and its location in developing countries. Theories of firms cited above have identified locational factors as contributing to firm decision-making in foreign direct investment. I will list a few factors here that fall under the locational rubric. They include economic sectors, regional trade agreements, wages, and unionization.

FDI may be attracted to certain countries based on the strength of certain sectors. Much early FDI was attracted to extractive industries in raw materials, but newer investments are to be found in manufacturing and services. It is crucial, when looking at issues related to development, to account for differences not only between but even within sectors (Semyonov and Lewin-Epstein 1986).

Do these differences determine whether FDI enters developing countries? Research has linked investment in sectors to development in lesser-developed nations. While most pre-World War II foreign investment in Mexico was in public services and extractive industries, the latter half of the 20th century saw most investment go into the industrial sector (Weinert 1981). Export-led growth in manufacturing, aided by foreign direct investment, helped Sri Lanka rebound from a dismally underperforming economy to a vibrant outward-oriented economy (Athukorala and Rajapatirana 2000). Public investment in Malawi, which includes significant investments in the services sector, has been shown to demonstrate a two-directional causal relationship with private investment (Mataya and Veeman 1996). However, Root and Ahmed (1979) do not find any significance in the relationship between the ratios of manufacturing to GDP and raw material exports to GDP to foreign direct investment in manufacturing, and Crenshaw

(1991) finds that foreign capital penetration in extractive industries actually reduces total FDI stock, while foreign capital penetration in manufacturing increases FDI stock.

If sectoral differences are a factor in attracting FDI, there should be a positive relationship between one or more sectors and FDI performance, assuming that there are no causality questions. Developing countries with industrial economies or economies that focus on manufacturing should attract foreign direct investment. More recently, services have accounted for a greater share of overall foreign direct investment. Services accounted for the majority of FDI in developing countries in 2005¹⁴. In 2004, the share of services in FDI accounted for 63 percent of FDI flows, and 55 percent of FDI stocks in 2001 (Kolstad and Villanger 2004). Most of the share of services in FDI can be attributed to the financial and business sectors. Kolstad and Villagner (2004) also report that there is also evidence of a positive interrelationship among FDI in various sectors, particularly between the manufacturing sector and the services sector. Based on such evidence, it is expected that developing countries with economies focusing on services should also attract more FDI.

International Factors. International factors do not only affect FDI policies, but can have a large effect on FDI inflows. Membership in international organizations concerned with trade and investment, for example, may be an attraction for firms that look for a level playing field when making their investments. Besides Jodice's (1980) finding of a weak relationship between FDI and international institutional pressure in terms of expropriations, McGinnis and Movsesian (2000) explore the impact of the WTO on world trade and argue that its rules and norms restrict protectionist groups within

¹⁴ UNCTAD, 2006 World Investment Report. Highlights of the report can be found online at <http://www.unctad.org/Templates/webflyer.asp?docid=7431&intlItemID=2527&lang=1&mode=highlights>

domestic society and increase countries' abilities to engage in trade, and by extension, I would argue, foreign investment. Solingen (2001) defines internationalization as the expansion of global markets, institutions and norms, and maintains that countries in internationalizing regional coalitions attracted greater trade and foreign investment.

Proximity may also have an effect on FDI inflows. Deichmann et al. (2003) find that geographic factors helped determine Eastern European countries' attractiveness to foreign firms. Eastern European countries clustered in three groups geographically; those that were making progress in economic and political reforms, those that were implementing some reforms but struggling with others, and those that lagged behind. These factors, plus their proximity to Europe, helped determine their attractiveness to foreign firms. In addition, a recent study on the impacts of the globalization of health care and its meaning for the Caribbean nations argues that proximity to the United States, which has an aging population and high costs of health care, could benefit foreign investment in health care in countries such as Jamaica (Bernal 2007).

Other factors exist that may influence FDI inflows. Regional trade agreements (RTA) may enhance FDI inflows to individual countries within the RTA, but only if the country is already a desirable site for FDI and if it has liberal trade and investment policies (Blomstrom and Kokko 1997). Worth (1998) finds that RTAs enhance trade liberalization, which affects per capita GDP, GDP growth and market size and which, in turn, affect FDI flows.

FDI inflows in developing countries may also be affected by their comparative advantage in labor provision owing to a surplus of labor. Neoclassical economics argues that a greater supply of labor in a market should mean lower wages. Theories of

FDI argue that FDI should flow from high labor cost markets to low labor cost markets to minimize labor costs to firms. (Calvet 1981). Low wages are a basis for price competitiveness for firms (Ozawa 1992). Cushman (1987) finds that falling productivity and higher wages reduce the inflows of FDI. However, Hanson (1995) disputes this notion, demonstrating that low wages in developing countries have not been associated with higher investment rates – the reverse is true. He speculates that other factors, such as low labor productivity, have a greater influence on FDI. Also, years of FDI investment may have a residual effect. Several authors find that foreign investment raises wages in host countries (Feenstra and Hanson 1995, Aitken, Harrison and Lipsey 1997, Lipsey and Sjöholm 2001).

Unionization may be another influence on FDI inflows, and firms may assess unionization as one local factor that affects their decision to invest. Cooke (1997) lists three reasons why firms would want to avoid unions: restrictions on management ability to direct their workforce, added transaction costs from bargaining and work disruptions, and higher wages and benefits associated with unionization. He finds a significant negative association between percentage of union membership in OECD countries and U.S. direct investment. Alderson (2004) explores another angle, that union density causes firm production costs to rise and flexibility in production to drop, and so spurs foreign direct investment to non-unionized countries. However, he finds no relationship between union density and outward FDI.

Another characteristic that is associated with foreign direct investment inflows is corruption. Bardhan (1997) lists two main views of the effects of corruption on FDI inflows. The first argues that corruption depresses FDI inflows because it places

barriers against investment within the market and greatly decreases efficiency. The second argues that corruption aids the flow of the marketplace by allowing those investors that are willing to pay bribes to government officials to set up for business more efficiently. An example often given is China, which is considered to have rampant corruption but also garners much foreign investment (Wei 2000). Wei finds that increases in tax rates or corruption reduce inward FDI, and that American investors are as averse to corruption as investors of any other nation. Habib and Zurawicki (2002) find that not only does corruption have a negative effect on FDI, but also firms in corrupt countries will not invest in countries where corruption is even worse. Because corruption is widely seen as an impediment to investment and smoothly operating business, corruption should be negatively associated with FDI inflows.

Market size has been a long-established predictor associated with foreign direct investment, because larger markets provide greater potential sales and possibly greater local support and supply opportunities for businesses. As early as 1969, Scaperlanda and Mauer found that GDP, proxying as market size, was the only consistent predictor of U.S. foreign investment in the European Economic Community. Jaumotte (2004) found that market size, as operationalized by real GDP, was a significant and positive predictor of overall FDI within regional trade agreements. China is often cited for its meteoric FDI growth partly because of its large market potential. Even within China, regions with a larger market size attract more FDI (Wen 2005). However, Miller and Weigel (1972) did not find a significant correlation between market size and U.S. direct investment in Brazil. And Crenshaw (1991), operationalizing market size as total energy consumption in thousand-ton coal equivalents, found market size negatively

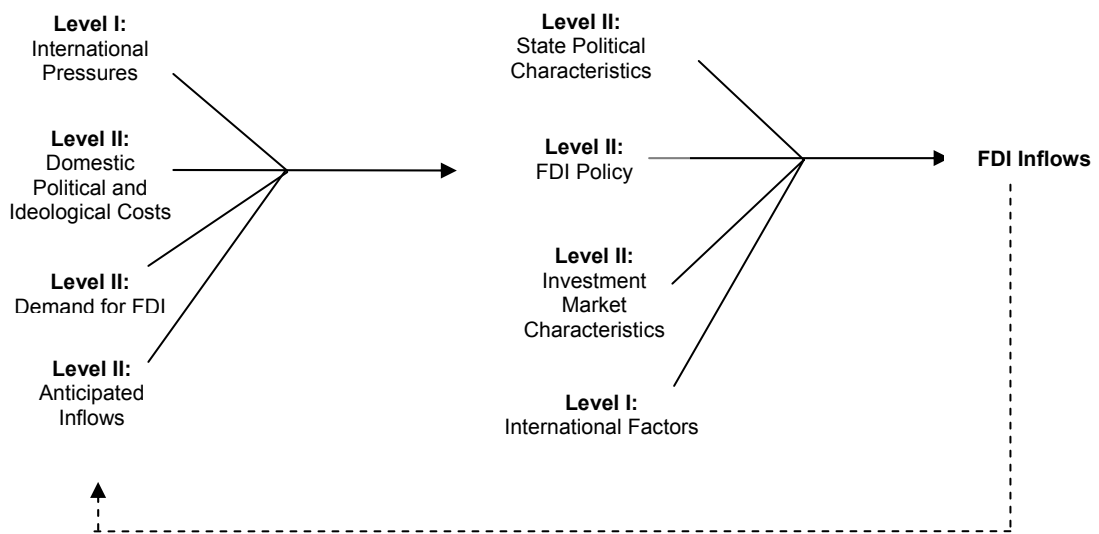
associated with total FDI stocks and stocks per capita, but acknowledged that elimination of overly-influential outliers in his analysis led to severe problems with heteroskedasticity. These factors should be controlled for in any test.

The Next Step: Testing the Model

The model outlined above is one possible explanation of FDI in developing countries. In the first part of the model, FDI policy is determined by domestic political and ideological costs, international pressure, demand for FDI, and anticipated inflows. The policies that result from the first stage then become determinants of FDI inflows in the second part of the model. The influence of policies is supplemented by characteristics of each developing state's political environment, investment market, and economic characteristics. Because there is an anticipatory aspect to the first model, inflows from previous time periods feed back into the first part. Figure 2-2 provides a graphical representation of the theory.

In Chapter Three, I will provide a quantitative test of this model. I introduce a new measure of FDI policy, the FDI Equity Index, which will shed light on how policies establish each state's openness toward FDI. I lay out a statistical model which defines independent and control variables for the concepts I propose above, and conduct a test to determine whether those variables influence FDI equity openness.

Figure 2-2: Determinants of FDI Policy and Inflows



Chapter Three

Quantifying and Testing Foreign Direct Investment Policies

In this chapter I lay out the first part of a model of FDI policy and its effects on FDI. This model follows the narrative and theory of FDI described in Chapter Two. I argue that FDI policies in developing countries follow the logic of two-level games, and therefore are influenced by both domestic and international level factors. Domestically, FDI policies are more open or closed based on attitudes (influenced by prevailing prescriptions for development in vogue at the time) that exist in the most powerful forces in the domestic political consciousness at any given point in time, along with realities of domestic economics. The direct domestic influences on FDI policies are political and ideological forces, international pressure, the demand for FDI, and state anticipation or prediction of actual flows of FDI. International influences on FDI policies come from pressures in the international political and economic environment.

In the second part of the FDI story, inflows of FDI to states are influenced by the level of openness to FDI as indicated in their FDI equity policy, as well as domestic and international influences on firms' decisions to invest. Firms decide to invest based on existing state policies, characteristics of states' investment markets, political regime type and stability, and other state economic characteristics. I test the proposition that FDI policy is the basis for agreements developing states make with firms, and therefore any agreements (as indicated by FDI inflows) are influenced by these basic policies. The levels happen concurrently, and the outcomes from both levels help explain the outcomes of the other.

States face a fundamental tension when dealing with FDI. I assume that states want to receive FDI, and I therefore argue that they are motivated to seek FDI for development and gain. However, there are costs to states for implementing policies that are open to FDI, and states that wish to bring in more investment have to take account of these domestic and international political costs. These costs may include domestic opposition to FDI by powerful interest groups, and loss of economic and political power to international actors such as international institutions and multinational corporations. Consideration of costs and benefits allow states to create and modify FDI policies, which serve as indicators of their FDI preferences. Such costs and benefits not only influence states' openness to FDI, but also predict the inflows of FDI into the state. States also examine their past inflows, which help them identify the usefulness of their current FDI policies. Therefore, the explanation and testing of the complete model will follow this approach.

Determinants of FDI Equity Policy

The first part of my theory explains the openness of countries to FDI. States considering the extent of their openness weigh the benefits and costs of FDI against a number of other domestic and international factors. In other words, we cannot assume that states are simply willing to accept FDI without first considering the factors that lead to such policies. The factors described below are an integral part of the way states weigh the benefits and costs of FDI.

States' openness to FDI is a difficult variable to measure, partly because there have been few quantitative studies of FDI policy and partly because the theoretical concept of FDI openness is very complex, consisting of many different components.

For example, Guisinger (1985) identified over 50 separate incentives and disincentives that pertain to FDI, and mapped these policies in ten countries. The policies affect corporate revenues, inputs, value-added, the ability of individuals or corporations to own land, and corporations' relations with labor. FDI policies can consist of restrictions on new investment, regulations on existing investment, respect for and government protection of property rights, and level of taxation on foreign corporations to name a few. Which of these is most important? Alternatively, are all of them important in determining FDI policy openness?

Similar problems exist in measuring trade policy, leading some scholars to employ creative solutions which have relevance to the study of FDI policy. A gravity model of optimal level of trade, employed by Hiscox and Kastner (2002) inspired Pinto (2005) to utilize their procedure to predict openness toward FDI. Basically, a gravity model of trade utilizes the distance between two units and their respective market sizes to predict trade flows. Pinto utilized the technique to develop a measure that indirectly represented FDI policy. However, an indirect measure based on flows of investment may be problematic because it assumes that flows relate to policy. This is not a sure assumption. The only way to determine if flows relate to policy is to develop a direct measure of openness to FDI and test it; otherwise other methods remain approximate techniques of determining this elusive concept.

One possible solution to the problem is to find a measure that more closely reflects FDI policy and policy changes which will allow a direct test of the influences on openness to FDI. To date, few solutions have been forthcoming. Bandelj, stating that "no other study has tried to quantify host country FDI policy," wrote perhaps the first

paper where a direct measure of FDI policy was utilized. She created her variable by conducting a content analysis of government provisions for incoming FDI in eleven Eastern and Central European countries (Bandelj 2002, 426). Her policy variable, which she used as an independent variable, did not significantly affect FDI inflows.

So far, FDI policy measures consist of indirect measures applicable to a large number of countries, as in Pinto's gravity model measure, or a direct and encompassing measure that is limited to a small number of countries, such as Bandelj's measure. A large-scale statistical analysis utilizing a direct measure of FDI policy has remained elusive. The variable created for this study, the FDI Equity Index, is a significant step toward resolving the gap between indirect and direct measures and offers researchers the benefits of each.

The FDI Equity Index is an ordinal measure of the equity openness to foreign investment of 57 developing countries over 29 years (1976-2004).¹⁵ The variable was created primarily through a content analysis of the Exporters Encyclopedia, a yearly publication currently published by Dun & Bradstreet which lists practical trading information for exporters. Much of the information published in the Encyclopedia has to do with specific trading issues, such as tariffs and other taxes, labeling and packing regulations, a description of ports and the machinery available in them, etc. However, a section on marketing in each country often includes a subsection on foreign investment and various policies that are in effect. From these descriptions, exporters can determine whether equity restrictions are in place against foreign investment and

¹⁵ The full list of countries in the sample may be found in Appendix A. A listing of summary statistics for each untransformed variable in this chapter is provided in Appendix B. Transformed variables are indicated in the listing.

whether tax breaks and customs duties exemptions are allowed. Sometimes even the entire text of a law or regulation is printed.¹⁶

The foreign equity index is thus a one-dimensional variable of equity openness.¹⁷ The countries for which information was obtained are listed in Appendix A. The variable was coded into four categories, with the lowest category correlating to the highest restrictiveness on foreign equity, and the highest category allowing the most foreign equity participation. The categories therefore take on the following values:

Category	Description
0	Less than 100 percent participation allowed, but majority foreign equity possible.
1	100 percent foreign equity allowed in some sectors, but many sectors (over 10) restricted or prohibited
2	100 percent foreign equity allowed in most sectors, but some sectors (6-10) restricted or prohibited
3	100 percent foreign equity allowed in nearly all sectors; small number of sectors (0-5) may be reserved for state or domestic equity.

This variable allows testing of an aspect of FDI policy that has not been directly tested before. It is a direct measure and is also available for a large number of countries, and therefore presents an improved alternative to existing measures of FDI policy. Figure 3-1 portrays the histogram of the variable.

¹⁶ Please refer to Appendix C for more information regarding the creation of the Foreign Direct Equity Index and problems encountered.

¹⁷ The index does not count free trade area policies or export processing zone policies, which a number of developing countries have set up. The policies creating these zones set aside a certain area where foreign companies can establish manufacturing plants, and where they get privileges not available to them in the overall domestic economy. These policies are an attempt by domestic governments to manage foreign investment. Free trade areas often allow 100% ownership and offer tax breaks and customs duty exemptions as long as all or a majority of the finished product is exported out of the country. However, these are exceptions to the general domestic economy, and not the rule. The FDI Equity Index only considers FDI equity policies that apply to the entire economy.

Over time, the countries in the sample moved toward greater openness in aggregate. Figure 3-2 illustrates more of this upward drift in categories. The mean value in 1976 for all countries is 0.92 and the median is 1. By 2004, the median value increased to 2, and the mean value to 2.14. A movement of one category in a positive direction for all countries in the sample does not seem like much movement, but it conceals some volatile movement within many individual countries. Table 3-1 illustrates that some countries have moved toward greater openness in their foreign equity policies over 29 years, while others have remained more or less static.

One fact stands out clearly: once countries passed new foreign equity policies, they were unlikely to reverse them. Only two countries in the sample ever reversed direction in their FDI equity policies. Iran began 1976 in category 0, and then moved up to category 1 in 1995 after passing a law that allowed more than 50% foreign equity in joint ventures. However, Iran fell back to category 0 in 2002 after a new law put a cap of 35% on foreign equity in individual companies and 25% cap on foreign equity in sectors. Nigeria, in category 2 in 1976, passed a 1977 law setting caps on new investment and calling for the gradual phase-out of foreign equity to domestic investors, moving it back a category. Nigeria moved up again after liberalizing its codes in 1989, and then to category 3 in 1995 following its Investment Promotion Commission Decree, which removed a number of sector-based restrictions on foreign equity.

Figure 3-1: FDI Equity Index
Histogram of index values: 1976-2004

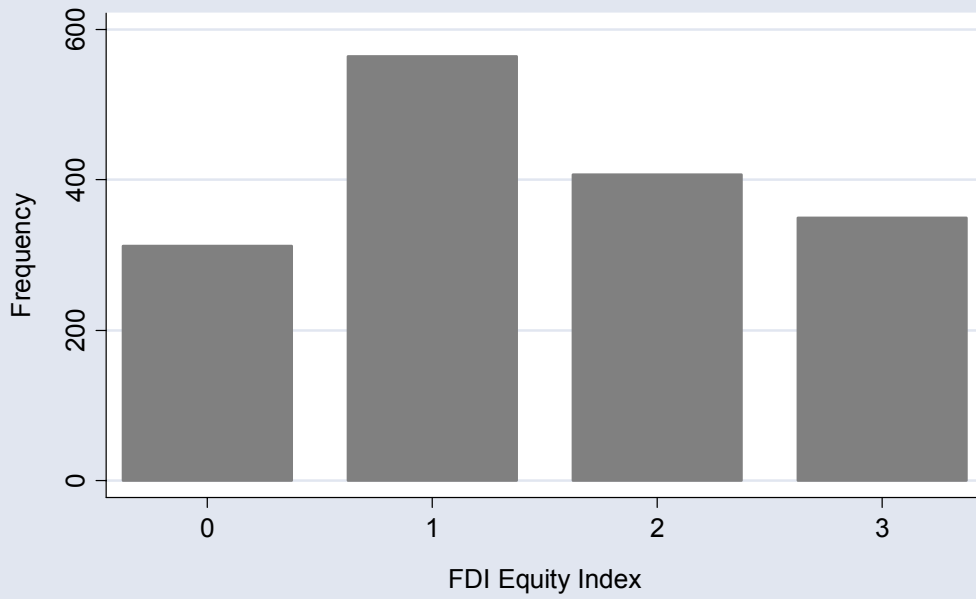
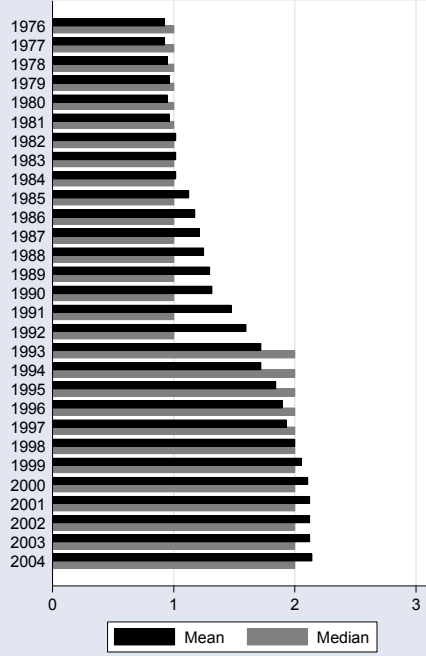


Figure 3-2: FDI Equity Index
Mean and median values



**Table 3-1: Movement of Selected Sample Countries Along Equity Index
1976-2004**

Countries Moving Upward Two or More Categories	Countries Remaining in Same Category	Countries That Reversed Course during time period
Algeria Bangladesh Bolivia Colombia Dominican Republic Egypt El Salvador Ethiopia Ghana Guyana Jordan Madagascar Morocco Mozambique Nicaragua Nigeria Peru Trinidad and Tobago Turkey	Brazil Chile Cote D'Ivoire Gambia Haiti Kenya Lesotho Malaysia Niger Papua New Guinea Philippines Swaziland Syria Tunisia	Iran Nigeria

What has influenced these countries' FDI policies at particular points in time? I have argued throughout this dissertation that factors at both the domestic and international levels affect FDI policies. This blend is conditioned by prevailing attitudes toward FDI at any given point in time and even toward globalization in general. The main domestic factors that influence FDI policies are domestic politics and economic realities. The main international factors are international political and economic pressures. I will operationalize these factors in more detail in the following sections.

Domestic Level Politics: Political and Ideological Costs to Government

In the previous chapter, I established that the domestic level political environment has an effect on FDI policymaking. Domestic level bargaining between interest groups, political parties, state governments and other players in the political system produce coherent policies which are then presented to foreign corporations as the basis for agreement on FDI. The state, once the policies are agreed upon, may enhance its prospects for agreement if it goes outside the bounds of domestic policy, but will face political costs at home. The next sections will discuss the domestic political factors that influence FDI policies

Regime type. The previous chapter established sound theoretical reasons for believing that regime type influences FDI policy. It has been argued here that democratic regimes tend to have safer environments for investments because they protect property rights and provide fair ways to resolve disputes. Despite the fact that autocracies also can provide protections for investment, democracies have been at the forefront of the globalization movement and therefore have been open to free trade and investment.

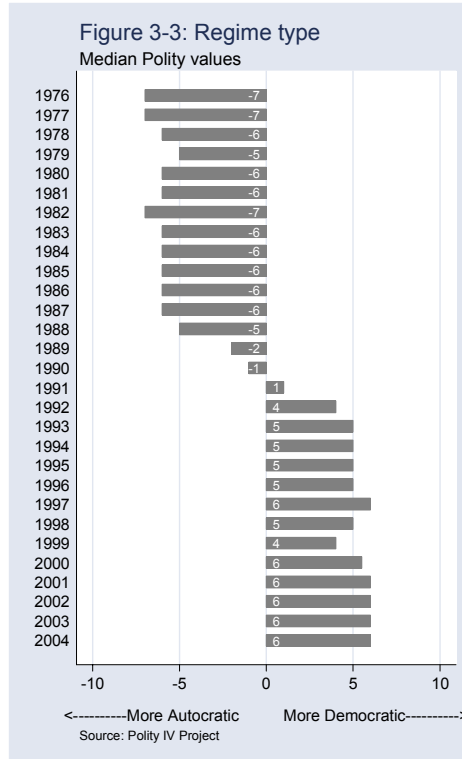
To test the relationship between regime and FDI policies, I use the Polity IV dataset, which is one of the most widely used dataset on regime characteristics. Polity IV consists of an index built on a number of regime indicators identified by Ted Robert Gurr.¹⁸ The dataset codes many countries from the early 1800s, utilizing a continuous scale from complete autocracy (-10) to complete democracy (+10).

Figure 3-3 illustrates the distribution of the Polity IV variable over the sample data. The Center for International Development and Conflict Management, which administers the Polity IV index, recently released its country codings through 2004, making them available for use in this study.

In 1976, the median Polity IV aggregate score was -7, indicating that most developing countries in the sample were highly autocratic. By 2004, the median aggregate score was 6, which put most countries in the sample in the democratic designation. In 1976, 39 of the 57 countries in the sample had a score that was -5 (autocratic) or below, and only 10 countries had scores of 5 or above (democratic). The remaining eight countries (which could be labeled “transition” countries) occupied the area between -5 and 5. By 2004, the situation had reversed. The number of autocratic countries had dropped to 10, and the number of democratic countries in the sample had risen to 36, with the remainder in transition.

There are theoretical and empirical reasons to believe that regime type is positively related to FDI policy. Democracies are more likely to have open economies, while autocracies prefer to maintain more control over their economies and are

¹⁸ The Polity IV dataset can be found at the website of the Center for International Development and Conflict Management, <http://www.cidcm.umd.edu/projects/project.asp?id=18>. Use of two other variables, the Vanhanen Polyarchy index and the Freedom House Freedom in the World index, were also considered. All three indexes are highly correlated with each other. The Vanhanen index only coded countries to the year 2000, and therefore did not cover the time-frame of this study. The Freedom House index had data for all the years of this study, and its substitution into the regression equation in place of the Polity variable does not alter the results of the regressions.



therefore likely to be more restrictive. It can be expected that this relationship will hold with FDI equity policies.

H1: Regimes that are more (less) democratic will have more (less) open FDI equity policies

Left-right spectrum. Theoretical links have been established between ideological orientation and economic preferences, which encourages a test of this concept. In general, literature reviewed in Chapter Two showed that the right is associated with free-market principles, free trade, and economic globalization while the left tends to be focused more on the national economy and various groups within it that depend on social welfare.

The measure utilized for ideological orientation is taken from the Database of Political Institutions (Beck et al. 2001). The DPI categorizes the ideological orientation

of each country's chief executive's party by labeling it as "left", "center", "right" or "other." The category "other" consists of those governments that cannot be categorized on a left-right continuum, such as monarchies, theocracies, some military dictatorships and periods of non-governance.

The database also lists the ideological orientation of the ruling party in government, and of the largest opposition party. In few cases were there any misalignments. The entries for Bangladesh in 2002, 2003 and 2004 were corrected for this study because the entries for the chief executive's party and the largest government party were not aligned even though they were both labeled as the same party in the database. In nearly all cases, the chief executive aligned with the ruling party in ideological orientation, and so the orientation of the chief executive's party was chosen as the measure to be used.

Out of the 57 countries in the sample, leftist governments averaged just over one fourth of all governments each year during the time period examined, with the highest proportion of leftist governments in existence from 1976 – 1990. Rightist governments averaged just over one-fifth of all governments during this same period, but gained a higher proportion during the 1990 – 2004 time range. Centrist governments only existed in about three countries per year in the sample. The governments characterized as "other" account for almost half the governments in the sample from 1976 – 2004.

The categorical variable from the DPI was reconfigured into separate dummy variables, labeled "left", "center", "right" and "other". The "right" category was left out of model estimations and serves as a basis of comparison. The variables were coded 1 if they possessed the required ideological attribute. For example, "left" is coded 1 if the

chief executive's party is oriented to the left and 0 if it is coded any other way. The same coding rules were utilized for "center" and "right."

Research suggests that the left tends to be less supportive of and open to FDI because it is more concerned with boosting and protecting the national economy, redistributing income and supporting a strong labor movement. Alternatively, the right tends to be less hostile toward FDI because in the past 30 years it has supported global interdependence and free trade. This relationship should therefore hold with FDI equity policy. There is little research on the center's attitudes toward FDI, and therefore the relationship could run in either direction or be non-significant.

H2: Left-oriented governments prefer less open FDI equity policies than right-oriented governments.

Nationalism. Neoclassical theory and researchers studying nationalism suggest that nationalist governments may be more inclined view the international economy as a competition for scarce resources. Nationalist governments also may attempt to shield certain constituencies in their country by protecting their markets from outside forces in the belief that greater openness to international economic forces may cause harm to local economies.

To test nationalism's effect on FDI policies, I employ a variable from the Database of Political Institutions, which is coded as 1 when the largest party in the government is a nationalist party and 0 when it is not. In the sample, nationalist governments made up 19.5 percent of all governments in all countries over the 29 years of data. The variable is missing 227 observations. I predict that nationalist

governments will be more inclined to pass FDI policies that have more restrictions than non-nationalist governments.

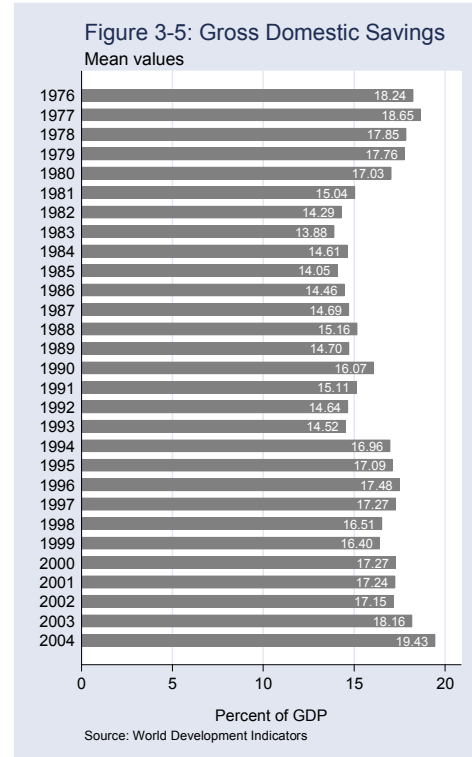
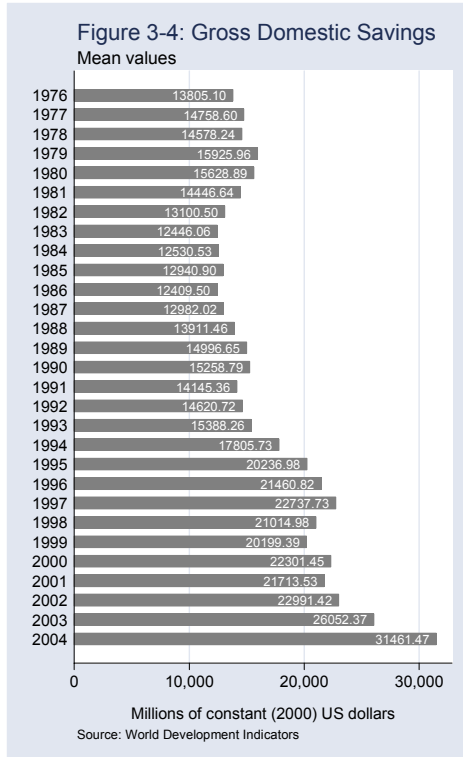
H3: Nationalist governments will prefer less open FDI equity policies.

Domestic Level Economics

Domestic level politics work in conjunction with domestic economic realities. These realities include the ways that the state funds development. If a state can rely on alternative sources of development, or it has had past success with FDI, these factors will influence state policies. The next few sections discuss the domestic economic environment.

Domestic savings. The previous chapter discussed the links between domestic savings and foreign direct investment, particularly that low domestic savings is associated with high rates of foreign direct investment. Countries that have low domestic savings are less able to develop using domestic capital, and must make up for the lack of capital by importing it from foreign sources.

Gross domestic savings is used as the measure of domestic savings in this model estimation. Figures 3-4 and 3-5 graphically depict the descriptive statistics for gross domestic savings in the country sample. From 1976 through 2004, average gross domestic savings increased over three times. In 1976, the average gross domestic savings in the country sample was \$13.81 billion (constant 2000 dollars). By 2004, the average gross domestic savings was \$31.46 billion. Overall, between 1976 and 2004, gross domestic savings as a percentage of GDP increased only slightly, from 18.24 percent to 19.43 percent. Between those years, the percentage dipped as low as 13.88



percent in 1983 but mostly fluctuated back and forth. Gross domestic savings as a proportion of GDP is the measurement used in order to control for market size and to solve autocorrelation problems resulting from a rising trend in the non-proportioned statistic. I expect that gross domestic savings will show a negative relationship with countries' policies on foreign equity.

H4: As developing states' proportion of gross domestic savings to GDP rises (falls), they are more likely to have less (more) openness to foreign equity

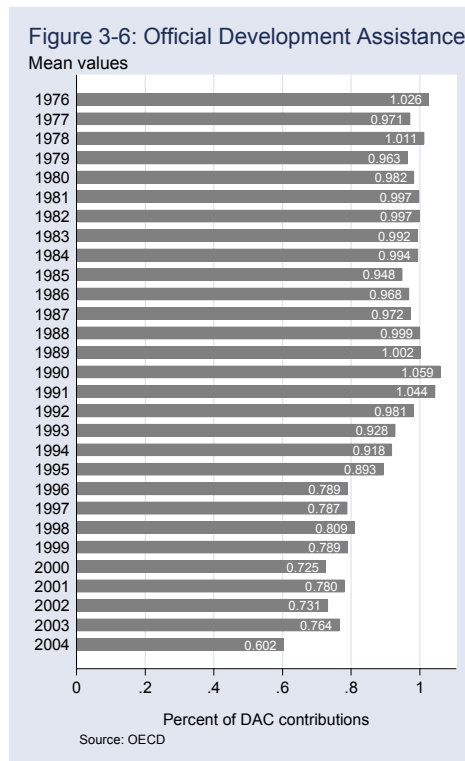
Foreign aid. Foreign aid, the next component of demand for FDI, is financial assistance given by developed countries to developing countries. The previous chapter discussed the research on the links between foreign direct investment and foreign aid, and its often contradictory findings. While foreign aid in some cases enhances foreign direct

investment, developing countries with capital shortages can turn to foreign aid to supplement or replace FDI.

The Organization for Economic Cooperation and Development (OECD) defines official development assistance (ODA) as “flows to countries...and multilateral institutions...to aid recipients which are 1) provided by official agencies, including state and local governments, or by their executive agencies; and 2) each transaction of which: a) is administered with the promotion of the economic development and welfare of developing countries as its main objective; and b) is concessional in character and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent).”¹⁹ This study uses ODA to each developing country as a percentage of overall assistance to all developing countries from OECD members. Because of a right-skew and kurtosis, the variable has been right-shifted and logged to mitigate these difficulties and in order to cut down on any loss of observations.

Figure 3-6 graphs the yearly mean of ODA to countries in the sample as a percentage of total ODA given to all developing countries by members of the OECD’s Development Assistance Committee (DAC). The amounts, as shown, are a very small percentage of overall ODA, either one percent or less. Overall, the amount of ODA given to countries in the sample has undergone reductions over time, and generally mirrors the situation among most developing countries. Net disbursements of ODA from the DAC countries to developing countries increased from about \$40 billion in 1976 to just over \$74.1 billion in 1992, then fell to \$57.6 billion in 1997. By 2004, net

¹⁹ From the paper *Is it ODA?* by the Working Party on Statistics of the Organization for Economic Co-operation and Development. Unclassified paper available online at <http://www.oecd.org/dataoecd/21/21/34086975.pdf>



ODA disbursements had again risen to \$79.4 billion.²⁰ Figures for ODA per capita mirror the overall decline in ODA as a percentage of net DAC disbursements, peaking at a high of \$86.14 per person in 1979 but declining to \$30.89 by 2004.²¹ However, the World Bank reports that ODA has been rising recently, though most of the increase in development assistance has gone mainly to a small number of countries, particularly Iraq, Afghanistan and the Democratic Republic of Congo.²²

Developing countries experiencing a dearth of foreign assistance may use policy to draw in greater amounts of foreign direct investment. Alternatively, greater amounts of foreign assistance may reduce a country's need for foreign investment. It is

²⁰ Source: Organization for Economic Cooperation and Development (OECD). Data in constant (2004) U.S. dollars. Statistical data for OECD development assistance can be found online at http://www.oecd.org/document/33/0,2340,en_2649_34447_36661793_1_1_1_1,00.html.

²¹ Source: World Bank, World Development Indicators 2006.

²² Source: World Bank, World Development Indicators 2006 World View: Goals. Report with analysis of Official Development Assistance can be found online at http://devdata.worldbank.org/wdi2006/contents/Section1_1_8.htm.

hypothesized here that a negative relationship will exist between official development assistance and FDI policy.

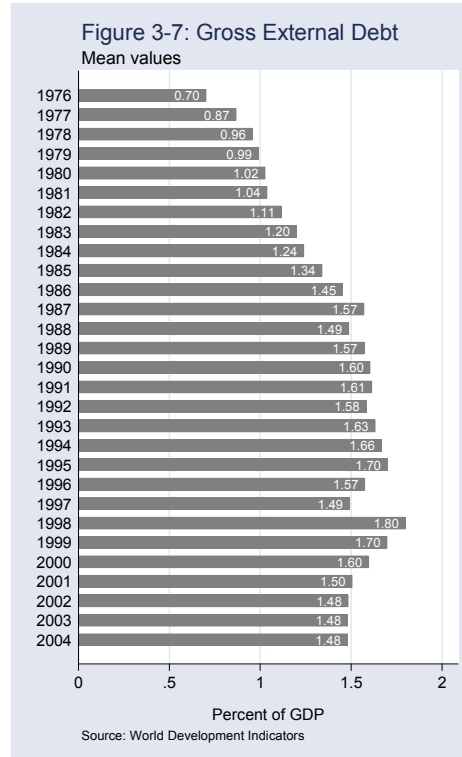
H5: As the percentage of ODA to overall ODA falls (rises), there will be more (less) openness to foreign equity.

Foreign borrowing. The theory presented in the last chapter includes foreign borrowing by developing countries as another alternative to FDI. Foreign borrowing has served to fund development in many developing countries, and is often seen as another form of investment. Rather than being mutually exclusive in all cases, FDI and borrowing may work together, as in the case of China.

I use gross external debt as the variable to represent foreign borrowing in this model. Gross external debt consists of the amount that is still owed on loans to creditors outside the country. According to the IMF, “Gross external debt is the amount, at any given time, of disbursed and outstanding contractual liabilities of residents of a country to nonresidents to repay principal, with or without interest, or to pay interest, with or without principal.”²³ Therefore it gives a direct indication of the amount of loans that developing countries are responsible for in any given year.

A potential problem with this variable is related to the range of time in the sample. The measure not only takes into account recent borrowing, but also older loans that have not been repaid. Therefore, the measure is fluid, and the statistics from 1976 – 2004 most certainly include external debt incurred before 1976. As with savings, debt as a percentage of GDP is used here. The variable has been logged to protect against biased outcomes due to right-skewness and kurtosis. Figure 3-7

²³ From the International Monetary Fund's *External Debt Statistics: Guide for Compilers and Users*, ©2003. On the World Wide Web at <http://www.imf.org/external/pubs/ft/eds/Eng/Guide/>

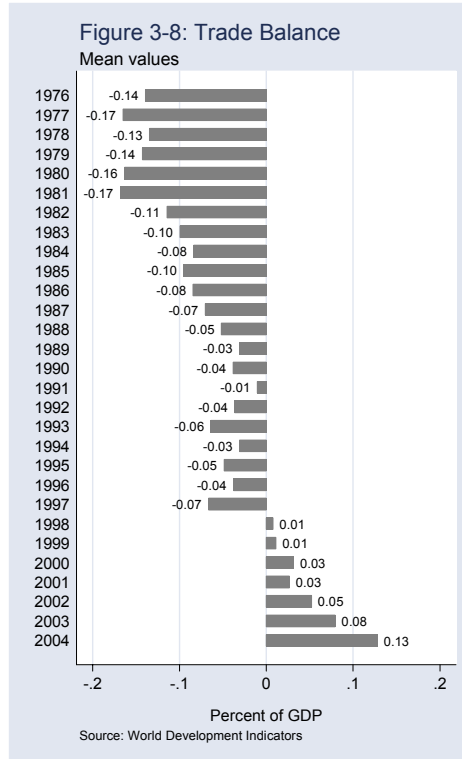


illustrates that the percentage of GDP of gross external debt among sample countries has been rising. A negative relationship is expected because external debt represents an alternative path to development.

H6: As percentage of external debt relative to GDP rises (falls), developing countries will have less (more) openness to foreign equity.

Trade Balance. As argued in the last chapter, with investment linked to trade balance, trade becomes another alternative to foreign investment. Countries that focus on export-led development can hope to reduce their eventual reliance on foreign direct investment by building up a surplus in savings.

The variable used in this study will be the trade balance as a percent of GDP. While the variable exhibits much kurtosis, logging the variable does little to mitigate this problem so the variable is used in its natural form. Figure 3-8 demonstrates that the



average trade balance for the countries across the sample for the years 1976-2004 was mostly negative, only turning positive around 1998. With trade and investment so linked, I expect that trade balance varies negatively with foreign equity openness.

H7: As the percentage of GDP of the trade balance in developing countries rises (falls), countries have less (more) openness to foreign equity.

Because the demand for FDI is inversely related to the availability of other sorts of development funding, we should see that the alternatives to FDI, such as gross domestic savings, foreign aid, external debt and the trade balance, are inversely related to the level of openness recorded in the FDI equity index. Alternatively, it is possible that general openness to FDI directly influences the demand for FDI. For example, developing countries that have greater openness to FDI may gain a positive reputation that justifies greater trust from international lending and aid institutions and decreases

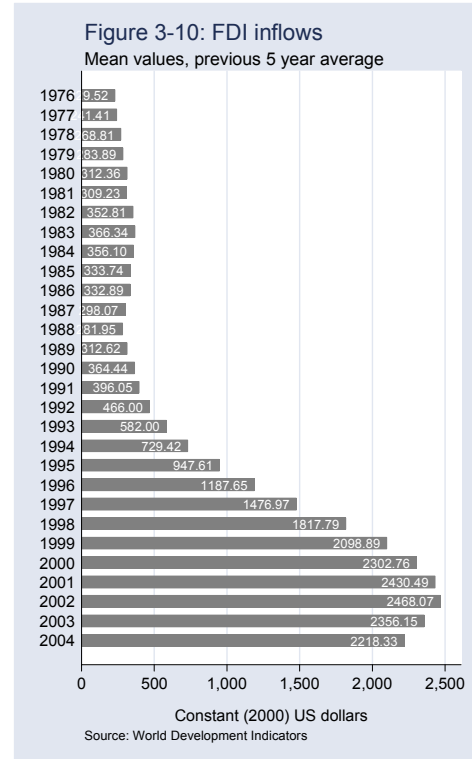
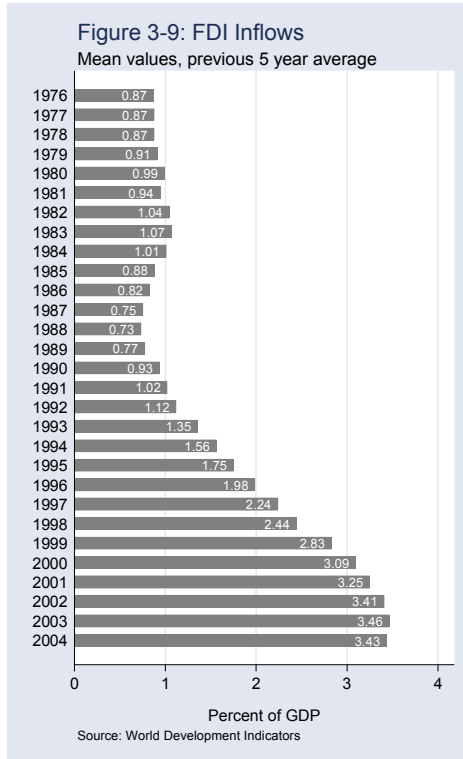
the amount of domestic savings as the economy develops and more local resources are tapped.

In other words, openness to FDI may precede demand for FDI, in which case we would not see these relationships develop as the theory predicts. Should the theory be supported in the model, then developing countries that rely on greater amounts of international loans, overseas aid, domestic savings and a positive trade balance will rely less on FDI, and therefore may be expected to be more restrictive in their FDI policies.

Past FDI Performance

Developing states that set policies on FDI and review these policies periodically will look at past FDI performance to determine present policies, specifically how much FDI they have received in previous years. How far in the past will they look? I argue that states look farther than just one year in the past in order to judge their FDI performance. Choosing a past time-frame may be somewhat arbitrary, yet many developing countries, especially those that were formerly socialist or under the Soviet sphere of influence, map out their economies in five year plans.

This variable of anticipated FDI inflows will be measured using the average of the previous five years of FDI inflows as a percentage of GDP. The variable is right-shifted and logged to reduce the effects of skewness and kurtosis. As operationalized, FDI as a percent of GDP measures the proportion of FDI to its overall economy, or in other words, the importance of FDI to each developing country. Figure 3-9 describes graphically the previous five year average for FDI inflows as a percent of GDP across the sample. Figure 3-10 shows the previous five year average for constant dollars. The



percent of GDP rose from an average of about 0.87 percent in 1976 to about 3.43 percent in 2004, and a similar pattern can be seen in the constant dollar amounts.

States may look at their past performances with FDI inflows and pass policies allowing for some opening if they are not meeting development goals and if FDI is too low. States that are meeting their development goals, or have grown wary of the amount of FDI flowing into their markets, may feel a need to restrict FDI through policy. Regardless, states policies are a result of their proactive attempts to control their FDI destinies. Therefore, a negative relationship between FDI policies and previous FDI inflow averages will result.

H8: A rise (fall) in the previous five-year average of FDI inflows will lead to less (more) openness in FDI equity policies.

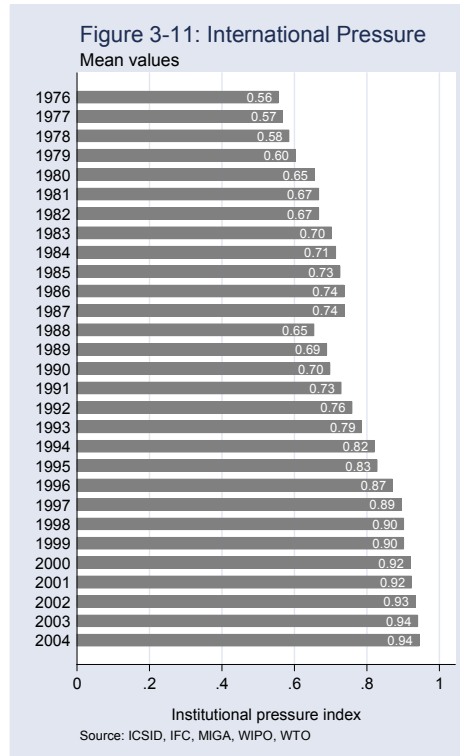
International Environment: International Political Pressures

Theoretically, international pressures influence FDI policies. A developing state occupies part of a large international political and economic playing field where it competes and interacts with other states, multinational firms, and international institutions. All of these interactions have influence on policy creation in developing states. Pressure may thus come from international institutions that develop and represent norms and ideas about FDI, and pressure may also come from closer proximity to more developed states which push for greater access for their home-grown multinationals in other developing markets through free trade and movement of capital. The next two subsections will introduce the variables that represent international political pressure.

International institutions. International institutions allow member countries to uphold norms by allowing for effective communication. They also provide an arena for generating ideas and solving problems and allow for punishments and rewards. As discussed in the previous chapter, there are theoretical reasons to hypothesize a relationship between international institutional membership and government policies. International institutions are generators of norms and values which in themselves exert pressure on the domestic policies of their members both directly and indirectly through alliances with domestic groups. Membership in international institutions, especially those that are organized around the international economy, should be a direct and indirect source of pressure on developing states because of their promotion of free trade, open movement of capital and other tenets of globalization.

The measure employed for international institutions combines developing countries' memberships in international institutions and conventions into an international institutions index. I selected five international organizations were selected: the World Bank Group's International Finance Corporation (IFC) which provides loans and other types of financing in order to spur private investment in projects in developing countries; The World Bank Group's Multilateral Investment Guarantee Agency (MIGA), which provides investment insurance for investors and lenders in the cases of currency transfer restrictions, expropriation, war, civil disturbance and breach of contract; the International Centre for the Settlement of Investment Disputes (ICSID), which offers arbitration services for dispute resolution and reconciliation between governments and foreign investors; the United Nations' World Intellectual Property Organization (WIPO), which standardizes international intellectual protection laws, policies and standards; and the World Trade Organization (WTO), whose members agree to curtail trade-related investment measures (TRIMs) that are inconsistent with WTO trade agreements and also agree to standardization of trade-related aspects of intellectual property rights (TRIPs). These five organizations represent important international norms on foreign direct investment. They also came into effect at different times, some before the time frame of the study and others between 1976 and 2004. The index thus represents a percentage of the available international institutions to which developing countries could belong as members at every time point in the dataset.

Figure 3-11 graphs the mean values of the index over the time range of the sample. Overall, from 1976 to 2004, the mean index values of the sample countries rose from 0.56 in 1976 to 0.94 in 2004, indicating that the sample countries became



more aligned with world standards on investment over time. The model should show that the relationship between developing country membership in international institutions and foreign policy is positive, with membership in more institutions focused on investment issues leading to greater equity openness.

H9: As developing countries belong to more (fewer) international organizations promoting investment norms, foreign equity openness will rise (fall).

Proximity to Developed Countries. Recent scholarship, as explored in the previous chapter, has addressed the effects of proximity to developed countries on the policies of neighboring developing countries. In this analysis, proximity means contiguity, either along borders or along economic zones. While there may be much variation in how developing states respond to overt or implicit pressure from contiguous industrialized states, there may be effects of this pressure regardless. States that are closed and

unfriendly to the developed world still face pressure. Cuba has faced isolation from the United States, but also friendlier relations and some encouragement from other industrialized states. Mexico has moved over the years from some restrictions on foreign investment to opening to U.S. and Canadian business through NAFTA. Even the presence of open, industrialized states near closed economies can generate its own pressure for reform. The collapse of the Soviet Union did not leave Eastern European states economically closed – they almost immediately opened their economies.

The variable used to measure proximity is taken from the Correlates of War (COW) contiguity dataset. The COW data codes contiguity for dyad pairs on a scale from 1 - 5, with 1 meaning that countries are only separated by a land or river border, and 5 meaning that countries are separated by 400 miles of water or less. The remaining categories reflect distances of 12, 24 and 150 miles between countries. COW considers 400 miles to be the maximum distance in which two 200 mile economic zones can intersect. The proximity variable used here codes each country as 1 if it falls between 1 and 5 in a dyad pair with the United States, a European Union country, Japan, or Australia and 0 if it does not.

Given the pressure that can be brought to bear by developed nations on developing nations all over the world, and considering that some developing nations' proximity to the developed world gives them some interest in putting policies in place that will make them attractive to capital from the wealthier countries, we would expect that proximity leads to greater equity openness.

H10: Developing countries that are in proximity to developed countries, separated either by a land border or by 400 miles of water, will have policies that demonstrate greater FDI equity openness.

Control Variables

Literature suggests controls are needed to account for other possible explanations of FDI policy. A common variable used in FDI studies is market size (Miller and Weigel 1972; Root and Ahmed 1979; Davidson 1980), though there are mixed findings on whether market size affects foreign direct investment. However, since the countries in the study sample are spread across a large range of countries and years, there may be differences between larger and smaller markets. There are two ways that market size is controlled for in this study. First, most variables measuring demand for FDI are proportioned as percents of GDP. This helps keep market size in perspective in the study as well as providing a smoothing technique on data that otherwise clearly trend. A second control for market size is added with the logged population variable, which lists the population of each country in each year. The previous mixed findings of the effect of this variable on FDI make it difficult to predict whether FDI policy is affected by market size.

A second control is labeled “region.” The theory presented in this study is one that argues that countries and multinational corporations come to agreement over FDI. This relationship is therefore assumed to involve one country and one MNC. However, there is a universe of developing countries that have made FDI a development strategy, and each country sets its policies given its domestic needs and the actions of other countries. Each country is therefore part of a larger set of countries, each individually

coming to agreement with firms and hoping to bring FDI into its economy, sometimes at the expense of other countries. This competition has been commented upon and studied in academic literature. For example, Haaland and Wooton (1999) extend a two-stage game model demonstrating how it is optimal for a country to subsidize FDI in order to attract it, illustrating that many countries that extend subsidies are drawn into competition which ultimately transfers income to MNCs at the expense of those countries if subsidies become too high. Governments compete by extending tariff protections, tax holidays, loan guarantees and tax grants. These incentives are used to offset other regulations and limits (Encarnation and Wells 1985). While countries' policies cannot be easily changed, individual negotiations provide countries with a chance to bargain on particulars in order to present a favorable environment relative to other countries competing for the same FDI.

Given that each country resides in a region with other actual and potential competitors, a set of six dummy variables representing geographical regions was created. These dummy variables represent Central Asia, North Africa, Sub-Saharan Africa, East Asia, South Asia, and Latin America. Five of the dummy variables were introduced to the model, with the sixth, Central Asia, serving as the comparison group.

Proposed Relationships

The hypothesized relationships proposed are listed in Table 3-2. In the first column are the domestic, international and control variables. The second column indicates by a + or – sign the hypothesized direction of the relationships. In the next section, I will estimate these relationships statistically to see if the hypotheses hold up, and explain the outcomes.

Table 3-2: Predicted Directions of Independent Variables

Independent Variables	Hypothesized Direction
<i>Domestic Political and Ideological Costs</i>	
Degree of Democracy	+
<i>Govt. Ideological Orientation</i>	
Left	-
Right	+
Nationalism	-
<i>International Pressure</i>	
International Pressure Index	+
Proximity to Developed Country	+
<i>Demand for FDI</i>	
Domestic Savings	-
Official Development Assistance	-
External Debt	-
Trade Balance	-
<i>Past Experience with FDI</i>	
FDI Inflows-Previous 5 yr average	+

Model Specification

Because the dependent variable, the FDI Equity Index, is categorical and therefore has discrete values, maximum likelihood estimation is the most appropriate method to employ in estimating the model. Maximum likelihood estimation assumes a curvilinear relationship and obtains a probability function, rather than expected or predicted values as in ordinary least squares, for categories of the dependent variable.

The multiple categories of the dependent variable offer a range of options for maximum likelihood estimation. Because of the ordinal nature of the categories, an ordered probit model is appropriate for estimation of the data. In addition, because the data is in the form of a pooled time-series, additional elements must be added to the model to account for time effects and the possibility for additional error inherent in time-series data, such as autocorrelation.

I estimate three variations on the policy model. Estimation 1a estimates the model using regime type and nationalism as domestic political variables, and 1b adds ideological variables. Estimation 1c consists of all variables together. The models were estimated using the statistical program Stata running the routine “gllamm.” Gllamm stands for “generalized linear latent and mixed models,” and this type of estimation is becoming more commonly used in the social sciences. “Mixed model” estimation does not just assume fixed effects, or in other words, that the observations are all completely independent of each other, but that random effects are also present. The clustering of observations under country units makes the presence of random effects likely. Gllamm designates these clusters as level-2 effects. We will consider the effects of the second

level country clustering which are nested in the level-1 cluster of individual observations. The random effects are the effects of latent or unobserved variables on the dependent variable in question. Using random effects will also allow for generalization from a sample to a larger population (Balestra 1992). In this study, it is assumed that the developing countries used in the estimations reflect the characteristics of all developing countries within a confidence interval defined by a standard error.²⁴

In this model, the dependent variable's responses are coded from greater equity restrictions to greater equity freedom. Therefore, it stands that interpretation of estimations of the primary parameters will be as follows: Positive signs will indicate the probability of greater equity openness as the value of the associated independent variables increases, and negative signs will indicate the probability of greater equity openness (restrictiveness) as the value of the independent variables decreases (increases).

The addition of a time component adds a host of factors to additionally consider when estimating this model. To control for autocorrelation, I created dummy variables representing a time lag for each category, and all but one of these dummies were added to the estimation equation (Long and Freese 2003). The addition of the dummies to control for autocorrelation was supported by a likelihood ratio test between the full model and the model without the dummies. Dummies for two-year time lags of the categories were also estimated, but they were insignificant and unnecessary to the final estimations. To correct for the effects of time, I introduced a count variable ranging from one to 29 for each year in each cluster, but it tested statistically insignificant and a likelihood ratio test indicated that the variable was unnecessary.

²⁴ For a mathematical specification of the ordered probit technique within gllamm, please refer to Appendix E.

Tables 3-3, 3-4 and 3-5 list the results of estimations of the FDI policy model. The estimations were run specifying the family as binomial, the link as oprobit and using robust standard errors. The estimations include 54 countries and 1329 observations in Estimations 1a and 1c, and 1511 observations in Estimation 1b.²⁵

In all estimations, time-lagged categorical dummies are all highly significant. The negative signs of the coefficients could mean that there is considerable inertia in the movement of policy, perhaps contradicting the significant movement of many countries from more restrictive policies to more liberal policies, as shown in Table 3-1. This is not surprising. First, 38 out of 57 countries in the dataset moved one category or remained the same over the time period.

Second, policies do not change very quickly. Jordan is an example. From 1976 until 1994 it remained in the lowest category. All of a sudden, in 1995 it implemented FDI policies that opened to foreign investment, and jumped immediately to the highest category. When policies do change, they tend to change quickly, and then remain where they are for a long period after the change. In other words, this could be an indication of state dependence – that governments are more inclined to maintain the same policies over longer periods of time than to change them incrementally.

In order to interpret ordered probit estimations, I used the cumulative distribution function and the probability density function to determine predicted probabilities. Table 3-6 demonstrates how the predictions of all estimations compare to actual values of the dependent variable. The proportional reduction of error, which compares the predicted results with the dependent variable, is very high for all model variations. Model 1a

²⁵ Two countries, Niger and Papua New Guinea, dropped out of the models due to missing observations in all 29 years in the trade balance variable. Swaziland also dropped out of the model due to missing observations in the nationalism variable

scored the highest gamma, 0.952, but all models were well over 0.90. Table 3-7 shows the effect each significant independent variable in Estimation 1c, the full estimation, has on the probability that FDI policies will fall under any of the categories when the independent variable falls along its range of values. The minimum and maximum values of the variable were used if it was dichotomous, and the minimum, mean and maximum values for continuous variables, plus a one standard deviation shift away from the mean in each direction.

For example, foreign equity policy has a 71.1 percent probability that it will be at its most restrictive category (less than 100 percent foreign equity allowed) when the variable regime is at its minimum, autocracy, and a 28.9 percent probability to be in the next category (100 percent foreign equity allowed with many restrictions). As the value for regime type is moved across its range through its mean and toward its maximum (full democracy), the probability that FDI equity policies will be more open increases. One can see the effects on predicted probabilities of all the significant variables in this way.

Table 3-3: Determinants of Foreign Equity Policy in Developing Countries

Estimation 1a			
Variables	Coefficient	Robust S.E.	P-value
Category 0 time lag dummy	-5.3566	0.3905	0.000
Category 1 time lag dummy	-2.4259	0.3245	0.000
Category 2 time lag dummy	-0.8095	0.2699	0.003
Regime type	0.0574	0.0123	0.000
Nationalism	-0.6687	0.1793	0.000
Institutional membership	2.0303	0.4072	0.000
Proximity	0.5610	0.4430	0.205
Savings/GDP	-0.0186	0.0044	0.000
Logged ODA/Total DAC aid	-0.9904	0.3927	0.012
Trade Balance/GDP	-0.1353	0.1706	0.428
Logged Debt/GDP	0.1740	0.0678	0.010
Logged Average FDI inflows/GDP – previous	0.6041	0.4130	0.144
Logged Population	0.0658	0.0621	0.289
Sub-Saharan Africa	1.5131	0.5750	0.009
East Asia	-0.1924	0.3134	0.539
Latin America	1.0607	0.4757	0.026
North Africa	1.1491	0.2885	0.000
South Asia	0.3916	0.4854	0.420
Cut 1	-1.7858	1.6110	0.268
Cut 2	1.3322	1.6690	0.425
Cut 3	3.7180	1.6850	0.027
	N=1329	Log Likelihood=-678.5378	
	Variance and Covariance of Random Effects=1.3740 (0.3590)		

Table 3-4: Determinants of Foreign Equity Policy in Developing Countries

Estimation 1b			
Variables	Coefficient	Robust S.E.	P-value
Category 0 time lag dummy	-4.7786	0.3068	0.000
Category 1 time lag dummy	-2.0936	0.2383	0.000
Category 2 time lag dummy	-0.8846	0.2476	0.000
Regime type	0.0765	0.0123	0.000
Leftist government	-0.2008	0.1711	0.240
Centrist government	-0.5486	0.1779	0.002
Other government	0.5095	0.1918	0.008
Institutional membership	2.2461	0.6099	0.000
Proximity	2.1543	0.6561	0.001
Savings/GDP	-0.0215	0.0037	0.000
Logged ODA/Total DAC aid	-0.7360	0.4672	0.115
Trade Balance/GDP	-0.1509	0.1987	0.446
Logged Debt/GDP	0.2798	0.0887	0.002
Logged Average FDI inflows/GDP – previous	0.6604	0.4383	0.132
Logged Population	-0.0786	0.0494	0.111
Sub-Saharan Africa	2.6513	0.6804	0.000
East Asia	1.2557	0.4368	0.004
Latin America	2.2248	0.7562	0.003
North Africa	1.8135	0.3668	0.000
South Asia	1.8778	0.7498	0.012
Cut 1	-1.8032	1.1043	0.102
Cut 2	1.1683	1.1237	0.299
Cut 3	3.4246	1.1058	0.002
	N=1511	Log Likelihood=-819.1927	
	Variance and Covariance of Random Effects=1.6756 (0.4330)		

Table 3-5: Determinants of Foreign Equity Policy in Developing Countries

Estimation 1c			
Variables	Coefficient	Robust S.E.	P-value
Category 0 time lag dummy	-5.3902	0.4242	0.000
Category 1 time lag dummy	-2.5093	0.3039	0.000
Category 2 time lag dummy	-0.8743	0.2545	0.000
Regime type	0.0775	0.0156	0.000
Leftist government	-0.3843	0.1779	0.036
Centrist government	-0.7441	0.2132	0.001
Other government	0.5297	0.1846	0.001
Nationalism	-0.5438	0.1246	0.000
Institutional membership	1.8494	0.4874	0.000
Proximity	1.5255	0.3116	0.000
Savings/GDP	-0.0176	0.0033	0.001
Logged ODA/Total DAC aid	-0.9055	0.3866	0.032
Trade Balance/GDP	-0.1369	0.1685	0.434
Logged Debt/GDP	0.1965	0.0674	0.004
Logged Average FDI inflows/GDP – previous	0.6814	0.4499	0.104
Logged Population	-0.1293	0.0552	0.056
Sub-Saharan Africa	1.7153	0.3495	0.000
East Asia	0.8783	0.3824	0.084
Latin America	1.3543	0.3601	0.000
North Africa	0.6566	0.2596	0.022
South Asia	1.5926	0.4607	0.002
Cut 1	-4.1012	1.1569	0.003
Cut 2	-0.9402	1.1138	0.817
Cut 3	1.5103	1.0627	0.039
	N=1329	Log Likelihood=-670.0941	
	Variance and Covariance of Random Effects=1.0358 (0.2432)		

Table 3-6: Predicted versus Actual Categories of Dependent Variable

Estimation 1a					
Actual Equity Categories	Predicted Equity Categories				
	<100%	100%-m.r.	100%-s.r.	100%-f.r.	Total
<100%	183	36	10	0	229
100%-m.r.	20	381	70	0	471
100%-s.r.	1	30	304	27	362
100%-f.r.	1	4	72	190	267
Total	205	451	456	217	1329
Gamma = 0.957					
Estimation 1b					
Actual Equity Categories	Predicted Equity Categories				
	<100%	100%-m.r.	100%-s.r.	100%-f.r.	Total
<100%	154	94	18	1	267
100%-m.r.	19	341	169	0	529
100%-s.r.	0	45	291	61	397
100%-f.r.	1	3	102	212	318
Total	174	483	580	274	1511
Gamma = 0.92					
Estimation 1c					
Actual Equity Categories	Predicted Equity Categories				
	<100%	100%-m.r.	100%-s.r.	100%-f.r.	Total
<100%	207	11	11	0	229
100%-m.r.	21	403	47	0	471
100%-s.r.	1	59	282	20	362
100%-f.r.	1	6	141	119	267
Total	230	479	481	139	1329
Gamma = 0.946					

Table 3-7: Predicted Probabilities of Foreign Equity Openness Varying Significant Variables

Variable	Probability	Min	-1 s.d.	Mean/ Median	+1 s.d.	Max
Regime type	Y=0	0.711	0.627	0.414	0.224	0.161
	Y=1	0.289	0.372	0.582	0.759	0.810
	Y=2	0.000	0.001	0.004	0.017	0.030
	Y=3	0.000	0.000	0.000	0.000	0.000
Nationalism	Y=0	0.414				0.628
	Y=1	0.582				0.372
	Y=2	0.004				0.001
	Y=3	0.000				0.000
Savings	Y=0	0.016	0.315	0.414	0.518	0.782
	Y=1	0.754	0.677	0.582	0.480	0.218
	Y=2	0.228	0.008	0.004	0.002	0.000
	Y=3	0.002	0.000	0.000	0.000	0.000
Debt	Y=0	0.634	0.481	0.414	0.349	0.223
	Y=1	0.365	0.516	0.582	0.645	0.760
	Y=2	0.001	0.002	0.004	0.007	0.017
	Y=3	0.000	0.000	0.000	0.000	0.000
Intl. Pressure	Y=0	0.883	0.605	0.414		0.255
	Y=1	0.117	0.394	0.582		0.731
	Y=2	0.000	0.001	0.004		0.013
	Y=3	0.000	0.000	0.000		0.000

Results of Estimations

In this chapter, the goal has been to test both international and domestic economic and political factors to determine if both have an effect on FDI equity openness, an element of policy that developing countries use to control foreign direct investment access to their markets. In this next section, I will examine the results of domestic factors, Hypotheses H1 through H8, on FDI equity policy.

Effects of Domestic Political and Economic Factors

Hypothesis 1, the democracy hypothesis, is supported in all model variations. The variable measuring regime type is highly significant. The positive coefficient is an indication that democracies are more likely to pass policies that have fewer restrictions on FDI equity, which supports theories that argue that democracies generally have more open economic policies and are by and large open to international economic integration. Coefficients estimated with maximum likelihood techniques are difficult to interpret directly, so with ordered probit I use the cumulative distribution function and the probability density function are used to determine predicted probabilities. Predicted probabilities of FDI equity policy equaling the various categories are depicted in Table 3-7, which shows small probabilities that countries in the sample will have extremely open policies, and that a shift toward democracy across the range of values from minimum to maximum increases the probability of more open policies.

Hypothesis 2, the hypothesis that leftist governments restrict FDI, is only weakly supported at best by Estimations 1a and 1c. Its coefficient sign is negative when compared to rightist governments in both cases, as predicted, but significance does not

reach the 0.05 level. In essence, the conclusion of this test is that there is very little difference between governments on the left and right regarding foreign direct investment. This stands in contrast with governments in the center and the governments that could not be classified, both of which show distinct differences with rightist governments.

The failure of the variable to reach significance may have something to do with the problematic nature of the measure. Part of the problem is the unknown quality of “other” governments, which consist of over half the observations. Given the structure of the variable, “other” governments had to be integrated into this study to use ideology as a variable. The inclusion of ideology adds something to the model, as indicated by the degree of agreement between predicted and actual outcomes, but it is difficult to determine just what is being added without a more reliable ideological measure.

The nationalism variable performed as predicted in Hypothesis 3 in all models. As in the result for regime type, we see that most governments start out with a high probability of allowing 100 percent foreign equity with many restrictions, but with the presence of nationalist governments the probability rises that governments will allow less than 100 percent foreign equity, severely restricting foreign investment.

The hypotheses on demand for FDI, Hypotheses 4-7, met with mixed success in all models. Savings was significant and negative as predicted across all estimations, making it a robust predictor. In the presence of greater savings rates, the probability of more restricted policies in developing countries rises. Debt was also significant across all models, but its sign was positive, contrary to the prediction. Developing countries that have greater external debt appear to have more open policies toward foreign

investment. While the results for savings are not surprising, the performance of debt may indicate that it does not serve as an alternative to FDI. Instead, debt may enhance or supplement foreign investment. Alternatively, debt may create conditions where high country debt loads lead to international doubt about the economic environment in developing countries, or the perception of this doubt domestically, causing them to pass more open FDI policies in order to attract more investment. As we will see in the case studies of El Salvador and Nicaragua, this last scenario is very likely.

Official development assistance reaches significance in Estimations 1a and 1c but not in 1b, though the direction of its sign is negative as predicted in all models. The trade balance variable has a sign in the predicted direction, but does not approach significance in any model.

Hypothesis 8, which proposed that past performance of FDI factors into the creation of state policies toward foreign investment, had a positive sign as predicted but it was insignificant in all estimations. The performance of this variable across the models indicates that the variable is weak at best in predicting FDI policies.

Effects of International Factors

The international pressure hypotheses (Hypotheses 9-10) are mostly supported. International institutional membership was supported across all estimations, whereas Estimation 1b did not support the proximity variable. All signs of the coefficients are positive and significant as predicted, indicating that international pressure accounts partly for foreign equity openness. Rising institutional pressure increases the probability that developing countries will be less restrictive in their equity policies, whereas

proximity to developed countries appears to have some relationship with foreign equity openness in developing countries

Effects of Control Variables

The control variables had mixed performance in all the estimations. The population variable, which controls for market size, was significant in one out of the three estimations, and therefore not a very reliable predictor of foreign investment policies. All the regional variables except for the East Asia and South Asia regions were significant across all models, and the insignificance came in Estimation 1a when the ideology variables were absent. The results indicate that region may have a role in determining the openness or restrictiveness of FDI policies when compared to the base group, Central Asia. However, given that all are relatively consistently significant, only Central Asia (in this sample this region only consists of Turkey) may stand out as being different.

Discussion of Results

In the opening paragraphs of this dissertation, I argued that developing countries may have some means of controlling their economic destinies, even as some scholars argue that the nation-state is becoming obsolete in the face of globalization. Despite the fact that pressure to open their markets to financial flows and free trade besets developing countries from all sides, the tests conducted in this chapter show that developing countries do have some means at their disposal, and can set their policies to allow themselves to remain more or less restrictive to globalization, depending on their preferences. These checks against globalization exist because developing countries

are beset by pressures that offset international pressures toward globalization. Domestic political pressures and domestic economic realities still mandate that many developing countries can be cautious about foreign investment because their governments may face political sanction if they are too generous with foreign firms. This cautiousness can be enhanced if there are alternatives to FDI for development, most critically domestic investment through higher savings rates.

What do these models say about the determinants of FDI equity policies in developing countries? First, it seems that governments take into account domestic political and ideological costs when forming their policies on foreign equity restrictions. Democratic governments demonstrate greater FDI equity openness than autocracies. Democracies tend to be more open to economic interdependence in general, perhaps because of a longstanding belief in economic liberalism and institutions that encourage transparency and openness. Autocracies tend to be centered more on control of the political, social and economic environment, and openness erodes their ability to maintain a tight rein.

Though political ideology of the left and right appears to be indeterminate from this data, it appears that nationalism is a force that leads to more restrictive policies on FDI. Nationalist governments tend to worry more about the implications of foreign investment on the national market and the possible harms it may inflict on the country as a whole and particularly on certain groups within the population. Nationalist governments on the right fear the impact foreign investment will have on local business, while nationalist governments on the left may be concerned about the social welfare of the population.

However, nowhere does globalization exert more pressure than on the international front, and in those forces firms have powerful allies that push for open trade and investment policies. Perhaps the variables that most clearly represent globalization are the international pressure variables, and this study has found that some elements of international pressure matter. In particular, membership in international institutions, especially those that have a focus on FDI, leads to more open FDI equity policies. Governments find it more difficult to remain closed as members of these institutions because they are subjected to an additional level of transparency, openness, and accountability. In international institutions, there are penalties for not conforming to rules and norms that are agreed upon, and for now developing countries tend to abide by the rules and not risk the costs associated with flaunting them.

There is a possibility that causation on the international institution variable runs in the opposite direction to that hypothesized. It is easy to see why. I hypothesized that membership in international institutions creates pressure for developing countries to maintain greater openness in their FDI equity policies. Perhaps the correlation may simply be a confirmation that developing countries that are more inclined toward economic openness are those that join international institutions. While this outcome is not tested here, it has to be considered. However, even if the causation runs the opposite way on international institutions, the pressure of globalization and of major international economic and political players is still present. Maybe countries that are inclined toward openness are more likely to join institutions, but those institutions also encourage even greater openness in their turn. Countries not inclined toward as much

openness, but who join institutions to have a voice, will still feel some pressures from the institutional environment.

From examining the predicted probabilities, it appears that the models predict mostly a greater degree of openness. As has been demonstrated, there are some powerful pressures to create and maintain open policies. It is true that most countries maintain policies that allow 100 percent foreign equity. Yet, the results also indicate that most countries have means to restrict foreign investment should they so choose. They can move in an autocratic direction, elect a nationalist government, and build their domestic savings at the very least to move in a more restrictive direction.

Of course, this study concentrates on policies that are on paper, and not on individual agreements between firms and states which may allow countries to waive this or that restriction. However, FDI policies are the initial starting point for most countries in their negotiations, and any restrictions that are attached must be negotiated away; which may entail a possibility of the loss of FDI. If countries did not put restrictions into place, there would be no need to bargain and no risk of either party pulling out of negotiations.

What allows developing countries to maintain some control? First, developing countries' suspicion of globalization and its costs fuel wariness about FDI. Nationalist governments tend to want to put the brakes on FDI. Autocratic governments only enhance this effect. It appears that for developing countries, the fear that the developed world will interfere in domestic political and economic affairs, and that unfettered free trade and investment will cause more harm than good in local economies, unites some in a desire to open their developing economies only as much as they deem necessary.

Second, the existence of alternatives to FDI allows developing countries more leeway in controlling the pace and quantity of FDI. Greater domestic savings, for one, allow developing countries to tap local resources and entrepreneurship and thus rely less on foreign capital. The difficulty for developing countries is, of course, locating adequate domestic savings to fund development. Official development aid, another pathway to development, may have a small effect in alleviating developing country's dependence on FDI. Foreign borrowing appears to either supplement FDI, or make developing countries more eager to attract FDI if their debt loads create adverse international opinion. Other potential alternatives, such as positive trade balances, may also serve to alleviate dependence on FDI, although their effect appears to be minimal.

A look at the dependent variable from 1976 through 2004 might give one an impression that regardless of their preferences, developing countries have moved inevitably toward greater openness. Only one country in the sample, Iran, became more restrictive in its foreign equity policy and remained so. Does this data in itself not indicate that globalization is winning and that developing countries should all simply become more open? I believe that despite the trend toward increasing openness, these models show that developing countries are not completely powerless in the face of globalization and open markets and have some control over their economic destinies. Specifically, governments of nationalist and autocratic developing countries appear to be at least somewhat hesitant toward foreign equity, despite the pressures, scrutiny and risk of sanction by other governments and multinational firms. The gradual drift toward less restrictive policies is an indication of that pressure. However, there are still developing countries that resist the pressure to open and others that open only

gradually. These results may stand in contradiction to theories like modernization theory, which proposes that all countries are marching toward greater industrialization, and therefore more openness on a Western model. It may uphold some tenets of dependency theory, which argues that the developing world is at best in an ever-increasing dependent relationship with the developed world, and at worst is being economically colonized. Certainly developing countries have not fared as well as their industrialized neighbors. Or, these results may simply reflect what developing countries say on paper, but not what they actually do when dealing with multinational firms. However, I suspect that for some developing countries, reducing the opening in the gate in the face of a horde of MNC suitors reduces the crowd down to the insistent few so that those countries may bargain more effectively with the remaining firms.

I have argued that the FDI process as a whole follows the logic of two-level games. Domestic political and economic forces play a powerful role in determining FDI policy, but one cannot dispute that international forces, brought to the table by firms and their allies on the global level, play a part in convincing some developing countries to open their markets to foreign investment. The next question to be studied, then, is whether the gateway to investment, represented by policies, affects the flow of investment into developing countries. If policies are the basis for eventual agreements between developing countries and firms, then those countries that set more restrictive policies limit the win-sets, or the range of possible agreements, between developing countries and firms and should have a diminishing effect on foreign direct investment inflows. Even if such restrictive countries enhance their bargaining position by claiming that they cannot get agreements past recalcitrant domestic political powers, they will

end up reaching no agreement with a greater number of firms than those they can come to agreement with. On the other hand, those countries that set open policies come into negotiations with firms with a wider range of agreement possibilities, and therefore should see more investment, even though their bargaining power is reduced. The next chapter will therefore test FDI policies' effects on FDI inflows in order to shed light on how this confluence of international and domestic forces enhances or lessens the chances of agreement, and therefore the flow of foreign investment.

Chapter Four

FDI Policy and its Effect on FDI Inflows

In previous chapters, I have laid out a narrative of foreign direct investment. To briefly recap, I discussed the role of foreign direct investment policies in the FDI process. In Chapter Two, I described how developing countries absorb prevailing attitudes toward FDI, which shapes their attitudes. Their attitudes consist of a blend of wariness and openness toward FDI, and therefore they fall somewhere along the spectrum of being more open or more restrictive toward FDI. The policies that developing countries pass on FDI are reflections of this blend of attitudes that plays out through domestic and international politics and the realities of domestic and international economics. Their policies serve as the basis for eventual agreements on FDI with multinational firms. I also argued that FDI follows the logic of two-level games. One level consist of the political agreement that leads to policy on the domestic level, and a second level is the agreement between firm and state that leads to FDI inflows. The activities on each level are influenced by international and domestic factors that affect both FDI policies and eventual FDI inflows. In Chapter Three, I tested hypotheses based on these conceptual factors, and discovered that policies are influenced by domestic political and economic factors such as regime type, nationalism, domestic savings, and external debt. They are also affected by international factors such as membership in international institutions related to trade and investment and proximity to developed countries. Policies were also influenced by geographic regions.

This chapter takes up the issue of FDI inflows. Tests performed in this chapter will determine whether policies work, or more specifically, whether inflows are affected by policies. If developing countries tighten control and flows slow, or if they open and the flow increases, then policies function and developing countries have some control over their economic destinies. If developing countries that desire greater FDI flows pass policies of openness and instead get a little trickle or nothing at all or conversely, if developing countries tighten restrictions and the flows continue unabated, then policies are meaningless and developing countries are at the mercy of globalization, that international concerns predominate, and development is largely out of their hands.

This dissertation has posed two questions. What accounts for variation in FDI policies? Do FDI policies affect FDI inflows? My model reveals some answers. The Chapter Three provided strong support for a model of FDI policymaking in developing nations. This chapter tests whether the policies that developing countries have promulgated have any effect on the FDI that flows into their markets. This may seem self-evident but it is very important. First, FDI flows are an indicator of how firms respond to the policies of developing states. If FDI follows the logic of two-level games, policies serve as the basis for agreement between firms and states over FDI. Policies establish the baseline range of agreements states are willing to consider. If that baseline is restricted, then the range of possibility for agreement is small. If the baseline policy is more open, then agreement can be made over a wider range of potential outcomes.

Do policies allow states some control over the investment process? Do states still have power to regulate their own development? On one hand, those that celebrate

international open markets and free trade argue that loss of national sovereignty over the economy is not something to bemoan, but simply to accept. The world is better off if nation-states have less control over trade and commerce and the markets are simply left alone as much as possible. Needless to say, many of these supporters of globalization represent developed countries that need not worry about their own power.

For others, such as dependency theorists, nationalist leaders and populist organizations in developing countries, loss of national sovereignty is a much more serious matter. It means that developing states are always at a disadvantage to the developed world, without any ability to control aspects of their own political and economic agendas. These countries will see further disruptions in social cohesion and participate in the proverbial race to the bottom. Any attempt to assert their independence through policy will lead to punishment in the international economic arena.

In sum, this model will demonstrate whether FDI inflows, and by extension firms, respond to policies, and whether developing states have some control over the development process. If developing countries' policies do not have any effect on FDI, or an opposite effect from that intended, then the forces of globalization are more powerful than individual developing states and international preferences trump domestic wishes and realities. On the other hand, if policies perform as intended, limiting FDI when developing countries want it limited or encouraging FDI when they want an increase, then the factors identified in the policy stage will be shown to have an impact on development outcomes. The next sections further define the inflows model,

explaining the dependent and independent variables, their hypothesized relationships, and the estimation results.

Determinants of FDI Inflows

The inflows estimations are an important part of the presented theoretical model. While the policy estimations in Chapter Two test FDI policies, in particular how open developing states are to FDI, the inflows estimations measure the effect of developing states' contribution to FDI agreements. They also capture firms' reactions to FDI policies. Developing countries commit to FDI policies and, along with other factors, see these policies affect their FDI inflows. In identifying this process in two separate estimations, we can represent the role of firm and state agreement through this second test.

I argue that inflows constitute a second form of the two-level games theory of FDI identified in Chapter Two. Whereas the policies are outcomes on the domestic level, influenced by factors on both the domestic and international level, the firm-state agreement process takes place on a different level, a transnational level. The outcomes of this level are indicated by agreement and, following agreement, inflows of FDI. FDI inflows are in turn influenced by domestic and international level factors also, such as FDI policies, domestic political and economic factors, and international political and economic factors. I will explain these concepts further in subsequent sections.

The dependent variable in these estimations, foreign direct investment inflows, is commonly used to measure foreign direct investment in national economies. Inflows are defined as "net inflows of investment to acquire a lasting management interest (10

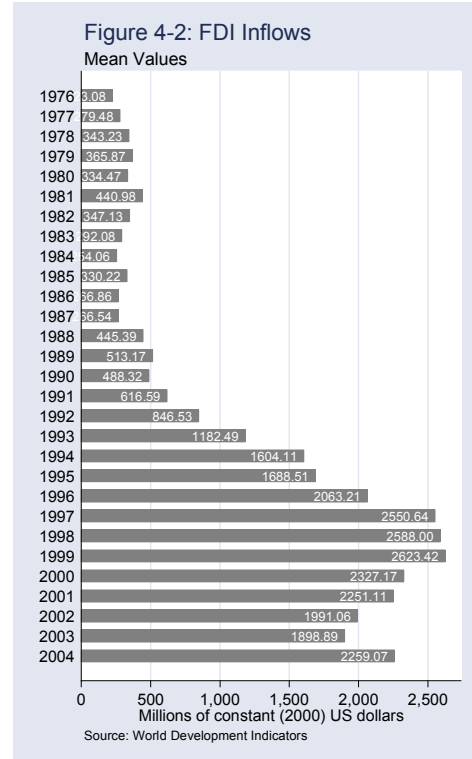
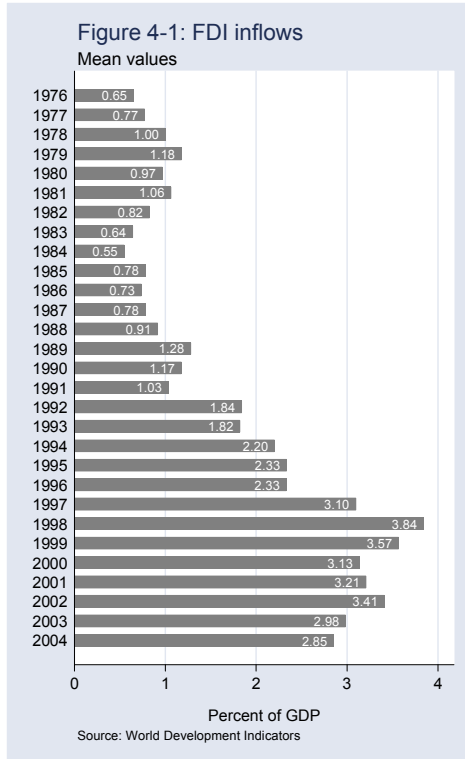
percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.”²⁶

I use foreign direct investment inflows as a percentage of GDP as the dependent variable. FDI as a percent of GDP accounts for the importance of FDI in each individual economy. The greater the percentage of GDP, the more that economy relies upon FDI. This allows a basis of comparison among developing countries and blunts the undue influence of large economies. The dependent variable was logged to normalize its distribution.

Figure 4-1 graphically describes the mean values of FDI as a percent of GDP for each year in the sample. Though characterized by peaks and troughs, the trend has been decidedly upward. In 1976, the mean percent of FDI to GDP was 0.648 percent. This percentage fell to its lowest point in 1984 at 0.546 percent, and then began an upward climb, peaking at 3.84 percent of GDP by 1998. Since then, the average percentage of FDI to GDP has fallen again to around 2.85 percent in 2004. Figure 4-2 shows mean values of FDI inflows in dollars, which averaged \$223.08 million dollars (constant 2000 U.S. dollars) in 1976, peaked at \$2.6 billion in 1999, and fell back to about \$2.3 billion in 2004.

These figures show that over time, FDI has become more important in aggregate economies in the developing world. These mean values conceal much variation among countries. Values for some countries over the range of years in the sample are negative. Negative inflows indicate a loss of capital at a rate greater than incoming capital. Other countries are very reliant on FDI. For example, since 2000, FDI inflows

²⁶ Definition provided by World Development Indicators: <http://www.lib.umich.edu/govdocs/wdi/wdivar/wdivar6.html>.



into The Gambia, Chad and Lesotho have accounted for 10 percent or more of those countries' GDPs. Some countries in the sample receive a great amount of FDI in dollar amounts. For example, China's mean inflows from 1976 – 2004 is over \$19 billion per year. Others receive little – Gabon, Gambia, Guyana, Haiti, Madagascar, and Niger average under \$30 million in FDI per year.

FDI Equity Openness

In the policy model in Chapter Three, I argued that developing countries' policies reflect their preferences toward FDI openness. Their degree of openness is based on restrictions and incentives on FDI that have been passed and implemented by the state. Once these policies are passed, the theory predicts that states' policies will be an indication to investors of their initial openness to foreign investment. In other words, the

policies are like a sign on a door. If states are less open to FDI, they will have less room for agreement with firms and they will know that attempts to invest there may be filled with roadblocks such as restrictions and regulations and take their capital elsewhere. Likewise, if states are more open to FDI, the range of possible agreements opens wider and states may offer incentives such as tax breaks and exemptions to attract investment by multinational firms. There should be a positive relationship between the openness of FDI policies and the inflows of FDI to developing state.

The variables used to measure FDI policy are categories of the FDI Equity Index. The variable's characteristics have been described already in Chapter Three. Dummy variables of categories one, two and three are used, following Long and Freese's (2003) advice to separate the categories of a discrete variable into separate binomial variables on the right hand side. The lowest category, labeled as Category 0 and representing policies allowing less than 100 percent foreign equity, will be left out of the estimation and used as the comparison group. I expect a positive coefficient on this variable.

H4-1: Countries that are more (less) open to foreign equity will have greater (smaller) amounts of FDI inflows.

Domestic Political Characteristics

Certain characteristics of each developing country can exert much influence on their amount of FDI inflows. There are two aspects of this concept that will be tested. First, the political environment must be considered because so much of the character of the investment market depends on the type of government in power, and the prevailing ideology of that government. Second, consideration should be given to economic

aspects of the market attractive to firms. The next sections will explain the measurements used for the political and investment market variables in the study.

Regime Type. As discussed in Chapter Two, degree of democracy should be associated with FDI inflows. Democracy has generally been associated theoretically and empirically with FDI inflows. Democracy is generally considered to foster greater economic openness, greater respect for market forces and greater adherence to property rights. A small number of recent studies have argued and demonstrated associations between non-democracy and greater FDI, however, these studies have been questioned on the grounds of methodology. It is expected that in this stage, democracy will retain its positive association with FDI inflows. The same Polity variable used in the policy stage will be used in the inflows stage estimations.

H4-2: FDI inflows will be greater (less) as developing countries become more (less) democratic.

Ideology. Theory has linked ideology to FDI. In particular, countries with rightist governments are thought to be more open to globalization in general, free trade and open markets in particular. Rightist governments are also thought to be friendly to business, with less regulation and taxation. Leftist governments, so the arguments go, are more concerned with the social welfare of affected groups within the population. Many believe they regulate and tax more often. Thus, countries with leftist governments should receive less FDI and those with rightist governments more FDI.

Will the predicted relationships appear when predicting FDI inflows? Using the same ideological variables from the Database of Political Institutions that were used in the estimations of the policy stage estimations, I expect that the traditional relationships

between ideology and FDI inflows will hold because inflows widen the scope of players in the model. In other words, firms, not states, decide which states will receive their investment. Firms may still perceive the left-right divide in the usual manner; the left is unreceptive to FDI while the right is welcoming to FDI. Given these perceptions, the relationships should conform to the customary expectations.

H4-3: Leftist governments receive less FDI inflows than rightist governments.

Nationalism. Nationalist governments are thought to be less friendly to FDI because they tend to view the international economic sphere as one of competition for scarce resources. They are perceived to subscribe to protectionism, and therefore are also thought to favor local businesses over foreign competition and to generally distrust “globalization.” In the last chapter, nationalism was a significant influence on foreign direct investment policies, pushing their countries toward greater restrictions. It is expected that nationalist governments will also receive less FDI.

H4-4: Nationalist governments will receive less FDI inflows than non-nationalist governments.

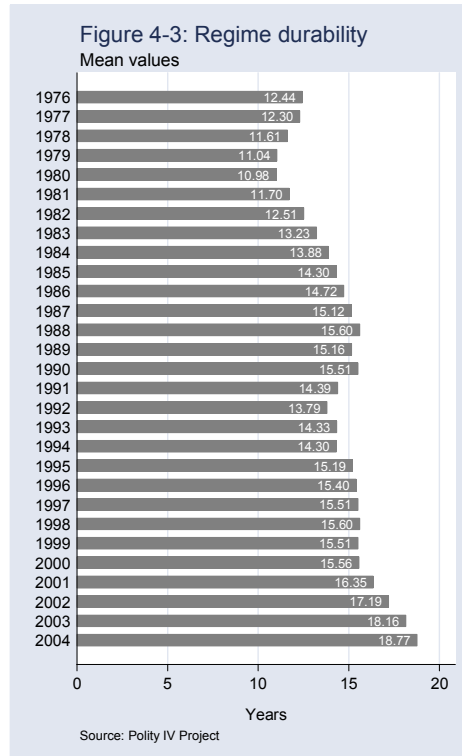
Political Stability. Chapter Two explored the potential relationship between political stability and FDI. Political stability is theorized to enhance FDI because it creates a secure environment for investment without the potential for costly disruptions or changes in the political and economic environment. Disruptions can occur because of changes in the rules due to government variability or economic disruptions due to violent upheavals. In this study domestic political stability is represented by two variables. The first measure of political stability is regime durability, and is taken from

the measure of durability defined by the Polity IV project as the number of years since the most recent change in regime. A regime change is defined as a three point change in the Polity score over a three year period or less, or the period immediately following a disruption or suspension of stable institutional structures.

Figure 4-3 graphically depicts the distribution of the durability variable over time. In 1976, the mean regime durability was about 12.5 years in the sample countries. By 2004, the mean durability had risen to almost 19 years, indicating longer-lasting regimes in developing countries.

Another measure of domestic political stability to be considered in this study is internal war. This variable is taken from the Peace Research Institute of Oslo's (PRIO) Armed Conflicts dataset (version 4 – 2006b).²⁷ This dataset lists intrastate, interstate and extra-state conflicts and includes starting and ending information, intensity, and type and issue of conflict. The dataset defines four kinds of conflict, and for the internal war variable we will consider two of these categories: internal armed conflicts are those between a state and an opposition group inside its borders without interference from another state; and internationalized internal armed conflicts are those between a state and an opposition group inside its borders and involving intervention from another state or states. In addition, the dataset identifies two types of conflict intensity levels. Conflicts can either be minor, reaching 25 – 99 battle related deaths, or major, reaching 1000 or higher battle related deaths. The dataset also contains a cumulative intensity variable, coded 1 when battle-related deaths reach 1000, and 0 otherwise. The major

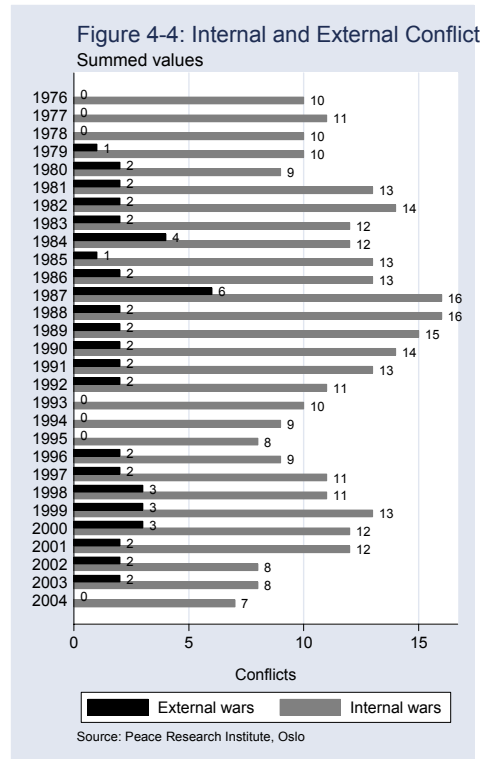
²⁷ The Armed Conflicts dataset can be found at PRIO's Center for the Study of Civil War website, <http://new.prio.no/CSCW-Datasets/>.



conflict intensity level, meaning conflicts with 1000 battle-related deaths, will be used for the internal war variable in these estimations

Figure 4-4 indicates the number of internal and external conflicts each year for the aggregate countries in the sample. External wars will be discussed more fully under the international factors section. Internal wars were more common than external wars during this time. The highest number of internal wars, sixteen, occurred in 1987 and 1988; the lowest number, seven, occurred in 2004. The most external wars in the sample, six, also occurred in 1987. Seven out of the 29 years recorded no external wars at all.

For this study, the internal war dummy variable is coded as 1 if the conflict type is internal or an internationalized internal armed conflict, and if the conflict has reached



1000 cumulative battle deaths. Otherwise the variable is coded 0. I expect that domestic political stability has a positive relationship with FDI inflows.

H4-5a: As governments in developing countries show greater (lesser) durability, FDI inflows rise (fall).

H4-5b: The amount of FDI inflows fall (rise) when developing countries are in a state of internal conflict (peace).

Characteristics of the Domestic Investment Market

The investment market, and its distinctiveness in different developing countries, is another important link to understanding FDI. In particular, the last chapter identified sectoral investment as a possible influence on FDI inflows. Firms, depending on their type of business and products in which they are involved, typically want to invest in

economic sectors that will meet their needs and be profitable, and some developing countries have attractive sectors that are better developed than others. Economic sectors refer to certain distinct areas of the economy. Those developing countries whose economies are primarily agricultural-based may not be attractive to multinational firms, because many developing countries tend to protect their agricultural sector through high tariffs, depressing the market and dampening prices for developing countries' products.²⁸

Some developing countries may be rich in natural resources, and would then attract investment in extractive industries. Still other developing countries may be poor in natural resources, but rich in actual or potential labor, and therefore FDI inflows into such economies would be associated with manufacturing investment. Finally, some developing countries may possess a superior financial infrastructure or a developed tourism industry. Others may have started a process of privatizing state-owned operations, including public service utilities. Countries such as these may already possess a reasonably trained workforce, and thus create an attractive service sector for foreign investment.

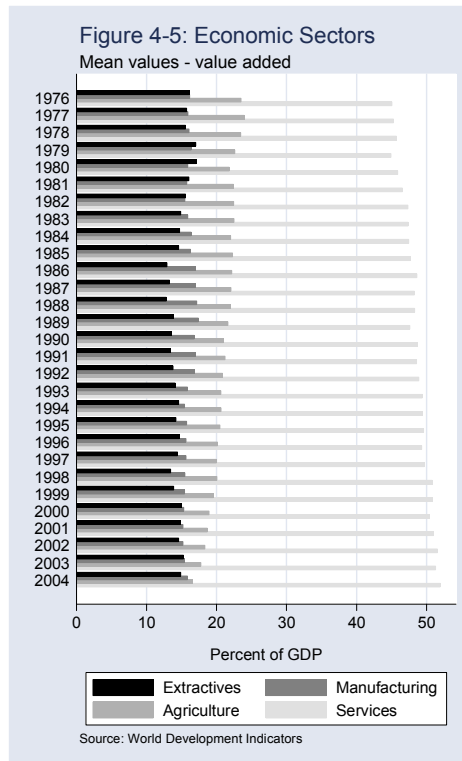
This study includes variables that capture four of the main economic sectors in developing countries; agriculture, manufacturing, extractives and services. The data was obtained from the World Development Indicators, and consists of each sector's value-added (or importance) as a percent of GDP in each developing country. Using the ratio to GDP allows observation of the importance of each sector in each developing country's economy at any particular time.

²⁸ From the online paper "Global Trade Liberalization and the Developing Countries," by the staff of the International Monetary Fund, November 2001. Found online at <http://www.imf.org/external/np/exr/ib/2001/110801.htm>.

The agricultural sector is comprised of the UN's International Standard Industrial Classification (ISIC -revision 3.1) codes 1 – 5, and consists of crop cultivation, livestock production, hunting, fishing and forestry.²⁹ The manufacturing sector includes ISIC codes 15 – 37, and consists of all manufactures, publishing and printing, tanning and dressing of leather, and recycling. The service sector comprises ISIC codes 50 – 99 and covers a wide range of economic activities, including wholesale trade, hotels and restaurants, transportation and storage, finances and insurance, real estate and business, public administration and defense, education, health and social work, community and social services, private households and extraterritorial organizations. The extractives figures were not provided by the World Development Indicators, but the WDI did provide an industrial figure that consisted of manufactures plus extractives. A reasonable representation of extractives was therefore created by subtracting manufactures value-added from industrial value-added. The extractives variable was logged to minimize problems associated with its distribution.

Figure 4-5 graphs the mean value-added as a percent of GDP of the agricultural, manufacturing and services sectors over the time-range of the sample. Agriculture declined from around 23.5 percent to just over 16.5 percent between 1976 and 2004. The decline was accompanied by an increase services, from about 45 percent to about 52 percent, over the same time period. Manufacturing stays relatively steady, measuring only a slight decline from 16.15 percent to 15.8 percent. I expect countries that depend upon agriculture to receive less FDI inflows as a percent of GDP, while those that depend more upon services and manufacturing to receive more FDI inflows.

²⁹ For a complete listing of ISIC classification codes, refer to the United Nations Statistics Division website on ISIC codes at <http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=17>.



H4-6a: As the percentage of agricultural value-added rises (falls) in relation to GDP in each developing country's economy, the amount of FDI inflows falls (rises).

H4-6b: As the percentage of manufacturing's value-added rises (falls) in relation to GDP in each developing country's economy, the amount of FDI inflows rises (falls).

H4-6c: As the percentage of extractives value-added rises (falls) in relation to GDP in each developing country's economy, the amount of FDI inflows rises (falls).

H4-6d: As the percentage of services' value-added rises (falls) in relation to GDP in each developing country's economy, the amount of FDI inflows rises (falls).

International Factors

International factors play an important role on the agreement level, and can inhibit or enhance the possibilities for firm agreement with developing states. FDI inflows indicate the extent to which agreement has been reached between firms and states. These agreements are aided by some international and domestic factors that we explored on the policy level, and some new factors from each that are have stronger association to firms and their preferences.

International stability. As discussed in Chapter Two, stability is theorized to improve the prospects of FDI in developing countries. On the international stage, stability is considered to be a peaceful international environment, or one that is free of war and conflict. For this reason, external war is used as a variable that provides a measure of international stability. The external war variable, like the internal war variable, was obtained from the Correlates of War (COW) project. For this variable, we will consider the final two COW categories of war: extrasystemic armed conflicts are those conflicts between a state and a non-state group outside its borders and interstate armed conflicts are those between two or more states. A dummy variable, coded as 1 if the conflict is an extrasystemic or an interstate armed conflict and has reached 1000 cumulative battle deaths, and 0 otherwise is used in these estimations.

H4-7: The amount of FDI inflows fall (rise) when developing countries are in a state of external war (peace).

Institutional membership. Just as membership in international institutions may play a role in determining domestic policies, membership may also play a role in influencing

FDI inflows. Firms that see that developing countries are members of international institutions concerned with creating rules and norms of foreign direct investment may be more likely to invest in those countries because these norms and rules level the playing field and encourage transparency. Employed in this capacity is a variable used in the domestic policy model, the institutional pressure index, described in Chapter Three.

H4-8: Developing countries that have higher (lower) rates of membership in international institutions will have greater (less) FDI inflows as a percent of GDP.

Proximity. Proximity to developed countries also plays a part in FDI inflows. Firms that can invest in countries that are nearer to their home bases can save on expenses that would be incurred over greater distances, especially if the investments consist of factories that produce or assemble and then ship the goods back to the home country or abroad to other countries. Thus, more investment may be likely in countries that are nearer to home.

H4-9: Developing countries that are closer (farther) from developed countries should see more (less) FDI inflows as a percent of GDP.

Control Factors

Other characteristics may also present influences upon FDI inflows along with the political environment, the investment market and policies. There are many possible influences, but of these, there are some that stand out. These influences include the level of industrialization of each state, the size of the market, wages, corruption and region. The following sections list those that are included in the estimations.

Corruption. A domestic characteristic that may be associated with foreign direct investment inflows is corruption. There are two main views of the effects of corruption on FDI inflows. The most common argument among researchers has been that corruption depresses FDI inflows because it places barriers against investment within the market and greatly decreases efficiency. A smaller contingent of researchers argues that corruption aids the flow of the marketplace by allowing those investors that are willing to pay bribes to government officials to set up for business more efficiently. However, because corruption is widely seen as an impediment to investment and smoothly operating business, corruption should be negatively associated with FDI inflows.

Corruption data is available for all countries in the dataset through the World Bank's Governance Matters dataset. The Governance Matters dataset measures governmental effectiveness, using a methodology called the unobserved components model to create six aggregate indicators from individual measures. One of its six indicators is governmental control of corruption. The corruption indicator is based on surveys of individuals and firms, and assessments of think-tanks, multi-lateral aid agencies, non-governmental organizations, and commercial risk-rating agencies. The corruption measure in this dataset is modeled as a fixed effect in each panel based on the average of the Governance Matters Control of Corruption index from 1996-2005. The range of the variable runs from -1.55 to 1.35, with higher values corresponding to greater government effectiveness. I assume that government corruption is entrenched and does not change much over time. The values bear this out – the mean standard deviation across all countries in the sample over the time range of the sample is only

0.21. It is expected that greater effectiveness in controlling corruption leads to greater FDI inflows.

Wages. A common argument about the globalization of business is that firms relocate manufacturing and services from developed countries where wage rates are higher to less developed countries with lower wages. Their motivation for doing this is greater profits. Developing countries are prime candidates for firm interest because they tend to possess a wealth of surplus labor, and we would expect that firm interest would correspondingly result in a higher rate of FDI inflows.

Unfortunately, no reliable direct indicator of wages exists. The International Labor Organization keeps wage rate data going back several years, but the wages are listed depending on how each individual country tracks them, and it appears there is no uniform way that countries report this data. Some countries report hourly wages, some daily, some weekly and some monthly. The dataset is full of missing observations. In addition, each wage is listed in each country's national currency, and with changes in exchange rates over time, converting wages to a meaningful uniform measure becomes very difficult.

Proxies for wage data used in previous research have included education and per capita income, with per capita income generally serving as the most popular proxy for wages (Hejazi and Zefarian 2002, Zak and Knack 2001, Agarwal and Winkler 1984). Given the discussion in Chapter Two, relating to FDI policy, about the importance of direct measures of concepts, it is important to include some measure for wages in this study. Educational data for developing countries is not generally available for all the

years covered in this research, but I am able to employ logged values of Gross National Income (GNI) per capita due to its availability for all countries in the sample.

Property rights. The extent to which countries protect and preserve property rights has been identified as a possible influence on FDI. Greater property rights protections have been identified most commonly with democracies, but as discussed previously, those states that make changes toward greater property rights protections have been identified with a greater probability of receiving FDI than those states that do not.

For that reason, property rights protections need to be included in any study of FDI. However, getting property rights data for a sample going back into the 1970s is difficult since data collection on economic variables was conducted to the greatest extent in developed countries than in non-developed countries. The Heritage Foundation's Index of Economic Freedom rates countries on 10 dimensions going back to 1995. I used the property rights dimension, which runs a range from 0 to 100, and is defined as "an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state" (Beach and Kane 2008). Countries with scores approaching 100 are those countries that rate higher on property rights freedoms, and those closer to 0 have less property rights freedoms. The countries in the sample range from the score of 10 for Haiti and Iran on the low end of the range to a score of 90 for Chile. I model the average of the property rights scores for each country from 1995 – 2004 as a fixed effect.

Market size. Another economic characteristic that may be associated with FDI inflows is market size, which can work to a state's advantage in attracting FDI. Firms may seek overseas markets partly so that they can sell their goods with greater advantages than

at home. Generally, larger markets have been associated with greater inflows of FDI. The variable used for market size is, like in the previous chapter, population. The variable has been logged because of its right skew.

Region. As in the estimations in the previous chapter on the policy stage, regional dummies will be included to control for possible differences related to developing countries' placement in geographical areas. This not only controls for potential competition for FDI, but also should further disperse any overwhelming effects that any large developing country's economy may have on the results. The regions included are Sub-Saharan Africa, East Asia, North Africa, Latin America, South Asia and Central Asia. Central Asia serves as the excluded and therefore the comparison category since it has the least number of observations.

Model Specification

The model estimations were run using the statistical program Stata, employing OLS assumptions and using panel-corrected standard errors. The sample consisted of 57 countries over 29 years (1976-2004). Panel-corrected standard errors yield better estimates than generalized least squares estimations, which have been known to bias standard errors downward and lead to erroneous conclusions of significance (Beck and Katz 1995). As discussed previously, some variables were transformed where necessary to reduce problems caused by the state of their distribution. The dependent variable, extractives variable and CO2 variables were transformed by right-shifting and

logging to minimize skew. The population variable was left-shifted and logged for similar reasons.³⁰

To model serial dynamics a lagged dependent variable is included on the right-hand side. Lagrange multiplier tests indicate the addition of this variable prevents serial correlation of errors. In addition, to account for questions of causality, one-year lags of most of the independent variables, except for variables with constant values and regional dummies, were used on the right-hand side, allowing for the interpretation that previous year's observation predicts the present year's result.

There were three estimations. Estimation 2a tests determinants of FDI inflows as the percent of GDP including nationalism and omitting ideology. Estimation 2b eliminates nationalism and includes ideology. Estimation 2c includes all variables. The general estimation equation for the models is as follows:

$$\begin{aligned} \ln(FDI)_{it} = & \beta_0 + \beta_1 \ln(FDI)_{it-1} + \beta_2 Regime_{it-1} + [\beta_3 Left_{it-1} + \beta_4 Center_{it-1} + \beta_5 Right_{it-1}] \\ & + \beta_6 Nationalism_{it-1} + \beta_7 Agriculture_{it-1} + \beta_8 Manufacturing_{it-1} + \beta_9 \ln(Extractives)_{it-1} \\ & + \beta_{10} Services_{it-1} + \beta_{11} Durability_{it-1} + \beta_{12} Internal\ War_{it-1} + \beta_{13} External\ War_{it-1} \\ & + \beta_{14} International\ Institutions + \beta_{15} Proximity + \beta_{16} Equity\ Category\ 1_{it-1} \\ & + \beta_{17} Equity\ Category\ 2_{it-1} + \beta_{18} Equity\ Category\ 3_{it-1} + \beta_{19} \ln(GNI / capita)_{it-1} \\ & + \beta_{20} Corruption + \beta_{21} Property\ Rights + \beta_{20} \ln(Population)_{it-1} + \beta_{21} Region \end{aligned}$$

Results of Estimations

The results of the estimations are recorded in Table 4-1, 4-2 and 4-3. Three estimations were performed. Estimation 2a omitted government ideology variables and included government nationalism, while Estimation 2b included the ideological variables and omitted the nationalism variable. Estimation 2c included both nationalism and

³⁰ For complete summary statistics of the variables discussed in this chapter, please refer to Appendix E. Variables transformed for the estimations are indicated.

ideology in the test. Overall the estimations performed well. The R^2 for the estimations, which measures how close the independent variables fit the proportion of FDI inflows as part of the overall economy, are 0.5399, 0.5288 and 0.5405 respectively, meaning roughly 52-54 percent of the variation of the dependent variable is explained by the independent variables within the estimations. The lagged dependent variable in these three estimations is significant and its coefficient is positive.

Hypothesis 4-1, the FDI equity hypothesis, received strong support in the in all of the estimations. All of the categories of FDI equity had positive coefficients as predicted and in all estimations the highest category variable reached 0.05 significance or better. This significance in Category 3 indicates an interesting result. Category 3, the least restrictive category, is positively significant when compared to the most restrictive group, Category 0. Categories 1 and 2, representing gradations of restrictions on FDI equity, show no difference with the comparison group. Apparently, developing countries that take the extra step to open their economies to foreign equity without restrictions, represented by Category 3, receive a boost in FDI inflows as a percent of GDP. Those countries that place some to many restrictions on foreign equity, represented by Categories 0 to 2, do not see this boost.

Hypothesis 4-2, the democracy hypothesis, proposed that democracies receive greater amounts of FDI inflows than non-democracies. In all estimations, the regime variable was positive and significant as predicted, indicating that as one moves across the range of countries in the sample from less democratic to more democratic, and countries themselves move from less to more democratic, they see greater inflows of FDI as a percentage of GDP. While this result does not support some recent

scholarship suggesting that FDI responds to autocratic regimes, it does support the more common finding that democracy is more conducive to greater amounts of FDI.

Hypothesis 4-3, the leftist government hypothesis, was tested in Estimations 2b and 2c. Neither of those estimations supported the premise that ideology of government has any effect on FDI inflows whatsoever. In terms of leftist governments, the variable did not approach significance, and the sign of the coefficient was positive, which was opposite of what was predicted. None of the other ideological variables were significant either, indicating that all ideological groupings had no appreciable differences with the comparison group, rightist governments.

Nationalism (Hypothesis 4-4) was included in Estimation 2a and 2c and registered significant results when alone and when included with the ideological variables. However, the results of nationalism were not as predicted. The variable was positive and significant in both estimations in which it was included. The result indicates that nationalist governments get greater amounts of FDI as a percent of GDP than non-nationalist governments. This appears to contradict conventional wisdom of nationalism as well as the results of other studies.

The variables representing domestic political stability yielded no significant coefficients in all the estimations, therefore giving little support to Hypotheses 4-5a and 4-5b in these models to the domestic political stability hypotheses. This suggests that FDI does not respond to issues of stability in developing countries, or that other conceptual measures of stability will better capture this relationship.

Table 4-1: Determinants of Foreign Direct Investment Inflows in Developing Countries

Estimation 2a			
Variables	Coefficient	Robust S.E.	P-value
Logged FDI/GDP _{t-1}	0.6485	0.0632	0.000
Regime type _{t-1}	0.0021	0.0009	0.016
Nationalism _{t-1}	0.0260	0.0106	0.014
Regime durability _{t-1}	-0.0001	0.0002	0.724
Internal war _{t-1}	0.0040	0.0086	0.640
External war _{t-1}	0.0169	0.0089	0.058
International Institutional Membership _{t-1}	0.0491	0.0235	0.036
Proximity to Developed Countries	0.0007	0.0076	0.918
Agriculture value-added/GDP _{t-1}	-0.0003	0.0009	0.696
Manufacturing value-added/GDP _{t-1}	0.0003	0.0010	0.809
Logged Extractives value-added/GDP _{t-1}	0.0413	0.0205	0.044
Services value-added/GDP _{t-1}	-0.0001	0.0008	0.930
Foreign equity category 1 _{t-1}	0.0076	0.0087	0.384
Foreign equity category 2 _{t-1}	0.0116	0.0123	0.346
Foreign equity category 3 _{t-1}	0.0337	0.0159	0.035
Logged GNI per capita _{t-1}	-0.0180	0.0072	0.013
Corruption	0.0239	0.0091	0.008
Property Rights	-0.0002	0.0003	0.495
Logged population _{t-1}	-0.0035	0.0034	0.305
Sub Saharan Africa	0.0087	0.0197	0.659
Latin America	0.0326	0.0122	0.007
North Africa	0.0129	0.0195	0.510
East Asia	0.0166	0.0162	0.307
South Asia	-0.0199	0.0137	0.146
Constant	0.9464	0.2054	0.000
	N=1255	R²=0.5393	

Table 4-2: Determinants of Foreign Direct Investment Inflows in Developing Countries

Estimation 2b			
Variables	Coefficient	Robust S.E.	P-value
Logged FDI/GDP _{t-1}	0.6407	0.0555	0.000
Regime type _{t-1}	0.0017	0.0007	0.011
Left government _{t-1}	0.0115	0.0111	0.299
Center government _{t-1}	0.0064	0.0117	0.581
Other government _{t-1}	-0.0028	0.0126	0.826
Regime durability _{t-1}	-0.0001	0.0002	0.826
Internal war _{t-1}	0.0005	0.0076	0.950
External war _{t-1}	0.0098	0.0105	0.351
International Institutional Membership _{t-1}	0.0480	0.0219	0.028
Proximity to Developed Countries	-0.0019	0.0095	0.845
Agriculture value-added/GDP _{t-1}	-0.0006	0.0007	0.426
Manufacturing value-added/GDP _{t-1}	0.0004	0.0010	0.703
Logged Extractives value-added/GDP _{t-1}	0.0201	0.0169	0.235
Services value-added/GDP _{t-1}	-0.0008	0.0007	0.271
Foreign equity category 1 _{t-1}	0.0083	0.0086	0.334
Foreign equity category 2 _{t-1}	0.0121	0.0110	0.272
Foreign equity category 3 _{t-1}	0.0342	0.0140	0.015
Logged GNI per capita _{t-1}	-0.0134	0.0065	0.039
Corruption	0.0092	0.0088	0.296
Property Rights	0.0001	0.0003	0.872
Logged population _{t-1}	-0.0064	0.0033	0.050
Sub Saharan Africa	0.0087	0.0194	0.655
Latin America	0.0263	0.0109	0.016
North Africa	0.0210	0.0160	0.189
East Asia	0.0146	0.0147	0.320
South Asia	-0.0136	0.0151	0.370
Constant	1.0821	0.1930	0.000
	N=1488	R²=0.5222	

Table 4-3: Determinants of Foreign Direct Investment Inflows in Developing Countries

Estimation 2c			
Variables	Coefficient	Robust S.E.	P-value
Logged FDI/GDP _{t-1}	0.6468	0.0634	0.000
Regime type _{t-1}	0.0019	0.0009	0.026
Nationalism _{t-1}	0.0240	0.0102	0.018
Left government _{t-1}	0.0092	0.0114	0.420
Center government _{t-1}	0.0050	0.0123	0.687
Other government _{t-1}	-0.0032	0.0151	0.834
Regime durability _{t-1}	-0.0001	0.0002	0.669
Internal war _{t-1}	0.0043	0.0087	0.624
External war _{t-1}	0.0142	0.0090	0.114
International Institutional Membership _{t-1}	0.0528	0.0246	0.032
Proximity to Developed Countries	-0.0048	0.0091	0.598
Agriculture value-added/GDP _{t-1}	-0.0002	0.0009	0.779
Manufacturing value-added/GDP _{t-1}	0.0001	0.0010	0.906
Logged Extractives value-added/GDP _{t-1}	0.0397	0.0197	0.044
Services value-added/GDP _{t-1}	-0.0001	0.0008	0.930
Foreign equity category 1 _{t-1}	0.0090	0.0088	0.309
Foreign equity category 2 _{t-1}	0.0129	0.0123	0.296
Foreign equity category 3 _{t-1}	0.0351	0.0162	0.030
Logged GNI per capita _{t-1}	-0.0156	0.0074	0.035
Corruption	0.0214	0.0091	0.018
Property Rights	-0.0002	0.0003	0.497
Logged population _{t-1}	-0.0031	0.0033	0.355
Sub Saharan Africa	0.0042	0.0216	0.847
Latin America	0.0291	0.0122	0.017
North Africa	0.0132	0.0205	0.521
East Asia	0.0192	0.0172	0.263
South Asia	-0.0243	0.0157	0.121
Constant	0.9327	0.2002	0.000
	N=1255	R²=0.5398	

Of the variables representing the value-added in various economic sectors, the only variable to reach significance was the variable representing the extractives sector. The sign of the coefficient matched the prediction in Hypothesis 4-6c. However, a possible mystery about this variable surfaces; the significance of this variable only appeared when the nationalism variable was included in the estimations, despite the fact that these two variables have a low correlation (-0.038). The inclusion of the nationalism variable reduces the estimated sample by 193 observations, so missing observations may account for the significance of this variable.

Some of the variables measuring international level factors were found to be of significance. External war nearly reaches significance in Estimation 2a, but does not in the other estimations, and its sign is opposite to the prediction in hypothesis 4-7. The variable measuring international institutional membership was significant across all estimations in the predicted direction of Hypothesis 4-8, indicating that membership in international institutions, especially those that promote norms and rules related to FDI, is associated with higher level of FDI in countries across the sample. Proximity to developed countries appears to have little if any relationship to FDI inflows, providing little support for hypothesis 4-9.

Some of the controls reached significance in the estimations as well. Wages, as represented by GNI per capita, appears to be a robust predictor of FDI inflows, with greater inflows moving toward countries with higher GNI per capita. Corruption reaches significance in the predicted direction in Estimations 2a and 2c, which may provide some indication that governments that are effective in fighting corruption receive more FDI as a proportion of their economies. Surprisingly, property rights protections

did not reach significance in any of the estimations, despite the fact that it has been identified as an important variable in studies discussed previously. Market size, as represented by population, gained significance in a negative direction only in Estimation 2b, and therefore does not appear to be a reliable predictor of FDI inflows.

Latin America was the only one of the regional variables to gain any significance at all, indicating that developing countries in that region may benefit from their location. When compared to Central Asia, the comparison group, Latin America's coefficient was positive and significant across all estimations. This may indicate that Latin America receives more FDI inflows than countries from other regions.

Table 4-4 shows the predicted outcomes of FDI as a percent of GDP from Estimations 2c after varying each significant independent variable through its range. The dependent variable outcomes have been transformed back to the dependent variable's original scale.

Discussion

The goal set for this chapter has been twofold. The dissertation's main focus has been to shed some light on the contribution of FDI policies to the FDI process. In order to bring that illumination, the entire FDI process has been framed in the logic of two-level games. The previous chapter focused on the determinants of FDI policy, created on the domestic level, which sets the basis for eventual state agreement with firms over FDI. This chapter takes the next step. How does policy interact with political and economic factors to contribute to state-firm agreement and therefore inflows of FDI into developing countries?

Table 4-4: Expected Outcomes of FDI Inflows Varying Significant Factors

From Estimation 2c					
Variable	Min	-1 s.d	Mean	+1 s.d	Max
Regime	0.77	0.86	1.05	1.24	1.33
Nationalism	1.05				1.10
Intl. Institutional Membership	0.48	0.85	1.05		1.24
FDI Equity Category 3	1.05				1.57
GNI/capita	1.75	1.29	1.05	0.82	0.53
Latin America	1.05				1.48

Since this firm-state agreement takes place outside the domestic political sphere, this environment constitutes the next level of agreement, and this chapter undertook to demonstrate that policy, formulated at the domestic level, affects agreement at the level of firm-state negotiation. The outcome of agreements between firms and developing states, flows of FDI into developing countries, served as the object of investigation in this chapter.

The estimations of FDI inflows and their determinants reveal two main findings. First, policy matters in developing countries when it comes to FDI. How does policy matter? While those countries that are less than completely open to foreign equity will receive FDI, those countries that have the most open policies will receive a boost in foreign investment inflows. This finding underscores something that has been missing from many empirical studies of FDI – policies are an important part of the FDI story. Lack of data has precluded a large-scale study of FDI that includes policy prior to this dissertation, but development of the FDI Equity Index, introduced in this dissertation, has brought an important new tool to the study of foreign direct investment.

The findings presented in this chapter further support the idea that FDI is not simply determined by domestic and international political and economic factors in isolation from each other, but follows a logic that resembles Putnam's two-level games. International and domestic forces influence FDI policies. These policies in turn influence flows of FDI along with some of the same and other different international and domestic forces. Should one be interested in only domestic or international factors and their effects on FDI, by all means they can study them in isolation. However, the full

story of FDI can only be told by considering FDI as a product of factors combining from both levels.

FDI can only be fully understood if one relaxes the assumption that states only interact with other states outside of the domestic level. Whether one considers firms as a player in the international community or one considers state and firm negotiation to belong in a realm separate from international relations but also outside the domestic purview of the state, the understanding that firm-state agreement is separate from the domestic sphere is essential. Even though the environment of firm-state agreement occupies a separate sphere, it is influenced by domestic and international forces and in turn, has its own effects on the international and domestic environment.

In the FDI story, states come to some agreements with other states over some aspects of FDI, but developing states are more likely to be in competition with each other over FDI and the foreign firms that invest. On the other hand, the relationship between firm and state is much more complex. Some competition is involved, centering on both firm and state's desire to maximize their gains and minimize their costs. Both firm and state in many cases have more incentives to come to agreement than to disagree, especially if they have any overlap in what they are willing to consider as acceptable agreements. Instead of true competition, states and firms come to agreements on how to work together. These agreements result in flows of FDI.

Some of the findings in the estimations uphold what has been found in other studies. Domestic political level factors that influence firm-state agreement include level of democracy in developing countries. Democracies simply gain more FDI inflows as a percentage of GDP than non-democracies. Democracies are friendly to and protective

of business, demonstrate transparency, have well-defined rules and laws, and constitute less risk for foreign firms than non-democracies.

Other findings on the domestic level surprised. Nationalism was shown to be positively associated with foreign direct investment. This finding goes against much of the literature that addresses the role of nationalism in the world economy. If nationalist governments are less enamored of the idea of an interdependent world economy, how do we explain this? Shulman (2000) provides a possible answer for this puzzle. He argues that nationalist governments face more complex choices and decisions about the international economy than they are generally given credit for. Nationalist goals of autonomy, unity and identity can in some instances be achieved by strong foreign economic policies. In addition, nationalist governments tend to rule smaller countries where FDI has a greater impact on the economy than in larger, more diversified countries. Indeed, examining the dataset shows that developing countries with nationalist governments in the sample have a mean FDI as a percent of GDP of 2.17 percent, while non-nationalist governments have a mean of 1.70 percent. Finally, based on Putnam's logic, nationalist governments may leverage some bargaining power with foreign corporations because the range of possible agreements they can consider is smaller, and therefore firms that want to invest must decide to take or leave what's offered rather than negotiating better deals.

Similarly, the lack of a role for government ideology is also a surprising finding. Indeed, all ideological forms of government appear to have very little difference from each other when it comes to receiving foreign investment. Some of the reasons for this finding may be attributed to methodological problems in the data that categorizes

government ideological forms. In particular, the contingent of a large set of governments that cannot be classified as left, center, or right but simply occupies a category called “other” is a problem that cannot be overcome. Either a greater effort to classify these “other” governments must be undertaken, or a new way of looking at government ideology must be created.

Another surprise is the feeble performance of political stability variables in all models. While political stability has had weak empirical success in other models of FDI, there has generally been agreement that a stable political environment enhances FDI flows. However, internal war, external war and regime durability do not have any consistent significant effects on FDI in these estimations. Does this mean that stability has no bearing on FDI? The answer may lie in the problem of defining what is meant by political stability. After all, democratic forms of government are also equated with stability, but what kinds of stability? Democracies may be more likely to have certain forms of instability, such as strikes, riots, demonstrations and the like, which would not be tolerated in less democratic governments. However, democracies are more likely to exhibit regime stability, as measured by the durability variable above.

The findings on political stability may indicate that, despite Bollen and Jackman’s (1989) warning of conflating stability and democracy, the particular stability brought about by democracy is more important to firms than stability for its own sake. After all, if foreign firms are more willing to send capital investment to democracies in developing countries, they get two benefits: more political stability and more open governmental decision-making. Transparency in democracies allows firms to anticipate possible

changes in advance and adjust, rather than having to adjust immediately to the whims of an autocratic government.

While this finding certainly merits more study, some possible answers may be in previous theories relating autocracy and democracy to development. Long lasting autocracies might be considered more stable in ways attractive to firms. Democratic political stability may come with policy instability. As countries change governments peacefully, the policies that they propose, the new sets of regulations and restrictions they pass, and the demands they make on firms may prove to be unattractive over the long term. Firms may invest in a developing democratic country under conditions at one time, and find that after elections the political landscape has changed. FDI policies may change, as might all policies that affect the business environment in developing countries. That being said, FDI equity policy in the dataset is remarkably stable, with changes in FDI equity restrictions occurring in only just over eight percent of the cases. However, if a wider range of policies that factor into firm decision-making were considered, a relationship such as proposed above may be found.

The variables measuring the characteristics of the investment market performed weakly, except for perhaps the variable characterizing extractives. It matters not whether developing countries are stronger in agriculture, manufactures, or services; these factors appear to be insignificant in both models. Even though extractives were somewhat significant, the finding was not as robust as some of the other variables. Why might sectoral strengths have weak effects? Despite the fact that more FDI worldwide is flowing into services, developing countries may not have the resources or the infrastructure to attract FDI into this sector like developed countries. A lack of

resources to promote other sectors may compound this effect. Countries that are strong in manufacturing appear to have no advantage when it comes to FDI inflows, which is surprising considering the amount of FDI that is invested in manufacturing around the world. Perhaps this result indicates that manufacturing investment is truly diverse and not concentrated in one area. The extractives sector, one of the oldest foreign direct investment sectors, is based in natural resources and investment in that area tends to be more fixed than other forms of investment because unlike manufactures, where a potential source of cheaper labor might be in the neighboring country or in another region, natural resources tend to be native to certain areas. Once firms find a source of a natural resource, they are not likely to give up on it until it has been worked through, and they will be less inclined to let competition join them in extracting that resource. Investment will likely be less than in other sectors, and relatively stable.

Domestic level variables do not tell the entire story of FDI, however. International level factors not only contribute to FDI policy, but with FDI policy they influence eventual agreements between firms and states, leading to FDI inflows into developing countries. In these estimations, international institutional membership is associated with greater amounts of FDI inflows. International firms are more likely to come to agreements with those developing countries that belong to international institutions concerned with trade and investment because they institutionalize rules and norms of international business, leveling the playing field for firms among various countries.

Controls included in the estimations show an extra level of factors that affect FDI inflows in conjunction with policies. In general, the standard of living, particularly the

wage level, appears to matter in attracting foreign investment. The results presented here suggest that FDI is attracted to low wage countries, much as has been reported in other research and reviewed previously. I would suggest that developing countries with lower average incomes have a wider range of possible agreements with foreign firms, because the need for jobs outweighs the wariness of costs to FDI. Some alternative explanations attribute somewhat darker designs for developing countries in attracting FDI. It has been argued that some developing countries can artificially hold down wages in order to attract investment and compete with other low-wage countries and areas. For example, there is evidence that in newly industrializing countries (NICs) in Asia, governments created incentives to lure foreign investment by artificially setting wage rates lower than the average real world wage determined by markets. They then let wage rates slowly rise over time so that both firms and governments received benefits – firms in the beginning and governments over time (Dooley, Folkerts-Landau and Garber 2004). The countries that want FDI have an incentive to keep wages low, while countries that do not place as high a priority on FDI can allow higher wages.

The control of corruption also plays a part in the FDI story. Countries are more efficient in dealing with corruption gain more FDI both as a percentage of GDP. Investment appears to seek out countries where business dealings are open and transparent, and where companies do not have to trouble themselves with unforeseen costs like paying bribes to get things done.

Interestingly, the results do not support propositions that market size or property rights are important when it comes to flows of FDI. Given that market size may allow for foreign investment to achieve greater local returns, this is a surprising result. However,

this may also be a function of investment being placed in countries not to compete locally, but to manufacture and ship the finished products back to the home country or other developed countries. In terms of property rights protections, which were also surprisingly insignificant, democracies have often been associated with greater property rights protections, and indeed there is a modest correlation (0.2341) between property rights protections and greater democracy in the sample. This overlap between democracy and property rights protections may preclude the latter from gaining any real significance. In addition, since the variable only accounts for an average of the years 1995-2004, the lack of information on the preceding years may have some effect on how this variable performed as well.

Of the regions, Central Asia, which consists of the country of Turkey, was excluded from the analysis as a basis of comparison given its limited observations. While regional differences are not overly present, an exception appears to be Latin America. The results indicate that Latin American countries collectively receive more FDI as a percent of GDP than Central Asia, and indeed any of the other regions. This is not a surprise. Latin American countries were among the first to emerge from colonization, and therefore they have a long history of relations with both Europe and the United States. In addition, the United States considers Latin America its back yard and has cultivated economic ties with most of its countries since the early 1800s. Given this head start, firms from the developed world are familiar with Latin America, and have done business in its countries and with its leaders for a long time. Even though Latin America and Sub-Saharan countries have the most open policies of any of the regions,

Latin America's history, relative stability, and its stronger democratic tradition most likely makes it a more attractive investment opportunity.

The Theory under Scrutiny: The Need for Case Studies

Does policy matter to foreign investors? In the face of the results of this chapter, it appears that policy, in combination with a variety of factors from both the domestic and international levels, has a great deal of influence on foreign direct investment inflows. Statistics aside, the true test of any theory is not only predicated on what the general numbers say, but also what happens in individual countries. Chapter Five will examine the theory of foreign direct investment that has been proposed in more detail by looking at the experiences of two countries, El Salvador and Nicaragua, and exploring the effects of policies on their FDI experiences. I will consider the following questions: What affects FDI policies in these two countries? Does policy matter when it comes to the extent of FDI in their economies? How do international and domestic influences interplay to produce not only FDI policy in these countries, but also FDI inflows? The answers will help shed light on these questions in specific, local conditions.

The case studies will take into account the countries' similarities and differences in drawing a more complete picture of FDI policy and its effects on FDI performance. By delving more deeply into the phenomena of FDI policies in specific countries, I hope to find more specific answers to some of the outstanding questions about their creation, character, and influences.

Chapter Five

FDI Policy in El Salvador and Nicaragua

The findings of the previous chapters reflect a general approach toward finding influences on FDI policies in developing countries, and how those policies may influence FDI inflows. This study relies on quantitative studies to test relevant hypotheses. While quantitative studies can provide fine evidence for possible causal relations between variables of interest, they cannot capture all variables of interest. In particular, there may be variables and subsequent hypotheses that are missed in pure quantitative studies, no matter how exhaustive the list that the researcher prepares. Other variables of interest may not be quantifiable. In the context of a more detailed examination of FDI policy, a complement to quantitative analysis may be appropriate. The utilization of case studies has long been a staple of social science research, and according to many scholars, qualitative case studies serve as an important complement to quantitative statistical studies. According to King, Keohane and Verba (1994), quantification encourages precision, but does not necessarily produce accuracy because quantitative indexes produced for large scale statistical studies may not relate closely to the concepts that the researcher desires to measure. Case studies can complement statistical studies because they can provide additional description and can lead to valid causal inferences.

The overall purpose of this dissertation has been to discover what role policy plays in the FDI process. I have looked for answers to the following general questions in order to discover how policy interacts with foreign direct investment. What accounts

for the variation in FDI policies among developing countries? How do policies influence FDI inflows?

In Chapter Two I reviewed literature to argue that developing countries are of two minds about FDI. These attitudes have been cultivated through exposure to prevailing thought during different time periods in their histories. In the 1950s and early 1960s, developing nations were encouraged by an optimistic view of modernization driven by a Western desire to win the allegiance of developing countries from the Soviet Union. Modernization theory argued that all countries are on the path to modernity and embracing capitalism and free markets will bring industrialization. By the end of the 1960s, many developing nations had turned away from these prescriptions. Dependency theory argued that the developing world's connections with the industrialized north were retarding its development and leading to greater inequality. Prescriptions included de-linking connections to the developed world, giving a greater role to the state in industrialization, and developing national industries to replace expensive and costly imports from the developed world with home-manufactured goods. But in the 1980s, after the rise of bloated state companies and debt crises partly predicated on massive borrowing made to finance those industries, a new modernization preaching free-trade and capitalism began to take hold. Often enforced by international institutions that set conditions for debt restructuring, developing countries began to privatize their state-owned industries, reduce their social welfare programs and scale back state involvement in the economy in favor of free-markets and free trade.

As a result, states exhibited a blend of attitudes toward globalization, and on foreign direct investment, over the past thirty years. This blend means that developing states' attitudes occupy a spectrum between completely closed and completely open to FDI. These attitudes are translated into their policies and at any point in time, depending on a coalition of factors, developing states' policies will be more or less open to FDI.

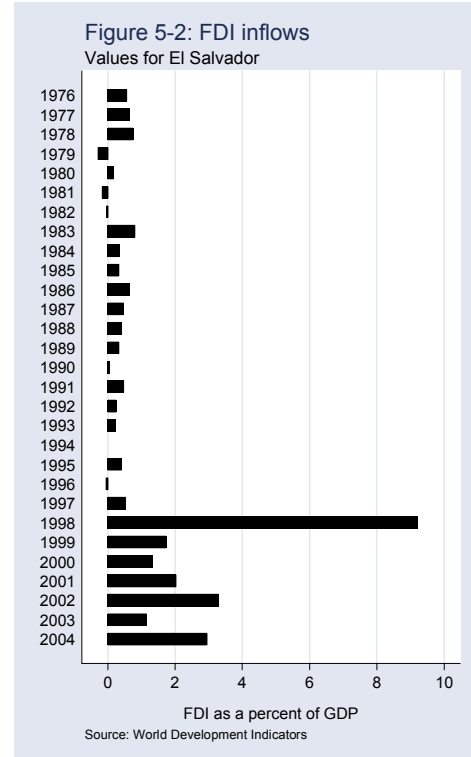
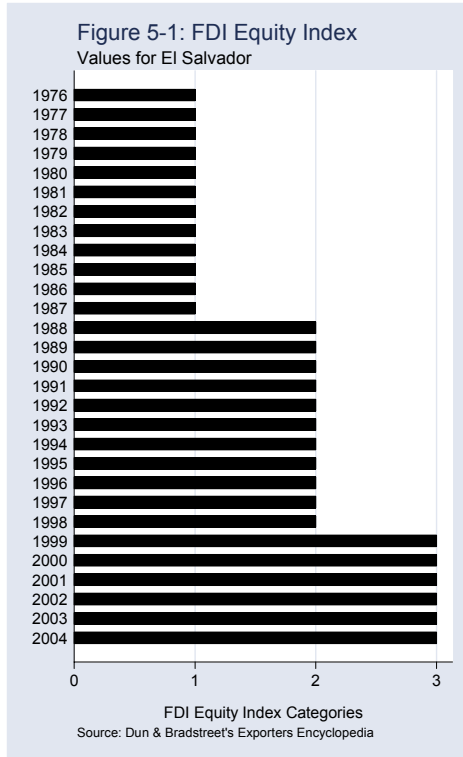
I argued that the factors that influence FDI policies follow the framework of two-level games. Developing countries create policies to control FDI on the domestic level, and bring these policies to the agreement process on the transnational level with international firms. International and domestic factors affect both domestic level policymaking and the agreement process. In particular, domestic factors include domestic politics, such as regime type, ideology and nationalism, and the domestic economic environment, such as potential alternatives to FDI for development and past experience with FDI. International factors include international pressures and the world political environment. I hypothesized that countries that are more democratic, non-nationalist, and right leaning would have more open policies. I proposed that international pressure, operationalized in the form of membership in international institutions with an interest in FDI and proximity to developed countries, would lead to more open policies. I projected that alternatives to FDI, such as gross domestic savings, foreign aid, foreign borrowing, and maintaining a positive trade balance, would allow developing countries to pass more restrictive policies on FDI. I also anticipated that past experience with FDI would affect countries' future attitudes on FDI. Countries that had strong past performances would continue to open to FDI based on their

experiences, and countries that had weak past performance would not see it as a viable option and remain closed.

I also asked if these policies influenced FDI inflows. I hypothesized that domestic factors such as current FDI policies, political factors, and international and domestic market characteristics act to create a push-pull influence on inflows. I specifically hypothesized that open policies would influence greater FDI inflows, while more restricted policies would inhibit those inflows.

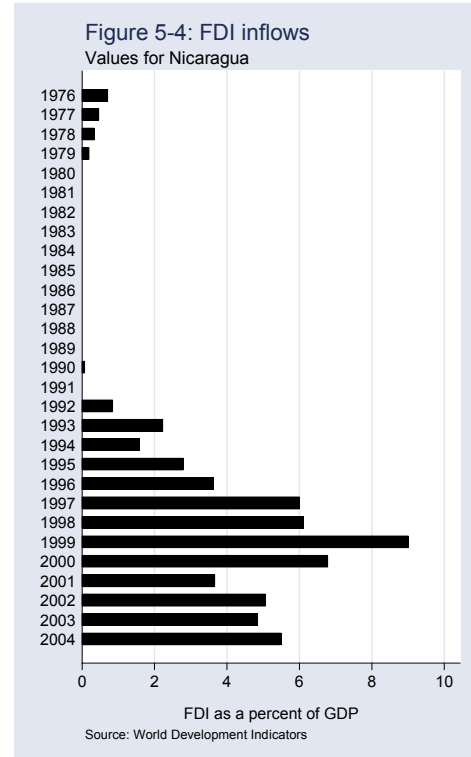
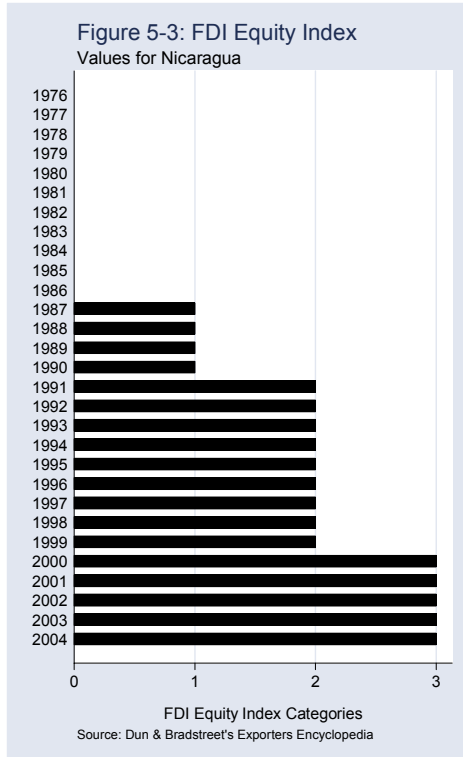
The next sections will examine these hypotheses in light of the specific experiences of El Salvador and Nicaragua. I will highlight the cases of these two developing countries. Why El Salvador and Nicaragua? Both countries have had similar histories, yet many times both countries have had divergent experiences with FDI. Both fought crippling and exhausting civil wars in the 1980s. Both have had a long, complicated and often troubled relationship with the United States. Both face the same political and economic difficulties, including the transition to democracy from civil war, the incorporation of a reactionary and guerrilla movements into the political process, and potential political pitfalls due to severe economic and political inequalities. Yet El Salvador's government has wholeheartedly embraced economic development, but controlled it in favor of its national elite. Nicaragua, on the other hand exemplifies a mix of wariness and openness to FDI, tempered by realities forced upon it. These differences in two otherwise seemingly similar countries make them interesting case studies for FDI policy.

Figures 5-1 and 5-2 show the values of the FDI Equity Index and FDI inflows for El Salvador. It can be seen that El Salvador shows a progression from more restrictive



FDI equity policies to more open from 1976-2004. While the overall amount of FDI as a percent of GDP has grown during that time, it has been characterized by mostly stagnant figures from 1976 to 1997, then a spike in 1998 due to a massive government privatization effort. From 1999 to 2004, FDI inflows have increased at an uneven rate. The increase in FDI inflows has matched the increase in FDI equity openness, but other factors have also contributed to the increase.

Figures 5-3 and 5-4 show the same data for Nicaragua. Like El Salvador, Nicaragua has shown an increase in FDI Equity openness. In fact, its policy change has been slightly more dramatic. FDI inflows as a percent of GDP fell dramatically from 1976 through 1980, when it reached zero. It stayed at zero or close to it up through 1991, and then began to rise rather dramatically from 1992 until 1999, when it began to



fluctuate through 2004. Some of the increase can possibly be attributed to policy change, but other factors will be considered and examined.

The Context for Comparison

El Salvador and Nicaragua for much of their histories followed similar political and economic paths. Both are rooted in the greater framework of the history of Latin America and particularly within the Central American region which gave them very similar early histories. Most of what is considered Latin America, save Brazil, was colonized by the Spanish in the 16th century, who carved out their colonies in areas originally belonging to indigenous peoples. These countries were rich in natural resources, which made them attractive for colonization, exploitation of those resources and abundant labor, and foreign investment. The arrival of Spanish conquistadors

brought Europeans and a political and economic system based on a hierarchical model. Later revolts for freedom from this system which tied the colonies to the mother country brought independence for most of Latin America, including the Central American region. Constant turmoil between different factions in Latin America contributed to the rise of military intervention in politics in many of these countries, Central America included. Today, Latin America continues to be an area of contrasts where abundant wealth exists next to extreme poverty, and where potential always seems to be around the corner.

In this vein, both El Salvador and Nicaragua began life as Spanish colonies with the purpose of providing wealth for the growing Spanish empire. Both countries gained independence after elite creoles began to chafe under the top-down, autocratic demands of the distant Spanish government, and both put into place republican forms of government, albeit representing only the elites, tied into an ideal vision of a unified Central American federation. As I will explore in more depth, both countries gave up their republican representative governments in the 1930s and for the next few decades were ruled by governments dominated by the military. The rise of a great number of civil groups in the 1960s led to greater political conflict throughout the 1970s, which led to devastating civil wars in both countries during the 1980s. Following the civil wars, both El Salvador and Nicaragua opened their political systems, implementing democratic forms of government and involving a wider spectrum of their populations in the political process.

Much of their economic histories have also been similar. Both countries have a long history of dependence on agriculture as the primary commodity for export,

particularly after coffee was introduced in each country in the 1840s. This cash crop helped define the power structures through land ownership in each country, setting the basis for future political conflict. It also made each country attractive to foreign trade and investment. Trade and investment in coffee led to the integration of each country into the world economy in the early 20th century, and each country set out on a course of industrialization. However, the inequities in land ownership in each country caused similar problems of poverty and underdevelopment and set the seeds for future political conflict.

Despite all these similarities, many questions can be asked. Why do El Salvador's and Nicaragua's policy changes look remarkably similar? Why do both countries have stagnant or moribund growth in FDI as a percent of GDP from 1976 through 1990? Why does Nicaragua's growth in FDI as a percent of GDP rise much more rapidly than El Salvador's? The graphs do not reveal the differences in how El Salvador and Nicaragua came to view and establish policies toward foreign direct investment, particularly during the 1980s. These differences were political, and involved both domestic level and international level factors, which influenced not only how each country viewed development but also how they put into place development strategies, including FDI.

The first difference that influenced the trajectory of FDI policies in each country, especially throughout the 1980s, was the domestic political environment leading up to the civil wars in each country and the subsequent way the civil wars played out. In the case of El Salvador, economic conditions combined with an awakening of civil society on the left, leading to military repression and an eventual rise of radical left-wing guerilla

groups bent on overturning the political and social order. However, the government continued to be run by the military in league with the right wing, and economic goals remained the same. These economic goals ensured that El Salvador's FDI policies remained relatively open in comparison with other countries in the region, thus allowing El Salvador to rebound in investment after the end of the civil war.

In Nicaragua, however, similar conditions led to radical left-wing groups taking political power away from the personalistic rule of one man, Anastasio Somoza, who operated independently from societal groups but whose actions often benefitted the elite. Upon taking power, the leftist Sandinistas passed policies to implement their own agenda and erase most vestiges of the Somoza past. Their agenda was at first one of restriction of FDI, but changed toward openness as economic realities became more apparent. These policies of openness, however, did little to enhance Nicaragua's attractiveness to international firms during Sandinista rule. Foreign investment, while recently exceeding the level of El Salvador's as a share of the economy, was completely moribund during the civil war and has traditionally lagged behind that of its neighbor.

The second difference, which predates policy decisions from the 1970s onward (but has a great deal of influence on how each country viewed its potential place in the economic arena, on the international level and how firms viewed each country's attitudes toward foreign investment) is the relationship that they have with world trading and investment powers, particularly the United States. Whereas El Salvador has tied itself to the world economy and has had close economic and political ties with the United States, Nicaragua has had a difficult relationship with world powers, except

perhaps the Soviet Union during Sandinista rule, and its relationship with the United States has a long and troubled history.

Finally, the third difference between the two countries is the disparity in the relative strengths of each country's domestic economy. El Salvador, despite its devastating poverty and severe inequality, has managed to maintain the impression of a relatively high-performing economy friendly to foreign business. Nicaragua, suffering the same problems with poverty and inequality, has had a consistently underperforming economy which has tended to depress investment. Though both countries have low savings rates, high foreign debt, and have relied on foreign aid, Nicaragua suffers by comparison in these areas. These differences in economic performance and strength have also affected FDI policies in each country. I will examine each of these areas in detail below.

Political Environment, Civil War and FDI

How have domestic level political factors influenced the FDI policies in El Salvador and Nicaragua? In previous chapters, I demonstrated that domestic level political factors play a role in shaping FDI policies and in determining FDI inflows. This has been true for El Salvador and Nicaragua. In fact, both countries' similar political histories have led them on similar paths, but at times their political histories have diverged. This section will examine the two countries and the political structures that led to their civil wars, and contrast the FDI policies that emerged from these two paths. Despite the similar histories in the early 20th century until the late 1970s and early

1980s, the political structures begat very different civil wars, which in turn led back to similar policies for FDI in the present time.

El Salvador's political history after independence helped it craft a political structure that centered around two elite parties with opposing views on the economy. The conservative party, representing the traditional landed families, favored economic nationalism that kept economic and political power largely under their control. The liberal party was made up of merchants and business owners, favored free trade and openness to the world economy. In 1871, the liberal position won out, and El Salvador traded on the worldwide market, utilizing its comparative advantage in agriculture. The government intervened little in the economy, effectively ceding control of the market to the owners of capital.

El Salvador kept tariffs low to ensure a market for British- and, after 1900, U.S.-manufactured goods which, unfortunately, displaced locally made goods. El Salvador also took a large amount of foreign loans toward projects such as an unrealized canal and railroads which established the first of its foreign debts. However, an abundant supply of labor exceeded demand, and land consolidation by coffee barons and ranchers left many people landless or with too little land to allow them to subsist. Any form of organization was not permitted, and often brutally suppressed.

A turn of events occurred in the 1920s, when class-based organization led to the lower classes demanding a greater economic share in the wealth of the country. In 1931, a democratically elected president, Arturo Araujo, was overthrown in a coup on the grounds that he was unable to check the forces of popular uprising and his government was unable to deal with the effects of the depression. The army installed

Hernando Martinez as president and began formal rule of the country, which it did not relinquish for another five decades. In early 1932, aware of a pending popular uprising, the army arrested several leaders including Farabundo Marti (from which the rebel group turned present-day political party Farabundo Marti National Liberation Front, or FMLN, gets its name). The uprising fizzled except in the western provinces, where the army brought its full force to bear upon the peasantry. By many accounts the army killed upwards of 30,000 peasants (Taylor and Vanden 1982).³¹ The brutality of the “matanza,” or massacre, practically wiped out the country’s remaining indigenous population and effectively ended any more popular uprisings until the 1970s. It also cemented the army’s pre-eminent power in the country, and served notice that the country’s ruling institution had little desire to implement any reformist measures.

In the 1940s, El Salvador’s military government embarked on a program of industrialization, and by the 1960s, industrialization was in full swing, with foreign investment used to fund industrial goods produced for the Central American market. However, El Salvador’s old problem of severe economic disparity and a large rural landless population came back with a vengeance in the 1970s. New groups began to organize for greater economic and political rights, and were greeted with much repression. In 1980, El Salvador exploded into civil war. Over the next 10 years, the FMLN and successive military governments, followed by centrist and rightist civilian governments (under Napoleon Duarte and then Alfredo Cristiani) waged a battle to a virtual stalemate, with the FMLN controlling large tracts of the northern countryside and wreaking havoc on the U.S.-funded Salvadoran army (Thomas 1987). The inability of

³¹ Some estimates put this number lower, others higher. Fisher (1982) states “at least ten thousands...”. Little (1983) puts the number between ten and twenty thousand. Ching (1998) says estimates vary from between fewer than ten thousand to more than thirty thousand in a country with a then population of 1.5 million.

the government to fully defeat the rebels, despite large amounts of aid from the United States, which was alarmed about a second possible leftist takeover (after Nicaragua) in Central America, was punctuated by severe brutality committed by the armed forces. Events such as multiple disappearances of leftist leaders at the hands of government paramilitaries, the army massacre at the village of El Mozote, the murder of Archbishop Oscar Romero, and the slayings of six Jesuit priests at the University of Central America shocked the world and had repercussions for El Salvador's ability to attract trade and investment. Eventually, with both sides exhausted and with the end of the Cold War reducing the importance of El Salvador in the eyes of the United States, peace accords were ratified in 1992 allowing the FMLN to become a full-fledged political party. The FMLN took its place in the country's legislature as the second largest political party and the Constitution of 1983, originally drafted to serve as the basis of democratic rule in El Salvador, appeared to finally live up to its promise.

However, some say little has changed. Despite some arguments that U.S. policy to build up the right-wing ARENA party and install it in power resulted in the removal of the army from political relevance and cemented democratic institutions. But after two decades of democracy, the control of politics still largely rests with those allied with the most economically well-off in the country, though the FMLN holds enough power in the legislature to serve as a major impediment to ARENA legislative initiatives (Stanley 2006). In addition, leftist and alternative parties hold many local offices, leading to some tensions between federal and local branches of government. However, the FMLN has also faced crises within its own party, as reformers fight for more transparent and party rules based on a democratic process, while orthodox members try to defend their

power base (Manning 2007). Civil organizations are not as powerful as they once were, but can still muster enough mass protest to be heard and influence government policy, and are greatly aided by the FMLN's support of progressive social movements (Stansbury 2006). Crime, however, is a persistent threat to internal stability. Gangs run rampant in San Salvador and other larger cities, and the U.S. State Department reports that El Salvador has one of the highest homicide rates in the world.³² Crime may have future implications for El Salvador's stability, as a study shows that Salvadorans are more likely to support a coup in response to higher crime rates, or at least strong government measures inimical to democracy.

Nicaragua, in turn, followed a similar path in its early political development except for one important difference: the involvement of foreign countries in its political and economic affairs. Nicaragua's agriculturally based economy led to the rise of coffee as the largest agricultural export. This in turn also strengthened the Conservative party, which was backed by the traditional land-owning families, favored economic nationalism and the role of the Catholic Church in the political sphere, and the Liberal party which was in favor of greater international commerce. However, Nicaragua's status as the largest of the Central American states, its position straddling the isthmus from both the Caribbean to the Pacific, and geographical features favoring easy transit between the two bodies of water made it very important to foreign business interests who were interested in building a canal.

Seeking to take control of Nicaragua from the Conservatives, the Liberals invited a mercenary force under the leadership of American William Walker in 1855 to help them drive the Conservatives from power. Walker instead set himself up as monarch of

³² United State Department of State, http://travel.state.gov/travel/cis_pa_tw/cis/cis_1109.html

the country, which discredited the Liberals and, after a force invaded from Costa Rica with backing from both the United States and Britain, led to Walker's execution by firing squad in Honduras in 1960 and Conservative rule of Nicaragua until the 1890s.

The United States' concern over the Nicaraguan Liberal government's courting of Germany and Japan to build a canal in its territory, in direct competition to U.S. interests in Panama, led to U.S. Marines landing on Nicaragua's coast in 1912 and installing the Conservatives in power. For the next 21 years, the United States would continue to have troops on the ground to both guard its interests and keep the Liberals and Conservatives from fighting a civil war. A withdrawal was attempted once, but led to a larger intervention and U.S. oversight of the next two elections. Nicaraguan governments at this time tended to toe the U.S. line, even if the policies favored were against the interests of the Nicaraguan people. For example, Nicaragua gave the United States exclusive rights to build a canal in Nicaragua, even though the United States planned to do nothing of the sort. They simply were protecting their interests in Panama. The U.S. presence also led to civil strife, with a former general of the armed forces and member of the Liberal Party, Augusto Sandino, leading a home-grown resistance against U.S. occupation.

U.S. intervention also led to the establishment of the Nicaraguan National Guard, which was trained and at first commanded by the U.S. military. Upon leaving in 1933, the United States handed control of the National Guard to Anastasio "Tacho" Somoza. At the departure of the U.S. troops, Sandino ended his guerilla actions, but was assassinated not long after. It was rumored that Somoza was an architect of the plan to have Sandino killed because Sandino wished to maintain his own military force in the

area of Nicaragua that he controlled. Not long after Sandino's death, Somoza forced the president of Nicaragua out of power, and took the presidency for himself. The Somoza family would rule Nicaragua for almost 50 years. Anastasio Somoza was assassinated in 1956, but his sons assumed power, with full power going to the younger Anastasio "Tacho II" Somoza after his brother Luis died of a heart attack. According to Millett (2007, 466), the Somozas used control of the National Guard, manipulation of the Liberal Party and the image of a close alliance with the United States to maintain their power.

In the early 1960s, a small Marxist-oriented guerilla movement sprung up in opposition to the Somoza regime. The Sandinista National Liberation Front (FSLN) was not well armed or well funded and did not have many members. However, in the mid-1970s, the Somoza regime had fallen out of favor with important elements of the civil and economic leadership in Nicaragua, as well as the leadership of the United States. The Sandinistas, meanwhile, had begun to temper their Marxist rhetoric and started to reach out to moderate opposition members. A number of events, including the evacuation of Somoza to Miami for treatment of his heart, the murder of popular opposition newspaper publisher Pedro Joaquin Chamorro, and the successful FSLN capture of the National Palace, where they held a number of legislators and other government representatives hostage for two days while negotiating the release of many FSLN captives from prison and a half-million dollar ransom, convinced other Nicaraguans to oppose the regime more actively under the FSLN umbrella. Somoza was eventually forced from power in 1979, and the FSLN set up a revolutionary government composed of a nine-member directorate. The new government embarked

on a program of restructuring both the political and economic environments, starting with the nationalization of many of the business holdings of Somoza and his supporters.

The United States under Carter had worked very hard to both force Somoza from power and bring about a moderate government in his stead. Given the facts on the ground, the Carter administration offered tentative support to the new Nicaraguan government. This only lasted until Carter's defeat to Reagan in the U.S. general election of 1980. Upon assuming office, Reagan's administration, fighting the Cold War more actively, began to work both politically and economically to isolate the leftist Nicaraguan regime. On the economic front, the United States embargoed trade and influenced multilateral lending agencies to cut off Nicaragua's access to loans. The Nicaraguan government was forced to seek out funding from the Soviet Union, Cuba and their allies. On the political front, the United States poured aid into a group of ex-Somoza supporters, former National Guard and Miskito Indians that were angry at the FSLN-led Nicaraguan government for displacing a number of their people from their traditional lands. This group was labeled the Contras. When the U.S. Congress, unhappy with the Contras' progress and reports of their human rights violations, cut off funding to the guerillas, the Reagan administration used various backdoor means, including some illegal ones, to continue supplying the Contras. The United States also illegally mined Nicaraguan harbors, and conducted espionage within the country.

The civil war took a toll inside Nicaragua and affected both political and economic development. Despite the military and financial aid received from the United States, the Contras were not able to mount a challenge that seriously threatened the Sandinistas, but the need to fund the war diverted government funds away from social reform

programs that the Sandinistas had envisioned and hampered the economy. Inflation was rampant and almost unchecked. Despite the civil war and the moribund economy, the Sandinistas rewrote the constitution, and in 1984 were re-elected in an election boycotted by opposition groups. However, the war against the Contras and the slipping economy took its toll. In 1990, the Sandinistas and their charismatic president Daniel Ortega were widely expected to win election again, but in a closely watched contest monitored by international observers, a coalition of opposition parties called the UNO won, propelling Violeta Chamorro into the presidency. The new president and her allies, despite internal struggles among the disparate opposition elements, rolled back some of the Sandinista reforms and embraced neoliberal economic policies. Though the economy did not recover as well as was expected, inflation was brought down to more manageable levels.

Today, Nicaragua is once again under the presidency of Daniel Ortega, the Sandinista leader, re-elected after three election defeats to his opponents in the 1990s and early 2000s. However, Ortega has to contend with an opposition legislature and has further removed himself from his past embrace of Marxist principles. In particular, he has promised to maintain private property rights and continue to reach out to foreign investors.

What effects did these domestic civil wars and the politics surrounding them have on the development of foreign direct investment policies in Nicaragua and El Salvador? In turn, was there spillover from these domestic level events into each country's ability to attract foreign investment and reach agreement with international firms? Was overall investment affected?

In the case of El Salvador, domestic upheaval appears to have had some effect on the development of FDI policies. El Salvador has not historically received great amounts of FDI, though it has long had experience with foreign investors in its economy. In addition, its ability to receive foreign direct investment was inhibited by the civil war, and by a reliance on foreign and military aid through the 1980s that was funneled into fighting the FMLN insurrection.

Fighting the war and defeating the guerillas, not foreign investment, was first on the government's agenda throughout the 1980s. Foreign investment policies remained as they were before the civil war. In 1979 when opposition organization began to gain strength, and in 1981 and 1982, during the first years of the civil war, El Salvador showed negative inflows of FDI as capital fled the country. Through subsequent years until 1997, its FDI inflows never rose above around \$48 million (constant 2000 U.S. dollars) despite the end of the civil war in 1989, and the adoption of a number of policies at the war's end designed to stimulate foreign investment.

For example, the Foreign Investment Development and Guarantee Law, adopted in 1988, offered 10 year tax exemptions on income taxes to firms exporting 25 percent of their non-traditional products, and a 10 year duty exemption on machinery, equipment and raw materials. Foreign companies in the industrial sector were given unrestricted remittances of net profits, while those in the commercial and service sectors were granted remittances of profits up to 50 percent of registered foreign capital. Other incentives were permission for foreign investors to establish U.S. dollar accounts and use them to obtain local financing, and unrestricted remittance of funds from liquidation, royalties and fees for use of foreign patents.

Two years later, the 1990 Foreign Investment Promotion and Guarantee Law offered unrestricted remittance of profits and return of capital. The Export Reactivation Law and the Free Trade Zone Law, both adopted the same year, granted additional benefits to exporting firms such as a total exemption from the stamp tax, a number of rebate opportunities, and additional fiscal incentives to companies operating in free trade zones. However, El Salvador continued to maintain strict controls on foreign banks, and foreign investment was still prohibited in key utilities and in foreign exchange houses.

FDI policies and foreign investment inflows have been influenced by the end of the war and the integration of the former leftist guerrillas of the FMLN into the political process. In 1992, after more than a decade of civil war, El Salvador's warring factions signed peace accords, integrated the FMLN into the political process, and paved the way for fair and free elections. The 1994 elections were roundly hailed internationally as fair and free, with the right-wing ARENA party gaining the most seats in the Assembly and also gaining the presidency, but with the FMLN establishing itself as a true opposition party. In subsequent elections, the FMLN gained strength. To this point it has never gained the presidency of the country, but it currently holds more seats in the Assembly than any other party. The presidency, however, is held by the ARENA party, and with its smaller party allies in the Assembly is able to pass important legislation.

While the process appears to be more democratic than during and before the civil war, there are some questions about the nature of El Salvador's democracy. Is El Salvador truly a democracy, or do the trappings of elections conceal something less

than democratic? And how has this apparent democratization of the country affected its policies and its investment status?

Let us look at the second question first. Since 1997, Freedom House has rated El Salvador as “free” despite some misgivings about various aspects of its political and economic situation. It cites, among positives, the right to freedom of association, academic and religious freedoms, a decline of human rights violations, and its recent history of free and fair elections. It cites concerns with corruption, crime, and occasional discrimination against women. Additionally, the Polity IV project has rated El Salvador as six and presently a seven on its ten point scale of democracy, indicating that El Salvador has more work to do if it is to reach a status as a strongly democratic country.

Yet questions remain about the strength of El Salvador’s democracy. While El Salvador has a basis of strong institutions that can sustain democracy, some important institutions that are important for democratic development, such as the judiciary, are perceived as lacking independence from the government and are not highly regarded by the people (Dodson and Jackson 2004). In addition, El Salvador lacks a political center in its Assembly, and power is split fairly evenly between the ARENA party and its allies and the FMLN. Without any strong centrist parties to moderate, stalemate in Assembly often occurs. This polarization extends down into civil society, with strong groups on the right and the left supporting the parties that ideologically agree with them.

Barnes (1998) argues that this polarization has created a democratic deficit in El Salvador. In particular, Barnes laments the absence of a center-left party, which he argues would blunt the more radical vision of the FMLN and create more areas for compromise. Without such compromise, El Salvador has been left with years of a ruling

right-wing that is stymied by an obstructionist left, and as has been occurring, a lack of interest in the polls at election-time. However, he sees promise in El Salvador's attempts to create democracy because of certain institutional structures, such as an efficient transportation system and a relatively high education rate, that make the possibility of a real democracy within reach.

In terms of the economy, these conditions tend to create two very different views of development in the country, with little common ground between them. In addition, most money for development projects from outside the country, particularly the United States and international institutions, tends to flow through groups aligned with those on the right. Development from the right tends to focus on a top-down approach, with those with economic and political power (often the same people) deciding what is best for the country's development. Left-oriented development tends to get its impetus from community involvement and participation, but is difficult to implement because of a lack of funding, though some does come from European sources (Foley 1996).

There are differing opinions in the country, particularly on the left. One observer, Dr. Salvador Árias, an economist and a member of the Assembly with the FMLN, argues that El Salvador is not a democratic country, because it doesn't have a "real" process for transferring power and that there is little separation between the mechanisms of state under the present ruling ARENA party. He added that the current government and those on the right tend to favor the quick attraction of foreign investment.³³ Dr. Guillermo Ramirez Alfaro, an economist at San Salvador's Technological University, says that democracy has no effect on foreign direct investment policies. He cites three other factors, El Salvador's lack of resources, a lack

³³ Interview with author, 7 June 2007.

of political stability, and the absence of a unitary economy to use investments toward development, as more important.³⁴

However, Roberto Góchez, an economist at the University of Central America, points toward political factors as having an influence on the government's stance toward FDI. The rightist government, according to him, is in the process of opening to FDI and deregulating and has made an agreement to take any investment disputes to international courts. He says El Salvador has already lost a case in international tribunals pertaining to electricity distribution.³⁵ Dr. Álvaro Trigueros of FUSADES, a non-profit think tank in San Salvador, asserts that the arrival of democracy signaled the arrival of El Salvador's new economic model, developed by FUSADES and similar to the Chilean model.³⁶ And Juan Carlos Rivas Najarro, of the Ministry of Economy of El Salvador, argues that the peace treaty with the FMLN, their entry into the political system and the current balance in government has helped foreign investment. El Salvador, he points out, has the lowest savings and loan interest rates in Central America, and provides enterprises with the macro-economic stability they need.³⁷

The large scale studies in Chapters Three and Four indicated that nationalism has an effect on FDI, with nationalism positively related to FDI inflows as a percent of GDP. For El Salvador, nationalism is only just beginning to play a part in domestic politics with the acceptance of the FMLN into the political system. The governments that have ruled El Salvador, military, centrist and right wing, have tended to be outwardly oriented in terms of trade and investment, but reserving most of the benefits of the economy for the wealthy class at the top of the economic pecking order. In many

³⁴ Interview with author, 25 May 2007.

³⁵ Interview with author, 1 June 2007.

³⁶ Interview with author, 30 May 2007.

³⁷ Interview with author, 29 May 2007.

ways, El Salvador resembles the tripartite alliance so well described in Evans (1979) between state, local outwardly oriented elites and international business. With the addition of the FMLN to politics, however, and the possibility that they will one day take power, nationalist rhetoric has begun to be heard in the halls and chambers of the assembly with discussions of reducing ties to foreign investment and increasing protections for national businesses. While nationalism has not played a part in El Salvador's economy since 1976, there are chances that it could in the future. If the predictions of the model studied here are correct, that may actually increase FDI in El Salvador in the long run.

Do domestic political factors have an effect on foreign direct investment policies and on actual investment in El Salvador? It depends on who is commenting. The conclusions appear to suffer from the same polarization as the politics in the country. The right wants to tout its economic successes, and points toward democracy and its own policies as important keys in the development of El Salvador. Right-of-center commentators say that the government is more open to FDI, and point to its privatization programs and its open policies. They paint the left as being hostile to foreign investment. They argue that the left does not care about the business environment. They argue that the left sees multinational corporations as evil, and therefore will tax larger businesses, regulate foreign investment and create disincentives for economic development. The left paints a picture of the emperor having no clothes. They argue that the Salvadoran government has given away everything to foreign multinationals which enter El Salvador, but contribute very little to the development of the economy. They argue that FDI must contribute more than just quick

profits to the wealthy. They envision a greater role for the state in deciding the country's economic future, including making investments in its own social programs.

This debate in El Salvador of whether the state or the private sector should be in charge of development and even basic services is a very hot issue – recently, demonstrations broke out when the government announced that it was privatizing the water system of the town of Suchitoto. Some members of the non-governmental organization CRIPDES were arrested while driving to a demonstration protesting the privatization of the water system in the town of Suchitoto and charged with acts of terrorism carrying possible sentences of 60 years (Mezzacappa and Towarnicky 2007). The debate will only get stronger in the coming year. In 2009, the presidency of ARENA party president Antonio Saca will come to an end. For the first time, the FMLN has united around a candidate that does not hail from the party's guerrilla old-guard. Their candidate, Mauricio Funes, is an early favorite for the presidency with a 75 percent approval rating.³⁸ The ARENA party does not appear to have united around a cohesive candidate at this time. If Funes wins the presidency, it will test the right's commitment to democracy, and possibly mark the first time since the 1930s that the country will peacefully transfer power to the left. Should that happen, there could be implications for FDI, perhaps even a movement away from FDI as a development strategy, as has happened recently in other Latin American countries, such as Venezuela, Ecuador and Bolivia, where the left has gained power. However, it will also mark a turning point in El Salvadoran politics. Whichever side is in power should have a significant impact on the policies and inflows of FDI in the future El Salvador.

³⁸ Bulletin 22(2), University Institute of Public Opinion (IUDOP) of the University of Central America. The text of this bulletin can be found at <http://www.uca.edu.sv/publica/iudop/Web/2007/Boletin-2-2007.pdf>

Like El Salvador, the story of Nicaragua's investment policies and foreign investment performance involves a civil war and an opening to FDI following the war's end. From 1936 until 1979, Nicaragua was under the personalistic rule of the Somoza family, which suppressed democratic forces within the country and ran the economy as if it was their personal estate. Under the Somozas, whose politics were right-wing and centered on a Nicaraguan nationalism limited to themselves and their friends and allies, the government pursued state-led industrialization with the Somoza family's hand in practically every business venture. The Somozas cultivated ties with the United States and other foreign aid donors. They also courted U.S. businesses, and most likely dealt with them like they dealt with any business – granting favors in exchange for personal gain. In the 1970s, the Somozas began to expand their holdings in domestic agriculture and industrial activities, crowding out other Nicaraguan businessmen. According to an article in *Business Week* (1978), one American businessman operating in Nicaragua put it very succinctly, commenting that "...you just don't do business here without offering the general a share in it from the beginning."

In the 1970s, Nicaragua, like many other Latin American countries, followed the import-substitution-industrialization model of development, and its foreign investment policies of the time reflected its goals. In 1976, under the Somoza regime, Nicaragua actively promoted itself as an offshore assembly location for foreign corporations, and established free trade zones to lure foreign companies. Nicaragua offered generous incentives in the free trade zones, including duty exemptions on imported machinery, tools and parts, unlimited raw materials imports, exemptions from income taxes on profits from exports, and special concessions for businesses that made commitments

for 10 to 15 years (Exporters Encyclopedia 1976). However, the Investment Law of 1955 did not specify that 100 percent foreign ownership was allowed, and the Somozas and their allies controlled or had a hand in the majority of the country's economic activity.

In 1979, the Somoza family was forced from power by the Sandinista National Liberation Front (FSLN). The FSLN was one of a number of groups that had arisen to oppose the Somozas after the 1972 earthquake, when a massive outpouring of aid from the developed world was pocketed by the Nicaraguan leader. In 1980, the new Sandinista government nationalized all Somoza family holdings and any abandoned businesses were claimed by the state. The Sandinistas also declared that Nicaragua's natural resources were also property of the state. The following year, the government nationalized the sugar industry and also export-commodities such as rum and instant coffee. The government also announced a takeover of any idle land of over 349 hectares in key states and unused land of over 698 hectares elsewhere. Even though the government wanted to maintain the impression of free enterprise in Nicaragua, as late as 1988 the government was taking over private businesses (Kinzer 1988).

The Sandinista uprising eliminated the corrupt Somoza era government. Originally tied to Marxist doctrine, the Sandinistas softened their stance to win more allies to their cause in the last few years of the Somoza regime. One view is that the FSLN wanted to prioritize the needs of the working class, while still allowing for capitalism and the free market (Roche 2006). Regardless, their ascent into power changed business as usual and led the Reagan administration, worried about Soviet and Cuban influence, to put economic pressure on the country. Despite their nationalist

language regarding the economy before they came to power, the Sandinistas tried to calm foreign investors. “The Nicaraguans, who realize that the smartest thing in the world for them to do is act responsibly, have been making their payments on time,” stated an American businessman (Gilpin 1983). To get around the U.S. economic pressure, the Sandinistas also attempted to diversify their trading sources, according to the same article, by opening up to greater economic relations with Cuba and the Soviet bloc.

Regardless of their leftist orientation and their nationalist rhetoric, the Sandinistas appeared to realize early that they could not simply jettison their ties with foreign corporations. Despite the Sandinista expropriation of businesses formerly owned by the Somoza family, the government planned to maintain a private sector, and allow foreign investment on a controlled basis with guarantees against state takeovers (*Economist* 1979). Nicaragua, faced with negative growth and declining domestic investment for the first time since the Sandinistas took power and desperate for foreign investment and bank credits, took action to try to make the country more attractive to foreign investors (*Business Week* 1983). In an effort to stimulate private Western investment and address a lack of confidence in the economy, the Sandinistas struck a more moderate tone after the 1985 elections (Volman 1985). They openly courted FDI and trade, but foreign nations and companies exercised caution (Adkins 1985b). The United States, due to its fears of a communist takeover in Central America leading to a Soviet foothold, openly discouraged any type of investment in the country and in 1985 set up a trade embargo against the country. This did not completely dissuade trade with Nicaragua. As the only Central American nation that was a member of the General Agreement on

Tariffs and Trade (GATT), the precursor to the World Trade Organization, Nicaragua pushed for hearings at that international body to discuss the legality of the U.S. embargo and openly courted European, Canadian and Eastern bloc trade (Foster 1985). In 1985, trade with the Soviet Union tripled (Shabad 1985). Despite the caution, foreign companies, including American firms, that were already established in the country did not leave. A partial list of foreign companies doing business in Nicaragua in 1985 includes Exxon, IBM, Monsanto, and Nabisco. A spokesman for IBM declared that the company had “no complaints about doing business in Nicaragua” (Adkins 1985a).

Under the FSLN, the foreign investment law was overhauled in 1987 for the first time since 1955. The Sandinistas did not bother to change the most basic laws regarding foreign investment but appeared to make individual deals, and negotiate individual incentives, with foreign corporations. In 1987, 100 percent foreign ownership was allowed in some areas, a degree of ownership not even set in law under the Somozas. Notwithstanding their efforts, the Sandinista takeover caused a complete halt to foreign investment in Nicaragua.³⁹ From 1980 to 1991, figures from the World Development Indicators show that except for 1990, when about \$880,000 of inflows were recorded, no new foreign investment came to Nicaragua – literally, the entries for foreign direct investment inflows in dollars and in percent of GDP from 1980 -1989 and 1991 show absolutely zero FDI inflows. The Multinational Monitor, a publication of the Multinational Resource Center, documented the difficulties of the Sandinista government in convincing foreign capital to invest in the country. Charles Roberts (1980) writes of the Sandinistas’ cautious attitudes toward foreign investment due to

³⁹ Source: World Bank's World Development Indicators.

past experience where, under Somoza, foreign investment mostly produced luxury goods with high import contents, and where the government made no effort to harness any returns from foreign investment for the country's development through taxes and regulations. Foreign banks were viewed with particular suspicion by the Sandinistas because they kept Somoza supplied with capital and, as his political opposition increased, he borrowed more heavily to keep himself in power. The Sandinista government envisioned at that time a mixed economy, with more controls on FDI.

That mixed economy never came to fruition under their rule. In 1990, the Sandinistas lost the elections, and the new government moved quickly to enshrine free market policies in law. The unexpected victory of the coalition of anti-government parties called the National Opposition Union (UNO) in a tightly fought, free and fair election brought the first trappings of full democracy to Nicaragua and a moderate government into power under Violeta Chamorro, but it proved incapable of turning around the economy. The government embarked on a campaign of privatization of state-run companies, opening the doors to trade and investment and receiving a resumption of trade and aid from the United States. Successive governments drifted farther to the right, but also proved unable to solve Nicaragua's economic woes. One administration, led by President Arnoldo Aleman, was so corrupt that he was arrested under the administration of his hand-picked successor, Enrique Bolanos.

By 1992, a new law on foreign investment had been passed that allowed 100 percent foreign ownership in most areas except telecommunications, energy, insurance, water and sewage and a few other small sectors. 100 percent remittances of profits were allowed. While the new government did not give explicit incentives for investment,

they did provide for dispute settlement through arbitration, specified no export requirements, and began a privatization process for government-owned agencies where foreign bidding was allowed. In addition, Nicaragua began opening new free trade zones, both public and private.

The return of Daniel Ortega to the presidency may signal a leftward shift in the country in keeping with trends in many other countries in Central and South America. Unlike before, the Sandinistas do not control the legislature, and so Ortega will have to deal with a hostile Congress. Ortega has toned down his former Sandinista rhetoric. After his 2007 election, he was quoted as saying that the launch of a \$35 million venture capital and private equity fund by Latin American Financial Services (Lafise) "...is one more step that proves we are committed to respecting private property and foreign investors and that we are a government of reconciliation and national unity" (Repo 2007). He does not sound like a revolutionary Marxist.

In the long run, FDI policies and inward FDI flows were both affected somewhat differently by the domestic political upheaval. Both countries took slightly different paths to greater FDI openness. The military government in El Salvador first relied on import-substitution-industrialization until the civil war. Once the civil war started, it placed prime importance on defeating the guerillas. Its path to FDI openness did not start until the conclusion of their civil war, when development began to be a concern again. The Salvadoran government has managed to push through legislation since the early 1990s that has been friendly toward foreign investment, but it faces a strengthening left that is very skeptical and wary of the influence of foreign corporations and their presence in the Salvadoran economy. And while FDI has been increasing slowly, particularly because

of privatization efforts initiated by the Salvadoran government, the threat of political instability and rising problems with gangs and crime continue to inhibit investment. In addition, competition from other nations both within and outside the region makes it more difficult for this small nation to make itself noticed.

Nicaragua's FDI policies were very affected by domestic political factors and its civil war. The Somozas treated the Nicaraguan economy as their personal business, and limited foreign investment inasmuch as they could profit from it. The Sandinista takeover brought in a government that had a Marxist and nationalist view of the economy, but which had also inherited the economic mess left by the Somozas. These hard facts first encouraged the Sandinistas to look to the Soviet Union, and when the Soviets were unable to provide much in the way of economic aid and investment, to try to develop any way possible. Therefore, Nicaragua began to open to 100 percent foreign equity ownership during its civil war. These policies were a product of a government trying to balance a need for development with wariness toward foreign influence, and all in the face of a hostile guerilla movement funded by one of the most powerful nations in the international arena. However, these policies had little initial effect on FDI, and Nicaragua only saw increases after the Sandinistas were ousted from political power and its successors brought even more openness to the economy. By that time, Nicaragua had lost its strategic value because of the end of the Cold War, and like El Salvador, it must now compete for FDI. With foreign investment rising, Nicaragua must convince investors that its democracy is stable and that it can control corruption.

The International Arena and FDI

The domestic political arena was not a solitary influence on FDI policies and inflows in El Salvador and Nicaragua. Each country has a place in the international environment. The relationships that each has forged, the institutions that they have joined, and other aspects of the international arena also have an influence on the development of FDI policies and the willingness of firms to consider El Salvador and Nicaragua for investment. In particular, the relationship each country has had with their closest superpower neighbor, the United States, has made a large difference in how each country has created its policies. For the decade of the 1980s, each country's relationship with the United States was profoundly different, and their policies were as much a reflection of that relationship as they were a product of the political realities within each country.

The first factor to be considered is the effects of international institutions on FDI policies and FDI inflows, examining El Salvador's and Nicaragua's relationship to five international institutions with FDI as a focus. These institutions are the International Finance Corporation, the Multilateral Insurance Guarantee Agency, the World Trade Organization, the International Center for the Settlement of Investment Disputes, and the World Intellectual Property Organization. Another factor for these two countries is their proximity and relationship to the United States.

El Salvador has experience with both. While not contiguous with the United States or its economic zones, El Salvador endures political and economic pressure from its neighbor to the north. Since around 1900, the United States has exerted profound political and economic influence in Central America, including El Salvador, directly and

indirectly affecting its development. The United States has been a source of foreign and military aid, the latter coming especially during El Salvador's civil war and during the civil war in neighboring Nicaragua. Edwin G. Corr, former chief of mission to El Salvador, lists a number of reasons the United States was concerned about the civil war in El Salvador, including that Nicaragua's Sandinista government was backed and financed by the USSR and Cuba, and that the El Salvadoran FMLN was trained and financed by Cuba and supported by the USSR and Nicaragua. He argues that one of the reasons El Salvador's conflict became, in the words of an FMLN participant, "the first revolution in Latin America won through negotiation," is because the United States supported a moderate government in El Salvador, supported efforts to consolidate democracy in the country, worked to end human rights abuses, and foster the country's economic growth (Corr 1995). He glosses over the very high amounts of United States military aid to El Salvador to defeat the FMLN guerrillas. This military aid grew from \$10 million in 1980 to \$283 million in 1984, and total United States military and development aid to El Salvador between 1980 and 1988 totaled \$3.9 billion (Pearce 1998). While many left-of-center commentators would dispute Corr's version of the United States' efforts, he highlights the important role the United States played during the civil conflict and in El Salvador's development strategies. Indeed, some El Salvadoran nationals I spoke with informally in the country are convinced that if the Salvadoran people elect a government headed by the FMLN, the United States will invade, or at least use the CIA to overthrow it, given the United States' close ties with the right-wing ARENA government. Suspicions of the United States and its ability to influence events in El Salvador obviously still run high.

The United States has had an important role in the El Salvadoran economy through its Caribbean Basin Initiative (CBI), which grants preferential, duty free entry to products manufactured in El Salvador and other regional countries. The Central American Free Trade Agreement (CAFTA) has replaced CBI with tariff-slashing across the board. CAFTA has caused much debate in both El Salvador and in the United States. In a talk with a delegation of students in San Salvador in May of 2007, César Villalona, a left-leaning Salvadoran economist, said that CAFTA promised four things: more El Salvadoran exports to the United States, facility for greater foreign investment in El Salvador, more jobs in El Salvador, and lower prices. He rated the first year of the agreement in terms of those four promises. In 2006, he said, exports to the United States from El Salvador went down 2.5 percent because of diminished exports from the maquiladora sector and greater competition from China. Coffee, sugar and ethyl-alcohol exports went up slightly, but imports from the United States increased by five percent, thus increasing the trade deficit with the United States. Foreign investment went down sixty percent from 2005-2006, from \$517 million dollars to \$204 million dollars, though U.S. investment in El Salvador rose by \$10 million dollars in 2006. To compare, he said Costa Rica, which has signed but not implemented the agreement, gained \$1.6 billion in foreign investment. Villalona said that prices increased in El Salvador after CAFTA was signed, and unemployment increased also.⁴⁰

People I interviewed on the left say that CAFTA has damaged El Salvador's ability to compete as it must against larger countries in the region such as Mexico and the United States, and has even hampered El Salvador's ability to compete out of its

⁴⁰ This statement by Villalona has an imperfect fit with the data. While the urban unemployment rate rose from 6.5 percent to 7.3 percent from 2004 to 2005, it fell to 5.7 percent, according to the Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean 2006*. There were many job losses in the maquiladora sector, however.

region against countries like China.⁴¹ One self-described centrist said that El Salvador needs integration with other Central American economies, but not through CAFTA.⁴² Interviewees on the right did not specifically mention CAFTA, but pointed out how much El Salvador has opened its markets and focused on free trade and how these measures would help El Salvador's economy overall.⁴³

Various international institutions also exert a fair amount of influence over El Salvador's fortunes. Pearce (1998) identifies a number of ways in which, post civil-conflict, the international community uses its authority to sway El Salvadoran policy. The United Nations was instrumental in monitoring the peace accords and helping parties move through hurdles and roadblocks. The World Bank and other economic institutions have supported Salvadoran policies toward economic adjustment, stabilization and growth. The World Bank has considered and funded 48 projects in El Salvador since 1949, of which six projects are currently active. Those projects include a land-tenure administration project, an environmental management program to increase sustainable conservation and use of El Salvador's ecosystems and forests, a judicial modernization project, an earthquake emergency reconstruction project, a project for biodiversity in coffee growing areas, and a technical assistance project for public sector modernization.⁴⁴ However, World Bank structural adjustment programs may have hurt El Salvador's post-war economy (Paris 1997). In particular, they limited El Salvador's public expenditures, which constrained its ability to fund its peacebuilding programs, compromised the government's social services, and may have even lead to a recession.

⁴¹ Interviews with Salvador Árias, 7 June 2007 and Roberto Góchez, 1 June 2007

⁴² Interview with Guillermo Ramirez, 25 May 2007

⁴³ Interviews with Juan Carlos Najarro, 29 May 2007 and Alfaro Trigueros, 30 May 2007

⁴⁴ World Bank, <http://web.worldbank.org>

Whether the World Bank helped or hindered El Salvador's economy, its ability to influence policy is clear.

Private sector enterprises in El Salvador can receive investment from the International Finance Corporation (IFC), a program of the World Bank. El Salvador has been a member of this organization since 1956. The IFC's stated goals are to promote sustainable private sector development, address constraints to private sector investment in infrastructure and social services like health and education, and developing financial markets. Since 1995, the IFC has invested in sixteen projects in El Salvador, including a \$30 million revolving credit account for Taca Airlines to make pre-delivery payments on new Airbus A-320 airplanes, a \$25 million corporate loan for the establishment of a new MetroCentro shopping mall in San Salvador, and two loans of \$45 million and \$65 million to help fund an AES (a U.S. energy company's) project to upgrade rural electric distribution networks. One attractive aspect of the IFC's funding is that it does not demand any repayment guarantee from the government. However, it too exerts an influential position on government policies and investment inflows. Not only does its financing help establish the validity of investment projects, but it also offers a range of advisory services that include prescriptions for simplifying business regulatory structures.

El Salvador became a member of the Multilateral Investment Guarantee Agency (MIGA) in 1991, which helps guarantee foreign investment projects from political risk. In 2006, MIGA provided \$1.8 million in guarantee coverage for a project by a Canadian biothermal company, Biothermica Energy, Inc., which looks to capture methane gas at a municipal waste dump in San Salvador, and a \$3.15 million guarantee to a Costa Rican

company, Corporación Interfin S.A., which looks to expand its leasing portfolio in El Salvador. These guarantees provide the companies with insurance against risk, such as transfer restrictions, expropriation, and war or civil unrest. Other coverage was provided in 1996 to Citibank and in 1992 to AVX Corporation. MIGA also provided El Salvador with technical assistance from 2000-2005 to develop and restructure the PROESA investment promotion agency.

There appears to be a two-way relationship between MIGA and its member countries. For example, in El Salvador, MIGA's coverage and technical assistance are a result of FDI policies that meet MIGA's approval that have been passed by El Salvador's government. Yet, MIGA assists El Salvador, in terms of the PROESA, for example, in implementing its policies and even redefining them. In addition, MIGA influences policy by holding countries accountable to minimum standards by investigating and sanctioning countries that engage in corrupt or fraudulent practices when dealing with foreign investors. Such a membership has another effect. It makes foreign investors more confident in El Salvador, and more likely to invest there.

Since 1984, El Salvador has belonged to the International Center for the Settlement of Investment Disputes (ICSID), which was established by the Convention for the Settlement of Investment Disputes between States and Nationals of Other States. The ICSID serves as an aid to member states when they or their members have an investment dispute with foreign investors by offering a location and resources for arbitration. The arbitration is judged by representatives of other member states, who are not party to the dispute. While the member states are not required to use the ICSID, once the case is submitted to the ICSID the member states must see the

arbitration through and abide by the decision that is rendered. How does this relate to FDI policy and FDI inflows? Individual country policy must allow for the dispute mechanism to be used. In the case of ICSID, this dispute mechanism is initially voluntary. To date, El Salvador has concluded one case in 2004 using the ICSID, *Inceysa Vallisoletana S.L. v. Republic of El Salvador*. In that case, an award was rendered to the company. El Salvador currently has no pending cases with the ICSID.⁴⁵

This form of dispute arbitration is increasingly being written into regional and bilateral trade and investment agreements. The North American Free Trade Agreement (NAFTA), for example, removes investor-state disputes from national courts and resolves them by arbitration. Similarly, the newly signed Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) does the same. In fact, in 2007 Guatemala was sued by the Railroad Development Corporation (RDC) for “an indirect expropriation of [RDC’s] assets and direct interference with its contractual rights.”⁴⁶ This action was believed to be the first to invoke Chapter 10 of the CAFTA investor-state dispute resolution process, and it takes the Guatemalan courts out of the resolution of the dispute. For investors, the dispute arbitration process gives assurance that the decision will not be decided in national courts, where nationalist tendencies may hold sway. Rather, an impartial international panel will make a decision, and these decisions will have the force of law in many countries because, as in the case of El Salvador, international treaties supersede domestic law.⁴⁷ However, national courts are often the only way for local groups affected by these disputes to be heard. International

⁴⁵ ICSID website, <http://www.worldbank.org/icsid/cases/conclude.htm>

⁴⁶ From Press Release issued 13 March 2007 by Greenberg Traurig, LLP, as posted on MarketWire: <http://www.marketwire.com/mw/release.do?id=723395&k=rdc>

⁴⁷ United States Trade Representative, “2006 National Trade Estimate Report on Foreign Trade Barriers: El Salvador”: http://www.ustr.gov/assets/Document_Library/Reports_Publications/2006/2006_NTE_Report/asset_upload_file785_9242.pdf

arbitrators often do not hear the concerns of these groups and therefore those concerns are not included in the decisions of the panels. Regardless, those countries that allow international panels to act as the law, at the expense of their own sovereignty, have enhanced reputations in the eyes of foreign investors as being friendly to business.

El Salvador has been a member of the World Intellectual Property Organization (WIPO), a specialized agency of the United Nations, since 1979. Intellectual property is defined by WIPO as creations of the mind, and these creations are classified into two categories: industrial property, which includes inventions, trademarks, designs, and geographic indications of source; and copyright, which includes literary and artistic works and architectural design. WIPO exists “with a mandate from its Member States to promote the protection of IP throughout the world through cooperation among states and in collaboration with other international organizations.”⁴⁸ WIPO has five core goals, among which are: to promote an intellectual property (IP) culture; to integrate IP into national development policies and plans; and to develop international IP laws and standards. This organization, therefore, not only has a mandate to promote and encourage policies within member countries but also brings the force of the international community and its opinions and mores to bear. In addition, developing countries that sign regional agreements, especially with developed countries, may need to accede to intellectual property requirements. The CAFTA agreement requires its member states to enforce intellectual property agreements agreed upon in previous international agreements, including WIPO.⁴⁹ Countries like El Salvador take these agreements seriously in order to be seen as investor friendly. While I was in El Salvador in May of

⁴⁸ “What is WIPO, from the WIPO website: http://www.wipo.int/about-wipo/en/what_is_wipo.html

⁴⁹ DR-CAFTA Agreement Text, United States Trade Representative website: http://www.ustr.gov/assets/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/asset_upload_file934_3935.pdf

2007, El Salvador cracked down on pirated CDs and DVDs sold by small vending stalls in its market area in downtown San Salvador, causing a riot that led to the arrests of a number of individuals. President Antonio Saca later announced that the arrested rioters would be tried under the anti-terrorism law.⁵⁰

In 1995 the World Trade Organization (WTO) was formed, building on its predecessor, the General Agreement on Tariffs and Trade (GATT). A number of agreements addressing intellectual property were already in force, such as the Paris Convention for the Protection of Industrial Property dating from 1883, the Berne Convention for the Protection of Literary and Artistic Works dating from 1886, and the World Intellectual Property Organization dating from 1979. The Uruguay negotiating round that brought the WTO into being addressed areas that were inadequately covered or not addressed by previous agreements. The WTO Agreement on Trade-Related Aspects of Intellectual Property Rights, or TRIPs, was part of the final agreements of the Uruguay Round. El Salvador ratified the agreement in 1995.

The TRIPs agreement expects that governments will both have intellectual property laws, and also enforce those laws. The agreement gave time limits to governments that signed it allowing them a period of years in which to phase-in the proper laws, and additional time for those countries that needed it to deal with specific difficulties that might occur because of immediate deleterious effects of intellectual property legislation. In this way, the WTO agreement influenced, and continues to influence, policy in developing countries. Force of world opinion is important. Those countries that take the necessary step to pass and implement legislation on intellectual

⁵⁰ Committee in Solidarity with the People of El Salvador, 15 May 2007, "*Actúe para poner alto al apoyo de EE.UU. a la represión en El Salvador*": http://www.cispes.org/index.php?option=com_content&task=view&lang=es&id=201

property, and enforce those laws in a timely manner, are seen to be friendly to investment. In a country like El Salvador, where the constitution mandates that international agreements trump national legislation, the enforcement of legislation guaranteeing intellectual property becomes a grave political issue, with the country caught between maintaining its international obligations on one hand, and dealing with economic conditions of poverty on the other, where vendors scratch out a living selling pirated music, video and software.

The international environment has also been a daily concern in the fortunes of Nicaragua, and has a long and complicated history. International influences take the form of membership in international institutions and pressure from the United States. These factors have exerted an influence on Nicaragua's foreign direct investment, both policies and inflows. Even more so than El Salvador, Nicaragua's main international pressure has come from one source, the United States. The United States has not hesitated to use most means at its disposal to protect its economic interests in Nicaragua throughout that country's history. Its means have included armed invasion and occupation, maintenance of puppet regimes and using those regimes to force through laws contrary to Nicaragua's interests, giving financial and political support to successive oppressive dictatorships, using covert and overt actions to bring down governments not to its liking, employing political and economic isolation, manipulating international organizations in order to adversely influence aid and funding initiatives in Nicaragua, and funding of Nicaraguan opposition political groups.

Nicaragua's nascent independence in the early part of the 19th century was clouded by both territorial and political disputes with its neighbors, and it banded

together with the other new Central American nations to repel political and territorial incursions by Mexico. Unlike El Salvador, Nicaragua's status as the largest of the Central American states, its position straddling the isthmus from both the Caribbean to the Pacific, and geographical features favoring easy transit between them made it very important in the eyes of first British, and then United States business interests in building a canal. The United States and Britain almost came to armed conflict over Nicaragua, in the 19th century, and capitalists from both countries competed for business in the area.

The intervention of the United States in Nicaraguan affairs and the installation of the Somoza family to preserve Nicaragua's relationship with the United States and protect U.S. interests were documented earlier in the chapter. However, by the 1970s, it became clear that the Somoza regimes excesses were leading to popular unrest and the United States recognized the danger that communist ideas could gain popular currency. After 1976, during the last years of the Somoza regime, the United States under the Carter administration walked a balancing act with Nicaragua, trying to ease Somoza out of power and replace him with a group of moderate anti-Somoza business leaders. The United States hoped that with this new regime, the suddenly strong leftist forces would be kept out of power and the United States would maintain its close economic and political ties. The rise to power of the Sandinistas destroyed that hope for the United States, and from 1980 through 1990 under the Reagan and Bush administrations, it embarked on a ten-year campaign to undermine the Sandinista regime by funding the Contra rebels and cutting back trade and commerce. The efforts to support the Contra rebels were ineffective in ending Sandinista rule, but U.S.

economic measures had greater effects, exacerbating problems in an already shaky Nicaraguan economy. Largely on the basis of the ordinary Nicaraguan's economic woes, the Sandinistas lost the 1990 elections, aided by U.S. funding to anti-Sandinista political forces.

The subsequent years have seen Nicaragua lose much of the strategic importance that it had during the Cold War. International institutions began to exert their pressures on the Nicaraguan government. The IMF, for example, continued to withhold aid to Nicaragua until the government promised to cut taxes or curtail government spending (Fidler and Scanlan 1993). The United States, in the meanwhile, began targeting the region, rather than individual countries, as partners in a regional trading bloc. In 2005 it hammered out the CAFTA between five Central American nations and the Dominican Republic. The deal was inked amid promises that the market for Central American exports in the United States would rise. However, there may be a number of ways in which the deal benefits the United States at the expense of countries such as Nicaragua. First, Central American farmers will be competing against heavily subsidized U.S. farmers. Second, development based on the CAFTA model will depend on extremely low wages and a lack of enforcement of environmental standards. Third, governments will have their authority to ensure basic services undermined by aspects of the agreement. Finally, provisions in the treaty will make it difficult for countries to escape their debt burdens and recover from financial crises by limiting their ability to favor domestic creditors at the expense of foreign creditors. This means that Nicaragua may need to make hard choices between paying wages and salaries, forgo

using preferential terms to domestic creditors to aid recovery, and may face damaging “investor-state” lawsuits should they try.

Nicaragua has relationships and memberships with international institutions related to trade and investment. Nicaragua has been a member of the International Finance Corporation (IFC) since 1955, the World Intellectual Property Organization since 1985, the Multilateral Insurance Guarantee Agency (MIGA) since 1992, the International Center for the Settlement of Investment Disputes (ICSID) and the World Trade Organization since 1995.

The International Finance Corporation is a world body that attempts to promote and address issues pertaining to private sector development in member countries without demanding repayment guarantees from member governments, and offer prescriptions for easing government regulatory structures. Since 1998, the IFC has invested in seven projects in Nicaragua, and there are proposed investments in three more.⁵¹ The projects involving foreign investment include loans to a German company that set up micro-financing opportunities for small entrepreneurs, and a proposed loan to a Guatemalan company, Pantaleon Sugar Holdings, the largest sugar producer in Central America, that wishes to expand and upgrade its Nicaraguan subsidiary. Unlike El Salvador, however, most of the IFC projects involve local business enterprises, possibly indicating the persistent lack of foreign investment in Nicaragua.

Nicaragua also has made use of its membership in the MIGA. MIGA insurance coverage is an indicator that Nicaragua’s FDI policies meet world standards of openness and that there is less risk of those factors that would harm investment, such as civil strife or government expropriation. The relative lateness of foreign investments

⁵¹ International Finance Corporation: <http://www.ifc.org>

covered by MIGA in Nicaragua as compared to El Salvador may attest to the country's difficulties in satisfying MIGA in regards to its FDI policies, but since 2000 it seems that MIGA has been inclined to provide coverage for some foreign investments.⁵² MIGA covered its first foreign investment project in Nicaragua in 2000, an investment by a Cayman Islands company in a government-owned geothermal plant, Ormat Momotombo Power Company, for the rights to expand and manage the plant for 15 years. A year later, MIGA guaranteed a \$63.3 million loan by an Israeli bank to the same plant.

In 2002, MIGA guaranteed a Spanish company's investment in a Nicaraguan electrical distribution plant as part of the Nicaraguan government's privatization efforts. The Spanish company's investment gave it distribution rights to the western half of Nicaragua. In 2003, MIGA guaranteed a Costa Rican company's investment in and loan to a Nicaraguan company specializing in leasing of industrial, agriculture, transportation, and construction equipment. In 2006, MIGA issued additional guarantees for this investment.

In the case of investor-country disputes, Nicaragua has made use of its membership in the ICSID. To the present, Nicaragua has concluded one case in 2006 with the ICSID, Shell Brands International AG and Shell Nicaragua S.A. v. Republic of Nicaragua over trademarks, which was discontinued and evidently settled before the arbitration hearing could end.⁵³ Nicaragua has no pending cases with the ICSID. Like El Salvador, Nicaragua is also a party to the DR-CAFTA agreement signed with the United States, and therefore investor-state disputes within the context of that agreement

⁵² MIGA website, <http://www.miga.org/sitelevel2/level2.cfm?id=1078>

⁵³ <http://www.worldbank.org/icsid/cases/conclude.htm>

will be submitted to arbitration, pleasing investors but removing cases from Nicaragua's national courts and entailing a net loss of sovereignty for Nicaragua over a portion of its economic fortunes.

Nicaragua's membership in WIPO indicates the government's willingness to protect intellectual property in conforming to the core goals of the organization. Thus, Nicaragua has some international pressure on this issue. The signing of DR-CAFTA further puts pressure on Nicaragua, according to a press release by the U.S. State Department (*Africa News* 2006). The press release states that the United States will provide funding to the DR-CAFTA signatories to help them enforce their intellectual property laws. Intellectual property rights are often brought up in the context of art-specific issues, such as pirated DVDs and CDs, but they can come up in a variety of situations. The aforementioned dispute resolved by the ICSID, *Shell Brands International AG and Shell Nicaragua S.A. v. Republic of Nicaragua*, grew out of a Nicaraguan court settlement against Shell Oil Company and other defendants such as Dow Chemical and Dole Foods in favor of farmers harmed by an agricultural chemical called DBCP. The government later tried to embargo Shell's products, leading Shell to file suit against the government under the Netherlands-Nicaragua investment protection treaty for expropriation of its trademarks. As stated before, the case was brought before the ICSID but was settled before the arbitration was complete (*Pensions Management* 2007). Even more recently, Nicaraguan entities have been named in four international cases involving internet domain names, showing the whole new area of intellectual property that is on the horizon for developing countries.

Further adherence to intellectual property concerns comes in the form of Nicaragua's membership in the WTO, and its TRIPs agreement, which guarantees a level of transparency of individual country laws on intellectual property rights. Under the agreement, the WTO "requires Members to notify the laws and regulations made effective pertaining to the subject-matter of the Agreement (the availability, scope, acquisition, enforcement and prevention of the abuse of intellectual property rights)."⁵⁴ In addition, in 2001 Nicaragua submitted answers to a questionnaire given out by the WTO on its legal framework for the enforcement of intellectual property rights within the country. Nicaragua's good faith adherence to the goals and the requirements of the WTO, along with a stated willingness to enforce its intellectual property laws, gives it credibility as a country that is friendly to foreign investment.

International level factors have influenced the foreign direct investment policies of each country, and the ability of each to draw foreign investment inflows. The presence of international institutions and powerful neighbors like the United States have meant that El Salvador and Nicaragua have been steadily pushed toward maintaining open trade and investment relations with the outside world. In particular, the United States has lavished much attention on both countries. This attention has been mostly to defend U.S. economic and international interests. In the 1980s, during each country's civil war, the United States played very different roles. In El Salvador, lavish foreign economic and military aid was meant to maintain the military government as a bulwark against further leftist gains in Central America. That aid allowed El Salvador to ignore issues of development and to concentrate its resources toward defeating the guerilla movement. This meant that little action was taken toward FDI because El Salvador did

⁵⁴ WTO website: http://www.wto.org/english/tratop_e/trips_e/intel7_e.htm

not depend on it because of a heavy flow of foreign aid. Policy remained unchanged, and inflows of FDI stagnated. The conclusion of the civil war and the integration of the leftist groups into the political process put the spotlight back on development, and the government began to refine and open its policies in order to satisfy international commitments. It also considered other ways of bringing in foreign investment, such as privatization. El Salvador additionally signed the CAFTA agreement, opening trade and investment between the United States and the countries of Central America, despite the opposition of many on the left.

In Nicaragua, the fall of Somoza and the takeover of government by the Sandinistas left the United States in an adversarial role. It funded the opposition Contras in their civil war against the government, and at the same time tried to discourage U.S. and Western companies from doing business there. Combined with the Nicaraguan government's Marxist orientation and attempts to undo the legacy of the Somozas, foreign direct investment policy did not change, and investment declined to zero. Only after the Sandinista government realized that it could not completely divorce itself from the world economy and that it had few resources of its own to invest in economic development while fighting the Contras did it begin policy steps to make itself attractive to foreign investment.

Each country's relationship with international institutions concerned with trade and investment has also exerted influence on their FDI policies and inflows. As members of these institutions, both El Salvador and Nicaragua agree to abide by the rules and norms of the organizations that they belong to. In general, these organizations are oriented toward greater openness to global trade and investment.

Military governments in El Salvador, and later the right-wing ARENA party, have generally been open to these agreements and institutions, and have therefore enjoyed a status as a country friendly to foreign investment. Nicaragua has had a more complicated relationship with these institutions largely because of the Sandinista government, but the Sandinistas learned early that the agreements signed by the Somoza regime could not be ignored lest they shred every bit of Nicaragua's credibility on the world stage. The post-Sandinista era has seen the government further open its economy to the world market, particularly through the signing of DR-CAFTA. As both countries begin the 21st century, pressures on them to maintain open policies toward trade and investment will likely continue.

The Domestic Economy and FDI

Domestic and international politics are not enough to explain the development of FDI policies and the rate of FDI inflows in Nicaragua and El Salvador. The domestic economy also has influence over both policies and inflows. In the case of policies, economic realities define the scope of the need for development. In this there have been some similarities and differences between the countries. Both countries have high foreign debt and stagnant domestic savings, and both have relied heavily on foreign aid.

In El Salvador, the spotlight has been on the extreme disparities of wealth between classes in society. These disparities have created social conflict, and have contributed to the growth of crime and gangs, which has the tendency to depress FDI. The government tends to look at foreign direct investment as necessary for development, and also as wealth generation for the upper class, and therefore passes FDI policies

that fit its goals. In Nicaragua, disparities of wealth exist but the country has historically had a smaller economy than El Salvador and a smaller upper class. Until the rule of the Sandinistas, wealth tended to be concentrated in the hands of the Somoza family and its allies, and was redistributed after his fall from power. Still, many problems remain for Nicaragua. Poverty, rising crime, and lack of investor confidence continue to plague Nicaragua's development.

El Salvador began its official existence as a colony of Spain. Its early story was one of a struggle between criollos, the children of Spaniards and members of the indigenous populations of the area, and ladinos, pure-blood Spaniards, to control the decision making process under the Spanish crown. As the Spanish crown became weaker, many Central American colonies, notably Mexico and Guatemala, became independent. Both Mexico and Guatemala wanted El Salvador to join them, but El Salvador rebuffed them in favor of a proposal of a united Central American federation. While the dream of a federation also did not materialize, El Salvador remained one of the idea's most fervent supporters in the subsequent decades.

El Salvador's initial economy, developed during colonial times, was based on the cultivation of indigo for dyes in weaving. The introduction of synthetic dyes killed this industry in the first half of the 19th century. In 1840, coffee was introduced as a cultivable crop. It thrived especially on the high slopes of El Salvador's volcanic landscape, and led to a new structure of power as individuals and families began to convert their newfound wealth into economic and political power. Coffee has continued to be El Salvador's most important export to the present day, even as other cultivable crops were introduced over the subsequent decades. Presently, cotton, sugar, prawns,

and cattle all occupy important places in El Salvador's economy, but still lag behind coffee as El Salvador's primary product.

El Salvador has for most of its political history been a fervid supporter of free trade. After political battles between groups with a liberal, pro-free trade outlook and a conservative, economic nationalism focus, the liberal position won out in 1871. El Salvador traded on its comparative advantage in agriculture, and adhered to little government intervention in the economy, effectively ceding control of the market to the owners of capital. The government kept tariffs low to ensure a market for British- and, after 1900, U.S.- manufactured goods which, unfortunately, displaced locally made goods. El Salvador also took a large amount of foreign loans toward projects such as an unrealized canal and railroads which established the first of its foreign debts. However, an abundant supply of labor exceeded demand, and land consolidation by coffee barons and ranchers left many people landless or with too little land to allow them to subsist. Any form of organization was not permitted, and often brutally suppressed, such as the massacre by the military of the lower classes in the 1932 uprising to protest the removal of the democratically elected Araujo from the presidency.

During the 1970s and 1980s, immediately before and during the civil war, the government, cognizant that economic disparity and landlessness was a political problem that needed to be resolved, undertook modest efforts at land reform. Some land was redistributed, but for the most part, the lands of the wealthy were left untouched. These actions were only enough to delay the civil war, and when it started, did little to change anything.

In the late 1990s, El Salvador dollarized its economy, which instantly raised prices for many ordinary consumers through a process of “rounding up,” making it difficult for a large segment of the population that already had enough trouble making ends meet. Indeed, Towers and Borzutzky (2004) write that dollarization was undertaken so that certain benefits, fiscal discipline, a decline in interest rates, better terms of trade and increased development through foreign investment would follow. However, they argue the decision was actually a product of the political polarization now enshrined in Salvadoran institutions. The government’s unstated reasons for dollarization were to serve the Salvadoran financial community, particularly supporters of the ruling party, and the result has been little effect on development and an exacerbation of inequality in a country that already ranks sixth highest in the world on indicators of inequality. Indeed, the economic situation for most people has changed little since the first stirrings of unrest in the 1970s.

As can be ascertained by its history, El Salvador has largely depended on a monoculture crop for export. This reliance on one crop, first indigo and then coffee, meant that most arable land was given over to production of the crop and that El Salvador needed to import most of its basic necessities including foodstuffs. Because of the expense of imports, the poorer segments of society, mostly landless or living on subsistence plots, often could not afford them. Today, this situation has hardly changed. El Salvador still imports most of its food and necessities, which hurts majority of the population that is poor.

Today, in many ways El Salvador outwardly looks like a modern state. After three decades of rule by the rightist ARENA party, modern shopping malls have sprung

up in the major cities and El Salvador is connected with the rest of the world through finance, high-technology and media. Yet, there are still vast areas that are underdeveloped and undeveloped. The control of politics still largely rests with those allied with the most economically well-off in the country. Many people live on very little, especially in the rural areas. Landlessness is an endemic problem. Large amounts of the population suffer extreme poverty, which has given rise to exploitation of rural labor, particularly in the maquiladora sector, and has contributed to an exploding crime problem. Gangs run rampant in San Salvador and other larger cities, and the U.S. State Department reports that El Salvador has one of the highest homicide rates in the world.⁵⁵

Yet, El Salvador's government looks to FDI as a source of development. Underlying the problems with poverty and relating directly to foreign direct investment are El Salvador's precarious positions on macroeconomic issues, such as sub-par investment levels, a low savings rate, rising external debt and an increasing trade deficit blunted by large amounts of foreign aid, especially in the 1980s. Even today, El Salvador receives almost \$500 million from the State Department under its Millennium Challenge Account program, which aims to help alleviate poverty by choosing to aid countries that score well on key indicators, including political freedoms and rights.⁵⁶ More recently remittances from Salvadorans living abroad have contributed almost 20% of the country's GDP, aided by the country's adoption of dollarization which makes currency conversion unnecessary (Luxner 2007). The country's savings rates from 1980 onward have plummeted, its foreign debt has risen, and its trade balance has

⁵⁵ United State Department of State, http://travel.state.gov/travel/cis_pa_tw/cis/cis_1109.html

⁵⁶ From a November 29, 2006 press release from the Millennium Challenge Corporation: <http://www.mcc.gov/press/releases/2006/release-112906-elsalvadorsigning.php>

been negative for the past 30 years. El Salvador has had a long history with FDI, but historically has not received large amounts of FDI. From 1976 to 2004, El Salvador averaged only about one-tenth of the mean FDI of sample countries collected for this study, and if China is excluded, it still only averaged about one-seventh of the mean FDI inflows for the rest of the countries.

. In particular, foreign debt from outstanding loans is a very significant and difficult situation for developing countries. For El Salvador, foreign debt has not been a crippling problem as it has for its neighbors, but it still has had important ramifications for the country and for its ability to implement economic policies. El Salvador's first experience with foreign debt was with British lenders in the 18th century and the beginning of the 19th century, who made credit available to large coffee growers. The experience soured the country on foreign lending, but all of the loans by British lenders were paid off over time. Always an agrarian-based economy concentrating on one principle crop throughout its history, El Salvador began to try to diversify in the 1940s, embarking on an economic and modernization and industrialization program. The economy of El Salvador grew very rapidly in the 1960s, though the benefits of the growth, like in many Latin American countries, were unevenly distributed across the economic spectrum of the country (Booth, Wade and Walker 2006, 98).

However, the slowdown in most of the economies of Central America that began in the 1970s with the oil crisis and the failure of the ISI policies of the Central American Common Market led to an important development in regards to El Salvador's external debt. Rising oil prices in the 1970s, plus the failure of the Central American Common Market and import substitution policies led to increased foreign debt across Central

America. From 1980 to 1990, external debt almost doubled in the Central American region to \$25 billion, and 30 to 40 percent of export income was used to service the debt in the region (Barry 1991, 15). El Salvador also saw a rise in its external debt, from 15.9 percent in 1976 to 46.7 percent in 2004, and had to enter into structural adjustment programs (SAPs) as a condition of re-servicing its debts and maintaining its access to credit with international lending institutions. These SAPs mandated government austerity programs. The government cut many public services such as education and health care as well as putting new taxes in place. Unfortunately, many of these taxes put more pressure on ordinary consumers. Taxes on the wealthier segments of society often go unenforced despite government promises to rectify the situation. The structural adjustment programs, in the words of one author, put the IMF in the position of supervising economic policy in El Salvador (Murray 1991, 83), including maintaining open policies toward foreign investment.

Foreign aid has also been a large component of El Salvador's economy. U.S. aid has been a staple of the Central American economic puzzle since Kennedy's Alliance for Progress programs were established during the 1960s to help maintain stability in Latin America and thwart Soviet ambitions, Especially from 1979 through 1992, and most specifically during the latter years of the civil war, U.S. economic and military aid poured into El Salvador. United States policy was geared around concerns that El Salvador would go the way of neighboring Nicaragua if it fell into the FMLN hands. U.S. aid ensured that the El Salvadoran government would not fall, and that it would be able to continue the war and, hopefully for the United States, defeat the guerillas. However, the end of the Cold War in 1989-90 and the defeat of the

Sandinistas in Nicaraguan elections meant that the El Salvador lost its importance in U.S. foreign policy. The United States, along with the rest of the world, pushed for a negotiated solution.

The importance of foreign aid to El Salvador during the civil war is evident in the statistics of the period. From the period of 1980 to 1990, El Salvador averaged almost 99 dollars per person per year in foreign aid, most of that from the United States.⁵⁷ This aid represented a jump from 1.3 percent of gross national income (GNI) in 1976 to a high of 11 percent of GNI in 1987. Currently, foreign aid has fallen to pre-civil war levels.

El Salvador's foreign aid during the 1980s served as a replacement for the lack of investment that occurred during the civil war. However, whether El Salvador's government responded to this influx of foreign aid by keeping FDI policies closed is difficult to know. Most likely the government was more interested in fighting the civil war and later bringing it to a conclusion than putting a lot of energy into FDI policies. This use of foreign aid does not necessarily fit with the idea of foreign aid as an alternative to FDI, even though the result is the same. If foreign aid was put toward building up domestic entrepreneurship and business, then it would be an alternative to foreign investment. However, if foreign aid was only used to fund the efforts of the government to defeat the FMLN, it does not qualify. What is clear is that during the civil war, FDI policies were not touched. They remained the same somewhat restrictive policies that were in place before the war began. Only after the war was over and El Salvador's right-wing governments began putting neoliberal economic policies in place did FDI

⁵⁷ Data from the World Bank's World Development Indicators

policies become more open. Even so, FDI inflows took some time to respond to the new policies, perhaps because of firm wariness about the stability of the country.

Another alternative to foreign investment, domestic savings, has not been much of an answer for El Salvador. On first glance, one would think that low domestic savings is the problem. El Salvador's domestic savings rate has declined in the past thirty years, from a high of 24 percent of GDP in 1977 to a low of -1.36 percent in 2004. Why the low savings rate? Hausmann, Rodrik and Velasco (2006), note that the results of Washington Consensus programs of development are highly varied. The Washington Consensus was a particular set of prescriptions advocated by neoliberal economists during the 1990s. They called for governments to scale back their activities in the market place, promote free market and free-trade policies, and reduce social welfare programs. The Dominican Republic, for example, has had dynamic growth since implementing those programs, while Brazil and El Salvador have not. In examining why El Salvador has not achieved sufficient growth levels, Hausmann et al. argue that El Salvador does not necessarily have a savings problem. In fact, remittances provide a possibility for greater savings, but remittances may spur higher consumption rather than savings (IMF 2005). They believe that El Salvador's problem is a lack of productive investment, which makes it a low return country.

The issue of remittances is a potential variable that surface in many conversations about the economies of Central America. Remittances are wages earned in one country by migrants and then sent back to relatives in their home country. Remittances can serve as a development alternative to FDI if they are channeled into productive investments in the home country. As of 2002, 873,000 Salvadorans lived

legally in the United States, according to the U.S. Census Bureau, though the number may be closer to 2.5 million when illegal immigration is taken into account. According to the U.S. State Department, in 2005 remittances from legal and illegal Salvadorans in the United States were sent to 22.3 percent of Salvadoran families, and they totaled \$2.8 billion dollars.⁵⁸ Total remittances constituted 17 percent of El Salvador's GDP in 2005.⁵⁹ Remittances have become the top income generator for the country.

According to some observers, remittances help make up for the country's large trade deficit, and may allow the country to afford more imports.⁶⁰ However, others do not see remittances as the answer to the country's woes, and argue they do not totally make up for the country's trade deficit.⁶¹ Indeed, Salvadoran migration splits up families, with men often leaving their wives and children to travel to the United States to find work. Women make the arduous trip less often, preferring to stay in El Salvador and seek work there. They usually move to the city to find work in the maquiladoras. Salvadorans migrate mostly to make up for the lack of opportunities available in El Salvador, especially the rural areas, but also to mitigate risk from economic shocks and natural disasters (Halliday 2006). The amount of remittances usually depends on the migrant's job status, education, familial relationships, time spent in another country, and whether there are other members of the migrant's immediate family also abroad and remitting funds home (Funkhouser 1995).

According to Popkin (2003), with 29 percent of the total Salvadoran population living outside El Salvador, remittances supply hard currency to El Salvador and provide

⁵⁸ US Department of State Background Note: El Salvador, January 2007: <http://www.state.gov/r/pa/ei/bgn/2033.htm>

⁵⁹ October, 2006 World Bank Country Brief: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/LACEXT/ELSALVADOREXTN/0,,menuPK:295253~pagePK:141132~piPK:141107~theSitePK:295244,00.html>

⁶⁰ Interview with Alvaro Trigueros and Juan Carlos Rivas.

⁶¹ Interview with Salvador Arias.

the largest source of foreign exchange to the country's economy. El Salvador's government has ample reason to foster this alternative source of development, because remittances also serve as a way to keep its population alive in the absence of adequate social programs within the country. El Salvador's government promotes remittances by attempting to lobby its migrant population outside the country to help El Salvador's economy, encourages migrants to import goods from El Salvador, and urges migrants to invest in private and government sector development projects in El Salvador. With the debate of recent anti-immigration laws in Washington, DC, the Salvadoran government has taken an active role in trying to lobby the U.S. government to allow Salvadorans to stay in the country lest its access to this vital resource be reduced or dry up completely.

Would a better trade balance help spur development in El Salvador? Imports have risen, and El Salvador's trade deficit with the rest of the world has grown to consistently average between 15 and 17 percent of its gross domestic product between 2000 and 2004.⁶² In particular, its trade deficit with its primary trading partner, the United States, grew from \$585 million in 1998 to \$1.08 billion in 2006.⁶³ A greater reliance on imports means fewer resources for home-grown development projects. The World Bank, in a 1996 study, argued for El Salvador to institute more outward-oriented export policies. Their concern was highlighted by the fact that though imports were not rising at a large rate, the trade deficit was widening due to declining exports and increasing remittances leading to consumption of imported goods. The cause of the declining exports was attributed to lower exports of traditional goods such as coffee,

⁶² World Bank World Development Indicators

⁶³ Banco Central de Reserva El Salvador: http://www.bcr.gob.sv/ingles/estadisticas/se_balanzacom.html

cotton, sugar and shrimp. In addition, firms in El Salvador were purchasing a far greater amount of their inputs from abroad than from home (49 percent to 12 percent) and that they were not operating at full production capacity because of low demand. More outward oriented export policies, the World Bank said, would consolidate the peace process by sustaining current levels of economic growth, lead to more rapid economic growth, and lead to a better quality of welfare for its population.

However, many of the economists and politicians I spoke with in El Salvador, particularly those on the left of the political spectrum, were extremely concerned and critical about the expanding trade deficit. Economist and politician Salvador Arias, for example, argued that the trade imbalance was not useful at all for development and that remittances were not enough to either attend the deficit or avert a crisis if there were no changes.⁶⁴ Economist Cesar Villalona argued that the country's insistence on exporting its primary agricultural products takes farmland away from local food production, and means that El Salvador must depend on food imports. He argued that CAFTA actually increased imports from the United States by 5 percent and increased the trade deficit as well.⁶⁵

Those on the right that I interviewed tended to downplay the trade imbalance. For example, Alvaro Trigueros of FUSADES argued that the trade deficit is not a problem because El Salvador does not have the manufacturing output to supply the country's demand for goods. In other words, he believes that given El Salvador's economy, a trade balance deficit is necessary. He argues that El Salvador's economy is the strongest in Central America in terms of macroeconomic stability. He also

⁶⁴ Interview with author, 7 June 2007

⁶⁵ Presentation to student delegation, San Salvador, El Salvador, May 2007

contends that financial stability and attractiveness to investors does not depend on the trade balance: El Salvador is one of only three countries in Latin America rated by Moody's as Investment Grade. He points out that despite the fact that El Salvador's debt, largely obtained so that it can purchase the goods it needs from abroad, has increased by \$1 billion it has still decreased by only four percent of GDP.⁶⁶

Juan Carlos Rivas Najarro, with the Ministry of Economy, largely concurs. He argues that most of the imports reflected in the trade deficit are due to imports of oil and its derivatives, which rose in the first quarter of 2007. He presents statistics showing that if oil and its derivatives are taken out of the trade deficit equation, the deficit decreases from roughly \$1.04 billion to \$710 million from January to March 2007. In addition, he argues there was a 4.3 percent rise in exports in the first quarter of 2007 as compared to the first quarter of 2006, which rises to 12.2 percent if one compensates for the five percent decrease in exports from the maquiladora sector.⁶⁷ Despite these statistical sleights of hand, Navarro's point largely mirrors Trigueros': El Salvador must import goods given its lack of means of production. One way to make up this deficit, therefore, is to increase production and exports by aggressively courting foreign investment.

Hausmann and Rodrik (2005) make an overall argument regarding El Salvador's potential for growth. They write that factors such as savings rates, taxation, property rights and education cannot explain El Salvador's low growth rate because El Salvador performs pretty well in these categories. They note that growth is fueled by investment, but investment in traditional sectors is lagging because of fierce competition from

⁶⁶ Interview with author, 30 May 2007

⁶⁷ Interview with author, 29 May 2007 and *Informe Económico Primer Trimestre 2007*, Ministerio de Economía de El Salvador, 8 May 2007, provided to author by e-mail from Senor Juan Carlos Rivas Najarro, Ministry of Economy.

outside the country. Investment in new products is essential for El Salvador, and for its economy to grow it must create an environment where investment, domestic and foreign, is encouraged in non-traditional sectors that carry a high risk potential. If some of those investments do not fail, they could position El Salvador for better growth and development. Thus, they claim that El Salvador's policies must not only encourage openness, they must help remove some of the risk faced by domestic and international investors when they invest in new products.

Like its neighbors, Nicaragua is a former Spanish colonial territory. Its indigenous population was depleted by intermarriage with Spanish citizens and by relocation carried out by the Spanish empire in order to supply labor for mines in Peru. Unlike its neighbor El Salvador, it still has culturally distinct indigenous populations, such as the Miskito, which have at various times during Nicaragua's existence as a state exerted their independence and autonomy.

Nicaragua's economy has also largely been agriculturally based. Coffee became the largest agricultural export in the country after it was introduced commercially in the 1840s, offering businessmen export opportunities as well as prospects for foreigners to invest. Industrialization proceeded rapidly with the advent of the Somoza family dynasty in the 1930s and especially in the 1960s and 1970s under the import-substitution-industrialization focus of the Central American Common Market (CACM) and encouraged by programs sponsored by the United States under the Alliance for Progress and the United States Agency for International Development (USAID). Economic hardship ensued, urbanization increased and the supply of labor outstripped

the available employment opportunities. By the end of the 1970s, ordinary Nicaraguans had lost almost a third of their purchasing power.

Nicaragua's experience with alternatives to FDI is characterized by low investment levels, a currently low savings rate that has fallen into negative levels many times in the past thirty years, very high external debt, reliance on foreign aid and consistent trade deficits. Nicaragua's foreign direct investment has since 1993 registered between 1.5 and 9 percent of GDP on an annual basis, but its GDP is the lowest of all the Central American countries. Some of the economic shortcomings in the country are made up by remittances from Nicaraguans working in the United States, Costa Rica and El Salvador. According to Jennings and Clarke (2005), remittances from the United States to Nicaragua are not as much as to El Salvador, and are dwarfed by remittances from the United States to Mexico but the numbers stand out when one considers that 24 percent of Nicaragua's GDP is made up of remittances. That number is greater than export earnings, equals foreign aid, and is five times higher than foreign direct investment.

In 1979, after the Sandinista takeover, Nicaragua's foreign debt was \$1.6 billion dollars which the Sandinistas realized that they would have to assume in order to maintain the country's credibility on the world markets (Booth, Wade and Walker 2006, 77). With the agricultural harvest lacking because of the civil war, Nicaragua was faced with a rising need for imports, especially basic goods, and only foreign aid to pay for them and service its foreign debt. This need to borrow abroad continued in the 1980s, as the government continued to use loans from Western banks at high interest rates to pay for basic goods. The government managed to continue to pay its foreign debt

obligations, and was considered such a good credit risk that Swiss banks loaned money to Nicaragua in 1980 (de Onis 1980). In 1982 Nicaragua even managed to secure a \$30 million short term loan from U.S. banks despite the U.S. government's clear attempts to isolate the country (Rowe, Jr. 1982). When the United States pressured multilateral institutions to stop lending to Nicaragua, the government faced high inflation, trade deficits and an inability to sustain its debt repayment schedule, becoming the first country ever to fall six months behind on its World Bank debt repayment schedule (Kristof 1985, Smith 1993, 244). Nicaragua ranks high on lists drawn up for countries most likely to be granted debt forgiveness, and is included in the World Bank's Highly Indebted Poor Countries program which makes it eligible for forgiveness of up to 80 percent of its debt, but rampant corruption and political crises have limited these possibilities (Campbell 2004). In this case, it appears that for Nicaragua, external debt has served less as a development strategy and more of a survival strategy.

Foreign aid has been a large component of Nicaragua's strategy to deal with its economic shortcomings, and like external debt has been more of a survival strategy for the country. During the 1980s under the Sandinistas, the strategy of the United States was to cut off as much funding as possible to the Nicaraguan government in order to pursue military solutions. However, according to Smith (1993, 283-84), the European Community saw the problems of Nicaragua and the region as socio-economic problems and saw economic support as the best way to help Nicaragua out of its difficulties and to keep it from falling under Soviet influence. European aid came to Nicaragua despite the fact that the European countries had deep misgivings about the direction that the Sandinista government's direction, and especially after Sandinista demonstrators

disrupted Pope John Paul II's Mass in Managua in 1983 (Kinzer 1983). Needless to say, the Soviet Union and its allies provided aid as well. In 1987, Eastern bloc countries provided some \$392 million in credits, \$37.5 million in donations and grants, and 600,000 tons of oil to Nicaragua (Kinzer 1987). The Soviet Union accounted for most of that aid, though by 1987 they began cutting back on their aid, preferring to focus on their own domestic economic stimulation and exercising caution during arms talks with the Reagan administration. For post-Sandinista governments, foreign aid continued to maintain a great importance. In a broadcast on January 19, 1993, Presidency Minister Antonio Lacaya of Nicaragua singled out foreign aid as a major contributor to the well-being of Nicaraguans, stating:

“Out of every dollar imported into our economy [i.e. out of every dollar's-worth of goods imported into the economy], 60 cents comes from foreign aid funds, grants and soft loans. We obtain approximately 60% of everything we import - oil, medicine, food, non-perishable consumption goods, raw materials, etc. - thanks to foreign aid. For those who naively ask where the foreign aid goes, it is in the electricity that lights our houses, the food we eat every day, the medicine for the sick, loans for production and gasoline for cars. I must say clearly that this foreign aid has been well spent. The international community has told us so. If Nicaraguans were not using our foreign aid properly, we would not receive any more foreign aid. (British Broadcasting System, *Summary of World Broadcasts*)

Lacaya goes on to say that the country cannot continue using foreign aid to finance consumption, but must invest the aid in the creation of new jobs, production and economic growth. Nicaragua can thank foreign aid from Europe for the modernization of its telephone and power systems in the mid-1990s (Blume 1995). However, foreign aid for development has taken a back seat to other, more pressing needs. According to Millett (2007, 474), Nicaragua still depends on foreign assistance for such basic programs as conducting elections.

Domestic savings for Nicaragua, like many of its Central American neighbors, has been difficult to maintain and therefore also not much of an alternative path to development. One reason for the poor savings rate came during the Sandinista years, when hyperinflation caused by the Nicaraguan government's efforts to finance itself by printing greater amounts of money cut into domestic savings of ordinary Nicaraguans and caused wealthier residents to take their savings out of the country (*The Economist*, 1989). Some of those savings spirited away began to return in the 1990s after the Sandinistas left power (Christian 1991). Regardless, domestic savings declined from about \$1.2 billion dollars in 1977, about 20 percent of the country's GDP, to about \$39 million dollars in 2004, or about 0.95 percent of GDP. The savings rate was negative for nine of the years between 1977 and 2004.

The Nicaraguan government in the 1990s made a large push for foreign investment, due to the lack of domestic savings to draw upon (Coone 1990). However, Nicaragua's ability to draw foreign investment was hampered by its large foreign debt and its debt-servicing obligations (Germani 1991). Thus, domestic savings has not served Nicaragua well as an alternative to foreign investment, nor even as a complement to foreign investment. Both are lacking.

Nicaragua's trade deficit also contributes to concerns about the country's ability to develop, and has not served as an alternative generator of investment capital. Since 1976, Nicaragua has not ended one year with a trade surplus. In some years, this could not be helped. For example, Hurricane Mitch in 1998 devastated the country's main agricultural export crops. In the 1980s, the departure of capital coinciding with Sandinista rule, along with slow production caused by the war, fueled the trade deficit.

Large amounts of aid from Eastern bloc countries helped cover the trade deficit for Nicaragua (Gasperini 1990). However, the ongoing large trade deficits underscore Nicaragua's need for productive capacity in order to boost its exports and to provide some of its own basic goods.

As with El Salvador and other countries in Central America, remittances are a huge issue in Nicaragua. Funkhouser (1995) estimated that in 1989 labor was the second largest export in Nicaragua. Funkhouser finds that Nicaraguans behave differently in their remittance patterns than do Salvadorans, perhaps due to emigration out of political hostility or family detachment. In examining patterns of migrants from four countries, Mexico, Costa Rica, the Dominican Republic and Nicaragua, Sana and Massey (2007) report that Nicaraguans are likely to make less trips to the United States, but to stay longer. Nicaraguans also travel in heavy numbers to work in Costa Rica, which is their number one destination. In 2000, remittances made up 14.4 percent of Nicaragua's GDP, and remittances to the Central American area as a whole were more than the total of foreign aid and a third of foreign direct investment (Portes and Hoffman 2003). Sana and Massey report that in 2001, as much as \$610 million came to Nicaragua in the form of remittances, or \$124 per capita. Up to 15 percent of Nicaraguan households receive remittances. In 2002, remittances accounted for thirty percent of Nicaragua's GDP (Booth, Wade and Walker 2006). Remittances sent back by migrants from Nicaragua and other countries far outweighs official aid and is undiluted by bureaucratic and other obstacles, instead going directly to the poor (Clark 2007). Remittances are the largest source of foreign exchange for both El Salvador and Nicaragua, and Nicaraguans tend to place more importance on remittances because of

their higher skill levels than Mexico and other Central American sources of emigration (Rosenblum 2004).

Remittances in Nicaragua help make up for shortcomings in the rest of Nicaragua's economy. However, in the case of Nicaragua, the growing dependence on remittances, at both the microeconomic and macroeconomic level, seems to serve all sections of society and government as yet another survival strategy rather than as an avenue to development and as an alternative to FDI. Nicaragua's fate has been to lurch from corrupt dictatorship to civil war to neoliberal economic policies with structural adjustment demands, with a sprinkling of natural disasters thrown in for good measure. Along the way, it has become the poorest nation in Central America (Deutsche Presse-Agentur 1997). The fact that Nicaragua continues to struggle with governments prone toward corruption does not inspire the confidence of its own people, much less foreign investors, and certainly does not bode well for its future.

What effect on foreign investment policies and FDI inflows have these economic realities had on the two countries? For both El Salvador and Nicaragua, extreme economic disparities between the wealthy and the rest of the population, lack of productive investment opportunities for domestic and international investors, and inadequate sources of development funds have put each country in a situation where they must try to attract foreign investment to meet their goals. Throughout the past three decades, FDI policies in both countries have reflected this need toward greater openness toward investment. However, foreign investment capital at current levels does not satisfy the need in both countries for development and social funding. In these cases, the need far outweighs the returns.

Nicaragua, El Salvador and Two-level Games

Nicaragua and El Salvador both can fit into the two-level games scenario. Recall that the premise of two-level games was that two countries, to reach agreement over something, must not only negotiate with each other, but must also negotiate within their own domestic political environment with politically powerful groups that stand to be affected by any agreement reached. Each country therefore brings a win-set to any negotiation. Those countries where opposition to any agreement is strong at home will have a smaller win-set, or range of agreements that they can accept, whereas those countries that have less opposition at home have a larger win-set and therefore a larger range of agreements.

If the scenario is relaxed to allow developing countries to come to agreement with international firms over foreign direct investment, then we essentially have the same situation. Developing countries bring their win-sets, their policies, to the table. Opposition to foreign investment constitutes a smaller win-set, while openness to FDI constitutes a larger win-set. The result of agreement between firms and developing countries is reflected in the amount of foreign direct investment inflows.

Policies are therefore passed on the domestic level, and brought to the negotiating table, at the transnational level. But policies themselves are influenced by not only the politics of the domestic level, but domestic environmental realities and factors from the international environment. They constitute the basis by which developing countries reach agreement with firms. In turn, agreements between firm and developing countries are indicated by FDI inflows. However, these inflows are not only

affected by FDI policies, but by domestic politics, domestic economics and international factors as well.

In the cases of El Salvador and Nicaragua, FDI policies have become more open. Looking at domestic politics in both countries, some growth in FDI has occurred with movement toward policies of greater equity openness. El Salvador's current political situation, with an investor-friendly right-wing government that is oriented toward the international trade and investment system, should allow for an expanded range of agreements that the government can accept with international firms. Some opposition from the left side of the political spectrum, particularly the FMLN and its status as the largest party in the Salvadoran Assembly, may limit the range of possible agreement due to the FMLN's ability to block some legislation if it can persuade the smaller party allies of the government to remain neutral or vote against the government position, but up to this point the government has been able to get much of what it wants. Thus policies, and the government's approach toward agreement with international firms on FDI, are currently very open. Should the FMLN win the presidency in the 2009 elections, the government's policies could become less open, limiting their range of possible agreements with international firms if the FMLN looks to scale back the government's involvement with FDI. The impression of a country with a friendly government and open policies also widens the win-sets of international firms, further allowing for agreements on FDI.

Even so, El Salvador's memberships in international institutions and its relationship with the United States will have the potential to keep FDI policies open and allow for more agreements with international firms, regardless of the government in

power. Once international agreements are signed and countries become members of international institutions, it is difficult for countries to back away from them. In particular, as El Salvador continues its involvement with international institutions, exercising a role within such organizations and making use of their services, it becomes more complicated for future governments if they do not wish to honor previous commitments. Should the FMLN take power in the next election, they might do well to heed the lesson of the Sandinistas over 20 years earlier: International obligations made by earlier governments cannot simply be ignored and often governments must continue to abide by them.

At the transnational level, where governments forge agreements with international firms, El Salvador's membership in international organizations appeals to firms. Such organizations level the playing field for international firms, codifying and strengthening baseline policies that are similar across all nations, and providing some guarantees of investment safety. Therefore, these memberships broaden the range of agreements possible, at least from the firm perspective. At the domestic level, such memberships have the potential to limit developing country win-sets if politically powerful groups are opposed to them, but in the case of El Salvador, this has not yet happened because the left has not gained enough of a position of strength to oppose involvement with them.

Domestic level economic realities may or may not open opportunities for El Salvador on the transnational agreement stage under the current political conditions. It appears to depend on whether the next elections maintain the current political structure, or bring the left to power. El Salvador's low savings rate, a rising international debt, and

a negative trade balance have convinced the current government that foreign investment is needed to provide jobs to the unemployed and to increase exports. Relief for the poor is not provided by government, but through a massive amount of remittances from Salvadorans working in foreign countries, particularly the United States. The Salvadoran government continues to encourage this practice. When viewing the same economic landscape, the left argues that the government needs to invest in social services to relieve poverty conditions and to encourage domestic business. Such investment by the government will keep El Salvador from losing its people to countries with greater work opportunities like the United States. Foreign investment, the left argues, must be scaled back or encouraged to work in combination with domestic initiatives. So, domestic realities could widen or restrict the areas for potential agreement with firms on FDI depending on who controls the government, and in turn, convince international firms to invest or to take caution.

Nicaragua's political situation gives a possible indication of what the situation may look like in El Salvador shortly. The parade of centrist and right-wing presidencies that ruled Nicaragua from 1990 up to 2006 has given way to a new presidency of Sandinista Daniel Ortega. Even though he has seemingly become friendlier to FDI than in the past, and has voiced support for foreign investment and free trade, the possibility exists that even if he does not follow the recent examples of leftist presidents in Latin America and scale back foreign investment policies, the government's range of possible agreements on FDI will be smaller. Restricting new FDI in any case will constrict Nicaragua's win-set of agreement opportunities, and foreign firms will watch Nicaraguan government actions and take their cue from those.

However, international agreements that Nicaragua is party to, and international institutions it belongs to, may temper any leftist plans to scale back FDI. The Sandinistas learned the hard way in the 1980s that they simply could not jettison their international obligations simply because their enemy Somoza agreed to them. To do so would have ruined their credibility, making their daunting task to get economic aid even more difficult. With the United States making things difficult enough for them on the international stage, the Sandinistas stood by Somoza's agreements, and played fair with foreign investment already committed to the country. Nicaragua's commitments have only increased under the governments following Sandinista rule, making it much more difficult for the current government to scale back foreign investment without suffering some kind of adverse international reaction. They may be able to slow down new investment, but they will not be able to eliminate it altogether.

Of course, like El Salvador, the domestic economic situation of Nicaragua may make foreign investment a requirement. Nicaragua's dependence on a tremendous amount of foreign aid to accomplish goals that most other countries' governments are able to fund themselves, a low savings rate, and the reliance of a large portion of the populace on remittances from Nicaraguans working abroad to meet daily needs is a clear indication that development is needed. There is an inadequate amount of domestic investment to meet development goals. On the transnational agreement level, the range of possible agreements with foreign firms that Nicaragua is willing to accept may widen due to these harsh economic realities. Unfortunately, other factors may inhibit firms' willingness to agree, including high government corruption. Daniel Ortega's readiness to embrace many aspects of the international environment's focus

on free trade and investment opportunity may be less of a choice and more of a necessity.

Chapter Six

A Summary of the Study

The goal of this dissertation has been to explain the role of foreign direct investment policies in economic development in developing countries. This area of research is vital for a number of reasons. On a general scale, answers to questions about development in the less-industrialized countries have implications in many academic areas, both inside and outside political science. On an immediate level, those developing countries that pursue rapid industrialization affect world markets as they become more and more indispensable to the international economic arena. Their importance is more apparent even as it is obvious that standards of health, safety, labor and product quality in developing countries are not on par with the expectations of industrialized countries. Recent controversies surrounding China's usage of lead-based paints in children's toys, and industrial by-products as fillers in pet foods only underscores the impact of such industrializing countries on the world stage and the trade-offs that the developed world faces now that it has become dependent on developing countries to mass produce goods for consumption. Developing countries also affect the global environment with greater emissions of greenhouse gases from their burgeoning manufacturing centers, and many have irrevocably altered and even harmed their natural environments to meet industrial goals. The repercussions of a few developing countries reaching industrialized status will have far-reaching impacts into the distant future.

The potential and actual effects of development are not only confined to macroeconomics. As economic development booms or fizzles in less-developed countries, many people are potentially affected on the most basic levels. Access to food, housing, jobs, and services hang in the balance. Successful development could mean a long life for many inhabitants of the developing world. They might gain decent jobs, be able to put food on the table for their families, receive medical care when needed, and live in adequate housing. Lack of success in development could leave millions, or perhaps billions, in a rapidly degrading quality-of-life cycle that promises little but hardship and misery.

A greater understanding of development can shed light on questions that may or may not seem connected at a close look, but in wider perspective have everything to do with issues related to globalization. Globalization promises development, and yet this promise may turn out to be empty for some. The outcome of globalization can even have implications for international peace. Successful development for a majority of the world's population may alleviate some core causes of international conflict. However, if development fails, the world may be reduced to several warring countries, each battling over access to increasingly scarce resources. The hardships of the disenchanting and miserable, trying to live amid war and chaos, may be the actual effect of globalization. The international environment could degrade to a few countries with access to all of the resources they need, and other countries saddled with depleted and dying populations and scrabbling for the remainders.

Scholarship about development is therefore very important. If the world is to experience growth in a way that measures up to the ideals that are propounded by

world leaders, the unevenness of development must be studied, and every finding and solution discovered by researchers must be fit into its place until full understanding is reached. This dissertation has been one small attempt to pose questions about one aspect of development, foreign direct investment, and find some possible answers that will enlarge the scope of knowledge on this issue.

Review of Findings

What do we know about FDI? From Hymer's first research on foreign direct investment until today, a number of theories of FDI have been proposed. These theories have been created from a number of different perspectives. Research on FDI grew from studies in economics, which explored firms' motivations to engage in foreign investment. Political science followed with its own research into political causes and effects of FDI. The impact of FDI on economics, markets, politics and the natural environment have been tackled by researchers, as have been myriads of other factors theorized to enhance or inhibit FDI. This interest in FDI has helped bring about new tools for researchers in the study of development. Countries now regularly report FDI statistics, giving researchers new conceptualizations of FDI to test empirically in quantitative tests.

I began this dissertation by putting forth some questions; pieces of the development puzzle that I felt needed to be addressed. In particular, I was curious about two mysteries that had not been adequately explored. I hoped to contribute to existing research on FDI, given its importance as a key part of development for the past thirty years. However, I wanted to look at the FDI story from a different point of view. In

particular, to better understand the process of FDI, I wanted to examine the role of policy. I was curious about the following questions. What is FDI policy? What determines FDI policy? What is FDI policy's role in attracting foreign direct investment inflows? I wanted to investigate these questions from the perspective of developing countries. Why do developing countries use FDI policies? If developing countries want to industrialize, why is there such variation of their degree of openness to foreign direct investment? These were questions that I did not think had been answered fully by existing research from any perspective.

Despite my role as a political scientist, I found that I needed to synthesize many pieces of the FDI research across disciplines. In other words, political science has told an important part of the FDI story. It has explored the politics behind FDI and development in general. However, economics tells another important part of the story, focusing on the motivations of firms and the transactions that occur between firms and other actors in order to make FDI a reality. Sociology brings a third area in play, highlighting effects of FDI and globalization on people. In conducting my research, I have been indebted to all of these perspectives to help me bring together my own story of FDI.

I told a narrative that moved across countries and over time, and encompassed bits of all perspectives. The story began with theories of development in vogue at various times in the past decades that had influence on developing countries and their perspectives. Modernization theory and the goals that it professes, despite being originally proposed as a way to keep developing countries in the Western camp during the Cold War, has maintained the hope that the world is moving inexorably toward

modernity and rationality. This new world will consist of all countries, industrialized and enlightened, with democratic forms of government. The hope has continued to live through the promises of globalization. Developing countries are guaranteed gains and benefits from the liberalization of international trade and finance and the free movement of capital around the globe. However, dependency theory arose to challenge the views of modernization theory. Dependency theory argued that countries are locked into a tiered system; those that are farther along in their modernization take advantage of the system to get the resources they need and to continue their advancement at the expense of other countries. Developing countries are at best junior partners of the industrialized countries, and at worst economically colonized by them. Developing countries give up their precious resources cheaply and receive expensive manufactured products that benefit only those few in their societies that can afford them. This system encourages a wealthy few to repress the mass portions of the world's population that are less well off, and keeps developing countries in a state of inferiority.

I argued that these two world-views of development were emblematic of attitudes that developing countries displayed toward FDI, one wary and one open, and that these attitudes help place their policies on a spectrum that ranges from complete openness to complete restrictiveness. All developing countries policies are informed by these attitudes, and therefore their policies fall somewhere in between these two extremes.

I proposed a scenario where developing states look to attract investment to their degree of comfort. Developing states wish to gain the benefits of FDI without giving up too much control in the process. They hope to gain new avenues toward industrialization using the technology, managerial expertise and know-how that foreign

firms from industrialized countries can bring. They anticipate, over the course of the relationship, to gain revenue from taxes on foreign firms' business and to expand employment for their populations. Their policies walk a delicate line between asking too much and not asking enough, and are conditioned by their attitudes toward foreign investment in general. Some policies establish restrictions on foreign investment equity or entry into economic sectors, while other policies set levels of taxation and types of regulations on multinational firms.

Firms seek new markets for extraction, manufacturing or their products and therefore they seek conditions where they can make the maximum amount of profits with as few costs as possible. Developing countries are attractive because of their natural resources, their abundance of labor and the untapped potential of their markets. Multinational firms hope to get the best possible agreement from developing countries in return for investing there. They want few restrictions on investment, low taxes and few regulations. Therefore, developing countries' policies are a first indication to multinational firms of whether foreign investment in a particular place fits with their global strategies. If policies are more restrictive, the number of firms willing to invest will be lower. If policies are more open, more firms will be willing to take the risk of investment.

As I presented in Chapter Two, the relationship between firms and states can fall into a scenario like that proposed by Putnam. Putnam outlined the logic of two-level games in negotiations between states. States negotiate agreements that are affected on two-levels. Agreements are affected by political negotiations on the domestic level which establishes a win-set, or a range of possible agreements, which each state can

accept. When there is overlap between the win-sets, agreement has a greater probability depending on the size of the overlap. Agreements are also affected on the international level by the international environment and circumstances during negotiations. States may need to update domestic groups on the progress of the talks and field those groups' reactions. In our case, the negotiating parties are not two developing states, but a developing state and a firm that operates on the transnational level. I expanded Putnam's theory, arguing that states not only negotiate with states, but with firms as well.

States typically face political negotiation with powerful groups that will be affected by FDI domestically. The results of these political dealings manifest themselves in policies of FDI. These policies are then brought to the transnational level to serve as the basis of agreement. Policies thus represent the win-set of the developing state as it tries to reach agreement with the firm. Firms have their own win-sets as well – which were not addressed in this dissertation – and if their win-sets overlap with those of the developing states, there is a greater possibility of agreement. There is probably less interaction between the domestic and transnational levels in FDI negotiations than in international arms agreements, but the principle is the same. The eventual success or failure of agreements can be observed by the amount of FDI inflows to each state. Greater inflows mean more success in agreement.

In the opening chapter, I introduced some perplexing examples. Why do China, Mexico and Brazil get so much investment despite the restrictive nature of their FDI policies? Why do Niger, Gabon and Swaziland get so little investment despite the open nature of their policies? The answer is that firms find the potential of investment in

China, Mexico and Brazil to be profitable and to their benefit. Most likely, those countries would gain more investment if their policies were more open. In Niger, Gabon and Swaziland, firms are not as impressed by what those countries have to offer, or how those countries fit into their global strategies. That does not mean that the open policies in these countries have no effect – they would probably be at a greater disadvantage in terms of FDI without them. Open policies allow those countries that want to gain more FDI to have a better chance of doing so, and restrictive policies allow other countries to maintain some control over the flow of foreign investment.

The theory that I proposed explained FDI utilizing Putnam's logic of two-level games, and tested the relationships in two models. In the first model, the policy model, I introduced the factors that influence a set of policy outcomes in developing states. The policies I describe, FDI equity policies, do not constitute the whole range of FDI policies but are a very important factor in the restrictiveness or openness of developing states to foreign investment. I treat developing states as collectivities of political actors act in a unitary fashion through policies when dealing with multinational firms. However, even though developing states operate in a unitary manner, the influences on developing states when they construct their policies are many, and come from a range of sources at both the domestic and international levels. I proposed that policies are mainly influenced by domestic politics, international political and economic influences, domestic economic realities, and past experience with FDI.

I found that elements of all of these factors have some influence over FDI policies. On the domestic politics side, democracies are more likely to pass open policies, and nationalist governments are also more likely to be open to FDI.

Democracies are widely seen to be more open and transparent, more willing to promote and engage in open markets and free trade, and more willing to protect property rights and extend other protections to foreign investment than authoritarian governments. Nationalist governments on the other hand, are usually associated with protectionism and a zero-sum outlook on international economic relations. They are linked with attitudes that exhibit wariness toward foreign investment, and prefer to foster national business rather than allowing foreign firms in the market. The finding that nationalist governments appear to favor policies restricting foreign direct investment is therefore not surprising. What is surprising is that government ideology does not appear to play a part in determining FDI policies, because policies from governments on the left and right showed no difference from each other. However, more studies on ideology and FDI policies will need to be conducted because of problems with the data classifying governments into a left-center-right spectrum.

I also found that developing countries' memberships in international institutions based on trade and foreign investment contributed to open policies. These institutions demand agreement with certain principles of foreign investment as a condition for membership, and failure to abide by those rules carries the risk of implicit or explicit sanction. This risk constitutes pressure on developing countries to abide by the rules of the institution. In addition, proximity to developed countries also appears to carry some weight in pushing developing countries toward greater openness to foreign investment. Industrialized countries that are contiguous along borders or economic zones with developing countries may want to extend the reach of their firms and therefore urge their neighbors to open to investment. A prime example is the United States – Mexico

relationship, where U.S. firms have, in great numbers, located south of the U.S. border with Mexico to take advantage of the labor supply and lower wages.

Some potential alternatives to FDI were found. Domestic savings appears to be an alternative to FDI in that it can provide investment capital for home-grown businesses and therefore reduce the need to utilize foreign investment for development. Countries that have higher savings rates can therefore afford to set more restrictive policies on FDI. External debt appears to be important in countries that rely upon FDI or where FDI makes up a larger portion of their economies. Larger external debt leads to more open FDI policies in developing countries, because it may increase the need for FDI to help bring in greater revenues to service debt payments to lenders. Also, many developing countries have followed policies of privatization of state-owned industries, and new foreign investment complements the debt already built up when governments created those industries or nationalized existing ones.

Market size also appears to play a role in FDI openness with larger market sizes contribute to more open policies. There may be some regional differences in openness to FDI, but only a little. All regions except perhaps East and South Asia in the estimated sample were significant and more open to FDI compared with the comparison category, so the regional differences may be small.

Given the influences that lead to more restrictive or more open policies, what countries represent open or closed policies? Guided by the estimations performed in Chapter Three, the least open countries should have authoritarian and nationalist governments. They should have a low degree of membership in international institutions, and not share a border or an economic zone with a developed country.

They should have a high savings rate and low external debt. Such a scenario describes Zimbabwe in the late 1980s and Syria in 2003-2004, where policies restricted foreign investment to minority status.

A very open developing country should have the opposite characteristics. It should have a democratic, non-nationalist government. It should have a high degree of membership in international institutions, and be in close proximity to the developed world. It should have a low savings rate and high external debt. These characteristics, except for proximity to developed countries, are shared by many countries. Argentina from 2000-2001, Gambia from 1983-1993, Ghana from 1996-2004, Guyana from 2002-2004, Madagascar from 1996-2003, Nicaragua from 2000-2004, and Zambia from 1992-2000. No countries that were in proximity to developed countries met the other criteria.

Do developing countries' policies make a difference in firm decision-making about investment there? In other words, do policies affect foreign direct investment inflows? This question was addressed in the second model. It is certain that FDI policies have an effect on FDI inflows. Developing countries that are most open to foreign equity appear to gain more FDI as a percent of their GDPs than those developing countries that put restrictions on foreign equity. Those countries that want or depend on FDI as a development tool therefore will gain more foreign investment if their policies are more open.

Open policies are not the only determinants of FDI inflows. Countries that are nationalist gain more FDI inflows as a percent of GDP. The explanation may lie partly because the size of nationalist countries in the sample tend to be smaller countries, and

possibly because nationalist governments cannot ignore the world economy even if they would prefer to be less involved in it. Once again, surprisingly, the ideological orientation of the government appears to have no impact on FDI inflows, indicating that foreign direct investment flows to developing countries regardless of whether they espouse leftist or right-wing ideologies.

International institutional membership also has a positive effect on countries' FDI inflows. Countries that belong to more international institutions that are concerned about international trade and investment receive more inflows of FDI as a percent of GDP. This could indicate that institutional membership strengthens the positive impression that multinational firms have of developing countries. International institutions promote norms and rules that level the playing field for potential investors, and provide protections against government actions that could be inimical to foreign investment. As firms decide whether to invest in developing countries, membership in a greater number of international institutions may set some countries apart from others and increase the potential range of possible agreements that firms are willing to accept.

Countries that have more income per capita tend to get less FDI as a percentage of GDP. This suggests that firms are attracted to lower income countries because they can cut costs on wages. A low-wage structure could strengthen some countries' bargaining positions if they have alternatives to FDI for development, but could leave other countries with few other alternatives in weak bargaining positions. Corruption appears to dampen FDI inflows, indicating that developing states that control corruption, regardless of whether they depend on FDI for development, will gain more FDI inflows. FDI also is attracted to larger developing countries, indicating that larger markets are

important to firms. Finally, regional differences play a part in the amount of inflows of FDI that developing countries receive. If a developing country is in Latin America, it appears that it has a better chance of receiving more FDI than countries in other regions. This may be due to the United States factor, which has taken a special economic interest in Latin America, which it considers as its own back yard, and has negotiated a number of trade and investment deals favorable to U.S. companies.

The findings suggest that those developing countries that are democratic, nationalist, have open FDI policies, belong to more international institutions, have a low income per capita, and control corruption will gain more FDI as a percent of GDP than other countries. In my dataset, Argentina from 1995-2004 (mean inflows 3.3 percent of GDP), Guyana from 1995-2002 (mean inflows 7.96 percent of GDP), Lesotho from 1995-1998 (mean inflows 29.44 percent of GDP), Malaysia from 1992-2004 (mean inflows 1.01 percent of GDP), and Trinidad and Tobago from 2003-2004 (mean inflows 7.84 percent of GDP) fit this description. Those countries receiving the least inflows as a percent of GDP, Algeria from 1994-1996 (mean inflows 0.19 percent of GDP), Bangladesh from 1981-1983 (mean inflows 0.02 percent of GDP), Ethiopia from 1989-1991 (mean inflows 0.07 percent of GDP), Gabon from 1989-1995 (mean inflows -1.37 percent of GDP), Haiti from 1977-1987 (mean inflows 0.57 percent of GDP) and from 1993-1994 (mean inflows -0.09 percent of GDP), Indonesia from 1977-1979 (mean inflows 0.47 percent of GDP), Iran from 1982-1990 (mean inflows -0.08 percent of GDP) and from 1993-1997 (mean inflows 0.02 percent of GDP), Nicaragua from 1977-1979 (mean inflows 0.32 percent of GDP) and from 1982-1990 (mean inflows 0.01 percent of GDP), and the Philippines in 1980 (inflows -0.33 percent of GDP), all had non-

democratic, non-nationalist governments ranking high in corruption and fewer memberships in international institutions concerned with trade and investment. In this category especially, there were also some countries that had somewhat higher inflows as a percent of GDP despite their characteristics. Chad (1992-1998), the Dominican Republic (1977-1978), and Guatemala (1977-1983) were all examples of countries that did not quite match predictions.

What are recommendations that can be made to policymakers regarding FDI policies in developing countries? Policymakers are the subject of many pulls and tugs, both domestically and internationally. Domestic politics and international pressures are largely out of policymakers' control. After all, policymakers do not decide whether their countries are democratic or authoritarian, nationalist or internationally focused, leftist or rightist. Domestic politics determines these particular characteristics. Policymakers should fashion policy according to their country's characteristics, playing up its strengths and downplaying its weaknesses.

For example, if a country wants to reduce FDI or reduce its reliance on FDI, it can do a number of things. First, it can restrict FDI through taxation, regulation and limit its entry into the market by passing more restrictive FDI policies. Second, it can build up reasonable alternatives to FDI and tap those for development purposes. Encouraging savings, for one, helps build up domestic sources of capital and reduces the need for the country to have open FDI policies. Paying down external debt and putting the extra capital into national development is another possible, though not easy, way reduce reliance on FDI. The highly indebted poor countries (HIPC) that are in line

for significant debt forgiveness in the next few years may be able to benefit from the advantage of a lower external debt.

Remittances from nationals of developing countries that work in the developed world are also a significant source of capital, and these remittances can be channeled into productive capital for investment, as long as the population can be encouraged to refrain from spending them on wasteful forms of consumption and if governments can encourage entrepreneurship. In El Salvador, for example, recipients of remittances tend to spend them on consumer goods, such as shoes, clothes, and televisions. That money ends up in the pockets of a few wealthy business owners whose interests do not necessarily coincide with those of the poorer populace.

On the other hand, if a developing country wants to increase its FDI prospects, such as increasing its importance in the economy or simply increasing the flow of FDI into its market, there are a number of actions that policymakers can take. First and foremost they should pass policies that open the economy. Open policies serve as an indication that a country is interested and serious about foreign investment. If a developing country is democratic it is already likely to have open FDI policies, but autocratic governments show more variation in their openness to foreign investment. Second, reducing corruption in government serves as a sign of encouragement to foreign investors. Foreign investors do not like cutting through red tape or paying bribes to set up business, and will prefer to deal with those countries that are more efficient and transparent in their processes and procedures.

These actions do not guarantee that developing countries can reduce or enhance their prospects for FDI, but such actions will not hurt their chances of achieving

development goals. The main thing for policymakers to remember, however, is that policies have repercussions on FDI prospects and on development projections in general. Policymakers in the developing world are in a position to take the resources that globalization offers them, or to reject them, but ultimately their policies have an impact on the path their country takes toward development. Globalization may be a source of pressure on policymakers, but ultimately developing countries can encourage or discourage globalization. Their economic paths are in their own hands.

Suggestions for Future Research

The process of creating theory, testing hypotheses, and achieving results that both fit and defy prediction are rewards in themselves, but are meaningless if future research does not add to and expand on what was learned in earlier research. In the hope that this dissertation has created a worthwhile avenue for future study, I would like to offer some thoughts and suggestions about possible future research based on this avenue of exploration, and the findings that have proceeded from it.

There are still many avenues to explore. I have argued that FDI policy consists of restrictions on foreign equity, regulation of foreign operations once the investment is made, and taxation. I introduced a measure of foreign direct investment policy, the FDI Equity Index, to serve as a measure of FDI policies. This measure is one-dimensional and only measures restrictions on foreign equity. It does not take regulation of foreign investment or taxation of foreign firms into account, but in the absence of measures of foreign direct investment it marks an improvement in the ability to test theories on FDI.

The next challenge for researchers is to provide alternative, and perhaps more complete, measures of foreign direct investment policy. Taxation has been quantified. Are there measures of corporate taxation rates for a large number of countries over a reasonable number of years? This information is available widely for the developed world, and for some developing countries, but not all. Categories of business regulations are spelled out in existing research, but can we quantify this information across countries and time so that additional studies that meet acceptable standards of validity and reliability can be performed?

Such information would be most helpful if it were available over time. It is possible to learn much about FDI from a static snapshot of one or two years, and we have gained unique insights from such studies. However, as I hope has become clear in this dissertation, foreign direct investment is a dynamic process. Attitudes toward FDI alter, and flows of FDI move in cycles. Collective mind-sets toward FDI have become more open in the past twenty years, but they may not always be that way. Recent nationalizations in Venezuela, Bolivia and Ecuador by leftist governments, for example, could indicate that the cycle is turning back toward restrictiveness of FDI in Latin America. The cyclical nature of economics and politics argues for more studies of the FDI process over time. The longer the dataset and the greater the number of observations over time, the more understanding will be gained from research.

The overall relationship between firm and state needs further development. There are a few causality questions that could be explored. Do policies lead to FDI, or does FDI lead to policies? I've tried to model the causality question of policies by first indicating that policies influence FDI inflows, but that past inflows then influence new

FDI policies. This circle of causation, however, does not truly uncover the dynamics of the interrelationship. At earlier points in time, some developing countries did not have laws that addressed FDI; instead restrictions and regulation of FDI was administered through bureaucracies and bureaucratic interpretation of leadership attitudes. Do these methods of dealing with FDI constitute “policy” as we know it? The Dominican Republic did not codify its investment law until 1978, Honduras until 1992, Panama until 1994 and Lesotho still does not have a law specifically on foreign direct investment on the books. Why have not some developing countries decided to codify their laws, and what effect does this have on openness to FDI?

Another issue I’ve not explored, but have suggested in my analysis of the agreement scenario between firms and states, is that developing countries’ policies could serve as a signaling mechanism to firms about their development intentions. Signaling is a concept that has been researched in the international relations field. Might the signaling literature be explored and adapted into theory that can fit FDI? Do states signal their intentions to firms through their policies? Do firms respond to signaling? There is much in this area that can be investigated.

More study on the role of FDI policies should be undertaken, in particular the economic factors that contribute to FDI policy formation. I proposed that openness to FDI that makes its way into policy responds to the existence of alternatives to FDI. These alternatives are avenues to development that can reduce the reliance of countries on foreign direct investment. The support I found for domestic savings as an alternative shows that there is at least one other avenue that developing countries can explore. The others I proposed, external debt, foreign aid, and a positive trade balance,

did not appear to constitute an alternative. Are there other options that inhibit or encourage FDI? Are there other ways to measure these concepts? My case studies of Nicaragua and El Salvador suggest that remittances from migrant workers to families back in home countries may be a potential alternative to FDI. More research on the relationship of remittances to FDI needs to be conducted, and data gathered that will support this research.

In particular, the role of debt and FDI policy needs to be made clearer. In proposing external debt as an alternative to FDI, my thought was that external debt was an avenue to industrialization because states used loans to invest in national businesses and to establish state-owned industries. This would allow policy-makers to reduce their reliance on FDI and therefore allow them to restrict FDI. However, the findings indicate that higher external debt and open policies are associated. Why might this be? I suggest that higher external debt creates more demands on the state in the form of repayments. In times when states are cutting back on social programs to simply make payments on their debts, FDI becomes essential if states are to continue to industrialize. Their ability to develop themselves has thus been severely compromised by their debt repayments, and they must turn to FDI as a mechanism for continued development. However, more research into the link between these two concepts will be important.

Regional differences in FDI policies should also be studied to a greater extent. I found regional differences to be largely absent, except perhaps Central Asia. However, it appears that Latin America receives more FDI inflows as a percent of GDP than other areas. Why does Latin America receive more inflows, despite the fact that its policies do not stand out among other regions? Does investment there from the United States

significantly affect the total amount of FDI inflows? Do European countries invest more predominantly there than in other regions? Why this disparity?

I also encourage more research on individual countries using the model I have proposed for FDI. I conducted case studies of two countries in Central America, but further case studies on other countries will further shed light on the role of FDI policies in particular economies, and continue to add to the breadth of research on development issues. The countries I chose, while having differences and similarities on many levels, are two small markets. There is much variation that can be explored. Large markets versus small markets, proximity to developed countries versus non-proximity, civil conflict versus peace, democracy versus authoritarian. Of particular interest would those countries that did not get into my statistical analysis because of lack of macro-data on various factors of interest. Do they follow the model I propose, or do they vary in some way?

Finally, I made a conscious choice to limit my investigations to developing countries. This decision was made because I argue that developing countries need to be studied separately lest some of the elements that affect only them get lost in the larger picture of foreign direct investment, globalization and development. This research was undertaken in the full knowledge that the bulk of the world's FDI occurs between developed countries. That leads to two possible avenues of research. First, does the model I proposed also apply to FDI between developed countries? If not, are there elements of the theory that can be modified to explain foreign direct investment in the developed world? The second avenue depends on the first. If such a model can be applied to the developed world, does it give rise to the possibility that foreign direct

investment can be explained for the world in general? Or, is there some line that has to be crossed, some set of factors not yet understood that will eventually transform certain developing countries (such as China, Mexico, India, and Brazil) into developed countries through FDI?

We end where we started. The first chapter proposed some mysteries. Why do some countries that restrict FDI, such as China, Brazil and Mexico, still seem to get so much, while others that have maintained a very open stance toward foreign investment, such as Gabon, Niger and Swaziland, get very little? Certainly China, Brazil and Mexico are attractive to foreign investment, and they could get more if they were to open their policies. Gabon, Niger and Swaziland are not as attractive to foreign investment, but where would they be if their policies were not as open? Foreign direct investment does not simply depend on the resources countries have, or the markets they offer, or the quality and expense of their labor. As developing countries consider courting foreign firms, their economic advancement not only depends on their attractions, but also on policies that indicate how wide they are willing to open the doorways to development.

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Appendix A

Countries Used in the Study

Algeria	Kenya
Argentina	Lesotho
Bangladesh	Madagascar
Bolivia	Malaysia
Brazil	Mexico
Cameroon	Morocco
Chad	Mozambique
Chile	Nicaragua
China	Niger
Columbia	Nigeria
Costa Rica	Oman
Cote D'Ivoire	Pakistan
Democratic Republic of Congo	Panama
Dominican Republic	Papua New Guinea
Ecuador	Peru
Egypt	Philippines
El Salvador	Senegal
Ethiopia	Sri Lanka
Gabon	Swaziland
Gambia	Syria
Ghana	Thailand
Guatemala	Trinidad & Tobago
Guyana	Tunisia
Haiti	Turkey
Honduras	Uruguay
India	Venezuela
Indonesia	Zambia
Iran	Zimbabwe
Jordan	

Appendix B

Descriptive Statistics – FDI Policy Estimations

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
FDI Equity Index	1633	1.4868	1.0302	0	3
Category 0 Dummy	1653	0.1760	0.3810	0	1
Category 1 Dummy	1653	0.3345	0.4720	0	1
Category 2 Dummy	1653	0.2232	0.4165	0	1
Regime type	1649	0.1025	7.0089	-10	10
Nationalism	1426	0.1950	0.3963	0	1
Left	1653	0.2601	0.4388	0	1
Center	1653	0.0557	0.2293	0	1
Other	1653	0.4785	0.4997	0	1
International Institutions	1653	0.7621	0.2615	0	1
Proximity	1653	0.1633	0.3698	0	1
Savings/GDP	1629	16.2427	15.0069	-92.7636	72.9801
ODA/DAC* ⁺	1650	1.3249	0.2407	0	2.5685
Trade Balance/GDP	1550	-0.0517	0.3896	-1.6962	6.09
Debt/GDP*	1630	-0.0765	0.8702	-2.9326	2.6984
FDI inflows/GDP (5 yr avg)**	1634	2.0085	0.2531	0	3.4925
Population*	1653	16.4355	1.5983	13.1174	20.9827
Sub-Saharan Africa	1653	0.3158	0.4650	0	1
East Asia	1653	0.1053	0.3070	0	1
Latin America	1653	0.3509	0.4774	0	1
South Asia	1653	0.0702	0.2555	0	1
North Africa	1653	0.1579	0.3648	0	1
* Variable logged for estimation		+ Variable right-shifted			

Appendix C

Descriptive Statistics – FDI Inflows Estimations

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
FDI inflows/GDP*	1642	2.7158	0.1747	0.3337	4.0881
Regime Type _{t-1}	1594	-0.0163	7.0114	-10	10
Nationalism _{t-1}	1411	0.1970	0.3979	0	1
Left _{t-1}	1596	0.2632	0.4405	0	1
Center _{t-1}	1596	0.0558	0.2295	0	1
Other _{t-1}	1596	0.5326	0.4991	0	1
Durability _{t-1}	1596	14.3346	14.5292	0	83
Internal War _{t-1}	1596	0.2024	0.4019	0	1
External War _{t-1}	1596	0.0320	0.1759	0	1
International Institutions _{t-1}	1596	0.7556	0.2629	0	1
Proximity to Developed Countries	1653	0.1633	0.3698	0	1
Agriculture Value-added / GDP _{t-1}	1540	21.1174	11.7337	1.1694	63.8267
Manufacturing Value-added/GDP _{t-1}	1466	16.0423	7.2324	0.4863	40.7060
Extractives Value-added/GDP _{t-1} **	1466	3.4905	0.3012	1.6289	4.4893
Services Value-added/GDP _{t-1}	1540	48.4456	9.9135	16.4766	78.5302
Category 1 _{t-1}	1576	0.3496	0.4770	0	1
Category 2 _{t-1}	1576	0.2475	0.4317	0	1
Category 3 _{t-1}	1576	0.2056	0.4043	0	1
GNI/Capita _{t-1} **	1632	6.6986	1.0293	3.6990	8.9997
Corruption	1653	-0.4487	0.5297	-1.5504	1.3578
Property Rights	1653	46.4279	14.7983	10	90
Population _{t-1} *	1596	16.3043	1.7647	10.8579	20.9763
Sub-Saharan Africa	1653	0.3158	0.4650	0	1
North Africa	1653	0.1579	0.3648	0	1
Latin America	1653	0.3509	0.4774	0	1
East Asia	1653	0.1053	0.3070	0	1
South Asia	1653	0.0702	0.2555	0	1
* Variable logged for estimation		+ Variable right-shifted		- Variable left-shifted	

Appendix D

The Foreign Equity Index

The original intent behind this study was to create a variable which employed a number of different dimensions of FDI policy. Not only was the variable envisioned to measure equity, but also tax breaks, duty exemptions, screening, and profit and capital repatriation. However, two things became apparent as the content analysis commenced. First, the information in the Exporters Encyclopedia had some gaps. All countries were not covered equally, and even ranges of years within some countries were not covered adequately. Second, except for foreign equity restrictions, which were often reported when they changed, there was a lack of “negative” information on the other components of FDI policy. Tax breaks and customs duties, for example, were often reported when they existed, but no mention of them was made in other years, and it could not be assumed that they did not exist in those times. Likewise, the same situation appeared for screening, and for repatriation.

In the case of foreign equity restrictions, however, it was apparent that long stretches of an unchanged description of a country’s FDI policy meant that its equity restrictions also were most likely unchanged. If it was learned, for example, that in 1976 a country only allowed foreigners a minority stake in its domestic businesses, and then in 1983 a new policy was introduced that allowed 100 percent equity investment for foreigners in some sectors, it could be assumed that the equity restrictions in 1976 stayed unchanged until 1983. In many cases, there were gaps that made determining whether a policy changed unclear, and so corroborating information was sought on the

Internet. A number of sites were helpful in filling gaps in the data or corroborating existing information from the Exporter's Encyclopedia, including sites belonging to the State Department, The Heritage Foundation, regional trade organizations and official government websites.

Appendix E

Specification of the FDI Policy Estimations

A multilevel generalized linear model follows the following specification:

$$\eta = x' \beta + \sum_{l=2}^L \sum_{m=1}^{M_l} \eta_m^{(l)} z_{m1}^l$$

where $z_{m1}^l = 1$, allowing for a random intercept at each level. By omitting the random terms, the equation for a two level generalized linear mixed model becomes:

$$v_{ij} = x_{ij}' \beta + \eta_j^{(2)}$$

Following this, fitting the glamm to an ordered probit is accomplished:

$$Y_{ij}^* = v_{ij} + \varepsilon_{ij}$$

where Y_{ij}^* = discrete categories of the FDI equity index for observation i in country j ,

v_{ij} = the generalized linear mixed model for observation i in country j

ε_{ij} = a random error term, assumed to follow a standard normal distribution.

The observed and coded discrete dependent variable, Y_{ij} , is determined from the model as follows:

$$Y_{ij} = \begin{cases} 0 & \text{if } -\infty \leq Y_{ij}^* \leq \mu_1 \\ 1 & \text{if } \mu_1 \leq Y_{ij}^* \leq \mu_2 \\ 2 & \text{if } \mu_2 \leq Y_{ij}^* \leq \mu_3 \\ 3 & \text{if } \mu_3 \leq Y_{ij}^* \leq \infty \end{cases}$$

where the μ_k 's represent thresholds to be estimated along with the parameter vector β .

Probabilities associated with the coded responses of this ordered probit model are as follows:

$$\begin{aligned}
 P_{ij}(0) &= \Pr(Y_{ij} = 0) = \Pr(Y_{ij}^* \leq \mu_1) = \Pr(x'_{ij}\beta + \eta_j^{(2)} + \varepsilon_{ij} \leq \mu_1) = \Pr(\eta_j^{(2)} + \varepsilon_{ij} \leq \mu_1 - x'_{ij}\beta) \\
 &= \Phi(\mu_1 - x'_{ij}\beta) \\
 P_{ij}(1) &= \Pr(Y_{ij} = 1) = \Pr(\mu_1 \leq Y_{ij}^* \leq \mu_2) = \Pr(\eta_j^{(2)} + \varepsilon_{ij} \leq \mu_2 - x'_{ij}\beta) - \Pr(\eta_j^{(2)} + \varepsilon_{ij} \leq \mu_1 - x'_{ij}\beta) \\
 &= \Phi(\mu_2 - x'_{ij}\beta) - \Phi(\mu_1 - x'_{ij}\beta) \\
 &\vdots \\
 P_{ij}(e) &= \Pr(Y_{ij} = e) = \Pr(\mu_k \leq Y_{ij}^* \leq \mu_{k+1}) = \Phi(\mu_{k+1} - x'_{ij}\beta) - \Phi(\mu_k - x'_{ij}\beta) \\
 &\vdots \\
 P_{ij}(E) &= \Pr(Y_{ij} = E) = \Pr(\mu_k < Y_{ij}^*) = 1 - \Phi(\mu_k - x'_{ij}\beta)
 \end{aligned}$$

where i is an individual observation, j is the level of observation, e is the FDI equity policy alternative, $P(Y_{ij} = e)$ is the probability that the policy is e , and $\Phi(\cdot)$ is the standard normal cumulative distribution function.

Vita

Michael L. Hess was raised in Fort Bragg, California. He attended Santa Clara University from 1982 through 1986, where he graduated with a Bachelor of Arts in English. From 1986 through 1995 he lived in the inner-city of Milwaukee, Wisconsin after arriving there to perform volunteer service with the Jesuit Volunteer Corps. In 1995 he married Megan Kamerick and they moved to San Antonio, Texas where he gained employment as the executive director of a non-profit group promoted corporate social and environmental responsibility. While in Texas, he earned a Master of Arts in International Relations at St. Mary's University. In 2000 he and Megan moved to New Orleans where he began his doctoral studies in Political Science at the University of New Orleans. He and Megan currently reside in Albuquerque, New Mexico with their dog, Zia.

Michael credits his uncle, former University of California doctoral candidate John M. Hess with his inspiration to pursue a higher academic endeavors; his family, especially his mother, Shirley Hess, for the constant encouragement; his wife, Megan Kamerick, for her loving support and patience; Dr. Larry Hufford of St. Mary's University for strongly suggesting a Ph.D. program; his doctoral committee, chaired by Dr. Marc Rosenblum, for its guidance; and the City and University of New Orleans for making his studies not only academically rewarding, but providing a wonderfully rich and diverse environment in which to live and work for four years. New Orleans will live on!