FOREIGN DIRECT INVESTMENT AND CIVIL LIBERTIES: A NEW PERSPECTIVE

Antonis Adam[♦]
and
Fragkiskos Filippaios
Athens University of Economics and Business
Department of International and European Economic Studies

Abstract

This paper blends the political economy and the International Business FDI literature and examines the relationship between FDI and democracy. Even though the usual conjecture that civil and political repression boosts FDI in developing countries has been widely refuted in empirical studies, we find support of this view. We distinguish between civil and political liberties that a regime delivers and we argue that multinational firms tend to invest in countries with low civil but with high political liberties. Empirical results, for US FDI, provide strong support the above distinction. Furthermore, we show that the negative relationship between civil liberties and FDI is non- linear such that a threshold level of civil liberties exits below which a decrease in civil liberties increases FDI and above it the opposite holds. Taking this non-linearity into account increases the predictive power of the model and the support of our original hypothesis. The results can be explained in terms of different economic motives for FDI activity in different group of countries.

Keywords: FDI, Political liberties, Civil liberties, USA, Repression
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♦ Author to whom correspondence should be addressed: Athens University of Economics and Business, Department of International and European Economic Studies, 76 Patission str., 104 34, Athens, Greece. Tel: +30210-8203354, Fax: +30210-8214122, e-mail: aadam@aueb.gr

1. Introduction

During the last years the focus of economic literature on developing countries has evolved a lot. Two are the main driving forces beneath this change: The process of globalization and the understanding that the developing countries are different in economic terms from the rest of the developed countries in the world. These two forces function in a complimentary way and the one reinforces the other. Many authors following this new trend, started to reappraise the nature of development and the way in which the multinational enterprises (MNEs) are responding to and influencing it.

In what nowadays is considered to be the Old Development Paradigm (ODP) as Dunning (2004) states, both the economic goals and the characteristics of developing countries did not differ from those of the developed ones with the only difference steaming out of the fact that the former were less developed. At the present time, the process of globalization is changing rapidly the economic environment through the liberalisation of markets and the technological advances in cross border transport and communication followed by vast and rapid information flows and knowledge. This created a need for a reassessment of the ODP. The creation of the New Development Paradigm (NDP) based on the work of three Nobel Prize Laureates is the answer to this need (Dunning, 2004). Three are the main pillars of the NDP: The progressing of real freedom for people in developing countries as described by the work of Sen (1999), the transformation in economic terms of resources, capabilities, societies and markets in developing countries coming out of the work of Stiglitz (2002) and finally the incentives structures affecting the process of economic development as posed by North (1990, 1994, 1999).

This paper is in the heart of the NDP, focusing on issues of foreign direct investment (FDI) and political and economic freedoms in developing countries. Until now the issue of MNEs expansion to developing countries is disregarded in economic literature, perhaps due to the relatively small amount of FDI attracted by these countries. The number, though, of developing countries' players in the international chessboard (Eden and Lenway, 2001) is increasing rapidly. According to United Nations Conference on Trade and Development (UNCTAD) data, the number of established foreign affiliates in developed countries is almost five times larger than those established in developed ones[1]. Moreover, the relative importance of FDI in developing countries is much larger in terms of Gross Domestic Product (GDP) and has gained further importance during the last twenty years. In table 1 we present the Inward FDI Stock as percentage of GDP.

Insert Table 1 here.

It is obvious that the importance is double than in developed countries and has more than doubled during the last twenty years. The need to evaluate MNEs as participants in the process of globalization with special attention in their activities in developing countries is therefore evident.

In this framework of analysis, seminal is the work of Rodrik (1996) who investigates the relation between democratic rights in various countries and whether they attract or deter FDI coming from the United States (US). His results are in support of the hypothesis that countries with weaker democratic rights attract less US capital. His study is the first to

[1] The actual numbers are 517.611 foreign affiliates in developing countries and 105.830 in developed countries.

give a clear answer to a debate starting back in the mid-seventies with the work by Huntington and Dominguez (1975) who supported that autocratic rulers provided a better economic environment for both domestic and foreign investments since they were more able to enact efficiency enhancing policies despite their non democratic attributes. The contrary argument comes from the work by Olson (1993) and McGuire and Olson (1996) who suggest that there is a large risk of policy reversals in dictatorships and a lack of credibility of autocratic rulers. These facts should deter investments and especially the international ones.

Several studies have followed these arguments trying to give straightforward answers in the relation between political and civil liberties and the FDI attraction. Greider (1998) and Meyer (1998) reach similar conclusions with the first one suggesting that FDI does not have a liberalizing effect in autocracy countries and the second one to support that MNEs are robbing developing nations of their economic sovereignty and furthermore support repressive regimes. Opposing to these arguments is the work of Harms and Ursprung (2002) who do not find support for the argument that MNEs have a preference for undemocratic regimes. Instead they found that individual freedom attracts FDI. Their results are confirmed by the work of Busse (2004) who states that MNEs appeared to be attracted by countries where democratic rights are protected.

Although implicitly assumed, all the above studies do not distinguish between political and civil liberties and their role in attracting or deterring FDI. This paper comes to cover this large gap in the literature by assuming that political and economic liberties do not play the same role in the investment decision. Democracy is not a one-dimensional issue, but it may involve several other dimensions. For this reason one cannot treat political and

civil liberties as perfect substitutes and simply measure democracy as the average of them. A better treatment of the underlying relationship requires for civil and political liberties to be treated as complements giving rise to different incentives and disincentives for investment.

This differential impact can be easily observed in a simple theoretical model of investment as in Hart and Moutos (1995). Even though repression of civil liberties may give rise to an incentive for investment, repression of political liberties and non-democratic decision making may have the opposite effect. Further the model predicts a non- linear relationship between civil liberties and investment.

A second contribution of this paper is the use of arguments coming from the International Business literature to explain MNEs behaviour towards developing countries.

The rest of the paper is organized as follows: The next section distinguishes between political and economic freedom and their role in investment decisions. Section 3 presents the theoretical model, whilst section 4 gives a brief description of the sample and data used and the underlying hypotheses. Then the results of our empirical exercise are presented in section 5. Finally, section 6 concludes the paper, offering possible extensions.

2. The measure of Democracy- Civil and Political Liberties

Political regimes across countries exhibit a large degree of heterogeneity. This heterogeneity is more profound in the case of non- democratic regimes. Only recently Wintrobe (1998) has presented a unified framework for studying dictatorial regimes. The driving force of decision making process in dictatorships is the “Repression” and

"Loyalty" the regime delivers to the citizens. On the empirical side, when one tries to measure the status of the regime in a country the most widely used measure is the Gastil Index constructed by the Freedom House foundation. Freedom House in a non-governmental organization that since 1972 is rating all countries in the world according to their democratic institutions and constructs two indexes, one for political rights and one for civil liberties. Each index takes a value from 1 to 7, with a rating of 1 for countries with political and civil liberties that come closest to the ideals and 7 for countries with absence of all democratic rights. The political rights index (POL) ideals mainly involve questions about how the government is elected and the constitutional role of the elected government in decision making. On the other end the civil liberties (CIV) ideals involve a series of various economic, political and civil liberties enjoyed by the citizens of the country, such as Freedom of Expression and Belief, Association and Organization Rights, Rule of Law and Personal Autonomy and Economic Rights.

Up till now the standard practice (Rodrik, 1996; Busse, 2004) was to treat the two measures POL and CIV as two components of the same variable namely "democracy". This is not however a sound practice since POL and CIV are two different components of democracy, that each induces different investment behavior. In our sample and for the 1989- 2000 period, even though POL and CIV are highly correlated[2], there are marked differences in the two variables. If one tests the hypothesis that POL and CIV are equal the t-test, of the null hypothesis that POL and CIV are equal, results in a value of -2.815, thus rejecting the null. This implies that although a dictatorial regime may deliver a low amount of political freedoms it may at the same time allow for more civil liberties. In the

[2] The Spearman rank correlation is estimated to be 0.93

theoretical model we build next we show that civil and political freedoms in fact affect the decision of whether to invest in a dictatorship asymmetrically.

Insert Figure 1 here.

In figure 1 we present the difference between (average across time) POL and (average across time) CIV in our country sample. In the horizontal axis we pot the countries. The difference between the two variables is clear to non- zero. Thus it is sound not to treat both POL and CIV as a single measure of democracy. In some instances political liberties are lower than civil ones and vice versa. To our knowledge all studies up till now tend to construct a single index, which is a combination of the two.

Civil liberties can be more directly linked to the workings of the economy. Association rights and rights of expression of beliefs, rights that are directly associated with civil liberties, affect the organization of the workers in unions. If and how workers are organized in unions and whether these unions can extract a large proportion of the rents of the FDI, directly affect the decision of how much to invest in the economy (Hart and Moutos, 1995).

On the other hand political liberties indirectly affect the economy. Less democratic countries are more likely to follow predatory policies (Drazen, 2000) in order to benefit a small minority elite and harming the general public. Such policies may involve very high tax rates, lower amount of public goods, etc. in order to ensure rents for the dictator's favorite group. Even though one can argue that such pressures also exist in a democracy, in a non-democratic regime these pressures are stronger due to the absence of the control

mechanism that the election provide (Ferejohn, 1986), that to some extend put an upper limit to such forces. Such predatory policies sometimes can be targeted more to foreign firms than to national firms, thus providing many disincentives to invest in the form of FDI in non- democratic countries.

In the section that follows we develop a simple model where the decision of whether to invest or not in the economy depends on the specific characteristics of the regime on civil and political liberties. Our main conclusion is that civil and political liberties work in two separate channels: civil liberties and the freedom to organize in unions negatively affects the decision for investment (less civil liberties create an incentive for investment), whereas the exercise of repression from the regime (lower political liberties) crates a disincentive for investment.

3. The Theoretical Model

The model builds upon Grout (1984) and Hart and Moutos (1995). The decision of the firm to invest abroad in the form of FDI, involves an initial cost that must be undertaken before the firm bargains with the local union about the wage rate. After the investment has been made the workers' union has an incentive to push for higher wages in order to extract a fraction of the FDI's rents. In other words we assume that the foreign firm undertaking the FDI and the union make a non- binding contract (Grout, 1984), where the union cannot commit to the wage rate after the investment is undertaken. The higher the power of the union on wage negotiations the higher the amount the union extracts from the foreign firm and the lower the FDI.

The degree of union power is directly related to the civil liberties allowed by the political regime. If there is complete absence of civil freedoms, and the workers cannot form a union, then there is no risk for the firm to lose (part of) its rents from the labor union. On the other hand when higher civil liberties are allowed, workers are free to form more powerful unions and eventually lead to a reduction on the level of foreign investment.

On the other hand a suppression of civil liberties as already suggested by Wintrobe (1998) may have large negative effects on the utility of the workforce, thus providing large disincentives for work effort and thus labor productivity. Thus the overall effect of the suppression of civil liberties on investment is ambiguous. A small repression of civil liberties may have a positive effect, whereas a large suppression may result into negative effects on FDI attraction.

As far as political liberties are concerned, we assume that where the electoral control is less efficient[3], the political regime provides less efficient policies. In the present model this is represented as a higher tax in countries with lower political liberties. This can be generalized to include all kind of public policies. In non- democratic regimes, the less efficient policies are attributed to predatory policies followed by the regime ruler. The ruler can act like a stationary bandit (McGuire and Olson, 1996) so as to maximize the amount he can extract from the economy. In the model that follows we take into account this latter view, a dictator is more likely to use predatory policies that maximize government revenue in order to benefit himself, and a small elite- minority, at the expense of the general public. For that reason we assume that the tax rate that the government imposes is a decreasing function of the political freedom: countries with lower political freedom ceteris paribus impose higher tax rates.

[3] i.e. Elections are not free or/ and fair, etc.

Firms

The firm produces a homogeneous good with the use of labor L and capital K. Since we focus on FDI decision we assume that K is the amount of firm specific capital that the firm transfers from its home country in order to benefit from the advantages of the foreign country (e.g. cheap labor cost, natural resources etc.). In order to get analytically tractable results we assume that the production function of the firm is Cobb- Douglas. Further we assume that inside the production process exhibits internal diminishing returns to scale.

The firm sells all its production in the free, competitive and tariff free product market at the world price p* which is normalized to unity. The objective of the firm is to maximize profits, i.e. the difference between revenues and cost:

$$\Pi = (1-t)Y(K,L) - wL - rK = (1-t)K^{\gamma}(eL)^{\delta} - wL - rK \qquad (1)$$

with $\gamma+\delta<1$ (Decreasing Returns to Scale) and t the tax rate that the government imposes and e is a labor specific productivity parameter, we shall call "effort" put forth by the workers. We assume that effort can be directly observed by the firm and thus propose a wage scheme that depends on the productivity of labor and thus the effort of each worker. Further we assume that the effort of the workers depends only on the civil liberties provided by the regime. When civil liberties are low, the workers cannot co- operate effectively since they are not accustomed to cooperative practices in other areas of their economic and social life. Moreover in an environment characterized where civil liberties are repressed, the work force is highly discouraged and not able to perform effectively at work. Further when civil liberties are relatively high then the effect of a small decrease in

these liberties is expected to exert lower discouragement on the work force than when civil liberties are initially low. All the above imply that if α is the amount of civil liberties then e=e(α), with e'(α)>0, e''<0.

With respect to the tax rate we assume that t is a function of the political freedom, i.e.:

$$t = t(P) \tag{2}$$

where P are the political freedoms, with t'(P)<0 and t''(P)<0.

The goal of the firm is to maximize expected profits from the bargaining. If an agreement between the union and the firm is reached during bargaining the firm earns profits as in (1), whereas if an agreement is not reached the firm has to pay for the capital it has transferred in the country. Then the firm during the bargaining seeks to maximize the difference:

$$\Pi - \overline{\Pi} = \left((1-t)K^{\gamma}(eL)^{\delta} - wL - rK\right) - (-rK) = (1-t)K^{\gamma}(eL)^{\delta} - wL \tag{3}$$

Unions

Workers are risk- averse and their interests are represented by a labor union who seeks to maximize its member's expected income[4] by bargaining over the wage rate and employment. The foreign firm pays a wage rate w and employs L workers from the total number N of union members. The rest of the union members that are not employed after the bargaining with the firm end- up in an alternative employment which pays an alternative income x. Since our focus is upon developing countries the alternative income may be the income raised by working in the rural sector, or the income raised while

[4] Since workers are risk- neutral, expected income maximization and expected utility maximization gives exactly the same results.

waiting for a job in the urban sector. Thus the expected income of the union if an agreement is reached is:

$$V = Lw + (N - L)x \tag{4}$$

On the other hand if there is no agreement between the union and the firm all union members find other employment and earn the alternative income x, i.e. the utility of the union if an agreement is not reached is:

$$\bar{V} = x \tag{5}$$

The timing of the events is as follows:

The firm first chooses how much capital to invest in the foreign country[5]. Then the firm and the union bargain over the wage rate and employment (efficient bargain). In order to obtain a time consistent solution we solve the model backwards.

Bargaining

The firm and the union at the second stage of the game, bargain over employment and wages, i.e. efficient bargain model. We assume that the union and the firm are both risk-neutral. The firm wants to maximize profits, whereas the union's objective is to maximize the expected excess utility of its members.

To determine the outcome of the bargain we have to define the Nash product. Given the above the Nash product is given by:

[5] We have taken all previous stages of investment decisions as given. Thus we do not explicitly model how the firm has decided the location of its investment. Given that we present a bargaining model with perfect information and since the location decision is made at an earlier stage preceding the game presented here it is clear that it will be affected by the solution of the model without affecting the later stages. Having a more complete model with explicit decision by the firm of where to invest will not affect the results derived here. So we choose to make such decision exogenous.

$$\max_{w,L} \Omega = \left(V - \bar{V}\right)^{\alpha} \left(\Pi - \bar{\Pi}\right)^{1-a} = \left((w-x)L\right)^{\alpha} \left((1-t)K^{\gamma}L^{\delta} - wL\right)^{1-\alpha} \quad (6)$$

where α is union's power in the bargaining process. When civil liberties decline, i.e. workers are not allowed by the political regime to form unions and bargain with the firm, α declines. So a reduction in civil liberties can be associated with a drop in α. On the other hand a fall on the political freedom is associated with a higher tax rate.

Maximizing (6) results in two first order conditions:

$$w = (1-\alpha)x + \alpha(1-t)K^{\gamma}e^{\delta}L^{\delta-1} \quad (7)$$

$$w = \alpha(1-t)K^{\gamma}e^{\delta}L^{\delta-1} + (1-\alpha)(1-t)\delta K^{\varepsilon}e^{\delta}L^{\delta-1} = (1-t)K^{\gamma}e^{\delta}L^{\delta-1}(\alpha - \alpha\delta + \delta) \quad (8)$$

If we solve the two first order conditions we can determine the equilibrium wage rate and employment of the firm:

$$w = x\frac{\left(\alpha + \delta - \alpha\delta\right)}{\delta} \quad (9)$$

$$L = \left(\frac{(1-t)K^{\gamma}e^{\delta}\delta}{x}\right)^{\frac{1}{1-\delta}} \quad (10)$$

Investment decision

The firm taking into account the later stages of the game (equations (9) and (10)) decides on the first stage the amount of capital to invest in the foreign economy by maximizing:

$$\max_{K} \Pi = (1-t)K^{\varepsilon}(eL)^{\delta} - wL - rK = (1-\alpha-\delta+\alpha\delta)K^{\gamma}(eL)^{\delta} - rK \quad (11)$$

where we have substituted in (1) equation (8). Maximizing (11) with respect to K results into:

$$r = (1-t)\gamma(1-\alpha-\delta+\alpha\delta)K^{\gamma-1}(eL)^{\delta} \quad (12)$$

Now we can solve equations (10) and (12) to determine K:

$$\mathrm{K}=\left(\frac{(1-t)\gamma(1-\alpha-\delta+\alpha\delta)}{r}\right)^{\frac{1-\delta}{1-\gamma-\delta}}\left(\frac{(1-t)\delta}{x}\right)^{\frac{\delta}{1-\gamma-\delta}}e^{\frac{\delta}{1-\gamma-\delta}} \tag{13}$$

Comparative Statics- Testable hypothesis

One now can easily determine the effects of a decrease in the civil liberties (decrease in α) and the effects of a decrease in political liberties (increase in t). Taking the derivative of K with respect to α and t one can show that:

$$sign\left[\frac{\partial K}{\partial\alpha}\right]=sign\left[(1-\delta)\frac{\delta-1}{1-\alpha-\delta+\alpha\delta}+e^{-1}\frac{\partial e}{\partial\alpha}\delta\right] \tag{14}$$

and

$$\frac{\partial K}{\partial t}<0 \tag{15}$$

Equation (14) suggests that the relationship between the degree of civil liberties and investment is ambiguous. When α changes there are two effects: the direct investment effect and the labor productivity effect. An increase in α (increase in civil liberties) increases the power of the union and thus the amount of profits of the MNE that the union can extract, thus depressing investment. On the other hand an increase in α increases labor productivity and thus the marginal product of capital increasing investment. When α is high (high civil liberties) then the second effect is small thus the first effect must dominate. Then a small decrease (from the originally high civil liberties) increases FDI. The opposite holds when α is low.

The above non- linear effect of a change in civil liberties on the level of (foreign) investment, and in a dynamic model, on the growth rate of the economy is a relationship verified on empirical analysis of the comparative performance of democracies and dictatorships (see Przeworski and Limongi, 1993 for a survey).

Turning to the political liberties, a reduction of political liberties via an increase on the tax rate decreases the marginal productivity of capital and labor thus decreasing investment.

In the next sections, where we test the empirical validity of (14) and (15).

4. Hypotheses and Data Description

The above theoretical model does not capture all aspects of the real world. For that reason if we want to estimate equation(13), we must add a series of other variables for the econometric model to be correctly specified. For that reason we add two group of variables: variables that capture the motives of MNEs activity and investment driving factors and variables that capture institutional factors.

To explain MNEs activity we use a tripartite typology of engaging in foreign production[6]. Market seeking (MS) involves primarily producing within a country to supply the market of that country or a, probably contiguous group of countries.[7] Three distinct elements condition the choice of MS operations in a country. Firstly, that the target market is a worthwhile (i.e. currently, or potentially, significantly profitable) part of the enterprise's logical competitive environment. Secondly, that there are reasons for supplying the market through local production rather than through trade and third in the case of

[6] The typology of motivations used here adapts earlier approaches of Behrman (1984) and Dunning (1993).
[7] For example, the specific nature of MS behaviour in W. Europe has evolved as individual countries have entered the EU (Tavares, 2001; Tavares and Pearce, 2001), whilst MS has proved to be a major reason for MNEs' initial operations in the CEE transition region (Lankes and Venables, 1996; Mutinelli and Piscitello, 1997).

developing countries the existence of a peculiarly prosperous elite. The FDI is a mechanism that generates new employment and rewards patterns to reinforce the existence of this elite. Another argument for MS behaviour in developing countries is suggested by Pearce (2004), stating that the entry allows MNEs to use their capabilities in order to learn about the real conditions of the local market prior to possible movement to more refined operations capturing efficiency seeking behaviour. To capture this MS behaviour we introduce the log of real country's GDP per capita (GDP). The real GDP data are taken from PWT (2003). Another aspect of MS motives is captured by the use of real GDP growth rates (GDPGR) capturing the growth potential of the market and thus implicitly future opportunities.

The second strategic imperative, in the form of efficiency seeking (ES) motives in developing countries, steams out of the Marxist era of Stephen Hymer's work (1970). Here production of specific existing goods is again relocated to a particular country or countries, but now with the main objective of sharpening the cost-efficiency. Trade openness (OPEN) taken from the PWT (2003) is used to control for import substitution or complementarity with FDI. Trade openness is defined as exports plus imports over GDP. This strategy will enable MNEs to enhance (or defend) their competitiveness in those (usually higher-income) markets where they are already well established. According to Hymer (1970) MNEs must keep under control the world's poorest segments of population in order to be unable to rise up against the inequalities of the international system. In this case it is the MNEs main objective to depress local wage and exploit local labour force in cooperation with a repressive government (Spar, 1999)

Both MS and ES represent ways in which MNEs seek to enhance the benefits they can secure from their mature competitive technologies, as embodied in successful established products. On the other hand our third strategic motivation, knowledge seeking (KS), relates to the internationalisation of the ways in which these companies pursue the medium- and long-term regeneration of their competitive scope. This type of investment is extremely scarce in developing countries mainly due to two reasons: First, the incapability of the local economy to support high-technology investments and second, the high risk of establishing high value-added activities in developing economies.

The second group of variables that affect the investment decision is the group of institutional variables. To control for the effects of these institutional factors, we use the data of IRIS (2000) and construct two qualitative variables NORISK and BUSCL. The variable NORISK measures the overall political risk of the economy whereas the BUSCL measures the overall investment climate in the economy. NORISK is the created a function of the IRIS variables Ethnic Tensions, repudiation of contracts by the government and risk of expropriation. Similarly BUSCL is a function of corruption in government, rule of law and bureaucratic quality. Since both variables are a combination of other variables we used the Cronbach's Alpha procedure, where we computed all interitem correlations between the components in order to create the variables NORISK and BUSCL. An increase in NORISK implies a decrease in the political risk, and an increase in BUSCL implies better working of the government. Table 2 summarizes the variables used and their respective sources.

Insert Table 2 here.

Finally many institutional aspects of the economy cannot be directly measured. Further these institutions are constant in time. In order then to control for these time invariable, country specific variables we estimate the model with country specific Fixed Effects. Since we are dealing with developing countries, the most important of these fixed effects that we want to capture are the country's natural resources. In all cases we found that the fixed effects are highly significant. Country specific factors such as natural resources, or cultural factors play an important role in affecting the investment decision.

Our empirical exercise uses a linear approximation of the model coming out of our theoretical background in section 3 and our hypotheses is the following:

$$FDIPC_{it} = GDP_{it} + OPEN_{it} + GDPGR_{it} + ECONFREE_{it} + POLFREE_{it} + BUSCL_{it} + NORISK_{it} + \mu_i + \varepsilon_{it}$$

where i represents country, t represents the time element, μ_i is the fixed effect and ε_{it} is the usual error term.

The sample involves a total of 105 developing and developed countries for the time period 1989- 1997. The time dimension is limited by unavailability of data for most of the developing countries. To measure civil and political liberties we use the Freedom House (2002) Gastil index as described in the previous section. The dependant variable in all equations is Foreign Direct Investment flows from US firms normalized by GDP (FDIPC). The FDI data are taken from the US Census Bureau of Economic Analysis, while for the rest of our economic variables, i.e. GDP, OPEN, GDPGR we use the Penn World Table (PWT, 2003) data.

5. Results and Interpretation

As a first step in order to test the reliance of our sample we replicate the results of Rodrik (1997) and Busse (2003). For that reason we create the variable DEMOCRACY defined as in Helliwell (1994):

$$DEMOCRACY = \frac{14 - POLFREE - ECONFREE}{12} \tag{16}$$

The results of this first step is shown in table 3. The qualitative results with respect to the democracy variable is the same as in previous studies. The democracy variable is insignificant. This seems to refute the hypothesis that less democratic countries tend to attract more foreign investment.

Insert table 3 here.

We now turn to the case where we split democracy into POLFREE and CIVFREE. In table 4 we present the results for the Full sample, only for the countries belonging to the Organization for Economic Co-operation and Development (OECD), and then for the rest of the countries not belonging to the OECD[8].

Insert table 4 here.

The results clearly support our initial intention to split the two variables capturing civil and political liberties. The two variables are differently signed in all three equations and furthermore they are both statistically significant in the Full sample equation and in the developing countries equation. What emerges as consistently positively statistically significant in all equations is the GDP, capturing the market seeking motive of US FDI.

[8] Similar are the results if someone distinguishes the countries accordingly to their income level.

This result is common in the literature both for studies focusing on developed and developing countries (Wheeler and Mody, 1992; Chakrabarti, 2001; Busse, 2004). On the other hand the openness to trade is significant only for the OECD sample suggesting a trade substituting effect on behalf of US investors. Finally, the last economic variable GDPGR is negative and statistically significant only in the developing countries sub-group, a result that is not common in the literature. Only a few studies like the one by Mencinger (2003) produce a similar result. A possible explanation given, is that this variable captures, through fluctuations in the GDP, the uncertainty of the market potential.

The two variables capturing the civil and political freedoms in the host countries are differently signed and statistically significant for the Full sample. The positive sign of CIVFREE variable assures our hypotheses for the repression of civil liberties, whilst the POLFREE variable is negatively signed suggesting avoidance from US investors of countries with low political liberties. The two variables remain significant for the developing countries equation reinforcing our previous argument, whilst for the OECD sample the POLFREE loses its significance, perhaps due to the high level and low variability in time of the political liberties in all OECD countries.

Then the main question that arises is whether the MNEs motives described in the theoretical model and the previous section are the same in all cases irrespectively from the level of civil and political liberties. As the theoretical model suggests the relationship between civil liberties and the ability to attract FDI is non- linear. A small suppression of civil liberties is expected to have a positive effect on FDI flows, whereas a large suppression has a negative effect on FDI, though disincentive effects that this may have

to the workforce. To test this hypothesis we decided to split the developing countries sample with respect to the level of civil liberties. In table 5 we present the results for countries that have either too high or too low civil liberties. The breakpoint is taken to be when CIVFREE is equal to 3. The choice of this breakpoint level was based on testing which level of CIVFREE gave the more statistical significant different estimated coefficients[9]. The splitting of the sample is also confirmed by a standard Chow test.

Insert table 5 here.

When MNEs invest in countries with high-level civil liberties, our argumentation for the different aspects of civil and political freedoms holds and is reflected in the different signs of the two variables, i.e. CIVFREE is positive and statistically significant and POLFREE is negative and statistically significant. The positive sign of the former suggests that US investors have primarily an efficiency-seeking motive for FDI. This is due to the suppression of unions, interest groups etc. This is also mirrored in the negative sign of the GDPGR variable, which suggests that future growth prospects might liberalize the economy (Wintrobe, 1998) and thus strengthen the power of the labor force. This motive does not hold for countries with too low civil liberties, i.e. CIVFREE larger or equal to 4. Both variables measuring freedoms are non statistically significant, probably due to the specific characteristics of the countries forming this group, i.e. these are the

[9] To choose among various breakpoints in our sample we also employed the Supremum F test, which involves estimating all Chow F statistics for each potential breakpoint in the sample and choosing the one where the F statistic was higher. When this test was implemented the breakpoint was determined at CIVFREE=4. The differences of the estimated coefficients among the two models (CIVFREE≤4 and CIVFREE<4) were not as statistically significant as the ones presented here. Further both R-squares were much lower than when the breakpoint was at CIVFREE=3.

most autocratic and suppressive regimes among the developing countries. The only reason for investing in such a country is the seeking of raw materials and natural resources, or a market seeking motivation through the existence of prosperous elite. The GDP variable emerges as the driving force of US investments implying a primarily MS motive. The OPEN variable is moreover positively signed suggesting an FDI strategy aiming at exporting raw materials or natural resources. It is thus clear that the investment motives in the two groups are completely different.

6. Conclusions

The main motivation behind this study is the blending of international business and the political economy literature in explaining US MNEs investments in developing countries. The objectives of various MNEs when they invest abroad may be quite distinct. This paper points towards this direction. Even though non- democracies may have factors that attract FDI, it is an open question whether MNEs will be encouraged by these factors in order to invest in that economy or whether they are seeking other advantages.

This paper also points towards another direction. Democracy cannot be treated always as a one- dimensional issue. Aspects of democracy that may spur FDI, such as lower taxation or more efficient policies than in non- democracies, may counteract other aspects that hamper investment flows such as increased union power. On the other hand the relationship may not always be linear and within each dimension of democracy, as here in civil liberties, differences may occur.

As far as the motives for foreign investment are concerned, efficiency seeking motives dominate the investment decisions into less liberal developing countries, because of the

suppression of labor unions and interest groups. The future growth of these countries, acting as a prospect-liberating factor deters FDI. On the other hand, for countries where freedoms are too low, the natural resource seeking and the market seeking through the existence of a prosperous elite rule FDI decisions.

The results of the paper give many insights into future research. If one wants to identify the motives of the MNEs into investing into non- democracies, must look further into more microeconomic data. A good starting point for this research is into the use of sectoral data. Labor or natural resource intensive FDI may be more easily attracted by the cost advantage of the non- democracies. On the other hand in sectors where R&D or human capital is important, the advantages of the democracies may be more important.

Finally if one wants to examine the relative performance of the democracies versus the non- democracies, then there is a vast need for a democracy index that incorporates more effectively all the dimensions of democracy. Such an index may be very appropriate into explaining many aspects of the economic performance of the non- democracies.

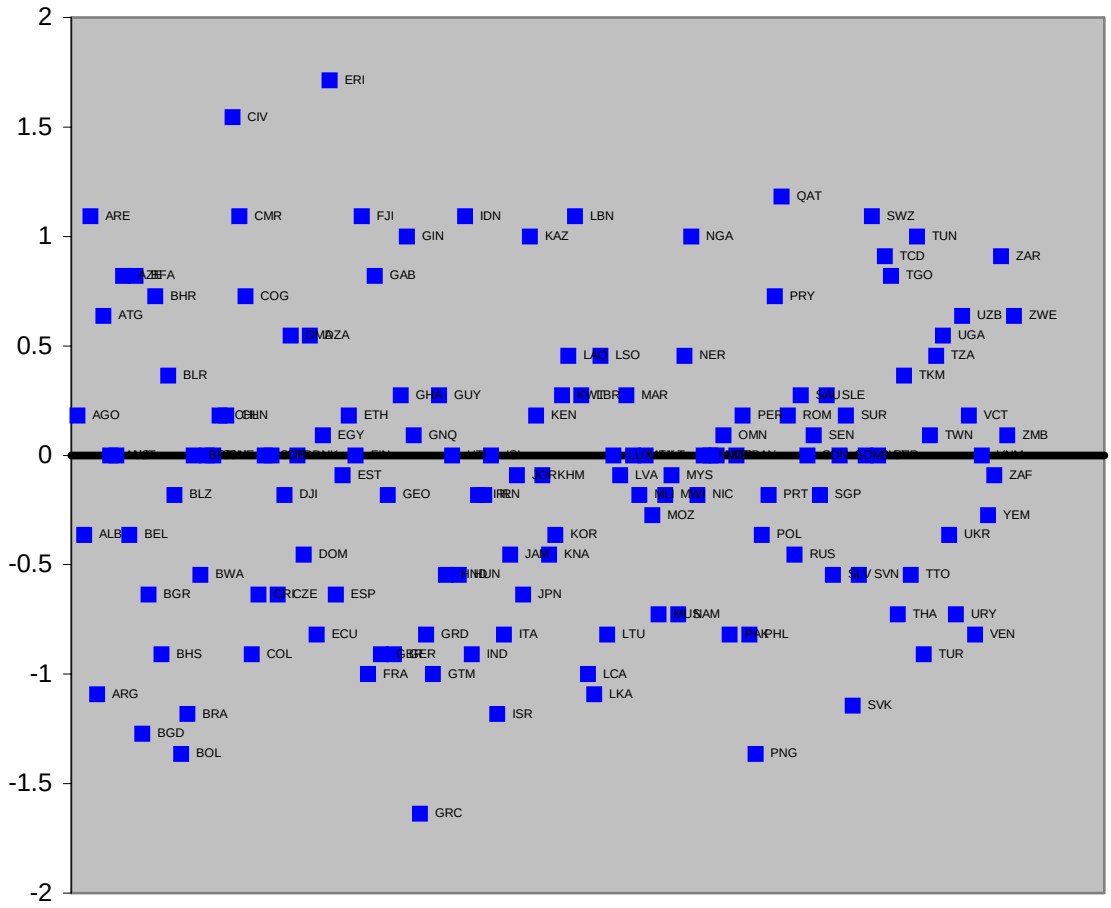
TABLES AND FIGURES

Table 1. Inward FDI Stock as percentage of FDI

	1980	2002
WORLD	6.7	22.3
DEVELOPED COUNTRIES	4.9	18.7
DEVELOPING COUNTRIES	12.6	36.0

Source: UNCTAD, 2003

Figure 1. Difference between Political and Civil Liberties by Country



Source: Freedom House (2003) Gastil index, Authors' calculations

Table 2. Variables Description

Variable Name	Explanation	Source
FDIPC	Foreign Direct Investment flows from US firms normalized by GDP	US Census Bureau of Economic Analysis and authors' calculations
GDP	Gross Domestic Product	Penn World Table, 2003
OPEN	Imports plus Exports over GDP	Penn World Table, 2003 and authors' calculations
GDPGR	Growth rate of GDP	Penn World Table, 2003 and authors' calculations
CIVFREE	Civil Liberties	Freedom House (2003) Gastil index
POLFREE	Political Liberties	Freedom House (2003) Gastil index
NORISK	Overall political risk of the economy	IRIS
BUSCL	Overall investment climate in the economy	IRIS

Table 3.

	Non-OECD
GDP	0.421***
	(3.07)
OPEN	0.001
	(1.12)
GDPGR	-0.235**
	(-1.98)
DEMOCRACY	-0.030
	(-0.47)
BUSCL	0.007
	(0.64)
NORISK	-0.005
	(-0.39)
R-square	0.06
Test Country Effects (F-test)	64.14
Observations	548

t-stats are in parenthesis.*** significant at 1%, ** significant at 5%, * significant at 10%

Table 4.

	Total	OECD	Non-OECD
GDP	2.512***	18.218***	0.430***
	(2.78)	(4.65)	(3.09)
OPEN	-0.009	-0.141***	0.001
	(-1.43)	(-4.06)	(0.86)
GDPGR	-0.685	-1.381	-0.223**
	(-1.50)	(-0.34)	(-1.98)
CIVFREE	0.095***	0.578***	0.062**
	(3.02)	(2.64)	(2.51)
POLFREE	-0.046**	-0.273	-0.036*
	(-2.02)	(-0.73)	(-1.81)
BUSCL	-0.111*	-0.654**	0.005
	(-1.65)	(-2.02)	(0.43)
NORISK	-0.089***	-0.235	-0.010
	(-2.57)	(-0.71)	(-0.83)
R-square	0.08	0.57	0.09
Test Country Effects (F-test)	19.7	24.91	65.72
Chow Test (OECD and Non-OECD) F(7,608)	88.95***		
Observations	727	179	548

t-stats are in parenthesis.*** significant at 1%, ** significant at 5%, * significant at 10%

Table 5.

Non-OECD countries only	I. CIVFREE≤3	II. CIVFREE≥4	Difference of coefficients(II-I)
GDP	0.489***	0.396**	-0.093
	(2.70)	(2.05)	(-0.35)
OPEN	-0.003	0.004**	0.007***
	(-1.64)	(2.42)	(2.83)
GDPGR	-0.506***	0.000	0.506**
	(-2.66)	(0.00)	(2.35)
CIVFREE	0.160**	0.027	-0.133*
	(2.29)	(1.64)	(-1.86)
POLFREE	-0.166**	0.007	0.173**
	(-2.10)	(0.81)	(2.17)
BUSCL	-0.029	0.006	0.035
	(-0.81)	(0.53)	(0.93)
NORISK	0.066**	-0.035**	-0.101***
	(2.04)	(-2.32)	(-2.83)
R-Square	0.21	0.14	
Test Country Effects (F-test)	68.36	11.96	
Chow Test (Structural Break when CIVFREE=3) F(29,430)	1.92***		
Observations	216	332	

t-stats are in parenthesis.*** significant at 1%, ** significant at 5%, * significant at 10%

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