POLITICAL GOVERNANCE AND MACROECONOMIC VARIABLES IN DETERMINING FOREIGN DIRECT INVESTMENT FLOWS

A Reply to John P. Tuman

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I thank Professor John Tuman for the opportunity to pursue questions I raised in my article but could not engage further in the original study (Montero 2008). I will attempt here to address his commentary with an eye toward clarifying how additional testing of the data not only raises questions about Tuman and Emmert's (2004) findings concerning human rights and regime type but also refines my own findings about macroeconomic performance and particularly the role of the current account. I hasten to underscore that it is still not my primary purpose to disprove the results of Tuman and Emmert (2004) or to engage the broader literature on regime type and investment flows. However, as I conclude in my article (Montero 2008, 76), the data thus far do not sustain consistently the finding that human rights violations and regime type affect foreign direct investment (FDI) flows in Latin America. Moreover, my study is not meant to challenge Tuman's point about the importance of the domestic political and economic institutions of the home countries of multinational corporations (MNCs). I argue here that exploring these factors requires a different kind of study than the one I initially designed. Yet I also raise doubts about whether such a study can be sustained with the data available and implemented using time-series cross-sectional techniques.

Regarding my study's findings that regime type and human rights violations proved inconsistent predictors of FDI, Tuman responds that a flaw in research design—namely, the pooling of FDI inflows per Latin American country-year—explains the performance of these political variables. He argues that the disaggregation of flows by sending countries would introduce the effects of different domestic institutions and pressures to direct FDI in certain ways in the Latin American region. The examples he gives in his commentary suggest that differences between liberal America and social democratic Europe explain the conditions under which

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regime type and human rights matter in the investment decisions of MNCs.[1] Yet even when the proposed remedy of disaggregating flows is pursued, the findings for the political variables remain uncertain. In the simplest time-series cross-sectional models in which U.S. FDI and European FDI per country-year are used as the dependent variables, the coefficients for the lagged Polity score and the Gibney terror scale continue to produce inconsistent results. The Polity score is insignificant in every test.[2] The Gibney terror scale is significant and negative for U.S. FDI (b = −.2422, $p < .05$) and for European FDI (b = −.2876, $p < .05$). This finding suggests that foreign companies are dissuaded from investing in polities that engage in state terror. In the original article, I ran the Polity and Freedom House (FH) scales in separate specifications as they are notoriously collinear. Keeping the Gibney terror scale in the model, the FH tests including the political rights and civil liberties scales offer similarly inconsistent findings for regime type. For neither U.S. FDI nor European FDI are the FH scales significant. Notably, the Gibney terror scale is insignificant for U.S. FDI and significant and, once again, negative for European FDI (b = −.3531, $p < .05$). European firms wish to avoid human rights violators, but we can come to no conclusions about the role of this factor for American firms.

When control variables are added to the preceding specifications, the story becomes more complex. Because two of the three governance models in the original article showed significant and correct-sign coefficients for Polity and the Gibney terror scale for pooled FDI, it is most appropriate to retest these specifications using disaggregated FDI—specifically, U.S. and European data. The first governance model in the original article was retested in two specifications using U.S. FDI and European FDI as separate dependent variables.[3] All of the governance variables were insignificant in these specifications. When tax burden and financial regulations were added, as in the Governance + $Cost_1$ model in the article, and market size was dropped but factor controls such as urban density, manufacturing intensity, mining, and fuel exports were added, as in the Governance + $Cost_2$ model, the results for the governance variables did not change. These results do not completely discredit regime and state terror as vari-

1. One might contest this bifurcation as insufficient given the variety of economic and political systems contained within the "social Europe" category. The category is overbroad because it includes liberal economies such as Britain and Ireland, social democracies of the Nordic type such as Sweden, continental social democracies such as the Netherlands and Belgium, corporatist cases such as Germany, and formerly statist cases such as France and Italy. On these distinctions, see Pontusson (2005).

2. As in the original article, all the political indexes are lagged one year and rescaled to use zero as their base.

3. The lagged dependent variable is kept to correct for AR(1) serial autocorrelation. All economic controls are lagged to control for endogeneity.

ables, because the pooled-FDI tests in the original article showed some effect, but once again, the performance of these factors is inconsistent using disaggregated FDI data.

Quite independent of Tuman's concerns, the retests produced some additional insights into the role of the current account, the variable of interest in the original article. The performance of the current account variable was inconsistent in these retests, being insignificant and with the opposite sign expected. Is the difference explained by the disaggregation of flows? I would argue that it is not, because these findings differ from Tuman's own disaggregated-FDI models that he reports in his commentary. For the role of the current account, Tuman's retest of his earlier study of U.S. FDI from 1979 to 1996, now including the current account/GDP ratio and economic reform, confirmed the findings of my original article. Only when FDI is disaggregated to U.S. FDI using my data is the effect of the current account inconsistent.

I believe that these results have to do with differences in the time frame covered by our respective data. Tuman and Emmert's (2004) analysis and Tuman's commentary cover the 1979–1996 time frame, while my tests of U.S. FDI use a later timeframe, 1985–2003. When I ran the same specifications with my data using panel records for the 1985–1996 period, the current account was positive and significant, but the political variables remained insignificant. Corruption, exchange-rate variance, per capita growth, trade, and tax burden were also significant, thus replicating Tuman's findings concerning these factors for the pre-1996 period.

Substantively, this may mean that there is a temporal frame for understanding the effects of both political change and macroeconomic variables. Multinational corporations stop differentiating among the Latin American countries on the basis of human rights and regime type as these countries' democracies mature. That is, if MNCs once sought the perceived "security" that authoritarian regimes might have provided in Latin America, those preferences diminished as Latin America's democracies became older and more stable. Likewise, macroeconomic variables, among them the performance of the current account, were more indicative of the investment climate in Latin America before 1996, as this was a period in which the region's debt crisis and periodic bouts of hyperinflation made investment especially precarious. The current account still matters as a rough indicator of investment climate post-1996, as my study in the original article suggests. Macroeconomic deeds and not reform words still prevail as the logic governing MNC investment choices. In contrast, human rights violations and other political governance variables perform less well in both the pooled-FDI and the disaggregated-FDI models.

Disaggregated FDI models can go only so far, and neither Tuman nor I have done a full set of tests involving domestic characteristics of sending countries. Following Tuman's recommendation for unpacking FDI flows to discover the role of these factors in the United States and Europe, analysis of nationally specific FDI flows might underscore the effects of differences between social democratic (Europe) and liberal (United States) economies. Yet testing this research question requires regressing Spanish, Norwegian, Swedish, British, and American FDI flows to the region and then testing national variables that measure differences in labor market systems, financial-industrial regulations, and other categories typical of the so-called varieties-of-capitalism literature on advanced capitalism (e.g., Pontusson 2005). Such was not the enterprise of my original article, and I admit that the effort could be well worth it to get at the questions Tuman raises.

One potential complication of taking this research further is the somewhat patchy distribution of data points for highly disaggregated European flows and perhaps for other sending countries. This can make the time-series element of the tests more precarious. I tried to test both Spanish and Chinese data but could not acquire enough data points in the country panels to allow for a time-series cross-sectional analysis. The panels are simply too unbalanced to use this device confidently at the present time, at least for the range of Latin American countries analyzed in the original study.

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