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# RESEARCH REPORTS AND NOTES

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## THE POLITICAL AND ECONOMIC DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN LATIN AMERICA

A Brief Comment on “Macroeconomic Deeds,  
Not Reform Words: The Determinants of Foreign  
Direct Investment in Latin America,” by Alfred P. Montero,  
*LARR*, Volume 43, Number 1

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In a recent article, Montero (2008) sought to clarify the determinants of foreign direct investment (FDI) in Latin America. Testing a number of competing hypotheses, he found that macroeconomic stability, as measured by the current account, had the most consistent effect on FDI flows across countries in the region. Although Montero was interested in the role of macroeconomic stability, he also explored the impact of governance factors, including human rights and regime type. His results suggest that the effects of rights and regime type are inconsistent. Briefly, in his models that focused on governance and cost-related factors, the coefficient for the terror scale (rights abuse) had a positive and significant effect in two of three trials; in the same trials, the coefficient for Polity IV (regime) was negative and statistically significant, which suggests that politically competitive regimes received less FDI.<sup>1</sup> Nevertheless, when Montero modeled

1. Measures of political risk were not significant in any of Montero's models (Montero 2008, Table 1).

the effects of economic reform, rights abuse and regime type were no longer statistically significant (Montero 2008, Table 1). Given the inconclusive nature of his findings with regard to rights and regime type, and the ongoing controversy in the literature, a brief comment on his article is potentially instructive.

As a result of problems with the research design used in his study, Montero's analysis of human rights and risk factors remains open to question. In particular, Montero employed FDI data (World Bank, n.d.) that pool observations of outward FDI flows from firms based in many different home markets. As I have argued previously (Tuman 2006), pooled FDI data can obscure the effects of political factors in FDI decisions. Within the home country of a multinational firm, a variety of different actors—ranging from unions (particularly those unions embedded in co-determination systems) to consumer groups or the state—may have the ability to influence the FDI strategies that corporate decision makers adopt. The influence of such actors within the home market might cause German and Swedish multinational firms, for example, to weigh labor and political rights in potential recipient (host) countries of FDI in ways that are different from the evaluations of U.S. firms. For this reason, a preferred methodological approach is to use FDI data that disaggregate flows by the home market of the multinational firm.<sup>2</sup>

The effects of rights abuse and political risk are clearly discernable when controls for the country of origin of FDI flows are introduced to the analysis. In a previous article, Tuman and Emmert (2004) presented a model of U.S. FDI to Latin America that tested many of the same (or similar) macroeconomic and governance-related variables that Montero employed in his models. To examine Montero's claims, I conducted a sensitivity analysis by reestimating the full model of U.S. FDI developed in Tuman and Emmert (2004)<sup>3</sup> with the addition of two covari-

2. Montero (2008, 70) acknowledges this but glosses over the problems associated with pooled data in his conclusion.

3. The model included current account/GDP, economic reform, real GDP per capita (log), change in real GDP per capita, trade/GDP, inflation (log), real exchange rate (log), secondary school enrollment, regional trade associations, rights abuse, revolution deaths (per 1,000), riots, attempted/successful coups, and a lagged dependent variable. Covariates were lagged by one year. The dependent variable in the model was U.S. FDI in constant 1995 U.S. dollars as a percent of recipient real GDP in constant 1995 U.S. dollars ( $100 \times [\text{real U.S. FDI} / \text{recipient real GDP}]$ ). The analysis covers fifteen Latin American and Caribbean countries (see Tuman and Emmert 2004). Inasmuch as rights abuse and political risk were not significant when Montero controlled for the current account, macroeconomic influences, and economic reform, the model used in the sensitivity analysis is a reasonable starting point for investigation of Montero's claims.

Sources for some covariates (e.g., revolution deaths) in Tuman and Emmert (2004) were unavailable after 1996; thus, the time series, 1979 to 1996, was not updated in order to maintain balanced panels. (Note, however, that data for some of Montero's covariates were avail-

ates: current account/gross domestic product (GDP)<sub>t-1</sub> and economic reform.<sup>4</sup>

The results of the sensitivity analysis indicated that the coefficient for the current account was positive and significant ( $b = .05$ ,  $z = 2.69$ ,  $p < .01$ ), but economic reform had no effect ( $b = -.02$ ,  $z = -.12$ ,  $p < .90$ ). Nevertheless, in contrast to Montero's findings, the sensitivity analysis also demonstrated that even when the current account, economic reform, and other macroeconomic influences were included in the U.S. FDI model, the coefficient for rights/liberties abuse<sub>t-1</sub> was positive and statistically significant ( $b = .10$ ,  $z = 2.03$ ,  $p < .05$ ),<sup>5</sup> while the coefficients for other risk factors remained statistically significant (revolution deaths [per 1,000 population]<sub>t-1</sub>,  $b = -.47$ ,  $z = -2.37$ ,  $p < .02$ ; riots<sub>t-1</sub>,  $b = -.45$ ,  $z = -2.20$ ,  $p < .03$ ; military coups<sub>t-1</sub>,  $b = .37$ ,  $z = 1.87$ ,  $p < .07$ ). In addition, the results called into question Montero's claim that the current account is the only consistent economic predictor. Trade, growth in real GDP per capita, and secondary school enrollment ratios continued to have a positive and significant effect on U.S. FDI in the sensitivity model.<sup>6</sup>

To summarize, the results of this brief note suggest that Montero's conclusions need to be qualified. First, controlling for the national origin of FDI flows, the sensitivity analysis confirms Tuman and Emmert's (2004) previous finding that U.S. FDI has concentrated in Latin American countries with more rights abuse. Second, although the current account is po-

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able only through 1999, thereby shortening his time series). Fuel exports were excluded because of missing observations; urban density was not included because school enrollment is a better proxy for workers' skills. Similarly, Montero's data for reform were not used because of missing observations before 1985.

4. Data for the current account/GDP are from the World Bank (n.d.); reform is a dummy for years when countries implemented International Monetary Fund reforms (e.g., privatization, deregulation, labor and financial reform; see Tuman and Ayoub 2004; Tuman and Emmert 1999). The model was estimated with ordinary least squares, panel-corrected standard errors, and a lagged endogenous covariate as an independent variable. Summed residuals and residual variance ratios of countries did not reveal any significant unit effects; therefore, no country covariates were included (Beck and Katz 2004, 2007; the drawbacks of using country dummies with a lagged dependent variable are discussed in Beck and Katz 2004). Wald chi-square for the sensitivity model = 65.50,  $p < .001$ .

5. Mean of political rights and civil liberties abuse scores (Freedom House 2004); higher values are associated with more abuse. In separate trials, the coefficient for the Political Terror Score (PTS; Gibney 2006) was positive and significant, but regime (Polity IV; Marshall and Jaggers 2008) had no effect.

6. The coefficients for change in real GDP per capita, trade/GDP, secondary school enrollment, and the lagged dependent variable were positive and significant; magnitudes and statistical significance levels were very similar to those in Tuman and Emmert (2004, Table 2) (results omitted for reasons of space). Coefficients for inflation, real exchange rate, regional trade associations, and real GDP per capita were not significant. With the exception of the current account and reform—which were new—results from the sensitivity model were completely consistent with Tuman and Emmert (2004).

tentially important, other political and economic influences also have a consistent effect on U.S. FDI.

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