



Democratization and Foreign Direct Investment Liberalization, 1970–2000

SONAL S. PANDYA
University of Virginia

Despite the central role of foreign direct investment (FDI) in global economic integration, we lack explanations for why countries restrict FDI inflows. This article analyzes the sources of FDI liberalization using a comprehensive new data set of national foreign ownership restrictions spanning over 90 countries for the period 1970–2000. Analyses of this data show that democratization contributes to greater FDI openness. Democratization elevates the political influence of labor, the primary beneficiary of unrestricted FDI inflows. Democracies restrict six percent fewer of their manufacturing and service industries as compared to nondemocracies. This finding is robust to several controls for alternate explanations including economic crises, coercion, and diffusion; alternate measures of both democracy and foreign ownership restrictions; and a variety of model specifications. This article elucidates the political economy foundations of the contemporary world economy.

Over time more countries have opened their economies to foreign direct investment (FDI) inflows. Countries that in the 1970s denounced multinational companies (MNCs) had, by the end of the century, reversed their positions to offer them all manner of enticements. For instance, in 1975, there were over eighty acts of expropriation against MNCs across nearly thirty countries.¹ A decade later, expropriation was not only rare but many states revised national laws and signed international treaties to strengthen MNCs' legal protections. In 1974, developing countries lobbied the United Nations for an internationally recognized right to expropriate MNCs assets under the aegis of the New Economic Order, a series of proposals designed to grant developing countries greater influence in the international economy. In 1995, under the auspices of the World Trade Organization, many of the same countries pledged to abstain from indirect barriers to FDI by signing the organization's Agreement on Trade-Related Investment Measures.

In the interim, FDI had grown into an extraordinary catalyst for economic integration. FDI flows are the single largest source of global capital flows, in some years worth more than all other forms of capital flows combined (World Bank 2003). FDI forges additional global economic links. In the 1990s, MNCs originated an astonishing ninety percent of all US trade (Dunne, Jensen, and Roberts 2009:536). Intrafirm trade, trade between subsidiaries of a single MNC, generates over one-third of total world trade (Hummels, Ishii, and Yi 2001; Yi 2003). FDI is a conduit for technology transfer with great potential to foster economic growth and development.² In light of

the recent global financial crisis, FDI's stabilizing effects are noteworthy. While domestic firms shrink during crises, MNC subsidiaries typically expand production during crises by drawing on parent companies' financial resources.³

Although FDI and, by extension, general economic integration flourish because countries have eliminated barriers, we lack explanations for this dramatic transformation. In this article, I analyze direct evidence of FDI liberalization: patterns in foreign ownership restrictions between 1970 and 2000. These policies limit foreigners to a minority equity share of any single company such that managerial control remains in local hands. MNCs must form joint ventures with a local firm in order to enter the market. These forced joint ventures facilitate the transfer of MNCs' superior production technologies and the revenues they generate to their local partners. Ownership restrictions deter FDI because MNCs lose exclusive control over their proprietary technologies and their associated revenue. Figure 1 suggests a stark inverse correlation between ownership regulations and FDI activity: The world's FDI stock grew sharply as average restriction levels declined.

I argue that FDI's distributive effects, the configuration of winners and losers it creates in recipient countries, and the recipient country's level of democracy help to explain politicians' choice to restrict foreign ownership. Labor is FDI's primary beneficiary because these investments raise labor demand. By contrast, existing local firms face higher labor costs and, sometimes, product market competition from the MNC. Foreign ownership regulations counteract these effects by channeling productive technology and income to local firms and minimizing increases in labor demand by deterring investment. Politicians choose foreign ownership regulations when they privilege the interests of narrow elite, for example, local capital owners, over securing aggregate economic gains for a broader cross-section of the electorate. Conversely, politicians with incentives to raise

Sonal S. Pandya is an assistant professor of Politics at the University of Virginia. She specializes in international relations with a focus on the interdisciplinary study of international political economy. Her research interests include the regulation of foreign direct investment (FDI), the role of international politics in consumer marketing strategies, and the international movement of intangible productive assets including intellectual property and skills.

¹ Jodice (1980:181). See also Kobrin (1980) and Minor (1994).

² See Romer (1993); Borensztein, De Gregorio, and Lee (1998); Alfaro, Chanda, Kalemli-Ozcan, and Sayek (2004) for discussion of the conditions necessary for FDI to promote economic growth.

³ See Aguiar and Gopinath (2005); Desai, Foley, and Forbes (2008); Alfaro and Chen (2012).

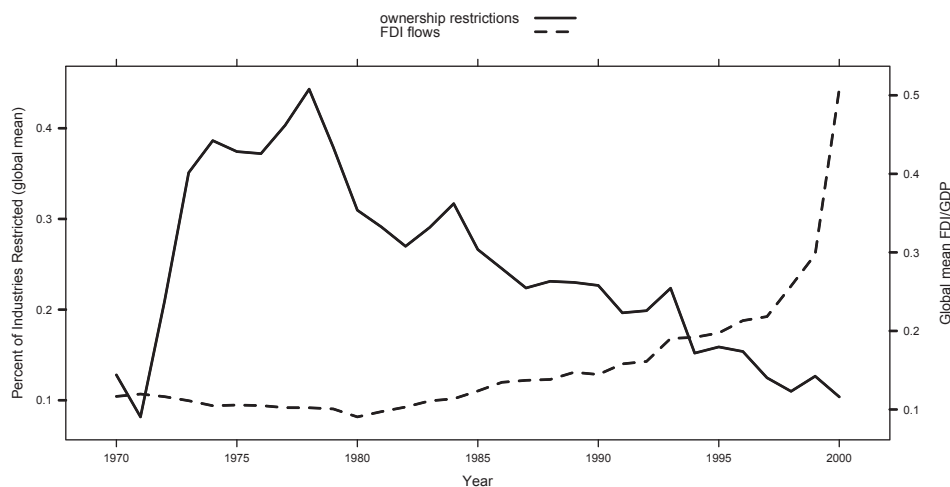


FIG. 1. Rising foreign direct investment (FDI) Flows Correspond to Foreign Ownership Liberalization. Foreign ownership restrictions data are annual averages for *Entry Restrictions*. Global foreign direct investment (FDI) stock data are from Lane and Milesi-Ferretti (2007)

incomes across the population are more likely to do so, even at the expense of capital owners. These policy-setting incentives correspond to autocratic and democratic political regimes, respectively.

Democratization promotes foreign ownership liberalization by giving politicians incentives to enact labor-friendly policies. Democratization's fundamental consequence is to make politicians accountable to a broader swath of the electorate to order to remain in office, prompting a shift to economic policies that contribute broadly to economic welfare. Figure 2 documents a robust correlation between democratization and foreign ownership liberalization. The dashed line, the number of democracies worldwide, illustrates the growth of democracy (Cheibub, Gandhi, and Vreeland 2009). Over the period 1970–2000, the number of democracies in the world nearly doubled from 31 to 57. The solid line shows that at the peak of restrictions in the 1970s, the median country protected approximately thirty-five

percent of its industries from the entry of majority foreign-owned firms. By 2000, this figure had dropped to approximately ten percent.⁴

The centerpiece of my empirical analysis is an original data set on foreign ownership regulations that spans over 90 countries between 1970 and 2000. My analysis of this data reveals that democracies restrict FDI into six percent fewer of their manufacturing and service industries relative to nondemocracies. This finding is robust to several possible alternate explanations for liberalization, including the exigencies of economic crises, the dictates of external creditors, and the influence of peer countries. Further, I confirm that democracies do not merely replace formal restrictions with less transparent equivalents in order to avoid popular backlash. Alternate measures of democracy and instrumental variable regressions using years of independence as an instrument for democracy address potential concerns about measurement and omitted variable bias, respectively.

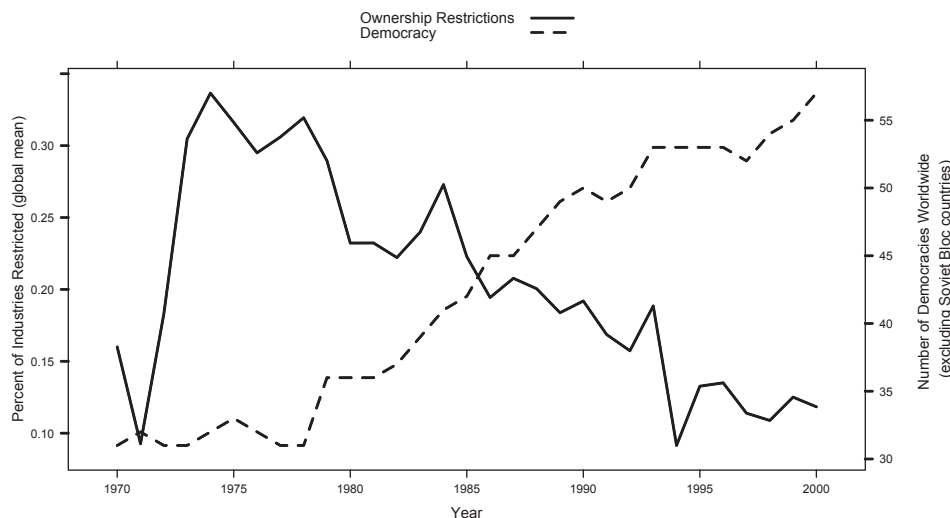


FIG. 2. Democratization Coincides with Foreign Ownership Liberalization. This figure plots the annual global mean of *Entry Restrictions* and number of democracies worldwide (*Democracy* = 1). Excludes all Soviet bloc countries for the duration of the sample

⁴ These are annual worldwide averages of *Entry Restriction*. See online appendix for details about these data.

This paper contributes to political economy research a theory of countries' demand for FDI inflows. Most international political economy research addresses demand for economic flows by explaining policy choices; consider the well-established research programs on trade policy and capital controls. Existing FDI research, however, generally overlooks questions of demand. Instead, these works focus on the political economy determinants of FDI supply, that is, how politics, especially risks to profits, influences MNCs' location choices (Li and Resnick 2003; Jensen 2006). Even the most theoretically sophisticated works, ones that recognize FDI's distributive effects, test claims about political risk, not the motives for FDI policies. For example, Pinto and Pinto (2008) argue that partisan governments have different FDI preferences based on FDI's expected distributive effects on their allied factor group. The authors' empirical tests, however, model how government partisanship correlates with the volume of sectoral FDI flows into OECD countries, inferring the presence of FDI barriers from changing volumes of FDI inflows.⁵ My direct study of formal FDI policies in a worldwide sample of developing and industrialized countries that expands back to the 1970s focuses attention on specific policy instruments and politicians' incentives to deploy them.⁶ The original data on foreign ownership regulations that I analyze are, to the best of my knowledge, the most comprehensive data set of FDI regulations in existence. It provides unprecedented insight into the frequency and distribution of regulations over time and allows, for the first time, direct study of FDI policy choices.

The paper is organized as follows. A brief overview of FDI and FDI regulations defines key concepts and assumptions. The following section explains FDI's distributive effects and how countries' institutional environments encourage politicians to privilege the policy preferences of specific groups. Next, the empirical section of the paper describes the new measure of FDI regulation used in the paper and the results of several empirical tests. The conclusion describes how these findings serve as building blocks to a larger research program on FDI regulation.

FDI and FDI Regulation: An Overview

Foreign direct investment is the international flow of firm-specific capital such as proprietary production technologies, managerial and organizational practices, and trademarked brands. Multinational corporations arise so that firms may capture higher returns to their assets in foreign markets while maintaining control over their firm-specific assets. Alternatives like technology licensing agreements leave firms vulnerable to the theft of their

assets and the income that they generate.⁷ FDI avoids these pitfalls by keeping assets within the firm and expanding the firm itself into multiple markets.⁸

Only the world's most productive firms become multinational because firms must be sufficiently productive to offset the high cost of establishing and monitoring multiple subsidiaries in distant and unfamiliar markets. Once firms become multinational, they register additional productivity gains due to their larger scale of production. Helpman, Melitz, and Yeaple (2004) find that multinationals are fifteen percent more productive than purely domestic, exporting firms. FDI generates profits in one of two ways: by allowing firms to enter new product markets that are otherwise inaccessible or by reducing production costs.

Foreign ownership restrictions force MNCs to share their highly productive firm-specific assets with a host country partner firm. These restrictions require foreign-owned firms to enter the host market through a joint venture with a local firm. Typically, regulations limit the MNC to a forty-nine percent equity share or less so that the local firm maintains control and earns a majority of the profits.⁹ Ownership restrictions, via these forced joint ventures, reallocate income from MNCs to local firms by requiring MNCs to share productive assets with their local partners. Local firms receive access to more efficient production technologies not otherwise available. Even if such technologies could be obtained through the open market, partnerships provide local firms opportunities for the close observation and hands-on training necessary to gain a working command of the technology independent of the MNC (Amsden and Hikino 1994). For example, in the standard management structure of Chinese joint ventures, all foreign managers have a shadow Chinese manager (Gallagher 2007). This structure allows the Chinese manager to directly learn management practices from her foreign counterpart. Alliances with foreign MNCs impart additional benefits, including easier access to financing through MNCs' own internal capital markets and enhanced credibility with third-party lenders created by their association with an MNC (Antràs, Desai, and Foley 2009).¹⁰

Developing countries have been the most frequent users of restrictions. Figure 3 plots the average foreign ownership restrictions for OECD and non-OECD countries in the period 1970–2000. On average, OECD countries, represented by the gray line, use foreign ownership limits minimally, whereas non-OECD countries were the

⁵ They also argue capital prefers unrestricted FDI into industries that complement capital, whereas I argue that capital strictly prefers foreign ownership restrictions to unrestricted FDI, regardless of industry.

⁶ Even scholars who pointedly inquire about FDI policy changes overlook the broader historical pattern. For example, Elkins, Guzman, and Simmons (2006) conclude that heightened competition for FDI between countries drove the explosion of bilateral investment treaty signings in the 1990s. Competition may well have been the proximate cause for the jump in treaty signings. This explanation, however, like most in the existing literature, begs the causally prior question of why countries opened to FDI.

⁷ This point highlights a crucial distinction between FDI and offshoring, the movement of production abroad by outsourcing production to an unrelated foreign firm. Much of international production in low-skilled sectors like textiles and footwear occurs through offshoring, not FDI. In most low-skill sectors, firms do not need to maintain the degree of control over firm-specific assets that FDI affords.

⁸ See Hymer (1976); Antràs (2003). Multinational firms resolve incomplete contracting problems by allocating residual rights of control, those rights that are not *ex-ante* contractable, to the parent firm (Grossman and Hart 1986).

⁹ In the absence of foreign ownership restrictions, firms sometimes voluntarily enter into joint ventures to exploit research or marketing synergies for their mutual gain. In voluntary joint ventures, participants also face such risks but the reciprocal nature of these risks sufficiently motivates mutual respect of property rights (Oxley 1997).

¹⁰ Ownership restrictions can also be the first step toward the direct expropriation of MNC assets and income. Bradley (1977) finds that expropriation of joint ventures involving foreign-owned partner is eight times more likely than expropriation of a joint venture between two domestic firms. Henisz and Williamson (1999:267) indicate that local partners "may opportunistically approach the government with requests to take actions that have the effect of favoring them at the expense of the multinational."

heaviest users of these policies. Restrictions were at their peak in the 1970s as developing countries entered the phase of late industrialization. The average non-OECD country restricted over half of their industries in the early to mid-1970s, the height of restrictions.

Foreign ownership restrictions were integral to the economic development strategies of most developing countries following WWII.¹¹ Foreign ownership restrictions rose dramatically in the early 1970s as less developed countries entered the later stages of state-led industrialization. The two most prominent strategies, import substitution industrialization and export-oriented industrialization, had a common goal of developing industrial capacity (Haggard 1990). In the later stages of industrialization, countries adhering to these strategies looked to multinational firms to provide the necessary technology to produce advanced manufactured goods. Typically, MNCs are the only viable source for these technologies because they are not readily available on the open market and are challenging to reverse engineer.¹² Ownership regulations provide domestic firms with access to these crucial assets. These considerations account for the initial rise in average foreign ownership regulations at the beginning of the time period and for their prominence in developing countries—as seen in Fig. 3.

Democratization and FDI's Distributive Effects

Democratization is a change in political practices and institutions that have the effect of expanding political participation. Specific measures include universal suffrage and contested elections. Buenode Mesquita, Smith, Siverston, and Morrow (2004) coin the term “selectorate” to describe the subset of a country's population that has political voice. In a democracy, the selectorate encompasses all citizens of voting age, whereas in an autocracy a smaller segment of the population, typically comprised of wealthy capital and landowners or military leaders, enjoys political efficacy. These scholars further define a winning coalition as the proportion of the selectorate whose support is necessary for leaders to remain in power. Democratization increases the size of both the selectorate and the winning coalition, requiring politicians to gain the support of a larger proportion of the population than was necessary under autocratic rule.

This process contributes to FDI liberalization by expanding political participation to include more citizens that prefer unrestricted FDI inflows. In developing countries especially, which are by definition more abundant in labor than capital, expanding political participation gives labor relatively more political influence than they enjoyed under autocracy. Following democratization, leaders look to economic reforms as a way to build allegiances among newly enfranchised citizens. Several scholars have established that democratization produces the liberalization of economic flows like trade (Milner and Kubota 2005; Milner and Mukherjee 2009) and portfolio capital (Quinn and Inclan 1997; Eichengreen and Leblang 2008). Like most forms of international economic flows, FDI inflows create winners and losers by changing relative demand

for factors of production. These distributive effects generate divergent preferences over FDI. The central cleavage is between labor, FDI's primary beneficiary, and capital owners, the losers from FDI. The shift toward FDI liberalization reflects a basic change in these two groups' political influence following democratization.

I apply the specific factors model of international trade to FDI in order to derive FDI's distributive consequences for recipient countries (Jones 1971). Political economy scholars have long relied on this model to establish the economic costs and benefits of economic integration, but few have applied it to derive FDI's distributive effects.¹³ The assumption of specific factors nicely captures the highly specific capital assets at stake in FDI. Assets are firm specific inasmuch as their value is maximized only when deployed in a single firm, but these firms compete in industry-wide product markets. The model is well suited to assessing FDI's distributive effects because it treats capital as immobile across industries within an economy. Within this context, FDI inflows increase the supply of productive capital in one industry. The model delivers clear implications for how this increase in industry-specific capital changes the income of existing firms and labor, revealing a stark division between labor and capital.

Labor supports unrestricted FDI inflows because FDI raises labor demand. MNCs hire local workers and introduce more efficient production technologies that raise labor productivity.¹⁴ Empirical support for this claim is exceptionally strong. FDI generates wage increases across industries or host country levels of development.¹⁵ Most studies find between a ten and thirty percent wage premium for unskilled workers in foreign-owned manufacturing firms. Pandya (2010) analyzes survey data from seventeen Latin American countries and establishes that labor support for FDI is robust to a wide array of possible reasons for labor to oppose FDI including the introduction of labor-saving technologies, greater volatility of labor demand, and non-economic considerations like nationalist sentiment.

Local firms, by contrast, oppose unrestricted FDI because they face higher production costs due to greater labor demand and, in some cases, must compete with the MNC for local consumers.¹⁶ FDI's negative consequences for local firms are evident in the declining productivity (Aitken, Harrison, and Lipsey 1996), market share (Chari and Gupta 2008), and stock share prices (Blonigen, Tomlin, and Wilson 2004) following MNC entry into their industry. Technology spillovers from MNCs to local firms, though theoretically possible, are not common and only

¹³ Exceptions are Batra and Ramachandran (1980) and Grossman and Helpman (1996).

¹⁴ To the extent that MNCs invest to sell in the local product market, there are additional gains to real income through product price reductions and expanded product variety.

¹⁵ See Lipsey (2002) and Pandya (2010), for an overview of existing results. A number of studies use firm-level panel data to control for the possibility that more productive firms may be more likely to be acquired. (Lipsey and Sjöholm 2002).

¹⁶ More precisely, in a constant returns to scale model like the specific factors model, an increase in wages is a redistribution of local capital income to labor. In an increasing returns to scale model, the introduction of an additional product variety reduces local firms' market share, thus increasing their average total cost markups over marginal cost.

¹¹ FDI restrictions were rare before WWII. See Teichova, Lévy-Leboyer, and Nussbaum (1986) and Wilkins (2004), for detailed histories of FDI policies in the nineteenth and early twentieth centuries, respectively.

¹² More precisely, only corporations with a large scale of production can profitability undertake research and development and are sufficiently productive to pursue FDI.

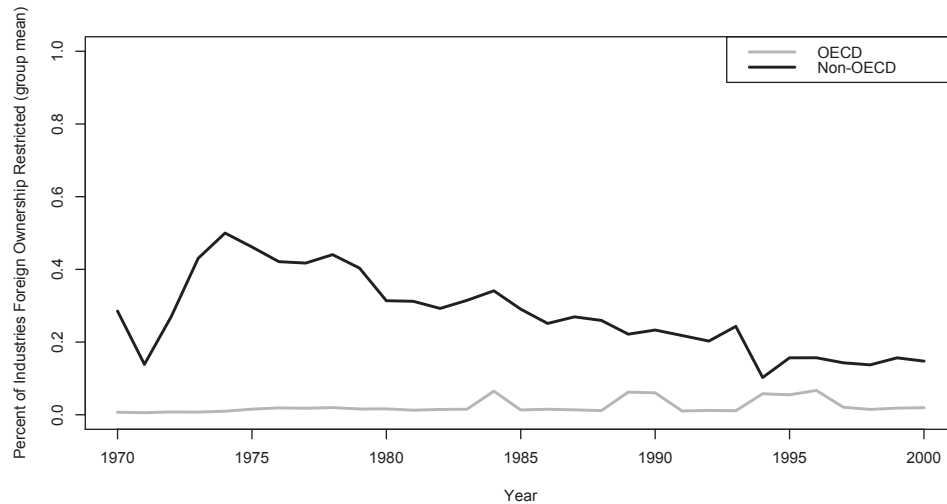


FIG. 3. Average Level of Foreign Ownership Restrictions: OECD vs. Non-OECD Countries Foreign ownership restrictions data are as described in text. OECD countries in sample: Australia (since 1971), Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Mexico (since 1994), Luxembourg, Netherlands, New Zealand (since 1973), Portugal, South Korea (since 1996), Spain, Sweden, Switzerland, Turkey, UK

obtain in the long term after considerable industry restructuring.¹⁷

Two dimensions of FDI's distributive effects are noteworthy because they differ sharply from existing applications of specific factors models. First and foremost, FDI inflows, the inflow of highly specific capital, drive a wedge between specific capital and labor rather than uniting them. This division along factor lines despite factor specificity is the exact opposite of the familiar result of unity among specific factors with regard to trade policy. In FDI, the opposite occurs, because an increase in the supply of specific capital raises demand for its complement, specific labor, but substitutes for existing specific capital. Indeed, the divergence between labor and capital FDI preferences increases with their industry specificity. This novel political economy implication of the specific factors model produces my factor-based explanation for FDI preferences and regulation.

Second, unlike trade and portfolio capital, FDI's distributive effects—gains to labor and costs to capital—are the same regardless of host countries' relative factor endowments or technological advantages. The drivers of FDI flows, especially market access, are at best weakly correlated with factor endowments (Helpman 2006). Even export-oriented FDI does not consistently flow to labor-abundant countries (Carr, Markusen, and Maskus 2003; Yeaple 2003). FDI raises labor demand in relatively labor-abundant countries just as much as it does in relatively labor-scarce countries. This feature of FDI's distributive effects speaks to the consistency with which these hypothesized FDI preferences should obtain across countries.

Following democratization, politicians have stronger incentives to supply economic policies that serve labor's interests. Policymakers are accountable to an expanded electorate through regular and contested elections, and labor's greater political participation throughout the

political process. Consistent with these specific mechanisms, Rodrik (1999) shows that democratization in this period resulted in higher manufacturing wages and labor share in the value-added of the manufacturing sector, a change attributable to labor's expanded political rights. Under the protections afforded by democracy, unions have greater bargaining leverage to capture potential gains from FDI (Guillen 2000).

The flip side of democratization is that it weakens the influence of local firms. In the typical autocratic developing country, foreign ownership restrictions sustained a political alliance between policymakers and a highly concentrated industrial class (Evans 1979). Large, diversified industrial conglomerates, like South Korea's *chaebols*, dominated the industrial structure of many developing countries of this era (Morck, Wolfenzon, and Yeung 2005). This feature of industrial organization facilitated coordination via business peak organizations and extensive informal contact (Leff 1978; Haggard, Maxfield, and Schneider 1997). In more clientelistic autocracies or in countries with a less developed industrial structure, family and kinship connections between policymakers and industrial interests serve an equivalent function (Fisman 2001; Bertrand, Johnson, Samphantharak, and Schoar 2008). Local industry lobbied for foreign ownership restrictions to access MNCs' technology and mitigate negative consequences of direct competition with MNCs. Following democratization and economic liberalization, many industrial groups dissolved as they were no longer viable in a world without barriers to foreign competition and extensive government subsidies (Guillen 2000).

Empirical Analysis: Explaining FDI Liberalization

My central testable claim is that as countries democratize, they impose fewer restrictions on foreign ownership. I model restrictions as a function of democratization. In the previous section, I outlined multiple ways in which democratization facilitates greater attention to labor's policy preferences. My use of broad democracy indicators captures its effects across these mechanisms. Additionally, I control for several other factors that could drive an

¹⁷ Sembenelli and Siotis (2008) show that, in the short-term, Spanish firms' markups decline following FDI into their industry due to heightened competition of the sort described here. In the long term, however, markups increase in research and development-intensive industries—those industries equipped with the technical capacity to capture positive technological spillovers from FDI.

apparent correlation between democracy and the extent of regulation.

I test this claim by constructing the first ever measure of country-level foreign ownership restrictions of its scope. The data set covers 94 countries between 1970 and 2000.¹⁸ The main measure of restrictions is *Entry Restriction*, the percent of all manufacturing and service industries in a country-year into which foreign ownership is restricted. The vast majority of laws simply specify that foreign-owned firms are limited to a minority share of ownership; in practice, this means forty-nine percent or less equity. I calculate this variable from industry-level data on ownership restrictions. This data were coded from US Commerce Department commercial guides for Americans conducting business abroad. The coverage of the commercial guides dictates the geographic and temporal scope of these data. The Commerce Department began systematic publication of these guides in the early 1970s, and at the time of data collection, they were available through 2000. By using this data source, I am in principle limiting my focus to those countries that the Commerce Department deemed as potential markets but, as the country list suggests, this is a broadly representative sample. The notable omission is communist countries for which the Commerce Department did not produce guides until the end of the time period. These countries are commonly absent from economic data sets that cover the Cold War period. If anything, omission of former communist countries biases my results downward as other research finds the postcommunist countries liberalized FDI inflows in a manner consistent with my findings (Dorobantu 2010). The online appendix describes data sources and data collection procedures in depth.

Entry Restrictions could underestimate the true level of restriction because not all industries exist in all countries (for example, denominator may be too large).¹⁹ This is most likely to be true of manufacturing industries because countries can import goods that are not produced domestically. I address this source of downward bias by using industry-level manufacturing data from the UN Industrial Development Organization to remove “null industries,” industries that do not exist as indicated by no employment and output in a given country-year.²⁰ Comparable data on service industries do not exist for this timeframe and country sample so I assume that all service industries exist in all countries. This is more likely to be true in services than in manufacturing—most services cannot be imported—but it likely over-counts the number of service industries. I also elect to omit the natural resources sector both because these all of these industries definitely do not exist in all countries and my theoretical claims about FDI preferences derive from the production of goods and services rather than resource extraction. As a consequence of including all service sectors and omit-

ting all primary sectors, my measure is conservative and probably underestimates the true extent of restrictions in an economy.

This is a direct measure of FDI regulation, whereas extant proxies for FDI restrictions conflate formal FDI regulations with political risk. Political risk measures capture the uncertainty associated with all aspects of foreign investment with the implication that higher uncertainty translated into lower expected profits because investing firms cannot optimize for a given business environment. All political risk measures take the form of an index that summarizes across different dimensions of risk.²¹ Such measures may be useful to investors, but they are misleading when used as measures of FDI regulation. They are noisy measures, capturing everything from bureaucratic hurdles, low-level corruption, to poor quality public services. Inasmuch as they rely on expert surveys, such measures also suffer from selection bias. The online appendix provides a comprehensive overview of existing proxies of FDI regulation.

By contrast, formal ownership regulations are the most explicit form of restriction and the only form of regulation with clear distributive effects. The use of foreign ownership restrictions, rather than another form of FDI regulation, merits some justification. Other forms of FDI regulation include performance requirements that govern MNCs’ production practices, and limits on MNCs’ financial practices and corporate organization. Ownership restrictions make for a more nuanced measure of FDI regulation. Other forms of restrictions exhibit less cross-industry variation and, in the case of performance requirements, are only meaningful for a subset of industries.²² Patterns in these other forms of regulation generally track ownership restrictions so this study’s findings have clear testable implications for the sources of these other FDI policies.

I calculate an alternate measure of ownership restrictions to test whether democratization also influences informal FDI restrictions. *Investment Screening* is the percent of all industries subject to mandatory screening to approve investment projects.²³ This variable captures informal barriers to FDI to the extent that countries can exercise discretionary power in the review process for political ends. This variable allows for tests of a switch from formal to informal regulation following democratization. Kono (2006) argues with regard to trade policy that democratization may prompt countries to dismantle formal regulations like tariffs, but that countries increase use of informal barriers like nontariff barriers so as to continue providing regulation, though in an opaque manner that spares policymakers from electoral backlash.

I measure democracy using a dichotomous measure of democracy, *Democracy*, that equals 1 when countries popu-

¹⁸ See the online appendix for full list of countries.

¹⁹ Weighting the measure by the importance of each industry to the overall economy is not possible because disaggregated data on industry output or employment as a percent of GDP are unavailable. Such weighting schemes are also susceptible to bias, because any meaningful weight is sure to be influenced by the presence of a restriction. I omit primary sectors, as the underlying distributive effects of FDI will differ from that of manufacturing and service sectors. Throughout the discussion of empirical results, when I refer to the number of industries in a country, I am referring to a country’s manufacturing and service industries.

²⁰ UNIDO data are organized by ISIC Rev. 2 classification so only industries that remain whole across the ISIC Rev. 2-ISIC Rev. 3 concordance are removed.

²¹ Most prominent among these investment climate measures are Political Risk Services’ *International Country Risk Guide*, Business Environment Risk Intelligence’s (BERI) *Business Risk Service*, World Economic Forum’s *World Competitiveness Yearbook*, Economist Intelligence Unit, *Wall Street Journal/Heritage Foundation’s Index of Economic Freedom*, and PricewaterhouseCoopers’ *Doing Business and Investment* series.

²² The presence of multiple forms of restrictions raises the possibility of an index of restrictions that summarizes across regulatory instruments. Such an index would obscure the distinctive patterns of variation across instruments as entry barriers vary across industries but most other requirements can only be imposed on a handful of sectors (for example, performance requirements) or apply to all FDI, regardless of industry. See Hardin and Holmes (2001); Golub (2003).

²³ This variable excludes any voluntary screening necessary to receive investment incentives offered by the host country.

larly elect both the chief executive and legislature (Cheibub et al. 2009). This measure is based on the claim that democracies are distinct from dictatorships in four ways: popular election of the chief executive or selection by a popularly elected body, popularly elected legislature, at least two parties participating in competitive elections, and a consistency in electoral rules during turnover of elected offices (Cheibub et al. 2009:69). Some researchers prefer this measure to more common measures, like Polity scores, because it precisely captures the accountability dimension of democratization that connects democratization to increase the adoption of labor-friendly economic policies. Additionally, changes in this binary measure can be interpreted as switches between dictatorship and democracy rather than changes in increments of democracy on a continuous scale. Below I show that my findings are robust to the choice of democracy measure.

These data have a time-series cross-sectional structure in which the number of cross-sectional units exceeds the number of temporal intervals. In all likelihood, these data violate multiple ordinary least squares assumptions. Under these conditions, estimates of naïve OLS model would produce incorrect standard errors. Following Beck and Katz (1995), I estimate OLS models with panel-corrected standard errors to account for contemporaneous correlation and panel heteroskedasticity. I include country fixed effects to control for omitted, time invariant, characteristics and focus on the temporal patterns in regulation within each country. In most specifications, I also include year fixed effects to control for temporal shocks common to all countries in the sample. A panel-specific AR(1) correction addresses serial correlation across error terms. I lag all explanatory variables by one year to account for a delay between a change in a country's economic and political circumstances and a corresponding change in foreign ownership regulation. Definitions and data sources for all variables are provided in the online appendix to this chapter. Table 1 provides summary statistics for all variables.

The first set of models compares the influence of democracy on formal and informal barriers to foreign ownership. Table 2 provides estimates of two baseline models that each includes two covariates: democratization and the natural log of *per capita* GDP, a standard control in models of international economy policy because it captures a variety of unobservable country-year economic fluctuations that can influence the demand for FDI regulations. Model 1 shows a negative and statistically significant correlation between democratization and formal restrictions on foreign ownership. Democracies, on average, restrict six percent less of their manufacturing and service industries from foreign ownership relative to dictatorships. The magnitude of this relationship is comparable to that found in analogous studies of trade liberalization following democratization (Milner and Kubota 2005:126). Scholars of trade policy raise the possibility that democratization does not generate true liberalization but rather a shift away from formal restrictions in favor of less transparent policy instruments (Kono 2006). Policymakers might seek to maintain policies benefiting local firms but try to conceal these policies from labor in order to avoid an electoral backlash. For example, policymakers could eliminate formal restrictions but mandate screening of all proposed investments and grant regulators wide discretion to impose restrictions on a case-by-case basis. This may be particularly attractive to local firms because it makes FDI protection a private good that regulators can use to serve the interests of specific firms.

Given that democratization likely raises the costs of collective action and lobbying, the move to regulation as private goods is plausible. Although informal regulations are more common over most of the sample period, both types of regulations declined over time. The Model 2 estimates confirm that countries do not replace formal regulations with less transparent equivalents following democratization. There is no correlation between regime type and the pervasiveness of informal regulations. This null finding confirms that the decline in formal regulations corresponds to a genuine reduction in ownership restrictions. This finding holds when all the models discussed below are re-estimated with *Investment Screening* in place of *Entry Restrictions*.²⁴

Economic crises are the second possible alternate explanation for ownership liberalization. There are two mechanisms by which crises can contribute to FDI liberalization. Crises that occur in the absence of political change provide a window for authoritarian leaders to adjust without backlash. Crises that precipitate the democratic transitions have a similar dynamic, but leaders enjoy something akin to a honeymoon period in which voters give them wider latitude to implement reforms.²⁵ In both scenarios, the crisis situation is thought to overcome a generalized aversion to risky and uncertain policy changes.²⁶

Following this logic, countries may liberalize foreign ownership not because of shifting political representation but in responses to sudden and severe economic downturns. This can operate through the great risk acceptance among the electorate in times of economic crisis or through greater deference granted to political leaders to address crises by whatever means necessary. For example, Aizenman (2005) models local firm owners' responses to crises that raise domestic interest rates and finds that crises can make firm owners more amenable to FDI to facilitate the search for equity partners. Alternately, policymakers might liberalize in hopes of attracting export-oriented investments that will help to correct payments imbalances or MNCs that will acquire ailing state-owned firms.

I distinguish between these scenarios by interacting economic crisis with the measure of democratization. The coefficient on the economic crisis variable indicated the expected change in FDI regulation when an economic crisis occurs in an autocracy. The interaction of economic crisis and democratization captures the second scenario of liberalization promulgated by new democratically selected policymakers. In recognition of the fact that the specific type of economic crisis that a country experiences matters for its responses to FDI, I control for three distinct types of economic crises: currency crisis, banking crisis, and sovereign debt crises. All three should contribute lower opposition to liberalization, but the size of this effect can vary by the type of crisis.²⁷

²⁴ See supplemental empirical online appendix.

²⁵ See Cukierman and Tomassi (1998). Haggard and Kaufman (1995) argue that regime transitions spurred by crisis are more dramatic because crises empower opposition groups early in the process, whereas non-crisis transitions are managed by outgoing elites who build in protection for their interests within more gradual democratic reforms. Crises, they argue, constrain autocrats' ability to maintain political alliances with business and labor groups, alliances that rest on state subsidies to producers and specific segments of the labor force. These groups withdraw their support from autocrats.

²⁶ See Fernandez and Rodrik (1991); Weyland (2002).

²⁷ In light of scholarly debates on the role of capital account liberalization in precipitating economic crises, I would reemphasize that foreign ownership liberalization is distinct from general capital account liberalization. There is no evidence that FDI inflows contribute to incidence of economic crisis.

TABLE 1. Summary Statistics

Variable	N	Mean	SD	Min	Max
Entry Restriction	2255	0.1955825	0.3673188	0	1
Investment Screening	1525	0.3427363	0.4642883	0	1
Democracy	2976	0.4422043	0.4967319	0	1
Currency Crisis	2911	0.3668842	0.4820374	0	1
Banking Crisis	2911	0.1700447	0.3757366	0	1
Sovereign Debt Rescheduled	2976	0.063172	0.243313	0	1
IMF Conditionality	2933	0.1397886	0.3468267	0	1
Average Restrictions—Language Group	2426	0.2029157	0.1793416	0	1
Average Restrictions—Colonial Origin	3131	0.2626835	0.2406964	0.0285609	0.8571429
Polity-Binary	3131	0.4816353	0.4997424	0	1
Ln(<i>per capita</i> GDP)	2868	7.765666	1.590695	4.442014	10.8627
Spain Colony	3131	0.1485149	0.3556664	0	1
France Colony	3131	0.0990099	0.298723	0	1
Belgium Colony	3131	0.029703	0.1697937	0	1
Netherlands Colony	3131	0.029703	0.1697937	0	1

TABLE 2. Democratization and foreign direct investment (FDI) Liberalization, Formal and Informal Barriers

	(1) Entry Restriction	(2) Investment S creening
Democracy ($t-1$)	-0.0623 (0.0304)*	0.0143 (0.0405)
Ln(<i>per capita</i> GDP($t-1$))	-0.0912 (0.0443) *	-0.267 (0.0809)**
Observations	2,112	1,470
Countries	97	72

OLS coefficients with panel-corrected standard errors in parentheses. All models include country and year fixed effects and a panel-specific AR(1) correction for serial correlation. Constant terms not reported.

** $p < .01$, * $p < .05$, + $p < .1$

Table 3, Models 1–3 estimate the correlation between one type of crisis and liberalization for both nondemocracies and democracies. The coefficients on *Democracy* are the correlation between democracy and the extent of ownership regulation when there is no economic crisis. Across the three models, *Democracy* retains its negative and statistically significant coefficient. These findings confirm that the observed correlation in the baseline models is not because autocracies are more likely to experience economic crises. The coefficient on the crisis variable in each model—currency, banking, or sovereign debt rescheduling—indicates the correlation between crisis and ownership regulations in nondemocracies, for example, when *Democracy* equals 0. The three crisis variables have the expected negative sign; countries that experienced a crisis in the previous year have less extensive regulations than countries that did not have a crisis in the previous year. Only the coefficient for *Sovereign Debt Rescheduled* in Model 3 is statistically significant.²⁸ This finding shows that countries that were autocracies and rescheduled their sovereign debt in the previous year had, on average, approximately two percent fewer of their industries pro-

tected from foreign ownership regulations relative to countries that a year earlier were democratic and rescheduled their sovereign debt. Aside from this finding, there is no statistically significant correlation between regime type and economic crises. Model 4 includes all three types of crises and their associated interaction terms to confirm that democracies have less extensive regulations independent of whether they experience any of the most common forms of economic crises.

The models in Table 4 examine external influences on the extent of countries' foreign ownership regulations. Models 1 and 2 test the alternate claim that countries liberalize ownership in order to comply with conditionality requirements associated with IMF assistance. The effect of economic crises may influence the extent of FDI regulations indirectly, through the conditions imposed by the International Monetary Fund (IMF) in exchange for economic assistance. FDI openness is a central element of the Washington Consensus, a set of economic reforms commonly suggested to developing countries in the 1990s. Anecdotal evidence provides little indication that the IMF explicitly includes FDI liberalization as a condition for assistance, but compliance with other common conditions, notably privatization, may necessitate foreign ownership liberalization.²⁹ Many developing countries lack sufficiently large domestic capital owners who can both raise the capital to acquire a state-owned enterprise and provide the technological upgrades necessary for profitable private production.

International Monetary Fund conditionality agreements could require foreign ownership liberalization in the absence of any form of political transformation. It could be the case that democracies are more or less amenable to the faithful implementation of IMF conditionality provisions. I test for this possibility by interacting the variables for democracy and IMF conditionality. The Model 1 estimates indicate that countries that signed an IMF agreement in the previous year had less extensive restrictions than countries with such an agreement. The correlation between democracy and the extent of restrictions remains negative and statistically significant. Model 2 addresses the possibility that democracies and dictators

²⁸ In the absence of established measures of default itself, incidence of rescheduling through the Paris Club, a standing but informal body of creditor countries, provides an indirect proxy for sovereign defaults. This choice of variable does not introduce selection bias because, for much of its active history, the Paris Club has had a mandate to provide assistance to even the most heavily indebted countries in need of debt rescheduling. Additionally, the group meets monthly so there is not a significant lag time between default and rescheduling.

²⁹ Trade agreements did not incorporate FDI provisions until the mid-to-late 1990s, which allows me to exclude them as an alternate source of external pressure. Bilateral investment treaty signings were also minimal until the same period (Elkins et al. 2006).

TABLE 3. Average Effect of Democracy on Ownership Liberalization During Economic Crises

	(1)	(2)	(3)	(4)
		<i>Entry Restriction</i>		
Democracy ($t-1$)	-0.0654 (0.0324) *	-0.0947 (0.0325) **	-0.0655 (0.0305) *	-0.0732 (0.0346) *
Currency Crisis ($t-1$)	-0.0110 (0.0152)			-0.0114 (0.0151)
Currency Crisis ($t-1$) \times Democracy ($t-1$)	0.00787 (0.0201)			0.00698 (0.0201)
Banking Crisis ($t-1$)		-.0283 (.02111)		-0.0172 (0.0212)
Banking Crisis ($t-1$) \times Democracy ($t-1$)		0.0221 (0.0313)		0.0200 (0.0311)
Sovereign Debt Rescheduled ($t-1$)			-0.0243+ (0.0137)	-0.0270+ (0.0148)
Sovereign Debt Rescheduled ($t-1$) \times Democracy ($t-1$)			0.0460 (0.0300)	0.0492 (0.0318)
Ln(<i>per capita</i> GDP($t-1$))	-0.0828+ (0.0474)	-0.194 (0.0486) **	-0.100 (0.0429) *	-0.0904+ (0.0469)
Observations	2,032	2,032	2,086	2,032
Countries	91	91	93	91

OLS coefficients with panel-corrected standard errors in parentheses. All models include country and year fixed effects and a panel-specific AR(1) correction for serial correlation. Constant terms not reported.

** $p < .01$, * $p < .05$, + $p < .1$

differ in their foreign ownership policies when subject to IMF requirements. The coefficients on *Democracy* and *IMF Conditionality* remain negative and statistically significant. The interaction of these two terms is not statistically significant. These three coefficients indicate that democracies have, on average, less extensive restrictions when they are not under an IMF agreement and that dictatorships have fewer restrictions when under an IMF agreement. The statistically insignificant coefficient on the interaction term establishes that democracies' average level of restrictions is insensitive to whether the country entered into an IMF agreement in the previous year.

External influences on economic policy extend beyond explicit coercion by multilateral donors. Diffusion scholars point to mechanisms through which policymakers respond to the choices of their foreign counterparts.³⁰ Policymakers can learn about the effects of policy reform or mimic the policy changes of countries based on a socialized view of appropriate or desirable economic policies. The testable implication of these mechanisms is that countries dismantle barriers to foreign ownership when they observe peer countries doing so. A correlation between the policies of peer countries is taken as evidence of diffusion processes.

I focus on two country traits that diffusion scholars have found influence countries' propensity to sign bilateral investment treaties: colonial origin and language group. Countries that share a former colonial power are more likely to look to each other to learn about the possible effects of policy reforms or as a model to emulate. These countries are likely to share a common language, similar political institutions, and the continued disproportionate exposure to ideas emanating from the former colonial power. Additionally, these countries are likely to compete for FDI to the extent the countries present a similar profile of transactions costs and market tastes for potential investors. Many of these dynamics are present among countries that share an official language. Although there is overlap between countries colonial and language groups, the language measure captures less direct cultural ties that are the basis for countries affinity for each other.

Following the existing literature on diffusion, I test for a positive correlation between the extent of regulations in a country and the average level of restrictions for all

countries in its peer group, whether it be colonial origin (*Average Restrictions—Colonial Origin*) or language group (*Average Restrictions—Language Group*). Both of these diffusion measures are heavily trended so I opt to remove year fixed effects.³¹ Both variables have a positive and statistically significant coefficient indicating a positive correlation between a country's ownership regulations and those of its peers. Democracy's negative correlation with ownership regulations is robust to the inclusion of these controls. Model 4 provides an alternate measure of colonial origin in the form of dummy variables for former colonies of Spain, France, Belgium, and the Netherlands. Former UK colonies and independent countries comprise the omitted group. This model treats the influence of colonial origin as fixed across time, but allows the salience of colonial origin to vary by colonizer and permits the inclusion of year fixed effects. The coefficients on colonial origin are negative and statistically significant for former colonies of Spain, France, and the Netherlands. Relative to the reference group, these countries have less extensive ownership barriers. Model 5 incorporates the full set of alternate explanations thus far. Due to the inclusion of the diffusion measures, year fixed effects are omitted. Democracy remains a significant correlate of ownership regulation in all five models.

Given disagreements about the optimal way to measure democracy, I establish that the main finding is robust to alternate measures of democracy. Table 5 summarizes re-estimates of seven of the previously described models with a binary measure of democracy constructed from the Polity IV database (Gurr et al 2009). In order to maintain consistency with the preferred binary measure, I collapse the twenty-point Polity scale into a binary variable equal to 1 for countries with a Polity Score in the top range of 6–10 and equal to 0 for all countries below that threshold.³² In each of the seven models, *Polity-Binary* maintains a negative and statistically significant coefficient. The substantive magnitude of this correlation is only slightly smaller than estimates generated with the preferred democracy measure. The coefficients on most control variables remain consistent; only the coefficients the colonial origin dummy variables in Model 6 exhibit

³¹ The correlation between time and colonial origin and language group are -0.689 and -0.391 , respectively.

³² Findings are robust to the setting the cutoff at Polity = 5 and Polity = 7.

³⁰ Simmons and Elkins (2004); Elkins et al. (2006).

TABLE 4. External Sources of Foreign Ownership Liberalization: Coercion, Learning, and Imitation

	(1)	(2)	(3)	(4)	(5)
Democracy ($t-1$)	-0.0635 (0.0307) *	-0.0637 (0.0313) *	-0.0692 (0.0319) *	-0.0623 (0.0215) **	-0.0710 (0.0323) *
IMF Conditionality ($t-1$)	-0.0183 (0.00895) *	-0.0182+ (0.0102)			-0.0116 (0.0112)
IMF Conditionality ($t-1$) \times Democracy ($t-1$)		-0.000500 (0.0220)			
Average Restrictions—Language Group ($t-1$)			0.144 (0.0733) *		0.155 (0.0749) *
Average Restrictions—Colonial Origin ($t-1$)			0.139** (0.0505)		0.147** (0.0521)
Spain Colony				-0.563 (0.112) **	
France Colony				-0.458 (0.216) *	
Belgium Colony				0.0755 (0.0647)	
Netherlands Colony				-0.445 (0.134) **	
Currency Crisis ($t-1$)					0.00169 (0.0123)
Banking Crisis ($t-1$)					-0.0153 (0.0189)
Sovereign Debt Rescheduled ($t-1$)					-0.00123 (0.0139)
$\ln(per\ capita\ GDP(t-1))$	-0.0624 (0.0467)	-0.0586 (0.0472)	-0.119 (0.0512) *	-0.0912 (0.0629)	-0.107+ (0.0555)
Observations	2,091	2,091	1,673	2,112	1,593
Countries	96	96	77	97	73
Year Fixed Effects	Y	Y	N	Y	N

OLS coefficients with panel-corrected standard errors in parentheses. All models include country fixed effects and a panel-specific AR(1) correction for serial correlation. Year fixed effects are included as indicated. Constant terms not reported.

** $p < .01$, * $p < .05$, + $p < .1$

meaningful change. The findings are also robust to the use to the full 20-point Polity scale.³³

I address the possibility that democracy is endogenous to foreign ownership liberalization. As noted above, several studies have ruled out the endogeneity of democracy to trade and capital account liberalization. It seems reasonable that foreign ownership liberalization would follow a similar pattern. I address possible omitted variable bias and endogeneity of democratization to ownership policies by estimating an instrumental variable regression. My instrument for democracy is *Years Since Independence*, the number of years that a country has been independent. This instrument satisfies the exclusion restriction by the following logic: The longer that a country has been independent, the more likely it is to be a democracy. The length of independence, however, has no systematic bearing on the number of industries into which a country chooses to limit majority foreign ownership. This variable has been used in analogous studies on democratization's role in trade and financial liberalization (Eichengreen and Leblang 2008; Milner and Mukherjee 2009). Table 6 presents the first- and second-stage estimates of this analysis. For both the baseline model and the full specification, the coefficient on *Democracy* remains negative and statistically significant. The first-stage F-statistic for both models, equal to 21.46 and 39.70 for the first and second models, respectively, meets the Stock and Yogo (2002) test to dismiss weak instruments.

I perform additional robustness tests that, in the interest of space, I describe here (full results available in online appendix). First, as noted above, I replicate all of the above models for the informal measure of ownership restrictions and find no systematic relationship between democracy and the extent of informal requirements. Second, I generate a binary version of the dependent variable that equals 1 if a country restricts more than half of all industries. This specification is more blunt, but it is less sensitive to possible measurement error in the number of industries a country has. I estimate a logit model with country fixed effects; the substantive conclusion is unchanged. Finally, I estimate whether the results hold when I remove OECD countries to confirm that their generally high levels of democracy do not drive the observed correlation. The results of the fully specified models hold when these countries are removed from the sample.³⁴

Conclusion

Over the period 1970–2000, countries liberalized FDI inflows. Despite FDI's prominent and varied role in the international economy, we lack the theoretical tools to make sense of this shift and the data on formal FDI restrictions necessary for systematic study of the puzzle. Existing political economy research focuses overwhelmingly on how politics influences the supply of FDI with little acknowledgment that politics also shapes countries' demand for FDI. In this article, I provide both the theory and data necessary to understand this vital, but curiously overlooked, dimension of international economic integration.

The politics of FDI regulation are rooted in FDI's economic consequences for recipient countries. Local labor supports unfettered inflows because FDI increases labor demand when MNCs hire local workers. Local firms prefer

³³ Results in online appendix.

³⁴ See Figure 3 for a description of which OECD countries are in the sample.

TABLE 5. Alternate Measure of Democracy, *Polity Score—Binary*

	(1)	(2)	(3)	(4) <i>Entry Restriction</i>	(5)	(6)	(7)
Polity-Binary ($t-1$)	-0.0546 (0.0259) *	-0.0654 (0.0281) *	-0.0506+ (0.0258)	-0.05237 (0.0262) *	-0.0552 (0.0274) *	-0.0546 (0.0183) **	-0.0543 (0.0271) *
Currency Crisis ($t-1$)		-0.0127 (0.0160)					0.00180 (0.0123)
Currency Crisis ($t-1$) × Polity-Binary($t-1$)		0.00991 (0.0207)					
Currency Crisis ($t-1$)		-0.0140 (0.0225)					-0.0169 (0.0190)
Banking Crisis ($t-1$) × Polity-Binary ($t-1$)		0.0110 (0.0287)					
Currency Crisis ($t-1$)		-0.0269+ (0.0148)					-0.00197 (0.0139)
Sovereign Debt Rescheduled ($t-1$) × Polity-Binary($t-1$)		0.0464 (0.0298)					
IMF Conditionality ($t-1$)			-0.0171+ (0.00891)	-0.00189 + (-0.0106) 0.0043 (0.0215)			-0.0105 (0.0112)
IMF Conditionality ($t-1$) × Polity-Binary ($t-1$)					0.147 (0.0733) *		0.158 (0.0749) *
Average Restrictions—Language Group ($t-1$)					0.141** (0.0510)		0.149** (0.0527)
Average Restrictions—Colonial Origin ($t-1$)							
Spain Colony						0.314 (0.238)	
France Colony						0.441 (0.123) **	
Belgium Colony						0.0689 (0.0658)	
Netherlands Colony						0.370 (0.298)	
Ln(<i>per capita</i> GDP($t-1$))	-0.0851+ (0.0447)	-0.0844+ (0.0476)	-0.0538 (0.0474)	-0.0524 (0.0262)	-0.120 (0.0510) *	-0.0851 (0.0642)	-0.107+ (0.0553)
Observations	2,117	2,037	2,091	2,091	1,673	2,117	1,593
Countries	98	92	96	96	77	98	73
Year Fixed Effects	Y	Y	Y	Y	N	Y	N

OLS coefficients with panel-corrected standard errors in parentheses. All models include country fixed effects and a panel-specific AR(1) correction for serial correlation. Year fixed effects are included as indicated. Constant terms not reported.

** $p < .01$, * $p < .05$, + $p < .1$

TABLE 6. Instrument for Democracy: *Years Since Independence*

	Entry Restriction			
	2nd Stage	1st Stage	2nd Stage	1st Stage
Democracy ($t-1$)	-0.590 (0.0866) **		-0.813 (0.272) **	
Time Since Independence ($t-1$)		0.0115 (0.00087) **		0.00765 (0.0016)
Currency Crisis ($t-1$)			-0.00258 (0.0172)	0.00517 (0.01317)
Banking Crisis ($t-1$)			0.0322 (0.0289)	0.050863 (0.018)
Sovereign Debt Rescheduled ($t-1$)			0.0325 (0.0343)	0.0312 (0.0252)
IMF Conditionality ($t-1$)			-0.0682 (0.0327) *	-0.0676 (.01967) **
Average Restrictions—Language Group ($t-1$)			-0.0516 (0.155)	-0.4916 (0.0552) **
Average Restrictions—Colonial Origin ($t-1$)			0.0328 (0.0628)	0.02007 (0.05143)
Ln(<i>per capita</i> GDP($t-1$))	-0.0866 (0.0315) **	-0.0386 (0.0288)	-0.0492 (0.0406)	-0.07403 (0.0327)
F-Statistic		21.46**		39.70**
Observations	2,043		1,575	
Countries	92		72	

Two-stage least squares estimates with standard errors in parentheses. All models include country fixed effects.

** $p < .01$, * $p < .05$, + $p < .1$

regulations that require MNCs to form joint ventures with their local counterparts. FDI inflows increase competition for labor and customers, but regulations counteract these effects by forcing MNCs to share their highly productive assets with local firms. Cross-country variation in the extent of FDI regulations emerges because policymakers differ in their incentives to privilege one group's interests over the other. In autocracies, leaders typically favor the interests of the industrial elite by restricting FDI in order that local firms' may access MNCs' highly productive assets.

As countries democratize, they lower restrictions on foreign ownership. This relationship derives from the shift in politicians' policymaking incentives that democratization creates. I exclude multiple alternate explanations for FDI liberalization including economic crisis, external pressure from donors, and the policy choices of peer countries. This explanation makes sense of broad historical trends in FDI regulation that set the stage for unprecedented international economic integration.

This research is the first step toward a rich research program on demand for and regulation of FDI inflows that emphasizes the precise economic activities that MNCs undertake and their consequences for recipient countries. This research recognizes that FDI is more than simply another form of capital flow or the quintessential example of credible commitment problems in the world economy. Rather, it brings FDI in line with other branches of political economy research to a sustained focus on how and why countries choose to embrace economic integration. Given FDI's critical role in the international economy, such a focus is long overdue.

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Supporting Information

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