ONE

Domestic Coalitions and the Political Economy of Foreign Direct Investment

1.1 Globalization of Production and Politics

We live in a world of globalized markets, where goods, services, capital, and workers move across national borders with ease, albeit with different degrees of latitude depending on the type of flow. The transforming effects of this rapid process of global economic integration are subject to heated debates among scholars, pundits, and journalists.

Some argue that technological innovation and changes in the patterns of production at a global level have flattened the world and forced national governments to adjust their regulatory standards to the levels acceptable to multinational businesses and institutional investors (Friedman, 2007; Strange, 1996).[1] Globalization pessimists argue that the forces of market integration have led to a negative form of policy convergence: governments are forced on a race to the bottom and a consequent leveling of national regulatory standards. The territorial state, which dominated the industrial era, is increasingly becoming obsolete, and is gradually being replaced by new forms of global governance (Ohmae, 1995; Strange, 1996, 1998; Rosecrance, 1999). Moreover, the pressure from global markets have blurred the ideological differences among political parties not only in developed countries, but particularly in the developing world: to stay competitive in the global marketplace governments of the left and the right alike have become fanatical advocates of the neoliberal cause (see Edwards, 1995; Williamson, 1990; Garrett, 2000). The conclusion is that when dealing with global market forces, politics does not matter any more, if it ever did.

On the opposing side of the debate we find claims that the incentives and constraints created by global economic forces lead to policy divergence

[1] See Garrett (2000) for an excellent review of the academic literature on the subject.

rather than convergence (Tiebout, 1956; Vogel, 1996; Berger and Dore, 1996; Kahler, 1998; Kahler and Lake, 2003). The patterns of divergence are systematic: they depend as much on the preferences of the actors as they react to the constraints and opportunities created by global forces (Cameron, 1978; Rodrik, 1997). Scholars ascribing to this tradition argue that governments have ample room to maneuver and make policy choices that are a clear reflection of their types (Swank, 1998; Hall and Soskice, 2001; Garrett and Mitchell, 2001; Swank and Steinmo, 2002). The heated debate on the consequences of globalization, present in politics, journalism, and academia, is far from settled.

Changes in global production spearheaded by multinational corporations are a central characteristic of the current era of globalization (Bordo et al., 1999). Yet, while there is profuse literature on the political economy of trade and financial flows, research on the politics of direct investment flows and the regulation of multinationals has only recently picked up steam. This book develops a political economy explanation of foreign direct investment (FDI) regulation and performance. The partisan theory of FDI, built around the strategic interaction between investors and host governments, predicts that divergence rather than convergence in regulatory standards is more likely to attain even under the pressure created by competition for foreign investment. An important determinant of this divergence is the partisan orientation of the ruling coalition, which determines the motivation to attract or deter FDI, and the ability of that coalition to effect the policy changes aimed at luring investors in or keeping them out.

The partisan theory of FDI is derived from the intuition that FDI "creates winners and losers domestically," and that these expected distributive consequences inform the politics of FDI. These distributive motivations are, at best, only implicitly accounted for in most of the academic work on the subject. The argument developed throughout the book brings preferences towards FDI to the fore. These preferences are explicitly derived from the differential effect of FDI on the demand for the services offered by different factors of production in the economy where the foreign investor operates. The predictions follow the theoretical and empirical literature on foreign investment, which persuasively shows that workers – both skilled and unskilled – tend to benefit from inflows of FDI (Lipsey and Sjöholm, 2004, 2005; Sjöholm and Lipsey, 2006), whereas the return to capital in the FDI-receiving country tends to fall (Lipsey and Sjöholm, 2005; Haddad and Harrison, 1993; Aitken et al., 1996, 1997; Feenstra and Hanson, 1997; Aitken and Harrison, 1999; Figlio and Blonigen, 2000; Feliciano and Lipsey, 1999).[2] Taken together, the results unveiled by the empirical literature on MNC activity suggest that in the aggregate investment flows result in higher labor demand, and this higher wages and employment; MNCs also create competitive pressure on firms in host countries and have limited spillover effects on indigenous firms. Moreover, the literature suggests that on average a dollar in FDI gets translated into roughly a dollar in domestic investment. Therefore, it has the potential to affect labor and capital productivity in the direction assumed by the model. Moreover the theoretical literature on MNCs and FDI, we believe that direct investment is a combination of capital and technology. Therefore, it is likely that at the extremes workers would prefer investment capital and technology that does not substitute for their service in production, and domestic capital owners would prefer access to labor-saving technology but no investment capital.

From the findings of this literature, I develop a political economy model of the interaction between foreign business and domestic government built on micro-foundations. The modeling strategy aims at capturing the incentives and constraints faced by the different actors involved. Regulatory restrictions on foreign investment would thus be a function of the strategic interaction between governments and investors. The argument is related to the positive political economy literature that has been built around trade politics, but the special nature of FDI makes some of the conditions in that literature inapplicable to this case. In particular, the dichotomy between sectors and factors does not necessarily apply as explained in the following paragraph. What matters is the factor bias of FDI: does foreign investment increase the relative demand for labor services and does it create competition to incumbent firms in product and factor markets? (Brown et al., 2004; Pinto and Pinto, 2008).

[2] Brown et al. (2004) and Lipsey (2004) review the empirical literature on the consequences of FDI. Brown et al. (2004, pp. 299–303) present an overview of the different theoretical models from which the distributional effects of the flow of capital on factor returns can be derived. They conclude that the *normal case* is "labor earning a higher wage as a result of an inflow of FDI." The result would be reversed in the case where capital substitutes for labor in production (Brown et al., 2004, p. 303, fn. 35), an intuition that is developed in Pinto and Pinto (2007, 2008, 2011). It is also plausible, in theory, that under special conditions an MNC becomes a monopsonist in factor markets and this negatively affect wage bargaining; historical examples could be found in foreign investment in plantation-style activities. But even when MNCs dominate factor markets they are also likely to enjoy product market power, leading to rents that could be shared with workers, especially when they are unionized, and in result wages would not necessarily drop (Katz and Summers, 1989). Yet, most MNCs face competition in labor markets from domestic and foreign firms suggesting that the negative effect on wages is now but an intellectual curiosity (Brown et al., 2004).

The predictions from the theory seem to be borne out by the evidence produced in the empirical section of the book: governments seek out investors that are likely to contribute to the well-being of the core constituents of their party or coalition; and investors choose forms of production that are tailored to the specific political conditions in host countries, particularly the partisan orientation of the incumbent government. By focusing on the constraints and opportunities created by the explosion of foreign direct investment, I can analyze in a rigorous manner the interaction between global economic forces and politics. The conclusions from this analysis provide stronger support to the divergence school, while shedding some light on central debates in political science on the role of political institutions and preferences in foreign economic policy making.

1.2 Domestic Coalitions and the Political Economy of FDI

Despite the dramatic increase in the flows and stock of direct foreign investment in the last thirty years, there is large variance in the amount of foreign direct investment that individual countries receive.[3] The motivations for engaging in FDI have expanded beyond securing access to natural resources, which had characterized most foreign direct investment in the past; manufacturing and particularly services now comprise the bulk of direct investment flows (Bordo et al., 1999). Host governments have quickly reacted to these new trends in production and investment strategies by multinational firms by changing policies targeted at foreign investors. While many governments adopted pro-investor regulations in the 1990s, the menu of policies toward foreign investment is extensive and not always favorable to foreigners (see Table 1.2). Moreover, within countries, changes in foreign investment regulation over time have been quite dramatic as well (UNCTAD 2000, UNCTAD 2010).

Surprisingly, we lack a convincing explanation for the cross-country and temporal variance in the regulation of foreign investment and in the amount of FDI inflows that countries receive. The specialized literature to date focuses on the role of institutional constraints and the protection of investors' property rights (Jensen, 2003, 2006; Li and Resnick, 2003). When choosing location sites for their projects, investors only care about minimizing their risk exposure; risk is likely to be lower when the ruler is institutionally constrained; and institutional constraints are more prevalent in polities with democratic institutions and limited government

[3] See section 1.4, Table 1.1, and UNCTAD (2000, 2010).

Table 1.1. *FDI/GDP (%) – selected countries*[a]

	1980–4	1985–9	1990–4	1995–9	2000–04	2005–07
Developed Countries						
EU	0.40	0.67	0.97	2.17	5.10	4.85
France	0.39	0.67	1.33	1.94	2.87	4.52
Germany	0.10	0.22	0.14	1.00	3.20	1.65
Ireland	1.00	0.28	2.10	8.11	13.59	−1.81
Japan	0.02	0.01	0.04	0.09	0.18	0.23
UK	1.04	2.29	1.84	3.65	3.58	7.04
USA	0.55	0.98	0.60	1.68	1.52	1.49
Developing Countries						
Argentina	0.55	0.76	1.42	3.75	2.11	2.64
Brazil	0.87	0.46	0.37	2.57	3.40	2.03
China	0.23	0.81	3.41	4.43	3.13	3.60
Hungary	0.00	0.00	3.44	8.22	4.94	17.08
India	0.03	0.06	0.14	0.64	0.92	1.56
Korea	0.09	0.42	0.25	0.99	0.98	0.45
Malaysia	4.05	2.31	7.10	4.56	2.75	3.76
Mexico	1.15	1.17	1.48	3.01	3.24	2.31
Poland	. . .	0.02	1.05	3.33	3.54	4.88
Thailand	0.75	1.19	1.84	3.33	3.41	4.26
World	0.54	0.77	0.85	1.99	2.65	3.17

[a] *Source:* World Bank, World Development Indicators (online resource).

(North and Thomas, 1973; North and Weingast, 1989; North, 1990). Therefore, democracy and FDI inflows should be positively correlated. The prediction that democracy should increase FDI through property rights protection is sensible and seems to find preliminary support in the empirical literature (Jensen, 2003, 2006; Li and Resnick, 2003). However, it overlooks two central elements in the political economy of foreign investment. First, it misses investors' central motivation: the search for higher returns. As much as they care about minimizing risk exposure, investors' main concern is to maximize the return of their investment. Second, these explanations treat host governments as passive actors: either they have the features that investors like or not, but there is nothing they can do about it. The decision on where to invest, however, is more properly characterized as the outcome of a strategic interaction between investors and host governments. Host governments enact policies to regulate economic activity, and in doing so they balance the demands of key political actors with the expected reactions of investors to these policies.

Table 1.2. *Changes in national regulations of FDI*[a]

	Number of		Type of Changes	
Year	Countries	Changes	More favorable	Less favorable
1992	43	77	77	–
1993	56	100	99	1
1994	49	110	108	2
1995	63	112	106	6
1996	66	114	98	16
1997	76	150	134	16
1998	60	145	136	9
1999	65	139	130	9
2000	70	150	147	3
2001	71	207	193	14
2002	72	246	234	12
2003	82	242	218	24
2004	103	270	234	36
2005	92	203	162	41
2006	91	177	142	35
2007	58	98	74	24
2008	54	106	83	23
2009	50	102	71	31

[a] *Source:* UNCTAD (2010), p. 77.

I provide an alternative explanation, one where the interaction between investors, who are motivated by the quest for higher returns, and politically motivated host governments, who are interested in advancing the preferences of their core constituents, takes center stage in the politics of FDI. Combining these two motivations, I argue that host governments' partisan alignment – whether pro-labor or pro-capital – determines whether countries are more open or closed to FDI. Arriving to this conclusion requires deriving the conditions under which we would expect investment flows to affect the relative demand for the services supplied by different economic actors in the host country.[4] Building on the expected distributive consequences of investment, I develop a political economy model of the regulation of FDI. I also derive the response of investors to the regulatory framework offered by governments, reflected in changes in investment performance within countries and over time. The explanation emphasizes the role of

[4] Whereas the model is based on the effect of inward FDI in factor markets, i.e., changes in the relative demand for services supplied by businesses and workers, the distributive consequences could be derived from increasing competitive pressure in product markets as well.

partisanship, which is defined in terms of the incumbent coalition's pro-labor or pro-capital orientation. The main corollary derived from this model is that labor-based parties or coalitions are more likely to welcome foreign investment, particularly those investments that would result in higher labor demand; conversely, governments catering to domestic businesses prefer restricting direct investment inflows that compete with domestic businesses in product and factor markets.[5] Therefore, countries governed by pro-labor coalitions adopt policies to promote foreign investment and are likely to be better hosts to foreign investors. Contrary to received wisdom, I find that the argument that the Left loves foreign investors and foreign investors love the Left is plausible, and that the result holds beyond the new era of globalized markets.

The main hypotheses of the partisan theory of FDI parallel the intuition behind the literature on the political economy of trade: flows of direct investment capital, such as flows of goods and services across national borders, can result in aggregate economic benefits to the host economy.[6] Just like trade, foreign investment flows are likely to have stark distributional consequences.[7] Direct investment flows have real effects on the host economy: they have the potential to increase output and affect competition in labor and factor markets. Inflows of capital, of which FDI is one form, affect the relative demand for the services supplied by different economic

[5] I build my argument around the *direct* effects of investment on the relative demand for labor services (see footnote 2). It is plausible that there are also indirect effects from FDI, where consumers and firms not directly in competition with the investor would benefit (or hurt) from the spillover effects of inward FDI (or its absence thereof) (Lipsey and Sjöholm, 2005; Lin and Saggi, 2005). The model presented in Chapter 2 accounts for these indirect effects: the degree of complementarity between FDI and domestic factors of production would make some local firms – those not in direct competition with the foreign firm – benefit from the higher economic activity that results from the entry of foreign investors, which they tradeoff for the potentially higher costs of factor services that results from the presence of the MNCs. The net effect on the income of these capital owners could thus be positive, yet not as positive as if the foreign investor enters as a substitute for labor (reducing labor costs), which is usually an exception rather than the rule. These positive spillover effects would mitigate the opposition to FDI, particularly when compared with capital owners in direct competition with the foreign investor in product and factor markets. Yet, they would still be relatively more opposed to inward investment than workers.

[6] The aggregate effects depend on the existence of absorptive capacities in the host; see Blömstrom et al. (1994), Easterly et al. (1994), Borensztein et al. (1998), and Carcovic and Levine (2005). On the effect of foreign investment on technological spillovers, see also Findlay (1978), Kokko (1994), Kokko et al. (1996), Blömstrom and Kokko (1998), Glass and Saggi (1998), Lipsey and Sjöholm (2005), and Lin and Saggi (2005).

[7] See Mundell (1957) and Brown et al. (2004). Mundell's equivalency proposition establishes that factor flows are likely to affect factor returns in the absence of trade, the model developed in Chapter 2 extends the logic for the case where the economy is open to trade.

agents in the host economy, and thus the well-being of these agents.[8] To the extent that collective action costs are not prohibitive, economic agents find that organizing politically in defense of their sources of income usually pays off. Put differently, failure to organize politically in the presence of competing groups with opposing preferences on any issue area is likely to make these agents worse off.[9] I predict that domestic capital will oppose FDI and demand policies aimed at keeping foreign investors out, whereas labor will embrace FDI and promote policies that encourage investors to flow in. Whether those demands get translated into policies and regulations depends on the degree of political influence of these groups, which is likely to vary with their organization and with their links to the ruling party. These predictions run counter to a vast body of literature in political science, which argues that foreign investors are aligned with domestic business owners forming a Triple Alliance aimed at exploiting the popular sectors. See, for example, Oneal (1994), Evans (1979), Evans and Gereffi (1982), and O'Donnell (1988).[10]

The central contribution of the partisan theory of FDI is the emphasis on the expected effects of foreign investment on factor markets, which has been neglected in the literature.[11] The model introduced in Chapter 2 explicitly incorporates the fiscal incentives in the regulation of FDI, which the extant literature makes central to its predictions about the politics of investment.[12] In this model, taxing foreign investors could have an effect on individuals' well-being in the marketplace, which they have to tradeoff for their participation in consuming government services financed with the taxes levied on foreign capital. The relative weights placed on the income derived from participation in the market and the utility from consuming government output, or receiving a direct transfer from the government, is reflected in the choice of policies adopted by host governments of different partisan types. These motivations, discussed in more detail in Section 1.6.6,

[8] In Chapter 2, I specify the conditions under which investment flows decrease the return to capital and increase the return to labor in the host. See also Pinto and Pinto (2008).
[9] On the conditions for collective action, see Olson (1971). In the canonical model of trade protection, for instance, political organization determines which groups get their preferred outcome and who is forced to pay for it. See Grossman and Helpman (1994).
[10] The conditions for the triple alliance argument discussed in Section 1.5.1 require very restrictive assumptions about the type of investment and the prevailing political conditions in the host country. Pinto and Pinto (2011) show that it could be considered a special case of the partisan theory of foreign investment where governments are pro-business, redeployment costs are high, foreign investment is a perfect complement in production of domestic capital, and/or a perfect substitute of labor services.
[11] Quinn and Inclan (1997), Alfaro (2004), and Pinto and Pinto (2008, 2011) are exceptions.
[12] See Quinn and Inclan (1997) for a review of this literature.

suggest that there are different shades of left: some parties of the Left prefer lowering taxes on MNCs to magnify labor market effects, whereas for others revenue incentives dominate. For most pro-business governments, on the other hand, regulating FDI is dominated by market effects: if FDI competes with domestic businesses in product and factor markets, these governments are more likely to adopt a *prohibitive tax* that would keep investors out.

Whereas a formal framework sustains the logic of the argument, its plausibility is assessed using a variety of statistical tools and historical evidence. The statistical analyses are conducted using data from developed and democratic countries, and from emerging markets that have received the bulk of foreign investment in the past decades. The historical analyses are based on a structured comparison of the evolution of investment regimes in Argentina and South Korea in the post-war era. The choice of cases and time frame aims at maximizing the cross-sectional and longitudinal variance in the degree of labor and capital influence in politics. This variance occurred as a function of changes in the institutional structure of the two countries, including transitions to democratic and authoritarian rule, and of changes in the orientation of the ruling coalition resulting from institutional changes in addition to electoral turnovers and lobbying.

The quantitative and historical evidence presented in the empirical section of the book provide some preliminary support to the partisan hypothesis: investment regimes and investment outcomes covary with the pro-labor or pro-capital orientation of the incumbent coalition in the host country. The corollary is that countries with labor-based coalitions receive more foreign direct investment than those countries whose ruling coalitions are built around domestic capital owners. The partisan effect on FDI could be mitigated when preferences for social spending are high and investment is highly elastic to taxes, or when access to natural resource and other sources of rents makes governments less dependent on factor market conditions to reward their followers. The theory and subsequent findings capture part of the large variance in the level of foreign investment countries receive that remains unexplained in the extant literature. In the ensuing sections, I introduce the puzzle that motivates this research, define the research problem, and discuss where the issue stands in the literature prior to introducing the partisan theory of FDI. The final section presents the layout of the book.

1.3 Political Alignment and Foreign Investment

Foreign investment and the activity of multinational corporations are controversial political issues. A positive or negative disposition toward foreign investors does not seem to be exclusively the result of political actors' attachment to nationalistic causes. In some cases, the objection to foreign investment is made in the name of labor. Some argue that multinationals and foreign investors are bad because their sole motivation is to exploit host countries; therefore, they line up with domestic capital and authoritarian governments to reap profit at the expense of workers. According to pundits and analysts of multinational activity, this negative sentiment is reciprocal: foreign investors hate places where labor is strong, such as Perón's Argentina. This has been the prevalent position of the *Dependentista* literature in the 1970s.[13] On the other hand, foreign investors usually complain about markets such as Japan or South Korea where they feel unwelcome.[14] The issue is, then, identifying the conditions under which different polities are more or less willing to provide a regulatory environment conducive to foreign investment. The Japanese and Korean cases are less surprising given that the interests of domestic business have been at the center of politics in those countries. But the argument that domestic capital in countries like Argentina, and elsewhere, holds FDI in higher esteem than does domestic labor is debatable at best. A military government that ruled between 1976–83 (the regime was known in Spanish as "*Proceso de Reorganización Nacional*") repressed labor and was allegedly friendly toward business, yet hardly received any foreign investment. In fact, industrial policies under the military regime actively discriminated against multinational corporations (Azpiazu and Basualdo, 1989). As a result, several of the most prominent multinationals, including automakers such as General Motors, Fiat, and Peugeot, left the country altogether during the military regime. In contrast, the country witnessed what was probably the biggest FDI inflow in history under a Peronist government led by Carlos Menem. These flows remained surprisingly high in manufacturing under the Kirchners, despite the reputation of Perón and his followers of having a negative disposition toward all things foreign.

The prevailing view in Argentina that labor hated FDI also seems questionable, especially in light of survey data that shows otherwise (Dominguez, 1982; Ranis, 1994). Moreover, anecdotal evidence seems to suggest that the depiction of FDI by pundits and analysts is flawed. First, democratic governments, which are usually associated with an erosion of the political influence of propertied interests, seem to attract more FDI than

13 Evans (1979), Evans and Gereffi (1982), and O'Donnell (1988). See Moran (1978) for an excellent discussion of the testable hypotheses that could be derived from the *dependentista* research program.

14 Kodak and Motorola are the typical case studies on the problems faced by foreign investors when trying to enter the Japanese market.