Interstate Political Relations and Bilateral FDI Flows*

Quan Li
Texas A & M University

Aleksandr Vashchilko
KIMEP

Tatiana Vashchilko
Penn State University & University of Western Ontario

Question: How do interstate political interactions influence foreign direct investment?

Motivation: An important question that has largely been ignored in international business, international economics, and political science.

But it has important implications for understanding business behaviors, the efficient allocation of resources, and the consequences of international conflict and cooperation.

- International business scholars devote much attention to studying how aggregate indicators of political stability capturing country-specific risks influence FDI investment decisions and flows.

- Examples: Schneider and Frey (1985), Loree and Guisinger (1995), Woodward and Rolfe (1993), Fatehi-Sedeh and Safizadeh (1989), Olibe and Crumbley (1997), Henisz (2000), Sethi, Guisinger, Phelan and Berg (2003), and Globerman and Shapiro (2003).

- In international economics, interstate political relations have never been considered either theoretically or empirically.

- Markusen's (2002) well-known Knowledge-capital model emphasizes the differences in countries' skill endowments and investment barriers.

- New firm-level theoretical models of FDI (e.g., Melitz 2003, Helpman 2006, Grossman and Helpman 2002, Helpman, Melitz and Yeaple 2004) focus on the role of productivity differentials.

- Empirical models of bilateral FDI flows (Brainard, 1997; Grosse and Trevino, 1996; Grubert and Mutti, 1991; Blonigen and Davies, 2004) largely omit interstate political relations as irrelevant.

- IPE scholars have focused on the impact of country-specific attributes on foreign direct investors, including
- democratic institutions (e.g., Li and Resnick 2003; Li 2006a, 2009; Jensen 2003, 2006, 2008; Garland and Biglaiser 2009),
- political violence (Frieden 1994; Li, 2006b),
- government partisanship (Pinto and Pinto 2008),
- and country memberships in preferential trade agreements (Buthe and Milner 2008).
- A growing body of literature (e.g., Hallward-Driemeier 2003; Neumayer and Spess 2005; Elkins, Guzman and Simmons 2006; Tobin and Rose-Ackerman 2005) studies the impact of BITs.
- Again, the relevance of interstate political relations is overwhelmingly overlooked.

Three exceptions:

- Nigh (1985) the only one to separate conflict and cooperation and distinguish interstate and intrastate factors (FDI by US firms to 24 countries over 21 years).

- Biglaiser and DeRouen (2007): the presence of U.S. troops encourages U.S. capital inflows among 126 developing countries between 1966 and 2002.

- Li and Vaschilko (2010): interstate military conflict and security alliances change both government policies toward international business and investor expectations of political risk. A gravity model of bilateral investment flows for 1117 directed dyads among 58 countries from 1980 to 2000.

Motivations:

- Cross-border jurisdictions, Interactions matt.

- Firm-level theoretical considerations of how international politics affects firm operations.

Model:

One host country, and two home countries (1, 2) providing FDI.

Consumer demand for variety$_j$ is a function of income and price:

$$q_i(j) = \frac{p_i(j)^{-\sigma}}{P_i^{1-\sigma}} I_i,$$

where I_i is the income of a representative consumer in a country i, and P_i is the price index that includes additively the prices of all varieties available for consumption in country i.

Productivity ϕ, quantity q_i^f,

Variable costs for host firm: $\frac{w}{\phi} q^d$

Variable cost for multinational: $a_i \frac{w}{\phi} q_i^f$.

Revenues for host and multinational

$$R^d(\phi) = \left[\frac{\rho\phi P}{w}\right]^{\sigma-1} I,$$

$$R_i^f(\phi) = \left[\frac{\rho\phi P}{\alpha_i w}\right]^{\sigma-1} I$$

Host firm fixed cost wf^d.

Multinational fixed cost: $\beta_i w f_i^f$,

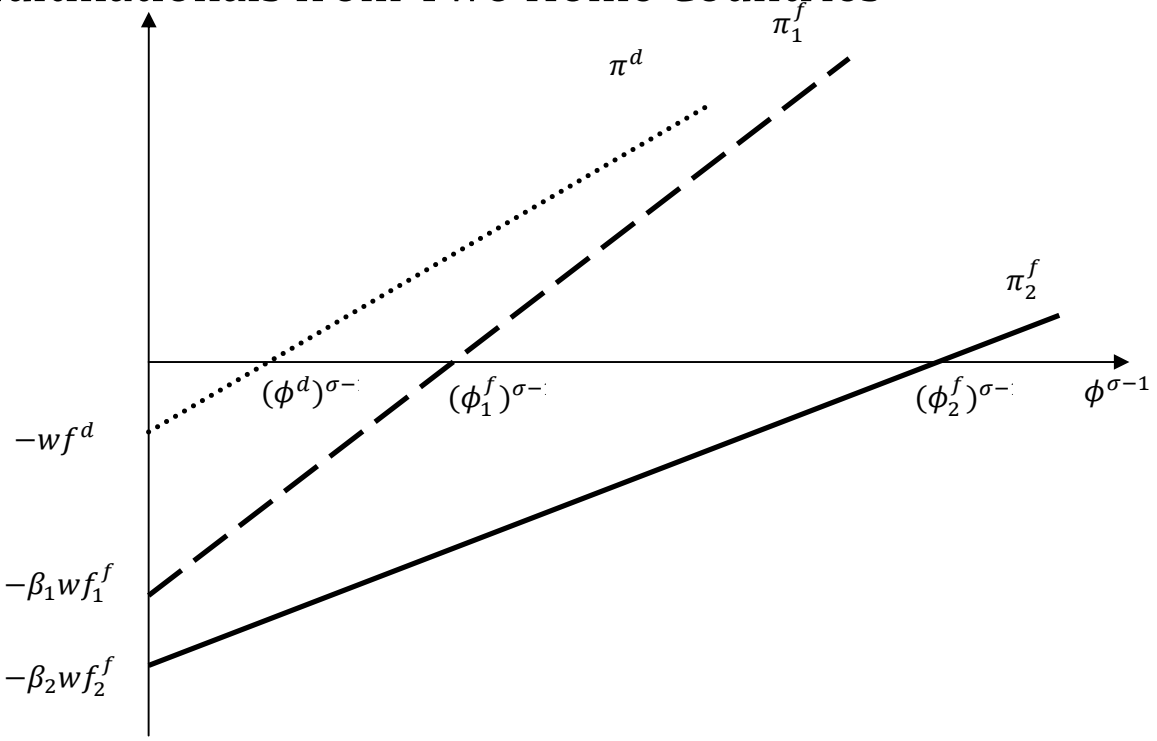
$$\pi^d(\phi) = \frac{R^d(\phi)}{\sigma} - wf^d, \qquad \pi^d(\phi^d) = 0.$$

$$\pi_i^f(\phi) = \frac{R_i^f(\phi)}{\sigma} - \beta_i w f_i^f, \qquad \pi_i^f(\phi_i^f) = 0$$

$$\frac{\phi_i^f}{\phi^d} = \alpha_i \left[\beta_i \frac{f_i^f}{f^d}\right]^{\frac{1}{\sigma-1}}$$

Mass of foreign firms: $(1 - G_i^f(\phi_i^f))M_i^f$.

Figure 1 Productivity Cut-Offs for the Host Firm and Multinationals from Two Home Countries



Empirical test:

Sample: 1013 directed dyads between 54 countries from 1990 to 2000.

$$y_{ijt+1} = \alpha y_{ijt} + \rho \sum_{km \neq ij} \omega_{pqt} y_{kmt} + \beta_1 X_{i,j,ij,t} + \beta_2 z_{i,j,ij,t} + \nu_{ij} + \varepsilon_{ijt},\ ij = 1,..N,\ t = 1,..T$$

Table 1 Effect of Interstate Cooperation and Conflict on Bilateral FDI Flows, 1990-2000

	(1)	(2)
Net cooperation (log)	0.194	
	(2.12)**	
Cooperation from destination to origin (log)		0.009
		(1.98)**
Conflict from destination to origin (log)		-0.008
		(1.18)
Lagged real FDI flows (log)	0.483	0.526
	(4.36)***	(5.03)***
Bilateral trade (log)	-0.010	-0.011
	(2.07)**	(3.14)***
Ratification of BIT	0.007	0.005
	(0.88)	(0.56)
GDP per capita of origin (log)	0.025	0.031
	(2.54)**	(4.58)***
GDP per capita of destination (log)	0.025	0.026
	(2.41)**	(2.98)***
Spatially weighted FDI (log)	0.011	0.010
	(2.58)***	(2.21)**
Distance (log)	-0.015	-0.008
	(2.27)**	(2.05)**
Population of origin (log)	0.011	0.015
	(1.14)	(2.00)**
Population of destination (log)	0.020	0.022
	(1.95)*	(3.19)***
Constant	2.901	3.265
	(3.56)***	(3.71)***
Observations	6679	6679
Number of Dyads	1013	1013

	(1)	(2)
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	(2.12)**	
Cooperation from destination to origin (log)		0.009
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