Foreign Direct Investment and Civil Rights: Testing Decreasing Returns to Civil Rights

Ponce, Aldo

University of Houston

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Aldo Fernando Ponce
afponce@mail.uh.edu

University of Houston

Department of Political Science

Philip Guthrie Hoffman Hall Room 447

Houston, TX 77204

Abstract:

In this paper, I examine the effectiveness of improvements in political and civil rights for attracting foreign direct investment flows (FDI) into democracies. I contend that advances in the quality of democracy – specifically those concerning civil rights – present positive but decreasing marginal returns in attracting FDI inflows. I empirically prove this proposition by using panel data regressions within the Latin American and Eastern European contexts from periods following their democratization (1991-2003).

Keywords: foreign direct investment, civil rights, democratization, developing nations, Latin America, Eastern Europe.

Overview

This study addresses the relationship between quality of democracy and the level of inflows of foreign direct investment (FDI inflows). In particular, it examines how effective improvements in political and civil rights are to attract inflows of foreign direct investment for democracies. I contend that advances in the quality of democracy -- specifically in the area of civil rights -- present positive but decreasing marginal returns for attracting FDI inflows. In other words, as the quality of democracy progresses, the marginal returns to civil rights decline. I empirically prove this regularity in polities with recent democratization experiences --- more precisely by using panel data regressions within the Latin American and Eastern European contexts from periods following their democratization (1991-2003).

Due to the evidence of decreasing returns to civil rights, I conclude that 1) countries that boost the scope of civil rights after democratizing (despite its diminishing but positive returns) are relatively more successful in attracting FDI inflows than those with extreme levels; 2) politicians and policy-makers should expand the provision of civil rights selectively if the maximum impact in terms of foreign investment (and eventually more economic development through foreign direct investment) becomes a priority; and 3) despite the existence of diminishing returns, the impact of any increase in the scope of civil rights is almost always positive on the amount of FDI inflows.

In order to extend the literature on the role of political variables in attracting FDI inflows, I estimate the impact of changes in the quality of democracy during the first stages of democratic consolidation on the behavior of foreign investment inflows. After verifying the existence of decreasing returns to the quality of democracy – measured by the scope of civil rights – new venues for further research are suggested to explore why and how different components of civil rights can produce such a property (decreasing returns to civil rights).

Politics and Foreign Direct Investment

Previous studies on the role of good governance or other political variables (concerning democratic quality) in attracting FDI inflows have mainly concentrated on the relationship between FDI inflows and 1) type of regime (whether democratic or not); or 2) only one aspect of democratic consolidation or political condition (e.g., corruption, tests of expropriation, political risks insurance, tax incentives, and property rights).

Using the first approach, several scholars have focused on determining the link between regime type and investor confidence (Jessup 1999; Jensen 2003; Li and Resnick 2003; O´Neal 1994). For example, O´Neal (1994) finds that authoritarian regimes provide investors with higher returns of profitability in developing countries. However, overall investment flows are not generally related to regime type. Likewise, Jessup (1999) argues that authoritarian regimes in developing nations attract more international investment. On the other hand, Jensen (2003) concludes that democratic governments attract higher levels of

FDI. Between these divergent views, Li and Resnick (2003) were perhaps the first to suggest that democratic institutions can affect FDI inflows both positively and negatively. However, Li and Resnick mainly focus on the role of property rights, arguing that increases in democracy improve property rights protection, thus encouraging FDI inflows. Like Li and Resnick, another group of scholars tested the hypothesis that enforcement of property rights can increase the attractiveness of a host country for foreign investors (Biglaiser and Danis 2002; Jensen 2003).

The second approach has more recently incited debate among scholars. This research has tended to move away from aggregate FDI flows. Traditionally, these studies were focused on the role of corruption[1] in explaining FDI inflows. New studies, however, include

[1] Some scholars conclude that corruption could provide incentives for investment, and consequently for economic growth (Leff 1964; Huntington 1968). Leff (1964), for example, addresses several positive effects of corruption on investment. First, corrupt practices encourage individuals to avoid bureaucratic delay. Thus, transaction costs are diminished. Second, bureaucrats who are "allowed" to receive bribes work harder. Therefore, a tendency toward competition and efficiency is introduced into the system. While the first mechanism increases the likelihood that corruption is beneficial to growth only in countries where bureaucratic regulations are numerous, the second theory would operate regardless of bureaucratic performance. In a similar vein, Huntington (1968) provides an interesting view on the nature of corruption as a product of the distinction between public welfare and private interest, which comes with modernization (defined as a transition from autocratic to more democratic government). Since modernization contributes to corruption by creating new sources of wealth and power, corruption in this sense is produced by a rise of new groups with new resources. Thus, Huntington sees corruption as a natural path to assimilate new forces into the political system. In other words, corruption represents a natural and predictable outcome of the modernization process in a country.
However, other scholars emphasize the negative consequences of corruption on the economy, namely lower economic growth (Murphy, Shleifer, and Vishny 1991; North 1990; Shleifer & Vishny 1993). For instance, Murphy, Shleifer, and Vishny (1991) provide evidence that nations where skilled people must resort to rent-seeking activities tend to grow more slowly. For these scholars, talented and highly educated individuals will be more likely to engage in rent-seeking activities than productive work, with adverse consequences for their country's economic health. Likewise, under the institutional neoclassical assumptions, corruption inhibits economic growth because it destabilizes rules and generates uncertainty for private investors (North 1990).

tests of expropriation[2] (Li 2009), political risks insurance[3] (Jensen 2008), and tax incentives[4] (Li 2006).

Democracy, Civil rights, Political rights, and Foreign Direct Investment

As noted above, regime type and specific political conditions -- as explanatory variables of foreign direct investment -- have been addressed in the literature. Even when FDI flows have been disaggregated, regime type has always been a focus of every study, evaluating the relationship of a certain political or economic variable and FDI flows under democracy or autocracy. In general, too much attention in the FDI literature has focused on regime type.

However, other aspects and features of the quality of democracy or the level of democratic consolidation may also matter when explaining FDI inflows. In fact, some of these may better explain the role of democracy in attracting FDI inflows. More precisely, regime type cannot determine whether (and what to extent) the degree of institutional development can explain the amount of FDI inflows within a group of democracies. Variations in the degree of institutional development or democratic quality might considerably matter when explaining institutional effectiveness in attracting FDI inflows. In addition, the marginal impact of improvements in institutional development on FDI inflows

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[2] Through an analysis of actual expropriation acts of 63 developing countries from 1960 and 1990, Li (2009) shows that the chief executive's political incentives, constraints, and policy-making capacity determine the host government's expropriation decisions.

[3] By employing price data from political risk agencies, Jensen (2008) studies how domestic political institutions affect the multinationals pay for coverage against government expropriations. Jensen finds that democratic regimes are better able to reduce risks for foreign investors, specifically through enhancing constraints on the executive.

[4] Li (2006) offers a theory that explains how regime type influences tax incentive policy in order to attract foreign direct investment. In general, Li shows that countries with better rule of law offer lower levels of tax incentives, and the effect is even stronger for more democratic countries.

might not be constant or fixed over time. As institutional development or quality of democracy increases, the impact on FDI – positive or negative – might also change. By only taking into account the type of regime, the study risks missing the potential existence of relevant dynamics in the relationship between democratic quality and FDI inflows.

Concerning more focused studies, different analyses on the role of either corruption or property rights only account for one aspect of democratic consolidation, not the *level of democratic development* as a whole (disaggregated into two general categories: political and civil rights). In order to go beyond these limits and evaluate the implications of the level of democratic development on FDI inflows, the index created by the Freedom House Institute is employed.

Despite of being often accused of a conservative bias, the Freedom House Index offers several advantages not present in other indexes: 1) it covers the entire period in which economic liberalization took place (in this project from 1985 to 2003); 2) it evaluates a broad range of characteristics associated with democratic consolidation or quality of democracy; 3) it disaggregates its scores on democratic consolidation into two categories: political[5] and civil rights.[6]

[5] Political rights in the Freedom House Index are measured using answers to the following questions: 1. Is the head of government or other chief national authority elected through free and fair elections?; 2. Are the national legislative representatives elected through free and fair elections?; 3. Are the electoral laws and framework fair?; 4. Do the people have the right to organize in different political parties or other competitive political groupings of their choice, and is the system open to the rise and fall of these competing parties or groupings?; 5. Is there a significant opposition vote and a realistic possibility for the opposition to increase its support or gain power through elections?; 6. Are the people's political choices free from domination by the military, foreign powers, totalitarian parties, religious hierarchies, economic oligarchies, or any other powerful group?; 7. Do cultural, ethnic, religious, or other minority groups have full political rights and electoral opportunities?; 8. Do the freely elected head of government and national legislative representatives determine the policies of the government?; 9. Is the government free from pervasive corruption?; 10. Is the government accountable to the electorate between elections, and does it operate with openness and transparency?; 11. Is the government or occupying power deliberately changing the ethnic composition of a country or territory so as to destroy a culture or tip the political balance in favor of another group?

[6] Civil rights in the Freedom House index are measured through the answers to the following questions: 1. Are there free and independent media and other forms of cultural expression?; 2. Are religious institutions and

Thus, the Freedom House Index includes several political and civil rights seen in any democratic consolidation process. Within the category of political rights, procedural democratic features such as free and fair elections; fairness of electoral laws; rights to organize political parties; opportunities for the opposition to gain political power through elections; political and electoral rights of cultural, ethnic, religious, or other minority groups; the degree of corruption; accountability of the executive, and respect for the ethnic composition of a country are all included.

Likewise, the category of civil rights incorporates other procedural democratic features such as independence of the media; freedom of religious institutions and communities; academic freedom; freedom in private discussion; freedom of assembly, demonstration, and open public discussion; freedom of organization for nongovernmental organizations (NGOs); freedom of organization for trade unions and peasant organizations; independence of the judiciary; rule of law; protection from political terror; equal legal treatment of various segments of the populace; state control of travel or choice of residence and employment; right to own property and establish private businesses; personal social

communities free to practice their faith and express themselves in public and private?; 3. Is there academic freedom and is the educational system free of extensive political indoctrination?; 4. Is there open and free private discussion?; 5. Is there freedom of assembly, demonstration, and open public discussion?; 6. Is there freedom for nongovernmental organizations? (Note: This includes civic organizations, interest groups, foundations, etc.); 7. Are there free trade unions and peasant organizations or equivalents, and is there effective collective bargaining? Are there free professional and other private organizations?; 8. Is there an independent judiciary?; 9. Does the rule of law prevail in civil and criminal matters? Are police under direct civilian control?; 10. Is there protection from political terror, unjustified imprisonment, exile, or torture, whether by groups that support or oppose the system? Is there freedom from war and insurgencies?; 11. Do laws, policies, and practices guarantee equal treatment of various segments of the population?; 12. Does the state control travel or choice of residence, employment, or institution of higher education?; 13. Do citizens have the right to own property and establish private businesses? Is private business activity unduly influenced by government officials, the security forces, political parties/organizations, or organized crime?; 14. Are there personal social freedoms, including gender equality, choice of marriage partners, and size of family?; 15. Is there equality of opportunity and the absence of economic exploitation?

freedoms (including gender equality, choice of marriage partners, and size of family); equality of opportunity, and the absence of economic exploitation.

The design of these indexes -- like the Freedom's House Index -- can certainly help test theories on democratic consolidation.[7] In particular, the Freedom House Index takes into account several aspects of procedural definitions of democracy[8] (which herein are called political and civil rights). Any expansion of such rights has always been seen as normatively "good." Thus, this paper pushes beyond these normative considerations to evaluate whether political and civil rights can increase the amount of FDI inflows, and through further investment, eventually foster economic growth.[9]

[7] In general, two main definitions have arisen within the empirical tradition of democratization and consolidation: the minimalist definition and the other procedural definitions of democracy. From the viewpoint of the minimalists, democracy is a system whereby the population votes in election time but concedes political power to govern to political leaders (Schumpeter 1942). In this perspective, Joseph Schumpeter essentially states that only certain minimal requirements must exist for a polity to be considered a democracy, such as free and fair elections. In other words, there must be competition.
Other procedural contributions expand the "minimal" requirements of the minimalist definition to include several aspects of political and civil rights of individuals participating in a polity. These factors are socioeconomic, institutional, and cultural and are not considered by Schumpeter's (1942) minimalist definition of democracy. Although the minimalist definition of democracy has tended toward more direct empirical applications (Przeworski et. al. 2000; Epstein, et. al. 2005), these conceptual additions of the more procedural definitions (e.g. Dahl (1971), Putnam (1994)), and others are now being considered seriously by several institutions and research centers. This is being done to build up new ways for measuring and comparing the degree of institutional development around the world (across countries and regions, and over time).

[8] The Index, however, intentionally dismisses societal or cultural factors considered relevant by some scholars in the literature democratic consolidation literature. Among these discarded concepts, I directly identify, 1) Putnam's (2000) definition of social capital and its role as a predictor of democratic quality; 2) Dahl's (1971) arguments on political cleavages and internal conflicts, elite and voter beliefs in democratic institutions (legitimacy), levels of trust and confidence in each other, and beliefs in either strictly competitive or strictly cooperative politics as relevant determinants of democratic consolidation. In addition, other social variables traditionally relevant in the literature on democratization such as capitalist development (Moore 1966; Rueschemeyer, Huber and Stephens 1992) and economic development (Przeworski 1991) are excluded from the Freedom House Index. In short, the Freedom House Index is focused on providing an evaluation of democratic quality, rather than an explanatory analysis.

[9] Borensztein, De Gregorio, and Lee (1998) show FDI to be a relevant medium for the transfer of technology, contributing relatively more to economic growth than domestic investment. Likewise, Bengoa and Sanchez-Robles (2003) find the same positive relationship between economic growth and foreign direct investment. Bengoa and Sanchez-Robles employed a panel data analysis on a sample of 18 Latin American countries in the period 1970-1999.

Along with the benefits of the Freedom House Index noted above, the use of this index provides additional advantages. First, the political rights index concentrates on characteristics pertaining to the type of regime such as free and fair elections, fairness of electoral laws, rights to organize political parties, and opportunities for the opposition to gain power through elections (which could be to some degree accounted for by the minimalist definition of democracy) that have been traditionally measured through the use of a dichotomous or a trichotomous variable (Schumpeter 1942). Conversely, the political rights index allows for additional variation (based on a 1 to 7 scale), which could help provide a more precise and detailed estimation of marginal increases in FDI inflows due to improvements in the scope of political rights of a polity.

In general, the opening of the political system, a product of the democratization process, immediately allows for substantial improvements in enforcing property rights, judicial decisions, and the rule of law. This provides political information that is necessary and relevant for potential foreign investors as they decide where to invest. Considering this argument, I put forth the following hypothesis:

Hypothesis 1: Because most of the gains in political rights are associated with the democratization process (and only democracies are being primarily analyzed in this study), I do not expect to find a statistically significant impact for changes in political rights on FDI inflows.

Second, the use of civil rights in this paper also contributes to testing and empirically analyzing several implications from the democratization literature. The concept of individual “civil rights” has been broadly employed within the literature to characterize and determine the degree of democratic quality or state of democracy in a polity. Most of these follow normative or ideological considerations (Fonte 1997; Layton 2000; Kotlowski 2001; Delton 2002).

The institutional characteristics employed by the civil rights index differ from those in the political rights index by their thematic orientation. In general, while institutions in the political rights index ensure democracy at the macro-institutional level, the characteristics considered by the civil rights index measure the degree of state intervention at the micro-level. An example would be state policies regarding institutions and rules that affect civil society and individuals.

Although the index does not provide an endogenous measurement of "civic community" as Putnam might have wished, it does render an exogenous evaluation of state regulations in societal life, which could concern foreign investors. In particular, judicial independence, the rule of law, freedom of organization for nongovernmental organizations (NGOs), freedom of organization for trade unions and peasant organizations, protection from political terror, equal legal treatment of various segments of the population, state control of travel or choice of residence and employment, and rights to own property and establish private businesses directly affect foreign financial interests.

This study contends that an overall expansion of civil rights would produce positive but decreasing marginal returns to civil rights in attracting FDI inflows. [10] The presence of positive but decreasing returns to civil rights can be explained by contrasting those rights that increase transactional and labor costs with those that strengthen the rule of law. In

[10] Indeed, Freedom House´s disaggregated data on the level or scope of civil rights -- by type of civil right -- (which has become available only for four years), indicates that the scopes of every type of civil right are highly correlated among them. The existence of this regularity makes this empirical study relevant.

general, foreign investors expect legal guarantees for their investments, and are particularly interested in strong rule of law and an independent judiciary. Credible legal guarantees for investments are expected to strongly and positively impact the amount of FDI inflows. However, foreign investors at the same time hope to avoid high transactional and labor costs, barriers to establishing private businesses,[11] and overregulated labor markets. As the scope of civil rights increases, transactional and labor costs also rise as a product of the increasing strength of trade unions, collective bargaining, and some nongovernmental organizations (e.g., those that oppose trade and labor market liberalization or work to protect the environment), which produces decreasing returns to civil rights.

Regarding transactional costs, there are two types clearly taken into account by the civil rights index. First, since barriers to establish private businesses increase the initial costs of starting any new business, they matter when foreign investors make decisions about where to invest. Second, the Freedom House Index takes into account excessive state control of travel or choice of residence as barriers and disproportionate freedom of organization for "anti-market¨ nongovernmental organizations.

The demands of relatively powerful trade unions can create and increase labor costs to potential investors from hiring, firing, and paying relatively high minimum salaries. Substantial empirical work supports this theoretical statement. For instance, Javorcik and Spatareanu´s results (2004) suggest that greater flexibility in the host country´s labor market in absolute terms or relative to the investor´s home country is associated with larger FDI inflows. In addition, Besley and Burgess (2004) find that pro-worker amendments to the

[11] Because barriers to establishing private businesses increase the initial costs of starting any new business, they matter when foreign investors make decisions about where to invest. In relation to the Freedom House Index, it takes into account excessive state control of travel or choice of residence, and disproportionate freedom of organization for nongovernmental organizations as barriers.

Industrial Disputes Act were associated with lowered investment, employment, productivity, and output in registered manufacturing from 1952 to 1992 in India. Likewise, Botero *et al* (2004) state that labor regulation generates costs without benefits.[12]

Specifically, those civil rights that tend to increase transactional and labor costs might exert a more durable influence on FDI inflows than those associated with enforcement of the law. As opposed to indefinite negative effects on FDI inflows due to increases in transactional and labor costs, improvements in the enforcement of laws might exert only a limited or truncated positive impact on FDI inflows over time. Once a certain level of legal enforcement has been reached, the positive impact on FDI inflows of this determinant may decline and eventually disappear.

In other words, while enforcement of the law would produce a positive but limited effect on attracting foreign direct investment, any increase in transactional costs would always raise marginal costs and discourage foreign investors. Thus, combining the relatively more rapid decay of the positive impacts of legal enforcement with the negative and indefinite effect of increases in transactional and labor costs might produce decreasing returns to civil rights. This assertion appears promising for further research,[13] which might reveal important implications for politicians and policy-makers in determining which and how civil rights should be implemented or modified to maximize FDI inflows, if in fact that becomes a priority.

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[12] More precisely, Botero *et al* (2004) find that heavier regulation of labor causes lower labor force participation and higher unemployment, especially for the young.

[13] Given the highly volatile nature of FDI inflows, a panel data regression controlling for a reasonable time span becomes the most appropriate method of evaluation. Unfortunately, Freedom House only reports disaggregated data ("subcategory scores") on civil rights since 2005 (only 4 periods).

After assuming the presence of decreasing returns to civil rights (in terms of FDI inflows), the relationship between FDI inflows and the scope of civil rights can be modeled through a curvilinear function as follows:

$$\text{FDI } \textit{inflows} = \beta * \text{CR} + \theta * \text{CR}^2 \qquad (1)$$

In this formula, FDI represents foreign direct investment, and CR the scope of civil rights. The top quadrant of figure 1 shows how civil rights relate to FDI inflows; given the quadratic relationship existing between them, the second graph in figure 1 displays positive but decreasing returns to civil rights.

[Figure 1 Here]

Therefore, as a product of how these components influence FDI inflows, a second hypothesis follows:

Hypothesis 2: The impacts of increases in civil rights on FDI inflows present positive but decreasing returns.[14]

As a consequence, a certain scope of civil rights should maximize -- ceteris paribus -- the amount of FDI inflows. Such a level would guarantee a scenario where the judiciary would not be totally controlled by the state (and there would be strong rule of law), and while, trade unions and NGOs could not simultaneously operate in an over-regulated labor market.[15]

Research Design and Method

[14] At some point, these marginal impacts could become negative as the transactional and labor costs increase with the polity producing increases in the "amount" of civil rights.

[15] Mathematically, negative returns for transactional costs would equal the positive returns for levels of legal enforcement.

Testing this phenomenon of decreasing returns in recently democratized polities becomes the most appropriate option, given the potentially higher levels of sensitivity or elasticity between FDI inflows and civil rights, which are likely to be depressed following periods of democratization. Given that civil rights present depressed levels in their scope before periods of democratization, the marginal impact of any increase in civil rights´ scope on FDI inflows is highest (during a certain period of time immediately following democratization) when assuming the existence of these positive but decreasing returns to civil rights. Hence, testing the dynamics and behavior of this assumption over time becomes critical to verify the existence of this phenomenon.

Considering the relatively recent and massive democratization experiences in Eastern Europe and Latin America, these two regions constitute an ideal setting for this study. First, given that countries within these two regions saw massive waves of democratization prior to the selected periods of analysis (1985-2003 for Latin America and 1991-2003 for Eastern Europe), the selection of these regions becomes convenient. In addition, studying these regions provides an opportunity to construct a compact database for a panel data regression in which all countries included have recently democratized. This allows us to evaluate the existence and characteristics of this phenomenon over time. I excluded other democracies from my sample for two reasons. First, each wave of democratization presents different characteristics from the rest of waves (Huntington 1991; Chull Shin 1994).[16] In fact, the

[16] Samuel Huntington distinguishes the wave of democratization under study in this paper from the others. Huntington argues for a shift in the research focus from causes to causers of democratization. Huntington proposed this shift since he observed so many democratizing countries (in the wave of democratization employed in this study) lacking the necessary or sufficient conditions for democracy that had characterized other waves of democratization. More precisely, democratization and democratic consolidation in this wave responded to a combination of factors – formula not present in other waves. Chull Shin (1994) takes the distinctiveness of Huntington´s argument even further to state that ¨in Eastern Europe and Latin America, many authoritarian regimes lost legitimacy simply because they failed to solve the economic and other

magnitude and elasticity of the returns to civil rights on FDI inflows might significantly change from one wave of democratization to another one. Combining democracies belonging to different waves may distort the estimations without any valid generalization.[17]

Second, this substantial increase in FDI inflows coincided with the implementation of market-oriented reforms in both regions.[18] Overall, both regions embarked on the implementation of market-oriented programs and initiated processes of political consolidation. This coincidence allows the econometric analysis in this study to remain as parsimonious as possible. This particular combination of these political and economic reforms could have created special dynamics, which might have triggered FDI inflows.[19] Other regions and countries have also democratized; however, they did not always adopt market-oriented reforms. Indeed, including these other democracies or other regions into the

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problems that had allowed them to take power in the first place….In Eastern Europe, for example, international factors played the more influential role. By contrast, in the majority of democratic transitions in Latin America, domestic factors played the more powerful role. Despite such differences, it is this confluence of domestic and international factors that distinguishes the current wave from the previous ones ¨ (152). As I note below, this key difference between Latin America and Eastern Europe is accounted by my model.

After excluding this difference, the other common characteristics belonging to this wave and these two regions make these regions – Eastern Europe and Latin America -- suitable to be employed in my study. In general, including other cases, originated from other waves and even other regions, might offer estimations that could not be valid for any case in particular. In general, differences among waves and its implications for political and economic risk, especially those related to structures (such as industrialization, urbanization, rise of the middle class) and actors (relevant for the wave under study) makes necessary a separate analysis.

[17] Further research could help test whether this phenomenon also existed, and if this is the case, how the magnitude of the decreasing returns has evolved.

[18] The goals of these economic reforms were to adjust the macroeconomies -- by reducing inflation -- and improve competitiveness by liberalizing trade, privatizing state-owned companies, and deregulating their markets. These reforms ended the import-substitution industrialization (ISI) policies in Latin America and the socialist centrally-planned economies in Eastern Europe, which had produced economic stagnation in these regions during the 1980s. In addition to stabilizing and liberalizing, these economic reforms were implemented as incentives to prospective businessmen to invest their financial resources in order to reduce current account deficits and reduce unemployment. For example, Rodrik (1996) argues that several Latin American nations initiated these reforms in hopes of signaling good intentions to international investors. However, after several years of economic reforms, Biglaiser and DeRouen (2006) find that countries where governments implemented economic reforms were not always the most effective in attracting FDI flows. For Biglaiser and DeRouen, the reduction of expropriation risk could enhance the effects of domestic financial and trade reform, and bolster reinvestment by multinational companies.

[19] Both Latin America (since the mid 1980s), and Eastern Europe (beginning in the 1990s, have experienced significantly increased inflows of foreign direct investment from other regions (Birch 1991; Grosse 2001).

study might also distort the estimated magnitude of the marginal returns to civil rights on FDI inflows. Therefore, further research is needed to test hypothesis 2 in other settings.[20] Finally, by testing hypothesis 2 only on Latin America and Eastern Europe, the potential effects of regional differences are minimized in the model.

Considering the need to test the existence of decreasing returns to civil rights by combining 1) cases (in this case, across countries in two regions), and 2) time; the panel data regression becomes ideal to use for periods following the democratization process (1991-2003).[21] If positive but decreasing returns to civil rights exists (on FDI inflows), I shall conclude from this regression that those Latin American and Eastern European nations that enjoyed a scope of civil rights closer to a maximizing level of civil rights (after democratizing) were relatively more successful in attracting FDI inflows than those with extreme levels. This particular result is produced by a curvilinear (quadratic) relationship between the scope of civil rights and FDI inflows. The existence of this curvilinear relationship can be explained by the presence of decreasing returns to civil rights.

As noted above, this study tests whether advances in the quality of democracy -- specifically concerning civil rights -- create positive but decreasing marginal returns to civil rights in attracting foreign direct investment. I show empirically that in the initial stages of

[20] An econometric analysis including all regions or nations would hardly capture differences in the types of politico-economic dynamics produced by various combinations of economic and political reforms ,or their implications for attracting FDI inflows (e.g. political liberalization with no economic reforms might produce a different dynamic in attracting FDI inflows).

[21] The Latin American countries included in this analysis are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Panama, Peru, Uruguay, and Venezuela. The Eastern European nations considered are: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russian Federation, Slovak Republic, and Ukraine. I purposively exclude Paraguay, Belarus, Mexico, and Moldova from the sample due to their authoritarian regimes during most of the period selected.

democratic consolidation, the marginal returns to civil rights are positive, and decrease as the quality of democracy improves in Latin America and Eastern Europe. In order to test the regularity of decreasing returns, panel data regressions with feasible generalized least square (FGLS)[22] estimators are employed.

In this study, the dependent variable is FDI inflows (measured in constant U.S. dollars) that these nations receive from abroad divided by the gross domestic product of the host country.[23] The key independent variables to test the hypotheses are civil and political rights.[24] The control variables included in the model are as follows:

GDP per capita (in constant U.S. dollars): This indicator controls for a nation's development and economic performance. By accounting for citizens' buying capacity in a given country, GDP per capita also captures the magnitude of the market for a potential investor. Hence, higher FDI inflows should appear as a response to higher GDP per capita levels. In fact, Campos and Kinoshita (2008) find a positive and statistically significant relationship between these two variables for Latin America and Eastern Europe.[25]

Inflation rates: High rates of inflation are a sign of economic instability for foreign investors, as well as a host government's inability to maintain healthy monetary policies. Foreign companies may avoid countries where governments are institutionally weak or have low technical capabilities. In addition, high inflation or recurrent changes in prices make

[22] A Random Effects Model is estimated using feasible generalized least squares (FGLS).
[23] The resultant ratio was scaled using logarithms and Source: UNCTAD. 2005. United Nations Conference on Trade and Development.
[24] Source of the data: Freedom House
[25] Source of the data: International Monetary Fund.

short-term pricing decisions more costly. For example, Schneider and Frey (1985) find that transnational companies invest less in developing countries with higher rates of inflation.[26]

Current account balance (constant U.S. dollars): Nations may finance their balance of payments deficits - possibly caused by deficits in current accounts - either by spending their official reserves or attracting more foreign capital. If governments desire to pursue the second alternative, they may modify some policies in order to attract foreign investment. Thus, the relationship between current account deficits and FDI inflows should be negative. In other words, the larger a country's current account deficit (negative values for the current account balance), the greater that country's FDI inflows will be. Schneider and Frey (1985) confirm the empirical validity of this relationship in a previous study.[27]

Global FDI (constant U.S. dollars): This variable measures FDI inflows in the world economy. Given that a relevant portion of this global FDI is captured by Latin America, global FDI may exert some relevant influence on what Latin American countries receive from abroad. The model also controls for this exogenous determinant.[28]

Ideology: Both economists and political scientists have researched whether differences in party ideology can explain differences in fiscal policy. [29] For instance, Cameron (1978) illustrates that the percentage of the government's electoral base that is composed of social-democrat or labor parties can explain a higher public spending share of the GDP in industrialized countries. Likewise, Roubini and Sachs (1988) find that leftist cabinets evince higher levels of public spending. Higher levels of public spending would tend to diminish prospects for severe macroeconomic adjustment programs.

[26] International Monetary Fund (IMF): International Financial Statistics.
[27] Data source: International Monetary Fund (IMF), Balance of Payments.
[28] Data source: UNCTAD. 2005. United Nations Conference on Trade and Development.
[29] Lewis-Beck (1988) offers a general discussion on the relevance of left-right ideological orientations.

During the period under analysis, the majority of the countries in both regions – Latin America and Eastern Europe – faced dramatic macroeconomic adjustments and massive market-oriented reforms. Within this context, the credibility of the cabinet -- as a function of lower (conducive to lower deficits) -- could explain differences in the willingness of foreign investors to act. To account for these differences, a trichotomous variable (right=2, center=1, left=0) is included in the model. If rightist cabinets tend to generate more credible and conservative fiscal policies, then I expect to see a positive coefficient for this variable. Since conservative policies would increase the likelihood of a more predictable macroeconomic environment (less risk), foreign investors might prefer such conditions.[30]

Literacy: Human capital levels can also represent an important determinant of FDI inflows. Given that foreign investors are interested in maximizing profits, they will be more willing to invest in countries that have greater productivity levels. In regard to this potential determinant, Bengoa and Sanchez-Robles (2003) find a positive relationship between human capital and FDI inflows. Likewise, Noorbakhsh and Paloni's (2001) empirical findings point out that (a) human capital is a statistically significant determinant of FDI inflows; (b) human capital is one of the most important determinants; and (c) its importance has increased over time. Rates of literacy are utilized here as a proxy for human capital. Given the potential positive impact of human capital on FDI inflows, a positive sign is expected for the coefficient of this variable.[31]

Majority: Haggard and McCubbins (2001) characterize polities along with two dimensions of institutions: separation of power, and separation of purpose. Separation of power and

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[30] Data source: World Bank, Database of Political Institutions.
[31] Data source: United Nations Statistics.

separation of purpose establish a trade-off regarding policy-making: decisiveness vs. resoluteness. On the one hand, decisiveness is characterized by the ease with which government can enact and implement policy change. As the effective number of vetoes decreases, the polity becomes more decisive and less resolute (e.g., at one extreme an authoritarian government could enact but would have no credibility to adhere to those policies). Resoluteness, on the other hand, is the ability to stick with a certain policy once it has been passed. As the effective number of vetoes increases, the polity becomes more resolute and less decisive (e.g. polities with very fragmented party systems could not enact or implement changes to improve policy performance).

Given this, potential foreign investors will prefer to invest in more-decisive polities if those governments are implementing or committing to market-oriented reforms. This is precisely the case of Latin America and Eastern Europe during the period under study. At the same time, political stability and government commitment to existing policies reduce risk levels in the economy – information that is crucial for investors when making portfolio decisions. In order to account for the level of decisiveness, the ratio of total seats divided by government seats is employed as a proxy. It is expected that an increase in the number of seats for the government will make the polity more decisive, and consequently less attractive to foreign investors.[32] In order to reflect the potential existence of a trade-off between decisiveness and resoluteness, a quadratic term of this variable is included to gauge whether loss of resoluteness reduces positive impacts of decisiveness on the attractiveness of markets for investors when governments implementing market-oriented reforms.

[32] Data source: World Bank, Database of Political Institutions.

Dummy for Eastern European Countries: A dummy for Eastern European countries is included to capture the potential influence of the prospective European Union membership. The assumption is based on the idea that this expected membership might play a relevant role in attracting export-platform FDI (Resmini 2000; Bevan and Estrin 2000).

Statistical Results and Additional Testing

Table 1 shows the results of estimations for four different specifications. In order to control for the presence of autocorrelation of first order AR(1) and heterokedasticity, a three-step feasible generalized least squares (FGLS) estimator was chosen for panel data models.[33]

[Table 1 Here]

Based on the results, the impact of political rights on the flows of foreign direct investment is not conclusive in supporting hypothesis 1. Neither the coefficient for the political rights variable nor the quadratic political rights term matters in the first two specifications when explaining FDI inflows (consistent with hypothesis 1). To verify the irrelevance of these explanatory variables in explaining FDI inflows, the polity2 index is also employed. Similar to the political rights index, it measures procedural democracy features. Both specifications -- third and fourth – do not exhibit a statistically significant effect for these on FDI inflows. To sum up, once countries have already democratized, improvements in political rights do not seem to substantially alter FDI inflows.

[33] This estimator allows estimation in the presence of heterocedasticity and AR(1) autocorrelation within panels (Greene 2003; Maddala 2001). I also lag the dependent variable and include it as an additional independent variable in order to evaluate whether previous FDI inflows affect future flows in my sample. As the FDI literature commonly states, the expectation is that FDI does not respond immediately to changes in economic and political conditions.

With respect to the coefficients reflecting the impact of civil rights on FDI inflows, the coefficients show positive and statistically significant values in all specifications, consistent with hypothesis 2. Estimated coefficients for the square of civil rights are also statistically significant and negative in all specifications, confirming the validity of hypothesis 2. Similar results in all model specifications display high levels of robustness for the two coefficients associated with civil rights.[34] Given these results, I conclude that the impact of increases in the scope of civil rights on FDI inflows points to positive but decreasing returns. As a consequence, only a certain scope of civil rights can maximize -- *ceteris paribus* -- the amount of FDI inflows.

Graph 1 shows the maximum level of FDI considering different scopes of civil rights, while holding other variables constant. The curve was constructed by accounting for the coefficient value of the civil rights variables in the panel data regression (shown in Table 1). Since only the dependent variable (FDI inflows) was scaled using logarithms, graph 1 reflects the relationship between civil rights and FDI inflows shown in the bottom quadrant of figure 1. This graph shows that only a scope of civil rights over the value of 6.3 (in a 1-7 scale) could produce negative returns. This finding ensures policy makers that any expansion in the scope of civil rights almost always guarantees greater FDI inflows despite its changing effectiveness (as the scope of civil rights is expanded).

[Graph 1 Here]

[34] Two different robustness checks are employed regarding the statistical significance of the civil rights coefficients. First, these estimated coefficients (statistically significant) are robust to any change in the models – more precisely, to any combination of independent variables. Second, I test whether the panel model presents a non-stationarity structure. Through a test inspired from Fisher´s work (1932), Maddala and Wu (1999) propose a non-parametric test that is a better test than the Levin-Lin (LL) and Im-Pesaran-Shin (IPS) panel data unit root tests. Given that the test is applied to a model with a nonzero drift, the Fisher´s test is used in its Phillips and Perron (1988) version. The test fails to reject stationarity as the null hypothesis.

Other variables that render statistically significant coefficients are the dummy for Eastern European countries (prospect of European Union membership), current account balance, GDP per capita of the host country, the lagged dependent variable, global FDI, majority (and its square), and literacy rates as a proxy for human capital. All estimations of the coefficients for these variables present the expected signs, as discussed above. However, coefficients of the variables for inflation, ideology do not rise to statistical significance. Several free trade agreements signed by Latin American nations may have mitigated the effects of prospective European Union membership for attracting FDI inflows (Ponce 2008). Because reducing inflation and plans for macroeconomic stabilization were a priority in both regions regardless of government ideology or legislative composition during the selected period, rates of inflation and the ideological orientation of the government do not appear to matter.

Conclusions

Several conclusions can be drawn from this study. In general, it appears that the design of certain institutional rules may still alter the amount of FDI inflows after democratization occurs. First, advances in the quality of democracy -- specifically those concerning civil rights -- present decreasing marginal returns to civil rights in attracting FDI inflows. Empirical evidence points out that in the initial stages of democratic consolidation, marginal returns to civil rights become positive and decline as the quality of democracy improves in Latin America and Eastern Europe. However, as the quality of democracy or democratic consolidation progresses in accord to broader definitions of democracy (e.g. Dahl (1971)), the marginal returns to civil rights decline to eventually become negative.

Second, I contend that those Latin American and Eastern European countries expanding their civil rights after democratizing were more successful in attracting FDI inflows relative to those nations with extreme levels (except if the scope exceeded a relatively high scope of civil rights (6.3)). Moreover, this study offers important lessons for politicians and policy-makers. On the one hand, if the maximization of FDI inflows becomes a priority -- for boosting economic growth and development -- they must selectively increase the scope of civil rights. Specifically, if this maximization goal becomes the aim of policymakers, they will balance (equalize) the negative marginal returns of transactional and labor costs with the positive marginal returns from more stringent legal enforcement. Under this scenario, the total marginal returns to civil rights should equal zero. Further research is also suggested for estimating (separately) the marginal impact of increases in these types of civil rights – transactional, labor costs, and legal enforcement -- on the amount of FDI inflows.

Third, greater decisiveness augments the chances of increasing FDI inflows. Like the scope of civil rights, decisiveness also presents decreasing returns. Since both regions actively pursued market-oriented reforms, greater decisiveness can provide a proxy of the effectiveness of governments in changing rules and creating a more favorable environment to attract foreign direct investment. As expected, when decisiveness increases, the government loses credibility in adhering to adopted policies. At the same time, this loss of resoluteness increasingly diminishes the ability of government to stick with policies which might favor potential investors. Further empirical research could confirm the validity of this trade-off in explaining the behavior of FDI inflows notwithstanding the presence of market-oriented reforms.

Finally, this project moves beyond these normative considerations to evaluate positively whether political and civil rights can contribute to economic development through greater FDI inflows. This paper illustrates that political scientists might face a "tragedy" when they make normative assumptions about the goodness and convenience of always "more democracy" in their research (Ricci 1984). Once again, the empirical results challenge these normative presuppositions, which view "more democracy" as always being best for a society.

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Tables

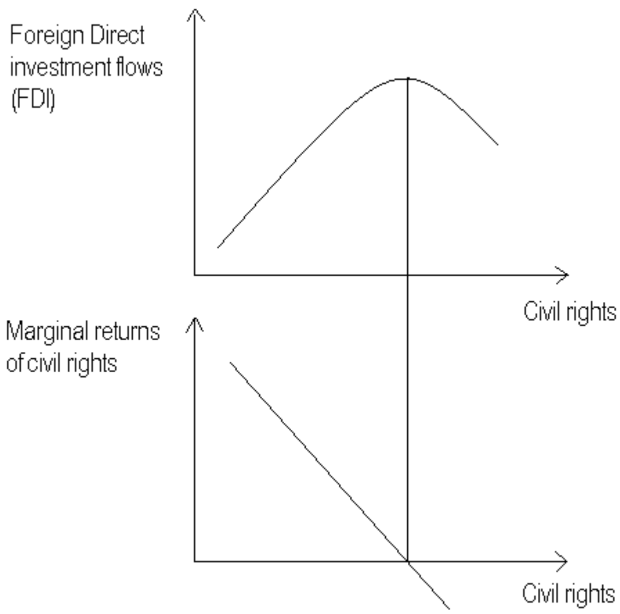
Table 1.- Panel data model for Latin America and Eastern Europe (1991-2003)

Dependent variable:	**Inward FDI/GDP (log)**	**Inward FDI/GDP (log)**	**Inward FDI/GDP (log)**	**Inward FDI/GDP (log)**
	FGLS estimator	***FGLS estimator***	***FGLS estimator***	***FGLS estimator***
Lagged FDI/GDP (log) (-1)	.666*** (.051)	.667*** (.051)	.658*** (.052)	.659*** (.052)
Civil rights	.540** (.269)	.550** (.271)	.522** (.267)	.537** (.272)
Civil rights^2	-.135*** (.046)	-.133*** (.046)	-.131*** (.046)	-.133*** (.047)
Political rights	.020 (.038)	-.123 (.116)		
Political rights^2		.024 (.018)		
Polity2			-.014 (.021)	-.044 (.078)
Polity2^2				.002 (.005)
Dummy for Eastern European countries	-.142* (.074)	-.147** (.074)	-.161** (.078)	-.146* (.082)
GDP per capita of the host country	-.00009*** (.00002)	-.00009*** (.00002)	-.00009*** (.00002)	-.00009*** (.00002)
Current account balance	-.028*** (.006)	-.029*** (.006)	-.028*** (.006)	-.028*** (.006)
Inflation (log)	-.023 (.023)	-.019 (.023)	-.026 (.023)	-.025 (.023)
Global FDI (log)	.058 (.051)	.052 (.051)	.059 (.051)	.059 (.051)
Ideology	.015 (.034)	.019 (.035)	.011 (.035)	.015 (.036)
Literacy (log)	1.009* (.523)	.808 (.540)	1.085** (.541)	.992* (.556)
Majority (log): Ln(Total seats/government seats)	-3.368*** (1.27)	-3.553*** (1.27)	-3.405*** (1.240)	-3.486*** (1.244)
Majority^2 (log)	.449*** (.170)	.468*** (.170)	.453*** (.166)	.462*** (.166)
Constant	1.935 (3.741)	3.459 (3.88)	1.886 (3.767)	2.516 (3.863)
Number of observations	197	197	197	197
Number of groups	23	23	23	23
Wald Test	638.34***	670.65***	642.85***	647.48***

***, **, * denote significance at the 1%, 5%, and 10% level, respectively.

Figures

Figure 1. Decreasing returns to civil rights



Graphs

Graph 1. Civil Rights and Foreign Direct Investment Ln(FDI inward/GDP) in both regions (decreasing returns to civil rights)