The Determinants of Liberalization of FDI Policy in Developing Countries: A Cross-Sectional Analysis, 1992-2001

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ABSTRACT

The decade of the 1990s was characterized by widespread liberalization of law and regulation affecting inflows of foreign direct investment (FDI) in developing countries. Using a data base supplied by UNCTAD this paper uses a cross-sectional regression methodology to analyze the determinants of liberalization in 116 developing countries from 1992 to 2001. Ninety-five percent of the changes in FDI policy over the decade (1029 of 1086) were liberalizing rather than restrictive. Two possible explanations of liberalization are posited: policy makers' beliefs that liberalization is in the best interest of the country and external pressure from either the dominant power (the United States) or international organizations such as the World Bank or IMF. Results provide support for the "opportunity costs of closure" argument and do not support the external pressure thesis. Country size, level of development, human resource capabilities and trade openness are the primary determinants of the propensity to liberalize.

The 1991 *World Development Report* (World Bank, , p. 31) concluded that a "sea change" had taken place in thinking about development: by the late 1980s many developing countries had moved away from state directed, inwardly focused strategies towards an acceptance of both markets and integration into the world economy. While the motivations for this marked shift in policy are complex, the failure of import substitution, the success of the relatively open Asian economies, the collapse of socialism as an alternative, and the economic crises of the 1980s all played a role (Millner, 1999).

In 1990 John Williamson concluded that there was a "Washington Consensus" about the desirability of openness to the world economy, liberalization of domestic markets and macroeconomic stability (Gore, 2000, Williamson, 2000). Williamson believed ten liberalizing economic reforms reflected a process of intellectual convergence after the collapse of communism: the seventh was liberalization of flows of foreign direct investment (he *did not* call for full capital account liberalization). In a retrospective article, he argues that "my version of the Washington Consensus can be seen as an attempt to summarize the policies that were widely viewed as supportive of development at the end of two decades when economists had become convinced that the key to rapid economic development lay not in a country's natural resources or even in its physical or human capital, but rather in the set of economic policies that it pursued" (Williamson, 2000, p. 254).

Williamson wrote at the start of a period characterized by the widespread liberalization of laws and regulations affecting flows of both portfolio capital and foreign

direct investment (Brune, Garrett, Guisinger, & Sorens, 2001)[1]. While developing countries began to liberalize restrictions on foreign direct investment (FDI) during the 1980s, the trend became pronounced and widespread during the early 1990s as increasing numbers of policy makers came to believe that integration into the world economy was a prerequisite to growth and development and that FDI from Transnational Corporations (TNCs) was the vehicle to accomplish that end.[2]

A number of factors led developing countries to attempt to attract flows FDI through both liberalizing regulation and providing incentives to investors. There was increased recognition that the bundle of assets and capabilities encompassed in FDI could contribute directly to development of the national economy. Declining levels of other forms of assistance increased reliance on FDI and various financial crises may have led to a preference for longer term, relatively stable and often tangible flows of direct investment. Last, developing country governments have gained confidence in their ability to maximize the benefits and minimize the liabilities of investment by TNCs (UNCTAD, 1994, p. 85). As a result, the late 1980s and early 1990s were characterized by a "de facto convergence" of government policy approaches towards FDI (Noorbakhsh, Paloni, & Youssef, 2001).

This paper reports a cross-sectional analysis of the determinants of liberalization of law and regulation affecting inflows of FDI into 116 developing countries during the decade from 1992-2001. It makes use of a data base provided by UNCTAD (described

[1] Brune et al found that there were no aggregate increases in capital account openness in low and middle income countries until 1991. After that point there was a period of rapid and dramatic liberalization (Brune, Garrett, Guisinger, & Sorens, 2001) . Also see (Eichengreen, 2001) and (International Monetary Fund, 2001) especially Chapter 4, "International Financial Integration and Developing Countries."

[2] Thus, after a critical review of studies of trade liberalization, Stanley Fischer (2003) concludes that "…openness to the global economy is a necessary, though not sufficient, condition of sustained growth."

below) which tracks liberalizing and restricting changes in eight categories of FDI policy by country over the ten year period. The changes were overwhelming liberalizing: 95% of the 1086 regulatory changes in the sample countries either loosened regulatory restrictions or provided new promotions and guarantees to attract FDI: all but two of the countries inclded in this study were net liberalizers of FDI policy.

The liberalization of FDI policy is both cause and effect of the marked increase in integration of the world economy in the 1990s which, in turn, reflected the transition of the ex-socialist to market economies after the "fall of the Wall," dramatic improvements in communication as a result of the digital/information revolution and the ideological shift to open market economies, among other factors. Flows of FDI into the developing countries increased dramatically over the decade in both absolute and relative terms: annual inflows to the LDCs increased six-fold from $36,958.5 million in 1990 to $229, 295.2 million in 1999, FDI inflows grew from 3.6% of GDP in the developing countries in 1990 to 14.4% by the decade's end (UNCTAD, 2004).

In their path-breaking study of capital account liberalization Dennis Quinn and Carla Inclan (1997) note that while there has been a good deal of research on the consequences of financial openness its origins or determinants are much less well understood. That is true for both capital flows in general and FDI in particular. (It is important to note that portfolio capital flows and FDI are very different both phenomenologically and in terms of cause and effect.[3])

[3] See (Eichengreen, 2001) for a thorough review of capital account liberalization. As a number of authors note, (e.g., Eichengreen, 2001, Fischer, 2003, Prasad, Rogoff, Wei, & Kose, 2003) there is a good deal more controversy about the desirability and impacts of capital account liberalization (on growth and stability) than there is for current account or trade liberalization.

While there is a considerable literature dealing with the impact of tax concessions and other incentives to attract foreign investment (see Morisset & Pirnia, 2001 for a review), the literature dealing with FDI policy is considerably more modest. Alvin Wint (1992), for example, reviews the liberalization of FDI regulation in ten developing countries and concludes that there can be a disconnect between formal liberalization and the actual implementation of the screening process. Stephen Gloub (2003) presents a complex scheme summarizing liberalization of restrictions on inward FDI in OECD countries. Jacques Morisset and Olivier Neso (2002) review administrative barriers to inflows of FDI in 32 LDCs. A larger body of work examines the impact of administrative reform or liberalization of regulation on either inflows of FDI or the FDI decision process (see, Gastanaga, Nugent, & Pashamova, 1998, Globerman & Shapiro, 2003, Loree & Guisinger, 1995, Sin & Leung, 2001, Taylor, 2000, Trevino, Daniels, & Arbelaez, 2002).

There are, however, very few empirical analyses of the determinants of liberalization of laws and regulations affecting inflows of FDI. A study done by Farok Contractor for the UNCTC (United Nations Centre on Transnational Corporations, 1991) looked at changes in FDI policies in 46 developed and developing countries over the years 1977-87. He constructed a data base of changes in seven categories of regulation affecting FDI, including both restrictions and incentives. Contractor concluded that there was "An unmistakable liberalization of foreign direct investment policies in all categories of nations" over the 1980s, with the largest number of policy changes per nation occurring in the newly industrializing countries (p. 59). While he argued that the recession of the early 1980s, the relative decline in the position of LDCs, the increased

tightening of the market for loan finance to developing countries, and a generally increased climate of competition for FDI all contributed to the increase in liberalization, his empirical analysis focuses on the impact of liberalization on future flows of FDI rather than its determinants.

What motivates liberalization?

Discussing the globalization of financial markets Benjamin Cohen (1996, p. 278) asks a very relevant question about the motivations for state behavior, "Were states operating as classic rational unitary actors, single-mindedly competing within systemic constraints to maximize some objective measure of national interest? Or were other, more subtle forces at work to shape government preferences and perceptions?"

Cohen's question certainly applies to the widespread liberalization of FDI policy in developing countries during the 1990s. On the one hand, it is possible that states liberalized in response to changes in technological and market conditions that affected all states and increased the potential gains from FDI. Technical innovation – e.g., the digital/information revolution – markedly reduced the cost of transferring goods and, more importantly, information around the world and thus increased the gains from integration into the world economy and the potential benefits from FDI. Furthermore, there is increasing recognition that TNCs make a significant contribution to export capabilities and increased concern about export competitiveness in many developing countries (UNCTAD, 2002).

As Geoffrey Garrett (2000, pps. 943-44) argues, "…increasing costs of closure probably have been the major motivation for liberalization in the arena of foreign direct investment…the increased opportunity costs of closure approach suggests that

governments have liberalized their economies simply because it is the efficient thing to do."[4] Thus, one possibility is that policy makers in developing countries reacted independently to changed technological and economic conditions and decided that liberalization to promote increased inflows of FDI was in the national interest.

Every economic argument, however, is "two-handed." It is also possible that policy-makers in LDCs responded to other "subtle" (or not so subtle) forces shaping their preferences and perceptions. External pressures on policy makers rather than a drive for efficiency may have motivated the widespread liberalization of FDI policy in LDCs during the 1990s (Cohen, 1996, Garrett, 2000). Neoliberalism -- a belief in markets, privatization, deregulation and open economies -- which took hold in the U.S. an UK during the 1980s may have been "imposed" on LDCs (altering policy makers' preferences) as a result of economic dependence on the United States or international institutions such as the World Bank and IMF. Policy liberalization also could have resulted from a process of diffusion with policy makers' perceptions and preferences altered by actions taken in other countries of interest such as those in the region or those regarded as competitors.

It is important to note that it is possible for these views to be complementary as well as competing, policy makers can be influenced by actions taken in other states or external political pressure and still make decisions based on the perceived "national interest." That said, distinguishing empirically between these two competing categories of explanation is difficult at best. "It is a common problem in the literature on contagion, financial and other wise, that the simultaneity of policy initiatives in different countries

[4] Put differently, "The case for liberalizing FDI is similar to the case for liberalizing trade: under the right conditions, freer FDI leads to a more efficient allocation of resources across economies and , where markets are not distorted, within a host economy" (UNCTAD, 2003, p. 104)

may reflect not the direct influence of events on one country on another countries but a tendency for decision makers to respond similarly to economic and political events not adequately controlled for in the analysis" (Eichengreen, 2001, p. 350). The conceptual problem is exacerbated by the limitations of cross-sectional analysis.

While I will not test a diffusion hypothesis directly, the analysis includes two sets of explanatory variables. The first is consistent with an rational efficiency explanation for liberalization. It contains indicators of national characteristics which would lead policy makers to believe that their country would benefit from increased flows of FDI; that liberalization of FDI policy – either a loosening of restrictions or an increase in incentives – reflects a judgment that a country will benefit from either more FDI or fewer restrictions on existing investment. The second set of indicators is consistent with an externally imposed motivation for liberalization, with the spread of neoliberal ideology through pressure from either the U.S. or international institutions. As will be discussed below control variables are also included in the analysis.

Determinants of liberalization

Virtually all countries maintain some restrictions on inflows of foreign direct investment and virtually all have some sort of application or approval procedure for FDI: no country presently offers an unconditional right of entry to foreign investors (UNCTAD, 2003). However, the nature and extent of the regulation of FDI and efforts to attract FDI through promotion and incentives vary considerably across countries.

As noted above, I will review two sets of determinants of liberalization of FDI policy. The first assumes that liberalization reflects a judgment by a country that it will

benefit from either more FDI or fewer restrictions on existing investment. The second that liberalization results from the external imposition of a neoliberal economic ideology.

As discussed below, the data base is "left censored" in that the first year for which data is available is 1992. While there is every reason to believe that the "great wave" of both portfolio capital and direct investment liberalization in the LDCs occurred during the 1990s (Brune, Garrett, Guisinger, & Sorens, 2001, Eichengreen, 2001), it is necessary to control for the possibility of prior liberalization of FDI policy.

Opportunity costs of closure

- Country size. One clear conclusion of empirical research on the determinants of FDI is that variables related to market size dominate (Nunnenkamp & Spatz, 2002). Larger markets are more likely to attract market-serving FDI and market serving FDI is more likely to result in technological and managerial spillovers – by developing forward and rearward linkages -- than that which is strictly export oriented. Furthermore, larger countries may be more confident of their ability to deal with TNCs, of their ability to shape policy to maximize the benefits and minimize the disadvantages of FDI. On the other hand, larger countries may have more bargaining power which should enable them to maintain restrictions if so desired. While there is every reason to believe that market size is a significant determinant of the propensity to liberalize, it is difficult to predict the direction of that effect *ex ante*.
- Level of development. In his review of empirical studies of capital account liberalization Eichengreen (2001, p. 347) concludes that "perhaps the single most robust regularity in this literature is the negative association between per capita

income and controls." The more developed the country, the more likely it is to have liberalized. However, existing analyses of capital account openness do not distinguish between portfolio and direct investment and generally include both developed and developing countries. As noted above there is every reason to believe that policy makers see portfolio flows and FDI as very different phenomena.

As with market size, it is difficult to predict the direction of the effect of level of development (income per capita) on the propensity to liberalize. On the one hand, it is reasonable to argue that the wealthier developing countries should have more developed capabilities and institutions and thus be able to obtain greater benefits from FDI and be more likely to liberalize. However, *ceteris paribus*, it is also possible that less developed countries recognize a greater need for FDI and thus will be more willing to liberalize restrictions and offer incentives or guarantees to attract TNC investment.

- Growth of GDP. Policy makers in countries experiencing economic growth are more likely to believe that increased investment, including FDI, will have a positive impact. As important, distributional issues may be minimized in a rapidly growing economy and thus opposition to FDI muted. Thus, growth of GDP should have a positive impact on the tendency to liberalize.
- Trade openness. Recent studies have rejected the older argument that "tariff jumping" is an important explanator of FDI, that trade and FDI are substitutes. Rather, at this point it appears that FDI and trade are complimentary to one another (Markusen, 1997). That being the case, a country's openness to trade

should be an indicator of policy makers' perceptions that additional FDI would be beneficial, that linkages to the world economy have a positive effect on growth and development.

- Human resource capabilities. One of the more significant developments in the FDI literature has been the recognition that much of the activity of TNCs is now knowledge and efficiency seeking (Stethi, Guisinger, Phelan, & Berg, 2003). The other side of that argument is that host countries with more developed human resource capabilities should attract FDI that seeks higher skill levels or even technological and managerial capabilities. To the extent that is true, countries with higher levels of human resource capabilities should believe that there is a higher probability of technological and managerial spillovers and greater benefits from FDI. Furthermore, higher levels of capabilities may increase policy makers' confidence in their ability to generate positive returns from FDI.
- Democracy. There have been a number of studies associating democracy with capital account liberalization (Eichengreen, 2001). While there are counter arguments, a democratic process may allow resolution of social conflicts that would otherwise lead to restrictions. Thus, democracy may lead to liberalization of FDI policy as well as capital account liberalization in general.

External factors affecting decision makers' perceptions

- Dependence on the United States. During the 1980s and 1990s the United States Government strongly supported a neoliberal economic policy including deregulation, privatization and openness to the world economy. It is reasonable to argue that policy preferences of the dominant economic power will have an

impact on policy preferences in poorer countries, especially to the extent those countries are dependent on the United States as an export market or for inflows of FDI. Thus, to the extent a developing country is dependent on the United States economically – in terms of its exports or inflows of FDI, for example -- it might be more likely to liberalize FDI policy.

- Dependence on international institutions. Both the World Bank and IMF were strongly promarket and proliberalization during the period of this study. The IMF in particular pressed an agenda of deregulation and liberalization on developing countries as a condition accompanying loans. Thus, to the extent a country is obligated to the IMF or the World Bank it might be more likely to liberalize FDI policy.

Control factors

- FDI Penetration. As noted above, the data used in this study measure changes in policy rather than the level of policy openness at any point in time. Furthermore, there is no indicator available of the level of FDI policy liberalization in each country at the start of the study. The level of FDI normalized by GDP is used as a proxy for relative openness at the start of the period. The assumption is that, *ceteris paribus*, countries with higher levels of FDI penetration relative to the size of the economy were more likely to be more open to FDI.
- Growth of FDI. Garrett (2000) argues that, at least in the case of portfolio capital, policy changes may lag "facts on the ground." Given the information revolution's impact on the relative ease of moving capital across borders and the difficulty individual countries have in controlling portfolio flows, liberalization

may be technologically determined, it may reflect the reality of increased flows into a country. While FDI represents a "tangible" cross-border flow and is thus much easier for a host country to control, it is still possible that liberalization is a *de jure* reflection of a *de facto* change. Thus, a relationship between the growth of FDI prior to the start of the period encompassed by the data and liberalization would be an indication of legitimization of *de facto* change.

- Resource Dependence. Many of the major exporters of minerals and petroleum nationalized FDI at the well-head or mine in the late 1970s and then developed contractual arrangements for the involvement of multinational firms during the 1980s. Thus, to the extent a country is dependent on mineral exports (including petroleum) it might be less likely to report changes in FDI regulations during the 1990s.

Regulatory changes

The UNCTAD data base contains the *number* annual changes in each of eight categories of national law and regulation affecting inflows of FDI during the decade from 1992 to 2001. The categories, which are defined in Appendix 1, include: foreign ownership; sectoral restrictions; approval procedures; operational conditions; foreign exchange; promotion including incentives; guarantees; and corporate regulations. There are two observations for each category-country-year: the number of more and of less favorable FDI policy changes (i.e., liberalizing and restricting). It should be clear that what is measured are *changes* in a country's openness to FDI rather than its level of openness at any point in time.

There are a number of reasons to be concerned about the accuracy and validity of the raw data as a comparative measure of change in FDI policy across countries. First, there is no information about the magnitude or extensiveness of change. Every liberalizing or restricting change is coded as one event regardless of whether it is a relatively major or relatively minor change. Second, there is no way to know if reporting is consistent across countries. It is possible, for example, that three changes in sectoral restrictions in a single year are reported as three separate changes by country A and only one by country B. As a result, there are serious questions about whether a continuous scale is an accurate or valid measure of the extent of regulatory change: does a score of "3" for a given country-category-year actually represent three times the "amount" of change of a score of "1"?

To attempt to minimize these problems and facilitate cross-sectional analysis each category-country-year score was recoded to take one of three values: -1 if there were one or more restrictive changes; 0 if there was no change; and +1 if there were liberalizing changes. (Only 57 of the 1086 regulatory changes in the sample countries were restrictive and there were only thirteen instances where a single country reported both liberalizing and restrictive changes in a single category in a single year. In these cases the net score was used as a basis for coding.) While recoding results in some loss of information, it should allow for a more accurate representation of differences in changes in FDI policy across countries.

Country sample

The objective of this analysis is to identify the determinants of liberalization of FDI policy in the developing countries. To that end, three categories of countries were

dropped from the UNCTAD data base: developed countries; those with cumulative inflows of FDI of under $50 million between 1991 and 2001; and those classified as tax havens by the OECD. That leaves a sample of 116 developing and transitional countries distributed as follows. (A country list is attached as Appendix 2.):

North Africa and Africa	32
Latin America and the Caribbean	22
Mid-East	11
Central Asia	8
Asia and Pacific	24
Central and Eastern Europe	19

The data

The decade encompassed by the data base (1992-2001) was one of widespread liberalization of FDI policy in the developing countries. Table 1 reports the total number of liberalizing ("more") and restrictive ("less") policy changes over the ten year period (the "raw" data) by category and region. Ninety-five percent of the changes were liberalizing: 1029 of the total of 1086.

The most striking finding is that the single most important policy category over the decade was positive attempts to attract FDI in the form of promotion and incentives rather than a loosening of restrictions. Promotion and incentives account for almost one-third (31.5%) of the more liberalizing changes, loosening sectoral restrictions 21.4%, operational conditions 15.9%, and increasing guarantees 12.2%. These four categories account for over 80% of liberalizing FDI policy changes over the decade in question. Changes in regulations affecting ownership, approval procedures, foreign exchange and corporate regulations each accounted for only between four and five percent of the total. I will return to the question of the importance of promotion and incentives below.

As noted above, given concerns about the accuracy and validity of the "raw" numbers of events, the data were recoded as –1, 0, and +1 reflecting de-liberalizing, no, and liberalizing changes respectively in a given category-country-year observation. Table 2 contains a the sum of the recoded country-year score (-1, 0, +1) by category. The distribution across categories parallels that of the raw data. Changes in promotion and other incentives designed to attract FDI account for just under one-third of total events. The regulatory categories with the highest reported frequency of change are sectoral restrictions, operational constraints and guarantees. Changes in ownership requirements, approval procedures, foreign exchange requirements and corporate regulations each account for only about five percent of the total.

Summing the recoded data across all eight categories and all ten years provides an indicator of the total net change in FDI policy for each country over the ten year period (Total). The value for Total in all but two of the countries in the sample was one or greater; that is in 114 of the 116 countries in the sample were net liberalizers across all categories of FDI policy over the period from 1992-2001. (One country had a score of zero and one minus one.) The mean country recorded six (net) liberalizing changes in FDI policy over the decade and the median four. (Again, only five percent of all of the changes recorded were deliberalizing.)

The number of countries actually liberalizing a given category of FDI policy, however, varies considerably. At one extreme, 75% of the countries in the sample enacted new laws or regulations providing promotions or incentives to attract FDI at least once during the decade in question. Fifty-eight percent of countries liberalized sectoral restrictions, 51% provided guarantees and 47% liberalized operational conditions – again

at least once during the decade. On the other hand, only 29% liberalized ownership regulations, 26% application procedures, 25% foreign exchange regulations and 22% corporate regulations.

It is important to note that the data measure the number of laws or regulations enacted over the period 1992-2001 rather than the level of a country's openness to FDI. Furthermore, I do not have data which would allow me to characterize the FDI policy at the start of the period. Thus, it is entirely possible that the relatively low number of countries liberalizing ownership regulations during the 1990s, for example, reflects earlier liberalization of this constraint. (I will attempt to control for this problem statistically as discussed below.)

That said, it is not unreasonable to assume that efforts to liberalize FDI policy in developing countries were limited and sporadic before the late 1980, there is general consensus that the "great wave" of liberalization occurred during the 1990s. Given that assumption, several admittedly speculative, inferences can be drawn from the data.

First, many of the developing countries attempted to attract FDI by *both* loosening policy restrictions and increasing investment incentives. More specifically, two-thirds of the countries (78) recorded at least one liberalizing change in promotion and incentives *and* at least one of the other regulatory categories during the decade. While beyond the scope of a cross-sectional analysis, that is consistent with UNCTAD's "three generation" concept of investment promotion policy: liberalization of regulation in the first stage, followed by investment promotion in the second and specific targeting of investors in the third (UNCTAD, 2001).

Second, while virtually every country requires that foreign investment gain approval prior to entry, only 26% of the countries liberalized application procedures at least once during the decade. Thus, even though many of the countries liberalized sectoral restrictions (58%), operational conditions (48%) or provided guarantees to foreign investors, the vast majority did not make changes to their approval process.

Multivariate analysis

A correlation matrix of the eight regulatory categories is shown as Table 3.[5] As can be seen, there is a very high degree of inter-correlation among the eight categories, the correlation coefficient is significant in all but three of the cells.[6] The relatively high correlation between promotion and operations (.51) and sectoral (.38) confirm the tendency of countries to attract FDI though both removing restrictions and offering positive incentives.

As Cronbach's Alpha for an unweighted index of the eight variables (Total) is quite high at .76, it is productive to look at the regulatory categories in aggregate. For any given country Total could range from –80 if it had a deliberalizing regulatory change in each of the eight categories in each of the ten years to +80: in practice, the minimum is –1 and the maximum 32. Total is interpreted as the sum of category-years in which there was a net liberalizing regulatory change. The sum of Total for all of the countries in the sample is 704, that is there were 704 of a possible 1160 country-years in which a net liberalizing event took place.

[5] Stata 8.0 was used for all statistical analysis.
[6] China is a clear outlier as its score for Total is 32 compared with a median of 4. India and Vietnam are also outliers as their scores for Total are each 27. The matrix is robust as the virtually all of the correlations remain significant even if these three countries are deleted.

The distribution of Total across regions is shown in Table 4. As can be seen, Asia – Pacific and Central and Eastern Europe (including Russia and Ukraine) stand out as having a higher per-country average than the mean of 6.1. Put differently, Asia – Pacific accounts for 31% of the country-year changes and 21% of the countries in the sample; the ratio of the percentage of events to percentage of countries is 148. It is 125 for Central and Eastern Europe.

China (32), India (27) and Vietnam (27) were the three countries in the sample with the highest scores for Total. However, virtually all of the major Asian countries score well above the sample average. In the case of Central and Eastern Europe, while there are few outliers, many of these transitional countries had a higher than average tendency to liberalize FDI policy.

The number of net total regulatory changes by year is shown in Chart 1. The trend over time shows two peaks over the decade, the years from 1993 to 1995 when the number of net regulatory changes ranged from 65-70 per year and 1998 to 2001 when the number of net changes ranged from 85 to 79. Analysis of trends over time is beyond the scope of this analysis.

Independent variables[7]

The independent and control variable are operationalized as follows:

- Country size. GDP current $US 1991; Population 1991
- Level of development. GDP/Capita current $US 1991
- Growth in GDP. Growth in GDP 1987-91
- Trade openness. Exports + Imports/ GDP 1991
- Human resource capabilities. Second level school enrollment ratio 1991
- Democracy.[8]

[7] Data sources include: IMF Financial Statistics; Penn World Tables; UNCTAD Foreign Direct Investment Data Base; World Bank Development Indicators; and the Polity IV Data File.

- Dependence on the U.S. The proportion of a country's exports going to the U.S. 1991
- Dependence on International Institutions. Presence or absence of IMF obligations 1991
- FDI Penetration. FDI stocks/GDP 1991
- Growth in FDI. Growth in stocks of FDI, 1987-91
- Resource dependence. The percentage of a exports accounted for by minerals (including petroleum) 1991

Unless otherwise noted, data for the independent variables were collected for 1991 immediately prior to the period encompassed by the data base.

Table 5 contains pair-wise correlation coefficients for Total and each of the predictor and control variables. The strongest bivariate relationships are found between the Total and country size (GDP), the measure of human resource capabilities (secondary school enrollment ratio) and the growth of FDI from 1986-1991. (GDP and per capita GDP are transformed logarithmically). None of the other independent variable's coefficients with Total are significant.

Ordinary least squares regression results are shown in Table 6. Three points should be noted before the regression results are discussed. First, the range of the dependent variable is limited; in theory it could vary from – 80 to + 80, in practice it ranges from -1 to 32. However, as results are virtually identical if the bounded nature of the dependent variable is taken into account (Tobit), OLS is reported. Second, due to data limitations, the sample of countries used in multivariate analyses includes only 64-79 of the 116 countries drawn from the UNCTAD data base. (There are no missing values for any of the dependent variables, Total or FDI policy categories.) The deletions are not random as, at a minimum, all eight of the Central Asian countries and ten of the

[8] Democracy is computed from the Democratic and Authoritarian scores for each country in the Polity IV file. Each ranges from 1 – 10 and, as is the convention, Authoritarian is subtracted from Democratic to compute a variable with a range of –10 to +10.

nineteen Eastern and Central European countries are not included in the analysis. Last, as tests indicate heteroskedasticity (Cook-Weisberg) results are reported for robust estimates using the Huber – White correction.

Market size is the single most important determinant of Total, using *either* GDP or population as a measure it alone accounts for 39% of the variance in the overall propensity to liberalize. Model 1 contains four explanatory variables (lGDP, lGDP/CAP, Sch and Open) and FDIGDP as a control variable, 79 countries are included in the analysis. The independent variables account for 63% of the variance of Total.[9] As noted above, market size (lGDP) is the single most important determinant of a country's liberalization FDI policy.[10] The secondary enrollment ratio as a proxy for human resource capabilities and trade openness are both highly significant and positive. GDP per capita is significant and negative. The coefficient of the control variable (FDIGDP) is not significant.

Model 2 adds a dummy variable to control for China which is a clear outlier (Total = 32). As can be seen, aside from a slight increase in the variance explained (67%) the results are virtually identical to Model 1. (The coefficient for China is significant and positive.) The OLS regressions are robust as the coefficients are very similar when the three clear outliers (China, India and Vietnam) are dropped from the equation. Multicollinearity does not appear to be a problem: the Variable Inflation Factor (VIF) for each of the independent variables in Models 1 and 2 is under three and the mean VIF two or less.

[9] As robust regression is used to correct for heteroskedasticity adjusted r-squares are not available.
[10] Standardized coefficients (betas) allow a direct comparison: lgdp (.801); lgdpcap (-.673); sch (.443); open (.260); and fidgdp (-.110)

Models 3-7 add other independent variables to the base equation (Model 2), mineral exports, IMF obligations, U.S. export dependence, democracy and growth of FDI. None of them are significant, even at the .10 level. It should be noted that the sample size varies for models 3-7 due to missing data. (The equation for growth in gdp is not reported.)

As noted above, due to missing data (independent variables), all of the Ex-Soviet republics in Central Asia are dropped from the regressions as are over half of the Central and Eastern European States. However, data for GDP and Per Capita GDP are available for most of the Central and Eastern European countries and half of the Central Asian states. A regression including both of these variables as well as a dummy variable coded one for a transitional or ex-socialist country is of interest. The three independent variables account for 51% of the variance (adjusted r-squared) and the dummy variable is positive and significant. Thus, the transitional countries were more likely to liberalize, holding country size and level of development constant.

Regressions were also run for each of the four most important categories of FDI policy individually: operational constraints; sectoral limitations; promotion and incentives; and guarantees. In each case, market size (lgdp) was the primary determinant of liberalization of FDI policy. There are some differences among the four, however (regression results are not reported). Open (exports plus imports over GDP) was not a significant determinant of operations and both export dependence on the U.S. and the growth of FDI (1986-91) were significant at the .05 level or better. The only difference observed for sectoral limitations is that open was not significant. The control for China was not significant for either promotion or guarantees. Export dependence on the U.S.

was significant for promotion. Last, the set of independent variables explained only 24% of the variance of guarantees and the only significant explanators were GDP, open, and fdigdp which was negative.

Discussion

As noted above, while it is reasonable to assume that market size should be an important determinant of liberalization, there is no conceptual reason to assume that the effect will be either positive or negative. That said, the single most important determinant of liberalization of FDI policy during the 1990s (1992-2001) is market size with a strong positive impact; either GDP or population explain 39% of the variance of Total. The larger the country the higher the value of Total the measure of overall liberalization; larger countries reported a larger number of category-years in which net liberalization was positive.

This analysis cannot provide insights into the specific mechanism linking country size and liberalization of FDI policy However, at a minimum it would appear reasonable to argue that countries with larger markets are more likely to believe that the net benefits from additional inflows of FDI are likely to be positive.

Recent research indicates that FDI is a compliment to rather than a substitute for trade and that relationship is confirmed in this study. Countries that were more open to trade before the start of the period were more likely to liberalize FDI during the decade in question. That appears reasonable from a number of perspectives. First, trade openness indicates a general predisposition to an economic openness, a belief that growth and development are enhanced by linkages to world economy. Thus, trade openness should be an indicator of a belief that FDI and TNCs are a net contributor to development.

Second, trade openness may lead to a concern for export competitiveness and an appreciation of the roles that TNCs play in generating export capabilities.

The importance of school enrollment ratios as a proxy for human resource capabilities may reflect, in part, the emergence of efficiency seeking FDI. The logic here is that countries with more advanced human resource capabilities are able to attract more skill intensive FDI and policy makers in these countries have reason to believe that they gain from inflows in terms of skill-intensive employment and managerial and technical spillovers. Furthermore, school enrollment ratios should proxy public as well as private sector capabilities and countries with a more educated public sector workforce may have more confidence in their ability to deal with TNCs on favorable terms.

The coefficient for per capita GDP is consistently significant and negative. This contradicts a robust conclusion of the literature on capital account liberalization that the wealthier countries are more likely to liberalize. That, however, appears not to be the case for FDI policy liberalization; controlling for market size the coefficient of GDP per capita is negative.

Most of the studies of capital account liberalization include both portfolio and direct investment as well as both developed and developing countries and their relevance may be limited. While as with market size it is not possible to establish precisely a linkage between development and liberalization, several explanations appear possible. The simplest is that controlling for market size, countries that are relatively less developed may perceive the need to "catch up" and thus have a stronger motivation to attract FDI through liberalization of regulation and increased incentives and guarantees.

Country size and level of development (GDP and GDP per capita) account for 47% of the variance of Total.

It is important to note that the data used in this study reflect changes rather than levels of openness and the earliest year for which I have data is 1992. While FDI/GDP in 1991 is used to attempt to control for previous level of FDI, it is entirely possible that at least some of the wealthier countries liberalized before 1992. However, even when the wealthier countries are dropped from the regression, controlling for market size, the relationship between Total and per capita GDP is negative and significant. Further research is necessary to confirm and explain this finding.

None of the other independent variables were significant predictors of Total. However, export dependence on the U.S. was significant in the equations for operational constraints and promotions and incentives. Thus, this analysis does not provide support for an argument that liberalization of FDI in the developing countries was externally imposed by the policies of either the United States or International Organizations.

Conclusions

Changes in FDI policy over the decade encompassed by this study were overwhelmingly liberalizing, 95% of the 1086 individual policy changes either lessened restrictions on inflows of FDI or provided additional promotions and incentives to attract increased flows. All but two of the countries (Kazakhstan and Kenya) of the 116 studied were net liberalizers.

Two alternative explanations for liberalization of FDI policy were discussed earlier. The first argues that liberalization reflects host country policy makers' response to changed technological and economic conditions, the increasing "costs of closure" for

FDI. In this view, liberalization reflects a belief that lower barriers and increased flows of FDI are in the national interest. The second argues that liberalization was a response to external factors, specifically, the spread of neoliberal ideology possibly through pressure from either the United States or international institutions.

The analysis does not provide support for an external pressure explanation of liberalization. While there are other possible modes of diffusion of a neoliberal ideology such as emulation of the actions of regional neighbors or competitors is not possible to test a diffusion hypothesis through cross-sectional analysis and those issues must be left for further research. That being said, the results of this analysis are certainly consistent with the efficiency or "costs of closure" argument. Liberalization of FDI policy is a function of market size, level of development, trade openness and human resource capabilities, controlling for FDI penetration (fdigdp). While none of the variables operationalizing the external pressure explanation were significant as explanators of Total, it should be noted that export dependence on the U.S. was significant in the equations for operational constraints and promotion. That at least raises the possibility that external pressure plays a role in FDI policy liberalization, at least for these two categories of policy. However, given the limitations of cross-sectional analysis the most that can be said for the external pressure argument is the old Scotch verdict of "not proven."

Four policy categories accounted for over 80% of the changes: promotion and incentives (31.5%); sectoral restrictions (21.4%); operational conditions (15.9%) and guarantees (12.2%). The most important policy change in terms of frequency of occurrence was increased incentives offered to investors: tax reductions, training,

infrastructure provisions and the like. Seventy-five percent of the countries in the sample offered new promotions and/or incentives at least once during the period 1992-2001. Furthermore, countries which offered increased promotions were also likely to reduce operational barriers and sector restrictions limiting inflows of FDI; the simple correlation between promotions and operations is .51 and sectoral .38 (see table 3).[11]

That raises an important policy question: are reducing operational restrictions and/or sectoral limitations a substitute for increasing promotions and incentives? As this analysis looks at the determinants rather than the effects of liberalization, nothing can be said about the relative impact of reducing restrictions versus increasing incentives as a means of attracting further flows of FDI. However, the results do raise the possibility that the two are seen, at least to some extent, as substitutes by policy makers. If that is the case, given that many studies of the impact of promotions and incentives conclude that it is a zero sum game across host countries, policy makers might be encouraged to consider liberalizing restrictions rather than offering increased incentives as a means of attracting increased inflows of FDI. Again, it is important to note that no conclusions can be drawn about the substitutability of liberalization of restrictions and promotions based on the data and analysis in this study. The question, however, is certainly of interest.

Further research is required to answer a number of the questions raised in this analysis. Longitudinal analysis, specifically some form of cross-sectional time-series analysis, is needed to deal more rigorously with both questions of the relative importance of ideational arguments and diffusion as an explanation of policy liberalization. It would

[11] A factor analysis not separately reported confirms the relationship between promotions and operations which are the only two variables "loading" on the second of three factors which together account for about half of the variance of the eight categories of fdi policy considered in this study.

also be of interest to use the data to pursue studies of the impact of liberalization on future flows of FDI.

Appendix I

Category Definitions

Incentives (Promotional): measures providing incentives, fiscal and/or financial, creating special zones with facilities for FDI operations, establishing or reinforcing national institutions entrusted with the promotion of foreign investment, and setting up permanent or ad hoc councils that include foreign investors in their membership and offer advice to the governments.

Foreign ownership: allowing foreign investors to own companies or shares, properties (moveable or otherwise) and assets.

Approval procedures: introducing, streamlining or lifting of procedure for approval, authorization, admission and/or establishment of FDI and foreign investors (Companies, branches, subsidiaries). Notice requirements are also included here.

Operational conditions: introducing, easing or lifting of performance requirements imposed on FDI and/or foreign investors, post establishment treatment, discrimination, internal administrative encumbrances etc.

Guarantees (protections): through internal and international mechanisms, in areas of intellectual property rights laws, dispute settlement, ownership and other proprietary rights and interests, and protection from subsequent changes to laws and regulations adversely affecting the interests of the foreign investors. Movement of capita, including guarantees to repatriation and transfer of capital, income, profits, royalties).

Sectoral liberalization: Access for the first time to a sector or further liberalization of various sectors and sub-sectors, including *services*, including, financial, banking, telecommunications, *manufacturing* and *natural resources*, including energy (mining, hydrocarbon ..., etc

Corporate regulation: corporate governance, stock exchange, financial markets laws.

Foreign exchange: controls over exchange, including permission to possess other currencies, amount thereof.

Appendix 2 – Country List

Algeria
Egypt
Morocco
Sudan
Tunisia
Angola
Botswana
Burkina Faso
Cameroon
Congo
Côte d'Ivoire
Eritrea
Ethiopia
Ghana
Guinea
Kenya
Madagascar
Malawi
Mali
Mauritania
Mauritius
Mozambique
Namibia
Niger
Nigeria
Senegal
South Africa
Swaziland
"Tanzania, United Republic of"
Uganda
Zambia
Zimbabwe
Argentina
Bolivia
Brazil
Chile
Colombia
Costa Rica
Dominican Republic
Ecuador
El Salvador
Guatemala
Guyana
Honduras
Mexico
Nicaragua
Paraguay
Peru
Uruguay
Venezuela
Barbados
Cuba
Jamaica
Trinidad and Tobago
"Iran, Islamic Republic of"
Jordan
Kuwait
Lebanon
Oman
Qatar
Saudi Arabia
Syrian Arab Republic
Turkey
United Arab Emirates
Yemen
Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyzstan
Tajikistan
Turkmenistan
Uzbekistan
Fiji
Guam
Papua New Guinea
Bangladesh
Brunei Darussalam
Cambodia
China
"Hong Kong, China"
India
Indonesia
"Korea, Democratic People's Republic of"
"Korea, Republic of"
Lao People's Democratic Republic
Malaysia
Mongolia
Myanmar
Nepal
Pakistan
Philippines
Singapore
Sri Lanka
Taiwan Province of China
Thailand
Viet Nam
Albania
Belarus
Bosnia and Herzegovina
Bulgaria
Croatia
Czech Republic
Estonia
Hungary
Latvia
Lithuania
"Macedonia, the Former Yugoslav Republic of"
"Moldova, Republic of"
Poland
Romania
Russian Federation
Serbia and Montenegro
Slovakia
Slovenia
Ukraine

Table 1
Changes in FDI Policy by Region

Region	**Africa**	**LA & Carr**	**West Asia**	**Cen. Asia**	**S, E, &SE ASIA**	**Cen & East Europe**	**Total***
Ownership							
more	2	9	11	1	18	6	47
less	0	0	0	0	1	3	4
Sectoral							
more	21	40	14	14	94	37	220
less	0	2	1	1	1	3	7
Approval							
more	9	6	8	5	18	6	52
less	0	0	1	0	2	1	4
Operatioal							
more	29	11	20	6	63	33	164
less	0	0	1	1	1	2	5
Forex							
more	10	6	1	2	15	12	46
less	2	1	0	1	1	2	7
Promotion							
more	64	37	19	14	107	83	328
less	1	6	0	2	1	7	22
Guarantees							
more	13	33	24	8	27	21	126
less	0	0	0	0	1	0	1
Regulations							
more	6	5	3	4	20	8	46
less	0	2	0	0	1	4	7
Total							
more	154	147	100	54	362	206	1029
less	3	11	3	4	14	22	57

* Includes Pacific region not reported separately.

Table 2
Recoded Events by Category 1992-2001

Category	Number	Percentage
Own	40	5.7
Sectoral	143	20.3
Approval	38	5.4
Operations	102	14.5
Forex	37	5.3
Promotion	226	32.1
Guarantees	82	11.6
Regulations	36	5.1
Totals	704	100.0

Table 4
Total by Region

Region	Total	# Countries	Total/Country	Event/Country Ratio*
Africa	128	32	4.0	66
LA & Car.	118	22	5.4	88
Mid-East	63	11	5.7	100
Cen. Asia	37	8	4.6	71
Asia-Pacific	219	24	9.1	148
Cen. & East. Eur	139	19	7.3	125
Total	704	116	6.1	

* percentage of changes in a region divided by percentage of countries in a region

Table 3
Correlation Matrix -- Regulatory Categories
N = 116

	own	sec	app	ops	forex	prom	guar
own	1.0000						
sec	0.3721	1.0000					
	0.0000						
app	0.2685	0.2846	1.0000				
	0.0036	0.0020					
ops	0.3414	0.4085	0.4655	1.0000			
	0.0002	0.0000	0.0000				
forex	0.2719	0.4387	0.4466	0.5577	1.0000		
	0.0032	0.0000	0.0000	0.0000			
prom	0.2632	0.3771	0.2173	0.5066	0.4386	1.0000	
	0.0043	0.0000	0.0191	0.0000	0.0000		
guar	0.2209	0.3083	0.0771	0.1323	0.2747	0.3128	1.0000
	0.0172	0.0008	0.4110	0.1568	0.0028	0.0006	
regs	0.3504	0.4483	0.2367	0.3732	0.5463	0.2005	0.2437
	0.0001	0.0000	0.0105	0.0000	0.0000	0.0310	0.0084

	regs
regs	1.0000

.

Table 5
Correlation Matrix

	total	lgdp	lgdpcap1	open	sch	fdigdp	grfdi
total	1.0000						
lgdp	0.6277	1.0000					
	0.0000						
lgdpcap1	-0.0086	0.3847	1.0000				
	0.9318	0.0001					
open	-0.0958	-0.1454	0.4509	1.0000			
	0.3803	0.1896	0.0000				
sch	0.2066	0.3153	0.6449	0.2678	1.0000		
	0.0319	0.0015	0.0000	0.0138			
fdigdp	-0.0891	0.0482	0.2871	0.6152	0.0868	1.0000	
	0.3830	0.6480	0.0055	0.0000	0.4027		
grfdi	0.3960	0.5715	0.3040	0.4734	0.1680	0.4768	1.0000
	0.0001	0.0000	0.0038	0.0000	0.1095	0.0000	
grgdp	0.1670	0.1928	-0.0054	0.1857	-0.2913	0.2871	0.4196
	0.0871	0.0547	0.9575	0.0907	0.0028	0.0050	0.0000
minexs	-0.0052	-0.0202	0.0265	-0.0540	-0.0112	0.0115	-0.1001
	0.9666	0.8721	0.8328	0.6875	0.9281	0.9273	0.4204
perus	-0.0595	0.1020	0.0849	0.0565	-0.0032	0.1460	0.2408
	0.5863	0.3589	0.4452	0.6253	0.9769	0.1798	0.0264
Dem	0.1399	0.1959	0.1447	-0.0565	0.1636	0.0377	0.0960
	0.1566	0.0642	0.1736	0.6254	0.1093	0.7285	0.3763

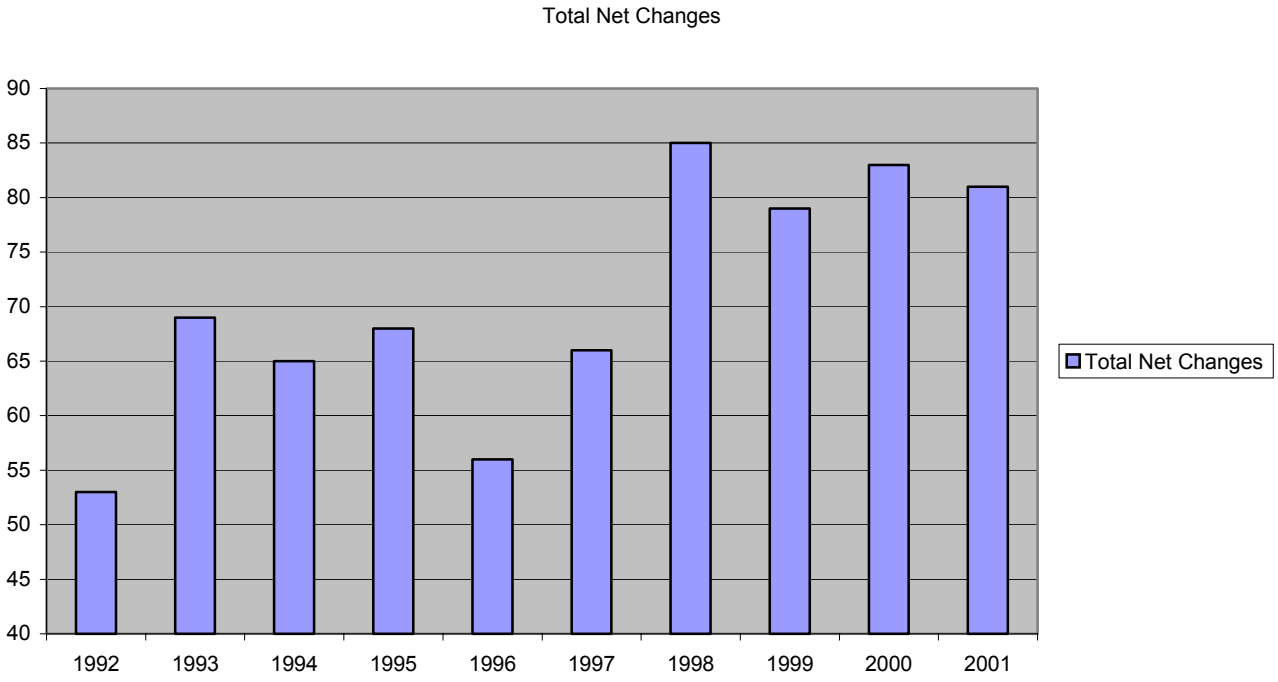
	grgdp	minexs	perus	Dem
grgdp	1.0000			
capact	0.3870			
	0.0046			
minexs	-0.1097	1.0000		
	0.3808			
perus	0.1198	-0.1558	1.0000	
	0.2775	0.2153		
Dem	-0.1494	0.0797	0.3311	1.0000
	0.1485	0.5313	0.0029	

Table 6
Regressions on Total

Variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7
lgdp	3.141*** (.442)	2.815*** (.406)	2.740*** (.443)	3.142*** (.439)	2.929*** (.430)	2.557*** (.431)	3.563*** (.672)
lgdp/cap	-3.854*** (.043)	-3.286** (1.056)	-2.433** (.885)	-3.582** (1.102)	-3.260** (1.072)	-2.966** (1.218)	-3.227** (1.021)
sch	.106*** (.023)	.098*** (.022)	.090*** (.024)	.095*** (.022)	.099*** (.024)	.089*** (.024)	.087*** (.024)
open	.030** (.012)	.028** (.010)	.029** (.011)	.053*** (.020)	.034** (.012)	.031** (.012)	.043** (.016)
fdi/gdp	-.027 (.027)	-.030 (.025)	-.049 (.028)	-.020 (.030)	-.085 (.027)	-.036 (.025)	-.024 (.022)
china		12.508*** (2.533)	14.268*** (2.519)	12.161*** (2.493)	12.075*** (2.074)	14.028*** (2.726)	16.359*** (2.950)
minexp			.021 (.019)				
Imf91				.002 (.005)			
ex-US					-2.216 (2.074)		
dem						.084 (.068)	
grfdi							-.000 (.000)
constant	-46.223*** (7.184)	-42.147*** (6.423)	-46.450*** (7.026)	-49.695*** (7.223)	-44.792*** (6.835)	-38.311*** (6.105)	-59.846*** (3.051)
F	24.51***	24.40***	23.62***	21.67***	20.72***	17.90***	22.10***
r-sq.	.627	.670	.747	.700	.687	.669	.692
N	79	79	64	73	74	70	77

*** p <= .001 ** p<= .01 * p<=.05
Standard errors are shown below the coefficient in parenthesis

Chart 1
Total by Year



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