

**Subject:** Manuscript Revisions for *Political Science Research and Methods*

**Manuscript ID:** PSRM-OA-2019-0085

**Manuscript Title:** Complex Dependence in Foreign Direct Investment: Network Theory and Empirical Analysis

**Date:** August 6, 2019

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We thank the editors for the opportunity to revise and resubmit our manuscript. In this memo we have separated the editor's and reviewers' comments into separate criticisms and suggestions. Under each comment, we describe how we have revised the manuscript in response to the feedback provided. We generally agree with the criticisms offered, and think that our manuscript has improved substantially as a result of incorporating this feedback.

## Editor

**E1:** *Both reviewers would like to see a more developed justification for the use of count ERGMs. R1 wants to know why the count ERGM is preferable to "spatial" models with exogenous connectivity matrices. Perhaps the most relevant model in this tradition is the dyadic model in Neumayer and Plmper, International Organization, Vol. 64, No. 1 (Winter 2010), pp. 145-166. With directed dyads, this model can handle reciprocity and transitivity. If the spatial lag is time lagged, one could model zero-inflation in a selection framework. R2 suggests that Hoff's AMEN model for networks can be easily amended to handle zero-inflation. R2 would also like to see some mention of Ward, Ahlquist and Rozenas.*

**E2:** *Both reviewers would like to see you address more of the literature on FDI. R1 points out that there's a literature on structural dependence across countries that goes back to Coughlin and Segev and includes several papers by Blonigen and Egger. R2 notes the research on PTAs and FDI and, based on the findings in this literature, would like you to control for trade agreements as well as BITs in your analysis.*

**E3:** *R1 notes that your explanations for the two network effects seem to be rooted in different theoretical traditions. Reciprocity is older idea that is tied to market expansion while transitivity is rooted in the logic of global production chains. R1 suspects that reciprocity may only apply to North-North dyads. (This seems to be borne out in Appendix F. ) I think it would be fruitful to explore these connections. Is reciprocity important for understanding North-North FDI and transitivity critical to understanding investment within mixed, North-South dyads that is driven by the multi-nationalization of production?*

**E4:** *R1 sees your findings with respect to political institutions as potentially important. Looking at Table 1, it seems like analyses that don't account for network effects tend to overstate the importance of both economic size and political institutions. Do we inflate the importance of these factors because there's so much reciprocal investment among the rich democracies?*

**E5:** *R2 has a number of reasonable requests for the appendix: more on the estimation process; how is the multiple imputation handled; detailed GOF statistics.*

## Reviewer: 1

**R1.1:** *I completely agree with their primary criticism of the FDI literature: structural dependence across countries is a real problem in assessing any determinants of foreign direct investment. This paper is not*

*the first to make that point; in fact spatial models FDI date back at least to Coughlin and Segev (2000), and perhaps earlier. In economics, Bruce Blonigen and Peter Egger have both investigated this topic with co-authors. But the real question for this paper is how to contribute to the political economy literature. The authors highlight several contributions in the paper, but I'm not sure that any fully succeeds in this version... Contribution number one is incorporating third-party effects on FDI. But are these network methods the best way to do that? On page 16, the authors suggest some other NETWORK estimators that might be appropriate, but they do not offer much evidence that network methods are better than other spatial methods. I have some skepticism on this point, given that the authors must use a count model to estimate the correlates of foreign direct investment stock. They choose their dependent variable based on the model's needs, and their hypotheses are limited to 'canonical forms of network structure' (p. 21). Surely other spatial models are better equipped to test multiple types of spatial effects that allow for more sophisticated spatial effects. For example, the network model cannot discriminate between third-country effects that are positive because FDI happens between countries A and B and where it is negative because of that transaction. An auto parts plant in Czech Republic may mean more FDI for Hungary, but a toothpaste plant may mean less because it uses one plant to serve all eastern countries in the European Union. In other words, it depends on the logic of the investment, but global supply chains have complex effects, not just increasing FDI everywhere. In fact, it remains highly concentrated... the authors exhibit a deep knowledge of the foreign direct investment literature, but they use that literature to justify the limited hypotheses that can be tested in network models. In its current form, the paper finesses this point, but it seems that in the end the authors are relatively honest, noting their 'network theory of FDI that includes reciprocity and transitivity as the core structural dependencies' (p. 29). If the others can make the case why network models have unique advantages, then why be indirect about the limitations of those theories. Be honest about what can be tested and what cannot. Crucial here is justifying how network models are better than other spatial models.*

**Addressed:**

**R1.2:** *Contribution number two is yet another take on political institutions and FDI. This may appear to be settled given the extensive meta-analysis in Li, Owen, and Mitchell (2018, henceforth LOM), but few if any of the papers they review account for third-party FDI effects. As such, this paper can reignite that literature, as all other papers can be critiqued as misspecified. Additionally, LOM find that the debate over whether democracy attracts FDI is governed by the choice of measure, but FDI stocks are not as commonly used as flows and therefore may show different results. Any finding here must deal with the critique by Arel-Bundock (2017) that political institutions are just not very important for FDI.*

**Addressed:**

**R1.3:** *Contribution number three is the focus on expansion of global supply chains, given the unique timeframe of the data. The relationship between FDI and trade may therefore be unique to this time period, and care should be taken regarding generalization of the results. Again the network setup limits the analysis of panel data to either pooled or multiple cross-sections, but the authors do as well as can be expected with these limitations. Strangely, the first hypothesis is justified with older motivations for MNCs (who saturate domestic markets and must look abroad for profits) rather than theories that are more attuned to cross-border supply chains. Their logic seems appropriate for rich country pairs, but much less so for North-South dyads. I expect the results do not hold for non-OECD countries.*

**Addressed:**

**R1.4:** *...the dependent variable is imperfect in ways that are not addressed. UNCTAD has done great work on this data set, and I'm glad the authors are making use of it. Furthermore, I like that they use a lagged dependent variable, which might initially make the setup seem similar to a model of FDI flows*

*because it looks for variation in the one year changes of stocks. FDI stocks, however, can vary from year to year for multiple reasons, including both new flows and revaluation. For example, the book value of a factory may deteriorate from one year to the next due to the depreciation of capital assets. To the extent that these depreciation's are reflected in the FDI stocks measure, it is more than just a representation of flows. Perhaps controlling for inflation would solve this problem, but I am not optimistic of any real solution. Furthermore, the measure still aggregates data at the country level, although the decision-makers are firms. These are important limitation of the data, and should be mentioned in the text.*

**Addressed:**

## **Reviewer: 2**

**R2.1:** *One simple request that I have is that the authors account for the effect that PTAs may have on FDI. Though PTAs are often thought of as simply means to ensure reciprocal market access vis a vis adjustment of tariffs and related border measures, more recent PTAs contain provisions that cover a wide array of non-tariff measures such as rules on investment and intellectual property rights protection. The DESTA database provides a very useful way to account for these types of deep PTAs and I'd be interested in seeing whether or not that parameter accounts for some of the clusters the authors are picking up through their transitivity term. The relationship between PTAs and FDI is not uncommon in the literature, for example, see Buthe & Milner (2008), Medvedev (2012), and Osnago et al. (2016).*

**Addressed:**

**R2.2:** *I was surprised to not see a term for actor heterogeneity in the model. I imagine this could manifest in the FDI network for a variety of reasons (beyond those accounted for by the already included covariates) as some countries are more active or reliant on FDI than others. It would be useful to at least see an Appendix item in which the authors include a term for actor heterogeneity in the model and present the results in a format similar to Table 1.*

**Addressed:**

**R2.3:** *In general, more detail should be provided at least in an appendix about the estimation process for the count ERGM. I'm guessing the authors are using the model from Krivitsky (2012), which provides a way to estimate ERGM on valued networks and specifically dispersed count dependent variables but it would be useful if this was made clearer in the manuscript, especially since this has been submitted in a methods journal.*

**Addressed:**

**R2.4:** *On page 14, the authors note that the count ERGM is "the only network model that can currently be used to model weighted data with zero-inflation". This is not correct as the Ward, Ahlquist, and Rozenas (2013) piece introduced a latent space model for trade data to account for the excess of non-trading dyads via a mixture approach. I understand that the authors are interesting in estimating substantive effects for network terms such as transitivity, which cannot be done via a latent space or factor approach, but the quoted text should be corrected. Additionally, extending Hoff's AMEN framework to handling dispersed count processes is also a trivial task.*

**Addressed:**

**R2.5:** *Additionally, the choice to model FDI as a count process is something that I at least have not often encountered in the FDI literature. I understand that extending GERGM in a way to handle the excess of zeros is not straightforward, but it would be helpful if the authors provided some grounding for their choice beyond noting that an ERGM for a continuous dependent variable with an excess of zeros does not exist.*

**Addressed:**

**R2.6:** *In terms of dealing with missing data, the authors have effectively applied a number of robustness checks. However, the robustness check I was most interested in was Section D of the Appendix, in which they imputed via Amelia. Specifically, how was the imputation and estimation process done, were multiple imputed datasets generated and then count ERGMs run on each imputed dataset? How were the parameter estimates results from each of the ERGM-imputed datasets combined? Was it simply a matter of employing Rubin's rules?*

**Addressed:**

**R2.7:** *For Figure 2, I'd be interested in seeing the results broken out by year. Additionally, I think that a corresponding yearly figure for transitivity is useful and necessary. Of course, figure 3 is helpful in terms of showing that the transitivity and reciprocity parameters are significant but I would like to know how far away a model without network terms is in accounting for transitivity especially after the authors have accounted for PTAs. My guess is that the network model will still outperform the canonical approach, and this will strengthen the key contribution being made by the authors.*

**Addressed:**

**R2.8:** *Whenever I see an ERGM I also always want to see detailed GOF statistics. Some tests of how well the authors' proposed model accounts for standard ERGM GOF diagnostics relative to a model without network dependence terms would be useful. I imagine the authors will just include these results in an Appendix but in my opinion they must be included so that we can be sure the ERGM is properly specified.*

**Addressed:**