

A Microeconomic Approach to the Influence of Terrorism on Foreign Direct Investment

Abstract

Recent empirical literature dealing with the impact of terrorism on FDI has not come to clear-cut results. While Abadie and Gardeazabal (2008) find a severe negative influence of terrorist attacks on FDI via an open-economy channel, others, such as Enders et al. (2006), estimate the detrimental effect of violent terrorism to be very limited in both country prevalence and size.

Utilizing a simple two country production model with inputs labour and capital, I show that the influence of terrorist attacks on FDI depends on the characteristics (labour/capital intensity, substitutability of inputs) of the targeted economic sector. In this model, terrorist organizations are economic actors who engage in kidnapping, capital destruction or both, as motivated by their particular goals. By perpetrating attacks in one country, they raise the cost of labour and capital and therefore change the capital-labour ratio and also drive investment abroad. Depending on whether a terrorist organization is constrained by manpower or financial means, governments of terror afflicted countries may find it beneficial to spend part of the taxes levied on foreign firms on anti-terror measures which raise the cost of engaging in terrorist activities. This model is especially applicable to developing countries such as Columbia and Nigeria in which foreign firms are mainly engaged in resource extraction, but can be generalized to other countries and sectors. Furthermore, as wages paid by foreign firms are not captured by FDI, the model shows that just considering FDI can overstate the economic effect of terrorism as labour is substituted for capital.

References

Abadie, A. and J. Gardeazabal (2008). "Terrorism and the world economy". *European Economic Review* 52, pp. 1-27

Enders, W., Sachsida, A. and T. Sandler (2006). "The Impact of Transnational Terrorism on U.S. Foreign Direct Investment". *Political Research Quarterly* 59, No. 4, pp. 517-531

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