

# When Will States Liberalize? Lost Monies as an Explanation for Institutional Change\*

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## Abstract

Most examinations of state liberalization focus on political change and the likelihood of democratization in the state. However, this misses the real effects that economic change has in providing the institutional structure that facilitates these democratic processes. Starting with the theoretical premise that international leaders balance between the domestic costs and international incentives of political liberalization, we argue that states liberalize when the monies lost as a result of poor institutional design are consequential for leaders' tenure. Our results strongly support this argument. Using a global cross-section of states from 1970 to 2008, we find that the opportunity cost of lost trade and FDI due to poor institutions matters tremendously for certain states and explains future economic liberalization.

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## Introduction

Not all leaders are willing to liberalize their economies, and much attention has focused on how to affect change among illiberal regimes. There are many possibilities. Aid may be conditioned to political and economic liberalization, regional integration may provide leaders political cover as market protectionism is relaxed, or, more generally, systemic norms of free trade may encourage both globalization and free-market reforms among affected states. Nevertheless, each of these arguments misses the point that economic liberalization had already happened in many countries, including most advanced countries, without the incentive structures these methods are trying to foster. There were first movers among liberal states, and there continue to be countries that liberalize without strong interventions from outside. What explains this?

We focus on the incentives to leaders that are created by exposure to international investment. We assume that leaders will, in most cases, want to increase the monies their states receive and their regimes can tax, and we argue that, when a substantial amount of money is lost because of poor domestic policies, those policies are more likely to change. Leaders have an opportunity cost associated with poor domestic policies, and that opportunity cost can be incentive enough to encourage economic liberalization.

We test our argument by first creating a measure of how much foreign direct investment each country likely loses in a given year because of poor domestic property protections. We then use that measure of lost monies as an independent variable that predicts reform. We find that leader incentives do matter, but there is variation across regime type. Those states with leaders who have the most domestic freedom to change policy—the personalist dictators and the oligarchic regimes—are also the leaders who are most susceptible to the pull of opportunity costs. Among democracies, we find a negative relationship. Democratic leaders are less likely to reform their property protections as opportunity costs increase. Consistent

with many traditional arguments of macro-economic growth, we believe that high levels of lost investment are indicative of the strength of parochial interests in democracies who act to protect their position, even at the cost of good governance.

Our argument has numerous implications but chief among them is the evidence we give for the temporal sequence between economic and political liberalization. We find that economic liberalization comes first. Democracies are not normally incentivized to increase their property rights protections in our sample, which implies that economic liberalization mostly occurs prior to democratization. The unconstrained leaders among non-democracies are the ones who liberalize, assuming opportunity costs are high enough; this may be an indication that economic liberalization is a precursor to political liberalization and democracy. We begin our argument in the next section with a review of how property protections shape the attractiveness of each country for foreign investment.

## **The Costs and Benefits of International Interdependence**

International states have much to gain from participating in the growing international economic networks, such as foreign direct investment (FDI) and trade (Chyzh 2016*a*; Li and Resnick 2003). According to a recent World Bank report, seventy percent of international goods and services are supplied to markets via global value chains, or cross-border economic partnerships responsible for movement of goods through every production stage from design and parts manufacturing to final assembly and retail. Increasing participation in global value chains may lead to higher than average economic growth (Echandi, Krajcovicova, and Qiang 2015, 2). FDI has also been shown to enhance domestic productivity, drive additional investment in research and development, boost the quality/pay of domestic jobs, and decrease short- and long-term levels of unemployment (Aitken and Harrison 1999; Javorcik 2004; Keller and Yeaple 2009; Poole 2013).

Attracting FDI, however, requires implementation of a number of crucial domestic level policies that will incentivize investors to choose a given venue over a set of comparable venues. Many considerations behind the investment decisions, such as resource endowments or particular structure of the workforce, are determined exogenously, and therefore, difficult or impossible to control. This is not to say, however, that domestic leaders have no way to influence international investment through policy-making. In particular, domestic policy-makers have two general strategies of attracting international investment: (1) creating additional incentives to compensate businesses for possible losses due to higher risks, and (2) enacting policies aimed at mediating the risks of investment (Chyzh 2016*b*). The first strategy may include tax credits and exemptions, weak or ineffective anti-monopoly legislation, low level of regulation, such as that related to health and environmental standards, wages, or working conditions (Cao 2010; Li 2006; Li and Resnick 2003). The second strategy, on the other hand, is aimed at building domestic market-protecting institutions, such as rule of law, property rights protections, or impartial judiciaries (Simmons 2000; Jensen 2003; Souva, Smith, and Rowan 2008).

While the two strategies have somewhat divergent implications, they are technically not mutually exclusive; in fact, leaders and policy-makers in most countries tend to opt for a mix of the two. In the limit, however, policies aimed at compensating for possible risks rather than addressing their root causes (i.e. the lack of market-protecting institutions) are more naturally associated with authoritarian regimes, whose economic and political regimes may be more responsive to particularistic interests to the detriment of the interest of the broader public (Ahlquist 2006; Feng 2001; Jensen 2008; Li and Resnick 2003). In contrast, the strategy of ameliorating risks through building market protections aligns with the goals of democratic regimes, whose leaders have stronger incentives to pursue the interests of the public.<sup>1</sup> The focus on compensation over institution-building has also been shown to prevail

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<sup>1</sup>Democratic regimes, however, are not necessarily equivalent to regimes with strong property rights

in regimes with shorter time horizons (Moon 2015).

Growing research has also cast significant doubts on the effectiveness of attracting international business through side-payments, such as lucrative tax incentives (Bobonis and Shatz 2007; Buettner and Ruf 2007; Jensen et al. 2014). Having limited effect on investment patterns, tax incentives have been shown to be little more than politician's tools for either claiming the credit for firms that chose to investing in the area (for unrelated reasons) or minimizing the political fallout for failing to attract an important investor (Jensen et al. 2014).

Recent research has also called into question the continued viability of attracting international business through lax policy regulation (Chyzh 2016a). In particular, collusion relationships between the ruling elites and multinational corporations (MNCs) tend to attract a lot of negative publicity from international non-governmental organizations (INGOs), the media, and the public in the MNCs home countries (Murdie and Davis 2012). As a result, MNCs, many of which originate from the US and Western Europe, face significant domestic costs of maintaining poor working conditions in their overseas factories, or failing to adhere to fair and reasonable standards as they relate to labor rights and safety, or environmental concerns. Many such standards have been written as clauses in trade and investment agreements that regulate economic relationships between MNCs' home and host countries (Hafner-Burton 2009).

## **Lost Monies and the Incentive to Liberalize**

There is some disagreement about how effectively leaders may respond to the best interests of their constituents and improve the economic conditions of the state. Most sanguine about leader agency and responsiveness are Bueno de Mesquita et al. (2003). They develop a 

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protections. The two are conceptually and empirically distinct, although correlated. Gibler and Randazzo (2011, 703), for example, find that 40% of democracies lack the independent judiciaries necessary to constrain predatory government action.

theory of government that is based on the incentives leaders have for remaining in power. Given scarce resources, leaders must choose between public and private goods to maintain the coalitions that support them, and the size of those coalitions control that choice. Leaders kept in power by a small group of elites will respond by favoring those elites with private goods. Meanwhile, leaders who rely on large coalitions seldom have the resources to reward their supporters with private goods and, therefore, turn to public goods to generate loyalty.

Bueno de Mesquita et al. (2003) argue that this model explains the correlation between democratic governments and better economic policies such as economic growth, private property protections, and open international trade policy. Leaders who respond to smaller-sized coalitions are more likely to be kleptocratic and/or protectionist according to their model. Their parsimonious model thus unifies domestic and international policies as functions of leader incentives and how domestic institutions structure those incentives.

The selectorate theory actually presents a break from the macroeconomic arguments that linked economic stagnation and decline to the rent-seeking associated with many mature democracies. Olson (1982), for example, attributed the extraordinary economic growth of many post-war democracies to the destruction of the entrenched, private interests within society. Interests in Japan and West Germany were swept away by World War II, and those countries prospered immediately with quick growth. However, Britain's interests maintained after the war, and economic stagnation and decline followed. According to this argument, as democracies mature, parochial interests concentrate and take over the state, ultimately capturing governmental policy. This implies, of course, that democratic leaders may not always be able or even willing to directly respond to their constituencies with public goods.

The core of Olson's argument rests on the likelihood that individuals are going to free-ride on the actions of others, especially when their pecuniary benefits are small. Dispersed interests will always lose to those with concentrated interests over particular policies. Thus, the assumption that public goods will always dominate leader interests when the voting

public is large and active may actually be naive. Under a more traditional logic, leaders are more likely to be responsive to powerful parochial interests in large democracies, especially as those institutions mature over time.

There are other reasons to think that leaders may be stymied even when trying to implement good policies. Open, liberal government—the kind we find in large-coalition states—also brings with it many veto players who are unwilling to support change. Tsebelis (2002) argues that increases in the number of veto players are likely to be associated with more stable policies that favor the status quo. Change is much easier when relatively few players are able to stall, change, or stop new policies. Those veto players may come from the entrenched and parochial interests of vested elites, but they need not do so. Even assuming that all players want better economic policies, for example, an increase in the number of veto players will still be correlated with fewer policy changes.

The differences across these theories present some important implications for observations of liberal economies in the international system. Bueno de Mesquita et al. (2003) argue that leader interests explain the correlation between large-coalition states and liberal economic policies, but almost all of their tests are cross-sectional and assume the causal arrow leads from coalition size to economic policy. It is possible that economic liberalization comes first, and expansion of the franchise follows. This explanation would be more consistent with Olson's (1982) theory that associates mature democracies with rent-seeking. The argument also implies that at least some leaders have interests in economic liberalization prior to democratization.

### **Identifying Interests—Recovering Monies Lost from Bad Economic Policies**

We begin with the assumption that leaders will want to increase the amount of monies their countries receive from investment. Of course, not all countries can affect their foreign investments substantially, even with good domestic policies that protect investment and trade.

The country may have few skilled workers, few resources, or no developed infrastructure to support penetration by global interests. In these cases leaders will have little incentive to change their domestic policies because they realize there will be little to gain.

Instead, those leaders who are most likely to change the economic policies of the state are those whose economies are most affected by lost trade and investment. These are the countries with resources, a decent workforce, and/or decent institutions that are suffering from poor macroeconomic policies. The implication is that, if property protections and liberalization are encouraged, then more investment will follow. Leaders of these countries will have the greatest incentive to change their state's policies because they have the most to gain. Thus, as the amount of lost investment increases so, too, does the likelihood of economic liberalization within the state and that is especially true for those leaders who prefer public goods or those leaders who can reap the rewards of increased investment (Bueno de Mesquita et al. 2003).

Importantly, leaders' benefits from investment as well as leaders' ability to change domestic policies in response to lost economic opportunities are structured by domestic institutions. In democracies, the economic benefits from international investment or the costs of forgone economic opportunities are incurred by the broader group within the country. In contrast, in regimes with low institutional constraints on the leader, the economic benefits from investment or the costs of missed opportunities accrue *directly* to the leader and his/her narrow winning coalition, often made up of immediate family and close friends. Due to a virtual lack of separation between the economic and the political elites in authoritarian regimes, the national economic interests in such regimes directly affect the profit margins of the ruling elites. The size of the leader's winning coalition, therefore, is inversely related to the amount of direct benefits from international investment or the costs of forgone opportunities.

Moreover, as the number of interests and veto players within the state increases, the leader's ability to change policies decreases. This implies that the incentives affecting lead-

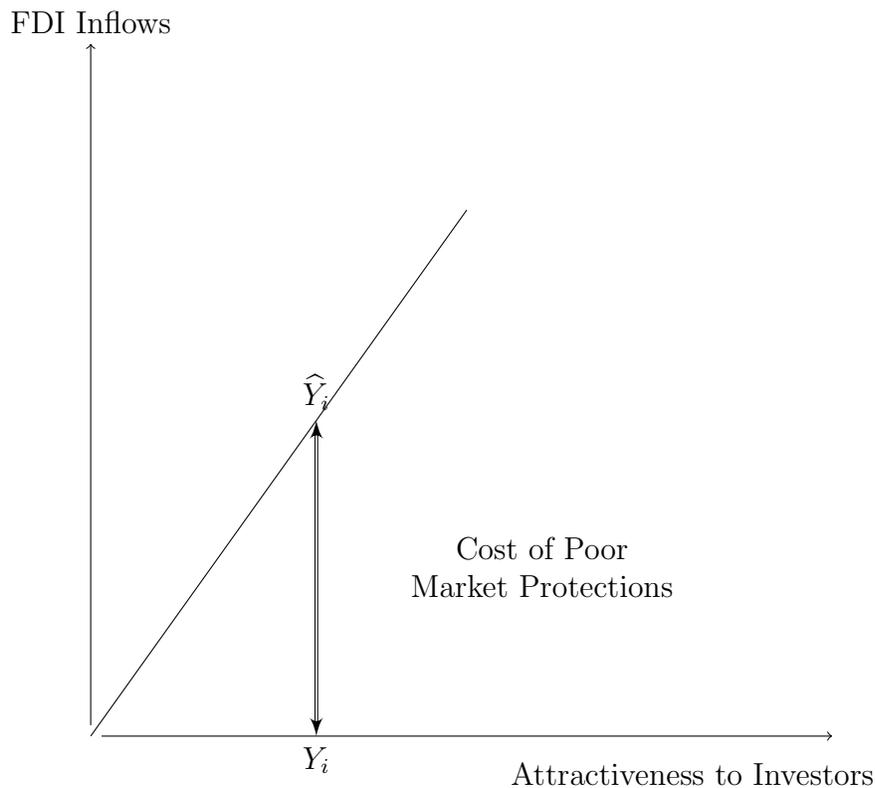
ers will matter much less, and status quo policies become more likely. Thus, we suggest an interactive effect: *increases in the amount of money lost by the state due to poor economic policies at home should encourage liberalization, though that effect is conditioned by government type or the number of veto players in the state.* We test this argument in the remainder of the paper.

## Measuring Lost Investment

We estimate the amount of lost investment due to poor domestic policies by using an opportunity cost measure that was introduced by Gibler (2008). For each observation in the data, we first estimate the *observed* amount of foreign direct investment, given the current level of market protections and conditional on several factors previously shown to affect investment. We then compare this amount to the *expected* amount of investment if each state were to liberalize. We treat the difference between these amounts as the expected lost investment due to poor domestic economic policies. As this difference increases for a country, there should be strong incentives for that country's leaders to change their policies, all else equal. This measure is visualized in Figure 1.

A state's ability to attract investment depends on its resource endowment, the characteristics of its domestic economy (e.g., market size, stability, openness), and the broader international economic conditions (e.g., globalization). The relationship between these characteristics and the expected amount of investment is represented by the positive slope of the function, depicted in Figure 1. Poor levels of property protections, however, may depress the actual amount of investment that a state is able to attract. Therefore, the difference between the expected amount of investment,  $\widehat{Y}_i$  and the actual amount,  $Y_i$ , is the opportunity cost in lost investment that result from poor property protections, controlling for other factors. If leaders respond to economic incentives, large differences between expected and actual levels

Figure 1: Measuring Lost FDI as the Opportunity Cost of Poor Market Protections



of investment should encourage domestic liberalization.

Table 1 presents the models we used to estimate the amount of lost FDI as a function of domestic market protections. Our dependent variable for these estimates is the net FDI inflow to the country, in billions of constant 2005 \$US (logged) (World Bank 2016). Our primary independent variable is our proxy for strong property rights which is a measure of judicial independence that was developed by Linzer and Staton (2012). This measure of judicial independence is a Bayesian average of the existing measures of rule of law and judicial independence, including data from Henisz (2000), CIRI (Cingranelli and Richards 2010), and Tate and Keith (2007). It is a fitting proxy for property rights because it correlates highly with the ability of property owners to defend themselves against government extraction at their expense; judicial independence also correlates highly with contract strength, which is

a key component of property protection.<sup>2</sup>

Our control variables include standard identifiers of cross-country political and economic variation (e.g., Li and Resnick 2003). We measure regime type using the 21-point measure of Polity IV (Marshall and Jaggers 2014); higher values on the polity scale are associated with more democratic political systems. We also control for whether there was a regime change within the state in any given year. We code regime change as a binary variable that is positive if a country experienced any change in its polity score within the last three years. We examine the level of instability in the state with the natural log of the total number of domestic assassinations, strikes, guerrilla attacks, government crises, purges, riots, revolutions, and anti-government demonstrations in each year (Banks 2015). Our economic indicators include several measures from the World Development Indicators dataset (World Bank 2016), including GDP (market size), the GDP per capita (economic development), economic growth, total international trade, and the level of world foreign direct investment (FDI). We also include data on resource rents for the country, which is the logged total of mineral, oil, and natural gas receipts. We control for financial openness with data from Chinn and Ito (2008), and we coded OECD membership using information provided by [www.oecd.org](http://www.oecd.org). All continuous economic variables are logged to account for skewness, and all independent variables are lagged one year.

Models 1 and 2 of Table 1 present our estimates of the effect of poor property protections on FDI after controlling for the political-economic environment of the state. We use both OLS regression and an OLS regression with country-specific fixed effects (FE), respectively. While the coefficient on *Property Protections* is positive and statistically significant in Model 1, the effect is suppressed by the inclusion of fixed effects in Model 2, which is an

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<sup>2</sup>The measure itself also has some beneficial properties when compared to other property protection measures. The averaging overcomes the temporal dependence associated with numerous measures, the boundedness in the latent quantity, substantial missingness across datasets, and measurement error among observable indicators (see Fariss 2014; Linzer and Staton 2012; Ríos-Figueroa and Staton 2012).

Table 1: The Effect of Market Protections on FDI

	OLS	FE OLS	FEVD OLS
Property Protections	0.059*** (0.012)	0.012 (0.017)	0.038*** (0.008)
Polity	-0.003*** (0.001)	-0.002*** (0.001)	-0.002*** (0.001)
Regime Change	0.002 (0.004)	0.005 (0.003)	-0.001 (0.003)
Domestic Instability	-0.003 (0.002)	-0.004*** (0.002)	-0.004*** (0.001)
Economic Development (GDP/cap)	-0.014*** (0.002)	0.164*** (0.010)	-0.014*** (0.001)
Market Size (GDP)	0.011*** (0.003)	-0.163*** (0.010)	0.011*** (0.002)
Economic Growth	-0.001 (0.001)	-0.001* (0.001)	-0.001 (0.001)
Financial Openness	0.007*** (0.001)	-0.004*** (0.001)	0.007*** (0.001)
Trade	0.018*** (0.003)	0.032*** (0.005)	0.018*** (0.002)
Resource Rents	-0.007*** (0.001)	-0.007*** (0.002)	-0.006*** (0.001)
World FDI	0.044*** (0.003)	0.112*** (0.005)	0.042*** (0.002)
OECD Member	0.044*** (0.006)	0.033** (0.013)	0.048*** (0.004)
Constant	0.723*** (0.030)	2.946*** (0.148)	0.744*** (0.021)
Group Effect			1.017*** (0.014)
$\sigma_u$	0.26		
$\sigma_e$	0.07		
$R^2$	0.37	0.72	0.72
N	4324	4324	4204

Note: \* p<0.1, \*\* p<0.05, \*\*\* p<0.01

Model 1 is estimated using an OLS, Model 2 is estimated using on OLS with country random effects, Model 3 is estimated using an OLS with fixed effects vector decomposition and bootstrapped standard errors. All variables are lagged 1 year.

indication of time-invariance in the market protections measure.<sup>3</sup> Given this, we re-estimate our model using an OLS with FE vector decomposition (FEVD) (Plümper and Troeger 2007, 2011). While country-level FEs or country dummy variables are often the best way to account for unobserved country-specific causes of the dependent variable, their inclusion necessarily suppresses the effects of time-invariant variables—the covariates with little of no within-country variation (Wooldridge 2001; Hsiao 2014). The intuition behind the FEVD approach is to parse the effects of the time-invariant variable (market protections) from the country dummy (country fixed effect): in attribution of the explained variance, the theoretically relevant variable takes preference over the country-dummy, i.e. if there is an amount of variation that is explained by both, it gets credited to the former. This is achieved by, first, regressing only the de-meaned time-invariant covariates on the dependent variable and, then, substituting the residuals for the country dummies in the full model (Plümper and Troeger 2007, 2011). Finally, the standard errors in the full model are bootstrapped to allow for uncertainty in the estimates (Plümper and Troeger 2011).

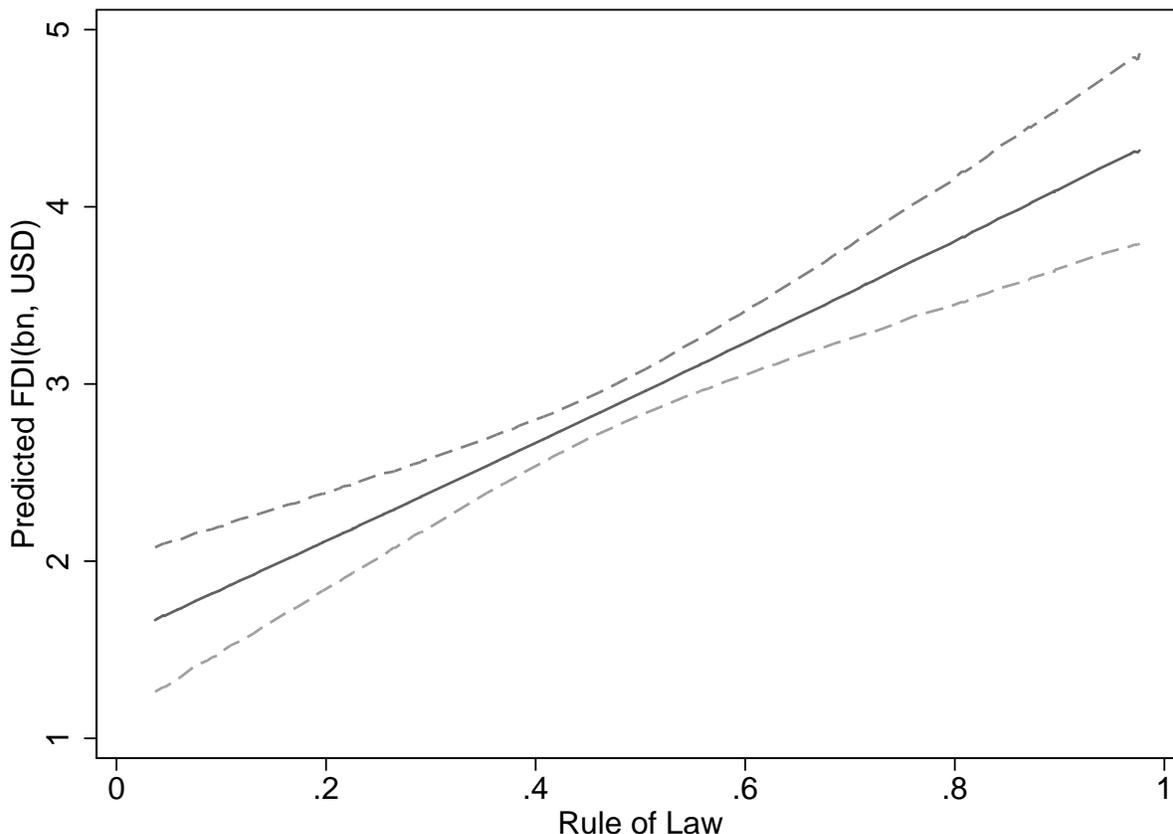
We present the OLS with FEVD model in the third column of Table 1. In this corrected model, property protections are again a statistically significant predictor of investment, and this is true after controlling for the effects of regime type and domestic instability, both of which are linked to moderate decreases in overall investment. OECD membership, market size, financial openness, international trade, and the level of world FDI all predict increases in the level of investment for the state. Resource rents and growth are correlated with less investment in the corrected model.

Figure 2 presents a visualization of the expected effect of property protections on the actual amount of FDI (the inverse log of the dependent variable), calculated based on Model 3 of Table 1. All else equal, a move from few or no property protections to a high level of property protections is associated with approximately \$3 billion more FDI—a sizable amount

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<sup>3</sup>We confirm this by country, see Figure A6 in Appendix for a visualization.

Figure 2: The Effect of Market Protections on FDI



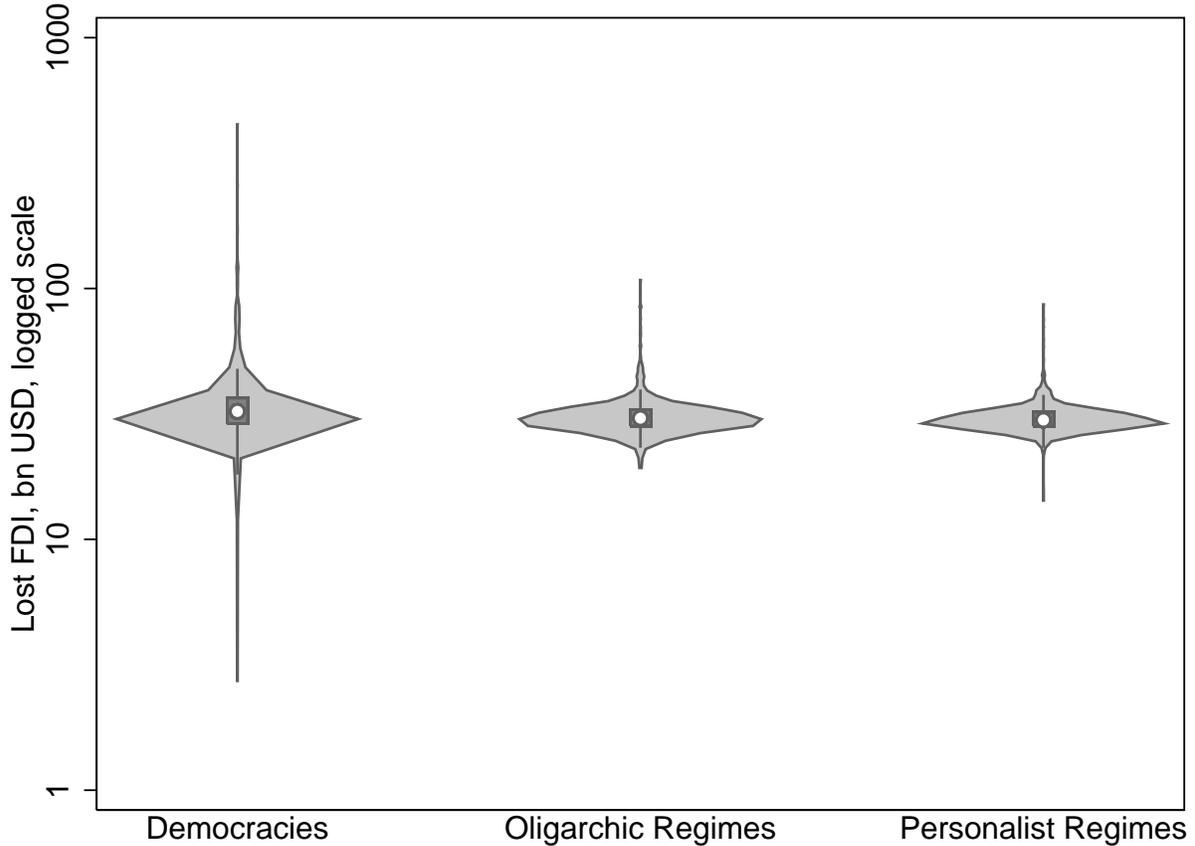
*Notes:* Predicted values were generated using estimates for Table 1 Model 3, varying *Market protections* from 0 to 1, while holding all other variables at their mean values. Dashed lines give 90% confidence interval.

given the sample mean of FDI inflows of \$4.8 billion and a median of \$0.25 billion.<sup>4</sup>

The estimated amount of FDI lost as a result of poor market protections are summarized via violin plots in Figure 3. Violin plots are a useful visualization tools as they convey the information regarding the median and the inter-quartile range (via a boxplot) with the information on the tails of the distribution (overlapping kernel density estimates) (Hintze and Nelson 1998). According to our estimates, all else equal, poor market protections lead to

<sup>4</sup>As expected, the distribution of the *FDI* variable is highly skewed, with most countries in the data attracting little or no net FDI or even losing FDI (negative net inflows). Most of world FDI flows to a just a handful of the developed countries (Alfaro, Kalemli-Ozcan, and Volosovych 2008). While the variable ranges from  $-25$  to  $637$ , ninety-five percent of the state-year observations attract less than \$21 billion.

Figure 3: Estimated Loss in FDI Due to Poor Market Protections, by Regime Type



*Notes:* Lost FDI is estimated as the difference between potential and actual net FDI inflows, where potential FDI is estimated by increasing a country’s market protections to it maximum of 1, while holding all other variables at their actual values. Box plots and kernel density distributions show the variable’s distribution for each regime type.

an average loss of \$33 billion (sd=\$13 billion) in any given country year. The average amount of lost monies does not depend on domestic regime type, although democracies exhibit more variation than either oligarchic or personalist regimes, as indicated by the differences in the length of the tails of each distribution.<sup>5</sup> Regardless, a lack of heterogeneity across regime type implies that we suffer no selection effect as a result of some regime types selecting out

<sup>5</sup>We define regime type consistently with several previous studies. Democracies are country-years with Polity IV scores greater than 6, and all other countries are coded as either *Oligarchic* regimes or *Personalist* regimes. We differentiate among non-democracies based on the *Executive Constraints* component of Polity IV: oligarchies have more executive constraints, scoring three or more on the Polity IV component, and personalist regimes score only 1 or 2 (see Chyzh 2014; Lai and Slater 2006; Weeks 2014).

of the sample of states that lose money as a result of poor market protections. In particular, this helps address a possible critique that democracies may not respond to the same economic incentives, because they are already able to attract higher levels of FDI. Contrary to this critique, Figure 3 demonstrates that, on average, democracies lose as much in lost FDI as either personalist or oligarchic autocracies. This is an important point for our next set of analyses.

## The Decision to Improve Domestic Property Protections

We now have an estimate of the monies lost to each state because of poor property protections, and we use this measure to determine how sensitive leaders are to these lost monies. To assess this we create a dependent variable that measures the change in property protections per state-year, which is the difference between *Property Protections* in years  $t$  and  $t - 1$ . If leaders are sensitive to lost monies, then large values of our estimated opportunity cost should induce changes in domestic property protections. Again, though, we expect differences across regime type. Either democratic leaders are more likely to pursue public goods like property protections, or non-democratic leaders will be better able to respond to their interests. We embed this analysis in a standard model of predictors commonly associated with domestic legal institutions (Chyzh 2016b).

The results of this analysis, estimated using an OLS regression with country-level random effects, are presented in Table 2. Since the primary variables of interest are interactive, we supplement the main table with Figures 4 and 5 that show the marginal effects for each regime type for different levels of lost FDI. Consistent with our theoretical predictions, our results demonstrate that a leader's ability and/or willingness to respond to lost economic opportunities, at least in the short term, is strongly conditioned by domestic institutions. According to Figure 4, the effect of lost FDI is strongest for personalist regimes, followed

Table 2: The Effect of Lost FDI on Change in Property Protections (1972-2008)

Lost FDI*Oligarch	0.055***(0.013)
Lost FDI*Personalist	0.070***(0.016)
Lost FDI	-0.018***(0.005)
Oligarch	-0.072***(0.018)
Personalist	-0.087***(0.022)
FDI	-0.002 (0.003)
Foreign Aid	-0.001** (0.001)
Regime Change	0.008***(0.001)
Civil War	-0.005***(0.001)
International War	0.002 (0.003)
British Colony	-0.002* (0.001)
Trade	-0.004***(0.001)
Economic Growth	0.001 (0.001)
Economic Development (GDP/cap)	0.002** (0.001)
Market Size (GDP)	0.003***(0.001)
Constant	0.057***(0.011)
$\sigma_u$	0.004
$\sigma_e$	0.016
N	3664

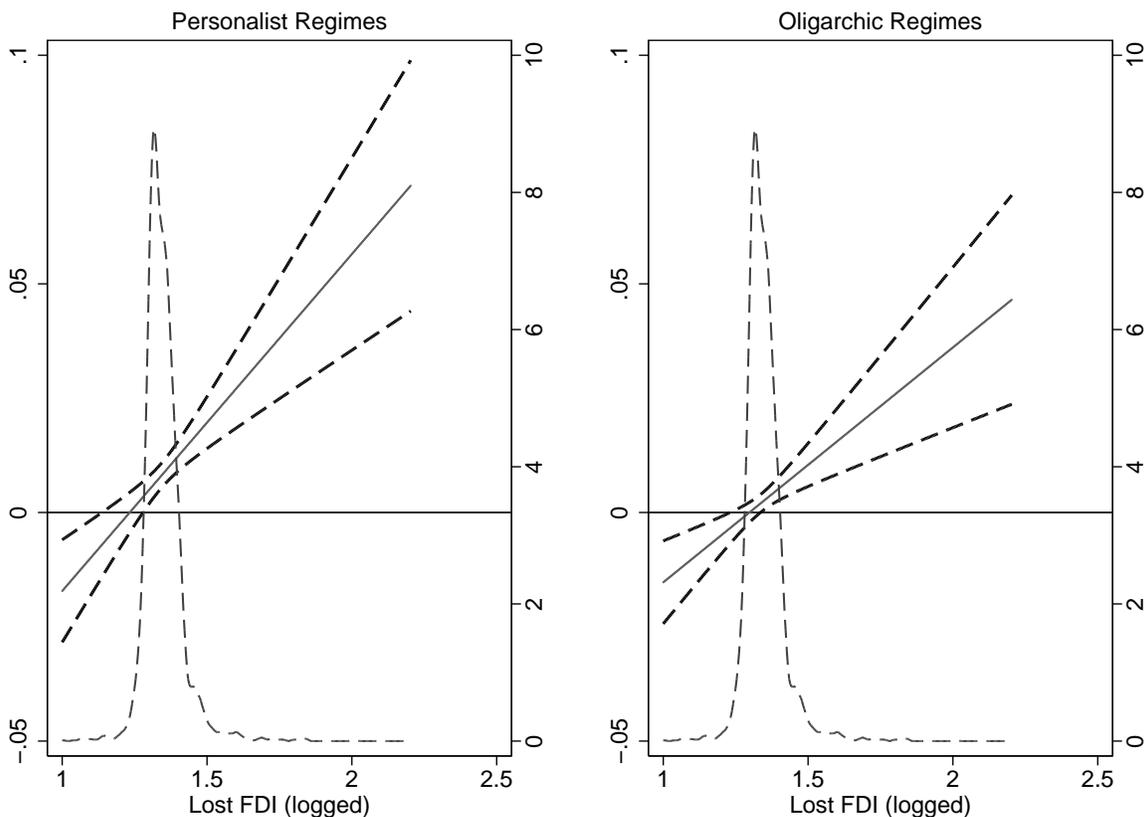
Note: \* p<0.1, \*\* p<0.05, \*\*\* p<0.01

Results are estimated using a random effects regression. Democracy is the reference category for the interactions. All variables are lagged 1 year.

closely by oligarchic regimes. These leaders are less constrained by their domestic institutions, and these results are consistent with the argument that the lack of constraints allow them to adapt to international economic incentives and improve their property-protecting institutions. In contrast, Figure 5 demonstrates that the marginal effect of *Democracy* is negative and decreasing with the amount of *Lost FDI*. This supports our argument that leaders of democracies are less flexible and may be unable to quickly adapt to the international economic pressures.

The model presented in Table 2 suggests that non-democracies are generally unlikely to encourage property protection in the state. When *Lost FDI* (and hence the effect of the interaction terms) is equal to 0, the effects of both *Personalist* and *Oligarchic* regimes are

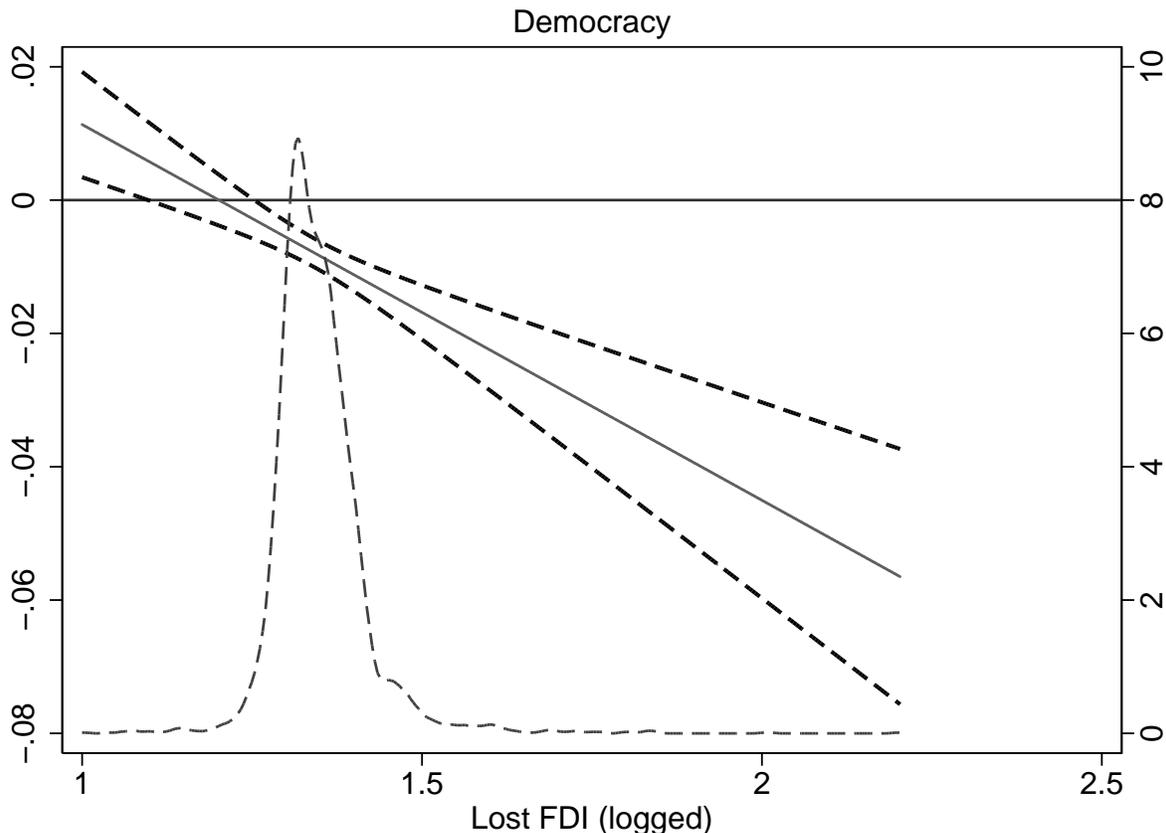
Figure 4: Marginal Effect of Autocracy Type on Change in Market Protections, by Lost FDI



Notes: The reference category is democracy. Dashed lines give 95% confidence interval.

negative and statistically significant. The qualifier of this effect is, of course, the amount of FDI that is lost by the state as a result of poor property protections. These findings have implications for the temporal sequence of economic and political liberalization. We find no added benefit of democracy on the likelihood of increased liberalization. Instead, consistent with traditional arguments (e.g., Olson 1982), we find that democracies may respond to parochial interests and fail to respond to the international market demands for property protections.

Figure 5: Marginal Effect of Democracy on Change in Market Protections, by Lost FDI



*Notes:* The reference category is all autocracies. Dashed lines give 95% confidence interval.

## Conclusion

Our theoretical model and results contribute to the broader literature on development and economic liberalization by explaining a number of known empirical patterns, such as the tendency of economic liberalization to take temporal precedence over political democratization, or larger fluctuations in economic performance, characteristic to authoritarian regimes. Our research also speaks to the literature on economic sanctions, such as the leader-specific punishment argument. Finally, our results help explain a number of crucial empirical cases, such as economic growth and liberalization in South East Asia that is frequently credited to

the high levels of power concentration during the periods with initial increases in economic growth.

Our study contributes to the theoretical debate on the sequencing between democratization and economic liberalization (cf. Carothers 2007; Mansfield and Snyder 2007). Highlighting a central weakness in the arguments that authoritarian institutions may be conducive to economic growth, we identify an important necessary condition for such a relationship—a presence of strong economic incentive. We demonstrate, specifically, that while power concentration may facilitate the development of property protecting institutions (e.g., by putting few constraints on leader’s decision-making), authoritarian leaders rarely liberalize their domestic institutions out of the kindness of their heart, but respond to obvious economic incentives, such as forgone amounts of FDI. Our research also points to a weakness in the opposite argument, that emphasizes that economic liberalization may be facilitated by the presence of democratic institutions. Our results suggest, in particular, that democratic constraints may slow down or impede a leader’s ability to respond to market’s incentives, such as lost economic opportunities.

Our results also highlight the important drawbacks of authoritarian institutions, whose lack of constraints and the resulting responsiveness to the international market is known to lead to a greater amount of fluctuation in domestic economic policies, economic performance, and stability. Regimes that lack domestic institutions to moderate their responsiveness to international market incentives, such as Russia or Iran, are known to go through frequent cycles of economic prosperity and decline, which undermine the domestic population’s support for the government.

Our research also highlights the advantages of economic engagement with target regimes and possible flaws in the leader-specific punishment arguments (McGillivray and Smith 2008). If, as we argue, nondemocratic leaders liberalize in response to economic losses incurred by a winning coalition that is made up of family and close friends, economic sanc-

tions targeted at the winning coalition will remove the leader's incentive to liberalize. Since economic liberalization necessitates cooperation from the political elites, by conditioning economic incentives on the removal of the leader in power, the international community may be effectively removing the very condition for sanctions' success—incentives for cooperation by the political elites. The policy of leader-specific punishment, in other words, may be counterproductive for the goal of economic liberalization. If leader removal or regime change are the primary goals, then the international community must still recognize the weaknesses of the leader-specific economic sanctions, highlighted by this research.

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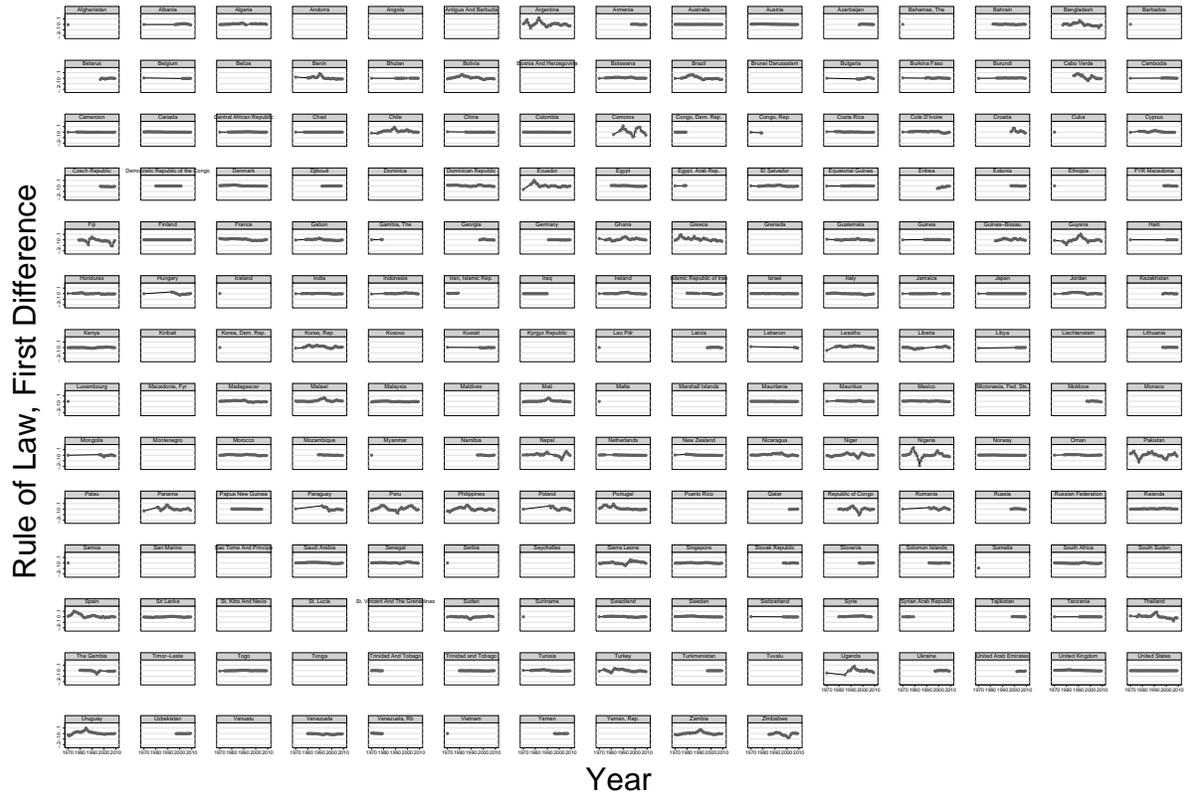
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# Appendix

Figure A6: Temporal Change in Market Protections, by Country



Graphs by Country