
Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries

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Increasing economic globalization and the diffusion of political democracy are arguably the two most important characteristics of contemporary international political economy. As a salient dimension of globalization, foreign direct investment (FDI) inflows have grown faster than world income since the 1960s, multinational enterprises (MNEs) now account for about 70 percent of world trade, and the sales of their foreign affiliates have exceeded total global exports.¹ Foreign production capital has dispersed to almost all developing countries since the 1980s, and the number of foreign affiliates located in developing economies has reached 129,771, compared with 93,628 in the developed world.² Paralleling this economic structural change is the spread of liberal or representative democracy. A growing number of less-developed countries (LDCs) have experienced increased political participation, open competition for elected office, and expanding civil society. The proportion of democratic and partially democratic countries rose from about 31 percent in 1975 to about 73 percent in 1995.³

The flood of FDI and the diffusion of democratic governance have come to an inevitable encounter. While the effect of FDI on democracy has long attracted both scholarly attention and public interest,⁴ the effect of democracy on FDI is surprisingly understudied and poorly understood. Explaining the effect of democratic institutions on FDI, however, has clear significance for both theory and policy. Many

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1. Held et al. 1999.

2. *Ibid.*, 245.

3. *Ibid.*, 47.

4. Some examples of empirical examinations include Bornschier, Chase-Dunn, and Rubinson 1978; Jackman 1982; de Soysa and Oneal 1999; Li and Reuveny forthcoming; and Quinn 2000.

countries that are democratizing also happen to be developing economies pursuing foreign capital. If democratic governance hurts a country's attractiveness to foreign investors, the developing country faces a trade-off between competing for limited FDI and democratization. If, on the other hand, deepening democratic governance enhances a country's ability to attract FDI, then democratization helps to deliver the economic benefits from foreign capital. The stakes for leaders in the LDCs are high given the potential consequences. Theoretically, the lack of an adequate explanation for the effect of democracy on FDI suggests an important gap in how scholars explain interactions between economic globalization and political democracy. In this article, we set out to fill this gap by focusing on the causality from democratic institutions to FDI inflows. More specifically, does increased democracy lead to more FDI inflows to LDCs?

Previous theoretical work, while providing a broad framework for our question, suggests conflicting answers. Olson argues that in well-established democracies, independent judiciaries and electoral challenges help to guarantee property rights, ensuring that investments are secure for the long haul.⁵ Investors favor such regimes because their assets are shielded from predatory banditry by dictators. Following this argument, one concludes that higher levels of democracy should be associated with more FDI inflows. O'Donnell presents a contrasting view, arguing that investors and autocrats often share a cozy relationship.⁶ Because of political leaders' interest in the economic benefits of FDI, the autocrats shield foreign capital from popular pressure for higher wages, stronger labor protection, or less capital-friendly taxation. Olson and O'Donnell each suggest plausible yet contradictory answers to the democracy-FDI relationship. Olson tells us that property rights make stable democracies fertile territory for investment; O'Donnell illustrates how investor-state collusion favors foreign capital in highly autocratic countries.

Other scholars offer similarly contrasting arguments. Because democracy receives broad domestic support, avoids irregular political changes, and institutionalizes income redistribution, democratic developing countries have fewer property rights violations and more private investment.⁷ In contrast, Haggard argues that authoritarian rule may be attractive to investors in countries with traditions of "strong pressure from labor or the left to their economic viability or basic property rights."⁸ Autocrats, in some contexts, may also protect property rights rather than practicing banditry, even though they can be quite effective at banditry. In addition, authoritarian regimes "give political elites autonomy from distributionist pressures," allowing a broader range of economic policy options.⁹ An alliance of the state, local, and multinational capital is likely in autocratic countries where their leaders prefer repression to increased pluralism out of fear of diluted control.¹⁰

5. Olson 1993.

6. O'Donnell 1978 and 1988.

7. Feng 2001; Pastor and Hilt 1993; and Pastor and Sung 1995.

8. Haggard 1990, 258.

9. *Ibid.*, 262.

10. Evans 1979, 49.

While Olson, O'Donnell and others offer useful insights about the expected effect of democratic institutions on FDI inflows to the developing countries, they disagree on the direction of the effect. In this article, we offer a theoretical synthesis and extension. Basing our theory on the logic of why firms invest abroad, we argue that democratic institutions have conflicting effects on FDI inflows. On one hand, democratic institutions hinder FDI inflows through three avenues. First, democratic constraints over elected politicians tend to weaken the oligopolistic or monopolistic positions of MNEs. Second, these constraints further prevent host governments from offering generous financial and fiscal incentives to foreign investors. Third, broad access to elected officials and wide political participation offer institutionalized avenues through which indigenous businesses can seek protection. In each case, the increased pluralism ensured by democratic institutions generates policy outcomes that reduce the MNE's degree of freedom in the host developing country. On the other hand, democratic institutions promote FDI inflows by strengthening property rights protection. The representation of the interests of common citizens in the legislature prevents the state from predatory rent seeking. Constraints over elected politicians further guarantee contract enforcement for businesses. These effects generate credible property rights protection, reducing risks for foreign investors and encouraging foreign investment. Hence, the net effect of democratic institutions on FDI inflows to the developing countries is contingent on the relative strength of these two competing forces.¹¹

Existing empirical work rarely explores the effect of democracy on FDI. Oneal stands out as the first quantitative study of how regime characteristics affect FDI.¹² He examines whether foreign firms invest more and collect more profit in authoritarian countries than in democracies. He finds that the relationship between regime type and FDI flows is not statistically significant, and that returns on investment are best in developed democracies but greater in authoritarian countries among LDCs. While Oneal addresses democracy-FDI connections, he does not consider the competing effects of democracy. In addition, he focuses on FDI from the United States to LDCs dyadically and covers a different time frame.¹³

11. Looking at a different dependent variable (borrowing in the international capital market), Sobel also examines the effects of property rights institutions (the regulatory state) and democracy (the participatory state). He finds that the regulatory state affects international borrowing significantly while the participatory state affects such borrowing subtly. Borrowers from more democratic developing countries can borrow more than their less democratic peers, but this relationship does not hold where the regulatory state is weak and corrupt. While our arguments are similar, FDI and international borrowing are different phenomena, driven by different causal logics. Sobel 1999.

12. Oneal 1994.

13. Several authors consider the effects of other political factors on FDI. Chan and Mason find that country size, level of industrialization, alignment with the United States, and strength of central government increase FDI inflows. Jun and Singh find that industrial disputes reduce FDI. Enders and Sandler find that terrorism reduces FDI in Spain and Greece from 1968 to 1991. Crenshaw finds that growth and over-urbanization are associated with increased FDI penetration, arguing that the level of FDI can be explained without reference to political factors. Schneider and Frey find that political instability decreases FDI flows but other political factors, including government ideology, are insignificant. Chan and Mason 1992; Jun and Singh 1996; Enders and Sandler 1996; Crenshaw 1991; and Schneider and Frey 1985.

Resnick analyzes how democratic transition affects FDI, though he does not consider the role of property rights independent of democratic institutions. He finds that transition to democracy has a statistically significant negative effect on FDI.¹⁴

Our theory identifies the causal avenues through which democratic institutions promote or hinder FDI inflows. We assess quantitatively both the positive and negative effects of democratic institutions on FDI inflows with empirical tests covering fifty-three developing countries from 1982 to 1995. We find that both property rights protection and democracy-related property rights protection encourage FDI inflows while democratic institutions improve private property rights protection. After controlling for the positive effect of democracy via property rights protection, democratic institutions reduce FDI inflows. These results support our theoretical claims and are robust against alternative model specifications, statistical estimators, and variable measurements.

The article proceeds as follows. We first elaborate our theory on the effects of democratic institutions on FDI inflows. Next, we discuss the research design and the results of our empirical analyses. We conclude with a discussion of implications of our findings.

A Theory on How Democratic Institutions Affect FDI Inflows

Our theory on the effects of democratic institutions on FDI inflows is based on the logic of why firms invest abroad. As shown below, the level of FDI inflows hinges on the interactions between MNEs and host countries. By affecting these interactions, democratic institutions encourage or deter foreign direct investors.

Why Do Firms Invest Abroad?

As widely accepted, FDI implies that a multinational enterprise organizes production of goods and services in more than one country, involving the transfer of assets or intermediate products within the investing enterprise and without any change in ownership. It involves additional costs of setting up and operating factories in foreign lands. Given the disadvantages of operating overseas, why do some firms locate their production abroad instead of at home? Why do they own foreign production facilities instead of serving the intended market with such alternative means as trade or licensing? Why do they invest in one country instead of another? The logic of international production behind these questions holds the answer to how political institutions affect FDI inflows to the developing countries. Our discussion draws heavily from John Dunning's eclectic paradigm of international production,¹⁵ which encompasses various competing explanations,

14. Resnick 2001.

15. Dunning 1988 and 1993.

including those based on the industrial organization approach,¹⁶ transaction cost economics,¹⁷ and trade and location theory.¹⁸

Dunning explains that international production is motivated by three sets of advantages perceived by firms.¹⁹ The first set is a firm's ownership-specific advantages. These include its ownership of intangible assets and common governance of cross-border production. Some examples of intangible assets are product innovations, management practices, marketing techniques, and brand names. Diversification across borders allows a firm to exploit economies of scale and to develop monopoly power based on its size and established position. The foreign investor's ownership-specific advantages are sensitive to property rights protection in the host country. In other words, an MNE's success is tied to the security of its intellectual and physical property in multiple countries.

The second set of advantages concerns the firm's internalization advantages deriving from its hierarchical control of cross-border production. Internalization refers to a firm's direct control over its value-added activities in multiple countries, as opposed to outsourcing, trade, or licensing. The size of a firm's internalization advantages correlates with the degree of transnational market failure. For example, where the risks of opportunism by foreign buyers and sellers are high, such as disrupting supplies and violating property rights in primary product and high technology industries, the firm has an incentive to claim hierarchical control of cross-border production.²⁰ Where economic rents from exploiting oligopolistic or monopolistic market structures or large-scale production are high, the firm is also likely to exert hierarchical control of transnational production. The greater the internalization advantages, the more likely a firm is to pursue international production—hierarchical control of its assets, instead of trading or leasing. The exploitation of these advantages is affected by the antitrust or competition-oriented regulation in the host country.

The third set of advantages refers to the location-specific advantages perceived by firms or the characteristics of host countries in terms of their economic environment or government policies. They may include scarce natural resources, abundant labor, high economic development, or favorable macroeconomic, microeconomic, and FDI-specific government policies. For instance, oil companies have to produce overseas where required resources are available. Export-processing firms typically shift production based on labor cost. Firms also consider government policies on tariffs, domestic corporate taxation, investment or tax regulation of foreign firms, profit repatriation or transfer pricing, royalties on extracted

16. For example, Hymer 1976; and Caves 1971.

17. For example, Rugman 1981; and Teece 1981.

18. Vernon 1966. See also Dunning 1988 and 1993; and Caves 1996 for reviews of the literature on international production.

19. Dunning 1988 and 1993.

20. For example, metals firms are often MNEs. They centralize the management of different steps of production (mining, smelting, and milling) to avoid the risk of being held hostage by a supplier to whom they have outsourced an aspect of production.

natural resources, antitrust regulation, technology transfer requirements, intellectual property protections, and labor market regulation.

In the context of our analysis, the connection between politics and FDI inflows hinges on the interaction between host governments and MNEs. Firms select investment sites based on how well their ownership-specific and internalization advantages mesh with location-specific benefits.²¹ Host government policies create location-specific conditions that affect how well a firm can exploit its advantages.

The logic of international production discussed above suggests the following implications that set the stage for our analysis of the effects of democratic institutions on FDI inflows. First, the MNE's ownership-specific and internalization advantages often result from, and are further enhanced by, the oligopolistic or monopolistic market structures. Host government regulatory policies can limit the use of these advantages, particularly through the application of antitrust and other competition-oriented legislation. Second, endowed with the ownership-specific and internalization advantages, the MNE is more competitive than, and often displaces, indigenous firms in the host country. The host government may adopt industrial policy that either protects indigenous businesses from the MNE or favors the MNE. Third, expecting FDI to bring about managerial skills and production technology beneficial to economic growth, the host government may offer foreign investors financial and fiscal incentives. Such incentives not only affect the choice of FDI location, but also strengthen the competitiveness of foreign investors. Finally, the MNE must rely on the host government for protection of its property rights in proprietary assets, without which its ownership-specific advantages would disappear.

These implications depict a contrast between a good and a bad investment climate for MNEs. A good climate is one in which the location-specific advantages existing in the host country facilitate the MNE's exploitation of its ownership-specific and internalization advantages. For example, the host government provides favorable regulation, preferential treatment for MNEs, and sound property rights protection. Conversely, a bad investment climate is one where the conditions in the host country hinder the MNE from exploiting its ownership-specific and internalization advantages. Firms that enjoy monopolistic or oligopolistic positions may shy away from host countries with strong antitrust regulation. MNEs may also balk at weak property rights protection and strong preferences of the host government for domestic firms. Domestic political institutions, because they define the policymaking environment, have significant effects on the quality of the investment climate.

Suppressive Effect of Democratic Institutions on FDI Inflows

The nature of domestic political institutions is defined largely by the relative strength of democratic versus autocratic characteristics of a country's political system. Generally speaking, it depends on the degree to which citizens are able to choose how

21. Dunning 1993, 548–51.

and by whom they are governed. Democratic institutions under a representative democracy or “polyarchy”²² typically include free and fair elections of the executive and legislative offices, the right of citizens to vote and compete for public office, and institutional guarantees for the freedom of association and expression such as an independent judiciary and the absence of censorship.²³ These institutions supply “regular constitutional opportunities for changing the governing officials, and a social mechanism that permits the largest possible part of the population to influence major contenders for political office.”²⁴ Under democratic institutions, politicians have incentives to develop public policies reflecting the popular sentiment.²⁵ Representative democracy also allows various interests to be represented in the legislature, thereby constraining executive power. In addition, the stronger a country’s democratic characteristics, the more likely its social interests are to get organized and participate in political competition. Even in fledgling democracies, the state is subject to a broad spectrum of political interests as it attempts to broker compliance with democratic rules, offering relevant political actors welfare improvements to induce their consent.²⁶ Hence, democratic political processes are characterized by the influence of diverse opinions over electoral and public policymaking outcomes.

In contrast, autocratic characteristics derive from “limited pluralism” as opposed to “almost unlimited pluralism” under a representative democracy.²⁷ They may include government co-optation of civil society leadership or legal limitation of pluralism, a single leader or small ruling clique, and weak political mobilization. Regardless of the methods rulers use to enhance their legitimacy, autocratic politics is biased in favor of narrow elite control over public policy.

Countries exhibit heterogeneity in how and to what extent they conform to democratic or autocratic properties.²⁸ Despite such cross-sectional and temporal heterogeneity, regime characteristics within the democratic or autocratic category tend to correlate with and reinforce each other. For example, free elections are sustainable only if leaders are constrained through some mechanism by the citizenry; free election can effectively reflect the will of the people only if citizens participate actively in political competition. To a great extent, the relative strength of democratic and autocratic characteristics defines the nature of political institutions. The manner in which these competing democratic and autocratic characteristics are manifested in democratic institutions has implications for foreign direct

22. Though not the focus of our analysis, other variants of democracy include democracy based on a one-party model or direct or participatory democracy, where citizens are directly involved in policy-making. Held 1993, 15.

23. Dahl 1971 and 1998.

24. Lipset 1960, 27.

25. Politicians converge to the median voter’s preference in a majoritarian system and to the ideal point of the median voter of popularly elected legislators in a proportional representation system. Huber and Powell 1994.

26. Przeworski 1991, 32.

27. Linz 2000.

28. The development of democracy is not a linear, monotonic process, but is punctuated by reversals and sudden changes. Casper 1995.

investors. Below we suggest three mechanisms through which these institutions hinder FDI inflows.

Effect on MNE exploitation of monopolistic or oligopolistic position. Democratic institutions in host countries attenuate many MNEs' ability to exploit and enhance their monopolistic or oligopolistic positions. As discussed earlier, firms invest abroad to take advantage of their ownership-specific and internalization advantages, advantages that often result from, and further result in, oligopolistic or monopolistic market structures.²⁹ Such large MNEs constitute the bulk of FDI,³⁰ possess enormous market power, and have significantly shaped trade patterns and the location of economic activities in the global economy.³¹ In the host countries, such MNEs seek to create and strengthen their oligopolistic or monopolistic positions that result in higher returns. The associated imperfect market structures, however, lead to less optimal allocation of resources in the host economy than perfection competition. While MNEs consider the pursuit of monopolistic or oligopolistic positions a legitimate corporate strategy for greater returns, their desire to create, maintain and increase their monopoly or oligopoly positions sets them at odds with host country governments, particularly democratic ones.³²

In more democratic host governments, elected politicians presumably encourage and manage inward investment to improve national economic performance, benefit their electoral constituencies, and increase their odds of being reelected. That many MNEs may decrease market competition motivates elected politicians to limit the monopoly or oligopoly positions of the relevant MNEs through public policy. In reaction, the MNEs may seek to bribe and collude with the host government to influence domestic politics of the host country.³³ However, freedom of expression and open media bring about relatively better monitoring of elected politicians and allow the opponents of FDI to access the public policymaking process relatively more easily. Hence, democratic characteristics of the host country collectively constrain the pursuit by many MNEs of monopoly or oligopoly.

Conversely, more autocratic host governments are less likely to clash and more likely to collude with the oligopoly or monopoly-seeking MNEs. By definition, the size of the winning coalition for autocratic leaders is smaller than for democratic leaders because autocratic rulers depend less on broad popular support to stay in power. While such rulers are happy if FDI improves national economic

29. Dunning 1993; and Stopford and Strange 1991, 74.

30. Graham 1996.

31. For example, the hundred largest MNEs control about 20 percent of global foreign assets, employ about 6 million workers and account for about 30 percent of total world sales of all MNEs. Contemporary MNEs further strengthen themselves vis-à-vis the state by collaborating with each other through mergers, acquisitions, and strategic alliances. The number of strategic alliances—cooperative ventures between firms of different countries to undertake research and development—rose from 280 in 1991 to 430 in 1993. United Nations Conference on Trade and Development 1997, 8, 14.

32. Our argument is consistent with the evidence at the aggregate level in Oneal and Oneal that efforts to pursue supernormal profits by British and American MNEs appear thwarted in the developing regions. Oneal and Oneal 1988.

33. Bergsten, Horst, and Moran 1978; and Tarzi 1991.

performance, their primary focus is to generate more revenues for the ruling clique.³⁴ As long as they obtain increased revenues and benefits from foreign capital, these rulers would tolerate the imperfect competition and concentrated market power of oligopolistic or monopolistic foreign firms. Narrow elite control further allows rulers to subdue dissenting voices within or outside of the regime. As a result, the weaker the host country's democratic institutions, the less likely the host government is to limit the monopoly or oligopoly position of the MNEs.

Effect on host country industrial policy. Industrial policy is another arena in which democratic institutions in the host country degrade conditions for MNEs. Because of their ownership-specific and internalization advantages and exposure to international competition, MNEs are typically more competitive than indigenous firms in the developing host country. While inward investment raises competition in the host country and may improve the allocation of resources, foreign firms typically displace local businesses and even compete for loans in the host country.³⁵ Just as with trade, the growing presence of more-competitive foreign firms often turns less-competitive local firms into losers. Local business owners and the unemployed, suffering concentrated losses, are likely to get organized and lobby for protective industrial policy from the government. While MNEs also bring about new jobs and resources, such benefits do not directly go to the displaced capital and workers.

Grievances are likely to be more pronounced in developing countries, where social welfare systems are not well developed and provide limited compensation for displacement.³⁶ Where democratic institutions are strong, the opponents of FDI have multiple avenues to influence public policymaking. Domestic interests that lose out to the MNEs can resort to elections, campaign finance, interest groups, public protests, and media exposure. Under such pressures, the host government is compelled to cushion the blow to domestic losers by subsidizing less competitive indigenous firms, imposing more restrictive entry conditions on MNEs such as joint ownership, limiting the sectors open to foreign capital, or demanding solely foreign financing of initial investments. It also could pose more restrictive operating requirements in terms of local purchases of capital goods and raw materials, local employment, the proportion of output to be exported, and the use of technology.³⁷ These policies reduce the MNE's degree of control over its overseas production and weaken its competitiveness.

34. Olson 1993.

35. Graham and Krugman 1995; and Stopford and Strange 1991.

36. Such societal opposition is discounted and indeterminate if local firms are concerned about foreign retaliation or their own investment entry into foreign countries, as Jonathan Crystal shows to be the case with U.S. firms. In the developing world, however, local firms are not likely to have these concerns and thus are more likely to organize to pursue protection from the host government. Crystal 1998.

37. See Dunning 1993, 559–60 for a review of the host government policies that affect inward investment. Although the latitude available for such policies has diminished in the context of the World Trade Organization (WTO) and other international agreements, an international regime on foreign inward investment is still lacking, and host countries have exhibited great creativity in maintaining benefits for domestic producers.

This is not to say that MNEs in more democratic countries do not have access to host governments, but MNEs' influence is likely to be balanced and diluted by various opposing groups in these countries. Conversely, where democratic institutions are weak and autocratic characteristics are strong, the host government is exposed to pressures of only limited social interests and, as Evans suggests, may resolve the dilemma by forming an alliance of the state, local, and multinational capital.³⁸ Restrictions on political participation further prevent the losing groups from getting organized and affecting the policymaking process.

Effect on fiscal and financial incentives to foreign capital. Democratic institutions also limit the generosity of the fiscal and financial incentives host countries often offer to attract foreign investors, placing more-democratic LDCs at a comparative disadvantage in the hunt for FDI. Inducements are one of many factors affecting the choice of FDI location.³⁹ Examples of such inducements include tax holidays, exemptions from import duties, deductions from social security contributions, accelerated depreciation allowances, investment grants, subsidized loans, donations of land or site facilities, and wage subsidies. During the past two decades, various developing countries, regardless of their regime type, have used these fiscal and financial incentives to lure foreign capital in an increasingly vigorous competition. Even Cuban leader Fidel Castro has joined the bandwagon, remarking, "Who would have thought that we, so doctrinaire, we who fought foreign investment, would one day view foreign investment as an urgent need?"⁴⁰

Democratic politics matters for the design of various incentive programs. Any inducement to foreign capital, such as tax breaks or subsidies, represents a transfer of benefits from domestic taxpayers or firms to foreign investors. As noted earlier, where democratic institutions are strong, domestic players have various ways to pressure elected executives and legislators and influence policymaking. Hence, the host government is limited in its degree of freedom to supply or upgrade such incentives. Compared with more autocratic countries, more democratic host governments have a harder time obtaining the acquiescence of opposing domestic interests to the provision of generous incentives to foreign capital.

Conditions particular to the LDCs also suggest that opposition by domestic interests to generous fiscal and financial incentives is stronger in more democratic host countries than in less democratic ones. FDI stock, inflows, and the associated financial openness tend to increase income inequality.⁴¹ FDI also concentrates in certain sectors, industries, and regions, leading to dual economies and with the backward sectors unlikely to take advantage of the beneficial spillovers from MNEs. Furthermore, as Oman suggests, because fiscal and financial incentives to foreign capital often occur in an insulated, bureaucratic context to facilitate successful

38. Evans 1979.

39. Dunning 1993; and Oman 2000.

40. Quoted in de Soysa and Oneal 1999.

41. Dixon and Boswell 1996; Quinn 1997; and Reuveny and Li forthcoming.

negotiation with foreign investors, the process inherently lacks transparency and accountability and often leads to graft, corruption, and rent seeking.⁴²

In more-democratic countries, critics of FDI have greater access to political participation and hence, are more able to limit the generosity of incentives their governments offer to foreign capital. Regularly held elections, freedom of speech and association, political representation of local interests by legislators—all constitute venues through which executives' and legislatures' policies toward foreign investors can be questioned, criticized, and rejected. As voters evaluate politicians based on their competence and performance in a well-functioning democracy, voters scrutinize and quite possibly oppose overly generous incentives that do not appear to benefit the community at large. Conversely, in more-autocratic countries, social groups suffering adverse effects from FDI may be inhibited by the lack of institutionalized access to "veto" officeholders through election or through other open and regular channels of participation and representation found in democracies.

Positive Effect of Democratic Institutions on FDI Inflows

Democratic institutions in developing host countries also exert a positive effect on FDI inflows. Because democratic institutions lead to legislative representation of a wide range of social interests and facilitate political mobilization of these groups, government encroachment on private property rights is minimized. Such property rights protection is extended to MNEs, reducing risks for foreign investors and encouraging FDI inflows.

Property rights protection and FDI. North defines property rights as "the rights individuals appropriate over their own labor and the goods and services they possess. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behavior—that is, the institutional framework."⁴³ Take, for example, an MNE that owns a bicycle factory in a foreign country and sells its bicycles to retail outlets in the host or home country. The host government recognizes the firm's ownership of tangible and intellectual property through legal title and protects it from a variety of threats including theft or trespass. The government also recognizes contracts between the factory and the retailers as legally binding, intervening to protect the rights of both parties through administrative or judicial action in cases of contract violation. Without having these rights secured, the foreign business is unlikely to invest in a host country. In general, foreign direct investors face several types of threats to their property that the host government can mitigate or exacerbate.

Expropriation, which causes investors to lose their sunken assets, falls at the extreme of the spectrum. Though the likelihood of expropriation declined significantly by the early 1980s,⁴⁴ theft of intellectual property is perhaps the most prev-

42. Oman 2000.

43. North 1990, 33.

44. Kobrin 1984.

alent form of seizure in the contemporary world, with entertainment, software, pharmaceutical, and publishing firms facing significant losses. Foreign investors also worry about contract enforcement. While foreign investors could request state assistance to enforce contracts in countries lacking independent judiciaries, most firms would prefer to operate in a more transparent legal system. Government corruption in a country also hinders FDI inflows. While some MNEs offer side payments to government officials to avoid costly government regulation or to obtain preferential treatment, rent-seeking behaviors by government officials impose costs of unpredictable magnitude on firms, undermining not just their ability to budget or account for costs, but also the rule of law.

Expropriation, seizures of assets, contract repudiation, ineffective rule of law, and government corruption all constitute violations of property rights that deter foreign direct investors. Conversely, the expectations of long-term asset security, regulatory stability and transparency, and institutionalized legal process imply less uncertainty and lower risks for foreign businesses. Better property rights protection should encourage more FDI inflows.

Regime type and property rights protection. Democratic institutions are on average more effective at securing private property rights than autocratic institutions. Typically, the state offers to protect the property rights of firms and individuals in exchange for their tax payments. The state monopoly on coercive power that makes property rights protection possible, however, simultaneously endangers the credibility of the state in the eyes of private agents, rendering the state's *ex post* compliance questionable.⁴⁵ Why should the state follow through on its promise to respect or protect assets when no other domestic actor has access to the use of force?⁴⁶ Protection by the state is not self-enforcing in that the state has an incentive not to abide by the agreement *ex post* under various contingencies (for example, war).⁴⁷ Therefore, the provision of effective property rights protection relies on a constrained state—a state with a transparent, codified legal structure and institutionalized access to enforcement mechanisms.

Olson and others argue that more democratic governments offer better protection of private property rights.⁴⁸ North and Weingast show how England's commitment to secure private rights became credible, as the British Parliament gained greater control vis-à-vis the Crown over fiscal policy (borrowing and taxation) and legislative and judicial power. "Increasing the number of veto players implied that a larger set of constituencies could protect themselves against political assault, thus markedly reducing the circumstances under which opportunistic behavior by the government could take place."⁴⁹ In addition, because the diversity of interests in

45. Olson 1993 and 2000; and North and Weingast 1989.

46. Concern for reputation and the shadow of the future are not sufficient to guarantee compliance by the state, as the latter may renege under various contingencies. North and Weingast 1989.

47. *Ibid.*

48. Olson 1993 and 2000; Bates 2001; and North and Weingast 1989.

49. *Ibid.*

the legislature and a politically independent judiciary raised the cost of supplying private benefits, the Parliament did not elapse into another rent-seeking Crown. It is the representative institutions that make the property rights institutions credible.⁵⁰

Similarly, Robert Bates argues that from the earliest agrarian society to the current post-Cold War era, the individual willingness to invest is contingent on whether the specialists in violence in charge of the state employ coercion not to seize private wealth but to protect its creation.⁵¹ The productive use of coercion is made possible because the state delegates power to entrepreneurs and businesspeople to form economic organizations and oversee the use of force.

While stable autocracies with a long-time horizon, like the stationary bandit, also may offer secure property rights,⁵² their credibility is weakened by the fact that their leaders are accountable merely to the ruling elite and exercise power out of their own volition. New democracies may do a poor job protecting private property, as new regimes often violate preexisting property rights to secure popular support.⁵³ The establishment of democracy, particularly the conduct of an election itself, does not necessarily lead to secure property rights.⁵⁴ Where democratic institutions are secure and developed, however, governments are more likely to protect private property rights, enforce contracts, and refrain from predation. As Olson argues, lasting democracy inherently implies secure property rights, because the same institutional mechanisms—such as limited executive, the independent judiciary, and respect for law—that are needed for the survival of democracy also imply secure private property rights.⁵⁵ Clague et al. find empirically that more-democratic countries develop better property rights institutions than less-democratic ones.⁵⁶

Therefore, the set of democratic institutions, including the dispersion of power, the limited executive, the large number of veto players over public policy, legislative and judicial power, the diversity of interests in the legislature, and the independent judiciary, collectively serve to secure private property rights and lower the risks of expropriation, contract repudiation, ineffective rule of law, and government corruption for domestic citizens as well as foreign investors.⁵⁷

Our theory as a whole suggests that democratic institutions in host countries exert conflicting effects on FDI inflows. On one hand, democratic institutions tend to limit the oligopolistic or monopolistic behaviors of multinational enterprises,

50. Frieden 1994 argues that foreign direct investors are concerned about monitoring and enforcing their property rights in the host state. Where such monitoring and enforcement is difficult, as in site-specific investments, the use of force and colonial annexation by the home state is more likely. Interestingly, democratic institutions reduce the need for using military violence to enforce rights by enhancing the credibility of the property rights institutions in the host state.

51. Bates 2001.

52. Clague et al. 1996; and Olson 1993 and 2000.

53. Przeworski 1991, 34. Land reform is a good example. As states attempt to provide subsistence or earning opportunities for rural citizens, investors can suffer the loss of valuable land. Even compensation at assessed or market prices may not cover the loss of a stream of potential future earnings.

54. Olson 2000, 41.

55. *Ibid.*

56. Clague et al. 1996.

57. Appendix 4 provides empirical confirmation of this connection.

facilitate indigenous businesses to pursue protection against foreign capital, and constrain the host government's ability to offer generous financial and fiscal incentives to foreign investors. Hence, they discourage FDI inflows. On the other hand, more-democratic countries offer better property rights protection, reducing risks and attracting more FDI inflows. The empirical analysis below tests these two competing effects.

Research Design

The empirical analysis covers fifty-three countries (listed in Appendix 1) from 1982 to 1995. These countries exhibit temporal and spatial variations in the level of FDI inflows and democratic characteristics, enabling a discriminating statistical assessment. Because our arguments are applicable to comparisons both cross-nationally and over time for individual countries, the pooled time-series cross-section (TSCS) design is appropriate for uncovering relationships persistent across time and over space. We use the one-tailed *t*-test for hypothesis testing because our hypotheses are directional.

Dependent Variable

The dependent variable is the level of FDI net inflows into a country each year, measured in billions of current U.S. dollars. The measure is compatible with our central research question: "Does increased democracy promote or jeopardize foreign direct investment inflows to less-developed countries?" The operationalization resembles the dependent variable measure in Chan and Mason, and Oneal—the level of FDI flows rather than a transformed variable.⁵⁸ FDI net inflows refer to those investments that acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. Because of possible divestment, the level of FDI net inflows can appear as a negative value. Data are from the World Bank's *World Development Indicators*.⁵⁹

Negative Effect of Democratic Institutions

We separate empirically the positive and negative effects of democratic institutions on FDI inflows to the developing countries. We use two different methods to capture the negative effect of democratic institutions on FDI because of host country policies on market regulation, industrial protection, and fiscal and financial incentives. The first method is to use a composite measure of democracy, while the second method is to include different components of democratic institutions as separate variables. For both methods, we expect that these variables take on the

58. Chan and Mason 1992; and Oneal 1994.

59. World Bank 1999.

negative sign. The inclusion of separate measures of democratic institutions in the model controls for the heterogeneity of different countries in terms of conforming to the democratic ideal. While different aspects of democratic institutions should correlate with and reinforce each other, as discussed earlier, their effects may differ in size. Furthermore, countries differ in the strength and content of their democratic institutions while their regime characteristics change over time.

The composite measure of democratic institutions, denoted as LEVEL OF DEMOCRACY, is drawn from the Polity IV database.⁶⁰ The widely used Polity data register various democratic and autocratic attributes of many countries on an annual basis from 1800, with Polity IV updated to 1999. The Polity IV data set operationalizes institutionalized democracy and autocracy along five dimensions: competitiveness of political participation, regulation of political participation, competitiveness of executive recruitment, openness of executive recruitment, and constraints on the chief executive. The composite measure of democratic institutions from Polity IV is the difference between DEMOC and AUTOC, ranging from -10 (strongly autocratic) to $+10$ (strongly democratic).⁶¹ The same measure is used in a variety of previous studies.⁶²

The separate measures of democratic institutions are also based on the Polity IV database. As Marshall and Jaggers point out, democratic institutions consist of three essential, interrelated conceptual elements: institutions and procedures through which citizens choose alternative policies and leaders, institutional constraints on the exercise of decision-making power by the executive, and the guarantee of civil liberties to all citizens in their daily lives and political participation.⁶³ In Polity IV, these three elements are measured as three variables: executive recruitment (covering regulation of executive transfers, competitiveness of executive selection, and openness of executive recruitment), executive constraints, and political competition (covering regulation of political competition and government restrictions on political competition). We denote the three variables as SELECTION, CONSTRAINT, and COMPETITION.

Positive Effect of Democratic Institutions

The positive effect of democratic institutions works via the causal link of property rights protection. We test the positive effect of democratic institutions with two

60. Marshall and Jaggers 2000.

61. Polity data contain many observations with "standardized authority codes" (that is, "-66," "-77," and "-88") though studies using the Polity data rarely report how they treat such cases. Polity IV suggests for the first time how to handle these observations. Specifically, annual cases identified as "interruption" (that is, foreign domination, coded "-66") are treated as missing values, as they are not considered independent regimes. Annual cases identified as "transition" (coded "-88") are treated by averaging the last regime score before the transition period began with the next regime score following the end of the transition period. Annual cases identified as "interregnum" (coded "-77") are treated as "perfectly incoherent" regimes and assigned values of "0." We follow these coding rules. Marshall and Jaggers 2000.

62. See, for instance, Londregan and Poole 1996.

63. Marshall and Jaggers 2000.

methods. The first method includes both the LEVEL OF DEMOCRACY and the level of PROPERTY RIGHTS PROTECTION in one model, where PROPERTY RIGHTS PROTECTION captures the positive effect of democratic institutions on FDI inflows while LEVEL OF DEMOCRACY captures the leftover, negative effect only. With this method, the estimate of the PROPERTY RIGHTS PROTECTION variable contains the effects of both democracy and other variables such as ECONOMIC DEVELOPMENT. We use the property rights protection index, constructed by Stephen Knack and Philip Keefer for the IRIS Center at the University of Maryland with risk-rating data from the International Country Risk Guide.⁶⁴ The index is based on five components: rule of law, bureaucratic quality, government corruption, contract repudiation by government, and expropriation risk.⁶⁵ Rule of law, government corruption, and contract repudiation are on a 6-point scale while bureaucratic quality and expropriation risk on a 10-point scale. Like Knack and Keefer, we build a 50-point index of property rights protection by rescaling the 6-point variables to 10-point scale and then summing the five 10-point measures.⁶⁶ The same index is also applied as a measure of property rights protection in Knack and Keefer to examine its effect on economic performance,⁶⁷ in Clague et al. to examine its effect on investment and growth,⁶⁸ and in Sobel to examine its effect on international borrowing.⁶⁹

Our second method separates the effect of democracy on property rights protection from the effects of other variables. We estimate a Tobit model in which the dependent variable is PROPERTY RIGHTS PROTECTION. We use Tobit for estimation

64. Some may argue that this measure, based on investor evaluations, is circular in explaining FDI. Circularity is not a problem here for two reasons. First, the property rights protection index is not based on investor evaluations but data from a risk-rating firm, the Political Risk Service Group. The distinction between direct investor evaluation and risk-rating agency assessment is subtle and not trivial. The risk-rating agency is not an investor but specializes in information gathering and analysis, selling its research as a product to potential foreign investors. It is a third-party observer, just like an academic analyst. Second, the index is supposed to capture the strength of property rights protection as an institutional feature. Institutions are "rules, enforcement characteristics of rules, and norms of behavior that structure repeated human interaction." North 1989. Property rights protection as an institutional feature should not be equated with written rules, but should reflect the enforcement characteristics of rules and norms of behaviors.

65. According to Knack and Keefer, government corruption refers to whether "high government officials are likely to demand special payments" and "illegal payments are generally expected throughout the lower levels of government in the form of bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans." The rule of law refers to "the degree to which the citizens of a country are willing to accept the established institutions to make and implement laws and adjudicate disputes." Bureaucratic quality refers to the "autonomy from political pressures and strength, expertise to govern without drastic changes in policy or interruptions in government service, and the presence of an established mechanism for recruiting and training." Contract repudiation refers to the "risk of modification in a contract taking the form of a repudiation, postponement, or scaling down due to budget cutbacks, indigenization pressure, a change in government, or a change in government economic and social priorities." Expropriation risk refers to the risk of "outright confiscation or forced nationalization." Knack and Keefer 1995, 225–26.

66. Knack and Keefer 1995.

67. *Ibid.*

68. Clague et al. 1996.

69. Sobel 1999.

because the index is bounded between 0 and 50 and ordinary least squares (OLS) generate predicted values beyond this range. The independent variables include the level of PROPERTY RIGHTS PROTECTION in the previous year, ECONOMIC DEVELOPMENT, REGIME DURABILITY, and POLITICAL INSTABILITY, but exclude the LEVEL OF DEMOCRACY. We expect that previous PROPERTY RIGHTS PROTECTION, REGIME DURABILITY, and ECONOMIC DEVELOPMENT affect PROPERTY RIGHTS PROTECTION positively, and POLITICAL INSTABILITY negatively. We lag the independent variables one year to control for possible reciprocal effects of PROPERTY RIGHTS PROTECTION on the independent variables. The model specification is similar to that in Clague et al.⁷⁰ We use the predicted values of PROPERTY RIGHTS PROTECTION from this Tobit model to measure DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION, that is, the effect of causal determinants other than democracy on property rights protection. DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION is the difference between the actual level of property rights protection and the democracy-excluded level, normalized to non-negative values. This difference variable captures the positive effect of democracy independent of other factors on property rights protection. The Tobit results are presented in Model 1 of Appendix 4. For reference, Model 2 includes Model 1 as well as democracy, where consistent with our theoretical expectation, democracy has a positive and statistically significant effect on property rights protection.

Control Variables

REGIME DURABILITY. We expect that the volatility of regime change increases investors' uncertainty about the host country's future economic policies, such as interest rates, government budget deficits, or taxation. Conversely, stable domestic political institutions reduce the risks for foreign capital. We use the measure of regime durability from Polity IV. According to the Polity IV manual, regime durability is the number of years since the most recent regime change, defined by a three-point change in the Polity score over a period of three years or less, with the end of transition period defined by either the lack of stable political institutions or the year 1900, whichever comes last. The first year during which a new (postchange) polity is established is coded as the baseline "year zero" (value = 0) and each subsequent year increases the value of the variable by one. We expect REGIME DURABILITY to encourage FDI inflows.

POLITICAL INSTABILITY. Investors are generally less interested in entering a country with high political instability. Along these lines, Schneider and Frey find that the sum of strikes and riots has a negative effect on FDI flows.⁷¹ Levis,⁷² Schneider

70. Clague et al. 1996.

71. Schneider and Frey 1985.

72. Levis 1979.

and Frey,⁷³ Crenshaw,⁷⁴ London and Ross,⁷⁵ and Jun and Singh⁷⁶ also employ similar political events data. Bollen and Jackman argue that political stability and democracy should not be equated because events such as strikes, riots, or assassinations may occur to varying degrees across regime types, even within stable democracies.⁷⁷ They suggest that political stability and regime type should be studied as separate variables in order to disentangle their effects. To measure POLITICAL INSTABILITY, we use Banks's event counts of assassinations, strikes, guerilla wars, government crises, purges, riots, revolts and antigovernment demonstrations, and sum them into an index of political instability.⁷⁸ We expect POLITICAL INSTABILITY to reduce FDI inflows.

MARKET SIZE. The size of the host market affects the amount of FDI inflows. Large markets are more likely to attract FDI because of an expected stream of future returns, for which China is often cited as an example. Conversely, small market size attracts less FDI. Studies of FDI inflows typically control for market size.⁷⁹ We follow this convention, using gross domestic product (GDP) to measure market size. The variable is converted to international dollars using purchasing power parity (PPP) rates for intercountry comparability and is logged to deal with its skewed distribution. Data are from the World Bank's *World Development Indicators*.⁸⁰ MARKET SIZE is expected to affect FDI inflows positively.

ECONOMIC DEVELOPMENT. Economic development should affect FDI inflows positively. More-developed countries often attract more FDI than less-developed ones, because of differences in consumer purchasing power, capital endowment, and infrastructure. Hence, we include ECONOMIC DEVELOPMENT as a control variable. The variable is measured as GDP per capita based on PPP (international dollars using PPP rates), logged to deal with its skewed distribution. Data are from the World Bank's *World Development Indicators*.⁸¹

GROWTH. Economic growth is often found to induce more FDI inflows to a country.⁸² Profit-maximizing foreign investors are attracted to fast-growing economies to take advantage of future market opportunities. We measure GROWTH using the annual percentage growth rate of GDP at market prices based on con-

73. Schneider and Frey 1985.

74. Crenshaw 1991.

75. London and Ross 1995.

76. Jun and Singh 1996.

77. Bollen and Jackman 1989.

78. Banks 1999.

79. See Chan and Mason 1992; Jun and Singh 1996; and Oneal 1994.

80. World Bank 1999.

81. *Ibid.*

82. See Crenshaw 1991; Gastanaga et al. 1998; Jun and Singh 1996; and Schneider and Frey 1985.

stant local currency. Data are from the World Bank's *World Development Indicators*.⁸³ GROWTH is expected to affect FDI inflows positively.

LABOR COST CHANGE. Large increases in labor cost are argued to suppress expected returns, causing FDI investors to shy away. The effect is particularly important for developing countries with concentrated labor-intensive industries. We measure LABOR COST CHANGE with the annual percentage change in the real manufacturing wage index for each country. Data are from the International Labor Organization's *1999 Key Indicators of the Labor Market* (KILM).⁸⁴ LABOR COST CHANGE should affect FDI inflows into a country negatively.

CAPITAL FLOW RESTRICTIONS. Capital flow restrictions erect barriers to entry into a country, barriers to exit from a country, or both. Under various restrictions, a foreign investor may have difficulty getting into a country, be trapped on shore after investing, or both. As Gastanaga et al. have found, fewer capital flow restrictions are associated with greater capital inflows.⁸⁵ The variable is a summed index of eight types of state restrictions on foreign exchange, current and capital accounts.⁸⁶ Data are from International Monetary Fund's *Annual Reports on Exchange Arrangements and Exchange Controls*.⁸⁷ CAPITAL FLOW RESTRICTIONS should reduce FDI inflows.

EXCHANGE-RATE VOLATILITY. Exchange-rate risk may also affect FDI inflows. Large movements in the exchange rate inhibit long-term planning and disrupt local markets, reducing FDI inflows. We measure EXCHANGE-RATE VOLATILITY as the mean absolute deviation from the mean of the official exchange rate of local currency units per U.S. dollar. Data are from the World Bank's *World Development Indicators*.⁸⁸

WORLD FDI INFLOWS. The variable is the total world FDI inflows in a given year. It controls for changes in the supply of FDI available to recipient countries. We expect WORLD FDI INFLOWS to have a positive effect on the amount of FDI inflows to individual countries.

Method

The data has a pooled TSCS structure, which helps to uncover the effects of democracy and property rights protection on FDI inflows across countries and over

83. World Bank 1999.

84. International Labour Office 1999.

85. Gastanaga et al. 1998.

86. Restrictions include capital or current transaction limits, currency prescription, import surcharges, advance import deposits, export proceeds surrender requirements, and bilateral payment arrangements with IMF members and nonmembers. Garrett applies the same type of data. Garrett 1995.

87. International Monetary Fund various years.

88. World Bank 1999.

time. Despite such inferential advantages, the TSCS design involves potentially more serious assumption violations than the nonpanel design in terms of heteroskedasticity, autocorrelation, and contemporaneous correlation in the error term.⁸⁹ To deal with these problems, Beck and Katz recommend OLS with panel-corrected standard errors (PCSEs).⁹⁰ The PCSEs adjust for disturbances that are heteroskedastic and contemporaneously correlated across panels. We also correct for autocorrelation in the error term.⁹¹ All independent variables are lagged by one year to control for the possible reciprocal effects of FDI inflows.

Findings

Table 1 presents the statistical results from four model specifications. Model 1 includes PROPERTY RIGHTS PROTECTION, LEVEL OF DEMOCRACY, and control variables while Model 2 replaces LEVEL OF DEMOCRACY in Model 1 with its component measures. Model 3 includes DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION, DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION, LEVEL OF DEMOCRACY, and control variables, while Model 4 is the same as Model 3 but uses the component measures of democracy instead. Appendix 1 presents the by-country descriptive statistics for the dependent variable, LEVEL OF DEMOCRACY and PROPERTY RIGHTS PROTECTION from Model 1. Appendix 2 includes the correlation matrix of variables based on the estimation sample in Table 1. Finally, Appendix 3 presents descriptive statistics for all variables based on the estimation sample.

Effects of Independent Variables

Statistical results for the key variables offer strong support for our theoretical arguments. In Model 1, PROPERTY RIGHTS PROTECTION is statistically significant at the 1 percent level and positive, as expected. LEVEL OF DEMOCRACY is statistically significant at the 1 percent level and negative. As expected, PROPERTY RIGHTS PROTECTION encourages FDI inflows; as we capture the positive effect of democratic institutions via PROPERTY RIGHTS PROTECTION in the model, the LEVEL OF DEMOCRACY reduces FDI inflows.

In Model 2, PROPERTY RIGHTS PROTECTION is still positive and statistically significant. The three measures of different dimensions of democratic institutions (SELECTION, CONSTRAINT, and COMPETITION) are all negative as expected, but none is statistically significant. The statistical insignificance may result from high collinearity among the three measures, with their pairwise correlation ranging from 0.78 to 0.95 (see Appendix 2). A joint F-test rejects, at the 1 percent level with F

89. Stimson 1985.

90. According to Beck and Katz 1995, the conventional feasible generalized least square (FGLS) estimator generates artificially smaller estimated standard errors of the coefficients, causing incorrect inferences.

91. Estimation uses Stata7 XTPCSE procedure, with AR(1) correction for serial correlation.

TABLE 1. *Effect of democratic institutions on FDI inflows to developing countries 1982–95*

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>
DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION			0.0757** (1.67)	0.0761** (1.67)
DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION			0.0435*** (3.01)	0.0437*** (3.08)
PROPERTY RIGHTS PROTECTION	0.0522*** (3.16)	0.0519*** (3.33)		
LEVEL OF DEMOCRACY	-0.0878*** (3.45)		-0.0943*** (3.48)	
SELECTION		-0.0714 (0.72)		-0.0798 (0.77)
CONSTRAINT		-0.0935 (1.05)		-0.0921* (1.33)
COMPETITION		-0.0896 (1.06)		-0.0976 (1.17)
JOINT F-TEST		28.5***		42.2***
REGIME DURABILITY	0.0229*** (2.53)	0.0230*** (2.93)	0.0232*** (2.62)	0.0230*** (2.97)
POLITICAL INSTABILITY	-0.0172 (0.90)	-0.0201 (1.00)	-0.0163 (0.82)	-0.0184 (0.89)
LABOR COST CHANGE	-0.0007 (0.30)	-0.0007 (0.28)	-0.0019 (0.76)	-0.0019 (0.73)
ECONOMIC SIZE	1.0299*** (3.61)	1.0289*** (3.72)	1.0775*** (3.68)	1.0759*** (3.76)
ECONOMIC DEVELOPMENT	-0.0973 (0.34)	-0.0858 (0.32)	-0.0047 (0.02)	0.0074 (0.02)
ECONOMIC GROWTH	0.0227** (1.82)	0.0240** (1.87)	0.0189* (1.51)	0.0195* (1.54)
EXCHANGE-RATE VOLATILITY	-0.0001** (2.24)	-0.0001*** (2.12)	-0.0001** (2.05)	-0.0001** (1.95)
CAPITAL FLOW RESTRICTIONS	-0.0854** (1.88)	-0.0877** (1.95)	-0.0801** (1.69)	-0.0815** (1.72)
WORLD FDI INFLOWS	0.0036*** (3.81)	0.0037*** (4.05)	0.0037*** (3.32)	0.0037*** (3.42)
Constant	-25.3194*** (4.58)	-24.1824*** (4.72)	-27.3675*** (4.82)	-26.1584*** (4.96)
Observations	483	483	458	458
R ²	0.21	0.22	0.22	0.22

Note: OLS estimates and *t*-statistics in parentheses are based on panel-corrected standard errors (PCSE) with AR(1) correction.

****p* < .01.

***p* < .05.

**p* < .10.

statistic 28.5, the hypothesis that all three measures in Model 2 are jointly equal to zero. As we discussed in the theory section, different dimensions of democratic institutions—executive recruitment, constraints over executive policymaking, and regulation of political competition and participation—appear to reinforce each other in affecting FDI inflows.

In Model 3, DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION is included to capture explicitly the positive effect of democracy on FDI via strengthening property rights protection. DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION is also included to control for the effect of property rights protection on FDI beyond the influence of democracy. Both variables are statistically significant and positive, as expected. These results support the claims that better property rights protection allows a country to attract more FDI inflows and that democracy improves property rights protection in a country, hence making it more attractive to foreign investors. Model 3 also shows that the LEVEL OF DEMOCRACY is statistically significant and negative, as expected. With the positive effect of democracy on FDI via property rights protection controlled for, democratic institutions reduce the amount of FDI flowing into a developing country.

In Model 4, DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION and DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION remain statistically significant and positive.⁹² Similar to Model 2, the three measures of different dimensions of democratic institutions (SELECTION, CONSTRAINT, and COMPETITION) are all negative as expected, but none is statistically significant except for CONSTRAINT. A joint F-test rejects, at the 1 percent level with F statistic 42, the hypothesis that all three measures are jointly equal to zero.

Strength of Effects of Democratic Institutions

Based on Models 1 and 3, a 1-point increase in the LEVEL OF DEMOCRACY causes a decline of about 88 and 94 million dollars, respectively, in FDI inflows to a country. In contrast, a 1-point increase in PROPERTY RIGHTS PROTECTION leads to an increase of about 52 million dollars in FDI inflows to a country, and a 1-point increase in the DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION leads to an increase of about 76 million dollars in FDI inflows to a country. For better illustration, we present some scenarios of how the level of democracy and the democracy-related property rights protection affect FDI inflows in Table 2. We use the coefficients for the LEVEL OF DEMOCRACY and the DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION variables in Model 3 of Table 1 to compute the level of FDI inflows, holding all other variables at zero.

92. We also test whether DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION and DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION are equal in the size of their coefficients. The null hypothesis that the two variables have equal coefficients fails to be rejected statistically for both Models 3 and 4.

TABLE 2. *Effects of democracy and property rights protection on FDI inflows*

<i>Democracy-related property rights protection</i>	<i>Level of democracy</i>	
	<i>−6 (20%)</i>	<i>6 (50%)</i>
3.85 (20%)	0.86	−0.27
4.82 (50%)	0.93	−0.20

In Table 2, at the sample 20th percentile values of both democracy and the democracy-related property rights protection, FDI inflows are about 0.86 billion dollars. The combination of 20th percentile property rights protection and 50th percentile democracy level results in an FDI divestment of 0.27 billion dollars. At the 50th percentile property rights protection and 20th percentile democracy level, FDI inflows are about 0.93 billion dollars. At the 50th percentile values of both property rights and democracy, there is an FDI divestment of about 0.2 billion dollars.

These scenarios, though hypothetical, are illustrative. *Ceteris paribus*, countries with strong democracy-related property rights always outperform those with weak property rights. More FDI flows to countries with better democracy-related property rights protection. Holding the democracy-related property rights protection constant, a less democratic country receives more FDI inflows than a more democratic one. Democracy has positive and negative effects on FDI inflows.

Effects of Control Variables

Now we discuss the results of the control variables. *REGIME DURABILITY* is positive and statistically significant in all models in Table 1. We expect that regime stability is conducive to attracting FDI inflows by reducing risks for foreign capital; frequent large swings in a country's regime reduce FDI inflows by increasing uncertainty. The statistical evidence in Table 1 supports this expectation.

POLITICAL INSTABILITY has the expected negative sign in all four models in Table 1, but is not statistically significant in any of them. We expect that political assassinations, general strikes, guerrilla warfare, purges, riots, revolutions, and anti-government demonstrations contribute to growing political instability and reduce FDI inflows to a country. The statistical test does not offer enough evidence supporting this claim, not inconsistent with the fact that previous studies have produced mixed evidence regarding this variable. Indeed foreign investors may worry about political unrest most when it threatens their property rights. This interpretation is consistent with the fact that property rights protection is significantly correlated with political instability (correlation -0.16 , see Appendix 2).

MARKET SIZE is statistically significant and positive as expected in all four models in Table 1. Larger economies are likely to attract more FDI inflows, as they

have large markets and more investment opportunities. ECONOMIC GROWTH is positive as expected and statistically significant in all models as well. Fast-growing economies attract more FDI than slowly-growing economies.

ECONOMIC DEVELOPMENT is statistically insignificant in all four models in Table 1. Its statistical insignificance appears to be an artifact of high collinearity with other variables. Its correlation within the sample is 0.50 with property rights protection, 0.37 with level of democracy, and -0.42 with capital flow restrictions. One may interpret the result for economic development as meaning that its positive effect on FDI works through better property rights protection, high level of democracy, and low capital flow restrictions.

LABOR COST CHANGE is negative as expected, but statistically insignificant in all four models. Many analysts believe that as labor cost rises quickly in a developing host country, foreign investors will balk or divest. The claim does not appear supported by our evidence. The effect of large changes in labor cost on capital flight may have been exaggerated.

EXCHANGE-RATE VOLATILITY is negative and statistically significant in all four models of Table 1. As expected, volatile exchange-rate movements raise transaction costs and decrease FDI inflows into a country. CAPITAL FLOW RESTRICTIONS are negative and statistically significant as expected in all four models. High barriers to entry and exit may reduce a country's ability to attract FDI. Capital control liberalization, on the other hand, may reduce the transaction costs for foreign investors, promoting FDI inflows. WORLD FDI INFLOWS are statistically significant and positive in all four models of Table 1. The level of individual-country FDI inflows tends to move together with the level of WORLD FDI INFLOWS. A host country can expect to attract more FDI when more foreign capital seeks investment opportunities in the world economy.

Sensitivity Analysis

To investigate the robustness of the results in Table 1, we conduct some sensitivity analysis. Specifically, we analyze two different dependent variable measures, use Freedom House data to measure democracy, employ a different measure of property rights protection, and apply different estimators and an alternative model specification. While these analyses are applied to Model 1 and Model 3 in Table 1, results are similar enough across both models and hence, we focus on discussing the sensitivity analysis of the Model 3 specification alone. We report the results in Table 3, omitting the control variables because of space limitation. Overall, the effects of democracy and democracy-related property rights protection on FDI inflows reported in Model 3 of Table 1 are replicated across the ten experiments in Table 3. We therefore conclude that our results are highly robust.

Part I of Table 3 reports the results from five experiments based on two different dependent variable measures, different measures of democracy, and property rights protection. In column (1), FDI inflows are measured instead as the share of a country's FDI inflows in total world FDI inflows. While FDI inflows are a level

TABLE 3. Sensitivity analysis

Part I. Alternative measures of FDI inflows, democracy, and property rights protection

	<i>FDI-share</i>	<i>FDI/GDP</i>	<i>Freedom House</i>	<i>Freedom House</i>	<i>Property Rights</i>
DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION	0.0004*** (2.35)	0.0227* (1.61)	0.0752** (1.72)	0.0758** (1.74)	0.1951*** (5.34)
DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION	0.0002*** (4.39)	0.0352** (1.97)	0.0424*** (2.61)	0.0425*** (2.64)	0.1832* (1.86)
LEVEL OF DEMOCRACY	-0.0004*** (3.99)	-0.0065 (0.56)		-0.2102*** (3.41)	-0.0826*** (3.24)
POLITICAL RIGHTS			-0.1694** (2.15)		
CIVIL LIBERTIES			-0.2610*** (3.00)		

Note: OLS estimates and t-statistics in parentheses are based on PCSE, with AR(1) correction. Control variables not reported.

Part II. Alternative statistical estimators

	<i>Country-fixed effects</i>	<i>Random effects</i>	<i>GEE</i>	<i>3SLS</i>	<i>OLS with Y_{t-1}</i>
DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION	0.1123** (2.28)	0.0908* (1.52)	0.0694* (1.30)		0.0329* (1.34)
DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION	0.0982*** (2.95)	0.0521* (1.48)	0.0420* (1.36)		-0.0126* (1.33)
PROPERTY RIGHTS PROTECTION				0.0922*** (3.44)	
LEVEL OF DEMOCRACY	-0.0756*** (3.34)	-0.0965*** (2.95)	-0.0537* (1.55)	-0.1142*** (5.47)	-0.0144* (1.52)

Note: Country-fixed effects with PCSE and AR(1) correction. GEE with White robust standard errors and correction for serial correlation. OLS with lagged FDI inflows and PCSE. Control variables not reported.

*** $p < .01$.
 ** $p < .05$.
 * $p < .10$.

variable in Table 1, a related question is whether more-democratic countries are more competitive at attracting FDI.⁹³ Indeed, if a country is able to have more FDI inflows each year, it also should be more competitive than other countries, given the limited amount of total FDI inflows in the world.

In column (2) of Part I, FDI inflows are measured as the ratio of a country's FDI inflows to its GDP. Some studies investigate the causal determinants of the importance of FDI to national economy, using as the dependent variable the ratio of FDI inflows to gross national product (GNP), GDP, or population. Such a measure, however, is inconsistent with our research question and distorts the effect of democracy on FDI inflows.⁹⁴ Still, it is important to evaluate the robustness of our results against this popular measure of FDI.

In columns (3) and (4) of Part I, democracy is based on Freedom House data instead, using a composite measure and two disaggregated measures respectively. Some scholars employ the Freedom House data to measure democracy.⁹⁵ Polity data emphasize the constraints on the executive decision-making power, competitiveness in political recruitment, and political participation. Freedom House data not only include institutional aspects directly measured in Polity data, but also capture aspects that are only indirectly implied in Polity IV, such as the *de facto* power of the opposition, freedom from foreign domination, minority rights, freedom of expression and belief, association rights, and human rights. These different elements collapse into two conceptual components: "political rights" and "civil liberties." As Burkhart and Lewis-Beck do, we construct the Freedom House composite measure of democracy as a sum of two 7-point measures of "political rights" and "civil liberties."⁹⁶ This procedure gives an index ranging between 2 (lowest democracy) to 14 (highest democracy). The statistical correlation between the two composite measures from Polity IV and Freedom House is quite high (0.75) in our estimation sample.

In column (5) of Part I, property rights protection is based on data from Gwartney et al.⁹⁷ The property rights protection index, ranging between 0 and 10, is constructed from three measures: risk of confiscation and expropriation, risk of contract repudiation by government, and the rule of law. Higher scores of the index indicate better property rights protection. Data on the three components are collected from International Country Risk Guide and Business Environment Risk Intelligence. Gwartney et al. also adjust the values to make the components consistent over time.

93. Resnick 2001 and Tsai 1991 use similar measures.

94. For example, two countries A and B both receive \$60 million in net FDI inflows in a year. A has a GDP of \$600 million for the year while B has \$300 million. The FDI/GDP ratio is 10 percent for A and 20 percent for B. Even though both countries receive the same amount of FDI inflows, FDI appears more important to country B than to A. Conceptually, FDI/GDP addresses research questions different from ours. The FDI/GDP ratio measures the relative importance of FDI to a country's economy, while our research question concerns FDI inflows per se. In addition, democratic institutions affect both FDI and GDP. Using FDI/GDP as the dependent variable does not allow us to separate the effects of democracy on FDI and GDP, as the results in Table 3 show.

95. See Diamond 1999; and Burkhart and Lewis-Beck 1994.

96. Burkhart and Lewis-Beck 1994.

97. Gwartney, Lawson with Dexter Samida 2000.

Across all five columns of Part I, the hypothesis testing results remain broadly similar to those in Table 1 for property rights protection and democracy. DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION is positive and significant in models of alternative measures of the dependent variable, democracy and property rights. DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION is also positive and significant in all models. LEVEL OF DEMOCRACY is statistically significant and negative in all models with one exception. Its effect is robust against one alternative measure of FDI inflows, different measures of democracy and PROPERTY RIGHTS PROTECTION. It is negative but insignificant in the model on FDI/GDP, as we expected.

Part II of Table 3 presents the results obtained from using five estimators: country-fixed effects with PCSE, random effects, general estimating equation (GEE), three-stage least squares (3SLS), and OLS with the lagged dependent variable.⁹⁸ The fixed effects estimator introduces country dummies into the model, controlling for systematic country-specific effects and spurious findings. Because country dummies are atheoretical and soak up many of the variations in the dependent variable attributable to other theoretically meaningful variables, the fixed effects estimator poses an extremely conservative test of the effects of democracy and property rights protection.⁹⁹ While it is difficult to accept the statistically insignificant results unequivocally as disconfirming evidence, the robust findings from such a model deserve greater confidence. The random effect estimator parameterizes the random error associated with different cross-sections, but without addressing the potential problem of autocorrelation. The GEE estimator is a population-average-based estimator frequently used for panel data.¹⁰⁰ It also corrects for serial correlation and controls for heterogeneity by estimating robust standard errors clustered over countries. The 3SLS estimator, which is consistent and asymptotically efficient,¹⁰¹ endogenizes both property rights protection and FDI inflows. While foreign capital is encouraged by an enforceable system of property rights, the increased involvement of foreign business in the domestic economy may in turn affect the rule of law and other domestic institutions. While in Table 1 we followed the conventional strategy in known studies and lagged the property rights variable by one year, it may be argued that if such a strategy is inadequate, our results about the effect of democracy will not be statistically consistent and robust. The FDI model includes the same variables as Model 1 of Table 1, while the property rights protection model is specified as Model 2 of Appendix 4.¹⁰² The system estimates the positive effect of democratic institutions via property right protection and the neg-

98. See Sobel 1999 on international borrowing for the use of a nonparametric estimator. See Greene 2000, 222, for a discussion of how normality may not be necessary for multiple regression analysis.

99. As King 2001 noted in a recent debate, using theory-based measures and statistical techniques is preferable to fixed effects estimation.

100. Liang and Zeger 1986.

101. For technical details, see Greene 2000.

102. The endogenous variables are contemporaneous in this system and capture the immediate feedback between them, a difference from the single equation models in Table 1 and Appendix 4.

ative effect simultaneously. Finally, the last column in Part II investigates whether the results in Table 1 are robust to the inclusion of the lagged dependent variable instead of using AR(1) correction of serial correlation.¹⁰³

The results from all five statistical methods remain consistent with those in Table 1 in terms of hypothesis testing for property rights protection and democracy. DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION is consistently positive and significant across four models. As for the 3SLS system, PROPERTY RIGHTS PROTECTION is also positive and significant. LEVEL OF DEMOCRACY remains negative and significant in all models as in Table 1.

Conclusion

Previous studies related to the connections between investor behaviors and regime characteristics have produced conflicting theoretical expectations as to whether democratic or autocratic characteristics encourage FDI inflows. These studies also have placed more emphasis on the preferences of the host state and paid less attention to the motivations of foreign investors. In this analysis, we offer a theory that synthesizes and extends the conflicting expectations in previous studies. Instead of starting with the state analytically, we build our theory on the logic of why firms invest abroad. The phenomenon we study, foreign capital inflows, suggests that the logic of international production is the right place to begin our inquiry. How political institutions affect FDI inflows should mesh with why firms go abroad. Based on this premise, we derive a theory suggesting that democratic institutions affect FDI inflows both positively and negatively.

The empirical findings based on OLS with PCSE and a sample of fifty-three developing countries from 1982 to 1995 support our central argument that democratic institutions affect FDI inflows to developing countries via competing causal avenues. Increases in democracy yield improved property rights protection, which encourages FDI inflows. Meanwhile, increases in democracy also reduce FDI received by this set of LDCs. Our sensitivity analysis demonstrates that our findings are robust against alternative measurements of key variables and various statistical methods. With that in mind, we turn to the theoretical and policy implications of our research.

Confirming our argument that democratic institutions affect FDI in a complex manner, our theory and empirical findings offer qualified support for previous explanations. While Olson and many others argue that well-established democracies offer secure property rights and the optimal environment for investors, these analysts fail to recognize that central aspects of democratic politics can attenuate the

103. We do not include the lagged dependent variable in the models of Table 1, for the sake of lacking a good theoretical reason. As Achen shows, the inclusion of the lagged dependent variable is not appropriate in the absence of a strong rationale. In our case, the dependent variable, FDI inflows, is a flow concept realizing within a year, rather than a stock variable that accumulates over time. Achen 2000.

effect via property rights. While increasing levels of democracy help to produce better judicial systems and rule of law, these higher levels of democracy also drive foreign investors away by imposing constraints on foreign capital and the host government. Similarly, while O'Donnell and several others illustrate that close alignment between states and MNEs often plays a central role in attracting FDI, they fail to take into account that property rights protection and democracy go hand in hand. While foreign investors may fear state exposure to popular will, they welcome restrictions on banditry provided by more democratic governments. Hence, our theory moves substantially further in understanding the interactions of economic globalization and political democracy.

This study also advances the stalled discussion on the effect of democracy on economic growth.¹⁰⁴ Our narrower focus on FDI, a measure reflecting the combined wisdom of world investors on a country's economic prospects, avoids certain problems associated with measuring economic success with GDP. What we have discovered is that a source of economic growth, FDI, has a complex relationship with regime type, suggesting the difficulty of unpacking a direct relationship between democracy and growth. Our results are consistent with other studies arguing that property rights protection may be more important to growth than democracy or that democracy promotes growth by improving property rights protection.¹⁰⁵

Our findings have policy implications for developing countries in search of FDI. Incremental improvements in property rights protection are likely to induce a more attractive environment for foreign direct investors without requiring wholesale restructuring of state-society relationships. For instance, attempts to increase bureaucratic competence or provide enhanced contract enforcement could go a long way toward setting a country apart from competitors for FDI. Conversely, states that are unable to improve property rights protection may have to amend that weakness with more incentives in tax holidays, discounts on land purchases, or exclusive access to natural resources. Superior property rights provision may thus provide an avenue for attracting investors with less sacrifice of state resources, not to mention the benefits that other actors in the economy would enjoy under a system with clearer costs and incentives.

Our findings also hold implications for transitional economies. As new democracies set up democratic institutions that may adversely affect their ability to attract FDI, these democracies may not yet be ready to provide offsetting improvements in property rights protection because they need to consolidate power and avoid conflicts with powerful domestic actors. Over time, however, the consolidation of democratic governance should bring about better property rights protection, improving the prospect of getting more FDI inflows. Countries experiencing a transition from democracy to autocracy would face the challenge of persuading foreign investors into believing the credibility of their property rights protection.

104. Przeworski and Limongi 1993.

105. See Goldsmith 1995; and Leblang 1996.

Appendix 1: List of Countries Included in Estimation in Table 1

Country	Data			FDI inflow (billions of current \$US)			Level of democracy			Property rights protection			
	Coverage	Mean	Minimum	Maximum	Mean	Minimum	Maximum	Mean	Minimum	Maximum	Mean	Minimum	Maximum
Albania	1991	0.020	0.020	0.020	1.0	1	1	27.8	27.8	27.8	27.8	27.8	27.8
Algeria	1993-95	0.009	0.004	0.018	-5.7	-7	-3	30.0	28.0	31.0	28.0	28.0	31.0
Argentina	1982-95	2.045	-0.019	5.090	6.4	-8	8	27.2	21.3	37.0	21.3	21.3	37.0
Bahrain	1988-94	0.014	-0.031	0.181	-9.7	-10	-9	35.8	31.1	42.3	31.1	31.1	42.3
Bangladesh	1992	0.014	0.014	0.014	6.0	6	6	15.3	15.3	15.3	15.3	15.3	15.3
Bolivia	1989-95	0.187	0.027	0.474	9.0	9	9	23.0	15.7	30.6	15.7	15.7	30.6
Botswana	1984-95	0.022	-0.287	0.114	9.0	9	9	35.3	33.0	37.3	33.0	33.0	37.3
Brazil	1982-95	2.490	0.320	11.200	5.4	-3	8	33.2	29.4	37.4	29.4	29.4	37.4
Bulgaria	1991-95	0.080	0.042	0.109	8.0	8	8	36.4	33.5	37.7	33.5	33.5	37.7
Chile	1982-95	1.127	0.078	4.724	1.3	-7	8	32.3	26.7	38.2	26.7	26.7	38.2
China	1987-95	18.103	3.194	40.180	-7.0	-7	-7	32.7	27.7	40.7	27.7	27.7	40.7
Colombia	1982-95	0.993	0.203	3.276	8.2	7	9	27.9	25.3	33.5	25.3	25.3	33.5
Costa Rica	1985-95	0.209	0.061	0.427	10.0	10	10	33.3	31.0	37.0	31.0	31.0	37.0
Cote d'Ivoire	1985-90	0.049	0.016	0.088	-8.7	-9	-7	31.4	29.0	32.3	29.0	29.0	32.3
Czech Republic	1993-95	1.627	0.878	2.568	10.0	10	10	41.3	39.6	42.3	39.6	39.6	42.3
Dominican Rep.	1982-95	0.168	0.036	0.404	5.9	5	6	25.0	22.0	32.6	22.0	22.0	32.6
Ecuador	1982-95	0.203	0.050	0.531	8.7	8	9	28.5	24.7	32.7	24.7	24.7	32.7
Egypt	1986-95	0.782	0.253	1.256	-3.8	-5	-3	28.0	21.7	37.8	21.7	21.7	37.8
El Salvador	1985-95	0.015	-0.005	0.038	6.5	6	7	18.5	13.7	30.9	13.7	13.7	30.9
Ghana	1982-91	0.010	0.002	0.023	-6.7	-7	-4	20.4	14.5	30.3	14.5	14.5	30.3
Guatemala	1982-95	0.097	0.038	0.330	0.6	-7	3	17.5	14.2	25.8	14.2	14.2	25.8
Guinea	1991-95	0.010	0.001	0.024	-4.2	-5	-1	26.8	25.0	28.0	25.0	25.0	28.0
Honduras	1991-95	0.050	0.027	0.0909	6.0	6	6	23.9	21.0	25.7	21.0	21.0	25.7
Hungary	1993-95	2.548	1.144	4.5186	10.0	10	10	43.3	42.3	45.3	42.3	42.3	45.3

India	1982-95	0.529	0.006	2.426	8.1	8	9	29.2	23.1	37.2
Indonesia	1993-95	4.217	2.109	6.194	-7.0	10	-7	35.6	34.7	36.8
Jamaica	1987-92	0.089	-0.012	0.142	10.0	10	10	24.8	22.7	27.7
Jordan	1982-95	0.021	-0.034	0.078	-6.1	-10	-2	25.7	15.3	39.1
Kenya	1982-95	0.023	0.0004	0.062	-6.3	-7	-5	28.1	22.6	34.3
Korea, Rep.	1982-95	0.844	0.069	2.326	1.3	-6	6	34.5	27.3	45.0
Malawi	1982-95	0.0004	0.000	0.003	-6.6	-9	7	25.1	23.8	28.6
Malaysia	1982-95	2.580	0.423	5.183	3.9	3	4	35.6	30.3	40.7
Mexico	1982-94	3.725	0.390	10.972	-1.1	-3	4	28.6	22.3	33.8
Nicaragua	1982-95	0.019	0.000	0.097	1.6	-5	8	23.7	15.3	33.3
Pakistan	1983-94	0.226	0.055	0.719	0.7	-7	8	20.9	15.2	29.1
Panama	1982-94	0.086	-0.062	0.354	0.4	-8	9	19.0	16.3	25.2
Paraguay	1984-94	0.087	0.001	0.184	0.3	-8	7	23.8	18.0	32.3
Peru	1982-95	0.660	-0.089	3.226	5.1	-3	8	21.2	15.7	31.9
Philippines	1982-95	0.656	0.009	1.591	3.4	-7	8	18.1	11.5	32.0
Poland	1991-94	1.982	0.678	3.659	8.0	8	8	40.5	34.7	43.4
Romania	1992-94	0.285	0.094	0.419	5.0	5	5	33.8	32.2	34.8
Russia	1992-95	1.283	0.000	2.479	4.5	4	6	30.1	28.4	33.4
Singapore	1987-95	5.232	2.204	8.368	-2.0	-2	-2	42.9	40.6	45.0
Slovak Republic	1993-95	0.222	0.183	0.281	7.0	7	7	40.3	39.3	41.5
South Africa	1993	0.334	0.334	0.334	7.0	7	7	39.0	39.0	39.0
Sri Lanka	1982-95	0.072	0.020	0.195	5.0	5	5	23.6	19.0	33.1
Thailand	1990-95	1.950	1.366	2.336	6.3	-1	9	38.5	37.4	39.1
Trinidad-Tobago	1988-95	0.265	0.109	0.516	9.0	9	9	32.0	30.7	33.2
Turkey	1983-94	0.585	0.099	0.885	8.3	7	9	29.7	24.6	37.5
Uganda	1986-90	0.001	-0.002	0.005	-7.0	-7	-7	15.9	14.2	16.5
Uruguay	1982-95	0.050	0.000	0.157	6.1	-7	10	27.3	24.4	31.3
Venezuela	1983-95	0.598	0.016	2.183	8.7	8	9	29.6	23.6	33.3
Zimbabwe	1991-95	0.036	0.015	0.063	-6.0	-6	-6	30.9	24.3	34.9

Appendix 2: Correlation Matrix of Variables Based on the Sample in Table 1

<i>Dependent variable</i>	PROPERTY RIGHTS PROTECTION	DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION	DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION	LEVEL OF DEMOCRACY	SELECTION	CONSTRAINT	COMPETITION	REGIME DURABILITY
PROPERTY RIGHTS PROTECTION	1.000							
DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION	0.317	1.000						
DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION	0.962	0.046	1.000					
LEVEL OF DEMOCRACY	0.167	0.023	0.169	1.000				
SELECTION	0.105	-0.024	0.117	0.924	1.000			
CONSTRAINT	0.233	0.044	0.232	0.945	0.806	1.000		
COMPETITION	0.178	0.048	0.173	0.935	0.783	0.852	1.000	
REGIME DURABILITY	0.195	0.065	0.186	0.900	-0.026	0.075	-0.036	1.000
POLITICAL INSTABILITY	-0.048	-0.044	-0.161	0.051	0.092	0.060	-0.009	-0.004
LABOR COST CHANGE	0.105	0.068	0.176	0.021	0.025	0.041	-0.004	0.082
ECONOMIC SIZE	0.440	0.067	0.303	0.181	0.145	0.223	0.155	-0.015
ECONOMIC DEVELOPMENT	0.133	0.508	0.542	0.369	0.307	0.349	0.417	-0.055
ECONOMIC GROWTH	0.239	0.181	0.215	0.005	-0.001	0.043	-0.017	0.148
EXCHANGE-RATE VOLATILITY	-0.026	0.014	0.027	0.112	0.088	0.135	0.108	-0.077
CAPITAL FLOW RESTRICTIONS	-0.087	-0.326	-0.324	0.011	-0.013	0.017	0.003	0.043
WORLD FDI INFLOWS	0.221	0.252	0.470	0.226	0.186	0.216	0.251	0.058
POLITICAL INSTABILITY		LABOR COST CHANGE	ECONOMIC SIZE	ECONOMIC DEVELOPMENT	ECONOMIC GROWTH	EXCHANGE-RATE VOLATILITY	CAPITAL FLOW RESTRICTIONS	
1.000		1.000						
0.032	1.000							
0.323	0.157	1.000						
-0.177	0.106	0.243	1.000					
0.005	0.332	0.158	0.093	1.000				
-0.017	0.016	0.133	0.046	0.004	1.000			
0.167	-0.069	0.127	-0.420	-0.168	0.122	1.000		
-0.119	0.111	0.155	0.278	0.119	-0.026	-0.254		

Appendix 3: Descriptive Statistics Based on the Sample in Table 1

<i>Variable</i>	<i>N</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Minimum</i>	<i>Maximum</i>
DEPENDENT VARIABLE	483	1.074	3.452	-0.287	40.180
PROPERTY RIGHTS PROTECTION	483	27.980	7.481	11.500	45.333
DEMOCRACY-RELATED PROPERTY RIGHTS PROTECTION	458	5.106	2.030	0.230	16.474
DEMOCRACY-EXCLUDED PROPERTY RIGHTS PROTECTION	458	27.982	7.047	13.108	45.305
LEVEL OF DEMOCRACY	483	2.543	6.630	-10.000	10.000
SELECTION	483	6.257	2.208	2.000	8.000
CONSTRAINT	483	4.592	2.097	1.000	7.000
COMPETITION	483	6.131	3.127	1.000	10.000
REGIME DURABILITY	483	15.814	17.157	0.000	95.000
POLITICAL INSTABILITY	483	3.814	5.817	0.000	48.000
LABOR COST CHANGE	483	-2.321	17.130	-167.700	50.000
ECONOMIC SIZE	483	24.594	1.574	21.692	28.794
ECONOMIC DEVELOPMENT	483	8.068	0.769	5.991	10.146
ECONOMIC GROWTH	483	3.467	5.133	-27.700	16.075
EXCHANGE-RATE VOLATILITY	483	317.135	1846.331	0.000	14471.08
CAPITAL FLOW RESTRICTIONS	483	4.037	1.981	0.000	8.000
WORLD FDI INFLOWS	483	176.213	82.343	40.329	314.253
PROPERTY RIGHTS PROTECTION (Gwartney et al.)	473	4.857	1.851	0.500	10.000
FREEDOM HOUSE DEMOCRACY	483	1.224	0.666	0.000	2.000
POLITICAL RIGHTS	483	3.511	1.766	1.000	7.000
CIVIL LIBERTIES	483	3.791	1.420	1.000	7.000
SHARE OF FDI OVER WORLD FDI	483	0.005	0.014	-0.002	0.147

Appendix 4: Tobit Estimates for Property Rights Protection in Developing Countries, 1982–95

	Model 1	Model 2
PAST PROPERTY RIGHTS PROTECTION	0.9397*** (105.89)	0.9341*** (103.06)
LEVEL OF DEMOCRACY		0.0306*** (3.36)
REGIME DURABILITY	-0.0074** (2.07)	-0.0046 (1.27)
POLITICAL INSTABILITY	-0.0080 (0.64)	-0.0196* (1.55)
ECONOMIC DEVELOPMENT	0.4106*** (5.38)	0.3843*** (5.09)
Constant	-0.7546 (1.43)	-0.4058 (0.77)
Observations	1159	1151
Pseudo R^2	0.39	0.40

Tobit estimates with *t*-statistics in parentheses.

*** $p < .01$.

** $p < .05$.

* $p < .10$.

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