

# Does democracy moderate the obsolescing bargain mechanism? – an empirical analysis, 1983-2001\*

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Developing country governments have seemingly become more receptive towards transnational corporations (TNCs). Nonetheless, political risks remain. The present article contends that authoritarianism and the host-TNC bargaining relationship still represent two potent sources of government intervention risk. In particular, the lack of democracy and executive constraints increases the likelihood of obsolescing bargaining and thus increases the risk of *ex post* intervention. I perform two empirical tests. In the first model, I use four different measures of political freedom and three different specifications of the dependent variable to examine if TNCs prefer to invest in democracies. Results confirm that democracy positively impacts on foreign direct investment. To substantiate the claim that the presumed credibility-enhancing properties of democratic nations reduce intervention risk, I also test the effect of political freedom on property rights protection. Here, too, the findings support the hypothesis. Evidently, democracy and international capital flows are highly compatible.

**Key words:** political risk, FDI, democracy, obsolescing bargain, developing countries

## Introduction

In the past two decades, governments in the developing world have seemingly become more receptive towards

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\* I would like to thank Jonathon Moses, Indra de Soysa, Thomas Oatley, the Editor of *Transnational Corporations* and three anonymous referees for helpful comments and suggestions. Only I am to blame, however, for any remaining errors.

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transnational corporations (TNCs) and foreign direct investment (FDI). Much has changed since the 1960s and 1970s - the era of large revolutions, fiercely anti-capitalist and nationalist developing nations, across-the-board nationalizations, and a booming political risk assessment and insurance industry. As other sources of capital had dried up by the late 1970s, and the much-favoured protectionist development programmes had proved unsuccessful, these countries started to take a more pragmatic and cooperative approach to FDI (Graham, 1996; Narula and Dunning, 1999).

In spite of this general trend, I contend that political risks remain. This assertion is supported by three arguments concerning TNCs and the environments in which they invest. First, I hold that while spectacular macro-political events have become rare, less dramatic and more subtle micro-political risks still represent huge problems for TNCs. First and foremost among such risks is the risk of *policy changes* and *government intervention*, including price controls, forced contract renegotiations, ownership restrictions, corruption and tax increases.

Second, government intervention in TNC affairs is often the result of a gradual shift in the relative bargaining power of the host government and the TNC. This shift – identified by Vernon (1971) and referred to as the *obsolescing bargain mechanism* (OBM) – largely transcends the ideological orientation of the government and functions independently of the world's general investment climate. The OBM dictates that the host government, *ceteris paribus*, increases its leverage *vis-à-vis* the TNC after the latter's capital is sunk in the host country. Third, I argue that the obsolescing bargain problem is magnified in non-democratic countries with weak political institutions and few institutional or partisan constraints on the executive. This is mainly because the ability of dictators or other unconstrained policy-makers to change the terms of an initial agreement with foreign investors is practically unbounded and the promise not to do so is inherently not credible (Henisz, 2000; Henisz and Williamson, 1999; Jensen, 2003, 2006).

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This article, then, contends that a lack of democracy, being highly correlated with policy discretion, increases the likelihood of the obsolescing bargain mechanism and thereby increases the risk of government intervention and policy reversals. These arguments will be theoretically outlined and empirically demonstrated in three main steps. First, I will discuss the link between various sources of political risk and political risk effects. Second, through a time-series cross-section (TSCS) analysis of 96 developing and emerging economies from 1983 to 2001, I test whether democracy and executive constraints are related to FDI inflows. Since some argue that many available indicators of democracy are not interchangeable despite being highly correlated (Casper and Tufis, 2003), in these tests, I employ four different measures of political freedom. I also use different specifications of the dependent variable and perform extensive sensitivity tests. Results suggest that political freedom is robustly related to FDI. These findings, however, do not by themselves exclude other possible causal mechanisms. To investigate further whether democracy and “checks and balances” really lower the risk of government intervention, I therefore test the effect of political freedom on property rights protections. Here, too, the findings support my hypothesis.

### **Political risk**

Following the Cuban, Iranian, and Nicaraguan revolutions, the 1970s and early 1980s saw the publication of a large number of studies dealing with definitional and conceptual issues in the field of political risk analysis (Green, 1974; Robock, 1971; Simon, 1982). Explicitly or implicitly, these studies focused on the causal link between sources of political risk and risk effects. Somewhat surprisingly, no real academic consensus on these issues was ever reached.

The early literature yielded two contrasting definitions of political risk (Desta, 1985; Kobrin, 1979). Following the violent upheavals and mass expropriations in a number of developing countries, one group of scholars defined political risk as the occurrence of political events that could directly or

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indirectly affect the foreign investor (Bunn and Mustafaoglu, 1978). Two main categories of such events were identified. The first is *political instability*, which could result in the deterioration of the general investment climate of a country and cause losses for the firms (Thunell, 1977; Weston and Sorge, 1972). The second category concerns political events that take place “at the junction of environment and enterprise” (Kobrin, 1979, pp. 68-69) - for example, expropriations, nationalizations, tax increases, and exchange controls. These incidents are normally the *actions of governments* that directly obstruct the goals of TNCs.

The latter category of political events involve host government interference with TNCs’ operations and was, by the second strand of scholars, perceived to be the main direct cause of investor losses, i.e. the main form of political risk *effects*. That is, many analysts questioned the value of focusing too heavily on political instability on the grounds that such instability happened infrequently (Rummel and Heenan, 1978), did not necessarily lead to policy changes relevant to foreign investors (Kobrin, 1979), and thus did not *per se* pose a significant risk to TNCs (Robock, 1971). More often than not, the argument went, TNCs suffered losses due to relatively undramatic changes in policy towards foreign affiliates.

Most scholars now acknowledge that policy changes and government intervention constitute the most important class of political risk outcomes (Graham, 1996; Jensen, 2006; Wells, 1998). Substantial or subtle changes in the “rules of the game” seem to pose a greater threat to TNCs than events initiated by non-government forces, like kidnappings, sabotage, and terrorism. This is so despite the fact that dramatic mass expropriations have all but ceased to be a major issue (Minor, 1994). Evidence from the political risk insurance industry is illustrative. Even though insurance claims related to damages from political violence are more numerous than “expropriation” losses (with expropriation being broadly defined; see Moran and West, 2005), losses of the latter nature are usually far more costly in dollar terms (Jensen, 2005; O’Sullivan, 2005). This

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can be true even if the action that causes the loss seems innocuous and unspectacular. A “death of a thousand cuts” (Zonis and Wilkin, 2001, p. 178) – which often arises from ineffective legal or regulatory regimes – could hurt a company more than a violent *coup d’état*, which does not necessarily have any bearing on TNCs’ activities (Morisset and Neso, 2002). The notion that micro-political risks are a significant impediment to FDI also receives support from recent surveys of TNCs (A.T. Kearney, 2003; Batra, Kaufmann and Stone, 2003). Often such risks, of which there exists a wide variety, are placed under the general heading of “creeping expropriation” as they gradually, yet significantly, erode the firms’ property rights (Oetzel, 2005). In the existing literature, the heterogeneity of possible political risk outcomes is matched by an equally vast array of potential *sources* of risk. Some argue that political instability is what matters (Green, 1974; Weston and Sorge, 1972). Others highlight host country attitudes in general (Ascher and Overholt, 1983) and economic nationalism in particular (Lipson, 1985; Moran, 1974). Yet another group of scholars identify the host country-TNC bargaining relationship and industry-specific characteristics as prime causes (Poynter, 1985; Vernon, 1971). Furthermore, some scholars and practitioners treat political risk as more of a multidimensional phenomenon (Bunn and Mustafaoglu, 1978; Robock, 1971; Simon, 1982), while a recent series of studies have focused more sharply on host country institutions (Henisz, 2000; Jensen, 2006).

This brief review of the literature suggests that a more succinct and, at the same time, more powerful framework for explaining political risk effects is needed. Taking as my point of departure the observation that policy changes and government intervention are the most important forms of direct obstacles to TNCs, I contend that the sources of such outcomes are often – albeit not exclusively – to be found in: (1) the relative bargaining power of the host and the firm, and the inevitable shift in this bargaining relationship over time; and (2) specific characteristics of the host country’s political system. Moreover, these two root causes of risk often work in tandem, ensuring that the risk of host government appropriation of sunk TNC assets – a risk that

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is significant irrespective of institutional traits – is heightened in autocratic nations with few checks and balances.

### **The obsolescing bargain**

Initially proposed by Vernon (1971), the obsolescing bargain model states that investment deals involving the deployment of significant fixed assets will, almost unavoidably, be susceptible to later revisions by the host government. This is so mainly because investment, once undertaken, becomes a “hostage” in the custody of the host country. Large oil rigs, production plants or copper mines cannot easily be removed by the TNC. Consequently, the firm cannot, *ex ante*, credibly threaten to pack up and leave if the host government reneges on the agreed contract. All else being equal, the relative bargaining power of the firm decreases and that of the host government increases with time.

The pre-investment distribution of bargaining power tends to favour the TNC; hence, the initial deal is often relatively advantageous for the investor. Depending on the nature of the proposed investment, the foreign investor can offer the host much needed capital, management know-how, marketing skills, advanced technology and access to export markets (Fagre and Wells, 1982; Vachani, 1995). The “bargaining chips” of the host country include its market size and growth prospects, access to cheap and/or highly skilled labour, natural resources, infrastructure, and an investor-friendly regulatory regime (Dunning, 1988). The outcome of the bargaining is also influenced by the level of TNC and host country competition. While the TNC may succeed in working out a favourable initial agreement for itself, the point Vernon (1971) makes is that this deal might not last for long if immobile fixed assets are involved. In countries where the risk of expropriation (however defined) is substantial, the host government’s inclination to renege on contracts increases with the degree of asset specificity, which makes investments involving large sunk costs a particularly risky undertaking (Teece, 1986). Paradoxically, the size of the required

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investment, which in the pre-investment phase is a crucial bargaining chip for the TNC, becomes a liability in the post-investment phase. This mechanism has proved particularly troublesome for companies in extractive industries, where fixed-asset investments are substantial and the period required for recouping investment is long (Bray, 2003; Moran, 1974, 1998). The infrastructure industry is also vulnerable, as evidenced by the wide-ranging forced contract renegotiations and investment disputes that followed the FDI boom of the 1990s (Ramamurti and Doh, 2004; Wint, 2005).

TNCs' profits also constitute a double-edged sword. High initial returns may make an affiliate a more attractive target for government takeover or the imposition of regulation (Poynter, 1985), and even more so if monopoly rents are extracted by the firms, as is often the case with infrastructure investments (Jodice, 1980; Wells, 1998). Besides, once a foreigners' project has proven commercially viable, the "risk premium" from the pre-investment phase – a common feature of investments in natural resources – suddenly looks excessive and unfair; accordingly, both politicians and the public at large are inclined to demand a larger slice of the revenue as time passes. Moreover, as technical and management skills spread to host country nationals, the government comes to realize that the project can - and perhaps should - be run by locals (Poynter, 1982).

The general outcome of these processes is the increased risk of government intervention. There exist many studies on government interference where the root causes are to be found in the logic of the obsolescing bargain. Moran's (1974) seminal analysis of the gradual *nacionalización* of United States copper firms in Chile is perhaps the most comprehensive empirical treatment of the model. Others, too, have used Vernon's model to account for TNC losses (Poynter, 1982; Vachani, 1995; Wint, 2005). Considering the empirical evidence, the notion of the obsolescing bargain appears to be a valid theoretical explanation of politically-induced TNC losses.

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## Democracies, autocracies and veto players

While highlighting the bargaining relationship as a potential source of political risk is fairly uncontroversial, the notion that foreign investors prefer democracy over autocracy is not left uncontested in the literature. O'Donnell (1978), for example, argues that various military dictatorships in the 1960s and 1970s forged strong alliances with international capital. Likewise, Li and Resnick (2003) contend that autocracies tend to support TNCs' oligopolistic or monopolistic behaviour and are more capable of offering generous fiscal incentives to foreign investors. In addition, authoritarian regimes may, through their ability to suppress the criticism of deals with TNCs, provide some protection, which democracies – especially fledgling ones – cannot (Przeworski and Limongi, 1993; Wells, 1998).

The benefits of democracy should nonetheless far outweigh the costs associated with its supposed lack of flexibility. Some recent qualitative evidence suggests that sound political institutions matter more to TNCs than financial incentives, and investment promotion agencies utilize their respective countries' democratic institutions as a major selling point (Jensen, 2006). Similarly, although the evidence is still mixed, recent quantitative studies find little to suggest that TNCs are particularly attracted by autocratic governments, repressive regimes or low labour standards (Busse, 2004; Jakobsen and de Soysa, 2006; Jensen, 2003; Neumayer and de Soysa, 2005).

Political institutions, first and foremost, enter into the consideration because the likelihood of policy reversal is such a major concern for investors. Olson (1993), for example, argues that democracies are more conducive to investment and growth than autocracies because an autocrat is unable to commit credibly to protect his citizens' property rights. Citizens in autocracies will thus invest and produce less than the optimal level. Of course, an autocrat does have an incentive to *promise* property rights protection, but such a promise lacks credibility because it is not backed up by any independent sources of power. Sound

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political institutions, although they do not *guarantee* policy stability, do enhance the credibility of promises to protect investors' assets (Henisz, 2000; Henisz and Williamson, 1999; Jensen, 2006). This is of utmost importance to TNCs, given that most FDI is undertaken with a long-term view. Having invested in immobile assets in the host country, the TNC's financial viability will surely be under threat if foreigners are discriminated against; contracts are not upheld; or business laws are enforced in an arbitrary manner (North, 1990; Rondinelli, 2005; World Economic Forum, 2004). Forward-looking TNCs, therefore, generally value solid political institutions and secure property rights more than investment incentives (e.g. tax breaks), because good governance is the foundation for *future* policy stability, while FDI incentives are perceived as non-permanent and unstable (Morisset and Pirnia, 1999; Streeten, 2005).

The credibility-enhancing nature of democracies is in no small part due to the existence of veto players and executive constraints, such as the parliament, opposition parties, independent courts and regional/local governments (Henisz, 2000; Leeds, 1999; Levy and Spiller, 1994). These are actors of the political system that can block the adoption of a policy (Tsebelis, 1995). The central thesis is that for policy stability to be effectively promoted, the state or government must be limited in its ability to exercise its power arbitrarily. By definition, checks and balances favour the status quo, diminishing the scope for policy reversals, uncertainty and self-interested behaviour (Leeds, 1999; North, 1990). Other things being equal, a low number of veto players increases policy risk (McIntyre, 2001; Tsebelis, 1995).

Henisz (2000), for example, argues that the *feasibility of policy change* is proportional to the level of political hazards or political risk. Based on this idea, he creates a simple spatial model of political interaction or political constraints (POLCON) that includes a number of relevant actors (the executive, the lower and upper houses of legislature, sub-federal units, and the judiciary) and their possible preferences. He then proceeds to calculate yearly POLCON scores for 157 countries for the

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period 1960-94,<sup>1</sup> thereby generating an *objective* measure of an important source of political risk.

The checks and balances concept can usefully be regarded as a subset of democracy, which, in turn, is an important factor in the make-up of a nation's general institutional arrangement. A widely held belief is that investing in emerging markets requires that the "soft infrastructure" be in place (Dunning, 1998; Globerman and Shapiro 2002). If political freedom, bureaucratic efficiency and the rule of law prevail, uncertainty and transaction costs for economic actors are reduced and rent-seeking and opportunistic behaviour are curtailed (Eggertsson, 1990; Mudambi and Navarra, 2002; North, 1990). In contrast, if institutions are poor, as they are in many developing countries, nations tend to become trapped in a vicious circle of autocratic arbitrariness, poorly defined and ineffective property rights, high transaction costs, lack of fixed investments and long-term agreements, and subsequently lack of growth (North, 1990).

The argument that democracy enhances credibility is adopted by Jensen (2003, 2006), who advances the explanation by suggesting that the existence of "audience costs" further induces democratic leaders not to break promises. When state leaders are held accountable by their constituencies, reneging on promises tends to come with a political price, as policy reversals are bound to harm important sub-groups in the host country (e.g. suppliers of TNCs' suppliers, employees, customers). Thus, the fear of an electoral backlash can contribute to constraining democratically elected leaders (Jensen, 2003, 2006; Leeds, 1999).

The preceding discussion outlines the main reason why democratic environments are conducive to FDI. Yet, non-democratic nations have a number of other characteristics that

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<sup>1</sup> The database has since been updated and now contains POLCON scores for practically all economies of the world for the period 1800-2004. The dataset is available at <http://www-management.wharton.upenn.edu/henisz/>.

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also tend to make them politically riskier than their democratic counterparts. For example, political freedom may decrease the ability of bureaucrats or local businesses to extract rents from administrative procedures and to exploit institutions often marred by cronyism (Jakobsen and de Soysa, 2006; Morisset and Neso, 2002). Others point out that autocratic regimes, although seemingly stable, may hide an underlying instability, eventually causing erratic and unpredictable change (Bremmer, 2005; Feng, 2001). Another common contention is that investing in repressive autocratic regimes causes reputational risks for TNCs and increases the likelihood of vigorous NGO (and shareholder) activism and costly litigation processes against the management (Bray, 2003; Kobrin, 2005).

### *The obsolescing bargain mechanism in autocracies*

Some argue that the OBM transcends partisanship at the level of national politics and brings the perceived national interest to the forefront (Moran, 1998). For instance, the many expropriations and forced divestments in the 1960s and early 1970s were instigated by governments of different political orientations; often the interventions had the characteristics of a rational process that was pursued to achieve national politico-economic objectives (Jodice, 1980; Kobrin, 1980). Yet, in terms of political institutions, the vast majority of countries undertaking mass expropriations in this time period were severely under-developed and their respective governments had come to power either through coups, revolutions or abrupt decolonization processes (Kennedy, 1993). In the absence of a functioning democracy, the hands of the executive power are untied, credibility is lacking, and government intervention becomes more likely (Leeds, 1999; Moran, 1998).

The relevance of the OBM depends critically on political institutions. Without credible commitments, contracts and policies are mere promises; they are not self-enforcing and therefore cannot be expected to be adhered to (Schelling, 1960; Williamson, 2000). The OBM predicts that the host government will behave opportunistically, once sunk investments are made,

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but the scope for such opportunism is significantly constrained if veto-wielding players are present, as they usually are in democracies (North, 1990). In countries without well-developed checks and balances, on the other hand, government intervention risk is magnified.

Recent evidence from oil-rich Venezuela is illuminating. Having been elected as president in late 1998, Hugo Chávez has since strived to curtail the political power of the opposition.<sup>2</sup> Acting on the basis of a temporary enabling law that gave the president and the government legislative powers, Chávez announced in November 2001 the enactment of 49 new economic laws, which had been subjected to hardly any consultation. Among these laws was a new hydrocarbons legislation that almost doubled royalty taxes and required the state's equity participation in joint ventures to exceed 50%. Critics complained that the move amounted to a virtual "renationalization" of the petroleum industry in which foreign corporations have invested billions.<sup>3</sup> Since then, the TNCs have suffered several tax hikes, the most sudden and dramatic of which occurred in April 2005 when the authorities made an unanticipated announcement – amid record oil prices – that they would raise both income taxes and royalties in the industry, securing for the state a minimum of 82.5% of profits.<sup>4</sup> A few months later, the government declared that the 2001 Hydrocarbons Law was to be applied retroactively and that 32 contracts signed with oil firms between 1992 and 1997 would be revised, to secure state majority ownership.<sup>5</sup> Similar contract revisions have also affected foreign-owned mining firms,<sup>6</sup> while a controversial land reform

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<sup>2</sup> In 2000, Venezuela's political constraints (POLCON) score dipped from 0.18 to 0, the lowest possible value.

<sup>3</sup> "Venezuela's 'revolutionary' laws", *The Economist*, 22 November 2001; "Venezuelan oil law 'threatens investment'", *Financial Times*, 20 November 2001.

<sup>4</sup> *Financial Post – Canada*, 18 April 2005: "Venezuela announces plan to increase income tax on private oil projects;" *The Economist*, 10 November 2005: "Chávez squeezes the oil firms."

<sup>5</sup> "Venezuela gives Exxon ultimatum", *BBC News*, 20 December 2005.

<sup>6</sup> "Venezuela reviews foreign deals", *BBC News*, 8 February 2005.

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scheme – which was also initiated under the 2001 enabling law – has resulted in the confiscation of allegedly idle rural estates.<sup>7</sup>

In the sections that follow, I will empirically investigate the hypothesis that political freedom and executive constraints reduce investor risks. First, this will be examined by way of a TSCS analysis of democracy's effect on TNCs' investment location decisions (i.e. FDI inflows). Granted, such a test does not exclude other possible mechanisms. To explore further the argument that political freedom mitigates the OBM and thereby reduces government intervention risk, I also test whether democracy and checks and balances are reflected in the strengths of property rights protection.

### *Democracy as a determinant of FDI – an empirical analysis*

Evidence in the empirical literature is somewhat mixed on the relationship between political freedom and FDI. Oneal (1994), for example, finds no evidence that investment flows are significantly related to the regime type, although the rates of return in developing countries seem to have been larger in autocracies. In a more recent study, Li and Resnick (2003) find that democratic developing nations actually receive less FDI than autocratic developing countries, if democracy's positive impact on property rights protection is controlled. Replicating that study, Jakobsen and de Soysa (2006) show that once the sample is extended and certain methodological problems are addressed, the relationship between democracy and FDI, in fact, becomes positive and significant. These results are supported by Jensen (2003). Likewise, neither Busse (2004) nor Harms and Ursprung (2002) find any consistent support for anti-globalization activists' claim that TNCs prefer to invest in countries with regimes that repress civil and political rights, although this conclusion is valid only for the 1990s. Others have found little evidence to suggest that TNCs find the business environment in autocratic countries more attractive because of restrictive conditions imposed on labour (Neumayer and de

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<sup>7</sup> "Venezuela's chaotic land reform", *The Economist*, 13 January 2005.

Soysa, 2005). Although, on balance, recent empirical literature suggests a complementary relationship between FDI and democracy, the evidence is not yet unambiguous. The discrepancies in findings may be partly due to the fact that different studies employ different specifications of both the dependent and the independent variable(s).

### *Model*

My main dependent variable is FDI inflows (FDI), logged in order to reduce skewness; to avoid problems of undue “influence” and heteroskedasticity; and to improve the model’s fit.<sup>8</sup> However, the existing studies on the determinants of FDI determinants differ in the choice of the dependent variable. Some studies utilize (logged) FDI per capita (Busse, 2004; Harms and Ursprung, 2002), while many employ FDI divided by GDP (Asiedu and Lien, 2004; Büthe and Milner, 2005). Even though different FDI measures are highly correlated (see table 1), in some tests I also use per-capita FDI (FDIPC) or the ratio of FDI to GDI (FDIGDP) to ensure that results are robust.

**Table 1. Correlation between democracy, property rights and FDI**

	POLITY	FREEDOM HOUSE	VAN HANEN	POLCON	PROPERTY RIGHTS	FDI	FDIPC	FDIGDP
POLITY	1.00							
FREEDOM HOUSE	0.86	1.00						
VANHANEN	0.75	0.73	1.00					
POLCON	0.77	0.69	0.67	1.00				
PROPERTY RIGHTS	0.21	0.29	0.31	0.23	1.00			
FDI	0.28	0.25	0.33	0.30	0.40	1.00		
FDIPC	0.29	0.33	0.35	0.29	0.45	0.89	1.00	
FDIGDP	0.25	0.26	0.27	0.26	0.33	0.88	0.96	1.00

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> FDI, FDIPC, and FDIGDP are logged.

<sup>8</sup> Data are from UNCTAD and can be downloaded from <http://stats.unctad.org/fdi/>. Transforming variables presents a few minor problems, such as how to treat negative and zero values. In my model, such values are set to a very small number (i.e. \$0.01 million) relative to the lowest absolute values in the sample. This transformation, however, only affects about 9% of the total in my sample.

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Since some argue that most available indicators of democracy are not interchangeable despite being highly correlated (Casper and Tufis, 2003), I test the effects of four different measures of political freedom and executive constraints on FDI. The first is the POLCON index (POLCON) by Henisz (2000), which specifically and objectively measures the level of constraints on the executive. POLCON ranges from zero (no constraints) to one (maximum constraints). Second, I draw on data from the Polity IV Project and include the Polity 2 index (POLITY) in some of the specifications. This broader (and more subjective) estimate of democracy is re-scaled so as to range from one (full autocracy) to 21 (full democracy).<sup>9</sup> Third, I also use Freedom House's aggregate political and civil rights index (FREEDOM HOUSE). This variable is also re-scaled and ranges from 1 to 13.<sup>10</sup> And finally, in some tests, I use the only available objectively measured indicator of democracy based on electoral data (Vanhanen, 2000). This latter measure of polyarchy (VANHANEN) gauges the narrowness of victory for the largest party winning any given election for executive office. The resulting variable is then interacted with the percentage of the population that participates in the election.<sup>11</sup>

In an analysis of the determinants of FDI, a number of variables that influence the host-country's potential to attract FDI have to be controlled. Some of these determinants have proven to be very stable over time (Nunnenkamp and Spatz, 2002). In the empirical literature, a consistent finding is that market size matters, as does market growth. I therefore include ECONOMIC SIZE (GDP, logged) and ECONOMIC GROWTH in my model. As a measure of the host country's trade potential

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<sup>9</sup> POLITY contains country-level information on executive constraints, political competition, and the competitiveness and regulation of political participation and executive recruitment. The Polity 2 version of the index also codes democracy scores for interregnum years previously reported as missing (Gurr and Jagers, 1995). The Polity IV dataset is available at <http://www.cidcm.umd.edu/inscr/polity/>.

<sup>10</sup> Data can be downloaded from <http://www.freedomhouse.org/>.

<sup>11</sup> The Polyarchy data are available from <http://www.prio.no/cwp/vanhanen/>.

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for export-oriented TNCs, trade openness (i.e. the sum of exports and imports, divided by GDP and logged) is, in most studies, also found to be a potent predictor of FDI (Harms and Ursprung, 2002; Jun and Singh, 1996). In addition, the variable ECONOMIC DEVELOPMENT (GDP per capita, logged) is included to control for the level of development, even though this variable is often found to have little statistical effect on FDI inflows (Li and Resnick, 2003; Neumayer and Spess, 2005). Data on these four variables are from the World Bank (2004).

To proxy investment risks that are not directly related to political freedom, I use several measures. Acknowledging that exchange-rate movements can have an impact on TNC profits, especially for manufacturing firms (Miller and Reuer, 1998), I control for exchange rate volatility (EXCHANGE RATE), as others do (Brunetti and Weder, 1997).<sup>12</sup> Following Li and Resnick (2003), I also use a proxy for regime durability, extracted from the Polity IV dataset. This variable is measured as the number of years since the last regime transition (i.e. a 3-point or greater shift in the Polity index). In addition, I include a dummy variable for civil war (CIVIL WAR) with over 25 battle-related deaths (Gleditsch *et al.*, 2002) to account for political instability.<sup>13</sup> CIVIL WAR, I suspect, is more relevant than proxies for general political stability and violence, which are sometimes used but often turn out to be insignificant (Brunetti and Weder, 1997) or even positive (Campos and Nugent, 1998). Given the recent evidence that government ideology matters (Jakobsen and de Soysa, 2006), I also include a dummy for the party political affiliation of the government. This variable (LEFTIST EXECUTIVE) is drawn from the World Bank's Database on Political Institutions (DPI), which is an indicator for the "economic policy orientation" of the ruling party and coalition. This database deems a government "rightist"

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<sup>12</sup> EXCHANGE RATE is the standardized absolute exchange rate deviation from the average exchange rate of local currency units *vis-à-vis* United States dollars over the last three years. Data are from the World Bank (2004).

<sup>13</sup> Data are obtained from the PRIO/Uppsala Armed Conflict Dataset, available at <http://www.prio.no/cwp/ArmedConflict/>.

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if ruling parties are defined as conservative, Christian democratic or right-wing, and “leftist” if ruling parties are communist, socialist, social democratic or left-wing (Beck *et al.*, 2001).

Some hold that failure to control for property rights and government policy may lead to contradictory results in analyses of FDI determinants (Knack and Keefer, 1995; Lecraw, 1996). I therefore include a proxy for property rights protection, which is based on expert-generated data from the International Country Risk Guide (ICRG) and closely resembles the index calculated by Knack and Keefer (1995) and utilized by Li and Resnick (2003) and Jakobsen and de Soysa (2006).<sup>14</sup> The measure, PROPERTY RIGHTS, runs from 0 to 60 and is a weighted average of four of the 12 variables included in ICRG’s political risk index: investment profile (weighted 40%), quality of bureaucracy (20%), corruption (20%) and the law and order (20%).

Geographical closeness to TNCs’ home countries may be a factor in location decisions. I therefore include a variable indicating FDI outflow-weighted summed surface distance between host countries and four major political and financial centres: Brussels, Washington D.C., Tokyo and Hong Kong.<sup>15</sup> The variable (WEIGHTED DISTANCE) is logged to reduce skewness.

I also acknowledge that FDI, by definition, exhibits a significant degree of stickiness and I thus include a measure of accumulated FDI divided by GDP (FDI STOCK). FDI STOCK also reflects the presence of other TNCs in a country, which by itself signals host-country potential and possible agglomeration economics (Dunning, 1998).

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<sup>14</sup> The weighting and naming of the individual variables included in ICRG’s composite political risk index has changed somewhat over the last few years. Therefore, I am not able to exactly replicate Knack and Keefer (1995).

<sup>15</sup> Data on distances between world capitals can be obtained from <http://wcr1.ars.usda.gov/cec/java/capitals.htm>. Data on FDI outflows are from UNCTAD’s database at <http://stats.unctad.org/fdi/>.

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The data have a panel structure, containing information on each country ( $i$ ) for each year ( $t$ ) over the period 1983-2001. Consequently, a TSCS design is employed. All independent variables – except WEIGHTED DISTANCE, whose hypothesized effect is immediate – are lagged one year under the assumption that it takes some time for changes in the explanatory variables to affect FDI. This should also ease possible endogeneity problems. My model only focuses on developing and emerging market economies, as is the convention in the bulk of the empirical literature (Jun and Singh, 1996; Schneider and Frey, 1985).

Following Beck and Katz (1995), I choose to estimate my regression parameters by OLS, which should yield consistent, albeit inefficient, results. The standard errors, on the other hand, are probably distorted. Since the model is cross-sectional dominant ( $N > T$ ), the Parks-Kmenta FGLS estimation technique cannot, and the panel-corrected standard errors (PCSEs) method should not, be used (Beck and Katz, 1995; Wiggins, 1999). The recommended estimation method in Stata, especially when the sample size is large, is to regress cluster (Wiggins, 1999; Wooldridge, 2003), i.e. OLS regression with Huber-White's heteroskedastic-consistent robust estimates of the standard errors .

The model is likely to be plagued by serial correlation in the error terms (as well as contemporaneous correlation, i.e. correlation between the errors of different units). Following Beck and Katz (1995), I therefore include a lagged dependent variable (LDV) on the right-hand side of the equation. By doing so, I basically treat the LDV as an explanatory variable in its own right, expecting it to represent relevant omitted historical factors and thus to account for a large part of the variance in FDI (Kittel, 1999; Wooldridge, 2003). In addition, the inclusion of the LDV should rid the model of autocorrelation. This expectation is confirmed by a TSCS version of the Lagrange-multiplier test. Since FDI levels vary greatly from year to year, suggesting that there may be large unit-invariant differences between time periods, I also include time dummies among the regressors.

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## *Results*

Table 2 presents results when FDI is regressed on four different proxies for democracy and executive constraints.<sup>16</sup> All of the main variables of interest are positively and significantly related to FDI in developing and transition economies as expected. A 1% increase in POLITY, other things being equal, induces a 5.76% increase in FDI inflows, and a ten-point POLITY improvement is associated with a 75% increase in FDI. Likewise, a relatively modest 0.10 improvement in POLCON (which ranges theoretically from 0 to 1) yields 21.56% more FDI. The other measures of political freedom show similar results.

The inclusion of a lagged dependent variable complicates the interpretation of substantive effects. However, the presence of the LDV increases the statistical significance of other explanatory variables. This is so because the LDV tends to soak up variance and masks or reduces other possible causal effects of the independent variables (Kittel, 1999). Therefore it seems that results reported in table 2 are reasonably reliable.

Regarding the control variables, most of them are significant and have the expected sign. Specifically, two of the market-related variables, ECONOMIC SIZE and ECONOMIC GROWTH, are positive and highly significant, confirming results reported by many other studies (Busse, 2004; Gliberman and Shapiro, 2002; Schneider and Frey, 1985). ECONOMIC DEVELOPMENT, however, is negative, and sometimes significantly so. This, however, should come as little surprise;

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<sup>16</sup> Several diagnostics tests were performed. VIF and tolerance scores did not show a problem with multicollinearity. A Lagrange multiplier test indicated that including a lagged dependent variable was warranted; the test was insignificant after the inclusion of the LDV. Histograms showed that the untransformed version of the dependent variable was highly skewed and that logging was necessary. Logging ensured that the dependent variable approximated a normal distribution and also removed the “fan” pattern whereby residuals increased as fitted values increased. No cases of undue influence (leverage) were detected.

**Table 2. Determinants of FDI in developing countries, 1983-2001**

Independent variables	(1) FDI	(2) FDI	(3) FDI	(4) FDI
LAGGED DEPENDENT	0.440*** (8.62)	0.478*** (8.15)	0.465*** (8.34)	0.470*** (8.61)
POLITY	0.056*** (3.22)			
FREEDOM HOUSE		0.118*** (3.04)		
VANHANEN			0.037*** (3.71)	
POLCON				1.952*** (4.16)
PROPERTY RIGHTS	-0.000 (0.04)	-0.010 (0.85)	-0.005 (0.43)	-0.005 (0.41)
CIVIL WAR	-0.579*** (2.67)	-0.424* (1.92)	-0.528** (2.40)	-0.558*** (2.63)
REGIME DURABILITY	0.055 (0.61)	0.059 (0.67)	0.056 (0.66)	0.077 (0.83)
LEFTIST EXECUTIVE	0.245* (1.71)	0.279* (1.79)	0.357** (2.49)	0.353** (2.35)
ECONOMIC SIZE	0.662*** (8.96)	0.635*** (7.03)	0.617*** (7.66)	0.603*** (6.99)
ECONOMIC GROWTH	0.044** (2.39)	0.048** (2.49)	0.040** (2.23)	0.040** (2.20)
ECONOMIC DEVELOPMENT	-0.369** (2.58)	-0.247 (1.34)	-0.348** (2.27)	-0.251 (1.59)
EXCHANGE RATE	0.000 (0.21)	-0.000 (0.27)	-0.001 (0.43)	0.000 (0.03)
TRADE	0.382 (1.59)	0.357 (1.54)	0.344 (1.54)	0.304 (1.37)
FDI STOCK	0.288*** (3.53)	0.187* (1.72)	0.255*** (2.96)	0.250*** (2.67)
WEIGHTED DISTANCE	-0.249 (1.10)	-0.129 (0.59)	-0.011 (0.05)	-0.228 (1.02)
Constant	-11.259*** (3.52)	-11.484*** (3.69)	-11.925*** (3.77)	-11.154*** (3.75)
Countries	94	95	95	95
Observations	1043	1002	1048	1052
R <sup>2</sup>	0.550	0.554	0.550	0.552

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> Regression with robust standard errors (regress, cluster() command in Stata 8.0).

<sup>b</sup> Time dummies are used in estimation but not reported.

<sup>c</sup> *t*-statistics in parentheses.

<sup>d</sup> All independent variables except WEIGHTED DISTANCE are lagged one year.

\* Significant at the 10% level.

\*\* Significant at the 5% level

\*\*\* Significant at the 1% level.

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while GDP per capita is a proxy for wealth and hence for the purchasing power of the host-country population (and, in effect, also for physical infrastructure), it is also an implicit measure of wages and should thus be negatively correlated with *efficiency-seeking* FDI. Others, too, report that the effect of income is not significant (Neumayer and Spess, 2005). WEIGHTED DISTANCE also exhibits little effect on the dependent variable, a result confirmed by Altomonte (2000). It seems, thus, that countries are not rewarded for being geographically close to TNCs' home countries.

The fact that FDI STOCK is consistently positive and significant is as expected. However, table 2 and further unreported analyses suggest that the inclusion of FDI STOCK works to eliminate the impact of TRADE on FDI.

The two proxies for political instability and regime instability vary in their observed effects. Reassuringly, CIVIL WAR seems to lower FDI inflows, possibly indicating that this variable is better suited to control for *investor-relevant* instability than the commonly employed event counts measures of instability that aggregates coups, revolutions, assassinations, riots and strikes into a single index. In fact, a similar reasoning may account for why REGIME DURABILITY is insignificant. Frequent changes of government or regime do not *per se* force a change in investment rules and thus do not necessarily pose a significant risk to foreign companies (Kobrin, 1979; Robock, 1971). Exchange-rate volatility, too, has little impact on aggregate FDI flows, a result also reported by others (Globerman and Shapiro, 2002).

The leftist dummy, however, is positive and significant, consistent with the findings of Jakobsen and de Soysa (2006). In other words, the popular perception that leftist governments deter TNCs *ex ante* receives no empirical support in this study. Similar results were reported by Schneider and Frey (1985) some 20 years ago. As we have suggested above, the OBM largely transcends partisanship, with rightist governments being no less prone to acting in the country's perceived self-interest (Moran, 1998).

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Somewhat surprisingly, PROPERTY RIGHTS – which should proxy *current* government intervention risk – is insignificant in all specifications. Perhaps this suggests that measuring the current investment regime reveals little information regarding what the future might bring. In fact, Henisz (2000) argues that his POLCON measure should perform better than most other proxies for political risk because the commercial risk assessment industry is rarely forward-looking. TNCs, on the other hand, invest on a long-term basis; political risk would therefore be defined in terms of the possibility of *future changes* in the investment regime, and the risk concept is probably better captured by proxies which focus on the current attributes of political institutions (e.g. executive constraints) that might – at a later stage – cause changes in the rules of the game. Nevertheless, different measures of political freedom are all positive and highly significant also after controlling for property rights protection, suggesting that democracy has an additional positive effect on FDI over and above its indirect effect via PROPERTY RIGHTS. Table 3 does not alter this conclusion. Here, FDIPC and FDIGDP are employed as dependent variables, while all independent variables are retained (only POLITY and POLCON are used to proxy political freedom).<sup>17</sup> Again, results indicate that democracy and executive constraints positively impact on FDI inflows.

### *Sensitivity tests*

Using alternative democracy measures as well as different specifications of the dependent variable make for solid robustness tests. Using table 2 (columns 1 and 4) as points of reference, additional sensitivity tests were also conducted. None of these tests changed the main findings. The effects of political freedom on FDI were just as pronounced when the lagged dependent variable was not included and when the robust standard errors were replaced with PCSEs and employed the AR(1) correction for first-order autocorrelation instead of

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<sup>17</sup> Since market size is captured in the *Y* term, when FDIGDP is employed as the dependent variable, ECONOMIC SIZE is not included among the regressors.

**Table 3. Determinants of FDI per capita and FDI/GDP in developing countries, 1983-2001**

Independent variables	(1) FDIPC	(2) FDIPC	(3) FDIGDP	(4) FDIGDP
LAGGED DEPENDENT	0.440*** (8.62)	0.471*** (8.61)	0.444*** (8.61)	0.473*** (8.72)
POLITY	0.057*** (3.25)		0.052*** (3.00)	
POLCON		1.971*** (4.19)		1.841*** (3.99)
PROPERTY RIGHTS	-0.001 (0.05)	-0.005 (0.42)	-0.000 (0.02)	-0.005 (0.46)
CIVIL WAR	-0.580*** (2.68)	-0.559*** (2.64)	-0.525** (2.46)	-0.521** (2.51)
REGIME DURABILITY	0.055 (0.61)	0.076 (0.83)	0.070 (0.77)	0.090 (0.97)
LEFTIST EXECUTIVE	0.247* (1.72)	0.356** (2.37)	0.265* (1.79)	0.367** (2.42)
ECONOMIC SIZE	0.103* (1.67)	0.074 (1.18)		
ECONOMIC GROWTH	0.044** (2.41)	0.040** (2.22)	0.045** (2.45)	0.040** (2.20)
ECONOMIC DEVELOPMENT	0.191 (1.26)	0.279* (1.84)	-0.247* (1.77)	-0.155 (1.06)
EXCHANGE RATE	0.000 (0.22)	0.000 (0.04)	0.000 (0.27)	0.000 (0.06)
TRADE	0.382 (1.58)	0.303 (1.37)	0.237 (1.04)	0.214 (1.02)
FDI STOCK	0.288*** (3.52)	0.250*** (2.66)	0.259*** (3.25)	0.222** (2.45)
WEIGHTED DISTANCE	-0.258 (1.14)	-0.238 (1.06)	-0.209 (0.92)	-0.188 (0.84)
Constant	-3.506 (1.22)	-3.810 (1.41)	-1.740 (0.64)	-2.716 (0.99)
Countries	94	95	94	95
Observations	1043	1052	1041	1050
R <sup>2</sup>	0.486	0.493	0.430	0.431

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> Regression with robust standard errors (regress, cluster() command in Stata 8.0).

<sup>b</sup> Time dummies are used in estimation but not reported.

<sup>c</sup> *t*-statistics in parentheses.

<sup>d</sup> All independent variables except WEIGHTED DISTANCE are lagged one year.

\* Significant at the 10% level.

\*\* Significant at the 5% level

\*\*\* Significant at the 1% level.

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including an LDV. Excluding the CIS as well as Eastern and Central European countries did not alter democracy's coefficient.

In the analyses of FDI determinants, where economic growth and trade are prime control variables, endogeneity might be an issue, given that FDI could boost both growth and trade.<sup>18</sup> In the main models, this potential problem is addressed by the quite elementary fix of using lagged independent variables (as well as an LDV) on the right-hand side of the equation. To further explore this matter, I adopted the instrumental variable (IV) approach and ran a two-stage least squares regression using TRADE (lagged two years) and first differenced ECONOMIC GROWTH as appropriate instruments. The main findings did not change, however. Furthermore, a Durbin-Wu-Hausman test for endogeneity turned out to be insignificant, lending further credence to the results.

Diverse additional control variables were also included in the base model for robustness analysis. None of the proxies for natural resources<sup>19</sup> turned out to be significant, and these were dropped from the reported models. Different controls for property rights protection were also included. An index of economic freedom,<sup>20</sup> the number of bilateral investment treaties (BITs) signed and membership in the International Centre for Settlement of Investment Disputes (ICSID) were employed as controls, but none of these variables altered the results. The findings also held when the CIVIL WAR dummy was replaced with a variable measuring the number of years since the last civil war. Using inflation as a proxy for macroeconomic instability had no effect either. And lastly, I included controls for physical infrastructure, wealth and human capital.<sup>21</sup> Results stayed the same.

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<sup>18</sup> I would like to thank one of the anonymous reviewers for stressing this point.

<sup>19</sup> Tests were conducted using measures of oil reserves (logged), fuel exports, resource\_rents/GDP, and ores and metals exports.

<sup>20</sup> The Economic Freedom index is available at <http://www.freetheworld.com/download.html>.

<sup>21</sup> I used a measure of fixed line and mobile phone subscriptions per 1,000 people (World Bank, 2004) and UNDP's Human Development Index, available at <http://www.undp.org/>.

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Evidently, democracies are rewarded by TNCs, as are countries where the executive cannot easily use its power arbitrarily. This relationship holds even when alternative measures of democracy and FDI, different testing methods and various model specifications are used. This article argues that the relationship is largely due to the fact that the OBM is constrained in democratic nations with well-developed checks and balances. The findings do not, however, exclude the existence of other causal mechanisms. TNCs may, for example, prefer to avoid autocracies because democratic countries are less likely to be marred by rent-seeking and cronyism; they are less prone to dramatic socio-political change; or they lower reputational risks. To further investigate whether political freedom and executive constraints really decrease the risk of government intervention, I will test if democracy affects property rights protection in the next section.

### **Democracy as a source of government intervention risk – an empirical analysis**

There is a lack of empirical studies exploring the relationship between *sources* of political risk and political risk *effects*. This is partly because of the difficulties involved in finding a suitable proxy for the dependent variable. Theoretically, the concept of “political risk effects” includes all politically-induced events that hamper TNCs’ activities. Systematic information-gathering at the level of the corporation is bound to be extremely time-consuming and costly and is hence limited to specific industries (Henisz, Holburn and Zelner, 2005) or to particular dimensions of risk effects (Jodice, 1980; Kobrin, 1980). Some studies instead regress aggregate TNC returns on diverse independent variables (Chase, Kuhle and Walther, 1988; O Neal, 1994). Others focus on host countries’ macroeconomic performance (Henisz, 2004; Miller and Reuer, 1998). One paper utilizes expert-generated data on (perceived) TNC losses (Howell and Chaddick, 1994), while a recent study draws on pricing information from the political risk insurance industry and finds that constraints on politicians reduce (slightly) expropriation and transfer risk coverage (Jensen, 2005).

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The link between democracy and political risk effects is nevertheless severely under-explored in the empirical literature. The study by Jensen (2003) is an exception. He follows a strand in the literature that examines economic determinants of country risk ratings (e.g. Cosset and Roy, 1990) and regresses the risk of debt default on democracy (a positive relationship is found). However, sovereign risk ratings are first and foremost relevant to international *creditors*. Instead, the present study uses a measure of property rights protection which specifically measures the current risk of *government intervention against foreign direct investors*. Using property rights protection should therefore be far better suited to answering my basic research question: do democracy and executive constraints enhance host government credibility, mitigate the OBM and thereby reduce the risk *ex post* government intervention?

### *Model*

As stated earlier, the dependent variable – PROPERTY RIGHTS – follows Knack and Keefer (1995) and is a weighted average of four of the 12 variables included in ICRG’s expert-generated political risk index: investment profile (which consists of the three subcomponents, contract variability/expropriation, profit repatriation and payment delays), quality of bureaucracy, corruption (broadly defined), and law and order. This measure is fairly broad and should thus capture several dimensions of the heterogeneous concept of political risk effects, including a number of “hidden” risks – e.g. administrative corruption and bureaucratic delays – which tend to have detrimental effects on TNCs (Poole-Robb and Bailey, 2003).

The main independent variables of interest are the four measures of democracy, but other potential sources of risk effects, both political and economic, need to be controlled. ECONOMIC DEVELOPMENT, ECONOMIC GROWTH and TRADE are included in the model as the level of risk may decrease with current and potential wealth, as well as with the host country’s integration into the world economy. I also control for exchange rate volatility, given that sharp depreciations could lead to the implementation of restrictions on capital and profit remittances.

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Following the early political risk literature (e.g. Thunell, 1977; Weston and Sorge, 1972), I include among the regressors different measures of political and regime instability, including CIVIL WAR, REGIME DURABILITY and REGIME INSTABILITY, the latter of which is a dummy variable that takes the value 1 if a country has experienced a 3-point or greater change in the Polity index in the last three years. The LEFTIST EXECUTIVE dummy, which proxies government ideology, is also included in the model. Lastly, I control for two variables which may signal to the investor that the host government intends to protect its property rights (Büthe and Milner 2005). The first of these variables measures the number of BITs a country has signed (BIT).<sup>22</sup> The second is a dummy variable that takes the value 1 if a state is a member of the Centre for Settlement of Investment Disputes (ICSID MEMBERSHIP).<sup>23</sup>

### *Results*

The basic TSCS model – an OLS regression with heteroskedastic-consistent robust standard errors – is shown in table 4. These specifications do not contain a lagged dependent variable on the right-hand side, and they should thus be interpreted with caution. Yet, the results do indicate that some of the independent measures might affect the level of property rights protection. Of particular interest, all four measures of democracy and executive constraints are significantly associated with the dependent variable. The same is true for all proxies for economic sources of risk effects. Only three of the controls are insignificant: REGIME INSTABILITY (which, incidentally, is highly correlated with REGIME DURABILITY), ICSID MEMBERSHIP and LEFTIST EXECUTIVE. Having earlier established that leftist governments do not deter TNCs *ex ante*, the latter result indicates that government ideology is also a poor predictor of political risk effects. Nonetheless, we should not place too much confidence in these findings. An *ovtest* suggests that the model has omitted variables, and a Lagrange multiplier

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<sup>22</sup> UNCTAD data are downloaded from <http://stats.unctad.org/fdi/>.

<sup>23</sup> See <http://www.worldbank.org/icsid/>.

test shows that autocorrelation in the residuals renders the significance tests and confidence intervals invalid. Further diagnostic testing reveals that these problems are remedied when an LDV is included.

**Table 4. Determinants of property rights in developing countries, 1983-2000**

Independent variables	(1) PROPERTY RIGHTS	(2) PROPERTY RIGHTS	(3) PROPERTY RIGHTS	(4) PROPERTY RIGHTS
POLITY	0.141** (2.38)			
FREEDOM HOUSE		0.339*** (2.79)		
VANHANEN			0.096** (2.42)	
POLCON				4.955*** (2.64)
CIVIL WAR	-3.191*** (3.07)	-2.503** (2.48)	-2.884*** (2.83)	-2.910*** (2.77)
REGIME DURABILITY	1.003** (2.04)	0.984** (2.07)	0.984* (1.97)	0.942* (1.98)
REGIME INSTABILITY	-0.199 (0.17)	0.007 (0.01)	-0.006 (0.00)	-0.117 (0.10)
BIT	0.101*** (3.49)	0.110*** (4.00)	0.092*** (3.11)	0.099*** (3.29)
ICSID MEMBERSHIP	0.643 (0.50)	0.279 (0.22)	0.264 (0.20)	0.470 (0.37)
LEFTIST EXECUTIVE	1.353 (1.38)	1.117 (1.12)	1.318 (1.31)	1.362 (1.41)
EXCHANGE RATE	-0.009*** (2.65)	-0.011*** (3.19)	-0.011*** (3.13)	-0.009*** (2.64)
ECONOMIC DEVELOPMENT	2.814*** (4.73)	2.482*** (4.14)	2.518*** (4.15)	2.695*** (4.57)
ECONOMIC GROWTH	0.278*** (5.20)	0.277*** (5.21)	0.279*** (4.97)	0.274*** (5.06)
TRADE	1.655 (1.62)	1.795* (1.71)	1.840* (1.71)	1.854* (1.84)
Constant	-4.565 (0.80)	2.328 (0.39)	-1.821 (0.33)	-3.555 (0.62)
Countries	96	96	96	96
Observations	1051	996	1052	1053
R <sup>2</sup>	0.407	0.401	0.388	0.395

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> Regression with robust standard errors (regress, cluster() command in Stata 8.0).

<sup>b</sup> *t*-statistics in parentheses.

<sup>c</sup> All independent variables are lagged one year.

\* Significant at the 10% level.

\*\* Significant at the 5% level

\*\*\* Significant at the 1% level.

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Table 5 presents results from an estimation where the insignificant controls from table 4 are removed and where an LDV is included to account for autocorrelation and omitted variables, as recommended by Beck and Katz (1995). This amounts to a very conservative test of the effects of the other causal variables, as the LDV will tend to soak up much of the variance in the dependent variable and mask or reduce the effects of the other regressors (Kittel, 1999). Nonetheless, POLITY, FREEDOM HOUSE, VANHANEN and POLCON are all significantly and positively related to PROPERTY RIGHTS. Of these four measures, POLCON exhibits the highest level of significance. Considering this article's main hypothesis – that the existence of veto players is the primary mechanism through which the OBM is mitigated and intervention risk reduced – this result is not surprising. In fact, if democracy is measured more broadly than merely as an institutional device that constrains executive arbitrariness and discretionary policy-making, it may also capture a few of the traits that, some argue, work to *increase* investor risk (e.g. opposition attempts to criticize deals with TNCs; see Li and Resnick, 2003; O'Donnell, 1978).

The fact that both CIVIL WAR and REGIME DURABILITY are insignificant in the presence of the LDV gives further support to my view that the relationship between political and regime instability, and government policy risk is far less clear than the link between political institutions and risk effects. Granted, civil war does affect TNCs in other ways – particularly by physically threatening assets and employees – but such conflicts do not *per se* cause expropriations or contract abrogation. Likewise, BITs can arguably convey to the TNC that the host government intends to adhere to investment contracts. However, if BITs are not backed up by a favourable institutional environment, they are rarely effective. Of course, *ex post* government intervention cannot be completely ruled out even if checks and balances are in place, but the scope for opportunism is likely to be significantly constrained if veto-wielding players are present.

**Table 5. Determinants of property rights in developing countries, 1983-2000, controlling for lagged property rights**

Independent variables	(1) PROPERTY RIGHTS	(2) PROPERTY RIGHTS	(3) PROPERTY RIGHTS	(4) PROPERTY RIGHTS
LAGGED DEPENDENT	0.870*** (67.23)	0.869*** (60.40)	0.873*** (64.85)	0.872*** (66.24)
POLITY	0.025** (2.25)			
FREEDOM HOUSE		0.061** (2.33)		
VANHANEN			0.020** (2.32)	
POLCON				1.204*** (2.96)
CIVIL WAR	-0.383 (1.45)	-0.186 (0.65)	-0.311 (1.18)	-0.305 (1.12)
REGIME DURABILITY	-0.071 (0.81)	-0.109 (1.16)	-0.086 (0.94)	-0.084 (0.92)
BIT	0.003 (0.34)	0.003 (0.39)	0.001 (0.15)	0.001 (0.13)
EXCHANGE RATE	-0.003** (2.20)	-0.003*** (2.64)	-0.003** (2.35)	-0.003** (2.10)
ECONOMIC DEVELOPMENT	0.319*** (3.24)	0.256** (2.33)	0.251*** (2.65)	0.281*** (2.94)
ECONOMIC GROWTH	0.081*** (3.86)	0.081*** (3.63)	0.083*** (4.04)	0.079*** (3.84)
TRADE	0.401** (2.47)	0.409** (2.43)	0.420** (2.60)	0.459*** (2.90)
Constant	0.002 (0.00)	1.446 (1.28)	0.539 (0.61)	0.077 (0.08)
Countries	96	97	97	97
Observations	1091	1040	1094	1099
R <sup>2</sup>	0.851	0.847	0.849	0.851

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> Regression with robust standard errors (regress, cluster() command in Stata 8.0).

<sup>b</sup> *t*-statistics in parentheses.

<sup>c</sup> All independent variables are lagged one year.

\* Significant at the 10% level.

\*\* Significant at the 5% level

\*\*\* Significant at the 1% level.

Table 6 presents the results when country-specific effects are also controlled.<sup>24</sup> Since including *N*-1 country dummies into a cross-sectional dominant data set drains the model of degrees

<sup>24</sup> ECONOMIC GROWTH is excluded from these specifications, as variation in growth rates is captured by country-specific variation in ECONOMIC DEVELOPMENT.

of freedom and seriously inflates VIF scores (Wooldridge, 2003), the fixed-effects estimation is merely performed as a robustness test and to illustrate the effect of institutional change on property rights protection *within* a given country. Here, too, results are generally supportive of my hypothesis, albeit VANHANEN's coefficient is rendered insignificant. On the whole, it seems that nations that move to democratize, in particular by constraining the executive's discretionary power, reduce the risk of *ex post* government appropriation of TNCs' sunk assets. The evidence

**Table 6. Determinants of property rights in developing countries, 1983-2000, controlling for country-fixed effects**

Independent variables	(1) PROPERTY RIGHTS	(2) PROPERTY RIGHTS	(3) PROPERTY RIGHTS	(4) PROPERTY RIGHTS
POLITY	0.319** (2.14)			
FREEDOM HOUSE		0.505* (1.81)		
VANHANEN			0.126 (1.45)	
POLCON				7.118** (2.52)
CIVIL WAR	-2.667* (1.78)	-2.590 (1.65)	-2.884* (1.83)	-2.774* (1.77)
REGIME DURABILITY	0.924* (1.78)	0.463 (0.95)	0.388 (0.79)	0.390 (0.95)
BIT	0.068 (0.494)	0.081 (1.61)	0.075 (1.42)	0.068 (1.38)
EXCHANGE RATE	-0.007** (2.48)	-0.009*** (3.31)	-0.009*** (3.24)	-0.008*** (3.01)
ECONOMIC DEVELOPMENT	6.079 (1.66)	5.736 (1.57)	5.752 (1.51)	5.917 (1.63)
TRADE	4.418*** (3.00)	5.305*** (3.37)	5.802*** (3.70)	5.555*** (3.57)
Constant	-46.711 (1.42)	-43.438 (1.54)	-51.81* (1.78)	-50.686 (1.56)
Countries	97	98	98	98
Observations	1112	1061	1115	1120
R <sup>2</sup>	0.690	0.678	0.670	0.679

*Source:* Own calculations, based on sources described in the text.

<sup>a</sup> Regression with robust standard errors (regress, cluster() command in Stata 8.0).

<sup>b</sup> Country-specific dummies are used in estimation but not reported.

<sup>c</sup> *t*-statistics in parentheses.

<sup>d</sup> All independent variables are lagged one year.

\* Significant at the 10% level.

\*\* Significant at the 5% level

\*\*\* Significant at the 1% level.

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clearly indicates that democracy and international capital flows are compatible.

## Conclusion

The empirical analyses in this article suggest that TNCs prefer democratic environments for their investments and that democracy and executive constraints improve property rights protection and lower the risk of government intervention and policy reversals. These findings can be further interpreted as evidence that foreign investors are less responsive to the state of the *current* investment regime – as proxied by the property rights index, which was insignificant in all tests – than to the risk of *future changes* in the treatment of TNCs. This latter risk is captured by the various measures of democracy which focus on current attributes of political institutions that may bode ill – or well – for the future. The obsolescing bargain theory outlines a dynamic mechanism and acknowledges just this: most FDI is conducted with a long-term view and sunk assets are particularly at risk. Hence, the future rules of the game may have little to do with the current ones. The second body of my analysis indicates more clearly that autocracies are more inclined to change these rules *ex post*. Democracies, on the other hand, provide firmer institutional barriers against policy arbitrariness.

Security of property and democracy evidently work in tandem; TNCs reward democracies, and democracies reciprocate by offering investors increased security for their assets. Considering the intensity and urgency of the ongoing debate about the virtues or vices of (the co-existence of) political freedom and economic globalization (e.g. Milner and Kubota, 2005; Shapiro and Hacker-Cordón, 2002), these are important findings. ■

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