

Does Democracy Promote Economic Openness?

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ABSTRACT

The relationship between democracy and economic openness has received a great deal of both popular and academic attention over the years, yet little systematic crossnational empirical research has been conducted on it. The current consensus of case studies and regional analyses seems to be that, despite recent trends toward both democratization and market opening, there is no consistent relationship between democracy and economic openness. This paper represents an initial attempt to trace the relationship between these two phenomena using a large-N statistical format. It models democracy both as a contemporary phenomenon and as an historical concept, and tests the hypotheses that longer tenures of democratic rule promote greater openness in trade and foreign direct investment, and better overall international investment ratings. Evidence from time-series-cross-section analysis suggests that both a country's current state of democracy as well as its democratic history are associated with higher levels of integration with the international economy. More democratic countries tend to have more open economies, all else being equal.

Simultaneous trends toward democratization and economic reform in the past few decades raise compelling questions. Does democratic rule promote economic openness? Or does it inhibit it? Alternatively, is there no systematic relationship at all between democracy and free-market policies? The nature of the relationship between political regime and economic models has been argued for decades, yet little systematic, cross-national research has been conducted on the subject. This paper attempts to take one small step toward filling this gap in the literature.

Recent crossnational empirical research has shed light on several long-standing questions in comparative political economy. For example, recent research has considered the impact of economic openness on growth and development.¹ Others have taken up the question of the impact of democracy on economic performance, or growth.² But with few exceptions (see below), little systematic, crossnational empirical research on the impact of democracy (or authoritarianism) on economic openness has been conducted.

This omission is particularly noteworthy given the popular and academic attention given to recent global trends in democratization and neoliberal economic reform, and to the connections that many have attempted to draw between them. Many have argued, for example, that radical economic change imposes high distributive costs on potentially powerful interest groups. In this context, open, democratic politics would not be a propitious environment for economic reform (O'Donnell 1973). The experience of the East Asian Tigers and their move to export-oriented industrialization under authoritarian rule in the 1960s and 1970s stands in evidence of this proposition. Strong leaders, unencumbered by the pressures of democratic rule, are necessary to undertake the arduous

¹ Among the numerous studies on the effect of trade on growth, see Dollar 1992, Edwards 1998, Frankel and Romer 1999, Harrison 1996, Krueger 1995, Lewer and Van den Berg 2003, Lutz 2001, Rodrik 1995, Yanikkaya 2003. On the question of the relationship between neoliberalism and human development, see Gerring, Thacker and Moreno forthcoming.

² See, for example, Gerring et al. forthcoming, Krieckhaus 2004, and Rigobon and Rodrik 2004 for a sampling of new work on democracy and growth.

task of opening closed economies. Others, going back at least as far as Huntington's (1968) watershed volume on economic and political modernization, have argued that political and economic opening are not only compatible, but also mutually reinforcing (Dominguez 1998). In this view, policies that promote the general interest should be encouraged in a system where politicians are responsible to the broader democratic electorate, rather than to a narrow, authoritarian constituency. Furthermore, economic reforms adopted under democratic rule are likely to enjoy greater social acceptance and credibility, and therefore more success economically.

After several decades of case study and regionally oriented research on these issues, few definitive conclusions have been reached. The closest thing to a consensus that has emerged is the observation that the broad concept of regime type itself may make little difference (Bates and Krueger 1993, Geddes 1994, Nelson 1990, Przeworski and Limongi 1993, Williamson and Haggard 1994). Instead, the nature of more fundamental political institutions, such as party systems, the bureaucracy, and organizations of interest group representation, along with external factors, may be more important in determining economic policy than regime type per se (Haggard 1986, 1997, Haggard and Kaufman 1989, 1995). To the extent that it matters, it may be necessary to draw distinctions within broader categories of regime type. Stallings and Kaufman (1989), for example, argue that newly established democracies reacted and adapted poorly to economic crisis in Latin America in the 1980s. Remmer (1990), however, finds no distinction among the performances of new democracies, old democracies and authoritarian regimes, once she controls for the initial debt burden (see also Remmer 1986). Others have attempted to distinguish among different subcategories of regimes (new democracies, old democracies, strong authoritarian regimes, weak authoritarian regimes, one-party regimes, military regimes, personalistic regimes, etc.). Bermeo (2001), for example, notes that postponement of structural adjustment until after the democratic consolidation in Spain was complete helped promote economic reform while protecting democracy,

while Bienen and Herbst (1996) note the fragility of economic reform among democratizing nations in Africa.

What underlies much of this recent scholarship is its method of focusing on a single case or a small number of cases, most often from within the same region (most frequently Latin America, Asia, or Africa). Such studies provide valuable insight into the details of the policymaking processes and enable us to generate hypotheses about possible causal pathways linking regime type and economic policy and outcomes. But they are also circumscribed in scope by their small number of cases, among which there is often relatively little variation in the key variables in operation, and often a relatively small window of time (e.g., the 1980s). Few studies have attempted to explore these issues empirically in a wider sample and over a longer time period. Those that do tend to focus on a single outcome (trade, investment, etc.). This paper addresses many of these long-standing but still open-ended questions about the relationship between democracy and economic openness through a large-N, crossnational analysis that complements prior work on the subject and attempts to provide at least initial evidence that may shed new light on the questions posed at the outset.

The remainder of the paper is organized as follows. The next section develops a series of hypotheses about the impact of democracy on economic openness in three areas: trade, foreign direct investment, and investment ratings. The following section presents the methodology, analysis and results of the research. A brief conclusion follows.

HYPOTHESES

Much of the uncertainty surrounding debates on the relationship between democracy and economic policies and outcomes may stem from the time frame within which such debates are framed. With so many different factors operating at a given point in time, it is difficult to separate

out the short-run effects of regime type from other potential causes of openness or closure. This is especially true of studies that examine a single country or a small group of countries, often at a single point in time or a relatively short period of time. Political institutions, by their very nature, can take a long time to exert their effects. The effects of regime change, for example, may cumulate over time as new institutional rules begin to affect actions and expectations and to shape other political institutions. The predominant research designs to this point have been ill equipped to capture many of these aspects of the problem. The goal of this paper is examine and compare the effects of contemporary levels of democracy with those of the accumulation of democracy over time. In one sense, economic policies are relatively elastic; they can respond relatively quickly to changes in the political context in which they are formed. New political alignments, interest distributions, and institutional arrangements can generate policy changes that alter the overall orientation of a country. On the other hand, such changes, though more feasible than substantial changes in some other issues areas, are still relatively rare. Thus, in another sense, economic policy changes, like many other issues of public policy and development (see Gallagher and Thacker 2007, Gerring et al., 2005, Gerring et al., 2006), may be more responsive to longer-term patterns in a country's institutional history. This paper tests two overarching hypotheses linking democracy and economic openness. First, the contemporary level of democracy is positively associated with economic openness. Second, countries with a long history of strong democratic rule are more likely to be economically open. This general argument can be applied profitably to two specific economic policy issues and a third, broader category.

Trade

To the extent that trade provides net benefits to a country, based on the logic of comparative advantage and the gains from specialization associated with trade, it should provide an incentive for democratic politicians to open up their economies to foreign competition over time. If

politicians depend on voters' support, and if trade improves voters' economic fortunes, democratic politicians should have an incentive to open up their economies, all else being equal.

On the other hand, it is often noted that the biggest winners from free trade, consumers, are an unorganized, diffuse lot that doesn't have full information about the effects of trade on their welfare. The total consumer effect of trade is quite large, but the impact on any single individual may be difficult to separate from other forces. The losers from free trade, however, are often a) very well organized into producer associations and labor unions, and b) acutely aware of the potential impact of foreign competition on their livelihood. Thus, we might expect free trade's losers to be more politically motivated and active in a democratic polity, and to put corresponding pressures on politicians for protection. Of course, we must also consider another group of influential actors who win from free trade: internationally oriented traders and investors (Milner 1988, Thacker 2000). We can expect these actors to exert pro-trade pressures on their governments to counteract the protectionists.

Little systematic research has been done on these questions. Mansfield, Milner and Rosendorff (2000) find that democratic pairs of countries tend to trade more with each other than do authoritarian pairs or mixed pairs. Milner and Kubota (2005) find strong evidence linking contemporary measures of democracy to lower levels of protectionism in the developing world. Theoretical expectations, backed up by these prior findings, lead to the first hypothesis of this study:

H1: Democracy contributes to greater openness to foreign trade.

This paper measures trade as a percentage of GDP (World Bank 2005), a standard measure of trade openness. Empirical tests will examine the relationship between both contemporary and historical measures of democracy and trade.

Foreign Direct Investment

Similar to the arguments made for trade, if foreign direct investment (FDI) brings net benefits to the recipient country, we can expect democratic politicians to encourage its inflow, all else being equal. FDI can bring in foreign capital and technology, create employment, improve productivity, and boost economic growth. While many criticisms of FDI were raised in the 1960s and 1970s, since at least the 1980s most governments appear to want to attract FDI and capture many of its putative benefits.

From the perspective of the multinational corporation (MNC), it has often been argued that authoritarian governments offer safe haven for their activities and a stable investment climate by stifling political opposition and maintaining control over a cheap, quiescent labor force. On the other hand, the stabilizing effects of authoritarian rule may be exaggerated. In many ways, democratic governments may offer greater stability and reassurances to potential investors to the extent to which they enjoy greater societal and international support and legitimacy. Democratic governments may also enjoy more credibility of commitment, as they would be loathe to turn away new or existing FDI that may provide net economic benefits for the constituencies whose support is critical to their own political survival (Jensen 2003).

Finally, because democratic governments enjoy greater political legitimacy at home and offer more effective means of interest group participation in decisionmaking, such groups (e.g., labor unions) may offer greater support for FDI in a democratic context than they would in a closed one (Guillen 2000).

H2: A country's present and cumulative experiences with democracy positively influence the amount of foreign direct investment it receives.

This paper measures FDI as a percentage of GDP (World Bank 2005). (Very similar results obtain when FDI is measured as a percentage of gross capital formation.)

Investment Rating

Similar to the arguments above with regard to foreign direct investment, democratic countries may be perceived by ratings agencies as more creditworthy and less risky than their less stable and less reliable authoritarian counterparts. Domestic punishment for democratic leaders who renege on their financial commitments, for example, or who print money to pay off their debts, may to be swifter and stronger than that suffered by entrenched despots. Because they are accountable to an electorate that reaps benefits from the country's economic interactions with the outside world, democratic governments might be expected to maintain policies favored by outside actors. Measures of investment rating, though often narrowly defined as credit ratings, often resemble broader "report cards" on a nation's overall economic policy environment. (Investment ratings are typically highly correlated with measures of neoliberalism.)

H3: Democracies enjoy greater policy commitment and credibility, and therefore tend to receive stronger investment ratings.

There are several investment or risk rating agencies, but the one with perhaps the most comprehensive country coverage is *Euromoney's* country risk index.³ Broadly interpreted, we can infer from these ratings the judgment and verdict on countries' economic policies and economy of the international financial community.

³ *Euromoney* ratings are based on polls of economists and political analysts and supplemented by quantitative data such as debt ratios and access to capital markets. The overall country risk score derives from nine separate categories, each with an assigned weighting (in parentheses): 1) political risk (25%; the risk of non-payment or non-servicing of payment for goods or services, loans, trade-related finance and dividends, and the non-repatriation of capital), 2) economic performance (25%; based on GNP Figures per capita and on results of *Euromoney* polls of economic projections), 3) debt indicators (10%; including total debt stocks to GNP, debt service to exports, and current account balance to GNP), 4) debt in default or rescheduled (10%; scores are based on the ratio of rescheduled debt to debt stocks), 5) credit ratings (10%; nominal values are assigned to sovereign ratings from Moody's, S&P and Fitch IBCA), 6) access to bank finance (5%; calculated from disbursements of private, long-term, unguaranteed loans as a percentage of GNP), 7) access to short-term finance (5%), 8) access to capital markets (5%; heads of debt syndicate and loan syndications rate each country's accessibility to international markets), and 9) discount on forfeiting (5%; reflects the average maximum tenor for forfeiting and the average spread over riskless countries such as the United States) (*Euromoney* 2004).

METHOD, ANALYSIS AND RESULTS

With the exception of Milner (2005) and Jensen (2003), there are few quantitative studies of the relationship between democracy and economic openness. And I am aware of none that take a historical view of democracy like the one taken here. This study represents the first global, historical, quantitative analysis of the relationship between democracy and economic openness.

Democracy

As mentioned above, the principal independent variable used in this analysis takes on a historical conception of democracy, testing the argument that political institutions take time to exert their full effects. To measure the *level* of democracy in a given country, I use the Polity IV Polity2 measure, which ranges from -10 (least democratic) to 10 (most democratic).⁴ To measure the *stock* of democracy in a given country, I sum its Polity2 scores from 1900 to the observation year, applying a one percent depreciation rate back in time.⁵ The underlying assumption in constructing the stock variable was that history matters (i.e., a country's long-run experience with democracy is what helps drive economic policies and outcomes), but that recent history matters more. I conduct three tests for each outcome variable: one for democracy level, one for democracy stock, and one that includes them both simultaneously.

Estimation techniques

⁴ Marshall and Jagers (2002). Because the Polity2 democracy score does not contain data for several countries (mostly micro-states), missing values were imputed using the following alternative measures of democracy: the Freedom House Political Rights indicator (Gastil, various years), Bollen's (1993) Liberal Democracy variable, Vanhanen's (1990) Competition measure, and Banks's (1994) Legislative Effectiveness and Party Legitimacy variables.

⁵ I choose the year 1900 as a threshold period that ushered in a period in which mass democracy becomes a world-historical phenomenon (no longer restricted to the US and a few European states). I choose a one percent depreciation rate because it seems a reasonable estimation of how a long-run historical effect might play out.

The regressions in this paper all employ a time-series-cross-section (TSCS) format, with country-years as the unit of analysis. In order to maximize data points, and because the relationships hypothesized above should hold in a wide variety of contexts (with appropriate controls for level of development, etc.), I include all years and countries for which data are available. Each analysis is carried out in a fixed-effect format, using Newey-West (robust) standard errors and an AR(1) correction for autocorrelation. All independent variables are lagged by one year, offering some protection against X:Y endogeneity.⁶

This paper will spare the reader a long disquisition on methodological features of TSCS analysis, an issue that has received a good deal of attention from econometricians in recent years (see Beck 2001; Beck and Katz 1995). The fixed effects approach is a conservative one, designed to establish a difficult research design (one biased against the achievement of statistically significant results). Results are substantially the same in a variety of other formats including random effects, Prais-Winsten regression with panel-corrected standard errors, and LSDV. [Re-check this to verify.]

The fixed effects format sacrifices efficiency while protecting against unobserved unit heterogeneity. This format effectively removes many of the specification problems that typically plague cross-country studies, imposing a unique intercept for each country and controlling for factors unique to individual countries that are invariant across time. This precludes the inclusion of factors that are for the most part constant across the time-period of interest (1970-2000). It also means that the results will suffer greatly from omitted variable bias only if the *change* in independent variable and the *change* in IMR are both driven by some other (unmeasured) factor.

⁶ The one exception to this is democratic stock, which is lagged by two years to separate it temporally from democracy level.

Trade

In testing the impact of a country's history with democracy on trade policy and outcomes, we must control for other potential influences on trade. To this end, the regressions for trade all include a control for GDP per capita (logged). Industrialized, developed countries typically have lower barriers to trade; this variable controls for that potential effect. Population (logged) is included to take into account the fact that large countries typically are more economically autonomous and therefore trade relatively less than smaller ones. GATT-WTO is a dummy variable coded one if a country is a member of the GATT or WTO in the observation year. Membership should promote trade openness, or at least not diminish it. Finally, though neoclassical economic theory notes that the movement of factors of production, such as capital, can substitute for trade in goods and services, practical data show that FDI and trade typically move in tandem (as evidenced by the rise in intrafirm trade in recent decades). Thus, I include a control for FDI as a percentage of GDP, on the expectation that FDI should foster trade.

As seen in Table 1, results for the trade variables are somewhat mixed, but favorable on balance to H1 above. Overall model fit is good (as it is in all models), as seen in the high significance of the F-test. As expected, richer countries tend to trade more, and countries with more FDI also enjoy more trade. Unexpectedly, more populous countries appear to have higher levels of trade. With respect to the role of democracy, the contemporary (t-1) level of democracy shows a significant relationship to trade in both estimations. The stock measure of democracy falls just short of conventional levels of significance, with p-values below 0.15. On the whole, democracies tend to be more open to international trade.

FDI

Controls for the FDI equations include GDP per capita, for which expectations are mixed (returns are likely higher but riskier in the capital-scarce developing world). The log of real GDP

captures the size of the market that may lure foreign investors. GATT-WTO membership should promote FDI because its rules often protect the interests of foreign investors and because multinational corporations (MNCs) often engage in extensive intrafirm trade and GATT-WTO membership provides both some assurance that the host country market will remain open and more stable access to third party markets. Trade as a proportion of GDP (logged) is included to account for the fact that many firms invest in countries as part of a global strategy of intrafirm and arms-length trade in which they serve not only domestic markets but also foreign ones. Extensive trading networks should promote higher levels of FDI. On the assumption that MNCs prefer stable investment climates, I include three variables measuring various aspects of domestic stability: inflation (logged), investment rating (Euromoney), and social conflict (Marshall). Higher levels of inflation, lower investment ratings, and greater social conflict should dampen FDI.

Results for FDI are quite strong. Results for control variables are consistent with expectations for those that are significant: GDP and inflation. GDP per capita performs inconsistently, perhaps reflecting the tradeoff between higher returns and higher risk in developing countries. Results for trade and inflation are quite strong and in the expected direction, while those for other control variables are much less robust. Results for democracy are very strong, with both measures emerging significant at better than the 0.01 level, even when included together in the same estimation. Both the current level of democracy and a country's democratic history make it more attractive as a destination for foreign direct investment. Even when we control for a country's current state of democracy, its historical stock of democracy matters (and vice versa).

Investment Rating

Controls used in the investment rating equation are the same as those used in the FDI estimations, except that FDI/GDP is exchanged for the investment rating control used previously.

Expectations for the control variables are similar to those for trade and FDI. As expected, GDP per capita appears to be associated with better investment ratings. Larger and higher inflation economies, as well as socially unstable countries, tend to have worse investment ratings, while GATT/WTO members and countries with high levels of FDI and trade tend to have stronger ones. Results for the democracy variable are strongly suggestive of a robust relationship. Both democracy today and more experience with democratic rule over a long period of time raise a country's creditworthiness. To the extent that this measure is a proxy for an overall liberal orientation of an economy, we can say that democracy promotes economic openness writ large.

Robustness Checks

The findings displayed in Table 1 are robust to a variety of different specification tests (not reported). Exchanging population for GDP does not alter the results of any of the equations, for example. Most importantly, a series of robustness checks using a wide variety of control variables found that the results presented here are not sensitive to the inclusion or exclusion of particular controls. Results for the democracy variable are more robust than those for virtually any of the control variables tested.

CONCLUSION

This study offers the most comprehensive and historically sensitive test of the relationship between democracy and economic openness. Previous studies were either of the small-N, case study variety, or focused typically on a single category of economic openness (e.g., trade, FDI, etc.). Fewer still have considered democracy as both a contemporary and historical phenomenon. More broadly, this paper's findings on contemporary levels of democracy differ from those of others. Some have found no consistent relationship between contemporary levels of democracy and development outcomes, while finding a robust relationship between development and democratic

stock (Gerring et al. 2005, Gerring et al. 2006, Gallagher and Thacker 2007). In contrast, this paper finds fairly robust relationships for both democracy level and stock, even when controlling for the other.

Finally, many other studies, including many of those associated with this project, offer highly suggestive evidence of a causal relationship between democracy and development. But many of the causal mechanisms linking the two together remain fairly theoretically opaque and empirically untested (indeed, many are unmeasurable and therefore not amenable to empirical testing). Economic openness itself has little or no intrinsic value; its value lies in the consequential benefits that it produces for society as a whole.⁷ If democracy promotes economic openness, that may be one way in which it promotes the broader social welfare. While I do not argue that economic policies are the only, or even primary, possible causal link between democracy and development, it is conceivable that they are one manner in which democracy helps promote development.

⁷ While there is not complete consensus on the impact of economic openness on growth, it seems likely that its effects are unlikely to be strongly negative on average (see above). Prior studies have found that economic openness can promote human development and help lower corruption (see Gerring et al., forthcoming and Gerring and Thacker 2005).

Table 1: Estimation Results

<i>Model</i>	1	2	3	4	5	6	7	8	9
<i>DV</i>	Trade			FDI/GDP			Investment rating		
Democracy level	0.004*** (0.001)		0.003** (0.001)	0.104*** (0.034)		0.102*** (0.034)	0.313*** (0.084)		0.300*** (0.085)
Democracy stock		0.0002 (0.0001)	0.0002 (0.0001)		0.014*** (0.004)	0.013*** (0.004)		0.054*** (0.011)	0.053*** (0.011)
GDP per capita (ln)	0.248*** (0.033)	0.235*** (0.037)	0.238*** (0.036)	2.284*** (0.883)	1.530 (0.961)	1.516 (0.947)	16.632*** (2.534)	13.171*** (2.657)	13.066*** (2.594)
Population (ln)	0.271*** (0.035)	0.309*** (0.034)	0.282*** (0.035)						
GDP (ln)				0.000 (0.000)	-0.000 (0.000)	-0.000 (0.000)	-0.000*** (0.000)	-0.000*** (0.000)	-0.000*** (0.000)
GATT/WTO	-0.007 (0.021)	-0.004 (0.021)	-0.012 (0.021)	0.899* (0.469)	0.901* (0.525)	0.693 (0.494)	4.909*** (0.986)	4.702*** (0.943)	4.019*** (0.971)
FDI/GDP	0.007*** (0.001)	0.007*** (0.001)	0.007*** (0.001)				0.264** (0.103)	0.264*** (0.093)	0.206** (0.095)
Trade/GDP (ln)				1.297*** (0.371)	1.431*** (0.349)	1.308*** (0.365)	4.338*** (1.477)	4.679*** (1.551)	4.295*** (1.527)
Inflation (ln)				-0.522*** (0.099)	-0.416*** (0.098)	-0.480*** (0.098)	-2.144*** (0.273)	-1.766*** (0.268)	-1.930*** (0.272)
Investment rating				0.013* (0.008)	0.011 (0.008)	0.007 (0.008)			
Social conflict				0.204 (0.305)	-0.109 (0.337)	-0.130 (0.337)	-5.452*** (1.908)	-6.618*** (1.879)	-6.671*** (1.866)
Constant	-0.091 (0.377)	-0.329 (0.365)	-0.111 (0.375)	-21.371*** (6.871)	-15.392** (7.587)	-14.481* (7.413)	-80.598*** (20.214)	-53.302** (21.786)	-50.610** (21.217)
<i>Observations</i>	3799	3790	3790	1812	1812	1812	1916	1916	1916
<i>Countries</i>	162	162	162	146	146	146	146	146	146
<i>Time period</i>		1970-2000			1982-98			1981-98	
<i>R-squared</i>	0.15	0.15	0.15	0.10	0.09	0.11	0.22	0.22	0.23
<i>Prob. > F</i>	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Standard errors in parentheses

* significant at 10%; ** significant at 5%; *** significant at 1%

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