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Foreign Direct Investment's Contributions to Democratization:

In Central and Eastern European countries after the fall of the Iron Curtain, democratic reform has been a relatively rapid phenomena throughout the region. Much of this is due to two major factors – those being the allowance of competitive elections wherein parties pushing for democratic reform, could compete, and be a prospect (for many of these nations) to join the European Union. With these factors being held constant, we observed that many countries adopt democratic policies at a much more fast pace than others. For example, the Satellite countries (save Bulgaria and Romania) and the Baltics were the first countries to adopt democratic institutions whereas those that were formerly part of the Soviet Union, still to this day struggle at adopting such policies. It is interesting then, that those countries which did indeed adopt democratic reforms rapidly, were also those that were the most economically tied to Western Europe: Poland, Slovakia, Czechia, Slovenia, and the Baltics. Alongside this, Western European countries saw the benefits of potential cheap labor in the East, and thus, were eager to work with these countries. Thus, these nations that were in close proximity to the European Union received the largest amount of foreign direct investment from the EU 15. This trend may imply a correlative relationship between economic support from abroad and adoption of democratic principles. To measure my dependent variable (levels of democracy over a twenty-year time span) I will be using Polity IV democracy scores. To measure my independent variable (economic support from abroad) I will be using foreign direct investment inflows to specific CEE countries. I'll be using FDI as a percentage of GDP as it is perhaps one of the most straightforward ways to analyze how much foreign support a country is receiving from abroad.

In this endeavor, I expect to find a rather strong positive correlative relationship between support from abroad (FDI inflows) and the rate at which a country adopted democratic institutions (Polity IV democracy scores).

Review of Literature:

Democracy adoption as a phenomenon is one that has posed a particularly challenging topic to pin down for political scientists. Largely, this can be attributed to the fact that there are so many possible confounding variables that could induce democratization. Each individual country, whether a democracy or not, has its own history, culture, and customs that could give large sway in a country's decision on whether or not to adopt democracy as a form of government. Luckily for researchers in the Post-Cold War era, we are able to see a natural experiment take place. The fall of the Soviet Union gave the world a slew of countries that by and large have most of these societal factors controlled. Though there are minor differences, the cultural shift between Romania and Bulgaria is just as minute as the shift from Estonia to Lithuania. In short, the world was presented a natural presentation of what allows former non-democracies to succeed or fail in their transitions to becoming democracies. This natural experiment has been obvious to many researchers and has allowed them to produce various works on what allows a country to develop into a democracy. In light of this, a number of various scholars have posited their theories on contributing factors to democratization.

There seems to be a particularly stark split amongst the academic community on whether or not economic well-being for a country has any positive correlation with the likelihood that any given country is a democracy. Przeworski and his co-authors argued that the "political history of regimes and their past instability, has an important role in determining whether that current regime [democracy] will survive or die" and that economic well-being, or, 'modernization' simply “reduces the likelihood of democratic breakdown” (Przeworski, 90). In essence, Przeworski argues that democratic achievement (though determined by many factors) is largely based on a country’s past experiences and that economic development is simply an exogenous factor which reduces the likelihood of authoritarian reversion rather than being causes the rise of a democracy. Supporting this view, Michael L. Ross argues that rentier states – particularly those oil rich countries in the Middle East, though developed, “had antidemocratic effects… that tends to both keep authoritarian regimes in power and undermine low-income democracies” (Ross, 11). Furthermore, Barro, in the *Journal of Political Economy* suggested that “having been a British colonial heritage… yields with it… democratic regime favoritism.” (Barro, 164). If these viewpoints are to be true in regard to democratization, it seems that economic development (in terms of GDP/capita) has no true causal relationship with democracy, and in fact, in the cases of countries that are reliant on primary goods (natural resources, minerals, oil, etc.), leads of a lodging of authoritarian regimes.

On the other hand, a surfeit of research has been conducted by comparative political scientists since the mid 19th century postulating modernization theory; that which states there is a strong correlation between industrialization and democratic development. Seymour Martin Lipset in his 1960 work, *The Political Man*, stated, “all the various aspects of economic development — industrialization, urbanization, wealth and education — are so closely interrelated as to form one major factor which has the political correlate of democracy” (Lipset, 41). This school of thought has been expounded on throughout the subsequent years with stronger statistical models to develop the theory. One such would be that of Inglehart and Welzel who found that their statistical model:

> …Demonstrates that fundamental changes are occurring in the belief systems of publics around the world. They show that these changes are shaped by an interaction between the forces of socioeconomic development and persisting cultural traditions. And using data from representative national surveys in eighty societies, demonstrate that changing mass values are producing growing pressures for the establishment and strengthening of democracy. (Inglehart and Welzel, 7)

These scholars are of the full conviction that economic development is a necessary, though not sufficient, condition to be met in order for democracy to be taken on. I hope to contribute to this debate by expanding on the correlative linkage between foreign direct investment inflows and democratization.

<u>Country and Variable Selection:</u>

In my country selection, I've decided to opt into analyzing the various Central and Eastern European countries en masse in order to collect the most possible data and receive the clearest possible answer to my research question. I will be referring to countries in regional blocks, which can be found in **table 1**). Using all of the countries will (to some degree) incorporate the various claims of those who've previously studied democratization into my essay. The two axes which claims for democratization that mainly take place (modernization and cultural/historical) will be somewhat accounted for by the choice to examine each country. For example, the Baltics share quite a bit of history/culture with the former USSR but have been quite economically prosperous. Meanwhile, those newly minted former USSR states (Moldova, Belarus, and Ukraine) also have strong historical/cultural ties with the former USSR but have weaker economies. Each of these regions, (whether the former satellites [Poland, Hungary, Czechoslovakia], the former Yugoslav states, the former Baltic States, or the former parts of the Soviet Union) will be able to be analyzed with each other. With all of these countries and their various cultures/histories accounted for, I suspect that foreign direct investment will be favored to those nations which have potential for economic growth (namely in the Baltics and in the former Soviet satellites). However, the question of whether or not these nations succeed more with their democratization efforts is one of which I'm uncertain.

Block:	Countries:
Former Soviet Union States	Belarus, Moldova, Russia, Ukraine
Former Soviet Satellites	Bulgaria, Czechia, Hungary, Slovakia, Romania, Poland
Baltic States	Estonia, Latvia, Lithuania
Former Yugoslavia + Albania	Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia, Slovenia

Table 1: *List of Central and Eastern European 'blocks' (left column) with the countries which they comprise of (right column)*

Democratization itself (my dependent variable) is a rather complex item to measure. I will be using Polity IV scores of democratizations per country, which are given from a range of -10 to 10. The Center for Systematic Peace (who operate the Polity IV project) define three different categories regime type based on various scores. They are as follows: autocracy (-10 to -6), anocracy (-5 to +5), and democracy (+6 to +10). Polity bases these scores off of a few key indicators of regime type. These indicators are competitiveness and openness of elections, political participation, and the extent of checks on the executive parts of a given government. Generally, the Polity IV data set.

As for my specific cases, the Polity IV data set indicates all of the countries, prior to the fall of the Iron Curtain, fell into the Polity IV score range of -10 to -6, indicating that these Central and Eastern European countries were universally autocracies. Miraculously, by the end of the 20th century, just about all of these countries had achieved scores that fell within the democracy range. 1985 is the final year of which no Polity IV score changes were recorded in these countries, with Poland's increase from a score of -7 to -6 in 1986 being the first. For this reason, I've decided to use 1985 as the first year in my 21-year analysis of democratization. After 1986, we see rapid democratization taking place across the region. To show this, I've taken the average Polity IV score for each region. For example, to find the average Polity IV score of the Baltics in 1991, I've simply added the three values assigned to Estonia, Latvia, and Lithuania, and divided it by three. This was repeated for each region over the time span of 1985-2005. By the year 2004, Polity IV scores begin to settle for the region, without much variation being able to be detected. For this region, I've ended my analysis in 2005.

In analyzing these Polity IV scores, I've found that each region executes their democratization process at a slightly different time and all achieve unique levels of democracy over different time periods (**figure 1**). I found that the Satellite states were the first to democratize and were also able to achieve the highest levels of democratization. I hypothesize that this is due to their relatively close links with Europe and the financial boon the EU 15 saw in investment opportunities in this region. Similarly, the Baltics were able to quickly become full democracies after their independence from the USSR. I would also assume that this is due to the same factors which caused the Satellites to have such success in their democratization efforts. Unlike their close neighbors, the European states of the former USSR have seen considerable difficulty in their democratization. It wasn't until the dissolution of the Soviet Union in 1991 that these states began democratization efforts that rivaled that of their neighbors in Central Europe and the Baltics. Even after democratization efforts had taken place in these states, significant amounts of democratic backsliding began in 1994 (largely due to Belarus and Russia), and have yet to return to their mid-1990's level. This region is the only one which, on average, scores in the anocracy range of the Polity IV scale. Perhaps the most unique path taken toward democratization was that of the states that formerly comprised Yugoslavia. No significant democratization took place until 1991 which by and large were stunted, most likely due to the War of Yugoslav Succession (1991 – 2001) which perfectly overlay the dormant levels of democratization change seen in the region over the ten-year period of the war. After these wars had mostly ended, the former Yugoslav states began to see significant increases in democratization, culminating in their reaching of democracy classification by the end of 2005. Seeing the differences in democracy levels and the time frame in which changes to Polity IV scores take place, I can now begin to analyze my key independent variable to hopefully contribute some amount of explanation the variations in this phenomenon.

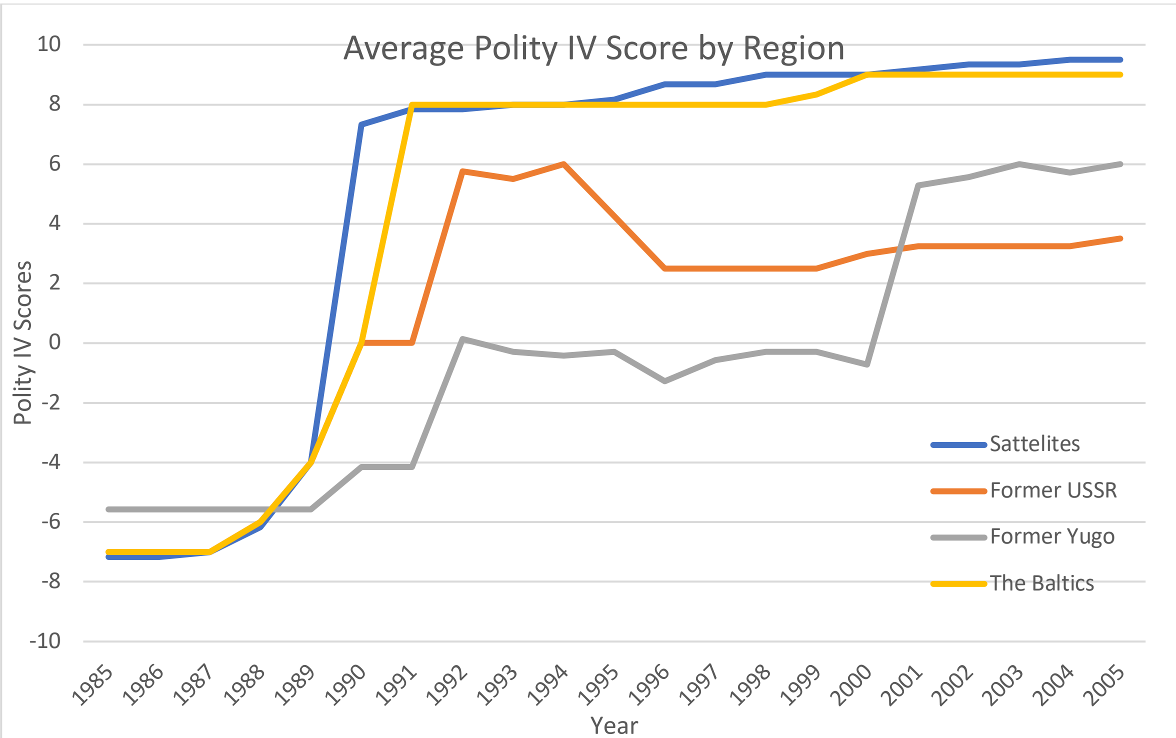

Figure 1: Average Polity IV scores in the four different regions over the 21-year democratization period.

To best measure economic support from abroad, I will be using foreign direct investment inflows as a percentage of total GDP as reported by the World Bank. This variable is essentially a measure of what percentage of a given country's economy is made up of foreign direct investment inflows. From this, I will be able to directly ascertain if a certain regional block is receiving more or less foreign support relative to its total GDP when compared to other regional blocks. In order to calculate this variable, I have used a similar strategy as I did with my dependent variable. I have found the levels of FDI as a percentage of GDP for each CEE country and then averaged it for each year in each regional block. This, in turn, gives me the average amount of FDI as a percentage of GDP for each region per year.

I expect that the level of FDI as a percentage of GDP will be strongly correlated with Polity IV democratization levels and may even follow just about the same patterns per region as was the case in figure 1. By and large, this hypothesis is inspired by Lipset's *The Political Man* book. I believe there to be some serious credence to modernization theory. Due to this, direct economic investment in these formerly autocratic states would lead to modernization, and as a byproduct, democracy as a favored regime type in these states which receive large amounts of foreign investment.

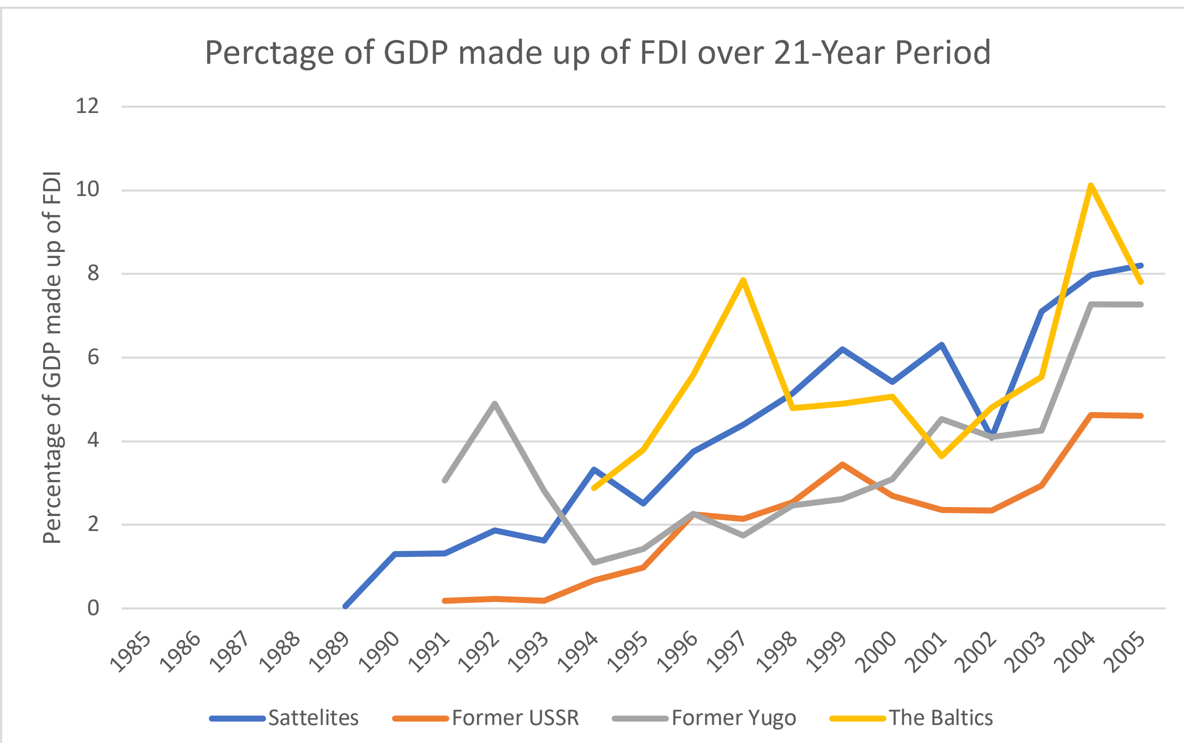

Figure 2: Average FDI as a percentage of GDP in the four regional blocks. Data prior to 1989 was unavailable, meaning the further regression analysis will only include data from 1991 to 2005.

Regression Analysis and Results:

In the results below, I've run a regression test on the average Polity IV Democracy score that all of the various CEE countries have received over the course of the previously specified sixteen-year period (1991-2005). The regression model incorporates three explanatory variables. The first is our main explanator variable (FDI inflows as a percentage of GDP) and the other two are simply control variables that attempt to negate any influence of external factors. To accomplish this task, I've held constant two variables which I believe to be correlated with democratization - GDP/capita and percentage of the population which is employed in agriculture. Using GDP/capita will control for the relative wealth of the nation when compared to others whilst using employment in agriculture will allow me to control for levels of industrialization. All of these data were found on the World Bank website.

	Coefficients	**Standard Error**	**T-Statistic**	**P-value**	**Lower 95%**	**Upper 95%**
FDI as a % of GDP	.39	.29	.78	.48	-.42	1.2
GDP/Capita	.0002	.00001	2.03	.25	-.00001	.00006
% of Population in Ag.	.13	.01	.28	.78	-.22	.27

Table 2: Regression analysis results of a model wherein FDI as a % of GDP, GDP/Capita, and %of population employed in agriculture account for levels of democracy in various CEE countries.

Perhaps the most notable item about the result is that I am unable to reject a null hypothesis for any of the variables if I assume a significance of less than .25. Due to this, I can make no definitive claims about the nature of any of these variables on democratization with a strong level of certainty. Furthermore, there is more proof that this model fails to definitively give answers to how any of these variables relate to democratization by observing the confidence intervals for each of these variables. The intervals (which are measured at the 5% significance level) all have a possible zero value, meaning that within the model itself, there is a chance that these variables have no meaningful bearing on democratization.

However, given this, I can still extrapolate some interesting observations from the model. In my model, I see that a one percentage increase in the amount of GDP made up of FDI will yield a .39 increase in the Polity IV score, which is quite a sizable increase. In effect, if the model is true (though this more than likely is not the case), then increasing the amount of foreign direct investment will, in turn, yield a substantive increase in the level of democracy a country has. In short, every incremental increase in the percentage of GDP made up of FDI, we can multiply that number by .39 and add that to the level of democracy a country has. For example, if a country receives a ten percent increase in the amount of FDI its GDP is comprised of, the given country will also experience an increase of 3.9 points on the Polity IV democratization scale. It should also be noted that this variable has a large amount of standard error associated with it. This means that this variable accounts for .29 Polity IV points of error between the model's predicted value and the model's observed value.

Alongside this, one of my control variables (percentage employed in agriculture) almost entirely fails in terms of its probability of accounting for democratization levels. It, much like FDI, has a very high P-value, which precludes the probability of it having any significant level of effect on democratization. However, if it indeed did, I would expect a .13 increase in Polity IV scores for each percentage increase.

Most interestingly, perhaps, is the control variable which I expected to have the most effect on democratization – GDP/capita. This variable is much more likely to actually have a bearing on Polity IV levels than are the other two, however, it is still not able to be concluded definitively. The probability of this variable having an effect is much higher, with a P-value of .25 and a confidence interval, that while encompassing a 0, is mostly positive. With this variable, we would expect that a one dollar increase in the GDP/capita would increase the Polity IV score by .0002. Though this may seem rather insignificant, this is due solely to the nature of the variable. If this effect were to be scaled up, results would be noted rapidly. For example, if the GDP/capita of a country increased by $1000, the model would predict a .2-point increase on the Polity IV democracy scale. This comes along with the fact that this variable has a very low standard error – meaning this variable accounts for a small percentage of the model's error between expected values and observed values.

In sum, my model indeed does have a positive correlation with democratization, however, it also contains within it a substantial amount of standard error. My adjusted R square, which notes the correlation when adjusted for the number of explanatory variables within the model, is a .51. This number suggest there is a correlation between the three variables and democratization, however, it is not necessarily a strong nor is it a weak correlation. The model also has rather critical error problems. The standard error is a 1.46, which means that if a country were to be observed as having an average Polity IV score of 6 over the fifteen-year time period, the model, on average, would either predict that score to be somewhere between 4.54 and 7.46. These two numbers mean wildly different things. The first suggests a anocracy wherein democracy is lacking its essential features, whereas the rightmost number suggests a rather strong democracy.

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.81861445
R Square	0.68980708
Adjusted R Square	0.50966239
Standard Error	1.45792158
Observations	19

Table 3: Basic summary statistics of the regression model. Note that while the correlation coefficient is high (.69), the adjusted correlation coefficient, which accounts for the number of variables, is significantly lower (.51).

Conclusion:

Though plenty of literature suggests that modernization is likely to lead to democratic adoption, there seems to be little evidence that foreign direct investment contributes to that process. I've observed nineteen Central and Eastern European countries and have taken their average Polity IV score over a fifteen-year period (1991 – 2005) and have attempted to use FDI as an explanatory variable for increases in that score. My model, though it predicted large increases in Polity IV scores if GDP made up of FDI increased, showed that there was little statistical evidence to support that FDI had any true effect on democratization. It is important however, to attempt to fit my research into the collective understanding of democratization as a process. Though I've not disproved or proved any aspect of modernization or cultural attempts to explain democratization, I have indeed concluded that foreign direct investment has an extremely low probability of being part of the democratization process. It seems much more likely that foreign direct investment is simply a consequence of other factors rather than a cause of democratization. These factors could be geographic distance to the EU 15, a country's political ties to other countries throughout the world, or perhaps the prospects of the given country returning a lucrative investment.

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