

MISLEADING MODERNIZATION:  
A CASE FOR THE ROLE OF FOREIGN CAPITAL IN DEMOCRATIZATION

by

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## THESIS ABSTRACT

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Title: Misleading Modernization: A Case for the Role of Foreign Capital in Democratization

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Modernization theory posits that economic growth and democratization are mutually constitutive processes. I extend a recent literature that finds this relationship to be spurious due to the existence of a number of international factors, specifically the role of foreign capital. Through two-stage least square (2SLS) regressions for as wide a sample as the data allow and two case studies (Indonesia and the Philippines), I find that the presence of US capital significantly influences domestic political institutions. This relationship, however, is non-linear and interrelated with exogenous shocks.

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Dedicated to my mother, Diane Weinerman, who has steadfastly supported me throughout graduate school and every other semi-coherent or ill-advised venture on which I have set my sights.

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## CHAPTER I

### INTRODUCTION

Studies of the causes of democracy are wide ranging in their theoretical impetus, methodologies, and conclusions. Despite being the basis for a wide body of research, very little consensus exists about what factors lead to democratic outcomes. The idea that economic prosperity and democratic institutions are tied together over time, sometimes referred to as modernization theory, has perhaps the greatest pedigree in the literature and in foreign policy circles.<sup>1</sup> But contending perspectives argue that this perceived relationship is far too simplistic and overshadowed by greater influences. These views have received just as much support, and from a wider range of scholarly sources.<sup>2</sup> One of the more important recent challenges to modernization theory has come from those arguing that democracy is diffused through international channels. This literature finds that the prevalence of democratic institutions in a country's region and the exposure of a country to transnational networks positively affect the country's level of democracy or probability of democratizing.<sup>3</sup> The works in this field, however, typically under-specify the mechanisms driving this relationship. In this paper I look closely at one of the

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<sup>1</sup> Perhaps most famously put forward in Seymour Martin Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *The American Political Science Review* 53, no. 1 (1959).

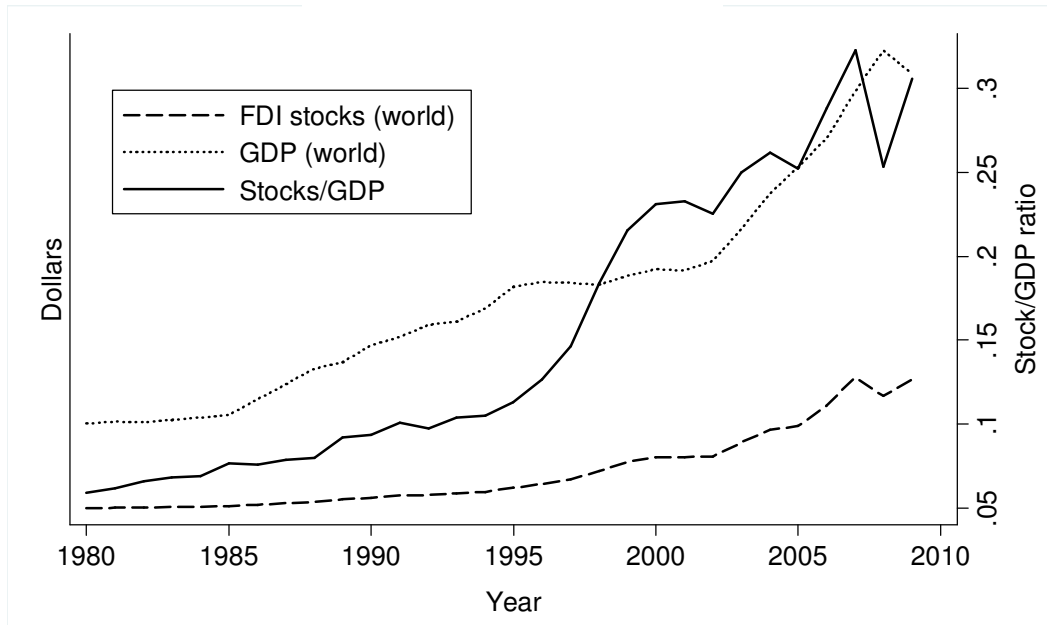
<sup>2</sup> Andre Gunder Frank, *The Development of Underdevelopment* (Boston: New England Free Press, 1966); Dankwart A. Rustow, "Transitions to Democracy: Toward a Dynamic Model," *Comparative Politics* 2, no. 3 (1970); Guillermo O'Donnell and Philippe C Schmitter, *Transitions from Authoritarian Rule: Tentative Conclusions About Uncertain Democracies* (Baltimore, MD: The Johns Hopkins University Press, 1993); Adam Przeworski et al., *Democracy and Development: Political Institutions and Well-Being in the World, 1950-1990* (2000); Daron Acemoglu et al., "Reevaluating the Modernization Hypothesis," *Journal of Monetary Economics* 56, no. 8 (2009).

<sup>3</sup> This is typically defined in a functional sense. Democratization is the introduction of representative government in lieu of autocratic government. Empirical definitions of democracy vary, but typically emphasize formal constraints on the executive, free and fair elections, and civil liberties.

standard diffusion variables, the presence of foreign capital, and explore the venues through which it may affect domestic institutions. Specifically, I use an instrumental variable approach to measure whether foreign direct investment (FDI) from the US has an effect on political development that is distinct from general openness to foreign investment and economic growth. I also follow two autocratic regimes over their lifespan to parse out the influence of US-capital. Ultimately, this investigation suggests a significant, positive relationship between US-capital and levels of democracy, but this relationship is complex and highly contingent.

FDI is defined by the Organization for Economic Cooperation and Development (OECD)<sup>4</sup> as a lasting management interest in a foreign venture consisting of at least a 10 percent share. This is in contrast to portfolio investment, which is typically short-term, consists of purchases of stocks and bonds in a country, and can be purely speculative in

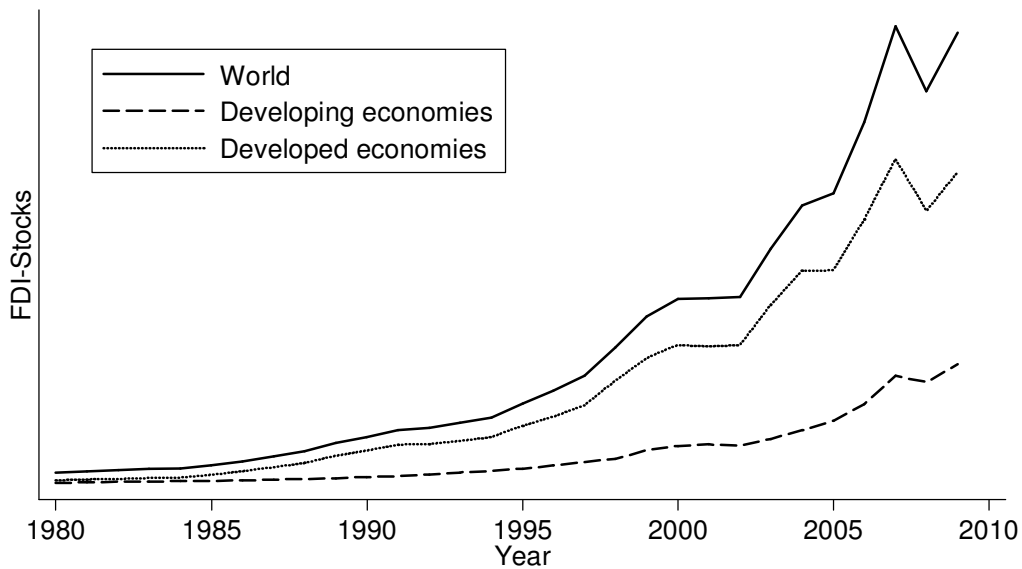
Figure 1: GDP and FDI Stocks



<sup>4</sup> Organisation for Economic Development and Cooperation, "Oecd.Statextracts: Fdi Positions by Partner Country," ESDS International, (Mimas) University of Manchester, <http://stats.oecd.org/Index.aspx>.

nature. Increases in FDI stocks have been outpacing growth in incomes, as seen in Figure 1. Since 1980 FDI stocks have quintupled from about 6 to 30 as a percent of world GDP. This is significant in its own right, but also suggests that the political impact I find for FDI in this analysis can be expected to grow as FDI becomes an ever more prominent component of economic growth and development. Notably, while the growth rate of FDI stocks in developing countries have been large, the rate growth of FDI stocks in developed countries has been larger, as seen in Figure 2. This does not undermine the main result of this paper, that US-FDI has a particular affect on political outcomes, however, as growth in FDI stocks is not a zero-sum game between countries; the effects found in this research are not merely aberrations constructed by North-North investment patterns for which high investment is closely correlated with high levels of democracy. But this pattern suggests the potential of reverse causality. That is, because most highly developed countries of the world are democracies and economically-minded rulers in non-democracies may believe that democratizing is necessary in order to obtain higher

Figure 2: “North/South” FDI-Stocks



levels of direct investment, given that developed democracies get the lion's share of FDI. Therefore, with the proper political institutions, leaders of developing economies may think that FDI will come rolling in; here the type of political institutions causes the level of FDI.

This thesis, however, is looking specifically at the effect of foreign investment on domestic political institutions. A number of explanations could account for an influence of FDI beyond its impact on levels of growth and growth's subsequent effect on democracy, as modernization theorists propose. In particular, multinational corporations (MNCs), who are the primary suppliers of FDI, are likely to be partial to the political institutions of their home country, whether they are based in democracies or not. Thus MNCs may condition lasting investment in a host country on political reforms that move the country toward the MNCs political preferences. MNCs could also pressure local governments towards reforms once they attain a significant stake in a venture in the host country. Foreign employees or management that comes with the investment in physical capital also may introduce cultural traits and political leanings that are diffused through social interactions with locals, which I refer to as the "cultural diffusion" channel. And the MNCs may have dynamic economic incentives that are closely related to particular forms of institutions. I find evidence for some of these modes of transmission below, but this does not preclude the existence of others.

It is important to point out that most countries with large MNCs have, historically, been high-income and politically democratic and most MNCs are therefore expected to have democratic leanings if the argument proposed here holds. But if the vast majority of MNCs are from these developed democracies it is then difficult to say whether MNC's

political preferences are due to home-country institutions or inherent to the existence of MNCs wherever they exist. This concern is difficult to address because of the lack of data on MNCs coming from poorer non-democracies, but the following research addresses this issue in a few ways: first, on a theoretical level, there is no compelling reason to believe that MNCs will inherently prefer one type of political institution over another unless one type of political institution always provides a better investment environment. It is unclear that anything except secure property rights will be preferred in terms of political institutions. Second, the case studies in Section IV each find significant effects from the presence of US foreign capital on emerging democratic institutions. Conversely, Chinese businesses had a significant presence in both Indonesia and the Philippines over the period of study. In neither case did Chinese businesses pressure for more democratic institutions during the transitional periods. My findings thus suggest that historical happenstance may be driving the correlation between total FDI and the diffusion of democracy; FDI has, until recently with the rapid increases of Chinese and other developing world FDI, been dominated by MNCs from high-income democracies.

The baseline argument for the following research is that political leaders that provide a stable and secure investment climate tend to be supported by MNCs, but once this payoff-certainty dissipates, the MNCs' political preferences shift as well. If the political outcomes of the host country are not known, rents demanded by host-country elites and payoffs for the corporation are also murky. In such situations, I find that MNCs tend to support opposition groups that bear closest resemblance to the political leanings of their home-country regimes. This conclusion is based on the case studies of the Philippines and Indonesia, which are bolstered by time-series cross-sectional regressions

that utilize the broadest possible sample that the data allow. This is not to say that the “cultural diffusion” effect is found to be nonexistent, but rather that finding evidence for this more complex type of democratic diffusion requires a depth of evidence and on-the-ground research beyond the scope of this project.

The primary findings of this paper are that FDI helps prop-up regimes,<sup>5</sup> but as MNCs see the value of their investments evaporate due to political or social instability their support for political factions based on ideology rises. The rents garnered by regime elites through FDI strengthens their domestic position, but also binds their actions and places elites between the conflicting interests of foreign capital and domestic labor that supports opposition groups. These constraints tend to magnify the severity of exogenous economic and political crises. MNCs face increased discount rates in times of instability, which decreases the value of the regime in power and increases the value of political ideology amongst opposition candidates. Foreign investors will support the viable opposition groups that are closest to their own political ideology, which I argue tend to be closest to that of their home country. In particular, if US-capital has a significant presence during a transitional period it will have a democratizing effect on a country, but this effect is limited and does not extend to the consolidation of democracy post-transition.

The paper proceeds as follows: Chapter II is a brief review of the diffusion and FDI literature that provides context for my research. Chapter III describes the quantitative data, regression analysis, and discusses the conclusions. Chapter IV includes the case

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<sup>5</sup> Significant evidence for the stabilizing effect of exposure to international economic networks, in general, has also been found by Ersin Özsahin, "The International Constraints on Regime Changes: How Globalization Hinders the Prospects for Democratization" (VS Verlag für Sozialwissenschaften, 2010).



studies of the Philippines and Indonesia. Finally, I offer some concluding thoughts in Chapter V.

## CHAPTER II

### LITERATURE REVIEW

Research on the diffusion of democracy has found that spatial proximity to other democracies or democratizing nations and the socioeconomic networks to which a country belongs are good predictors of whether or not a country will democratize. Not only is this relationship found to be strong, but it detracts from the otherwise significant relationship between domestic factors like education and levels of GDP that are found in the democratization literature.<sup>6</sup> A cursory look at the third wave of democratization<sup>7</sup> of the post-war era, however, suggests that the clumping of democracy in both space and time is a somewhat intuitive, if under-explained, pattern. Studies in the diffusion vein have tended to fall short of fleshing out the mechanisms driving diffusion, however, and have instead jumpstarted the field by arguing that a pattern does indeed exist that conflicts with standard modernization accounts. Two main lines of research are relevant for unpacking and theorizing about an FDI-diffusion variable: 1. the general diffusion literature and 2. modernization studies that include foreign capital as a correlate of economic growth.

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<sup>6</sup> Quan Li and Rafael Reuveny, "Economic Globalization and Democracy: An Empirical Analysis," *British Journal of Political Science* 33, no. 01 (2003); Rafael Reuveny and Quan Li, "Economic Openness, Democracy, and Income Inequality," *Comparative Political Studies* 36, no. 5 (2003); Barbara Wejnert, "Diffusion, Development, and Democracy, 1800-1999," *American Sociological Review* 70, no. 1 (2005); Kristian Skrede Gleditsch and Michael D. Ward, "Diffusion and the International Context of Democratization," *International Organization* 60, no. 04 (2006); Daniel Brinks and Michael Coppedge, "Diffusion Is No Illusion," *Comparative Political Studies* 39, no. 4 (2006).

<sup>7</sup> Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman: University of Oklahoma Press, 1991).

Previous scholarly attention given to FDI, has primarily focused on the effects of FDI on domestic incomes and economic structures<sup>8</sup> and the determinants of FDI.<sup>9</sup> The relationship between FDI and national income is generally found to be highly conditional or even ambiguous. Borensztein et al. (1998), for instance, find that FDI effects growth by both increasing investment and through technology transfers. But most of these positive externalities are found to be mitigated when FDI “crowds out” domestic investment. The same authors therefore argue that the host country must have adequate human capital, presumably through higher levels of education, to absorb new technologies and, in turn, realize the positive effects of FDI. De Soysa and O’Neal (1999) respond, however, that FDI benefits a host country via technology transfers and through more efficient modes of production that only come with foreign investment. The work on the determinants of FDI is slightly more homogenous. This literature tends to agree that political stability, macroeconomic health, and export orientation all positively increase levels of FDI.

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<sup>8</sup> Eduardo Borensztein, Jose De Gregorio, and Jong-Wha Lee, "How Does Foreign Direct Investment Affect Economic Growth?," *Journal of International Economics* 45, no. 1 (1998); Luiz R. de Mello, "Foreign Direct Investment-Led Growth: Evidence from Time Series and Panel Data," *Oxford Economic Papers* 51, no. 1 (1999); James R. Markusen and Anthony J. Venables, "Foreign Direct Investment as a Catalyst for Industrial Development," *European Economic Review* 43, no. 2 (1999); Indra de Soysa and John R. O'Neal, "Boon or Bane? Reassessing the Productivity of Foreign Direct Investment," *American Sociological Review* 64, no. 5 (1999); Xiaoying Li and Xiaming Liu, "Foreign Direct Investment and Economic Growth: An Increasingly Endogenous Relationship," *World Development* 33, no. 3 (2005).

<sup>9</sup> Robert E. B. Lucas, "On the Determinants of Direct Foreign Investment: Evidence from East and Southeast Asia," *World Development* 21, no. 3 (1993); Harinder Singh and W. Jun Kwang, "Some New Evidence on Determinants of Foreign Direct Investment in Developing Countries," (1995); Alan Bevan and Saul Estrin, "The Determinants of Foreign Direct Investment in Transition Economies," (C.E.P.R. Discussion Papers, 2000); Nathan Michael Jensen, *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment* (Princeton: Princeton University Press, 2006); Matthias Busse and Carsten Hefeker, "Political Risk, Institutions and Foreign Direct Investment," *European Journal of Political Economy* 23, no. 2 (2007); Agnès Bénassy-Quéré, Maylis Coupet, and Thierry Mayer, "Institutional Determinants of Foreign Direct Investment," *World Economy* 30, no. 5 (2007).

Purely economic perspectives of FDI are potentially important to the question of FDI's effect on democracy since, according to adherents of modernization theory, domestic incomes are a prominent determinant of democracy; FDI may affect economic growth, and levels of economic growth may in turn lead to changes in levels of democracy. It is useful to make a first cut into arguments about the effect of FDI on institutions along the modernization line of thinking given that a number of important perspectives revolve around the modernization hypothesis. First, dependency theorists have posited that FDI tends to impede long-term growth, increase economic inequality, and leads to authoritarian outcomes. Depressed growth and increasing inequality in turn undermine prospects for democracy.<sup>10</sup> Conversely, those finding a primarily positive effect of FDI on growth posit that FDI tends to make democratization more likely through the faster economic growth it spurs.<sup>11</sup> In other words, the net effect of FDI on political institutions hinges on FDI's economic impact on a country, but this net effect remains a contentious debate and has trended to the conclusion that FDI's effects are context and content specific. Those same discussions suggest that FDI's political effects will also be context and content specific.

A large number of often-contradictory theoretical contributions have been made about the effects of openness to foreign investment and other types of economic

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<sup>10</sup> For instance, Volker Bornschie, Christopher Chase-Dunn, and Richard Rubinson, "Cross-National Evidence of the Effects of Foreign Investment and Aid on Economic Growth and Inequality: A Survey of Findings and a Reanalysis," *The American Journal of Sociology* 84, no. 3 (1978).

<sup>11</sup> Jensen, *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment*.

globalization on democratization.<sup>12</sup> Whether FDI may influence host country institutions in a way other than through an impact on domestic economic factors, however, has not received as much attention. There are a number of reasons to believe that FDI could influence host country institutions beyond the standard modernization mechanisms. First, FDI is a lasting and large economic investment in the host country. This involves employing and maintaining a work force with adequate skills, maintaining fixed capital stocks through reinvestment and sustained property rights, and securing lasting access to natural resources and intermediate goods. Many different theoretical mechanisms could explain how these lasting economic investments might have an impact on political institutions, but I focus on a few specific modes of diffusion discussed below.

The country of origin for FDI may play a part in how FDI affects host institutional development. Numerous authors have included a general FDI variable in regressions in an attempt to measure the holistic influence of international factors on institutions in the receiving country,<sup>13</sup> but I have not found a country-specific FDI variable in quantitative works. This is most likely due to data limitations regarding country-specific FDI data. A country-specific argument is supported, however, by some authors who have found that being in the US “sphere of influence” makes a country more

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<sup>12</sup> Summarized nicely by Li and Reuveny, "Economic Globalization and Democracy: An Empirical Analysis."

<sup>13</sup> Indra de Soysa, *Foreign Direct Investment, Democracy, and Development: Assessing Contours, Correlates, and Concomitants of Globalization* (London; New York: Routledge, 2003); Li and Reuveny, "Economic Globalization and Democracy: An Empirical Analysis."; David L. Epstein et al., "Democratic Transitions," *American Journal of Political Science* 50, no. 3 (2006); Özsahin, "The International Constraints on Regime Changes: How Globalization Hinders the Prospects for Democratization".

likely to democratize.<sup>14</sup> Balaev uses country-specific trade variables to highlight the effect that trade with Russia had on satellite states' levels of democracy.<sup>15</sup> The author draws from world systems theory to argue that the countries within the Russian sphere of influence can be split into the hegemon (Russia), semi-periphery, and peripheral countries. Economic proximity to Russia is measured by three different operationalizations of the reach of trade with Russia and is a statistically significant and substantively large predictor of lower levels of democracy, robust to the inclusion of the standard control variables. Balaev measures trade exposure as a percentage of total trade, GDP, and population, respectively. I borrow from this operationalization to measure the influence of FDI coming specifically from the United States, the global hegemon over the period of study.

In sum, international economic networks and the geographic proximity to other democratic countries in general have both been fairly well established as significant determinants of democracy in the literature. But why this pattern exists is less obvious, rigorously expounded, or agreed upon. There are strong reasons to believe that FDI will have significant and direct effects on levels of democracy, but the available literature suggests that these effects will be highly conditional in both magnitude and direction. Exploring this idea further, the following section establishes that US-FDI has a positive effect on levels of democracy that is separable from economic variables and diffusion variables alike.

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<sup>14</sup> For example, Brinks and Coppedge, "Diffusion Is No Illusion."

<sup>15</sup> Mikhail Balaev, "The Effects of International Trade on Democracy: A Panel Study of the Post-Soviet World-System," *Sociological Perspectives* 52, no. 3 (2009).

## CHAPTER III

### QUANTITATIVE ANALYSIS

Most of the major contributions to the diffusion literature use worldwide datasets that encompass as large of a sample over as long of a time period as possible. Typically, the sample ends up being strongly truncated in either the number of variables included or the time span covered. Most studies also only make a cursory mention of the within-country effects that might complicate the story. The inherent assumption being that there is a generalizable trend across countries. Below I build on this research by including variables with a higher degree of country-specificity than is typically included in the diffusion literature. This necessarily comes at the cost of statistical power and time-span of the study. Nevertheless, the results suggest that there exists a direct, positive relationship between US-FDI and levels of democracy, although the relationship is conditional on the definition of democracy employed. This definitional ambiguity motivates the case studies that follow the quantitative portion of my research.

#### **The General Model**

Untangling the causal relationships between two broad and intertwined variables like democracy and capital investments is a complex process. In particular, there is likely to be a problem of endogeneity between my explanatory and outcome variables. I expect this to bias estimates upwards in a standard OLS regression estimation. With US-FDI we would expect US-based firms to be more likely to invest in democracies, based on the theoretical considerations above, and the economic impact of FDI to also have an effect on regime type, as modernization theorists would argue. The two-stage least squares (2SLS) approach is a standard method of producing unbiased coefficient estimates in

situations with a potentially large endogeneity problem. 2SLS approaches control for endogeneity bias by utilizing an instrumental variable that is correlated with the “independent” variable, but is not a direct determinant of the “dependent” variable. If these assumptions hold, then the 2SLS approach removes the bias introduced by having a reciprocal relationship between the “independent” and “dependent” variables. The basic 2SLS model for this study is as follows:

$$\text{1st Stage: } fdi_{it-1} = \alpha_0 + X_{it-1}\alpha_1 + \alpha_2 ER_{t-1} + \gamma_i + \varepsilon_{it-1}$$

$$\text{2nd Stage: } y_{it} = \beta_0 + X_{it-1}\beta_1 + \beta_2 \widehat{fdi}_{it-1} + \lambda_i + u_{it}$$

In the above model  $y_{it}$  is the democracy outcome variable with  $i$  and  $t$  being country and year indicators, respectively.  $X_{it}$  is the set of control variables discussed in more detail below.  $\lambda$  and  $\gamma$  are country fixed effects, which control for country-specific trends over time.  $ER$  is the US-China exchange rate discussed in greater detail in the next section.  $u$  and  $\varepsilon$  are stochastic elements. The main variable of interest is  $fdi_{it}$ , which measures the extent of the influence of US-FDI. I use two operationalizations for this variable: US-FDI as a percentage of GDP and per capita US-FDI. Both types of measurements are borrowed from Balaev’s (2009) treatment of trade with Russia. Balaev also includes a third variable, which is bilateral Russian trade as a percentage of a country’s total trade. As described below, however, this variable poses a particular problem and is therefore not included in this study. While the  $\frac{US\ FDI}{GDP}$  and  $\frac{US\ FDI}{Pop}$  measures are each absolute in terms of measuring the relative influence of US-FDI, the  $\frac{US\ FDI}{Total\ FDI}$  variable can fluctuate based on changes in FDI coming from other nations or from changes in US-FDI. Therefore a similar change in magnitude in the  $\frac{US\ FDI}{Total\ FDI}$  variable for



two different countries could be explained by widely different circumstances. For example, the same observed change could be due to a mass influx of investment from US firms for one country and a large decrease of FDI from, say, China for a different country. Although in many cases this third element is an important measure of the relative importance of US firms to a country's investment portfolio, it is highly problematic if one expects FDI from other countries to have a similar influence on domestic institutions to that of US-FDI.

Another noteworthy trait of the model is that the explanatory variables are all lagged one year. A contemporaneous relationship between the explanatory and dependent variables is difficult to theorize and to accurately measure as simultaneous changes are not particularly feasible in a causal sense and further compound endogeneity problems. The standard approach in the literature is to lag variables by one period. Also worth mentioning is the lack of a lagged dependent variable amongst the explanatory variables in this model. A few of the more significant works in modernization studies include a lagged dependent variable,<sup>16</sup> the rationale being that institutional 'stickiness' can explain much of the variance, or lack thereof, in democracy indices. Importantly, however, many more works, particularly in the diffusion literature, do not include a lagged dependent variable.<sup>17</sup> 2SLS approaches are also not regularly used since it is prohibitively difficult

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<sup>16</sup> Epstein et al., "Democratic Transitions."; Daron Acemoglu et al., "Income and Democracy," *American Economic Review* 98, no. 3 (2008); Acemoglu et al., "Reevaluating the Modernization Hypothesis."

<sup>17</sup> Li and Reuveny, "Economic Globalization and Democracy: An Empirical Analysis."; Nita Rudra, "Globalization and the Strengthening of Democracy in the Developing World," *American Journal of Political Science* 49, no. 4 (2005); Gleditsch and Ward, "Diffusion and the International Context of Democratization."; Elias Papaioannou and Gregorios Siourounis, "Economic and Social Factors Driving the Third Wave of Democratization," *Journal of Comparative Economics* 36, no. 3 (2008).

to find an instrument that has a causal effect on either democracy or economic growth, but not on the other. Eichengreen and Leblang,<sup>18</sup> notably, use 2SLS model and do not include a lagged dependent variable. Indeed, a lagged dependent variable should be included when more direct and conventional ways of controlling for endogeneity, such as 2SLS, are not feasible for one reason or another. I argue that my inclusion of an instrumental variable preempts the need for a lagged dependent variable.

### **FDI and Other Diffusion Variables**

The statistical models and sets of variables employed in studying the diffusion of democracy vary widely. These always include some measure of the proportion of neighboring democracies and/or the global proportion of democracies. Other variables that vary depending on the focus of the authors include trade, trade partners, openness to investment, total FDI, portfolio investment, and membership in intergovernmental organizations (IGOs). All such works also include modernization variables, including per capita GDP and growth, as well as other country-specific controls. The significance of coefficient estimates across these specifications vary quite a bit, except for the diffusion variables, but the specifications usually have a couple of problems at a theoretical level: namely that endogeneity between dependent and independent variables is not addressed and “kitchen sink” specifications neglect the potential multicollinearity between, say, trade and FDI. Nevertheless, there is good reason to think that US-FDI will have an effect on democracy that is distinct from these other diffusion mechanisms.

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<sup>18</sup> Barry Eichengreen and David Leblang, "Democracy and Globalization," *Economics and Politics* 20, no. 3 (2008).

Firstly, FDI stocks represent a more lasting interest in a country compared to the other economic variables that are often employed. Levels of trade might represent elite interactions to reach trade agreements and norms could be transmitted in this venue. But trade could also be a purely economic interaction where companies have a mutually beneficial incentive to decrease trade barriers due to a comparative advantage. Likewise, portfolio investment is more likely to be speculative, fickle, and less representative of direct interactions. But it is also expected that all of these variables will be closely correlated and therefore difficult to detach in statistical analysis without solid theoretical distinctions. In sum, the large and long-term characteristics of FDI make it more likely to have a direct political effect in host countries, whereas other international economic factors may only affect a country through their impact on economic growth. The inclusion of these other variables as controls, however, is complicated by the fact that they typically are closely correlated with FDI.

My regressions also include Coppedge's diffusion variable, which is significant in all of the specifications, but the regressions do not include the proportion of democracies in the world or membership in IGOs, other variables sometimes included in the diffusion literature. These variables are more difficult to justify theoretically. Including the proportion of worldwide democracy as an independent variable is problematic since worldwide democracy, obviously, predicts worldwide democracy and therefore will be endogenous to any country level shift in level of democracy. Therefore, a significant coefficient estimate here could be due to a worldwide trend or merely a not-so-cleverly constructed variable.

Membership in IGOs may be a mechanism by which worldwide democracy is transferred to a particular country, but it is unclear which IGOs should display this effect and how to measure the “extent” of membership for each IGO. Furthermore, there is reason to believe that, depending on the IGO, the pressure for democracy may be negative or positive. Therefore including blanket IGO measures would be flawed. Likewise, truncating the IGOs included and focusing solely on major IGOs will undoubtedly lead to significant results. This result found in the literature could originate from a selection bias in which large democracies are the dominant members of IGOs and have a disposition towards selecting other democracies as new members. It could also be possible that countries usher in reforms in order to gain membership to IGOs, but this too is far from clear in the literature and is not a direct diffusion mechanism, *per se*.

Conversely, FDI is a lasting, country-specific, and internationally based factor. The relative lasting nature of FDI creates a shareholder status that leads to greater concern for social and political stability than other types of investment. Most of the other diffusion variables rely on loose logic and speculation about mechanisms between elites at the international level. These general diffusion mechanisms may exist, but finding statistically significant coefficients through particular, less than complete specifications is not a complete engagement with the issues at hand. Country-specific FDI is a much more viable mechanism when controlling for economic growth, regional diffusion, and any endogenous relationship than other diffusion variables. I discuss the method of controlling for endogeneity in the following section.

## China-US Exchange Rate Instrument

Naïvely estimating the second stage without an instrumental variable would lead to biased estimates because of the correlation between the democracy,  $y_{it}$ , and the error term,  $u_{it}$ . My exchange rate instrument effectively controls for this effect as long as the outcome variable is not also correlated with the error in the first-stage,  $\varepsilon_{it}$ ; the relationship between the exchange rate instrument,  $ER_t$ , and  $fdi_{it}$  is strong; and if there are theoretical grounds to believe that the relationship between  $ER_t$  and  $fdi_{it}$  is causal and not a statistical aberration. Since we are looking specifically at the effect that US-FDI has on political institutions I need an instrument that is highly correlated with US-FDI but is not also directly linked to democratic outcomes in order to identify the causal effects in the 2SLS method. I have settled on US-China exchange rates. While there is some conflicting evidence on the topic, there have been strong findings that the appreciation of a currency increases capital investment outflows from that country.<sup>19</sup> The logic behind an exchange rate instrument is that as the dollar becomes more valuable against world currencies, US investment abroad becomes more enticing for US-based MNCs. Likewise, as the value of the dollar goes down US investment is also expected to go down. Opting for the dollar-yuan exchange rate instead of another more comprehensive measurement of the strength of the dollar, however, may be problematic.

There is an argument to be made that instead of a China-specific exchange rate instrument one should instead use a more general exchange rate measure. Over the period in question (1985-96) China was just beginning to usher in the current era of high levels

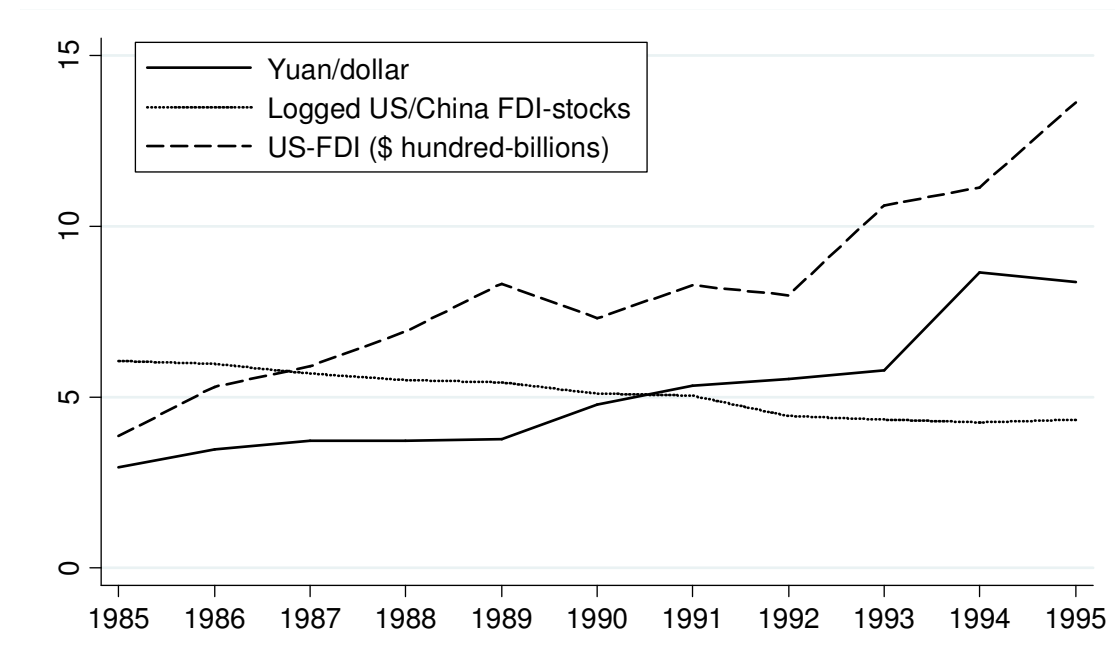
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<sup>19</sup> Kenneth Froot and Jeremy Stein, "Exchange Rates and Foreign Direct Investment: An Imperfect Capital Markets Approach," *The Quarterly Journal of Economics* 106, no. 4 (1991); Bruce A. Blonigen, "Firm-Specific Assets and the Link between Exchange Rates and Foreign Direct Investment," *The American Economic Review* 87, no. 3 (1997).

of FDI. There are a few practical and theoretical reasons to choose this instrument over another. First, I tested composite index of all major currencies against the dollar as well as the pound, yen, and yuan exchange rates (the euro did not exist over the extent of my study) as instruments for the US-FDI variables. Dollar-yuan exchange rates yield the strongest correlations and the most significant *F*-statistics (see table 3 below). The high *F*-stats suggest that this is a strong and valid instrument for the two FDI variables of interest, but this significance did not exist for the other potential instruments.

Second, the China/US exchange rate is a statistically significant predictor of the US-FDI variable over the period in question. As seen in Figure 1, as the dollar appreciated against the yuan overall US-FDI also increased. Importantly, however, over this period the disparity between US and Chinese FDI decreased by numerous magnitudes. This suggests that over this period Chinese FDI began to compete against US-FDI even if in aggregate it remained significantly lower. As it begins to become a

Figure 3: Exchange Rate Instrument and Other Key Indicators



global competitor for investment, the relative strength of the yuan against the dollar can determine which country is better able to invest at the margins. The coefficient estimates for the instrument in the first-stage regressions are also statistically significant. This is not to say that this exchange rate is *the* cause of increases in US-FDI, but it is certainly a factor or a proxy for other factors.

Finally, the importance of the yuan/dollar measure against the competing exchange rates variables is not that it is strong currency, but that it is one coming from a developing country, emerging economy, and non-democracy. This is important because the effect we are aiming to control for with this instrument is US-FDI that is going to other countries because the other country is an established democracy. When US-FDI has a democratizing effect this will be in countries with some similar characteristics to China, not in countries such as Japan or Britain. In conclusion, this instrument may not be perfect in determining US-FDI shares in the sample, but the evidence suggests that it is at least a good proxy for latent variables driving the increases of US-FDI to developing countries beyond time trends alone.

### **Description of Data**

The data originates from a number of different sources. Summary statistics are provided in table 1. I use the four major indices for democracy found in the literature: Polity IV,<sup>20</sup> Vanhanen,<sup>21</sup> PACL,<sup>22</sup> each of which was gathered from the relevant scholar's

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<sup>20</sup> Monty Marshall and Keith Jagers, "Polity Iv Project: Political Regime Characteristics and Transitions, 1800-2002," <http://www.systemicpeace.org/polity/polity4.htm>.

<sup>21</sup> Tatu Vanhanen, "A New Dataset for Measuring Democracy, 1810-1998," *Journal of Peace Research* 37, no. 2 (2000).

<sup>22</sup> José Antonio Cheibub, Jennifer Gandhi, and James Raymond Vreeland, "Democracy and Dictatorship Revisted," (2009).

website, and the trichotomous Epstein et al.<sup>23</sup> variable, which is constructed from Polity IV.<sup>24</sup> The yearly China-US exchange rate variable and the other exchange rates are gathered from the St. Louis FRED database.<sup>25</sup> US troop deployment levels come from The Heritage Foundation.<sup>26</sup> PPP-GDP, growth, and population data are from the Penn World Table.<sup>27</sup> The diffusion variable is Brinks and Coppedge's (2006) measure, available from Michael Coppedge's website.<sup>28</sup> This is a normalized measure of a country's level of democracy against that of its neighbors; a negative score indicates the country has a lower democracy score than the average of its neighbors. And finally the FDI variables are found on the OECD online database.<sup>29</sup>

The GDP and growth rate variables control for income levels and are highly correlated with levels of education, two standard variables in the modernization literature. The diffusion variable controls for the standard set of diffusion arguments about proximity to democratic countries. Previous works<sup>30</sup> have also found urbanization to be a significant predictor of democratic outcomes and a check on the modernization mechanisms. The US military variable is included as a check on other forms of a US

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<sup>23</sup> Epstein et al., "Democratic Transitions."

<sup>24</sup> Authoritarian is -10-0, mixed is 0-7, and full democracy is 7-10 on the Polity scale.

<sup>25</sup> "China / U.S. Foreign Exchange Rate," FRED database (St. Louis Federal Reserve, 2010).

<sup>26</sup> Tim Kane, *Global U.S. Troop Deployment, 1950-2003* (Washington D.C.: Heritage Foundation, Center for Data Analysis, 2004).

<sup>27</sup> Alan Heston, Robert Summers, and Bettina Aten, "Penn World Table Version 6.3," ed. Income and Prices at the University of Pennsylvania Center for International Comparisons of Production (2009).

<sup>28</sup> Brinks and Coppedge, "Diffusion Is No Illusion."

<sup>29</sup> OECD, "Oecd.Statextracts: FDI Positions by Partner Country."

<sup>30</sup> Acemoglu et al., "Reevaluating the Modernization Hypothesis."



presence that could explain why a country democratizes. For instance, there may have been a significant increase in US capital inflows into Iraq following the fall of Saddam Hussein, but the implementation of democracy was due to political and military actions in the country, for which US troop levels are an adequate proxy in most such cases.

The Polity variable is a twenty-one point range, with -10 being complete authoritarianism and 10 being complete democracy. It is comprised of a variety of measures such as executive constraint, political competition, and executive recruitment processes. Polity is by far the most used of the indices, but I also include other democracy indices as points of comparison. The Vanhanen index is a composite score of participation among voters and competition amongst candidates in percent points. The PACL binary variable is particularly stringent in its definition of democracy.<sup>31</sup>

Table 1: Summary Statistics

Variable	Mean	S.D.	Min	Max
Polity	1.781	7.182	-10	10
Vanhanen	12.263	13.147	0	47.08
PACL	0.477	0.5	0	1
Epstein, et al.	0.948	0.874	0	2
Log FDI	7.573	2.68	0.039	15.096
Log US-FDI	6.508	3.013	0	13.064
US-FDI/population	67.981	214.154	0.003	2864.579
US-FDI/GDP	63.515	131.97	0.013	1265.806
Diffusion	-0.428	3.252	-10	10
Urbanization	51.239	23.577	4.84	100
Log US military	3.596	2.334	0	11.918
Growth rate	1.919	7.607	-64.36	118.243
Log GDP	8.323	1.163	4.777	11.559
China-US ex	6.476	2.178	1.981	8.64

<sup>31</sup> The conditions of which are that  
(1) The chief executive is elected;  
(2) The legislature is elected;  
(3) More than one political party exists;  
(4) There has been at least one transfer of power.

The data is unbalanced and constrained to an unrepresentative set of countries. The chief variable of interest, FDI, is the primary cause of the data shortcomings so there is no obvious way to get around this issue. The OECD did not begin collecting FDI data of any kind until 1975 and country-specific FDI data dates to 1985. Reporting of FDI variables is also relatively spotty. For example, there are no data available for former Soviet satellite states before 1991. The important democratic diffusion variable constrains the data set at the top-end with no data available beyond 1996. The data is limited to an 11 year period, 1985-96, and there are a number of missing data points. The number of usable data points we are left with is slightly above 600 and a sample that covers 102 countries with the maximum number of data points (11) only being available for 29 of these countries.<sup>32</sup> While the data is clearly not ideal or complete, a significant number of data points do exist. Below I discuss alternative techniques that are less data-intensive that could be used to address this problem.

Table 2 provides a correlation matrix of the explanatory variables. The closest correlation amongst the explanatory variables is between logged GDP and urbanization at 0.789. None of the variables are close enough to warrant worrying about multicollinearity problems. Also of note is the strong correlation between logged US-FDI and logged total FDI (see column 1) and the much lower correlation between the  $\frac{US\ FDI}{pop}$  and  $\frac{US\ FDI}{GDP}$

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<sup>32</sup> For the baseline Polity IV variable the following 102 countries are included in the analysis: Algeria, Angola, Argentina, Australia, Austria, Azerbaijan, Bahrain, Bangladesh, Belgium, Bolivia, Botswana, Brazil, Bulgaria, Burkina Faso, Cambodia, Cameroon, Canada, Chad, Chile, China, Colombia, Costa Rica, Croatia, Cyprus, Denmark, Dominican Republic, Ecuador, Egypt, El Salvador, Eritrea, Ethiopia, Finland, France, Gabon, Ghana, Greece, Guatemala, Guinea, Guyana, Haiti, Honduras, Hungary, India, Indonesia, Ireland, Israel, Italy, Ivory Coast, Jamaica, Japan, Jordan, Kenya, South Korea, Laos, Liberia, Madagascar, Malawi, Malaysia, Mali, Mexico, Morocco, Mozambique, Netherlands, New Zealand, Nicaragua, Niger, Nigeria, Norway, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Qatar, Romania, Saudi Arabia, Senegal, Sierra Leone, Singapore, South Africa, Spain, Sri Lanka, Sudan, Sweden, Switzerland, Syria, Tanzania, Thailand, Togo, Trinidad, Tunisia, Turkey, UAE, Uganda, United Kingdom, Uruguay, Yemen, Zambia, and Zimbabwe

variables and total FDI. This suggests that while total FDI and US-FDI are closely related, the proportional effects of  $\frac{US\ FDI}{pop}$  and  $\frac{US\ FDI}{GDP}$  cannot be explained by diffusion arguments about total FDI.

Table 2: Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1 Log FDI	1									
2 Log US-FDI	0.855	1								
3 US-FDI/pop	0.375	0.41	1							
4 US-FDI/GDP	0.538	0.577	0.457	1						
5 Diffusion	-0.174	-0.1	0.059	0.148	1					
6 Urbanization	0.546	0.587	0.276	0.287	-0.108	1				
7 Log US mil	0.408	0.491	0.105	0.323	-0.129	0.394	1			
8 Growth rate	0.136	0.087	0.043	0.006	-0.122	0.033	0.024	1		
9 Log GDP	0.68	0.663	0.396	0.275	-0.212	0.789	0.435	0.128	1	
10 China-US ex.	0.283	-0.061	0.073	0.037	-0.005	0.131	-0.066	0.126	0.214	1

## Regression Results

Table 3 contains the first-stage estimates as well as the second stage results of my 2SLS regression. Each specification here includes country-level fixed-effects. These control for country-specific time trends or other idiosyncrasies that might otherwise bias the coefficient estimates. I report estimates for both the Polity and Vanhanen indices. For the first-stage regressions in columns (1) and (2), the US/China exchange rate variable is a highly significant predictor of the FDI variables and  $F$ -statistics are each well above 10 indicating a good and valid instrumental variable.<sup>33</sup>

<sup>33</sup> Stock, James H., Johnathan H. Wright, and Motohiro Yogo. "A Survey of Weak Instruments and Weak Identification in Generalized Method of Moments." *Journal of Business and Economic Statistics* 20, no. 4 (2002): 518-29.

The main regression results for the continuous democracy – Polity and Vanhanen – indices are in columns (3)-(6) of table 3. There is clearly a divergence between indices for both of the US-FDI variables. In both regressions, levels of urbanization and democratic diffusion are significant predictors of the level of democracy. Note that the negative coefficient values on the diffusion variable indicate that higher democracy scores amongst neighboring countries is positively associated with higher own level of democracy as this measure is essentially a deficit in the democracy index. Interestingly, the US-FDI/GDP variable is significant for the Polity index, but the per capita US-FDI variable is not. Both variables are significant for the Vanhanen dependent variable. Direct interpretation of these estimates are difficult with the Polity index and with the inclusion of the instrumental variables, but it is possible to back out an example of the magnitude of these coefficients with the Vanhanen index, which is a composite measure of vote-shares and voter turnout. For column (3), taking as an example Indonesia in 1996 and holding GDP and vote-shares constant, the regression estimates suggest that a one percentage point increase in US-FDI (US \$15 million) would result in about 975,415 more voters in 1997; \$15.38 in US-FDI in 1996 would lead to one more Indonesian voter in 1997, independent of the effect that Indonesian politics has on enticing US-FDI. This result should, obviously, be taken with a grain of salt, but remains highly suggestive as this investment is not in the form of political donations nor is directly political in any sense. By comparison, direct funding of get-out-the-vote efforts in the US are estimated to cost between \$5 and \$15 per person.<sup>34</sup>

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<sup>34</sup> <http://gotv.research.yale.edu/?q=node/10>

Table 3: First Stage and Continuous Variable Results.

Variables	First Stage		Second Stage			
	(1) US-FDI/ GDP lag	(2) US-FDI/ pop lag	(3) Polity IV	(4)	(5) Vanhanen	(6)
China/US exch	5.4275*** (0.839)	4.3319*** (0.784)				
US-FDI/gdp lag			0.025* (0.015)		0.076** (0.031)	
US-FDI/pop lag				0.031 (0.019)		0.095** (0.043)
Logged GDP lag	1.1105 (8.514)	45.0047*** (7.946)	1.355* (0.822)	-0.031 (1.498)	-1.146 (1.750)	-5.328 (3.307)
Growth rate lag	-0.4036* (0.239)	-0.3371 (0.223)	-0.033 (0.024)	-0.033 (0.025)	-0.127** (0.050)	-0.126** (0.055)
Diffusion lag	0.0283 (0.684)	-0.4532 (0.639)	-0.549*** (0.066)	-0.534*** (0.068)	-0.991*** (0.139)	-0.946*** (0.151)
Urbanization lag	0.7700 (0.884)	-2.3107*** (0.825)	0.181** (0.089)	0.273*** (0.085)	0.566*** (0.189)	0.843*** (0.188)
Log US military lag	-1.2099 (1.702)	2.5466 (1.589)	0.336** (0.165)	0.225 (0.175)	-0.291 (0.351)	-0.624 (0.387)
Observations	622	622	610	610	612	612
# of Countries	103	103	92	92	93	93
F-stat	20.10	28.80				

Standard errors in parentheses; \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Clustering standard errors by country is a technically superior methodology in this situation<sup>35</sup> and leads to quite similar results that can be found in table 4. Notably, however, neither of the FDI variables nor the urbanization variable is significant for the Polity index here. The US-FDI variables remain significant for the Vanhanen specifications as well as the urbanization variable. The diffusion variable remains significant for all specifications of Polity and Vanhanen indices.

<sup>35</sup> Petersen, Mitchell A. "Estimating Standard Errors in Finance Panel Data Sets: Comparing Approaches." *Review of Financial Studies* 22, no. 1 (2009): 435-80.

Table 4: Clustered Standard Errors by Country

Variables	(1) Polity IV	(2)	(3) Vanhanen	(4)
US-FDI/gdp lag	0.025 (0.019)		0.076* (0.045)	
US-FDI/pop lag		0.031 (0.024)		0.095* (0.051)
Logged GDP lag	1.355 (1.754)	-0.031 (2.610)	-1.146 (3.699)	-5.328 (5.196)
Growth rate lag	-0.033 (0.041)	-0.033 (0.042)	-0.127 (0.090)	-0.126 (0.091)
Diffusion lag	-0.549*** (0.158)	-0.534*** (0.168)	-0.991** (0.400)	-0.946** (0.435)
Urbanization lag	0.181 (0.131)	0.273 (0.185)	0.566* (0.310)	0.843* (0.478)
Log US military lag	0.336* (0.204)	0.225 (0.246)	-0.291 (0.334)	-0.624 (0.546)
Observations	610	610	612	612
# of Countries	92	92	93	93

Robust standard errors in parentheses; \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

As a further point of comparison, I test the model with two other standard measures of democracy. The results are in table 5. Przeworski et al.<sup>36</sup> make a strong argument against the convoluted and arguably biased Polity IV rankings, and against the received conclusions about the causal influence of economic development on levels of democracy. They create a binary democracy/autocracy set, as discussed above. Results for this binary variable are found in rows (1)-(4) of table 5. Rows (3) and (4) present country-level clustered standard errors.<sup>37</sup> Epstein et al. reply to Przeworski et al. that the

<sup>36</sup> Przeworski et al., *Democracy and Development: Political Institutions and Well-Being in the World, 1950-1990*

<sup>37</sup> Using the Przeworski et al. data set results in more data points for more countries being available. The following countries are included in my data set with those in italics being additions from the Polity regressions: *Afghanistan, Albania, Algeria, Angola, Argentina, Armenia, Australia, Austria, Azerbaijan, Bahrain, Bangladesh, Belarus, Belgium, Bolivia, Bosnia, Botswana, Brazil, Bulgaria, Burkina Faso, Burundi, Cambodia, Cameroon, Canada, Chad, Chile, China, Colombia, Costa Rica, Croatia, Cuba, Cyprus, Denmark, Djibouti, Dominican Rep, Ecuador, Egypt, El Salvador, Eritrea, Estonia, Ethiopia, Finland, France, Gabon, Georgia, Ghana, Greece, Guatemala, Guinea, Guyana, Haiti, Honduras, Hungary, India, Indonesia, Iraq, Ireland, Israel, Italy, Ivory Coast, Jamaica, Japan, Jordan, Kazakhstan, Kenya, Korea South, Kuwait, Laos, Latvia, Lebanon, Liberia, Lithuania, Macedonia, Madagascar, Malawi, Malaysia, Mali, Mauritania, Mauritius, Mexico, Moldova, Morocco, Mozambique, Nepal, Netherlands, New*

binary conception of democracy is too stringent and biases results by clumping all partial democracies into the autocracy category.<sup>38</sup> Epstein et al. find that most of the movement in regime type is to or from a middle, mixed-democracy category, but they agree with Przeworski et al. that treating Polity as continuous is problematic. Thus they group Polity into three sections: autocracy, partial democracy, and full democracy. The results for the Epstein et al. dependent variable, again with country-level clustered standard errors, are in rows (3) and (4). There is reason to believe, however, that introducing fixed effects into an ordered probit estimation like this yields inconsistent or nonsensical results.<sup>39</sup> Due to the probably unreliable nature of fixed-effect estimates, I drop the fixed-effects for the Epstein et al. variable in columns (6) and (7) of Table 5.

As would be expected since it is derived from the Polity index, the FDI variables with the Epstein et al. dependent variable are insignificant. We would expect these coefficients to become more significant if the inclusion of fixed effects was possible with ordered probit specifications, but this is unavailable. Nevertheless, these results bolster the insignificant coefficients found for the continuous Polity variable. The Przeworski et al. specifications all have significant coefficient estimates, except in column (4) which includes country-level clustered standard errors with the US-FDI/population variable. These estimates almost meet the standard 10% level of significance. The added

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Zealand, Nicaragua, Niger, Nigeria, Norway, Oman, Pakistan, Panama, *Papua New Guinea*, Paraguay, Peru, Philippines, Poland, Portugal, Qatar, Romania, Saudi Arabia, Senegal, Sierra Leone, Singapore, *Slovak Republic*, *Slovenia*, *Somalia*, South Africa, Spain, Sri Lanka, Sudan, Sweden, Switzerland, Syria, *Tajikistan*, Tanzania, Thailand, Togo, Trinidad, Tunisia, Turkey, UAE, Uganda, *Ukraine*, UK, Uruguay, *Uzbekistan*, Yemen, Zambia, and Zimbabwe.

<sup>38</sup> Epstein et al., "Democratic Transitions."

<sup>39</sup> A discussion from a few years ago is found at the link below. There has not been much in the way of progressing towards a manageable estimator in such models, much less when there is an instrumental variable included. <http://www.stata.com/statalist/archive/2003-09/msg00103.html>

explanatory power of the lagged income variable for the Przeworski et al. dependent variable is also noteworthy.

Table 5: Binary and Trichotomous Variables

Variables	(1) Przeworski et al.	(2)	(3)	(4)	(5) Epstein et al.	(6)
US-FDI/gdp lag	0.035*** (0.009)		0.035* (0.018)		0.009 (0.008)	
US-FDI/pop lag		0.034*** (0.007)		0.034 <sup>\$</sup> (0.021)		0.006 (0.010)
Logged GDP lag	2.969*** (0.530)	2.015*** (0.551)	2.969* (1.770)	2.015 <sup>\$</sup> (1.263)	0.705** (0.279)	0.525 (0.529)
Growth rate lag	-0.033 (0.020)	-0.034* (0.020)	-0.033 (0.021)	-0.034 <sup>\$</sup> (0.022)	-0.032* (0.018)	-0.033* (0.018)
Diffusion lag	-0.507*** (0.070)	-0.502*** (0.067)	-0.507*** (0.122)	-0.502*** (0.130)	-0.168*** (0.055)	-0.136*** (0.047)
Urbanization lag	-0.020 (0.023)	0.068*** (0.021)	-0.020 (0.068)	0.068 (0.068)	-0.011 (0.008)	-0.006 (0.010)
Log US military lag	-0.042 (0.221)	0.114 (0.119)	-0.042 (0.235)	0.114 (0.228)	-0.042 (0.121)	0.045 (0.060)
Observations	1247	1247	1247	1247	636	636
# of Countries	130	130	130	130	106	106

Standard errors in parentheses; \*\*\* p<0.01, \*\* p<0.05, \* p<0.1, <sup>\$</sup><0.12

## Potential Biases

A number of factors beyond the endogeneity problems discussed above could bias the estimates. First, more wealthy countries have better and more accurate data reporting, hence are disproportionately represented amongst the countries with the most complete FDI data for 1985-1996. One solution besides waiting for better data to become available is bootstrapping the data, so that underrepresented data becomes artificially better represented in the sample. But over the sample period we would expect wealthier countries to have both higher levels of investment and less movement in the democracy indices. Therefore the coefficient estimates here would be expected to be biased downwards, and thus can be considered lower-bounds. As FDI reporting becomes more



standardized and extends over a longer period this may be worth revisiting in future research.

Another important shortcoming of my quantitative analysis is the limited time range. The magnitude of FDI in the global economy has skyrocketed since the beginning of the OECD dataset in 1975. But my analysis is missing data from 1996-present due to the lack of the important (and significant across all of the specifications) diffusion variable. Given fewer time constraints, it would be straightforward to reconstruct Coppedge's diffusion variable for the years after 1996. As is, I must rely on the 1985-1996 sample as country-specific FDI data begins in 1985. This could underestimate the effects of FDI on democracy as there may be nonlinearities in the relationship between FDI and democracy. For instance, a threshold level of FDI may exist, relative to country or relative to corporation, where foreign capital becomes profoundly more influential and/or interested in domestic political outcomes. Or FDI may influence partial-democracies in a way that it does not affect autocracies because of the existence of, say, electoral politics. With this in mind, however, this 11-year analysis is meant more as a window into the relationship rather than definitive evidence of a specific relationship.

My argument also rests on the assumption that MNCs become more interested in political ideology in host countries when regimes are strained by exogenous crises and outcomes are uncertain. Major exogenous economic and political shocks are of particular importance and largely absent in the available data. For instance, I hypothesize that following the 1997 Asian financial crisis countries with a strong US firm presence that were severely hit by the crisis would be more likely to undergo democratization and more likely to have remained stable prior to the crisis. If data were available after the crisis

then this would warrant a Markov switching model that would find drastically different effects before and after the event. My case study on Indonesia goes some way in explaining the role the crisis played in the interaction between these variables there, but a more complete and longer data set would be needed to adequately measure this relationship quantitatively.

As a point of comparison, I ran the regressions over the whole sample omitting the diffusion variable.<sup>40</sup> Dropping this variable increased the sample size and the coverage period. The US-FDI variables also became more influential, but it is difficult to say how much of this came directly from the omitted diffusion variable and what explanatory power can be attributed to changes in US-FDI over the period. It is possible to restrict the sample to the one left by the diffusion variable and decompose the increase in the US-FDI variable due to dropping the diffusion variable. This approach, however, could not account for changes over time between these key variables. That is, it could explain how collinear diffusion and US-FDI were from 1985-1996, but the relationship between these variables may be altered in the years after 1996 or consistently change over time. If this is the case, then we could not accurately readjust the US-FDI coefficients downwards in post-estimation. The changes in patterns of FDI from 1997-2011 have been significant and so have the geopolitical interactions between countries. Therefore it is difficult to say what contributes to this increased significance of the US-FDI variables when dropping the diffusion variable. As I discuss below, the diffusion variable is one of the most consistently significant of the explanatory variables.

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<sup>40</sup> These results are not included here.

## Discussion

Results for my FDI variables with Polity, the democracy index considered to be the most reliable<sup>41</sup> and the most used, are insignificant. But it is difficult to tell what this indicates. To shed more light on these results I repeat the estimation with three alternative indices of democracy. Two of these three, Vanhanen and Przeworski et al, yield significant coefficient estimates. Different control variables, specifically levels of incomes and urbanization, also vary in significance across measures. Importantly, democratic diffusion remains significant across all specifications.

These results indicate some interesting findings. First, they corroborate previous works that have found that democratic diffusion actually does happen and that it undermines the typically strong relationship between income levels or economic growth and democracy. Second, if causal claims are going to be made regarding the determinants of democracy in a general sense then better measures of democracy are required. With a lack of consensus on the definition of democracy amongst social scientists we cannot make anything but highly qualified claims about the determinants of democracy. For instance, it is difficult to say that US-FDI puts informal constraints on the executive because the Polity index only includes a quantification of *formal* constraints on the executive. The case studies below, however, find that US-FDI has resulted in greater informal constraint on executives. Furthermore, the Vanhanen and Przeworski et al. specifications suggest that US-FDI tends to increase participation and competition in political elections, but considering that each index is a composite of multiple elements of “democracy,” it is difficult to say which parts are moving due to US-FDI. The suggestion

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<sup>41</sup> Gerardo L. Munck and Jay Verkuilen, "Conceptualizing and Measuring Democracy: Evaluating Alternative Indices," *Comparative Political Studies* 35, no. 1 (2002).

that participation and competition in elections increase due to US-FDI is corroborated in the case studies below, but these regressions do not suggest a particular mode for this effect. These mechanisms will be developed in the case studies.

A few issues are outstanding from my estimations. Country-level effects are not included here. These include race, ethnic, and religious fractionalization; levels of education; and the type of democratic institutions that are developed. Country fixed-effects control for the explanatory power of such factors, but do not shed light on which are significant or how they may interact with cross-country investment. Demographic homogeneity may affect countries in a number of different ways. It may lead to less rancor amongst minority groups and less demand for, say, proportional representation. Homogeneity may also make a country more stable and effectual, regardless of political institutions. Levels of education could lead to pressure for democracy as individuals come to recognize democracy as an ideal political institution through learning or demand greater civil liberties to go with their wealth.<sup>42</sup> Some have also argued that the durability of democratic regimes is partially a function of presidentialism versus parliamentarism.<sup>43</sup>

While strong cases have been made for all of these mechanisms, the fixed effects in the regression above will control for any explanatory power of static, country-level variables such as these. And, over the period of study, there is little to no variation across countries for most of these variables. The one potential problem would be if one of these omitted variables was a root cause of the instrumental variable and democracy. But there

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<sup>42</sup> Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy."

<sup>43</sup> Jose Antonio Cheibub, *Presidentialism, Parliamentarism, and Democracy* (Cambridge University Press, 2007).

is no intuitive reason why any of these demographic variables would be related to US/China exchange rates.

Democratic diffusion clearly happens across countries, but the statistical results above suggest that there are also cross-country effects through foreign investment in capital that augment diffusion. My results thus far suggest that these cross-country effects are ambiguous in level of significance and depend on far from perfect democracy indices. Nevertheless, the positive effect of US-FDI is independent of the general diffusion trend, economic growth, and the effect that FDI may have through economic growth. To get a better sense of how the presence of US-FDI may affect domestic politics I now turn to two case studies, the Philippines and Indonesia. Both countries made transitions towards more democratic institutions after significant stints under autocratic rule and shared regional trends and pressures during each of their respective transitions. Many of the influences of each transition were different, however, including the type of pressure from US capital. But despite the pressures being different in form, US capital constrained autocrats and supported fledgling democracy in each case.

## CHAPTER IV

### CASE STUDIES

The relationship between FDI and political development is complex and can only be roughly approximated by linear estimation. The cross-country statistical analysis detailed in the prior section reveals a positive relationship between US-based FDI and levels of democracy, with the significance dependent on the democracy metric employed. But the linear relationship this analysis finds is only a simple, direct relationship. Actors with vested economic interests may influence and constrain domestic elites in ways not picked up in regression analysis and these effects may vary over a longer time period than current data allows. If a country is politically stable and predictable, the constraints from foreign capital will be a standard set of political economy interests and pressures: corporations will compete to maximize their own profits and rents from the host country. However, once a transitional period has commenced the influence of FDI is conditioned by domestic political factors, the political ideology of the corporation with fixed investments, and the coalition(s) that the corporation joins and/or supports. Quantitative indices of democracy and political fractionalization do not include a level of nuance that can adequately measure these influences and so this project will now turn to two case studies in order to highlight a few ways that FDI can influence political transitions. By looking at countries that share regional trends, but vary in political and economic pressures, I argue that FDI generally constrains elites in times of stability. In times of instability, however, US-based FDI and portfolio investment tends to pressure countries towards more democratic institutions. I focus on the Philippines and Indonesia as

countries that share regional trends , but have varied patterns of economic and political development.

### **The Philippines**

The Philippines has experienced direct and strong political pressure from the US through virtually every channel possible since the country gained independence at the end of World War II. The chief benefactors of the US presence were the Marcoses, the ruling family from 1965 to 1986, and other elites close to the Marcoses. US political and economic actors played pivotal roles in installing Ferdinand Marcos as leader, suppressing opposition forces, and entrenching ruling elites with vast economic resources through kickbacks, graft, and direct aid. When Marcos began to lose control of the country, the Reagan Administration dawdled. US actors with an interest in the Philippines diverged in their long-standing support of Marcos, splitting along party lines in the US, with most Republicans standing by Marcos and most Democrats backing the opposition leader, Corazon Aquino. US business interests in the Philippines, which tended to be formally aligned with the Republican Party, pressured for more democratic procedures in the elections and clearly favored the opposition candidate Aquino both at home and in the Philippines. While democratization in the Philippines was primarily driven by domestic level politics, foreign actors played a significant and possibly pivotal role before and during the transition.

To further explore this idea, the following section will proceed by first outlining the various channels of political influence and pressure from the US, detailing the domestic situation around the time of Aquino's ascendance, and then describing the

unique role US capital played in influencing the political transition relative to other influences from the US.

### *US Military*

The US gained colonial rule over the Philippines following the Spanish-American war's end in 1898. This was followed shortly thereafter by a Filipino uprising against American authority, which was quashed a few years later in 1902. Legislation in the US slowly progressed towards Filipino independence until WWII and the subsequent Japanese occupation. Following WWII, independence was granted to the Philippines by the US, but the US maintained military bases on the island and continued to influence domestic politics overtly and covertly. Throughout its modern history the US military has been integral in shaping the political development of the Philippines.

The Japanese ravaged the Philippines along with much of East Asia during WWII. An already significant communist force known as the Huks strengthened during the occupation. After the Japanese left the archipelago, Huk energies continued to focus on combating foreign powers and landed elites, but the focus now turned to agrarian land reform. The US in the post-war period became increasingly opposed to communist groups in general and agrarian reform was viewed as antithetical to US interests. Edward Lansdale of the US Air Force headed a fight against the Huks in the 1950s with "a mix of paramilitary operations, psychological warfare, and old-fashioned electoral politics, [which] was to become the prototype of US anti-Communist counterinsurgency wars elsewhere."<sup>44</sup> These operations went so far as to spread rumors in villages concerning the

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<sup>44</sup> Raymond Bonner, *Waltzing with a Dictator: The Marcoses and the Making of American Policy* (Times Books, 1987), 34-35.



presence of vampires amongst the Huks, assaulting a Huk on patrol, puncturing his neck with two holes and draining his blood, and then leaving him to be found by villagers.

Lansdale also had a direct and pivotal influence on Filipino politics, providing vital support for the election of Ramon Magsaysay over the incumbent Elpidio Quirino. Quirino was viewed by Lansdale and other US diplomats as far too corrupt. Lansdale solicited funds for Magsaysay's campaign from both the CIA (US \$1 million) and US firms with lasting interests in the Philippines such as Coca-Cola. Numerous CIA operatives also worked directly for Magsaysay's campaign. This coalition of US economic and political power also contributed to the establishment of the National Movement for Free Elections (NAMFREL) during this period, which eventually played a pivotal role in the downfall of Ferdinand Marcos and the subsequent movement towards more democratic institutions.<sup>45</sup> Military leaders since Lansdale have not had nearly as significant and direct a role in Philippine politics, but the effects of military bases in the Philippines have been comparatively thorough and lasting.

After WWII, the US Clark and Subic Bay military installations in the Philippines became the largest such bases in the world, particularly during the escalation of the Vietnam War. The standard explanation given by US foreign policy makers was that the bases were needed to remain geopolitically relevant. Towns near bases saw large increases in populations with the primary employers being the bases themselves and the neighboring bars. One such town, Olongapo, increased from 40,000 to 200,000 residents from 1966-76 with almost no industrial development. While protests periodically erupted during Marcos' tenure that sought to expel the American military forces, many more

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<sup>45</sup> Ibid., 39-40

Filipinos accepted the bases because of the economic benefits that came with them. Although tales of exploitation and cruelty toward Filipinos by American troops were frequent,<sup>46</sup> the bases also employed 43,000 Filipinos not counting the external service industry that thrived on the troops from the bases. Altogether the installations were estimated to contribute \$200 million to the Filipino economy each year,<sup>47</sup> a total that does not include the large military and economic aid given to Marcos in order to allow the bases to remain.

The bases remained in the Philippines until Marcos' electoral defeat and flight from the country, which was followed by resistance to the prolonged US military presence and installations. President Aquino forced US troops out of the country within a few years of taking office in 1986, with the last of US marines ordered to leave the Subic Bay base in 1992.<sup>48</sup> The 47-year existence of these bases had a profound economic and cultural impact on the Philippines. Just as important was the economic aid provided to Marcos and the strength of the alliance with the US that the base presence enabled. Both factors helped Marcos maintain his grip on the country for as long as he did.

### *US Politicians and Politics*

American politicians and diplomats had a stronger and more direct influence on the politics of the Philippines than the US military. Marcos' rule spanned five US presidencies, from Lyndon Johnson to Ronald Reagan. All of these administrations had direct contact, influence, and varying levels of confidence in Ferdinand and Imelda

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<sup>46</sup> Ibid., 205-06.

<sup>47</sup> Ibid. 220.

<sup>48</sup> David E. Sanger, "Philippines Orders U.S. To Leave Strategic Navy Base at Subic Bay," *The New York Times*, 12/28 1991.

Marcos. The political support provided by the administrations underpinned Marcos' rule until Reagan wavered under growing pressure in the US to abandon the autocrat and reluctantly withdrew his political support. This national and personal closeness bred political dependence, which in turn led to a stark lack of a strong bureaucratic class in the Philippines.<sup>49</sup> This ultimately made the Philippines highly unstable and underdeveloped following the withdrawal of the US crutch.

The US fostered relationships with a burgeoning oligarchy and perpetuated this class with private sector ventures from the outset of colonial rule. "Under the American regime, the oligarchy consolidated itself into a national force, took control of the central government in Manila, and responded to countless new opportunities for enrichment."<sup>50</sup> But these opportunities were exogenous to state development. The stronger the oligarchy became, the better it was at plundering the country and further minimizing the role of the bureaucracy, particularly when at the behest of US investors. The lack of a strong bureaucracy inhibited the possibility of piecemeal economic reform given that all decision making was centralized with Marcos. This patrimonial, oligarchic rule also inhibited the emergence of new social forces that might otherwise be expected to grow along with high levels of foreign aid, investment, and growth. These social forces might have otherwise been the basis for piecemeal political reforms.<sup>51</sup>

Establishing and maintaining this political structure may be the most lasting impact of US activities in the Philippines. From independence through the fall of Marcos,

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<sup>49</sup> Paul D. Hutchcroft, *Booty Capitalism: The Politics of Banking in the Philippines* (Cornell University Press, 1998).

<sup>50</sup> *Ibid.*, 26-27.

<sup>51</sup> *Ibid.*, 53-54.

the US has further solidified the power structure of the Philippines through an often pivotal electoral influence. As mentioned above, Magsaysay experienced extensive US support from multiple channels in the 1953 presidential election. Garcia, Magsaysay's vice president, ruled following Magsaysay's death in '57, who then lost to US-backed Macapagal in '61, with Macapagal losing to Marcos in '65. The US took a particular interest in courting Marcos' favor at the time because of the Vietnam War. LBJ sent vice president Humphrey to Marcos' presidential inauguration to personally congratulate Marcos, an action that was not standard procedure for VPs. This was the beginning of what might be termed a 'chummy' relationship between Marcos and the long series of US administrations that would follow. The Carter administration, which always emphasized bettering human rights, pursued a human rights policy (or lack thereof) that was akin to Reagan's in the Philippines.<sup>52</sup> VP Mondale went to the country and instead of supporting fair and open balloting for the 1978 elections, supported Marcos' repression of an open ballot and would only covertly meet with opposition candidates.<sup>53</sup> These were not isolated policy positions, but indicative of the lengths to which US leaders were willing to go to stay in Marcos' good graces.

### *US Economic Influence*

Economic actors have also enjoyed a privileged and strong influence in the Philippines, particularly since the American led reconstruction efforts following WWII. Americans' parity privilege in capital ownership in the country was a somewhat unique

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<sup>52</sup> Bonner, *Waltzing with a Dictator: The Marcoses and the Making of American Policy*, 289.

<sup>53</sup> Mark R. Thompson, *The Anti-Marcos Struggle: Personalistic Rule and Democratic Transition in the Philippines* (Yale University Press, 1995), 85-86.

and overarching part of the rehabilitation agreement. This may make the Philippines a biased case study for the types of economic-based mechanisms that I find, as foreign capital has been much more prevalent here. It is more useful, however, to think of the Philippines as an endemic case of military, political, and economic influence. FDI has been notable in how much it has contributed to the rents and subsequent acquisition of power by Filipino elites and thereby intertwined with domestic political outcomes. These microeconomic mechanisms are augmented by macro-level economic pressures with the combined influence of domestic technocrats, the World Bank, the IMF, foreign donors, and foreign investors being able to essentially dictate policy for much of the period in question.<sup>54</sup> So while the Philippines is not a representative case of the reach of US economic interests, it is useful in highlighting many of the channels through which US capital can constrain and influence domestic politics.

The Philippine economy was destroyed during WWII and the US responded with the Tydings Rehabilitation Act of 1946. US \$620 million was sent to the country for reconstruction and was tied to the Bell Trade Act. This agreement included provisions precluding various barriers to trade, forbidding nationalist economic activities, and, most importantly, assuring parity rights for US citizens.<sup>55</sup> Parity rights included access to natural resources and investment opportunities for US citizens and corporations on the same levels afforded to Filipino citizens. These loose economic controls and openness to US capital structured the reemerging economy around agricultural and primary product production with little focus on manufactured goods. Most FDI went into agricultural

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<sup>54</sup> Gary Hawes, *The Philippine State and the Marcos Regime: The Politics of Export* (Cornell University Press, 1987), 81.

<sup>55</sup> *Ibid.*, 28-29.

production specifically for export.<sup>56</sup> The primary sectors of agricultural products have traditionally been coconuts (supplying 82% of world demand and 20% of Filipino wages), sugar, and fruit products. MNCs have been major players in all of these sectors, particularly for fruit products.

While not as large or important for the Filipino economy as the coconut or sugar industries, the fruit products industry was a larger source of political constraint for Marcos due to the concentration of the sector among a few corporations. The sector was dominated by three MNCs: Del Monte Corporation, the United Fruit Company, and Castle and Cooke, all of which are US based. The power of these foreign investors, in particular, was so ingrained as a vital part in a “triple alliance” scenario that it precluded Marcos from subjugating the investors to his political wont.<sup>57</sup> Much of the time, political elites acted in concert with these economic entities in buying out landowners to expand plantations, push down wages, and forbid labor unions.<sup>58</sup> The size and aggressiveness of these MNCs constrained Marcos and placed him in direct conflict with the working class in ways that would not have existed without the MNCs’ ventures.

Prior elite networks based on family ties or mere proximity and familiarity were also disrupted by a large influx of foreign investors. The incursion of foreign investment was largely due to a devaluation of the Filipino peso and came from many sources, but especially the US. This large number of new investors changed the incentives of local elites and led to a breakdown in elite cohesion.<sup>59</sup> While there is a pedigree in the

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<sup>56</sup> Ibid., 39.

<sup>57</sup> Ibid., 103.

<sup>58</sup> Ibid., 123.

<sup>59</sup> Ibid., 36.

literature arguing that a strong elite in favor of democratic reforms is necessary for democracy,<sup>60</sup> another related mechanism is a lack of elite cohesion and political power that is subjugated by foreign actors. Under an authoritarian government, these foreign actors will support the regime in power as this stabilizes the environment for their investment, but this type of relationship becomes more ambiguous following significant shocks.

US graft and collusion with Marcos extended into other spheres beyond agriculture and to an extent that severely hindered the development of the country. The construction of the Westinghouse nuclear power plant in Bataan is the best example:

... in 1975 Marcos authorized construction of the plant that ultimately could cost \$2.3 billion... Westinghouse is alleged to have paid \$17.5 million to Herminio Disini, who got Marcos to give the contract to Westinghouse; Marcos is accused of making \$80 million in kickbacks. The plant, to be built on a dormant volcano, lies near several earthquake fault lines and is just sixty miles from Manila. An international team of inspectors visiting the plant after Marcos's fall described it as unsafe, inoperable, and three times the price of a comparable plant Westinghouse built in South Korea at the same time.<sup>61</sup>

The plant has never been brought online. Marcos, elites close to Marcos, and Westinghouse all benefited greatly from this project and everything came from public coffers and financing through foreign loans. Perhaps the worst implication of this travesty is that the vast sums of money could have actually gone to real infrastructure projects instead of yielding nothing, even if many of the loans were ultimately forgiven. Such projects were not tightly held secrets. The populace knew of the corruption, formed weak

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<sup>60</sup> Barrington Moore, *Social Origins of Dictatorship and Democracy; Lord and Peasant in the Making of the Modern World* (Boston: Beacon Press, 1966).

<sup>61</sup> David J. Steinberg, *The Philippines: A Singular and a Plural Place* (Westview Press, 2000).

opposition pressure groups because of it, and given the proper catalyst shortly thereafter turned into a viable and successful opposition.

Overall, US economic actors were pervasive and their influence was quite multifaceted. Sometimes these political effects were intentional and sometimes took the form political externalities of economic activities. While many of the major ventures had close ties to US diplomats, it would be naïve to think that all of these investors intentionally colluded in their influences and pressures on the country. Instead, I make a broad claim about the general economic interest of foreign capital that pressure for political stability as a means towards a stable investment environment. Individual corporations and actors within corporations could have independent effects on political institutions as well, but unearthing conclusive evidence for any such behavior is beyond the scope of this project.

### *Domestic Politics and the Fall of Marcos*

We have just seen the strong support that US actors in every sphere provided to the Marcos regime. With this underwriting and Marcos' bouts of martial law, it is easy to understand how Marcos was able to hold on to power for his 20-year reign. The local public realized little gain in any realm during the Marcos era except through organizational capacity building around a common rancor for Marcos. Both the regime and opposition knew of the growing economic problems, which were due to large debt burdens and general economic mismanagement. This spurred the opposition leader Benigno Aquino Jr., exiled for the previous three years to the US, to return to the country in 1983 despite personal discouragement by Imelda Marcos who maintained a close relationship with Aquino. Ultimately, however, Aquino did not listen. Aquino was



assassinated minutes after landing in Manila and the public generally suspected or understood someone within the Marcos regime to be the perpetrator.

Benigno's wife Corazon Aquino filled the role of opposition leader as the head of the "People Power Movement" on a rising tide of support and mourning for her husband. Marcos called snap elections in 1985 and was forced into exile in Hawaii following the victory of Corazon Aquino. Throughout this period, domestic political factors were the most important factor leading to Marcos' downfall, but the loss of support from Ronald Reagan and the strong oversight of the elections also chipped away at Marcos' power base. US capital interests in the Philippines contributed directly to both of these processes in addition to setting the stage for his fall from grace.

The years of graft and corruption at the highest levels of government had crippled the country economically. Manufacturing was virtually non-existent, with the economy being driven primarily by agribusiness and resource extraction, neither of which yielded high income jobs nor facilitated significant technology transfers that could lead to compounding efficiency gains. The result was underdevelopment and massive inequality in the distribution of resources. Even foreign aid for the impoverished was always sent through the regime and whittled down to nearly nothing before it reached the populace. On one hand, this crippled the proletariat, rendering them unable to confront elites. On another, the actions brought together the non-elite opposition to Marcos that could be activated given the proper leadership and resources. But as long as all those that controlled the resources benefitted from keeping Marcos in power, they were unlikely to support any opposition movement.

Prior to the assassination of Aquino, however, Marcos had been losing the vital support of both foreign and domestic business interests in the Philippines. Violent outbursts were staged by the government and used as an excuse for the imposition of martial law in 1972.<sup>62</sup> But the ultimate goals of martial law were to quell nationalist pressures, to push the country towards a more outwardly-oriented economy, and to better abide by IMF and World Bank prescriptions all at once. This stabilized the Philippines in the short term, but also served to foment future conflicts. Marcos reappropriated much privately owned capital to family and friends much to the distaste of import-substituting interests, who supported a military coup.<sup>63</sup> Unsurprisingly, these crony firms then enjoyed even stronger import-substituting tariff protections than previous owners, further undermining efforts to increase exports which remained constant relative to GDP over this period.<sup>64</sup> Many of the same firms began to fail in the early '80s and required bailouts, which led to the fall of many cronies who were running the companies. The situation finally precipitated in a balance of payments crisis that was prompted by the flight of capital following the Aquino assassination in 1983,<sup>65</sup> as seen somewhat in Figure 4 (data from this period is sparse and unreliable, but some effect from the assassination is still visible in the data). This led to a large IMF restructuring program implemented in 1984 that further constrained Marcos and aimed to revitalize the alienated private sector. But Marcos then fueled the fire by blaming the crisis on tax evasion in the private sector.

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<sup>62</sup> Bonner, *Waltzing with a Dictator: The Marcoses and the Making of American Policy*, 100.

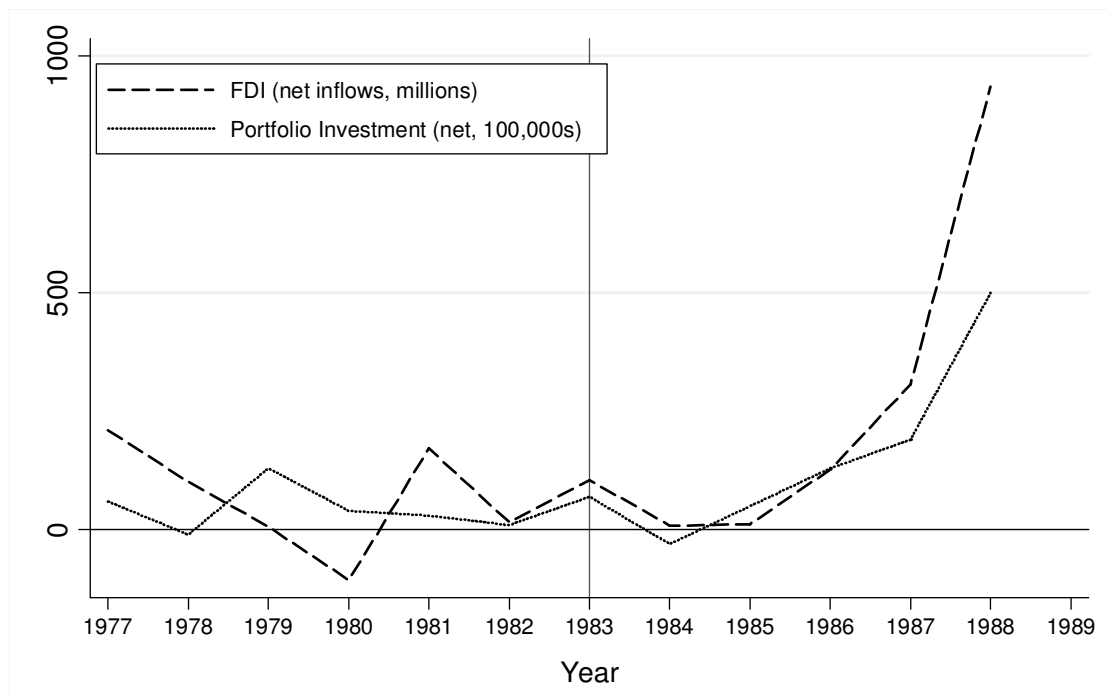
<sup>63</sup> Stephan Haggard, "The Political Economy of the Philippine Debt Crisis," in *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World*, ed. J.M. Nelson (Princeton Univ Pr, 1990), 223-24.

<sup>64</sup> *Ibid.*, 231.

<sup>65</sup> *Ibid.*, 236.

Thus Marcos sowed the seeds for his own downfall through cronyism and economic mismanagement, including affronts to private business interests that included foreign investors. The assassination of Aquino further rattled businesses and caused capital flight, further undermining Marcos' legitimacy. The opposition rallied around this laundry list of grievances and placed pressure on Marcos up until the snap elections in 1985. US policy makers were mostly divided along party lines, with the Reagan administration and Republicans standing by Marcos and Democrats pushing for Aquino.

Figure 4: Capital Flight from the Philippines Following Aquino Assassination



Marcos claimed victory based on the sham results of the snap election which officially had Marcos winning some districts with 100% of the vote. It was common knowledge that Marcos had stolen the election, but the supporting evidence for these claims came from the National Citizens Movement for Free Elections (NAMFREL),

which provided volunteer oversight of the elections. NAMFREL had its roots in earlier elections from the '50s (see above). The CIA remained a primary source of funds for NAMFREL through the '80s, which activated hundreds of thousands of volunteers during the snap election. Another significant source of funding for NAMFREL was Republicans Abroad, a group meant to maintain political connections amongst Republican nationals abroad, which consisted primarily of US businessmen living in the Philippines.<sup>66</sup> Some of the funds were also not given directly to election monitoring, but instead given to the Reform the Armed Forces Movement which for some time had sought to eliminate corruption in the military. Regardless, without the strong funding from the CIA and US business interests in the Philippines, it is difficult to say whether NAMFREL could have provided sufficient oversight and subsequent evidence to confidently declare the election fraudulent. Nevertheless, the funding indirectly bolstered the position of the opposition movement that quickly swept Marcos out of power and into exile.

Republicans Abroad also had a direct influence on US politicians and played an influential role in swaying US policy in the Philippines. In particular, Republicans Abroad possessed direct lines of communication with the Reagan administration. Generally, Republicans had stood by Marcos since he had been such a loyal ally to the US over the years, with the notable exception of Senator Richard Lugar of Indiana. Lugar led a delegation to the Philippines and witnessed the fraudulent results alongside NAMFREL. Lugar was then instrumental in conveying this message back to the US. But Lugar's reports did not single-handedly sway Reagan to withdraw his support for Marcos. Indeed, this was only part of the mounting pressure on Reagan to abandon the

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<sup>66</sup> Branches exist in most countries. <http://www.republicansabroad.org/>

long-time US ally. When questioned about the unwavering support of Marcos after meeting with Lugar, Reagan officials tended to detract from Aquino<sup>67</sup> and argue that Marcos is a necessary evil.<sup>68</sup> Republicans Abroad was another source of pressure on the president arguing, “But, Mr. President, the Republicans are for Cory. She’s a Republican.”<sup>69</sup> Of course this is not a causal story as it is difficult to say precisely what the deciding factor was in Reagan’s decision making, but it is reasonable to assume that pressures within his own political base and from the societal actors in the Philippines had far more influence than widespread knowledge of election fraud in the US. Indeed, it was generally understood that the elections had been fraudulent well before Reagan decided to abandon Marcos.

#### *Popular Discontent and International Constraints*

The role of international actors in much of the democratization literature is ambiguous and often ignored. In the case of the Philippines, we find that the influence of foreign economic actors, rather than being ambiguous, is time-variant and highly conditional on domestic political circumstances. Where relative stability exists, US firms invested in industries that made economic sense (i.e., in which profit margins are high enough relative to risk of loss and risk of reappropriation by the regime), which in the Philippines was primarily agricultural. But as the presence of US-FDI increased, unabated in quality or quantity, the effect it had on the political economy of the Philippines became more pronounced and multifaceted. Those close to Marcos were

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<sup>67</sup> Bonner, *Waltzing with a Dictator: The Marcoses and the Making of American Policy*, 400.

<sup>68</sup> *Ibid.*, 408.

<sup>69</sup> *Ibid.*, 415.

enriched through graft, income inequality increased dramatically, Marcos was constrained to actions that did not impede upon the interests of foreign capital, political and economic dependence on the US grew, and the lower classes were given a common cause with which to unite. The debt crisis and assassination of opposition leader Aquino goaded opposition groups into action and encouraged them to form into a viable political opponent. But the fall of Marcos was by no means assured by the organization of a viable opposition. The oversight of the elections by NAMFREL and the subsequent withdrawal of support from the Reagan Administration were pivotal in Marcos' decision to cede power and flee the country. US businesses with ventures in the Philippines provided support in both these realms and did so against dominant tides within their own political party. It is important to note that this support was not merely for the opposition to a dictator that was already falling out of favor, but included directed support toward democratic procedures in the form of fair elections in addition to support for an opposition candidate that espoused the creation of more democratic institutions.

The extent of influence that US businesses, and US interests in general, had in the Philippines is highly abnormal. While US-FDI was present in the country and did influence political outcomes it is difficult to say how strong these effects were relative to the other direct influences the US had over the country over the extended period of Marcos' rule. To partially address this qualm this study will now address Indonesia, which has not experienced the same extent of direct political influence as the Philippines and has experienced different forms of pressure coming from US capital interests.

## **Indonesia**

The direct effect of US-FDI on domestic politics is less apparent in Indonesia than in the Philippines. This is not to say that similar effects did not exist, but convincingly unearthing them is more difficult. Related to FDI, however, is portfolio investment and foreign-based loans. As discussed in the introduction above, there is reason to believe that FDI will have more of a direct impact on domestic level politics as, by definition, FDI is a lasting interest in the country and politics are a lasting enterprise. Short-term portfolio investments and loans, however, may also have indirect or less intentional political effects. These short term investments are also highly correlated with FDI, but indicate a different type of investment pattern. Because of this correlation it would be difficult to include portfolio investment in the models of the quantitative section because of multicollinearity problems, but, as we will see below, portfolio investment was quite important in the downfall of Suharto. Short term portfolio investment effects will be more pronounced in countries with high foreign debt levels and trade openness with Western countries. Indonesia is just such a country. And it was this same set of conditions that made it particularly susceptible to the collapse of the Thai baht and the subsequent Asian financial crisis. During that time there was massive capital flight from affected nations and Indonesia was, by many measures, the hardest hit. The widespread student-led protests following fuel price hikes were a direct cause of the fall of Suharto and the ushering of more democratic institutions, but the role that US investment played before and during the transition in Indonesia is similar in effect to what took place in the Philippines.

The democratic transition in Indonesia was spurred by the financial crisis and built on the widespread discontent for the Suharto regime. Much of this angst was fueled by endemic patronage and cronyism, but the regime was able to stave off these pressures through consistently strong economic growth and direct support from the US. Following the fall of the Soviet Union, US politicians had less of an interest in propping up friendly autocrats like Suharto and the Clinton administration had more of an interest in promoting liberalism of all sorts everywhere. Investors still wanted to maintain a stable investment climate in the country, but with the uncertainty that came with the Asian financial crisis, investors first exasperated the crisis through capital flight. Then through IMF restructuring programs, in which US investors had personal interests and the US treasury played a leadership role, US capital pushed for political decentralization as one means to make the country more stable and open to foreign investment. As we will see in the conclusion, this pressure did not ultimately have the desired political effect, but the intentionality of political decentralization was still present.

### *US Politicians and Politics*

Dutch colonial rule of Indonesia was disrupted during WWII with Japanese occupation of the country from 1943-1945. Following the departure of Japanese troops in 1945, national forces declared independence and embarked on a war that lasted until 1949 and resulted in formal independence in the country. Sukarno became president of the country and was largely influenced by the policies of Maoist China, but shifted more to the Soviet Bloc by the '60s. Indonesia became a darling in the eyes of US policy makers around 1966 primarily due to the polarization of global politics and the escalating Vietnam War. But despite this similarity with the Philippines, the country never



experienced the effects of a large US military presence the same way the Philippines had. With the ascendancy of Suharto over Sukarno in 1966 and the vast oil reserves in Indonesia, the country became a prize ally during the Cold War.<sup>70</sup> This helps to explain both the quick reentry into the UN following the rise of the New Order regime under Suharto and the vast quantities of aid that flooded into the country. Indeed, by 1970 Indonesia was the second-largest recipient of foreign aid in the world<sup>71</sup> and aid has continued to increase throughout its modern history. Throughout, Indonesia remained an important ally for the US, for both geostrategic reasons and to retain access to the large natural resource reserves.

Much of Suharto's success was due to the adept macroeconomic management of his chief technocrats. The team of reformers were trained in US universities, largely UC-Berkeley, and thus dubbed the "Berkeley Mafia." In addition to the trade and development strategies that opened the country to more investment, tighter fiscal and monetary policy was implemented in order to tame the hyperinflation that followed from the mismanagement under the Sukarno regime. Inflation was calmed from 636% in 1966 to 9% four years later in 1970.<sup>72</sup> Overall, these technocrats adopted policies that bore a close resemblance to the neoliberal thinking that was gaining ground in Western circles. The role of technocrats became institutionally entrenched during this period and had great influence over Suharto's policy decisions up until the financial crisis of the 1990s. The

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<sup>70</sup> Andrew Rosser, "Escaping the Resource Curse: The Case of Indonesia," *Journal of Contemporary Asia* 37, no. 1 (2007).

<sup>71</sup> Howard W. Dick, *The Emergence of a National Economy: An Economic History of Indonesia, 1800-2000* (University of Hawaii Press, 2002), 205.

<sup>72</sup> *Ibid.*, 204.

significant influence that the technocrats had in propitiating US economic ideology in Indonesia made for a natural alliance between the countries.

Whereas the Marcos regime ended largely as a result of the loss of support from the Reagan administration in the face of widespread protests, the seeds of Suharto's fall were planted with the oil crisis and harvested during Clinton's administration. Reagan's push for widespread deregulation everywhere in the world caused the private sector to eclipse government as a driver of economic growth in the '80s. Both domestic and foreign investors had a significant presence in the country, but deregulation enabled Suharto to make cronyistic power grabs through family and friends due to the sheer level of resources at his disposal, alienating many allies in these sectors.

The fall of the Soviet Union then caused US foreign policy to shift, primarily under Clinton, from a focus on combating communism across countries irrespective of economic policy to an emphasis on aid packages being conditioned on within-country reforms. In the prior period, Suharto could do as he pleased domestically as long as he supported US interests on an international stage. Under Clinton, movements towards political liberalization were a precondition for aid and investment and Suharto's external political outlook became less important.<sup>73</sup> While Reagan was a staunch supporter of Marcos, the Clinton administration was only a luke-warm supporter of stability in Indonesia as a whole, regardless of political leadership, and pushed for political liberalization where possible. When an opportunity presented itself through IMF restructuring programs, US officials pushed for broad-based political decentralization

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<sup>73</sup> Dewi Fortuna Anwar, "The Fall of Suharto: Understanding the Politics of the Global," in *Southeast Asian Responses to Globalization: Restructuring Governance and Deepening Democracy*, ed. Francis Kok-Wah Loh and Joakim Öjendal (Institute of Southeast Asian Studies, 2005), 206-10.

amongst other reforms. Decentralization on the scale proposed was anathema to Suharto maintaining his grip on the country, as it meant a diffusion of political power to local politicians, despite US officials publicly attesting to their support of Suharto.

The combined effect of the economic changes leading up to the crisis significantly constrained Suharto and determined much of the political change that would be possible following the end of the regime. First, the concentration of economic power in the class of elites close to Suharto ensured the existence of a class that could withstand the financial crisis that would hit in the late '90s. This concentration of power also further strained a populace already well accustomed to elite control of resources and political oppression. So while Suharto's circle became empowered and further enriched, the circle shrank in size and grew in concentration. The projects required to appease this group then grew in magnitude, but also had less reach amongst the populace in general.

Many of the business interests in Indonesia were so intertwined in both the politics and investment projects that it becomes difficult to detach where US political influence ends and US economic influence begins. But what is true is that these large conglomerates survived on patronage networks in which the political and economic were mutually constitutive entities. A prime example is The Sudarpo Group, which was comprised of 32 member firms. After being a chief contributor to an anti-Japanese occupation group, Sudarpo Sastrosatomo became a member of Sukarno's Ministry of Information and served a diplomatic role in the US from 1948-52. Upon returning to Indonesia he established the Sudarpo Corporation and benefited greatly from Sukarno's nationalization of Dutch firms by buying a Dutch shipping company. Sudarpo fostered close relationships with Suharto's future vice president, US Steel, and the Socialist Party

of Indonesia, drawing on all to maintain a significant influence in governmental affairs. Sudarpo's corporate empire was able to withstand the decline of both Sukarno and Suharto by remaining involved in industries that were vital parts of Indonesia's economy and by securing the backing of the US. This was done through relationships with US politicians that Sudarpo had developed while a diplomatic representative for Indonesia in the US. This situation stands in stark contrast to Chinese businesses in the country that were locally grown and depended mostly on local connections for their success. Such Chinese ventures did not emerge from the various crises and political changes as well as conglomerates like Sudarpo which maintained strong connections to the US.<sup>74</sup>

US political influence in Indonesia has been much more subtle and complex than that in the Philippines, where political pressure was full-on from all directions. Connections with US politicians helped prop up many Indonesian conglomerates and Suharto alike. At the same time, however, maintaining these connections constrained Suharto's actions before and during the various crises. He could not focus solely on shoring up local political support, but had to balance these interests against foreign policy-makers as well. More importantly and more indicative of post-Cold War global politics, however, is that Indonesia saw a thorough intertwining of the economic and political realms to a greater extent than Marcos faced during the run up to Suharto's fall. Clinton emphasized geopolitical interests, but combating communism took a far back seat to fostering a stable investment environment; Suharto's usefulness to security advisors and investors alike ran dry when economic stability was in doubt.

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<sup>74</sup> Hiroyoshi Kano, *Indonesian Exports, Peasant Agriculture and the World Economy 1850-2000: Economic Structures in a Southeast Asian State* (Ohio University Press, Ohio University Research in International Studies, 2008), 273-75.

## *US Economic Influence*

Throughout its modern history, economic growth and development in Indonesia has relied heavily on foreign capital<sup>75</sup> and access to markets in developed countries for manufactures and natural resources. Following independence in 1950, the US and other European markets displaced the Netherlands as the primary destinations for Indonesian exports, particularly rubber and oil.<sup>76</sup> This was accompanied by a long process of nationalization of the larger Dutch firms, which lasted through the fall of Sukarno. Through the mid-'80s, Japan and the US were the country's largest trade partners and accounted for 30% and 15% of Indonesian trade, respectively.<sup>77</sup> A majority of the largest businesses in the country also had some level of joint venture exposure with foreign capital, although this never reached a "dependency level."<sup>78</sup> Nevertheless, the withdrawal of capital during the crisis and how severely that withdrawal imperiled Indonesia proves that on some level the Indonesian economy was dependent on foreign investors, largely those of the US and China.

These high levels of foreign investment, however, caused unrest over the years as Indonesians had yet to forget the brutal experiences under Japanese occupation and Dutch colonial rule. This was particularly true of the experience with the Japanese, whose money was perceived to be particularly influential in the New Order growth spurt under

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<sup>75</sup> Ian Chalmers, "Introduction," in *The Politics of Economic Development in Indonesia: Contending Perspectives*, ed. Ian Chalmers and Vedi Hadiz (Routledge, 1997), 19.

<sup>76</sup> *Ibid.*, 82.

<sup>77</sup> *Ibid.*, 94.

<sup>78</sup> *Ibid.*, 253.

Suharto.<sup>79</sup> Thus in the early 1970s, after a period of reopening with Suharto's rise, the government began to implement stricter limitations on the amount of influence foreign capital could play in the domestic economy. This took the form of import substitution (ISI) policies meant to bolster domestic producers into competition with foreign industry and higher government investment in development programs. These policies typically took the form of restrictive trade policies that limited imports and direct government intervention in propping up "infant" industries that needed to reach economies of scale in order to compete with established MNCs. But ISI policies were followed with ever greater interventionist actions such as creating state owned enterprises in industries the government deemed important or strategic, particularly in the oil industry with the establishment of (the state-run oil company) Pertamina.

Beyond Pertamina, Indonesia also possessed a booming oil industry that inflated government revenues throughout the period and was the major source of funding for broad-based development programs. Social programs grew along with oil revenue, both in real terms and relative to the funding of the import substitution policies within the development budget. From 1970-1984, the percent of the development budget dedicated to education, health care, and family planning rose from 11% to 19%<sup>80</sup> and long neglected infrastructure also received much needed attention. Just as important as the increased levels of investment in social and physical infrastructure, however, is the method by which the centralized government instituted these new policies. The *Inpres* program, or Presidential Instruction program, focused on the development of poor

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<sup>79</sup> Kano, *Indonesian Exports, Peasant Agriculture and the World Economy 1850-2000: Economic Structures in a Southeast Asian State*.

<sup>80</sup> Dick, *The Emergence of a National Economy: An Economic History of Indonesia, 1800-2000*, 209.

regions outside of the government's central power base on Java. But rather than being strict central directives, funds were instead funneled through local government institutions with leeway in implementation.<sup>81</sup> This served the dual purposes of legitimizing local public administration in the eyes of the populace and bought the loyalty of low-level politicians in the poorer regions of the country for Suharto.

In the mid-70s, both the ISI policies and the large social development programs that came with oil revenues were disrupted by the bankruptcy and subsequent bailout of Pertamina.<sup>82</sup> While this in itself was a relative blip on the history of development in the country that briefly delayed social projects through sapping the development funds for a bailout of the company, it was indicative of the excessive reliance of Indonesia on oil revenues and the possibly negative implications of high resource endowments. Later, in 1986 the price of oil dropped by about 50% resulting in a drop in Indonesia's national income by 5%.<sup>83</sup> This shock contributed to the adoption of Reagan's push for deregulation more than any other event.<sup>84</sup>

The oil-price shock forced the regime to reevaluate industrial policy and implement a strategy that reduced the country's overexposure to oil by becoming more export-oriented. Adopting export-orientation as a strategy to getting out of the oil trap was multifaceted. It included formal incentives to export and loosening of exchange rate policies, and most importantly it also include a loosening of a previously strict divestment

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<sup>81</sup> Ibid., 208.

<sup>82</sup> Ibid., 210.

<sup>83</sup> Ibid., 211.

<sup>84</sup> Andrew J. MacIntyre, "Politics and the Reorientation of Economic Policy in Indonesia," in *The Dynamics of Economic Policy Reform in South-East Asia and the South-West Pacific*, ed. Andrew J. MacIntyre and Kanishka Jayasuriya (Singapore; New York: Oxford University Press, 1992).

rule that forced foreign firms to find Indonesian nationals to purchase an ownership stake in foreign based ventures within a short period of initial investment. A clear parallel can be drawn between the loosening of Indonesia's divestment rule and the Philippines' parity rule for US citizens in that both gave foreign investors much greater access towards funneling capital into the countries. In general, the financial deregulations of this period led to future bubbles in the banking industry and proved to have the greatest impact through the Asian financial crisis. Bouncing back from the oil-price shock and the push for greater export orientation, however, required help from the outside in addition to domestic level policy liberalization.

The role of oil in the political process and timing of democratization in Indonesia deserves special mention. Some scholars argue that having a significant oil sector impedes democracy.<sup>85</sup> They contend that social spending programs through higher government revenue, i.e. *Inpres*, mitigate what otherwise would have been social pressure for democracy and autocrats have no other incentives to liberalize politics. Further, they maintain that any potential modernization effect that might happen through higher levels of education and employment in higher income industry is sapped by citizens who are able to consume more without significant changes in employment. However, a major focus of the *Inpres* program was increasing education and access to greater economic opportunity. With that in mind, it would seem that this perspective is overly simplistic and fails to account for variance in the type of social program that is being implemented. The relevance to the question at hand is that the large oil industry may have been the primary impediment to democracy and, following its relative decline

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<sup>85</sup> Michael L. Ross, "Does Oil Hinder Democracy?" *World Politics* 53, no. 3 (2001).



in importance, democracy became more likely in the late '90s. There is reason to believe that oil was clearly not the only factor impeding democracy, however, if it impeded the emergence of democracy at all. If anything, it is the investors in the oil industry that took over after the fall of Pertamina and their close relationship with Suharto that propped up the autocratic regime in lieu of democratization. Where oil is found to hinder democracy it is most likely a combination of these factors: high cash-payouts to citizens, low institutional reinvestment, and conservative foreign investors interested in maintaining a stable investment environment. In Indonesia, the only clear effect of the oil sector is that investors and long-lasting oil interests in Indonesia solidified Suharto's position.

Aid from Western powers also helped to prop up Suharto by enabling the country to maintain a balanced budget and, when paired with the increased confidence of foreign investors, leading to high growth rates averaging 7% from 1967-73.<sup>86</sup> The strategic closeness to Japan and its pro-capitalist leanings, however, made the continued development of Indonesia a geostrategic priority for the US. Thus aid continued to increase during this period, making Indonesia the highest aid recipient in the world in the 90s.<sup>87</sup> Without strong and persistent aid from the US, Indonesia would likely not have been able to develop a strong export-orientation. So too, Suharto may not have been able to keep his grip on power without this aid. Or if he managed to retain power without the aid, he would have had the luxury of much greater policy flexibility at the height of the financial crisis due to lower constraints from donors.

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<sup>86</sup> Dick, *The Emergence of a National Economy: An Economic History of Indonesia, 1800-2000*, 206.

<sup>87</sup> *Ibid.*, 205.

Thus one finds that the presence of US-capital and aid augmented Suharto's political position in complex and time-variant ways. While there was no coordinated assault from different actors and often the most influential actors were off-shore entities, Indonesia has experienced significant exposure to both US investors and political pressures.

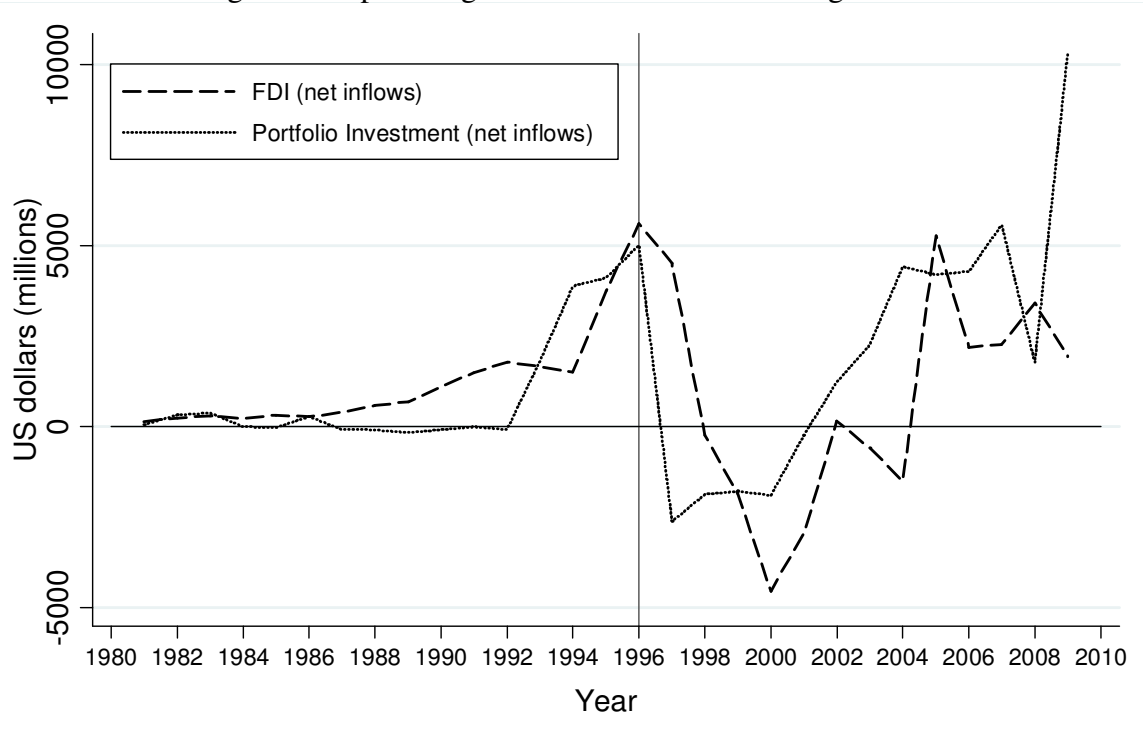
#### *Domestic Politics, the IMF, and the Fall of Suharto*

The beginning of the end for Suharto started in Thailand with the fall of the Thai baht. Unlike in Thailand, however, the crisis in Indonesia did not start with over leveraged loans on the part of local banks. In Indonesia the majority of corporate debt was held by foreign banks and so the crisis hit the financial sector after beginning in the real sector. Investor confidence in the region wavered as uncertainty about Suharto's policy commitments eventually led to vast capital flight. Suharto, however, quickly made commitments to cutting many crony projects, ending tariffs, and freeing the exchange rate of the rupiah from its peg to the dollar. But these commitments only stemmed bleeding from the rupiah for a couple of months after the crisis started in earnest in July of '97. As we can see in Figure 5, FDI was slower to take flight than portfolio investment and also slower to get back to pre-crisis levels

Continued investor skittishness in the region, however, led to further drops in the rupiah in October and forced the regime to seek assistance from the IMF shortly thereafter in the form of a \$23 billion dollar package. But the IMF agreement required further cuts into crony projects and Suharto started to display inconsistencies between what he agreed to cut with the IMF and what projects still received his approval. The proposed budget of January '98 disappointed the IMF and investors alike. As investors

fled from Suharto, essentially voting with their dollars, representatives from the US treasury and IMF visited the country to try to prop up the dying regime. The visit proved futile as now nothing except Suharto's departure could ensure a return of investor confidence.<sup>88</sup>

Figure 5: Capital Flight from Indonesia Following Financial Crisis



The political flash point, however, did not start with the internationally born and propitiated financial crisis. Student protests erupted following large fuel price hikes that ran abreast of the IMF restructuring program. The more general focus of the protests was the extensive role of foreign investors and businesses in the country. There was a widespread perception that foreigners yielded most of the economic gains in what had

<sup>88</sup> Andrew J. MacIntyre, "Political Institutions and the Economic Crisis in Thailand and Indonesia," in *The Politics of the Asian Economic Crisis*, ed. T. J. Pempel (Ithaca, NY: Cornell University Press, 1999), 154-61.

been a rapidly developing country. Beginning with the Dutch and lasting through Japanese occupation, astute Chinese businessmen, and prolonged US MNC activity, Indonesia had a long-latent nationalist presence. Chinese nationals bore the greatest brunt of the violence of the protests and the presence of Chinese investors in the country subsequently dropped further than most. In response to these uprisings, the long complacent parliament called for the impeachment of Suharto, who subsequently resigned from the presidency after a 32 year reign.<sup>89</sup>

The power vacuum left by Suharto was filled, although somewhat inadequately, by the Indonesian parliament. The rise of parliament brought with it a rehashing of some of the organizational problems that the same body faced during the Sukarno era. The IMF's purveyance and liberalizing influence ensured that there would not be another slide towards socialist policies, but the widely divergent interests across the islands, large population base, and sudden lack of central organization remains problematic to this day. This has, in turn, led to increases in bureaucratic excess and many opportunities for rent-seeking activities that may have even surpassed those under Suharto's rule. Overall, even-handed taxation and investment in development has become more difficult with the rise of democracy in Indonesia.<sup>90</sup> The benefits of patronage have shifted from those with connections to the power holders to those who have the best combinations of pivotal connections *and* adequate resources to take advantage of the government's spotty enforcement.

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<sup>89</sup> Budy P. Resosudarmo and Ari Kuncoro, "The Political Economy of Indonesian Economic Reforms: 1983–2000," *Oxford Development Studies* 34, no. 3 (2006): 350-51.

<sup>90</sup> *Ibid.*, 353.

### *The IMF and Wall Street*

So far it is clear that FDI had a stabilizing effect on Indonesia prior to the crisis, as also found in the Philippines, but what role that US capital played in the formative moments during and immediately following Suharto's fall remains ambiguous. Here the story and evidence is markedly different than in the Philippines. First, there was much greater capital flight in the build-up to the fall of the autocrat in Indonesia. This meant that there was not as much of a lasting interest in the country at the exact moment of transition. But the violence funneled towards foreigners, especially the Chinese, following Suharto's fuel-price hike also caused the physical flight of many investors that might have otherwise been in the country to influence political outcomes. More important, however, was the fact that the IMF was working closely with Indonesian economists and leaders in its post-Suharto recovery, and much of IMF policy was developed working in concert with the US Treasury and Wall Street firms.

Robert Rubin, Larry Summers, and Alan Greenspan all worked closely with the IMF to develop recovery packages. Prior to positions as economic advisor and Secretary of the Treasury, Rubin was co-chairman of Goldman-Sachs and after leaving the Clinton administration served briefly as chairman for Citigroup and then on the executive board. During this period, Summers was Rubin's Deputy Secretary of the Treasury and Greenspan the chairman of the Federal Reserve. Rubin's account of the crisis emphasizes the good side of IMF programs, places the blame for the severity of the crisis on Indonesian actors and the World Bank, and conflates economic and political goals of the IMF in his description.<sup>91</sup> Throughout the crisis this group of individuals also had

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<sup>91</sup> Robert Rubin and Jacob Weisberg, *In an Uncertain World: Tough Choices from Wall Street to Washington* (Random House Inc, 2003).

continued interactions directly with Suharto, advising him and his aides on various policies. The group stated their first goal was restoring investor confidence in Indonesia through stabilizing the economy, but addressing corruption was a persistent component of plans to restore confidence. Therefore when Suharto aimed to shore up support of cronies by repegging the rupiah to the dollar and thereby ensure stable prices while cronies could sell off projects, the IMF convinced him to do otherwise. Perhaps hindsight is 20/20, but it is rather apparent that Suharto's legitimacy was rooted in economic growth and his ability to expand the economy was rooted in his close connections to cronies; undermining the crony firms undermined Suharto's political position. Rubin's account does not belie explicit efforts to push Suharto out of office and appears to be ignorant of the political pressure these reforms put on Suharto, but the author does celebrate the democratic elections and steady strengthening that occurred after Suharto's fall. These are considered goods that came of the IMF programs even if the economic impact of the structural adjustments was not as intended.<sup>92</sup> The US Treasury forced the structural conditions under which the IMF programs to Indonesia were to be implemented with the intention "to create institutions and rules closer to those of Anglo-American capitalism and [those] more acceptable to US business."<sup>93</sup> And Wall Street was the chief influence in molding US Treasury policies in this direction with much of Clinton campaign funding coming from Wall Street and actors like Rubin running the show.<sup>94</sup>

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<sup>92</sup> Ibid., 242-50.

<sup>93</sup> Robert Wade, "Wheels within Wheels: Rethinking the Asian Crisis and the Asian Model," *Annual Review of Political Science* 3, no. 1 (2000): 109.

<sup>94</sup> Ibid., 110.

Hadiz and Robison argue that political decentralization<sup>95</sup> was a long running policy standard for both the IMF and World Bank programs that have rarely had the desired effect.<sup>96</sup> Nevertheless, these overly general programs had variable effects on countries. Indonesia stands in stark contrast to the experiences in South Korea and Thailand in that politico-business conglomerates survived and were not sold to foreign investors. This was largely due to the political connections of these conglomerates at home and abroad and the decentralization of power in the country. Such conglomerates were usually more powerful and well connected than the local politicians on whose patronage they depended. This led to an economy driven by money-politics and business interests co-opting populist ideology. Hadiz and Robison claim that these results demonstrate that business interests were only ever interested in economic liberalism, not political liberalism. While this sole emphasis on economic liberalism could be true of locally based conglomerates and might have been the main goal of investors in general, US politicians with connections to large US investment firms obviously pushed for both types of liberalism, as Rubin shows, with stability being the overarching concern. There is little doubt that Indonesia has yet to consolidate its democracy, but the direct – if naïve – actions of the IMF and US investors clearly constrained Suharto into an unactionable position. Intentionality may not have been explicit, but the conflation of political and economic goals on the part of IMF, Treasury, and Wall Street forced Suharto out and pressured for more democratic institutions to emerge after his fall. As with the

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<sup>95</sup> Here political decentralization simply means shifting from a unitary political authority to a system with multiple veto players at multiple levels of government.

<sup>96</sup> Vedi Hadiz and Richard Robison, "Neo-Liberal Reforms and Illiberal Consolidations: The Indonesian Paradox," *Journal of Development Studies* 41, no. 2 (2005).

Philippines, this explicit pressure for decentralization from US capital interests did not emerge until the crisis had hit.

Admittedly, pressure for greater political decentralization does not necessarily imply pressure for more democratic institutions. But it does entail is political and economic power leaving Suharto's hands to be distributed amongst elites at lower rungs. At that juncture Suharto was already constrained to the point where his only claim on legitimacy was his ability to direct the country towards high growth rates. This policy was the final tack that removed Suharto's political legitimacy, while also pressuring for a dispersion of political power, a necessary but not sufficient condition for democracy. While IMF policies did not necessarily push for democracy in the same, direct sense that foreign capital did in the Philippines, the presence of foreign capital pre-crisis and IMF policies during the crisis helped create the potential for the emergence of democratic institutions and provided the necessary impetus for a redistribution of power.

Domestic factors drove the regime transition in Indonesia as they also did in the Philippines. Where US-FDI in the Philippines formally supported Aquino, high-level US economic actors with ties to investment firms informally and formally constrained Suharto's actions and pressured for political decentralization after his fall. The evidence here stops short of demonstrating that US capital actually supported particular opposition forces that espouse more democratic institutions, as in the Philippines, but US-capital's support of these principles in general has had quite similar effects. Both countries now have formal democracy that is laden with patronage and, arguably, less stable investment environments.<sup>97</sup>

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<sup>97</sup> Ibid., 237.



## CHAPTER V

### CONCLUDING DISCUSSION

The future of democracy in the Philippines and Indonesia remains unclear; the consolidation of democracy, continuation of the current patronage politics, or a fall back into autocracy are all possibilities for both countries. This thesis has demonstrated, however, that two autocratic leaders of varying success and political connections were constrained by foreign capital in similar ways before and during regime transitions, but through different channels of foreign capital. Foreign capital also had a distinct influence in each state over what institutions would emerge to replace the autocrats. US capital and politicians behaving on its behalf played important roles in both transitional periods, but whether the goal of US capital was actual democracy or if the outcomes were truly democratic is ambiguous and depends on our definition of democracy.

Each index used in the quantitative analysis above employs a particular conception of democracy. Implicit in my case studies is also a loose conception of democracy that hinges on free and fair elections and peaceful transitions of power. This is a necessary assumption because a thicker consensus on what defines democracy is lacking in the literature. Is democracy a specific combination of formal institutions? Is it a level of participation amongst those that are to be represented? Is it something more abstract and tied to questions of equality in civil and economic rights? The flawed quantitative indices of democracy<sup>98</sup> develop contending perspectives. Polity hinges on the characteristics of the executive branch. Vanhanen measures electoral participation and competition. Przeworski et al. focus on a set of binary rules that arguably describe fully

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<sup>98</sup> Munck and Verkuilen, "Conceptualizing and Measuring Democracy: Evaluating Alternative Indices."

consolidated democracy (see footnote 31). Of the three, Polity was the only with no significant relationship with US FDI. At first glance this is odd considering that US FDI has been found to constrain executive actions first and foremost. There is some logic to this, however, given that the case studies researched in this thesis discovered mostly informal constraints from foreign capital.

These informal constraints stemming from foreign investors followed similar patterns in each country, even though they emerged through different channels. When unconstrained by exigent political or economic circumstances, increases in FDI lead to increases in rents extracted by elites. This bolsters rulers' political positions in the short-term, but also leads to dependence on these foreign sources of rents in the long-term. In particular, these foreign investors demand policies in line with free-trade and stable investment environments, which tends to run contrary to the interests of domestic labor. Elites can then maintain power until a significant exogenous shock occurs. The dependence on foreign investors then constrains the policy leeway of rulers and thus makes their exit from power more likely. At these junctures the specific characteristics of investments in the country influence which politicians emerge victorious and the form of future political institutions. Much of the impact found in this analysis happened through a greater likelihood of democratic elections. The Vanhanen and Przeworski et al. indices were significantly predicted by US-FDI. This is likely due to those indices hinging more on civil participation and the likelihood of power transitions, which the case studies both find to be correlated with US capital in particular.

If one chooses a 'thicker' conception of democracy, however, US capital might theoretically have a negative effect on democratic outcomes. For instance, foreign

investors might be expected to push for minimal redistribution of property and privileged access to natural resources. If we define democracy as equal access to politics, economic opportunities, and protection of citizens from excessive foreign pressures then foreign capital is undoubtedly a force for autocracy. Thus, the results of this project must be qualified by the fact that our Western, procedural understanding of democracy both in the abstract and especially in quantitative measures is heavily value laden towards free and fair elections rather than enduring civil or economic freedoms.

To this end, the influence of foreign capital after the respective democratization efforts has returned to something similar to its pre-transition role in the countries. I find that all forms of foreign capital have sought a stable investment environment and the highest degree of openness to trade and investment as possible. In autocratic systems in particular this can result in high-levels of rent being extracted by elites. These extra economic benefits serve at least three purposes in terms of political development: further empowerment of the autocrat through putting greater resources at the autocrat's disposal and, by proxy, reducing the relative economic power of opposition groups; constraining of the autocrat's policy choices to those that also fit within the preferences of the foreign capital, otherwise the autocrat could lose this now vital source of funds; and finally, the economic subjugation of lower classes that can serve to unite them around a common cause, such as the fall of Marcos and Suharto, in the Philippines and Indonesia, respectively. Foreign capital, over the long-run, thus creates a political dependence of the autocrat on capital which, when faced with political and/or economic shocks can lead to a political crisis.

Once such a crisis has emerged, a period of political indeterminacy occurs where the various domestic political groups pressure to get their desired outcome. The institutional outcomes are by no means determined at this point. But I find that US capital pressures both for the autocrat to remain permanently removed from power and in favor of more democratic political structures. In the case of the Philippines this took the form of explicit oversight of democratic elections and direct and indirect stumping for an opposition candidate. In Indonesia, this effect was more muted and not as directly supportive of a particular opposition group. The pressure against Suharto and in support of more dispersed political and economic power was nevertheless clearly present.

The results of the case studies build well upon the broad-based statistical analysis carried out in the first section of this project. The long-term effects of US-FDI on democracy, when controlling for the reflection of democracy on FDI, are significant with two indices and insignificant with the other two. In every specification, however, the coefficient of US-FDI is positively related to the respective index of democracy and these estimates should be considered lower-bounds. This is in line with the main findings of the case studies: US-FDI does indeed solidify the political situation of autocrats in the short-term, but it does not make countries more autocratic than they already were and, on a long enough timeline, generally leads to more democratic institutions. There are obviously many other variables, some country-specific others common between countries, that have an effect on political outcomes and FDI is by no means a check on all of those factors. However, the complementarity between the rigorous statistical analysis and case studies suggest that US-FDI has effects beyond other diffusion and modernization variables. Indeed, the evidence unearthed here suggests that country-

specific economic variables, in addition to diffusion in general, may be an omitted variable in some of the more prominent modernization works that explains the spurious causation found between economic growth and democracy.

Patronage networks have taken on different patterns now that decision making in both Indonesia and the Philippines has been decentralized. Some business interests, both local and foreign, have even been noted for their romanticism of the autocratic eras and the stability and predictability of the time.<sup>99</sup> Some may interpret this as a true distaste for the fickleness of democratic politics, but more likely is that unconsolidated democracy is too unpredictable: businesses are still adjusting to new sets of institutions and constraints, and capital is ill-equipped to deal with local instead of central politicians. This discontent may in turn prevent consolidated democracy. As the case studies above show, foreign capital remains relatively apolitical given investment stability, but when lacking stability it tends to step into the political fray.

My research is lacking in a few ways that warrant attention and could be the basis for future research. First are the data limitations. The FDI variables, in particular, most likely suffer from measurement error and comprise a relatively small data set. Since each country seems to have variable interactions with FDI, country-specific time-series analysis seems best suited for studying the dynamics of FDI and politics. But the available data spans too short a time period for this. A similar problem arises with introducing a variable for political stability, as is standard in many works. In these cases authors simply introduce a variable that is the number of periods since the country has

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<sup>99</sup> Hadiz and Robison, "Neo-Liberal Reforms and Illiberal Consolidations: The Indonesian Paradox," 237.

experienced a change in the value of the democracy index; the longer a regime has existed (stability) the more likely it is to remain in that same mold. But this is not possible with most countries in my sample due to the shortness and paucity of the data. Another viable extension would be to breakdown FDI by both country and sector. FDI in agriculture may have markedly different effects on a country than in manufacturing, especially if also taking into account the resources and labor endowments of the host country. Considering all this together, an ideal data set would have included all FDI inflows by country and sector for a longer period of time, a more complete diffusion variable interacted with FDI flows, and incorporated changes in sectoral endowments by country. A model based on this data with a similarly strong instrumental variable could develop a better, more nuanced story of the interaction between FDI and democracy.

On the qualitative side, ideal case studies could be done at the corporate and country level with ground-level research. For instance, establishing a connection with Dole and conducting interviews with managers and executives in charge of Latin American ventures could be highly informative in terms of foreign capital's political intentionality. Talking to social movement leaders on the ground in Indonesia and the Philippines would also be necessary to actually get a sense of how US firms may have engaged them before, during, and after the political movements. In the Philippines, for example, there is evidence that business interests had a stake in the elections and were active in pushing for Aquino, but to make this case strongly would require direct evidence from leaders in the Philippines. It may be that evidence is corrupted post-transition, as certain groups could jockey to take credit for what has come to be viewed as

positive changes in a country. But these types of case-studies are beyond the purview of my project.

The role of US capital in countries that experience political transitions is heavily under-researched. This is an important question as the political conditionality of investment grew significantly under Clinton, but the effects of US-capital investments before, during, and after this period are debatable. This paper aims to make an initial foray into research in this vein and finds a positive relationship between US-FDI and democratic elections. Case studies of Indonesia and the Philippines show that this relationship is nuanced, varying by macroeconomic characteristics and levels of political stability. Destabilizing events lead to US-capital pushing for political decentralization and free and fair elections. Prior to such events, US-capital intentionally bolsters autocrats in the short-term, but it constrains their policy choices in the long-term. As discussed above, these results are highly qualified and should be viewed as advancing the discussion on the political effects of US-capital investment rather than conclusive evidence for the particular effects found here.

Future works in democratization should take the methodological and conceptual queues in this thesis as pivot points. In particular, scholars may wish to put more theoretical leg-work into the measurement of democracy and more rigor into justifying the importance of democracy versus other, more-specific political or economic institutions and practices. Accurate scholarly work must, especially, drop a priori assumptions of the importance of democracy to all things social and political. Such conceptualizations suffer from the same methodological biases of dependency theorists, albeit in regards to a different set of variables. Furthermore, it is well past time for

scholars to move past studying democratization at solely the micro or macro levels. Complex interactions between yearly variables on a country-level cannot possibly account for context-specific and quickly moving political actions. Likewise, studies that focus only on ground level interactions overlook justifiably general, internationally-based effects and processes the direct effects of which may stop at the autocrat's door. The question is not whether international factors have a political effect or whether modernization theory holds true. These questions are far too simple. Instead we must study how the international, the domestic, and the personal interact under varying circumstances to yield particular political outcomes using all relevant and available social science methodologies.



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