

# Democratization and Economic Globalization

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## Key Words

democratic transition, trade liberalization and openness, capital account and financial liberalization, Stolper-Samuelson theorem, skill premium

## Abstract

We address two questions that are central to the literature on the emergence of democracy and economic globalization. First, does democratization foster higher levels of trade and capital account openness? Second, do trade and capital account openness increase the likelihood of democratization? We review the literature in international political economy and comparative politics that has theoretically and empirically addressed these questions. We then conduct some empirical tests in a sample of developing countries to briefly evaluate the empirical relationship between democracy and economic globalization. Our analysis reveals that evidence for the claim that democracy fosters trade and capital account liberalization is robust but that empirical support for the predicted positive effect of economic openness on democracy among developing countries is weak. More theoretical work is needed to clarify the link between democracy and economic liberalization, and to this end we provide possible topics for future research.

## INTRODUCTION

The past 30 years have been a period of intense global change. Many aspects of international relations have experienced rapid transformation, but two central trends stand out. The first is the “third wave of democratization,” which started slowly in the late 1970s with the transitions in Spain and Portugal, extended further to many Latin American countries in the 1980s, and then gathered momentum in the 1990s, engulfing Eastern Europe, the former Soviet Union, and parts of Africa and Asia. Democracy has thus become a global trend, and countries all over the world have become more democratic.

The second central trend has been characterized by the increasingly intense interchange of people, goods, information, and money across national borders. This phenomenon is commonly referred to as economic globalization, and a number of commentators have christened the contemporary period as “the era of economic globalization” (Friedman 1999). Although “economic globalization” is used to describe phenomena as diverse as trade and financial liberalization, immigration flows, cultural globalization, and the revolution in information technology, scholars often focus on two aspects of globalization: the adoption of free trade policies, namely trade liberalization, and the move toward greater financial openness, i.e., capital account liberalization.

The academic literature that attempts to explicate the causes and consequences of economic globalization is vast; so is the literature on democratization and democracy. In our review, we have chosen to focus on studies that examine the macro-level relationship between democratization and economic liberalization in the developing countries in the past few decades. More specifically, we address the following question, which is central to the literature on democracy and economic globalization: Is there an endogenous relationship between democracy and trade as well as capital account openness?

Studies in international political economy have largely focused on the causal effect of

democracy on trade openness and capital account liberalization rather than vice versa. These studies suggest theoretically and find empirically that political liberalization and democracy have a positive effect on trade and capital account openness (Brune et al. 2001, Dutt & Mitra 2002, Eichengreen & Leblang 2007, Garrett 2000, Milner & Kubota 2005, O'Rourke & Taylor 2006, Stokes 2001, Weyland 2002, Quinn 2003). In recent years, however, more scholars have started analyzing the causal impact of economic globalization, namely trade and/or capital account openness, on democracy (Acemoglu & Robinson 2006, Adsera & Boix 2002, Boix 2003, Boix & Garicano 2001, Eichengreen & Leblang 2007, Rudra 2005). Some scholars argue and show statistically that more trade openness increases not only the likelihood of democracy but also the level of democracy in the developed and developing world (Eichengreen & Leblang 2007, Lopez-Cordoba & Meissner 2005). Similarly, a few studies hypothesize and demonstrate empirically that financial openness also has a positive influence on democracy (Eichengreen & Leblang 2007). Other scholars are, however, skeptical of the claim that trade and capital account openness has a positive impact on democracy (Bussmann 2002, Decker & Lim 2007, Li & Reuveny 2003, Rigobon & Rodrik 2004, Tavares 2007).

In this review, we address the following questions:

- What do we learn from the literature about the effect of democratic transitions on international economic, i.e., trade and capital account, liberalization? Does democratization have a positive effect on trade liberalization and thus trade openness? Does democratization have a positive impact on capital account liberalization?
- Is there empirical evidence for an endogenous relationship, i.e., mutual causality, between democracy and economic liberalization? Does economic liberalization positively influence democratic

transitions and the level of democracy in general?

- Why does democratization affect trade and financial liberalization in developing countries? Why and how does the process of democratization lead to trade and financial openness?

We answer these questions by systematically reviewing the literature on the relationship between democracy and economic globalization in two main parts. First, we discuss the theoretical and empirical literature that explores the causal impact of democracy on trade openness. We then examine studies that analyze whether and why trade openness may negatively or positively influence the likelihood of democracy in developing countries. While reviewing the literature on democracy and trade openness, we conduct some simple empirical exercises to evaluate the relationship between democracy and trade openness in a sample of 130 developing countries observed between 1975 and 2002. We focus mainly on the developing countries because they are the ones that have democratized recently and have made the greatest changes to their economic policies. Second, we critically review the literature that addresses the effect of democracy on capital account liberalization. This is followed by a concise analysis of some studies that suggest more capital account openness raises the likelihood and level of democracy. We also conduct some basic empirical tests to assess the relationship between democracy and capital account openness in our sample of 130 developing countries from 1975 to 2002.

The literature and our empirical analysis reveal that democracy positively influences trade and capital account openness but that neither trade nor financial openness influences the level of democracy. However, a careful review of the relevant literature reveals that theoretical analyses of the potential causal impact of democracy on trade and especially capital account openness are underdeveloped. Indeed, research on democracy and trade openness, we believe, will progress substantially only if scholars develop

detailed causal theories that provide a comprehensive understanding of how the political dynamics of democracy in developing countries influences trade liberalization. Causal theories predicting that trade and financial openness foster democracy are still in need of careful and systematic statistical testing. In the absence of such tests, scholars will struggle to understand the complex relationship between democracy and economic globalization.

## DEMOCRATIZATION AND TRADE OPENNESS

### The Literature

Several economists and political scientists have recently documented the remarkable surge in trade openness across developing countries since the late 1970s (Anderson 2003, Goldberg & Pavcnik 2004, Harrison & Hanson 1999, Milner & Kubota 2005, Wood 1997). Preceding and concurrent with the move to free trade in the developing world, there has been a global movement toward democracy. The economists Papaioannou & Siourounis (2004, p. 8) define full democratization as a circumstance “where both the Polity and the Freedom House indicators have reached an almost perfect score,” and they ascribe partial democratization to “countries that have abandoned autocratic rule, but in which civil rights protection has not reached Western world levels.” Based on these definitions, they find that of a total of 59 episodes of full democratization and 24 episodes of partial democratization between 1975 and 2002, 95% have occurred in the developing world. Further, Milner & Kubota (2005, p. 158) state, “In 1975, there were approximately thirty democracies in the world; by 1992 there were about eighty-nine, which was roughly half the total number of independent countries in the world. By 2002, this figure had risen to more than 120 countries.”

The global wave of democratization and trade liberalization since the 1970s inevitably raises the two substantively important questions mentioned above: Do democratization

and (thus) higher levels of democracy foster trade openness? Does trade openness engender democratic transitions? Studies have addressed both questions.

The literature on the impact of political regimes, including democracy, on trade openness has evolved gradually. Early studies on the link between political regimes and trade openness hypothesized that autocracies rather than emerging democracies in the developing world are more likely to implement economic and trade reform policies. Haggard (1990), for instance, suggests that an autocratic government might pursue trade liberalization in an effort to maximize long-term tax returns. Furthermore, autocratic governments may be more insulated from lobbying by domestic groups that favor trade protection (Haggard 1990, Haggard & Kaufman 1995). Geddes (1995) and Remmer (1998), however, question the presumption that authoritarian governments have an inherent advantage with respect to implementing trade reform, thus implying that democratizing states are capable of implementing reform policies, including trade liberalization. Przeworski (1991) provides a more nuanced argument about the link between democratization and economic reforms such as trade liberalization. He suggests that democratizing states are likely to pursue economic and trade reform policies in the short run but may abandon such reforms over time once voters start incurring the costs of globalization.

The studies mentioned above are among the first to theorize how political regimes, including emerging democracies in the developing world, may influence economic reforms and trade openness. Yet these studies did not carefully test the impact of democratization and the level of democracy on trade openness across developing countries. Rather, it is primarily scholars of Latin American politics who systematically theorized and tested the effect of democratic transitions on economic and trade liberalization policies in developing Latin American countries.

For example, Stokes (2001) has recently argued that if trade reforms benefit large sections

of society in a developing country—this includes almost all countries in Latin America—then democratization will propel more trade openness. This is because if leaders resist trade liberalization when the electorate anticipates benefits from more openness, then they will be subject to electoral punishment in new democracies. Thus, politicians in new Latin American democracies may have incentives to adopt policies that promote trade openness. Likewise, in the context of Latin America, Weyland (2002, p. 60) suggests that democratization weakens the interest groups that favor protectionism:

[D]emocratization reduces the political clout of the vested interests that benefited the most from the old development model, such as protectionist business sectors and the military. At the same time, it enhances the role of the electorate, including the large mass of poor people who received meagre benefits under the old development model.

It follows that democratic transitions are likely to enhance the prospects for more trade openness (Weyland 2002). Stokes (2001) and Weyland (2002) systematically test their claim across countries in Latin America through a combination of statistical methods and case studies. They find fairly robust empirical support in several Latin American countries, including Argentina, Peru, Mexico, and Venezuela.

Although insightful, the analyses of Stokes (2001) and Weyland (2002) are primarily restricted to key developing countries in Latin America. However, several researchers have done systematic theoretical and large-*n* empirical work on the effect of both democratization and the level of democracy on trade openness. Studies initially posited that democracy can have contradictory effects on trade openness and liberalization. This is emphasized by Garrett (2000, p. 973):

On the one hand, democracy makes leaders more accountable to their citizens, promoting trade liberalization to the extent that

this is good for society as a whole. On the other hand, democracy also empowers distributional coalitions with intense interests, making higher levels of protectionism more likely.

In contrast, economists such as Dutt & Mitra (2002) argue that democratization may be compatible with trade liberalization in nations in which a majority of voters would stand to gain demonstrably via higher wages, but that this is contingent on local endowments of labor and other factors of production relative to trading partners. They find strong statistical support for their claim in a sample of >100 countries in the latter three decades of the twentieth century. In his theoretical study of trade politics in industrialized countries in the nineteenth century, Verdier (1998) suggests that democratic leaders were less likely to use trade barriers as a tool to create economic rent; thus, he argues that democracy had a positive impact on trade openness across the industrialized world in the nineteenth century. O'Rourke & Taylor (2006) suggest that democratization and higher levels of democracy have a positive effect on trade openness conditional on factor endowments, specifically the capital-labor ratio, in developed and developing countries. Their central prediction is statistically supported in panel data from 35 countries between 1870 and 1914. Eichen- green & Leblang (2007) also hypothesize that democracy promotes trade openness. They find robust statistical support for their claim in a large sample of developed and developing countries from 1870 to 2000.

Milner & Kubota's (2005) study supports the view that democratization has a positive influence on trade openness. They argue that because democratization expands the "selectorate" in a polity, it empowers whole groups in society that were formerly excluded from the political process. In developing countries, this implies that democratization enfranchises particularly low-skilled and unskilled labor in the rural and urban informal sectors, who, according to the Stolper-Samuelson theorem, favor trade openness because they are the abun-

dant factor that gains from trade. Put differently, since democratization increases the political voice of the abundant factor—low-skilled and unskilled labor—in developing countries, governments in new developing democracies have incentives to pay attention to the preferences of labor by lowering trade barriers. Milner & Kubota (2005) report robust statistical support for their main prediction in a sample of several developing countries from 1970 to 1999.

Thus, most studies report that democratization or higher levels of democracy has a statistically positive effect on trade openness. However, with the exception of Milner & Kubota's (2005) study, they infer this effect from estimating empirical models in large samples that include both developed and developing countries. Does an increase in the level of democracy have a positive effect on trade openness in a sample limited to developing countries? To provide a preliminary empirical answer to this question and check the direction of the causal link between democracy and trade, we first analyze the effect that the lagged level of democracy has on trade openness in a sample of 130 developing countries observed between 1975 and 2002. Thirty-three of these countries are in Africa, 39 in Asia, 25 in Latin America, and 33 in other regions. For the empirical exercise, we normalize the Polity measure of democracy to a 0–1 scale for every country in our sample to aid interpretation of the results, and we operationalize trade openness as the sum of exports and imports as a percentage of gross domestic product (GDP).

To assess the effect of democracy on trade openness, we estimate a system Generalized Methods of Moment (system-GMM) model—developed by Blundell & Bond (1998)—with robust standard errors corrected for finite samples using Windmeijer's (2005) correction procedure. The system-GMM model involves estimation of a single system that combines a regression in first-differences and a regression in levels. The instruments for the regression in first-differences are lagged levels (dated  $t - 2$ ) of the endogenous explanatory variables, and the instruments for the regression in levels are

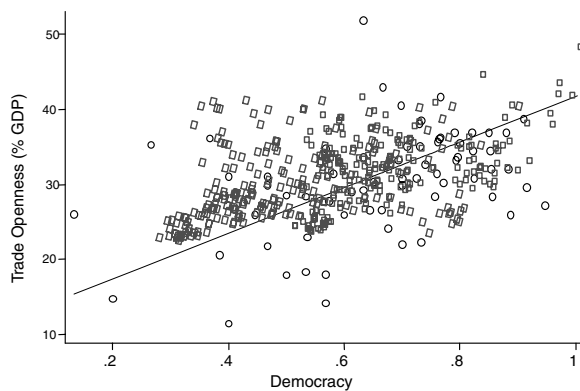
the lagged differences of the endogenous explanatory variables. Blundell & Bond (1998) show that estimating the two equations (levels and differences) in a single system reduces the potential bias and imprecision associated with just the first-differenced GMM estimator. Apart from correcting for potential endogeneity problems, the GMM technique allows us to account for unobserved time-invariant country-specific fixed effects (Blundell & Bond 1998). Following the literature, we control for standard variables in the specification that are known to influence trade openness: log of GDP per capita, log of population, log of total GDP at purchasing power parity, a dummy for participation in the GATT/WTO, and capital-labor ratio. Data for trade openness and the control variables listed above are drawn from Milner & Kubota (2005), *Government Financial Statistics* (International Monetary Fund 2006), and *World Development Indicators* (World Bank 2006).

**Figure 1** contains the scatter-plot from the levels regression of the system-GMM model described above. It reveals that a higher level of democracy indeed has a substantially positive effect on trade openness in our sample of 130 developing countries between 1975 and 2002. Though useful, this result is prelimi-

nary because we have not examined here the link between democracy and measures of trade *protection*—often missing for many developing countries—such as ad valorem tariffs or the effective rate of protection. Instead, as mentioned above, we focused on trade openness because even though this variable is an indirect and sometimes “noisy” measure of actual trade barriers (see Rodrik 2000), it is widely available for the large number of developing countries in our sample.

Although the results discussed above are somewhat basic, they corroborate research by Milner & Kubota (2005), for example, which shows that the emergence of democracy positively influences trade openness in developing countries. Although our crude empirical analysis matches Milner & Kubota’s (2005) finding, it must be noted here that the theoretical story presented by these two authors (discussed above) critically rests on the Stolper-Samuelson theorem, which posits that low-skilled/unskilled workers are likely to prefer greater trade openness in developing countries and less trade openness in developed countries. This is because low-skilled labor is the abundant factor in the developing world and the scarce factor in the developed world. Is the Stolper-Samuelson theorem, which Milner & Kubota (2005) employ to construct their theory, empirically valid?

Survey data in developed and developing countries suggest that low-skilled/unskilled workers are indeed more likely to prefer higher (lower) levels of trade openness in developing (developed) countries (Mayda & Rodrik 2005, Scheve & Slaughter 2001). Such evidence provides some empirical confirmation for the Stolper-Samuelson theorem used by Milner & Kubota (2005). However, recent survey-level evidence from developing countries in Latin America [Baker (2003), p. 449; 2005, pp. 935–36] reveals the opposite: The poor, including low-skilled and unskilled labor, in developing and thus skill-scarce countries tend to be more protectionist, whereas skilled workers in developing countries favor more trade openness.



**Figure 1**

Effect of democracy on trade openness. The y-axis denotes trade openness, operationalized as exports and imports as a percentage of GDP. The x-axis is the normalized 0–1 Polity democracy measure. Circles indicate observations from developing countries in Africa. Squares represent observations from developing countries in Asia, Central and Eastern Europe, Latin America, and the Middle East.

These mixed results are intriguing, and the trade policy preferences of low-skilled/unskilled workers across developing countries deserve further research. That said, Baker's (2003) finding that it is not low-skilled but rather skilled workers who favor more trade liberalization in some developing countries is perhaps not surprising. This is because economists have shown that after trade reforms are initiated, wages of skilled labor in developing countries grow much more rapidly than the income of low-skilled and unskilled labor (Acemoglu 2003, Wood 1995). Trade reforms thus engender a "skill premium." It may be difficult to pin down theoretically how democratization influences the skill premium and consequently trade reforms in developing countries. However, research on the emergence of skill premiums in developing countries suggests that it may be an oversimplification to treat labor in developing countries as homogeneous and assume *prima facie*, as Milner & Kubota (2005) do, that workers as a group prefer trade openness.

Scholars have made substantial progress toward understanding how democratization and higher levels of democracy affect trade openness. Yet research in this area raises numerous questions. First, Stokes (2001) and Weyland's (2002) theoretical argument is based on the assumption that voters in newly democratic developing countries experience some certainty *ex ante* that they will benefit from trade reform and more trade openness. This is questionable since economists have documented that unskilled workers, the rural and the urban poor in developing countries, often lack information about the benefits they may accrue from trade liberalization (Harrison & Hanson 1999). It also ignores Fernandez & Rodrik's (1993) seminal paper, which shows how citizens' *ex ante* uncertainty about the *ex post* benefits of economic (including trade) reform can delay or even block reforms across developing countries, including democratizing nations in the developing world.

Second, as discussed above, large-*n* work by scholars often hypothesizes that democracy has a positive effect on trade openness in the developing world either because of rel-

ative factor endowments in developing nations or because democratization politically empowers the abundant factor—low-skilled labor, workers who prefer free trade—in developing countries. Though useful, the causal stories currently provided by scholars do not theoretically explore how the process of democratic transition affects political dynamics between major social groups and the governing elite in a way that changes the elite's incentives to adopt trade reforms. In particular, how does democratization, compared to autocracy, affect political dynamics between key social classes and the governing elite? What are the consequences of these dynamics for trade reform?

These issues, in turn, raise the following questions about the political dynamics of democratization and trade reforms and thus trade openness in the developing world: Does the skilled middle class or low-skilled and unskilled labor favor greater trade openness in developing democracies? How do ruling elites in a democratizing country rationally respond to the demands of emerging socioeconomic groups such as the skilled middle class, low-skilled labor, and the unskilled poor when setting trade policy? Does democratization help to sensitize ruling elites to the distributive consequences of trade openness, and if so, how do concerns about the distributive costs and benefits of trade reform affect trade policy decisions by governments in new democracies? These questions indicate how much more research needs to be done to construct a nuanced theory of the link between democratization or higher levels of democracy and trade openness. We detail below several additional areas of research that scholars should pursue in order to develop a deeper understanding of how the dynamics of democratization and democracy influence trade openness.

At this stage, however, we assess the potential for reverse causality between democratic transitions and trade reforms. Do higher levels of trade openness that result from trade liberalization increase the likelihood of democratization? The theoretical literature on the potential impact of trade openness on democratization is rich. Lipset (1959) suggested long ago that

trade can spark development and create a larger middle class, which in turn might foster the emergence of democracy. More recently, Acemoglu & Robinson (2006) argue that greater trade openness can increase income inequality, and this shift in the distribution of income itself tends to be negatively associated with the likelihood of democracy.

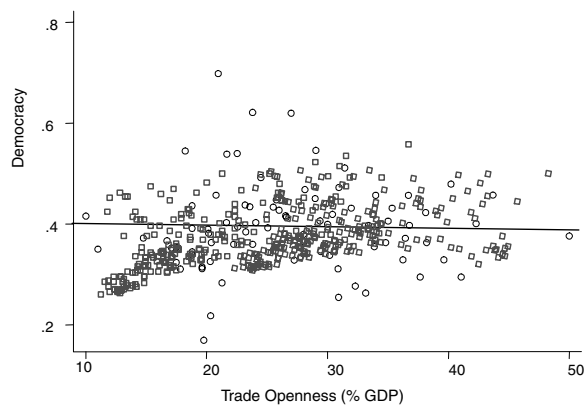
In contrast to Acemoglu & Robinson (2006), Boix (2003) and Boix & Garicano (2001) suggest that the effect of trade openness on democracy is contingent on the distribution of factors within a particular economy. When skilled workers are the abundant factor, trade openness increases income inequality within society by driving up the wages of skilled workers and deflating the wages of already poorer low-skilled or unskilled workers. Growing income inequality in turn discourages democratization. Adsera & Boix (2002) argue that greater trade openness actually endangers democratic institutions in emerging democracies. They emphasize that in countries in which democratic institutions are less well established, interest groups that benefit from more trade openness might try to void democratic institutions and impose openness through a dictatorship.

Thus, in stark contrast to the optimism expressed by Lipset (1959), the more recent stud-

ies argue that trade openness that results from liberalization of trade policies may actually reduce the prospects for democracy. Some studies find empirical support for the claim that more trade openness lowers the likelihood of democracy (Li & Reuveny 2001, Boix 2003). Several studies find that trade openness does not have a significant effect on either the likelihood of democracy or the level of democracy (Bussman 2002, Decker & Lim 2007, Rigobon & Rodrik 2004, Tavares 2007). However, Eichengreen & Leblang (2007) and Lopez-Cordoba & Meissner (2005) report that trade openness positively influences democratization.

Given the mixed evidence, we conduct a basic empirical exercise to check whether the lagged level of trade openness affects the normalized 0–1 Polity measure of democracy in our sample of 130 developing countries between 1975 and 2002. We estimate the empirical model—where democracy is the dependent variable and trade openness is the independent variable—by employing the system-GMM model. In the specification, we control for other variables that typically influence the prospects for and level of democracy: log of GDP per capita; GDP growth rate; rate of turnover of chief executives; an index of religious fractionalization; percentages of Catholics, Protestants, and Muslims in the population; a dummy for former colonies; number of democratic breakdowns suffered by each country; and total number of democracies in the world.

The scatter-plot in **Figure 2**, derived from the levels regression of the system-GMM model, indicates that the statistical effect of trade openness on democracy in our sample is weak. The preliminary result illustrated in this figure confirms the findings of numerous studies mentioned above that cast some doubt on the idea that increasing trade openness influences democracy, especially in the developing world. That said, it would be inappropriate to infer that trade openness does not influence democracy. More sophisticated empirical work needs to be done to carefully evaluate the effect of trade openness on democracy in developing countries. For instance, instead of focusing



**Figure 2**

Effect of trade openness on democracy. The x-axis denotes trade openness. The y-axis is the normalized 0–1 Polity democracy measure. Circles indicate observations from developing countries in Africa. Squares represent observations from developing countries in Asia, Central and Eastern Europe, Latin America, and the Middle East.



only on the impact of trade openness, scholars need to test the effect of direct and comprehensive measures of trade barriers, such as the effective rate of protection, on democracy to assess whether trade protection influences the prospects for and level of democracy.

Nevertheless, compared with the robust statistical results showing that democratization has a strong positive effect on trade openness, large-*n* empirical evidence for the positive or negative impact of trade openness on democracy is relatively weak. This weakness raises numerous questions in this issue area that need to be explored further. First, Acemoglu & Robinson's (2006) theoretical story is built on the crucial assumption that increased levels of trade openness engenders more income inequality. Although economists such as Barro (2000) and Easterly (2007) have found statistically that more trade openness indeed leads to more income inequality, other empirical studies have disputed the idea that trade openness causes or exacerbates income inequality (Dollar & Kraay 2004, Lee & Vivarelli 2006a). If it is indeed true that the causal impact of trade openness on income inequality is tenuous, then it may not be valid to argue—as Acemoglu & Robinson (2006) do—that trade openness decreases the likelihood of democratization because it engenders income inequality.

Second, we do not know of any empirical work that has attempted to carefully test the more specific link between trade openness, income inequality and the likelihood of democracy. This is unfortunate because Acemoglu & Robinson's (2006) theoretical claim can only be carefully evaluated if researchers empirically test the links between trade openness, income inequality, and democracy. Such testing would face difficult—perhaps insurmountable—problems of endogeneity. We, however, believe that it is important to conduct the empirical task in more detail.

## Future Research Agenda

Apart from the need to unpack the empirical relationships between democracy, income

inequality, and trade openness, we see four other critical issues in the study of democracy and trade openness that require theoretical and empirical research. First, political scientists often use a binary measure of trade liberalization—originally developed by Sachs & Warner (1995) and then extended by Wacziarg & Wallack (2004)—or continuous measures of tariff barriers, including average statutory tariff rates and import duties, to test theories on the political economy of trade reform (Eichengreen & Leblang 2007, Milner & Kubota 2005). Both kinds of measures are restrictive, since they fail to capture substantial sectoral and industry-based variation in tariff barriers across space and time in developing countries since 1980. This is unfortunate because new empirical research by economists indicates that the decline in tariffs on skill-intensive goods in developing countries, including developing democracies, has been quite dramatic compared with the changes in tariff barriers on low-skilled or agricultural goods (Goldberg & Pavcnik 2004; Wood 1995, 1997). Additionally, if the assumptions of the Stolper-Samuelson theorem hold for developing countries, then democratization in developing countries may cause an increase in tariffs on skill-intensive goods but a decline in trade barriers for low-skilled or agricultural goods. The intriguing relationship between the emergence of democracy and the variation in sectoral or industry-level tariffs suggests that researchers should develop a measure of trade liberalization that accounts for temporal variation in sectoral and industry tariffs across developing countries rather than relying solely on dichotomous or other standard average tariff measures.

Second, future political science research on the emergence of democracy and trade reforms may benefit from more attention to the socioeconomic impact of trade reforms. This is because ruling elites in new democracies may consider the distributive consequences of reducing trade barriers on society before opting to implement trade liberalization measures. This claim is not new; Przeworski (1991) attempted to explicitly theorize how *ex ante* uncertainty

about the social and political consequences of economic reform may influence the decision of new democratic elites to choose economic liberalization. Thus, a critical task for researchers is to build a comprehensive dynamic theory of the influence of democratic transitions on trade liberalization that analyzes how rational expectations about the socioeconomic impact of trade reforms held by leaders of new democracies affect their decisions about trade policy reform.

Third, Kono (2006) and Mansfield & Busch (1995) suggest that established democracies tend to use nontariff barriers (NTBs) rather than tariffs for protectionist purposes. Kono (2006) argues and demonstrates empirically that democracy induces politicians in the developed world to pursue “optimal obfuscation” by replacing transparent trade barriers with more complex, less transparent ones, primarily quality NTBs such as technical barriers to trade and sanitary and phytosanitary measures. His argument is undoubtedly insightful. But it raises two questions that require further research. First, are democracies more willing to reveal information about their NTBs than autocracies are? If so, then one can potentially claim that researchers such as Kono (2006) observe higher NTBs in democracies for that reason, and not because democratic leaders employ NTBs as a tool for optimal obfuscation. Second, if democracies can use NTBs to obfuscate their true levels of trade protection, then what prevents autocrats from also using NTBs to hide their true trade barriers? A comprehensive theory of regime type and NTBs should also address this question. Importantly, however, studies of trade barriers that only include tariffs must be concerned with how NTBs are being deployed when considering overall levels of trade openness. Few studies of democracy and trade openness, for instance, concern themselves with both tariffs and NTBs.

The fourth critical issue for future research is how different political institutions in new democracies affect trade policy. Students of international political economy have analyzed how other institutional factors within democratic systems, such as electoral institutions,

divided government, intersectoral labor specificity, and geographic concentration of certain industries in advanced industrial democracies, affect trade protection in the form of tariffs or NTBs (Busch & Reinhardt 2000, 2005; Gowa 1988; Hiscox 2002; Mansfield & Busch 1995; McGillivray 2004; Nielson 2003; Pahre 2007; Rogowski 1987). Is it plausible that electoral institutions, intersectoral labor specificity, and geographic concentration of certain industries, for example, may affect trade barriers in democracies across the developing world? Although some scholars have attempted to answer this question (Mukherjee et al. 2009), further theoretical and empirical exploration is certainly needed.

## DEMOCRATIZATION AND FINANCIAL LIBERALIZATION

### The Literature

In contrast to the burgeoning literature on the emergence of democratic institutions and trade liberalization, systematic scholarship on the impact of democratization and democracy in general on capital account liberalization is sparse. The relative lack of research on democratic transitions and financial openness could stem from the perception that capital account liberalization is not as politically salient as trade liberalization. Brooks & Kurtz (2007, pp. 11–12) state, “The high salience and relative tenacity of preferences surrounding the issue of trade opening are less apparent with capital account liberalization. Accordingly, studies of the politics of financial liberalization have largely focused on elite level negotiations. . . rather than mass-level politics.”

Notwithstanding Brooks & Kurtz’ (2007) claim, a few studies have examined both theoretically and empirically the effect that democracy has on capital account liberalization. For example, Brune et al. (2001, p. 9) argue that democratic transition may encourage citizens in the developing world to support economic openness and “liberalization—associating political and economic freedom as two halves of

the same acorn. This would imply that democracies are more likely to have open capital accounts.”

Using a similar argument, Eichengreen & Leblang (2007) also hypothesize that the introduction of democracy in developing countries generates political support for more financial openness; this consequently has a positive influence on capital account liberalization. Note, however, the contrast between this claim and some earlier comparative politics research suggesting that the absence of political constraints allowed autocrats to adopt capital account reforms (Haggard & Maxfield 1993).

Unlike Brune et al. (2001) and Eichengreen & Leblang (2007), Frieden (1991) does not explicitly focus on the impact of democracy on financial liberalization. But his theoretical arguments have important implications for the debate about democracy and capital account openness. Frieden emphasizes that capital account liberalization has distinct distributional consequences for different sections of society, which engenders the formation of political coalitions on the issue of capital account openness. Building on the Stolper-Samuelson theorem, he argues that capital account liberalization tends to benefit owners of mobile capital and diversified assets because it increases investment opportunities for these interest groups. Consequently, owners of mobile capital and diversified assets, which include domestic financial intermediaries and multinational corporations, apply political pressure on the government—in democracies—to remove restrictions on the country’s capital account. In other words, Frieden (1991) suggests that interest group pressure helps to promote capital account liberalization in the context of democratic political institutions.

Scholars of international political economy claim democratization and higher levels of democracy encourage capital account openness. Does empirical evidence support this hypothesis? Furthermore, what do the available data on financial liberalization—specifically capital account openness—in developing countries reveal? Has capital account liberaliza-

tion increased or decreased across developing countries in recent decades, and has it followed the pattern of democratization that has swept the globe? To answer these questions, we briefly examined data on the extent of capital account (i.e., financial) liberalization that has occurred across developing countries in the closing decades of the twentieth century.

More specifically, following existing studies (e.g., Eichengreen & Leblang 2007), we used Chinn & Ito’s (2005) updated measure of capital account liberalization in 130 developing countries between 1975 and 2002. Forty-six of these countries are in Africa, 23 in Asia, 25 in Latin America, and 36 in other regions. The Chinn & Ito (2005) measure is a continuous composite index that is scaled from  $-2.5$  to  $+2.5$ ; to aid interpretation of our results we rescaled it as a 0–5 scale. The Chinn & Ito measure captures on an annual basis the degree of liberalization of each country’s financial policies, including, for example, removal of restrictions on current and capital account transactions, the presence of multiple exchange rates, and removal of controls on credit operations. In addition to Chinn & Ito’s measure, scholars have also used Quinn (2003) and Brune & Guisinger’s (2007) measure of capital account openness for empirical tests in this issue area.

When we use the Chinn & Ito (0–5) measure of capital account liberalization, we find that financial openness across 130 developing countries more than doubled from an average of  $\sim 1.6$  in 1975 to 3.9 in 2002. The rapid surge in the degree of financial openness has fostered foreign portfolio and direct capital flows into developing countries, which have risen from \$12 billion annually in 1975 to  $> \$400$  billion in 2000 (International Monetary Fund 2006).

The dramatic increase in capital account openness across the developing world since 1980 strikingly parallels the equally dramatic emergence of new democracies in developing countries during the same time. As mentioned, there have been as many as 83 episodes of democratization, primarily in the developing world, since 1975 (Papaioannou & Siourounis 2004). The fact that democratization and

capital account liberalization have occurred almost simultaneously raises two key questions: Does democratization (and therefore higher levels of democracy) promote capital account liberalization in developing countries? Does capital account liberalization increase the likelihood of democratic transitions?

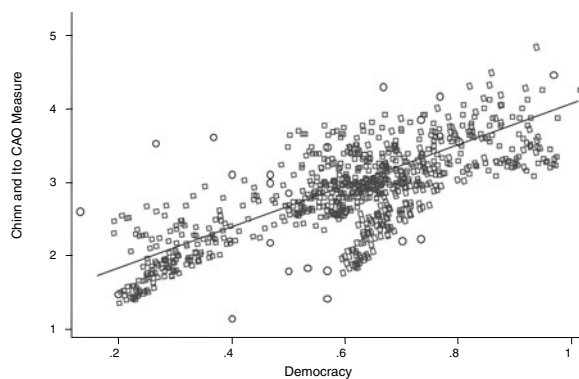
Statistical tests typically find a positive relationship between democracy and capital account openness. Quinn (2003, p. 201), for example, reports that the “correlation of democracy with capital account openness varied by time: it was zero to moderately negative in 1890–1919 and 1949–1959, but moderately to strongly positive in 1920–1938 and 1960–1999.” Brune et al. (2001) also report that democracy positively influenced capital account liberalization across a large sample of developed and developing countries during the latter part of the twentieth century. Eichengreen & Leblang (2007) find statistically that democratization has a positive and significant impact on several different measures of capital account liberalization since 1870 in a sample of developed and developing countries. In short, studies performed in fairly comprehensive pooled samples that include both developed and developing countries largely report robust

evidence that democracy promotes capital account liberalization.

Does democracy have a positive effect on capital account liberalization in a sample that only includes developing countries? To briefly answer this question empirically, we estimate a system-GMM model to assess the effect of the 0–1 normalized Polity score of democracy on Chinn & Ito’s (2005) capital account liberalization measure in our sample of 130 developing countries (1975–2002). Following extant studies, we control for variables that are known to influence capital account liberalization: log of GDP per capita, log of population, log of inflation, log of GDP at PPP, a dummy for participation in International Monetary Fund programs, current account deficit, and trade openness. **Figure 3** illustrates the scatter-plot from the levels regression of the system-GMM model mentioned above. This figure reveals that the effect of democracy on Chinn & Ito’s capital account liberalization measure across developing countries in our sample is positive and strong.

Put together, then, statistical tests—which include our simple empirical analysis—show that democratization and higher levels of democracy clearly have a positive impact on capital account liberalization in developing countries since the mid-1970s. But despite this robust empirical evidence, theoretical work on democratization and capital account liberalization (described above) is seriously underdeveloped.

For example, Brune et al. (2001) assume, rather than explain, that democratic transition necessarily encourages citizens to support capital account liberalization. They ignore the fact that capital account openness may be costly to certain social groups, providing them with incentives to block rather than support capital account liberalization. Furthermore, although Frieden’s (1991) study was published almost two decades ago, we do not know of any work that theoretically or empirically examines how the political dynamics of democratization affects the behavior of financial interest groups, and consequently the prospects for capital account openness, in developing countries. This



**Figure 3**

Effect of democracy on Chinn & Ito capital account openness measure. CAO denotes Chinn & Ito’s (2005) measure rescaled from 0 to 5. The x-axis is the normalized 0–1 Polity democracy measure. Circles indicate observations from developing countries in Africa. Squares represent observations from developing countries in Asia, Central and Eastern Europe, Latin America, and the Middle East.

is unfortunate, considering that interest groups in developing democracies, which may include domestic financial intermediaries for example, may be crucial in supporting or resisting more capital account openness. Later in this section we discuss other areas in which further research is needed to clarify the causal link between democracy and capital account liberalization.

At this stage, however, we assess the potential for reverse causality between democracy and financial openness. Do higher levels of capital account openness increase the likelihood of democratization? Although theoretical work has considered the effect of *trade* openness on democratization, we do not know of any study that theoretically addresses whether an increase in capital account openness leads to democratic transition. This is not surprising, given that the vast literature on the determinants of democratic transition pays almost no attention to financial openness. However, Eichengreen & Leblang (2007) suggest that more financial openness may generate domestic political support for democracy in autocratic states and that this, in turn, may improve the prospects for democratization. They do not explain why financial openness will lead the public to support democracy, but they find some statistical support for the expected positive influence of capital account liberalization on democracy.

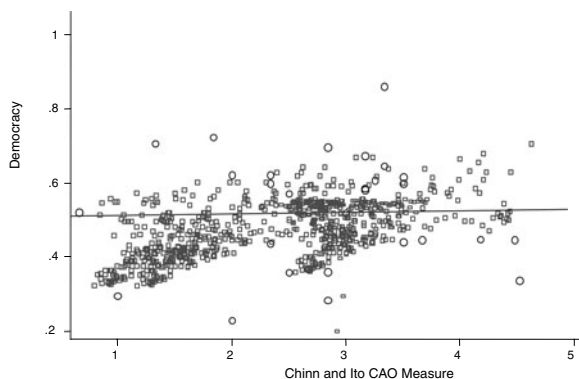
Based on few case studies of financial crises in Southeast Asia during the 1990s, some scholars suggest that capital account openness increases the likelihood of currency crises in autocratic states in the developing world. Currency crashes, in turn, engender domestic rebellion against dictators, which could lead to the demise of autocratic states and to the birth of new democratic regimes (Breslin 2002). This causal argument and Eichengreen & Leblang's (2007) finding are interesting, but they raise some concerns.

First, it is not clear why currency crises or other financial crises will destabilize only autocratic regimes in the developing world. After all, currency crises caused by open capital accounts may also endanger fragile democracies in the developing world. Second, recent empirical

research by economists has shown statistically that capital account liberalization *decreases* the likelihood of currency crises, in particular, in developing countries (Glick et al. 2006). This empirical finding makes it difficult to logically and empirically substantiate the argument that capital account liberalization promotes democratization by causing currency crises in autocratic states across the developing world.

Third, we mentioned above that Eichengreen & Leblang (2007) find empirically that capital account openness positively and significantly influences democracy in a sample that includes both developed and developing countries since 1870. Does capital account openness have a statistically significant positive effect on democracy in a sample restricted to developing countries in the latter three decades of the twentieth century? We attempt to empirically address this question by checking whether the lagged level of Chinn & Ito's (2005) capital account liberalization measure affects the 0–1 normalized level of the Polity measure of democracy in our sample of 130 developing countries (1975–2002). We estimate a system-GMM model where the normalized Polity democracy score is the dependent variable and the Chinn & Ito capital account liberalization measure is the independent variable. We control for other variables that influence democracy; these variables were listed in the previous section.

The scatter-plot in **Figure 4**, derived from the levels regression of the system-GMM model, shows that the statistical effect of Chinn & Ito's capital account liberalization measure on democracy in our sample is quite weak. We certainly would not infer from this simple illustration of preliminary results that capital account openness does not influence democracy in developing countries. Clearly, much more thorough empirical research is needed to gauge the precise impact of capital account liberalization on democratization and/or the level of democracy in developing countries. Note, however, that our result differs from that of Eichengreen & Leblang (2007), who find that capital account openness positively influences



**Figure 4**

Effect of Chinn & Ito capital account openness measure on democracy. On the x-axis, CAO denotes Chinn & Ito's (2005) measure of capital account openness rescaled from 0 to 5. The y-axis is the normalized 0–1 Polity democracy measure. Circles indicate observations from developing countries in Africa. Squares represent observations from developing countries in Asia, Central and Eastern Europe, Latin America, and the Middle East.

democracy. There are two reasons for this difference. First, in contrast to our focus on developing countries in the last three decades of the twentieth century, Eichengreen & Leblang (2007) employ a much larger sample that includes advanced industrial democracies and developing countries observed from 1870 to 2004. Second, Eichengreen & Leblang (2007) estimate the effect of capital account openness on a dichotomous measure of democracy, which is not done here.

We have so far focused exclusively on the literature that examines the link between democracy and capital account liberalization. In addition, political scientists have identified theoretically and tested four alternative factors that may drive capital account liberalization: international diffusion, government partisanship, the beliefs of political leaders, and interest groups (Alesina et al. 1994, Andrews 1994, Brooks & Kurtz 2007, Brune & Guisinger 2007, Cerny 1994, Frieden 1991, Goodman & Pauly 1993, Grilli & Milesi-Ferretti 1995, Helleiner 1994, Leblang 1997, Li & Smith 2002, Quinn & Toyoda 2007, Simmons & Elkins 2004). We do not discuss this literature because this review primarily focuses on the link between democracy and capital account openness. Instead, we

briefly discuss below several areas for future research that may help to enrich the scholarly literature on the potential impact of democracy on capital account liberalization across the developing world.

## Future Research Agenda

As mentioned, the drawbacks in research on capital account openness and the relative scarcity of comprehensive theoretical work on democratization and capital account liberalization raise several questions that deserve further research. These are similar to the questions we raised about trade and democracy in the previous section. We need to better understand the distributive consequences of international financial market liberalization. Which domestic groups or social classes gain or lose from capital account liberalization in democratizing countries in the developing world, and why? Specifically, does the skilled middle class or low-skilled or unskilled labor favor greater capital market openness in developing democracies? How do ruling elites in a democratizing country rationally respond to the demands of emerging socioeconomic groups, such as the skilled middle class, low-skilled labor, and unskilled poor, when setting financial market policy? Does democratization help to sensitize ruling elites to the distributive consequences of capital market openness, and if so, how do concerns about the distributive costs and benefits of capital market reform affect decisions by governments in new democracies? Compared with autocratic leaders, do democratic leaders have different political imperatives that make them more likely to take into account pressures for liberalization? Is the substantive impact of democratization on capital account liberalization homogeneous across developing countries around the globe? Finally, is it appropriate to deduce a common parsimonious theoretical framework that can explain how democratic transitions affect trade and capital account openness, or should scholars study the impact of democratization on trade and capital account liberalization as distinct phenomena?

The literature on capital account liberalization may also progress if researchers address whether the politics of democratization interacts with other exogenous factors to influence financial globalization. For example, do leaders in new democracies respond to the competitive pressures unleashed by international diffusion by further liberalizing their capital accounts? Or do they resist capital account liberalization despite the diffusion of capital account reforms across the developing world? Does government partisanship matter for capital account liberalization in emerging democracies across the developing world? Finally, do interest groups push for more (or less) capital account openness in developing democracies? And how do politicians in democratizing states respond to interest group pressure when deciding to liberalize the capital account? We need to better understand the behavior of both governments and domestic groups in order to comprehend the complex relationship between economic globalization and democratization.

## CONCLUSION

The rapid proliferation of democratic regimes across developing countries in the past 30 years has produced a lively debate concerning their relationship to economic globalization. Recent research in political science has been particularly driven by two key questions on the politics of globalization: Does democratization cause trade and capital account liberalization? Do greater trade and financial openness increase the probability of democratization in developing countries?

The most significant advance made in this issue area in the past decade is empirical. Political scientists have extensively analyzed whether the emergence of democratic institutions promotes trade and capital account openness. They have also tested whether trade and financial liberalization foster democratization. This literature has thus contributed to a larger set of questions about the impact of democracy on global capitalism and vice versa. We also conducted some simple empirical tests to check not only if

democratization statistically influences trade and capital account reforms, but also if economic liberalization affects democratic transitions.

Broadly, the literature and results from the empirical analysis conducted here suggest that democracy may help foster economic globalization but that globalization itself does not promote democracy. Political scientists have demonstrated via extensive empirical tests that democratic transitions and higher levels of democracy positively influence trade and financial openness. Most scholars, however, find that trade and financial openness do not statistically influence democracy or democratic transitions. The empirical results we report here reconfirm these findings. Specifically, we show that democratic transitions and higher levels of democracy have similar positive effects on trade and capital account openness, but that the reverse does not hold.

Despite impressive empirical progress, scholars have yet to develop a comprehensive understanding of the link between democratization and trade and capital account reforms. As emphasized repeatedly in this article, theoretical work on the causal effect that democratization may have had on trade and capital account liberalization is preliminary and lags far behind the empirical work. Empirical tests that lack solid theoretical foundations tell us something about correlation but not causality per se between democratic transitions and economic liberalization. Scholars need to develop comprehensive causal theories to explain why, how, and when democratization fosters economic liberalization in developing countries.

It is plausible that similar causal dynamics may account for the positive impact that democratic transitions have on both trade and capital account openness. Whether this is the case requires further exploration. It is also plausible that the effect of democratization and consolidated democratic institutions on trade and financial openness may not be homogeneous among developing countries. That is, the impact of democratic transitions on trade and capital account openness may vary across

developing countries from different regions. This possibility also requires theoretical and empirical exploration. Indeed, the central lesson that we learn from this review is that a vast amount of empirical and theoretical research is needed to unpack the connections between democratization and economic globalization.

### SUMMARY POINTS

1. Democratization has a positive effect on trade and capital account liberalization.
2. Neither trade nor capital account liberalization statistically affects democratization.
3. Trade reforms engender a skill premium in democracies across the developing world.
4. Distributional consequences of trade and financial liberalization are costly and politically salient.
5. More detailed theoretical research on the causal impact of democratization on trade and capital account liberalization is required.

### DISCLOSURE STATEMENT

The authors are not aware of any affiliations, memberships, funding, or financial holdings that might be perceived as affecting the objectivity of this review.

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## Errata

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