

1-1-2015

# Who Commits to the Rule of Law? Constrained Government and Foreign Direct Investment in Postcommunist States

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Published in *East European Politics* 31(4), 468-486. doi: 10.1080/21599165.2015.1088435

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## 1. Introduction

Political and economic transformations since 1989 have led to a wide variety of outcomes in postcommunist states in Eastern Europe and Eurasia. Several countries have established and consolidated democratic governments and market economies. However, other postcommunist states have yet to achieve these gains - in part because their moves toward new forms of authoritarian government have undermined commitments to the rule of law. The inability to commit to the rule of law is a chief concern, because scholars argue the rule of law facilitates investment, economic growth and political development (North and Weingast 1989; De Soto 2003; Diamond 1999; Haggard et al. 2008; Haggard and Tiede 2011; Holland and Pain 1998; Benecek et al. 2000). Specifically, investment flourishes when the state respects property rights, enforces contracts, and provides equal protection for investors under the law (Barro and Gordon 1983; North and Weingast 1989; Mauro 1995; Stasavage 2002; Frye 2002). For example, economists emphasise the ways governments' credible commitments to policy regimes convince investors of the sanctity of property rights, contract enforcement, and equitable treatment under the law.<sup>1</sup> However, investors will not commit their capital to a country's markets unless the state guarantees property rights and enforces contracts; two difficult tasks when states have violated such guarantees in the past (Haber et al. 2003; Hoff and Stiglitz 2004; North and Weingast 1989). The important and elusive nature of credibility raises a critical question: what generates credible commitment to the rule of law?

The rule of law is a contested concept, with some arguing the concept has become so diffuse as to be rendered meaningless (Weingast 1997; Tamanaha 2004; Munck 2009). I use the World Bank's definition of the rule of law, which captures "perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence." I add policy credibility to this foundation to complete my working definition: the rule of law exists when observers are confident legislation will be implemented and enforced in line with the constitution.

Considerable scholarship ties the rule of law to political and economic development, but we lack knowledge of how the rule of law emerges in the first place.<sup>2</sup> Theoretical frameworks on the rule of law are plentiful, but there are relatively few empirical tests of these arguments over time and across space.<sup>3</sup> I fill gaps in theoretical and empirical knowledge on the connections between political institutions, political practice, and credible commitment by identifying the determinants of perceptions of the rule of law in postcommunist states. The measure I use is perceptual, but perceptions are highly relevant: investors', country-experts', and risk-analysts' perceptions inform decisions to invest in one country relative to another. Investors' perceptions might also stem from broad, visible political and economic trends, because information on how institutions channel political interests can be difficult to come by because legal rules and institutions are often complex and opaque. Furthermore, the total number of politicians in positions of power over investors across an entire country is high. As a result, it may be difficult for

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<sup>1</sup> See North and Weingast 1989, De Soto 2003, Keefer and Stasavage 2003, Glaeser et al. 2004, and many others such as Coase 1960, and Demsetz 1967.

<sup>2</sup> Charron (2009), Acemoglu et al. (2001), Woodberry (2012), and Nunn (2008) represent a few exceptions.

<sup>3</sup> Weingast (1997), Maravall and Przeworski (2003), and O'Donnell (2001, 2004) provide strong theoretical foundations for the rule of law. Chavez (2004), Miller and Perito (2004), Perito (2003) and Peerenboom (2002) detail efforts to promote the rule of law in individual countries, but cross-national scholarship using comparable data on the rule of law is relatively uncommon.

even highly informed investors to build expectations surrounding property rights and contract enforcement based on analyses at the level of the firm. It is therefore tempting and perhaps instructive for investors to use different proxies to assess government credibility based on broad political and economic trends. For instance, I argue institutional checks and balances occupied by opposition politicians with incentives to exercise those checks and balances raises the costs of policy shifts and thus the credibility of a government's policy commitment. Checks and balances will not function unless there is some reason to trigger them - a reason politicians from the same party are less likely to have than would opposing, ideologically-distinct veto players in government.

The distinction between political institutions' form and their function is already present in the theoretical literature on commitment to the rule of law (North and Weingast 1989; Diamond 1996; Weingast 1997; Maravall and Przeworski 2003; Keefer and Stasavage 2003; Andrews and Montinola 2004; O'Donnell 2004; Haggard et al. 2008; Haggard and Tiede 2011). I take the next step in this logical chain and evaluate whether investors' perceptions do indeed shift based on the immediate political risk analysis that might accompany institutional reforms and/or new configurations of elected officials. I first test my argument against panel data for 24 Eastern European and Eurasian countries from 1996-2012.<sup>4</sup> I then address potential connections between constrained government and investment behaviour by modelling foreign direct investment (FDI) in postcommunist states.

I limit my dataset to postcommunist states in Eastern Europe and Eurasia for two reasons. First, some Eastern European countries experienced democratic transitions beginning in 1989. Economic transitions to market economies accompanied these political transitions, and spurred investment and growth in these states (Aslund 2012; Roland 2000). However, there is considerable variation in the level of democratic consolidation, commitment to the rule of law, and economic prosperity over time within countries and across space between countries (Frye 2010; Murphy et al. 1992; Piana 2013). Some postcommunist states in Eastern Europe have achieved high levels of democratic consolidation (e.g. the Baltic states), whereas none of the Eurasian states have experienced similar gains. In between these extremes, the decade from 2003 to 2013 featured backsliding toward authoritarianism in several regionally important, large countries such as Hungary, the Czech Republic, and Russia (Müller 2014; Alina-Pisano 2007; Hoff and Stiglitz 2004; Zakaria 2007). Many blame the postcommunist states' economic and political growing pains on the order of reforms. Eastern European countries attempted to reform politically as they reformed economically, whereas China, South Korea, and other East and Southeast Asian countries transitioned toward a market economy before considering political liberalisation (Elster 1993; Kitschelt 2013; Wade 1990; Touchton 2014). Variation in postcommunist constraints on government and the rule of law allows for an assessment of whether democratic politics - illiberal or otherwise - could be partially to blame for slow economic growth and political backsliding toward authoritarianism. Second, consistent data is available for postcommunist states covering all countries for all years in my study - such widespread data availability is less common for other regions and offers one more advantage for studying the relationship between political constraints and the rule of law in Eastern Europe and Eurasia.

My analysis suggests increased checks on political authority have a strong, positive, statistically significant relationship with perceptions of the rule of law. I argue politicians are more likely to exercise institutional checks and balances to defend the rule of law when they are not members of the executive's or legislative majority's party. Rather than only prevent needed reforms that improve governance and attract investment, I demonstrate that the benefits of legislative-executive polarisation for perceptions of the rule of law are overlooked. Rule of law perceptions improve as the institutional and political constraints on authority grow. These results are robust to the inclusion of many control variables that might also inform rule of law ratings, such as the strength of political rights in a country, its economic productivity, and the ideological orientation of its government. These results also highlight the gap between previous arguments surrounding the negative aspects of political polarisation such as those in Frye (2002; 2010)<sup>5</sup> and Ceka (2012) for Eastern Europe or Linz (1994) and Ames (2009) for Latin America and scholarship on policy credibility: a paralysed legislative process may prevent needed reforms, but constrained authority may also generate credible commitments to existing policies. Of course, studies on political polarisation

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<sup>4</sup> The countries in my study are as follows: Albania, Armenia, Azerbaijan, Belarus, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey, and Ukraine.

<sup>5</sup> Frye (2010) provides evidence political polarisation harms countries' ability to make reforms that would spur investment. However, his models use different independent and dependent variables than mine and cover data from 1990-2004, instead of 1996-2012.

use the term in a negative context, whereas constrained or limited government is frequently lauded. In this article, I demonstrate how institutional vetoes and an incentivized opposition with veto power benefits rule of law perceptions and attracts investment. I also provide evidence for the important role the EU accession process plays for external validation of policy reforms, improving rule of law perceptions, and attracting investment. This provides new insights on the relationship between checks and balances, policy credibility, and investment in postcommunist states and potentially, around the world.

## 2. How Politicians' Incentives Make or Break Credibility

Explanations of commitments to the rule of law often focus on how institutional constraints enforce political promises (Kunicova and Rose-Ackerman 2004; Persson and Tabellini 2003; Lijphart 1999). However, institutional structures do not make policy. Instead, politicians sit at the levers of representative institutions and channel partisan, constituent and their individual interests through their offices. Purely institutional arguments neglect this important element of democratic politics: the political preferences of elected officials within these institutions and the incentives driving their behaviour. Institutional explanations only describe one part of the story surrounding credibility: the incentives structuring politicians' behaviour *in theory*. In contrast, understanding the incentives driving politicians' behaviour *in practice* is crucial to understanding credible commitment the rule of law.

Credibility requires more than constitutional separation of powers or institutional checks and balances in postcommunist states, because so many institutions in Eastern Europe and Eurasia do not function as advertised. Rather than invest naively in countries where expropriation or confiscatory taxation is likely, investors would prefer to wait for evidence of institutional checks and balances protecting their legal rights before investing. This evidence takes time to accumulate in young democracies and may not exist at all in some countries in the region. My argument here is two-fold: First, the presence of an ideologically motivated opposition among elected officials provides opposition politicians with a  *motive* to thwart the majority party's policies by exercising institutional *opportunities*, as in Tsebelis (1995, 2002). In many cases those institutional opportunities may not exist. Nevertheless, my argument is that the rule of law is most protected in states where institutional veto points are coupled with politicians from ideologically-distinct opposition parties who occupy the institutional veto points. Politicians who do not agree with one another then have *greater* incentives to undermine one another's policies than would politicians from parties in ideological alignment, because they are in competition with one another and are less likely to work closely together in the future. These politicians also have greater incentives to expose one another's corrupt activities and to publicly challenge one another, as in Brown et al. (2011). The result is credible commitment to the rule of law, a key ingredient for investment in many analyses (North 1989; North and Weingast 1989; Henisz 2000, 2002; Henisz and Zelner 2007; Keefer 2004; Hicken et al. 2005; Keefer and Stasavage 2003; Andrews and Montinola 2004).

Second, I argue investors, risk analysts, and country experts use the presence of ideologically motivated opposition politicians among elected officials as an indicator of the rule of law. These observers may not have information on how particular firms or individuals fared in property disputes with the government. Similarly, these observers may have difficulty estimating the probability of a given contract being upheld. However, the partisan composition of the legislature relative to the executive is readily apparent to those outside the country. Firms and investors may therefore use a relatively easy shortcut to assess whether the government could arbitrarily pass new policies that would violate investors' rights. This is not to say all states with an opposition presence among elected officials make credible policies, protect investors' rights, and attract investment. Instead, my claim is only that the likelihood of passing credible policies increases as the costs of deviating from those policies increases, as in Madison (in *Federalist* #51, [1788] 1961), Douglass North (1981, 1990), and Barry Weingast (1989). An ideologically-motivated opposition presence increases the costs of policy shifts and thus increases the likelihood of credible commitment to the rule of law, all else equal.

Ideologically similar parties may still block one another's policies. I only assert that the likelihood of parties opposing one another increases as the distance between these parties' ideological and policy preferences grows. For instance, Estonia's four largest political parties fall on the political Left (Social Democratic Party), Centre (Estonian Centre Party), and Right (Estonian Reform Party, Union of Pro Patria and Res Publica). The Centrist Estonian Centre Party and either party on the Right may very well block one another's initiatives as members of a governing

coalition in parliament, but I would expect this to occur less often than for either Right-leaning party and the Left-wing Social Democratic Party if they were members of the same coalition government or had the potential strength to form a rival coalition.

### *The Rule of Law in Postcommunist States*

Previous research finds credible commitments arise from political institutions and constitutional rules that limit arbitrary power, bring accountability to government, and constrain politicians' behaviour in wealthy democracies (North and Weingast 1989; Tsebelis 2002; Weingast 1997; Barro and Gordon 1983). Yet, broad institutional elements identified in the literature as relevant for economic development are unsatisfactory explanations for the wide variation in perceptions of the rule of law in postcommunist states (Hoff and Stiglitz 2004). This is because many postcommunist states have had only mixed success after adopting political institutions modelled on those found in wealthy democracies (Hoff and Stiglitz 2004; Zakaria 2007; Kitschelt 2003). Constitutional separation of powers and checks and balances serve their intended purpose in Persson and Tabellini (2003). However, constitutions that are quite similar to those of liberal democracies do not necessarily check or balance power in Eastern Europe or Eurasia. Furthermore, legal origins that are similar to one another within the region, as described in La Porta et al. (2008) and Djankov et al. (2002), do not necessarily explain divergent outcomes between neighbouring countries. For example, many postcommunist countries place institutional constraints on authority by separating power between presidential heads of state and parliamentary heads of government. Yet many postcommunist institutions that separate power or create checks and balances on paper do not function as intended in practice because the rule of law is absent.<sup>6</sup> Instead, "illiberal" democracies that have developed in Eastern Europe and Eurasia follow liberal institutional form, but not their function (Zakaria 2007). Consequently, these countries violate investors' rights and back away from their promises so as to make incredible any commitments to the rule of law.

Hungary's recent history provides an example of how a state with a relatively liberal constitutional order can function illiberally. Prime Minister Viktor Orbán and his party, Fidesz, have dominated Hungarian politics since 2010 and rolled back constitutional checks and balances at regular intervals (Müller 2014; Dolenc 2013; Bayer 2013). This has occurred within Hungary's constitutional boundaries because Fidesz MPs and their partner at the ballot box, the Christian Democratic People's Party, have maintained the two-thirds majority in Parliament necessary to pass constitutional reforms. In turn, Fidesz MPs promote these reforms to maintain their position in the majority and to seek personal power because political advancement depended on pleasing Orbán and other Fidesz leaders. Prime Minister Orbán's promises to refrain from violations of investors' rights are thus not credible because few other elected officials in positions of veto-authority have incentives to constrain him. However, suppose we were to replace some members of Orbán's Fidesz majority with members of Orbán's main political opposition, the left-leaning Unity Coalition, in government. This would create a new coalition arrangement that might be *more likely* to block Orbán's illiberal policies because of the Unity politicians' opposing policy preferences. Investors might then consider it more likely that the checks and balances already present in Hungarian institutions would function as intended, because this new broad coalition would have incentives to moderate Prime Minister Orbán's policies. For instance, politicians from the Unity Coalition would back up their distinct policy preferences with a credible threat to seek a vote of no confidence and potentially defeat Fidesz in elections. As a result, the Hungarian commitment to the rule of law would become *relatively more* credible than under circumstances where one party dominates the country's politics or where similar parties maintain a parliamentary majority.

It is entirely possible political constraints act as a double-edged sword in producing policy credibility. For example, the inability to deviate from existing, credible policy could create legislative deadlock and disillusionment with the political process (Ceka 2013). Here it is instructive to move beyond Eastern Europe and Eurasia to Latin America, where scholars blame deadlock for military coups, economic stagnation, and unconsolidated democracy (Cheibub 2002; Linz 1994; Ames 2009). Postcommunist democracies with semi-presidential systems in Eastern Europe and Eurasia may be even more prone to deadlock between the executive and the legislature than in unitary Western European systems (Weyland 1999). Additionally, Frye (2010) emphasises political polarisation's role in preventing reforms and undermining investment in Eastern Europe. This literature thus presents evidence for a negative role for constraints on authority in new democracies around the world. However, my interest in exploring political

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<sup>6</sup> Of course, there are also large, visible historical differences in the level of institutional performance in Eastern Europe and Eurasia - dating to before the Communist era in many countries - as discussed in Pop-Eleches (2007).



constraints is somewhat different from these earlier studies: my dependent variable is a perceptual index of the rule of law, not the prospect of reforms to achieve the rule of law. This distinction is important: the institutional and political factors thought to increase the risk of deadlock by constraining elected officials and undermining cooperation might also generate benefits in other areas, such as commitment to property rights and contract enforcement, provided the government has already implemented legislation guaranteeing these rights. By the same token, constrained government could potentially preclude such commitments- a possibility I only test indirectly through analysis of rule of law perceptions.

### *External Credibility*

Internal institutional and political constraints are theoretically important for the rule of law, but only represent two of several options for generating credibility. A third option lies beyond a country's borders, where international organisations can serve to constrain governments. In particular, considerable scholarship demonstrates the role the EU accession process plays in institutional and economic reforms in postcommunist states (Gray 2009; Plümper et al. 2005; Svejnar 2002; Bevan and Estrin 2000; Claessens, Oks, and Polastri 1998; and Kaminski 2001). Gray (2009) identifies the accession process as a determinant of bond purchases in the region, with the risk premium associated with sovereign debt falling as EU negotiations progress toward full membership. In this sense, the risk of expropriation may still be high in the post-Soviet states in the dataset, but the leaders of countries on the path to EU accession would not risk jeopardising their chances for EU membership by expropriating property. In a broader sense, governments seeking investment make not only a strict commitment to property rights, but also to a transparent legal and business climate - an area the economic chapters of the EU accession negotiations emphasise.

Countries often undertake policy reforms designed to improve domestic economic governance and the rule of law well in advance of accession negotiations with the EU (Gray 2009). However, these reforms may not be sustainable and therefore credible on their own. Instead, closing each chapter of negotiations acts as an external confirmation of the country's suitability to join the EU - and of decreased future political risk associated with its debts, private property, and general business climate (Tomz 2012; Gray and Hicks 2014). Preparing to join the EU and other international organisations can thus allow governments to make commitments to a favourable legal and business environment by making reforms to satisfy external arbiters with more established credibility. These commitments can influence markets at several different stages of the accession process, but market expectations of eventual EU membership may be built into investor risk premiums in early negotiations as different *acquis* chapters close. I therefore include this important indicator of political risk in postcommunist states in my models of investment flows. I describe the other variables I capture and the methodology I use to estimate a model of the rule of law in postcommunist states in the section below.

### **3. Variables and Methodology**

I use an indicator from the World Bank's Governance Matters database to model the rule of law in postcommunist states (2012). This aggregate indicator reflects investors, risk-analysts, and country experts' accounts of the protection of property rights, enforcement of contracts, equality under the law, the judicial system, and crime around the world.<sup>7</sup> The Worldwide Governance Indicator (WGI) then generates a rule of law variable composed of a weighted average including property rights, contract enforcement, equitable treatment under the law, and street crime. The measure covers an average of 183 countries at two-year intervals between 1996 and 2002, and then annually through 2014.<sup>8</sup> Rule of law scores range from -2.31 (no rule of law) to +2.36 (full rule of law) and are scaled to a zero mean and constant standard deviation among each year's data.<sup>9</sup> The mean scores for countries in my dataset are -0.48. Estonia has the highest mean score in the region, at 1.04, while Tajikistan has the lowest at -1.31. There are 330 total country-year observations among Eastern European and Eurasian countries in the dataset for this article.

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<sup>7</sup> This material comes from polls such as the Afrobarometer, Freedom House, Gallup International, US State Dept., etc. (Kaufmann, Kraay and Zoido-Lobaton (1999) and Kaufmann, Kraay and Mastruzzi (2012).

<sup>8</sup> The data for the missing years is extrapolated from the existing data for 1997, 1999, and 2001.

<sup>9</sup> Kaufmann, Kraay and Mastruzzi (2007), and Kurtz and Shrank (2007) include a thorough discussion of the criticism surrounding the World Governance Indicators.

### *Independent Variables: Checks on Authority*

My principal independent variable is Beck et al.'s (2001) *Checks* variable, with coverage from 1990 to 2013. This index first records the number of institutional veto players in each country's political system. Then the measure is adjusted for whether these institutions are occupied by independent veto players as determined based on each veto player's partisan affiliation, the level of electoral competition in the political system, and the country's electoral rules. Beck et al. evaluate their coding relative to Roubini and Sachs' Legislative Index of Electoral Competitiveness for each country. If a country's score is less than four on the index, the "checks" measure is scored "1" reflecting few effective constraints on authority because elections are uncompetitive - regardless of the formal constitutional checks present in the political system. For states with competitive elections, Beck et al. increase the *checks* variable beyond one by the number of veto players in the system. Thus, the measure incorporates both *de jure* veto points from a state's constitution and *de facto* constraints based on the political context in creating the measure. The final measure is coded on an annual basis for each state in my dataset, with a mean score of 4.33 and a standard deviation of 2.14. The maximum number of checks is 10, which Slovenia has in 2012, while Albania, Azerbaijan, and Belarus are tied for the lowest number of checks on authority, with scores of "1" for some portions of the study and the lowest overall mean scores.

### *Democracy*

Competition in democracies creates incentives for politicians to hold one another accountable, and many postcommunist countries transitioned to democracy relatively recently, following the end of the Cold War. Other countries in the dataset experienced a partial transition, while some never transitioned to democracy at all. Assessing the extent to which rule of law perceptions in postcommunist states are tied to democracy as an overarching concept thus provides an opportunity to evaluate the relationship between democracy and the rule of law in countries where democracy is new and only recently consolidated.

Illiberal and authoritarian governments will likely decrease rule of law perceptions. Yet, this assumption is worth examining in greater detail because high economic growth rates under authoritarian regimes in some East Asian countries suggest these governments *may* have identified paths to credible commitments that bypass democratic political constraints (Gehlbach and Keefer 2011; Montinola et al. 1995; Knack and Keefer 1995; Barros 2003). Eastern Europe and Eurasia feature poor prospects for this argument: the countries in my dataset with the least democratic scores on Freedom House's Political Rights indicator (Albania, Armenia, and Belarus) are some of the ones exhibiting the lowest economic growth rates during the timeframe my dataset covers.<sup>10</sup> This suggests authoritarian governments perform poorly in protecting investors compared to democratic states. Still, democratic practice likely influences rule of law perceptions and therefore deserves to be included as a control variable in any models of the rule of law.

Contemporary Eastern Europe features mostly democratic governments, though many lean toward illiberalism. Some Eurasian countries fall on the illiberal end of the democratic spectrum, and many are not classified as democracies at all. There is therefore wide variation among political rights and civil liberties in postcommunist states, which I proxy with Freedom House's annual rankings for each country. Freedom House ranks each country in my dataset from 1 (most free) to 7 (least free) on an annual basis through expert responses to 10 different questions covering outcomes such as the ability of a population to exercise civil liberties and political rights (Freedom House 2015). It is distinct from the institutional and political configurations *Checks* includes and can thus be included in the same models.<sup>11</sup> The mean score for the countries in my dataset is 3.3 with a standard deviation of 1.1. Tajikistan features the highest mean score (least free), with a 7.1, while Poland, the Czech Republic, Slovenia, Slovakia, Lithuania and Estonia exhibit the lowest mean scores (most free) with 1.0.

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<sup>10</sup> Natural-resource rich countries like Azerbaijan and Russia have even lower rule of law scores, but attract more FDI and enjoy higher growth rates.

<sup>11</sup> The variance inflation factors are approximately 1 for both *Checks* and Freedom House scores when included in the same regression models.

### *Party Orientation*

The conventional wisdom on property rights and contract enforcement suggests right-wing parties generally have a pro-business policy platform and will have greater respect for property rights and enforce contracts more equitably than left-wing parties. The business community's potential preference for politicians on the political Right suggests that increasing political constraints may improve the rule of law when leftist Presidents are in office, but undermine it when the Right occupies the executive. I include a variable for the president's partisan political orientation relative to the legislature in my models to test this prospect. The measure I use is from Keefer and Stasavage (2003) and is highly correlated with other measures of Left-Right policy preferences such as those from the Comparative Manifesto Project (0.87) or Benoit and Laver (2006), (0.92).<sup>12</sup> The mean for the countries in my dataset is 0.53 and the standard deviation is 0.69.

### *EU Accession*

I follow Gray (2009), Plümper et al. (2005), Svejnar (2002), Bevan and Estrin (2000), Claessens, Oks, and Polastri (1998), and Kaminski (2001) by modelling the economic negotiations during the EU accession process in my analysis of investment flows. Specifically, I include a control variable for the completion of negotiations surrounding each economic chapter of the *acquis* requirements in each EU country's accession talks.<sup>13</sup> The country receives a dummy variable score of "1" for the year in which talks close as well as for all subsequent years. All other country-year observations receive a score of "0" for the variable.

### *Log of GDP/Capita PPP*

I add a control variable for a country's economic productivity to my models of the rule of law. This variable accounts for the possibility that statistical connections between institutional/political configurations and the rule of law only reflect wealthy countries' functioning legal and economic systems, which are often coupled with democratic governments featuring both *de jure* and *de facto* checks and balances. Including this variable also tests an aspect of modernization theory and assess whether economic growth improves perceptions of the rule of law as modernization arguments would suggest (Lipset 1959; Przeworski 2000; Boix 2011) The variable I use to assess this argument is the base 10 logarithm of each state's per capita Gross Domestic Product (GDP) recorded for each year in the database. GDP per capita is adjusted for purchasing power parity (IMF 2015).

### *Natural Resource Revenue*

Recent research emphasises the negative influence of natural resource sales on corruption and the rule of law (Humphreys et al. 2007; Ross 1999; Mehlum et al. 2006; Busse and Groning 2013). The resource curse literature is extensive and suggests statistical models will lack explanatory power if they fail to account for a country's extractive industries. Among my countries, including a variable recording the log of a country's annual revenue from natural resource sales (per capita, Purchasing Power Parity [PPP]) allows me to control for a country's vulnerability to the resource curse and offers the opportunity to examine resource based arguments in another context (World Bank 2015).

### *Ethnic Fractionalisation*

Ethnic fractionalisation (EF) is theoretically important for explaining the rule of law in the postcommunist states of Eastern Europe and Eurasia. The regions' diverse historical mix of ethnic representation among each country may influence governance and explain variance in in-group/out-group legal rights as well. This would not be at all surprising considering ethnic conflicts within the region and previous scholarship on the role ethnicity plays in the politics of postcommunist states (Kymlicka and Opalski 2002; Petersen 2002; Brubaker 1996). Others have also

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<sup>12</sup> I recode the variable for ease of interpretation resulting in scores of "0", "1", or "2" to reflect the party of the chief executive/majority coalition/largest party in the majority coalition's ideological positions as Leftist, Centrist, or Right-wing.

<sup>13</sup> This is very similar to Gray's (2009) "seal of approval" variable. I check this against a dummy variable for the onset of negotiations, which is a statistically significant determinant of FDI in the year the negotiations began and the following year in annual, cross-sectional data.



found EF relevant for the rule of law and investment globally, which also motivates its inclusion here as a control variable in my models of capital flows (Alesina et al. 2003; Habyarimana et al. 2007; Easterly and Levine 1997; Touchton 2013).

#### *Model Specification and Estimation*

I use a random effects cross-sectional, time-series regression model to estimate the relationship between political constraints and rule of law perceptions in postcommunist states. I specify several models using a variety of estimation techniques as robustness checks, which are described below and included in the technical appendix. Table I below presents the results of estimation using the primary model of the rule of law.

[Insert Table I About Here]

#### **4. Results and Discussion**

My results demonstrate a strong positive, statistically significant relationship between checks on authority and rule of law perceptions. Specifically, a one-unit increase in the *Checks* variable is associated with a 0.05 increase in rule of law scores. The mean shift for *Checks* in my database is 3, with estimated increases in rule of law perceptions of 0.15 for a mean *Checks* increase, 0.39 for a one standard deviation *Checks* increase, and 0.58 for a two standard deviation *Checks* increase, all else being equal. A *Checks* increase of two standard deviations generates an estimated shift in rule of law scores approximately equivalent to moving from Bosnia-Herzegovina, with a 2012 rule of law score of -0.36, to Croatia, with a score of 0.24 in one year (all else being equal). Other assessments support the assertion of a tangible difference between the two countries - Croatia consistently ranks ahead of Bosnia-Herzegovina on corruption, state capacity, and other measures of government effectiveness (World Bank 2012).<sup>14</sup> This example is informative, but is still an approximation with all other variables held constant at their means; Bosnia-Herzegovina and Croatia vary on many dimensions other than their *Checks* scores. These estimated rule of law scores only suggest that increases in checks on authority generate meaningful changes in perceptions of the rule of law, on average.

My results support previous scholarship on credible commitment and the rule of law by reiterating the importance of effective checks and balances for credibility (North and Weingast 1989; Keefer and Stasavage 2003; Henisz 2001; Barro and Gordon 1983; Andrews and Montinola 2004). There is an alternate explanation for my results in postcommunist states that deserves mentioning: namely, the possibility that adding effective veto players to government actually *increases* the prospects for reform. Gehlbach and Malesky (2010) found adding veto players weakened special interests who preferred inefficient outcomes in Russia and Eastern Europe. In this case, adding veto players might promote an economically efficient outcome such as an impartial commitment to the rule of law. The reforms in Gehlbach and Malesky (2010) would have been relatively unlikely under my framework, because I argue that increasing the number of veto players increases the credibility of any policy once it becomes more politically costly to gain the votes necessary to deviate from that policy. However, if at least some kinds of policy change are relatively easy with more veto players under Gehlbach and Malesky's framework, then a new group of reformers could potentially roll back these reforms in the future based on the desire to weaken special interests (which might include the private sector in this hypothetical scenario), and return private property to public ownership or tax it at very high rates to pay for public services. Thus, the Gehlbach and Malesky (2010) framework might explain reforms in the presence of a greater number of veto players, but it follows that these reforms might be easier to change than under my framework and thus, less credible. I do not have a direct, competitive test of these hypotheses, but the bulk of the existing literature argues that polarisation makes policies more difficult to change, rather than easier (Cheibub 2002; Linz 1994; Ames 2009; Weyland 1999; Frye 2010). My empirical results provide more evidence for this view, particularly because the *Checks* variable is still significant once I include a variable for EU accession negotiations. This may be due in part to the timing of new veto players being added to many countries' political systems. This variable likely captures many of the reforms associated with adding veto players to the region's governments as a run-up to EU accession. The fact that the *Checks* variable is still significant and negative then suggests that the presence of additional veto players helps to maintain the credibility of the reforms once they are in place.

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<sup>14</sup> The mean standard error for the World Bank's rule of law scores is 0.135.

Despite corresponding to several general studies on constrained government and investment, my results appear to run counter to some scholarship maligning political polarisation in Eastern Europe, such as Frye (2002, 2010), and (Ceka 2012). Yet, my research uses different dependent variables over a different timeframe than those in Frye (2010) while remaining largely in line with Frye's premise that political polarisation can make reforms difficult. In the present study, effective constraints on government make it difficult to renege on commitments to the rule of law, whereas it is the same level of polarisation that makes passing necessary reforms difficult for Frye (2010). It is still entirely possible for deadlock to undermine governments' abilities to generate necessary reforms or take rapid action to resolve crises. However, for my dataset at least, effective constraints on policymaking carry a silver lining of improving perceived commitments to the rule of law.

I also find support for other important arguments on democracy and the rule of law. Freedom House ratings are statistically connected to rule of law perceptions in my model, which accords with the theoretical and empirical arguments in Diamond (1996, 1999), O' Donnell (2001, 2004), Olken (2008), Keefer and Khemani (2005), Maravall and Przeworski (2003), Zakaria (2007), Gehlbach and Keefer (2011) and Montinola et al. (1995). In my data, rule of law perceptions decrease as Freedom House scores increase (reflecting states becoming "less free"). These results generally suggest that improvements in democracy lead to improved rule of law perceptions, though some states may still be able to make credible commitments to the property rights and contract enforcement while bypassing democracy. Freedom House scores do not have as strong an estimated relationship with the rule of law as *Checks* scores, but are still statistically significant determinants in my model.<sup>15</sup> Furthermore, my results suggest investors, country-experts and risk analysts rate the rule of law higher when politicians on the political Right hold the executive branch of government: moving from a Left to Right-wing President increases the rule of law by an estimated 0.08 points, holding all other variables constant at their means.

My results suggest increases in economic productivity improve rule of law perceptions. I estimate a country starting from the mean regional GDP/capita of \$7,515 and growing at a 3% rate over a decade could be expected to increase their rule of law score by 1.65, all else being equal. This large estimated increase would be approximately equal to a rule of law perceptions shift from Belarus (-1.04) to Slovakia (0.63). Increasing economic productivity thus provides the greatest opportunities for raising rule of law perceptions in my dataset. The relationship between economic productivity and rule of law perceptions also provides support for some aspects of modernisation theory, as in Lipset (1959), and for the relationship between development and democracy (Przeworski 2000; Boix 2011). Sustained increases in economic productivity have not been common in postcommunist states, but my results suggest rule of law perceptions would improve dramatically if states' economies were to grow consistently and in real terms. Yet this estimated improvement in the rule of law does not hold across all economic areas. As anticipated, I find increases in natural resource revenue result in decreases in rule of law perceptions.

Finally, my results demonstrate the importance of external credibility through the EU's accession process for investment decisions. Completing economic policy negotiations as a step toward joining the EU has a positive, statistically significant relationship with the rule of law and investment in my models. The coefficient on this variable is large, indicating a strong estimated influence for perceived rule of law scores- greater than any other individual variable. These results show the power of the EU to influence perceptions of governance and provide added support to arguments found in Gray (2009), Gray and Hicks (2014), Svejnar (2002), Plümper et al. (2005), Bevan and Estrin (2000), Claessens, Oks, and Polastri (1998), and Kaminski (2001). Those evaluating the rule of law may not deem credible postcommunist countries' institutional reforms- especially in the short term. Instead, progressing satisfactorily toward EU accession is a strong external signal of a country's credibility and carries considerable weight in my model of the rule of law.

## 5. Robustness Checks

I use both technical and theoretical robustness checks to evaluate the relationship between checks on authority and the rule of law. First, I add a lagged dependent variable to my random effects model (presented in Table I (a) in the technical appendix). Then, I estimate an Arellano-Bond dynamic panel model (1988, 1991) for perceived rule of

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<sup>15</sup> Annual changes in Freedom House scores among the countries in my dataset are small: the mean is 0.27 per year, with a standard deviation (SD) of 0.09. Estimates of rule of law perceptions based on my model are thus lower for a two-SD improvement in the Freedom House score than for a mean shift for the *Checks* variable.

law to account for the potentially endogenous relationship between the rule of law, the *Checks* variable, and GDP per capita (presented in Table I (b)).<sup>16</sup> Both *Checks* and GDP per capita retain statistically significant connections with rule of law perceptions in these new models, though the magnitude of the relationships are smaller.

My next robustness check is theoretical and perhaps more important. As a concept, the rule of law could be considered conceptually similar to checks on authority, which is my central explanatory variable. In this sense, constrained government may simply reflect the rule of law because constraining government renders arbitrary, potentially illegal, action difficult for politicians. Political constraints do not act directly on the rule of law in this conceptual framework. Rather, constrained government *is* the rule of law. Statistical connections between *Checks* and rule of law perceptions would therefore not be surprising. However, my interest in the rule of law lies in its relationship to investment and economic growth. Checks on authority need to influence investment decisions, not just rule of law perceptions, for the policy implications of constrained government to be useful in practice- whether *Checks* are distinct from the rule of law or not. Constraining government and improving rule of law perceptions would produce little economic payoff if there were no connection between political constraints and investment. Failure to find a relationship between political constraints and investment would also suggest a gulf between the “actual” rule of law - which could still be very important for investment - and perceived rule of law, which might not be as relevant. I address this concern by estimating a new, random effects model of Foreign Direct Investment (FDI) in postcommunist states. Table II presents the results of estimation using FDI as a dependent variable.<sup>17</sup>

[Insert Table II about here]

The results in Table II are similar to those in Table I: checks on authority increase FDI, as do higher economic growth rates, economic productivity, completion of EU economic negotiations during the accession process, natural resources, trade openness, and political rights. In this case, higher natural resource revenue increases investment because it reflects the presence of natural resources that are desirable to foreign oil, gas, mining and other firms in the extractive industries.<sup>18</sup> Party orientation is not a significant determinant of FDI in this model, which highlights a difference between rule of law perceptions, which are connected to partisan characteristics, and FDI flows, which are not in this data. Instead, my results suggest investors are much more concerned with democratic checks and balances internally, and external evaluations of these institutions than with political parties’ reputations.

## 6. Conclusion

Political institutions and the policy preferences of elected officials are some of the defining characteristics of politics. Using these aspects of politics to model the rule of law and investment solidifies connections between institutions and credibility. The results of my analysis show how effective checks on authority influence rule of law perceptions. These same constraints may still undermine necessary reforms in other areas, but my research suggests that, at a minimum, institutional and practical checks improve policy credibility, rule of law perceptions and increase foreign direct investment.

My findings carry direct implications for scholars and practitioners. First, my results demonstrate the importance of institutional structures and practical incentives for politicians to oppose, rather than appease one another if their countries are to improve policy credibility and rule of law perceptions. Similarly, increasing the probability that veto

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<sup>16</sup> Rule of law scores for most countries in the dataset change quite a bit 1996-2012. Large shifts in rule of law scores correspond to democratic consolidation in many countries in my dataset over this timeframe, as is the case with other studies of the rule of law in newly democratic countries, such as those in Touchton (2014). Despite large long-term shifts for most countries, annual changes in rule of law scores are rarely large. Some might argue that these small annual changes make the dependent variable relatively time-invariant. Arellano-Bond estimators are also appropriate under these circumstances and therefore provide added assurance that my results are not due to the slow-moving dependent variable in my models.

<sup>17</sup> These data come from the UN Statistical Commission’s National Accounts Database. I use the base 10 log of FDI per capita (PPP) in my models, giving a mean of 2.82 and SD of 1.17. I also add new control variables reflecting existing research on the determinants of FDI. I describe these variables in the Technical Appendix.

<sup>18</sup> The technical appendix contains a description of the new covariates along with several additional models to account for endogenous regressors, as with the perceived rule of law variable. I present these models in Tables II (a-b) in the appendix.

players will exercise their vetoes reassures foreign investors and induces them to commit FDI to a country. The caveat here is that institutional measures to improve property rights and contract enforcement may fail to convince sceptical investors unless these institutions emerge within a competitive, ideologically plural context. Furthermore, external actors' assessments are crucial for credibility in the early days of any reform process. Ultimately, politicians wielding institutional veto power improve rule of law perceptions and attract foreign investment because they impart credibility to a country's promises to protect investors' rights. These veto players will then defend the rule of law not just because they can, but because they benefit from doing so.

Table I  
Random Effects Estimates of Political Constraints and the Rule of Law in Eastern Europe, 1996-2012

Variable	Coefficient/(SE)
Checks on Authority	0.05* (0.02)
Per Capita GDP, PPP(logged)	0.03* (0.01)
Party Orientation	0.08* (0.04)
Ethnic Fractionalization	-1.55* (0.51)
EU Accession	0.28** (0.10)
Freedom House Score	-0.08* (0.04)
Natural Resource Revenue	-0.02* (0.008)
Constant	0.37 (0.45)
N	24
Observations	182
Wald Chi <sup>2</sup>	28.84
Prob> Chi <sup>2</sup>	0.00
R <sup>2</sup> (overall)	0.49

Standard Errors are Clustered on the Country: \*p < .05; \*\*p < .01

Table II  
Random Effects Estimates of Political Constraints and Foreign Direct Investment (Per Capita, logged) in Eastern Europe, 1990-2013

Variable	Coefficient/(SE)
Checks on Authority	0.22** (0.08)
Annual Economic Growth Rate	0.07** (0.02)
Freedom House Political Rights Score	-0.61** (0.11)
Per Capita GDP (PPP, logged)	0.05* (0.02)
Party Orientation	0.06 (0.14)
Natural Resource Revenue	1.99* (0.85)
EU Accession	0.45* (0.21)
Leadership Instability	-0.10 (0.30)
Trade Openness	0.02** (0.0001)
Constant	22.09** (2.80)
N	25
Observations	228
Wald Chi <sup>2</sup>	39.40
Prob> Chi <sup>2</sup>	0.00
R <sup>2</sup> (overall)	0.58

Standard Errors are Clustered on the Country: \*p < .05; \*\*p < .01



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### Technical Appendix for Who Commits to the Rule of Law? Constrained Government and Foreign Direct Investment in Post-Communist States

Table I (a)

Random Effects Estimates of Political Constraints and the Rule of Law in Postcommunist States, 1996-2012. This model has a lagged dependent variable.

Variable	Coefficient/(SE)
Lagged Rule of Law (L1)	0.71** (0.09)
Checks on Authority	0.04** (0.01)
Per Capita GDP, PPP(logged)	0.60** (0.19)
Freedom House Political Rights Score	-0.03* (0.01)
Party Orientation	-0.05 (0.04)
Ethnic Fractionalization	-0.23** (0.06)
EU	0.49** (0.15)
Natural Resource Revenue	-0.12* (0.06)
Constant	-1.46 (1.27)
Observations	182
Wald Chi <sup>2</sup>	32.59
Prob> Chi <sup>2</sup>	0.00
R <sup>2</sup>	0.57

\*p < .05; \*\*p < .01

I use Arellano-Bond dynamic panel estimation to evaluate connections between political constraints on elected officials and the rule of law (Arellano and Bond 1988, 1991). I choose the Arellano-Bond technique to resolve the potential endogeneity problem associated with estimating the impact of political constraints on the rule of law: namely, countries' previous levels of commitment to the rule of law may influence the likelihood of effectively constraining politicians through institutional reform as well as the threat of defeating sitting politicians through elections at a later date. For example, incumbents in countries with low rule of law may be predisposed to prevent challengers from winning elections and gaining veto power over the policy-making process in the first place. Any

results attributing rule of law levels to the relative constraints on elected officials might therefore only reflect officials' general predispositions toward or against the rule of law as opposed to any direct effect of political constraints themselves. The Arellano-Bond technique accounts for this possibility by creating a series of instrumental variables using lagged values of endogenous independent variables. I use these variables in the regression model along with a series of diagnostics following estimation to analyse the extent to which endogeneity is present among my variables and whether relationships between variables remain once I account for this possibility (Arellano and Bond 1988, 1991; Roodman 2009, 2013). Arellano-Bond estimators are also proposed for panels like mine with a relatively short time component compared to the cross-sectional observations. Moreover, some variables in my dataset are slow to change over time motivating my use of the Arellano-Bond technique (Holtz-Eakin et al. (1988); Arellano and Bond (1988, 1991); Roodman (2009, 2013)). The following table presents the results of estimation using this strategy.

Holtz-Eakin, Douglas, Whitney Newey and Harvey Rosen. (1988). "Estimating vector autoregressions with panel data." *Econometrica* 56: 1371 – 1395.

Roodman, David. (2013). "Xtabond2: Stata module to extend xtabond dynamic panel data estimator." *STATA: Statistical Software Components*.

\_\_\_\_\_. (2009). "A note on the theme of too many instruments." *Oxford Bulletin of Economics and Statistics*, 71(1), 135-158.

Table I (b)  
Arellano-Bond Dynamic Panel Estimates of Political Constraints and the Rule of Law in Postcommunist States, 1996-2012.

Variable	Coefficient/(SE)
Lagged Rule of Law (L1)	0.64** (0.01)
Checks on Authority	0.06* (0.02)
Per Capita GDP, PPP(logged)	0.65** (0.23)
Freedom House Political Rights Score	-0.08* (0.04)
Party Orientation	-0.05* (0.02)
Ethnic Fractionalization	-0.29** (0.05)
EU	0.47** (0.10)
Natural Resource Revenue	-0.14* (0.07)
Constant	-1.28 (1.55)
Number of Groups	24
Observations	192
Mean Obs/Group	13.20
Number of Instruments	28
F	135.81
Prob>F	0.00

\*p < .05; \*\*p < .01

Table II presents the results of estimation using a new dependent variable, foreign direct investment. The following section describes two new independent variables I include in this model and subsequent robustness checks.

#### Description of the “Leadership Stability” Variable

The relative stability of leaders may impact investment - both positively and negatively depending on the circumstances. For example, Vladimir Putin’s long-term occupation of the Russian presidency may have helped generate long-term commitments to property rights and contract enforcement outside of democratic institutions and checks and balances. Of course, leadership stability may reflect underlying economic stability. In this sense, the variable is a proxy for a welcoming, profitable investment climate in several senses and will likely influence FDI. For

example, investors would have been very risk-acceptant indeed to begin a new venture in Ukraine during the Orange Revolution or the recent conflict with Russia. Both timeframes feature leadership turnover and major policy swings, which I control for in general by including a measure of the annual turnover of political leaders over the course of the timeframe under investigation. The data comes from the World Bank's Database of Political Institutions (Beck, et al., 2001) and records the percentage of veto players who leave their offices in a given year.

### **Description of the "Trade Openness" Variable**

I also include a measure of trade openness to distinguish the ways governments commit to multinational corporations (MNCs) from the ways public officials interact with domestic, potentially low-level investors. It would be a mistake to assume countries relatively open to foreign MNCs would also protect their own citizens' investments. Some countries, like Poland, encourage foreign firms to produce goods for export markets using local labour, but also encourage domestic firms to compete in the same markets. However, many other countries around the region, such as Turkmenistan, are eager to attract foreign direct investment to build factories for exports, but have very high barriers to entry for domestic entrepreneurs interested in exporting (Djankov 2009). These countries likely provide much lower property rights protections for poorer domestic producers than for wealthy, foreign MNCs. In effect, these countries have auctioned off monopoly status for Export-Oriented Industrialization to foreign firms that have the resources to purchase it. The government has not necessarily made a credible commitment to these firms, but it has convinced them that the rewards from monopoly status outweigh the risks of state expropriation. I therefore control for the level of trade openness so as not to conflate commitments made to MNCs with commitments made to domestic entrepreneurs. The variable I use comes from the United Nations Conference on Trade and Development Statistics Division (2013) and shows the average value of imports plus exports as a percentage of nominal GDP.

Djankov, S. (2009). The regulation of entry: A survey. *The World Bank Research Observer*, 24(2), 183-203.

United Nations Statistical Commission. 2014. National Accounts Main Aggregates Database. Available Online: <https://unstats.un.org/unsd/snaama/Introduction.as>

Table II (a)  
Random Effects Estimates of Political Constraints and FDI in Post-Communist States, 1990-2013. This model includes a lagged dependent variable.

Variable	Coefficient/(SE)
Checks on Authority	0.12** (0.05)
Lagged FDI	0.56** (0.05)
Annual Growth Rate	0.003 (0.01)
GDP per capita (PPP, logged)	-0.18** (0.05)
Freedom House Political Rights Score	-0.21* (0.06)
Party Orientation	0.05 (0.09)
Leadership Instability	-0.11 (0.18)
Trade Openness	0.04* (0.02)
Natural Resource Revenue	0.31** (0.07)
Constant	4.09** (1.21)
N	24
Observations	224
Wald Chi <sup>2</sup>	295.25
Prob> Chi <sup>2</sup>	0.00
R <sup>2</sup> (overall)	0.71

Standard Errors are Robust to Autocorrelation and Heteroscedasticity: \*p < .05; \*\*p < .01



Table II (b)  
Arellano-Bond Dynamic Panel Estimates of Political Constraints and FDI, 1996-2012.

Variable	Coefficient/(SE)
Lagged FDI (L1)	0.27** (0.07)
Checks on Authority	0.14** (0.05)
Annual Economic Growth	0.01 (0.01)
Freedom House Score	-0.60** (0.12)
Party Orientation	-0.09 (0.09)
Ethnic Fractionalization	-0.15* (0.07)
Leadership Instability	-0.12 (0.14)
Trade Openness	0.009 (0.006)
Natural Resource Revenue	0.19** (0.04)
EU	-0.08 (0.34)
Constant	22.88** (7.86)
Number of Groups	24
Observations	218
Mean Obs/Group	9.1
Number of Instruments	28
Wald Chi <sup>2</sup>	194.96
Prob>Chi <sup>2</sup>	0.00

\*p < .05; \*\*p < .01

**TABLE A1. Descriptive Statistics**

<b>Variable</b>	<b>Mean</b>	<b>Std. Dev.</b>
Rule of Law	-0.24	0.75
Per Capita FDI (PPP, logged)	7.72	9.60
Checks	4.33	2.14
Freedom House Score	4.12	1.94
GDP Per Capita (PPP, logged)	17.68	7.67
Party Orientation	0.56	0.84
Leadership Instability	0.07	0.28
Trade Openness	0.61	0.27
Ethnolinguistic Fractionalization	0.29	0.19
Natural Resource Revenue	0.16	0.37
EU	0.09	0.29