Constitutions and Credible Commitments: Predicting Capital Market Responses to Order and Law

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Constitutions and Commitment: A Modern Day Investment Scheme?

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Credible Commitment Hypothesis

North and Weingast (1989):

The Glorious Revolution of 1688 in England allowed Parliament to make credible commitments to taxpayers as to how tax revenues would be spent and to investors as to when debt would be repaid.

Data

Data Sources

1. World Bank Worldwide Development Indicators (WDI)
2. World Bank Worldwide Governance Indicators (WGI)
3. UN Conference on Trade & Development Net FDI Inflow
4. CIA World Factbook

Summary of Data

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<td>CIA World Factbook</td>
<td>266</td>
<td>2000-2010</td>
<td>59</td>
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Dependent Variable

Net Foreign Direct Investment (FDI) inflow

Indicator Correlations

Findings

Bivariate Correlation

\[ \beta = 0.543, \quad se = 0.025, \quad p = 0.000, \quad Adj. R^2 = 0.22 \]

Findings, cont’d

The causal analysis suggests an anti-effect:

Categorizing countries by WGI Rule of Law score reveals an important second-order effect:

PREDICTABILITY

Stable: WGI score variation < 0.2
Mixed: WGI score variation 0.25 < x < 0.91 and changes signs
Unstable: WGI score variation > 1

The WGI Rule of Law score in Mixed countries was lower on average than in Unstable countries, yet Mixed countries netted statistically significantly more FDI each year.

Methodology

All of the data is observational and much of the analysis is descriptive, though I conduct significance tests on mean changes over time:

\[ X_{pre} = \% \Delta FDI_{[t-1]-[t-2]} / (t-2) \]
\[ X = \% \Delta FDI_{[t-1]-[t-1]} / (t-1) \]
\[ X_{post} = \% \Delta FDI_{[t+1]-t} / t \]

with dummy variables where ROL represents the WGI Rule of Law score and

\[ ROL_{pre} = 1 \text{ if } 0 < \text{ WGI score } < 0.2 \]
\[ ROL_{post} = 0 \text{ otherwise} \]

Hypothesis

Investors may prefer predictably weak rule of law countries over countries with higher average scores, but with more variability.

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