

## ABSTRACT

Title of Dissertation: FLIGHT OR FLIGHT? DEMOCRATIC  
CONSOLIDATION AND CAPITAL FLIGHT  
IN LATIN AMERICA

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Since 1980, developing countries lost US\$16.3 trillion dollars as a result of capital flight (Kar 2016) representing a major threat to international development efforts.

This dissertation investigates why some democracies in the developing world experience much more capital flight than others. Using the experiences of Latin America democracies, the fundamental reasons for flight lie in the failure of these countries to consolidate their democracies. As a result of their failure to consolidate, they are highly vulnerable to popular mobilization by excluded groups demanding redistribution, which has the effect of increasing perceptions of political risk among asset holders and incurring flight.

In an area of the world where wealth, income, and power is chronically unequal, my central argument posits a causal sequence that begins with mass mobilization by social movements directed towards new redistributive public policies and in opposition to pro-market democratically elected governments. Typically, as mass

mobilization strengthens, Leftist parties embrace the aims of popular movements whose electoral support subsequently increases to levels that allow them to form governments committed to redistribution. Under these conditions, as mobilization and support for the Left strengthened, asset holders' perceptions of risk increase significantly, leading to capital flight.

Using a mixed methods research design combining quantitative analysis with qualitative case studies I present empirical evidence to support my argument. For the quantitative analysis, regression analysis was applied to a cross-sectional time series dataset for 18 democracies. My results show that when Leftist parties actually form governments - thereby sealing the process of democratic inclusion and triggering more capital flight - the magnitude of capital flight is often mitigated a) if a Leftist party forming a government had been established for some time, in which case it typically moderated its redistributive policies; and b) by the continued electoral strength of pro-capital parties able to defend the interests of asset holders and effectively oppose the Leftist government. I reinforced these findings with two case studies: one, a within-case longitudinal study of the impact of class mobilization on capital flight in El Salvador from 1990 to 2009 when the Left finally won power, and the other a comparative study of two Leftist governments in power, in El Salvador from 2009 onwards and Bolivia after 2006.

FIGHT OR FLIGHT? DEMOCRATIC CONSOLIDATION AND CAPITAL  
FLIGHT IN LATIN AMERICA

by

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## Acknowledgements

My interest in the interactions between domestic politics and capital markets began while I was living in Argentina. Then and later while I was on a study abroad program in Washington DC, I witnessed the collapse of Lehman Brothers in the September 2008 financial crisis. As a result of these experiences, I became fascinated with questions revolving around the modern state and how it could weather the effects of globalization. It has been a fascinating journey from those first musings to this finished work.

I owe debts of gratitude to the many people who have helped me along this rewarding road. First of all, thank you to my dissertation committee, Virginia Haufler, Todd Allee, Joel Simmons, John McClauley, and Dr I. M. Destler who kindly offered to be my Dean's representative. My chair Virginia Haufler, with whom I had the pleasure of working with at Global Communities, has provided me with excellent advice and feedback along with the many stimulating discussions we have had over my time in graduate school.

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## List of Abbreviations

ADN	<i>Acción Democrática Nacionalista</i> (Nationalist Democratic Action), Bolivia
AMENA	<i>Asociación de Médicos Nacionales</i> (Public Health Care Doctors' Association), El Salvador
ANEP	<i>Asociación Nacional de La Empresa Privada</i> (National Association of Private Enterprise), El Salvador
ANTMSPAS	<i>Asociación Nacional de Trabajadores del Ministerio de Salud Pública y Asistencia Social</i> (National Association of Public Health Workers), El Salvador
ARENA	<i>Alianza Republicana Nacionalista</i> (Nationalist Republican Alliance, NRA), El Salvador
ASP	<i>Asamblea por la Soberanía de los Pueblos</i> (Assembly for the Sovereignty of the Peoples), Bolivia
BOP	Balance of payments
BPS	<i>Bloque Popular Social</i> (Popular Social Bloc), El Salvador
CAFTA	Central American Free Trade Agreement
CES	<i>Consejo Económico y Social de El Salvador</i> (Social and Economic Council)
CNTS	Cross-National Time-Series database
COHA	Council on Hemispheric Affairs
DPI	Database of Political Institutions
ECLAC	Economic Commission for Latin America and the Caribbean
FDI	Foreign Direct Investment
FMLN	<i>Frente Farabundo Martí para la Liberación Nacional</i> (Farabundo Martí National Liberation Front), El Salvador
FSC	<i>Foro de Sociedad Civil</i> (Civil Society Forum), El Salvador
FSTMB	<i>La Federación Sindical de Trabajadores Mineros de Bolivia</i> (Union Federation for Bolivian Mining Workers), Bolivia

FUSADES	<i>Fundación Salvadoreña para el Desarrollo Económico y Social</i> (Salvadoran Social and Economic Development Foundation), El Salvador
GANAN	<i>Gran Alianza por la Unidad Nacional</i> (Grand Alliance for National Unity), El Salvador
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
GFI	Global Financial Integrity
HMM	Hot Money Method
ICRG	International Country Risk Guide
IDB	Inter-American Development Bank
IMF	International Monetary Fund
INRA	<i>Instituto Nacional de Reforma Agraria</i> (National Agrarian Reform Institute), Bolivia
IPSP	<i>Instrumento Político por la Soberanía de los Pueblos</i> (Political Instrument for the Sovereignty of the Peoples), El Salvador
ISSS	<i>Instituto Salvadoreño del Seguro Social</i> (Salvadoran Social Security Institute), El Salvador
LAPOP	Latin American Public Opinion Project
MAS-IPSP	<i>Movimiento al Socialismo–Instrumento Político por la Soberanía de los Pueblos</i> (Political Instrument for the Sovereignty of the Peoples), Bolivia
MIR	<i>Movimiento de Izquierda Revolucionaria</i> (Leftist Revolutionary Movement), Bolivia
MNR	<i>Movimiento Nacionalista Revolucionario</i> (Revolutionary Nationalist Movement), Bolivia
NEO	Net errors and omissions
NGO	Non-governmental organization
ODA	Official Development Assistance
PCSE	Panel-Corrected Standard Errors
PELA	Parliamentary Elites in Latin America database

PRT	Power Resource Theory
PODEMOS	<i>Poder Democrático y Social</i> (Social Democratic Power), Bolivia
PRS	Political Risk Services
SIMETRISSS	<i>Sindicato Medico de Trabajadores del Instituto Salvadoreño del Seguro Social</i> (Union of Medical Workers of the Salvadoran Social Security Institute), El Salvador
STISSS	<i>Sindicato de Trabajadores del Instituto Salvadoreño del Seguro Social</i> (Union of Workers of the Salvadoran Social Security Institute), El Salvador
UNDP	United National Development Program
UNESCO	United Nations Educational, Scientific and Cultural Organization
WBR	World Bank Residual method
WDI	World Development Indicators
WEF	World Economic Forum
WGI	World Governance Indicators
WSJ	Wall Street Journal

## Chapter 1: Introduction

### Why do some countries experience more capital flight than others?

*The proprietor of stock is necessarily a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease.*

Adam Smith, *An Inquiry Into The Nature and Causes of the Wealth Of Nations*. Book V, Chapter II. Edinburgh, United Kingdom: Thomas Nelson and Peter Brown, 1827: 358.

During Argentina's Great Depression of 1998-2002, the country's government defaulted on its foreign debt and the economy shrank by 28 per cent. The main cause of this crisis was massive capital flight. In the space of just five months, Argentines withdrew over \$15 billion from their bank accounts, including \$1.3 billion in a single day. It is estimated that between December 1, 2001 and May 31, 2002 up to \$3.4 billion left the country (Auguste, Dominguez, Kamil and Tesar 2002). The crisis led to riots in all the country's major cities and the Argentine president Fernando de la Rúa was forced to leave the presidential palace by helicopter. By 2002, 57 per cent of this country's once wealthy population was living below the poverty line with 28 per cent living in extreme poverty.

The Argentina example dramatically shows how capital flight can devastate a country's economy. It is particularly damaging for developing countries attempting to escape poverty.

Global Financial Integrity (GFI), the Centre for Applied Research at the Norwegian School of

Economics and a team of global experts released a study in late 2016 showing that since 1980 developing countries lost US\$16.3 trillion dollars through broad leakages in balance of payments, trade misinvoicing, and recorded financial transfers (GFI 2016). Capital flight is now estimated to be in the region of \$991.2 billion a year (GFI 2012) and growing (Figure 1.1) and affects all regions of the world (Figure 1.2).

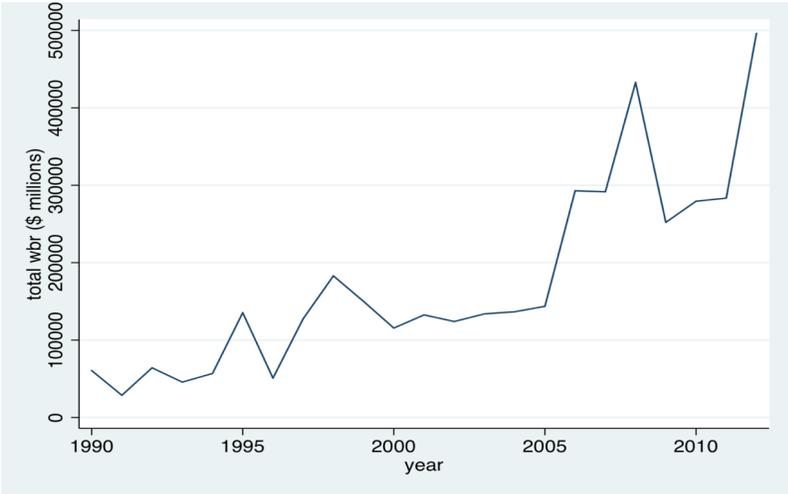


Figure 1.1. Total capital flight from developing countries, 1990-2012 (World Bank Residual Measure, WBR)

Data derived from the World Bank’s Development Indicators (WDI), UNCTAD and the IMF.

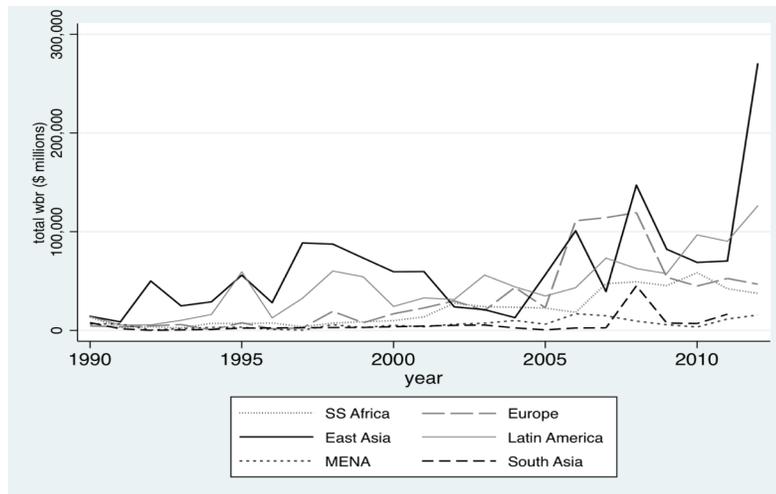


Figure 1.2. Capital flight by world region, 1990-2012 (WBR as per cent of GDP)

Data derived from the World Bank's Development Indicators (WDI), UNCTAD and the IMF.

The magnitude of such outflows imposes huge social costs on developing countries, undermines their economic development efforts, and condemns them to permanent indebtedness, low growth and poverty. International aid agencies' countervailing efforts to alleviate poverty and sustain economic growth seem depressingly Sisyphean in comparison. Kar and Cartwright-Smith (2009) show, for example, how capital flight dwarfs foreign aid and debt relief by as much as 10 to 1. In certain cases, outflows have reached such levels that poorer countries have effectively become net creditors to the developed world subsidizing wealthy countries (Boyce and Ndikumana 2000; Ndikumana, Boyce and Ndiaye 2014). This phenomenon is commonly referred to as the "Lucas paradox" (1990: 92-96) the paradox being that, rather than capital flowing from capital-rich industrialized countries to the capital-poor developing nations as conventional market economic theory would predict, the opposite has occurred with capital flowing out of poorer countries. If developing countries are to achieve long-term sustainable growth and development, they clearly need to curtail capital flight and reverse this paradox.

How should we explain patterns of capital flight such as these?

Most of the economic literature relies on conventional utility maximization models to argue that flight is fundamentally determined by macroeconomic conditions both inside and outside a specific country: when holders of capital in a given country perceive increased risks and/or costs, they export their capital in search of more profitable returns. In short, they make “rational” adjustments to the geographical locations of their portfolio holdings. A second kind of explanation argues that capital flight is essentially “dirty money” derived from criminal, corrupt and commercial activity and typically involves illicit unrecorded capital flows and essentially represents attempts by criminals to hide their ill-gotten gains by exporting them.

The focus of this dissertation is on a different kind of explanation, one of interest to political scientists in its focus on political risk. Political risk refers to political decisions, conditions and events that significantly impact corporate profitability or the anticipated value of a given economic action or set of assets. This occurs when significant political change occurs, such as a change in the ideological color of government, a major shift in government policy, or the onset of serious political instability, the extent of political risk increases. Now, while numerous studies have examined the impact of political risk on capital flight and found the condition to be a major driver of capital flight literature has little to say regarding the causes of this risk.

A parallel literature on capital *inflows* argues that a so-called “democratic premium” exists whereby democracies are better able to manage political risk and so enjoy higher levels of investment than do non-democracies. This literature emphasizes the importance of democratic institutions, regularized democratic political processes, and institutionalism in creating political

stability. Without the development of regularized institutions and processes and the rule of law associated with democracy, it is argued, political risk increases and with it the inclination by asset holders to export their capital.

The democratic premium argument, however, pays scant attention to the extent to the *qualitative* nature of democracies, which determines how politics plays out, which political forces have the strongest impact on state conduct and policies, and how effective democratic institutions within them (including political parties) are in serving the interests of their populations – all of which influence perceptions of political stability and risk, including those of investors, which may precipitate capital flight.

Specifically, the democratic premium thesis assumes its rationale applies to *all* democratic regimes rather than those that have been *consolidated*. Consolidated democracies are those in which democratic institutions penetrate deeply throughout society with the majority of the population incorporated into the political system. Notwithstanding the democratization process that spread through Latin America from the 1990s onwards, and regimes created exhibiting the procedural elements of democracy, most were yet to become consolidated. Colonial legacies that had left deeply entrenched inequalities, the elite-pacted character of their democratic transitions, and socio-economic structural changes that had significantly weakened organized labor, Leftist parties and popular sectors left “shallow” democracies in which significant sectors of the population remained excluded. Democratic consolidation requires that those sectors of the population hitherto excluded be recognized and accepted within the existing democratic system. In this important sense, democratic consolidation has implications for political risk because it

entails a major reconfiguration of power relations in terms of which groups in society have access to the state. Not only does the exclusion of popular sectors in societies where extreme inequalities are endemic create the potential for political risk, and the proclivity for high levels of capital flight so does the restructuring of power relations in the process of democratic consolidation – for the very important reason that existing elites will attempt to protect their assets by removing their them from the country.

The political dynamics of exclusion and democratic consolidation suggest the need for an alternative explanation for patterns of capital flight that challenges the assumed uniform impact of democracy on political risk and the proclivity for capital flight across democracies. Rather than seeing political risk and the level of capital flight as being dependent on the creation of democratic institutions *per se*, it sees the truncated process of democratic consolidation within developing countries as being a much more important driver. When these new and unconsolidated democracies experience extensive popular mobilization, elect Leftist governments and successfully overcome political opposition from capital and its party political allies, they *will likely experience greater political risk* and therefore capital flight to a much greater extent than in those that do not.

The political mobilization of disadvantaged groups is central to this alternative perspective. When such groups become political mobilized and protest against the actions and policies of Rightist pro-market governments – and are able to form powerful coalitions, popular pressure for greater redistribution from the state increases. This in turn leads to increased electoral support for Leftist political parties promising redistributive policies raising the likelihood that they will win

power. Given that such policies are usually supported by increased taxation, asset holders will perceive threats and costs to their capital and remove their funds abroad. However, when such mobilization occurs, whether perceptions of political risk significantly increase and lead to capital flight will likely depend on the newness of the Leftist party that can form a government, and the extent to which it has been institutionalized into the democratic system and the strength of a market-oriented Rightist party.

Established Leftist parties that form governments have undergone a process of institutionalization and in consequence learned to moderate their policies in order to win elections – and are less likely to trigger significant levels of capital flight - whereas newly formed Leftist parties are less likely to have been subjected to such moderating influences and thus perceived as a greater threat to asset holders. The degree to which popular mobilization and rising support for Leftist parties triggers capital flight will also be tempered by the presence of strongly supported Right-leaning political parties able to mobilize popular support and block popular demands for greater redistribution, even when proposed by Leftist governments. Under both these conditions – Leftist party institutionalization and strong Rightist opposition - the threat to asset values will be considerably reduced, and so capital flight levels are likely to be negligible or even non-existent.

This theory is tested in the dissertation by investigating the political risk conditions that account for patterns of capital flight in one particular region. In focusing on one region, the research purposely eschews a global approach that would necessitate losing contextual knowledge and undermine requirements for external validity arising from concerns about generality.

Whereas most of the recent literature on capital flight that has adopted a regional perspective has focused exclusively on Sub-Saharan Africa (Ajayi and Ndikumana 2015; Ndikumana, Boyce and Ndiaye 2015) - which is hardly surprising given the magnitude of capital flight from that continent and the comparatively higher burden on the domestic investment needs of its developing states (Henry 2012) - this research focuses on Latin America. Not only is capital flight a major problem in Latin America but also the problem is growing. Moreover, whereas capital flight from Sub-Saharan Africa has been typically driven by public embezzlement and corruption rooted in these countries' heavy reliance on natural resources exports, the Latin American economies are characterized by higher per capita income and greater economic diversification at the same time that society and politics are bound to a far great extent by a given set of rules implied by their particular constitutional contexts. As a consequence of democratization, most politicians in this region perceive only electoral paths to executive and legislative offices. They also see election to these offices as a means of instituting political change more than a lucrative source of illicit remuneration.

Latin American countries' shared history and culture permits holding a number of variables constant while focusing on variables of interest. With the exception of Cuba, all Latin American countries are democratic, albeit often of a shallow nature. One of the most distinctive features of Latin American politics and government is that all countries have presidential systems, constitutional frameworks that are inherently less able than parliamentary systems to engender political compromise among elites in forming a government. Regardless of whether they face a legislature dominated by the opposition party, presidents must govern with the result that presidentialism is pervasive often at the expense of political stability. Latin America not only

shares a great deal of history and culture, societies in the region are characterized by the absence of social solidarity and the presence of high levels of social and political conflict generated by large inequalities of wealth, income, power and effective citizenship. Although there is a notable absence of significant religious and ethnic conflicts, Latin America is characterized by high levels of social conflict. Social conflict has persisted, moreover, throughout the period that is the focus of this research (1990-2012). That different countries have democratized and liberalized their economies at different speeds and to varying extents, that they have exhibited different patterns and levels of popular mobilization, that their party systems have evolved differently, and that patterns of capital flight have varied considerably facilitates systematic comparative examination of competing political sources of capital flight, both across and within countries.

Figure 1.3 shows levels of capital flight from 16 Latin American countries between 1990 and 2012. The most notable feature of this figure is the enormous variation in mean levels of capital flight. To state the obvious, something other than these countries being democratic and having developing economies was going on in this period.

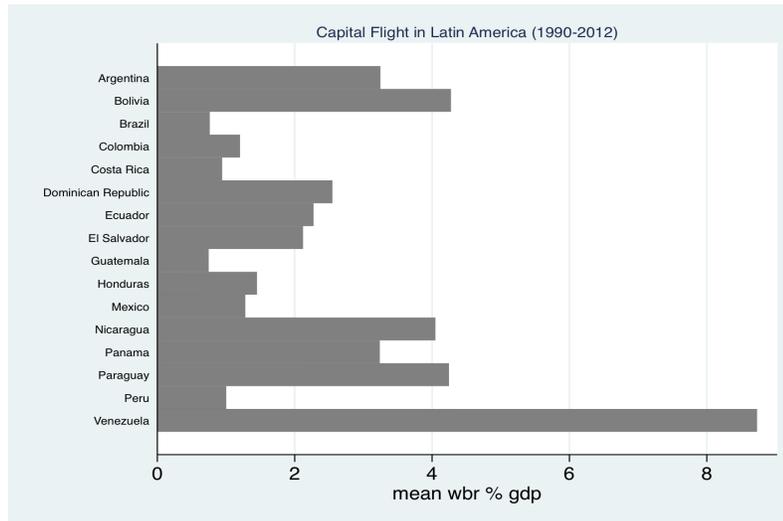


Figure 1.3. Mean capital flight in Latin America by country, 1990-2012. (WBR's as percentages of GDP)

Data are derived from the World Bank's Development Indicators (WDI), UNCTAD and the IMF

### Summary

This dissertation seeks to identify the political risk conditions that account for these patterns of capital flight in Latin America. The central question of the dissertation is why do certain democracies experience greater political risk and thus greater capital flight than others? The dissertation's core argument is that political risk in Latin America's shallow democracies is best evaluated – and best measured – by the extent degrees of popular mobilization, Leftist party electorability, the degree of institutionalization of Leftist party in government, and the strength of Rightist opposition to such mobilization, rather than the nominal configuration of democratic institutions and processes. Popular mobilization in response to political exclusion leads to rising demands for redistribution that threaten to incur costs on asset holders encouraging them to consider exporting their capital. In turn, popular mobilization leads to rising electoral support for Leftist parties to the point when – as proponents of redistributive policies - they become credible contenders to win government office, threatening Rightist/pro-capital party dominance and

triggering further capital flight. The magnitude of capital flight may be mitigated, however, if a Leftist party forming a government had been established for some time, in which case it will typically moderate its redistributive policies; and by the continued electoral strength of pro-capital parties able to defend the interests of asset holders and effectively oppose the Leftist government.

Not only does this research contribute to the existing capital flight literature, it also offers a coherent theoretical framework that more centrally addresses the role of politics in explanations of capital flight and in so doing contributes to ongoing debates in comparative political economy on the relationship between new “shallow” democracies and political risk. The study should also be useful to policy practitioners who too often focus primarily – often exclusively - on institution building in developing countries without also examining the quality of democracy and the extent of democratic consolidation within them.

Having introduced the broad thrust of the dissertation, the next chapter explores different definitions of capital flight and provides an in-depth review of existing explanations for the phenomenon. The following Chapter 3 explains in detail my theoretical argument and chosen research design. In Chapter 4, I report findings from a macro quantitative analysis in which measures of popular mobilization are regressed against patterns of capital flight using a cross-sectional time series dataset of 18 Latin American democracies covering the period 1990 to 2012. Finally, I analyze two cases that provide qualitative evidence in support of my core argument. Chapter 5 assess the impact of class mobilization on capital flight in El Salvador over time from 1990 to 2009, when elite-backed political parties dominated the political system

before the rise of the Leftist *Frente Farabundo Martí para la Liberación Nacional* (FMLN). Chapter 6 then provides a comparative analysis of the impact of rightist political oppositions in encouraging and discouraging capital flight under the FMLN government in El Salvador after 2009 and under the *Movimiento al Socialismo–Instrumento Político por la Soberanía de los Pueblos* (MAS-IPSP) government in Bolivia after 2006. Chapter 7 summarizes my findings and their implications.

## Chapter 2: What is capital flight and why does it occur?

Capital flight has existed as long as money has traveled across national borders. Kindleberger (1937: 326-48) recounts French Huguenots' huge capital withdrawals before they fled to Geneva, London, Hamburg, Amsterdam and the American colonies following the revocation of the Edict of Nantes in 1685. After the French Revolution a century later and with the onset of the Reign of Terror, members of the French nobility fled their country taking their capital with them. There are numerous other examples that tell the same story and prompted Keynes to write in the context of the Great Depression of the 1930s of the need for governments not only to raise demand in the economy but also eliminate "the phenomenon known as the "flight of capital" by investors" (Moggbridge 1980: 129-30, 212-13, 275-76).

It is over the last five decades, however, that the phenomenon of capital flight has received most scholarly attention as its incidence has increased. Despite its vast impact on the global economy, however, scholars have not reached agreement on how to define it beyond a general understanding that it refers to unusually large amounts of money leaving a country - typically a developing economy - to be invested elsewhere, usually in the developed world.

Clearly, not all capital outflows from a given country may be termed capital flight. Regular day to day outflows made by corporations and individuals to pay bills for imported goods and services or to invest abroad without some crisis occurring in the source country are not our concern here. Rather our focus is on illegal and illicit outflows of financial assets and capital -

usually initiated by private nonbank asset holders - that result in all or part of the income and capital being lost to the source country. Licit or legal outflows includes foreign investors repatriating capital back to their home country while illicit or illegal transfers involve evasion of government controls that restrict the outflow of assets out of the country.

### *Hot money/irregular short-term flows*

Much of capital flight comprises irregular short-term/speculative outflows - so called “hot money” - fueled by capital holders’ perceptions of high risks, such as political and economic crises, higher taxes, tighter capital controls or major devaluations of the domestic currency, or actual or emerging hyperinflation (Ajayi 1997; Hermes and Lensink 2002; Cuddington 1987: 2). This is “money that runs away” (Kindleberger 1937) “when investors *en masse* lose faith in a country’s economic prospects” (Constable 2016). Individuals or corporations acquire and transfer domestic assets and the income from those assets beyond the reach of their government into foreign liquid assets held abroad or by changes in trade credits. Faced by large international interest rate differentials or imminent devaluation, for example, a firm will cut its trade-related borrowing denominated in foreign currencies and become increasingly willing to engage in trade-related lending in foreign currencies. When this behavior becomes large scale, it is appropriate to call it capital flight (Cuddington 1987: 2). In countries that prohibit the legal transfer of funds abroad, notably but not exclusively developing countries, capital holders will likely devise more ingenious (illegal) ways of exporting capital abroad.

### *Unrecorded or Under-recorded capital flows*

A second common feature is that transfers are often unrecorded or under-recorded. For Benar and Dafour (2005: 175), capital flight is “any net capital outflow that is conducted unofficially and therefore never appears on the books”. Capital holders’ motivation is to conceal the origin, extent, destination and true ownership of the money sent abroad (Kar and Cartwright-Smith 2008) so as to avoid or evade government regulation, reporting or taxation (Heggstad and Fjeldstad 2010). Examples include smuggling of cash, goods, antiques, precious gems, bullion and other precious metals, bank transfers, swap arrangements, underinvoicing of exports, and overinvoicing of imports by private or corporate capital holders. So long as foreign country receipts from smuggled goods are retained outside a domestic government’s jurisdiction or reach, it will be unable to record either the outflow of goods or any corresponding increase in domestic holdings of assets held abroad in its balance of payments. The same will also be true for exports and imports with falsified invoices recorded in a country’s trade account or financial flow of funds. For example, criminals or dishonest government officials may “misinvoice” payments as a way to launder the proceeds of crime or corruption. Importers may seek to evade customs duties or taxes by underreporting what they bring in. Alternatively, exporters may illegally exploit generous tax incentives provided by governments by overreporting the value of goods and services they have sold abroad. For their part, investors may seek to evade government capital controls by misinvoicing the value of trade transactions to move funds in or out of the country (Bhagwati, Krueger and Wibulswadi 1974: 148-55; Cuddington 1987: 3; Gulati 1987; Kar and Spanjers 2015).

Some unrecorded or under-recorded capital flight, such as the export of embezzled state funds or assets, surely constitutes criminal activity (Baker 2005; GFI 2014) but the law in the source country may be silent, inadequate or non-existent, which explains why it is more useful to focus on licit and illicit financial flows rather than only illegal transactions.

### *(Large Scale) Capital Flight and Developing Countries*

Unsurprisingly, economists have devoted much greater attention than political scientists to the study of capital flight primarily because such outflows deprive developing countries of investment capital, exacerbate developing countries' foreign debt problems and nurture foreign debt dependence. Because much of the capital that flees beyond their governments' reach is untaxed, developing countries' domestic tax bases are eroded as the wealthy evade taxation by channeling funds abroad (Boyce and Ndikumana 2001; Pastor 1990) leaving the middle class and poor to pick up the costs of financing government programs. Since the fleeing capital does not return (at least, not as taxable revenue), the developing countries' pool of domestic savings is depleted as a potential source of domestic investment in productive activity prompting a vicious cycle leading to reduced economic output and future growth possibilities (Adetiloye 2012; Ajayi 1997; Cervena 2006; Fofack and Ndikumana 2010; Forgha 2008; Maski and Wahyudi 2012; Ndikumana 2015; Ndiaye 2009, 2014; Weeks 2014; Yalta 2010). Lawanson's study, for example, finds that a 10 percent increase in capital flight from West African countries led to a decline in investment of between 0.4 and 15 percent within the year and a serious loss of taxation revenue (2012).

Notwithstanding the effects of capital flight on savings and investment - in some cases as much as 80 per cent of public loans taken out by developing countries' governments - flee those countries as private assets (Ajayi and Khan 2000) thereby providing the appropriators (usually the wealthy and powerful) with foreign earnings while leaving taxpayers in the source country to pay debt servicing charges that could otherwise be spent on education, infrastructure, health and other human services that benefit the whole population. Ndikumana and Boyce (2013) estimate that each additional US dollar allocated to debt servicing means 29 cents less allocated to public health spending and resulting in additional infant deaths.

Khan and U1 Haque (1985) have also identified two-way capital flows where flown domestic capital re-enters a developing country as a publicly guaranteed loan by means of inter-bank transfers to money laundering schemes involving offshore financial intermediaries. In a similar vein, Boyce (1992) has described how capital that has flown from a source developing country – possibly from government coffers - is often recycled through a “revolving door” back to the same country as public debt (Boyce 1992) leaving the costs of servicing that debt to the whole of society. Over time, this “revolving door” creates demand for more external borrowing to finance human services that can also become funds for further capital flight.

The regressive effects of capital flight are often further compounded when developing countries devalue their currencies. While the wealthy can easily move their money abroad to evade the impact of devaluation the poor cannot and as a consequence see their purchasing power decimated. Over the long-term, the country's middle class and poor effectively subsidize the rich's consumption of public services at the same time that health and education programs most

needed by the poor are deprived of adequate funds and poverty reduction efforts are impaired (AfDB et al. 2012; Moulemvo 2016; Ndikumana and Boyce, 2011). Other economic effects of capital flight include destabilizing developing countries' interest and exchange rates; exhausting foreign exchange reserves; constraining monetary control; driving up the marginal costs of foreign borrowing; inflating the relative social return on capital in these countries; and eroding the legitimacy of their mixed economic systems (Blankenburg and Khan 2012; Cuddington 1986: 10-17; Epstein 2005; Gulati 1988; Khan and Ul Haque 1985; Lessard and Williamson 1987; Dooley 1988; Collier, Hoeffler, and Pattillo 2001; Rojas-Suarez 1990). When faced with a mass exodus of capital, even if a developing country's central bank tries to stabilize the exchange rate, it might exhaust foreign-exchange reserves in the process at the same time that domestic money supply contracts sharply (Cuddington 1986). In turn, these actions may trigger a downward financial spiral leading to even more capital flight, greater public indebtedness, and ultimately to a country being denied access to external borrowing as resource constraints bind tighter and economic growth potential is stalled.

As the experiences of Mexico in 1994, East Asia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2001 and Argentina in 2002 demonstrate, fleeing capital has also provided the root cause of a series of major financial crises that have occurred regardless of any dramatic shift in economic fundamentals (Guha 2005; MacIntyre 2003; Schneider 2003; Stiglitz 2002).

At the domestic level, capital flight undermines the legitimacy of national governments by providing channels for elites to enrich themselves at their country's expense. But even worse than this still, capital flight poses a threat to the legitimacy of the entire global capitalist system.

Facilitating illicit accumulation at the expense of socially productive wealth creation undermines the most compelling arguments for capitalism and globalization as the best strategy for spreading prosperity to developing countries. As Baker insists:

“When we pervert the proper functioning of our chosen system, we lose the soft power it has to project values across the globe. Capitalism itself then runs a reputational risk. As it is now, many millions of people in developing and transitional economies scoff at free markets, regarding the concept as a license to steal in the same way as they see other others illicitly enriching themselves” (2005: 369).

Having explored what is meant by capital flight, let us now examine competing explanations for what drives the phenomenon offered in the existing literature.

### *What Drives Capital Flight?*

Three broad approaches to the motivations behind capital flight may be identified in the literature.

#### *The Portfolio Approach*

Most economists rely on conventional market models of expected utility maximization by rational economic actors to explain capital flight. In what they term the portfolio approach, the macroeconomic context is most important. When macroeconomic indicators deteriorate such as declining profitability and growth or high inflation, the negative impact on investors' returns will incentivize them to move their assets out of the country. In this sense, capital flight is merely a portfolio adjustment caused by market distortions and asymmetric risks developing relative to

advanced economies, and resulting from rational economic agents looking to maximize returns beyond the source economy (Khan and Ul Haque 1985; Lessard and Williamson 1987; Dooley 1988; Collier, Hoeffler, and Pattillo 2001).

Within this literature, economists identify both “push” and “pull” factors. Push factors are the external global conditions that affect the rate of investment return in the source country, especially monetary and fiscal policies and risk appetite in the advanced economies, all of which affect global liquidity, growth, productivity, and interest rate differentials. Push factors, however, also include global economic “shocks”, specific crisis events (Albuquerque, Loayza and Serven 2005; Calvo, Leiderman and Reinhart 1993, 1996; Fernandez- Arias 1996; Fratzscher 2011) as well as more localized shocks and the “contagion effects” of global crises (Claessens, Dornbusch and Park 2001; Claessens and Forbes 2001; Forbes and Rigobon 2002).

Pull factors are country specific and typically go to the real divergences between developing countries and the advanced industrial economies. Strong economic performance in developing countries discourages capital flight, as does higher GDP per capita (apart from in the oil producing countries) (Boyce and Ndikumana, 2003; Baek and Yang 2010), high foreign direct investment (FDI) inflows (Antzoulatos and Sampaniotis 2002), rising stock market valuations (Puah et al 2012), high saving rates (Brada, Kutan and Vuksic 2013) and strong credit expansion (Vespignani 2008). Conversely, low growth, unfavorable interest rate differentials and high inflation are all positively linked to capital flight (Cuddngton 1986; Lessard and Williamson 1987; Murinde, Hermes and Lensink 1996; Nyoni 2000; Ndikumana and Boyce 2003; Nyoni 2000; Ndikumana and Boyce, 2003). So too are overvalued exchange rates, as asset holders

come to expect currency devaluation that will reduce the value of their assets (Collier, Hoeffler and Pattillo 2001; Dornbusch 1985; Cuddington 1986; Lessard and Williamson 1987).

The economic literature is less conclusive, however, on whether or not capital controls imposed by developing countries reduce capital flight. Cuddington (1986: 33) and Pastor (1990) find a positive effect for South American countries whereas Johnston and Ryan (1994), Schineller (1997) and Loungani and Mauro (2000) found no effect for a broader range of countries once controls are introduced for fiscal imbalances and the presence of an IMF recovery program - mainly because capital holders learn how to circumvent such controls at the same time that global financial liberalization has drastically reduced the costs of moving funds abroad (Brada, Kutan and Vuksic 2013).

Numerous economists have found that high levels of external public debt in developing countries - typically linked to state expropriation of fund – often drives capital flight, especially when the risk or probability of default sharply increases (Boyce 1992; Chipalkatti and Rishi 2001; Ndikumana and Boyce 2003). Higher levels of capital flight then drives further increases in public debt causing serious resource and fiscal shortfalls, which in turn incentivizes governments to increase taxes (which may prompt further capital flight) (Ndikumana and Boyce, 2003) or take out even more foreign loans leading to higher public sector borrowing, higher budget deficits, greater indebtedness, crowding out domestic private investment, and dampening long-run growth (Mitra 2006).

Still, despite its apparently rational explanation, several problems are evident in the portfolio choice approach. One is conceptual: if an investor from an advanced economy transfers capital

abroad, it is usually called “foreign investment” whereas if an investor from a developing country does so, it is called capital flight (Cumby and Levich 1987). Underlying this conceptual difference is the greater structural uncertainty (risk) about future investment in developing economies, which is why many developing countries introduce capital controls and advanced economies generally do not. In short, the portfolio approach conflates short-term utility (and profit) maximization with structural and political uncertainties, which are inherently greater in developing economies where the drivers of asymmetric investment risks also include the probability of higher inflation, exchange rate depreciation, and the possibility of high taxation and government-orchestrated expropriation. Concomitantly, the portfolio approach does not distinguish the effects of short-term fiscal and monetary policy – present in all economies – from longer term structural and institutional changes, which have obvious implications for future investment opportunities.

A second problem is the so-called “Lucas paradox”. Conventional market economic theory – which the portfolio approach reflects - holds that capital should flow from capital-rich industrialized countries to the capital-poor developing nations that offer higher investment returns. In his now classic example, Lucas (1990) compared the marginal products of the United States and India in 1988 and postulated that if the conventional market theory was valid the marginal product of capital in India should be 58 times that of the US. In this light, all capital should flow from the US to India. In fact, Lucas found that such flows were not observed.

Why might global patterns of capital confound the portfolio approach? Two other competing explanations address this question.

### *The Dirty Money Approach*

One explanation is that capital flight from developing countries is primarily driven by “dirty money” that is derived from criminal, corrupt and commercial activity and typically involves illicit unrecorded capital flows. Criminal activity includes drug racketeering, trafficking in counterfeit and contraband goods, people smuggling and slave trading, embezzlement, forgery, securities and credit fraud, burglary, sexual exploitation and prostitution, and so forth typically undertaken by organized crime. Corrupt illicit flows stem from bribery and embezzlement of public resources by state officials trying to hide their ill-gotten gains abroad while corporate dirty money derives from tax evasion, falsified or mispriced asset swaps, trade misinvoicing and abusive transfer pricing, often conducted with complicit corrupt officials (23; Heggstad and Fjeldstad 2017: 7; Kapoor 2007: 6-7). As Kar and Cartwright note (2008: 2), “the common motivation appears to be ... a desire for the hidden accumulation of wealth”.

Even so, although numerous studies have found a clear link between levels of corruption in a country and levels of capital flight from it (Moghadam, Samavati, Dilts 2003; Le and Rishi 2006), others have argued that the problem is weak governance that encourages corruption and so higher levels of capital flight (Blankenburg and Khan 2012; Boyce and Ndikumana 2012). In these analyses, a country’s economic structure is seen as particularly significant. Countries that are major exporters of natural resources such as oil, gas, and minerals are found to offer greater opportunities for embezzlement, theft, and trade misinvoicing, and have been shown to experience greater capital flight because their resources are more “lootable” (Asongu 2015; Boyce and Ndikumana 2012; Ndikumana et al., 2015; Mpenya et al 2016; UNDP 2011).

The dirty money approach typically equates illicit capital outflows with illegal transfers. Thus, for Baker (2005: 23) dirty money is “illegally earned, illegally transferred or illegally utilized.” This narrow approach is problematic, however, since capital flight from developing economies is not exclusively limited to that derived from criminal activity. Outflows such as transfer pricing, use of tax havens, and some corrupt activities may be considered abusive and damaging to developing economies but may not necessarily be illegal and may be encouraged and facilitated by external organizations such as multinational corporations that channel capital flight through the intentional misinvoicing of trade imports and exports. Indeed, studies have shown that trade openness itself has the effect of facilitating higher levels of capital flight through trade misinvoicing (Akesuba and Tabelini 1989; Bhattacharya 1999; Schineller 1993; Kant 2002). In the context of lax regulations in the developing country, banking secrecy in the developed world, and an “ask-no-questions” collusive culture, capital flight may occur openly with its real driver – at least in some circumstances – not necessarily the desire of capital holders in the source country to hide accumulated wealth, rather implicit or explicit collusion between organizations based in advanced economies and capital holders in source countries (Ndikumana, Boyce and Ndiaye 2015). As various other studies have shown, the expansion of tax havens has also encouraged illicit financial transactions across countries (Christensen, 2009, 2012; Fjeldstad and Heggstad 2013; Shaxson, 2011; Global Financial Integrity 2016).

Absent from both the portfolio and dirty money approaches, however, are the kinds of explanations for capital flight that interest political scientists, particularly those that study political risk.

### *The Political Risk Approach*

Although the term political risk has had many different meanings (Sottilotta 2013, 2015), it refers generally to political decisions, conditions and events that significantly affect the profitability of a business or the expected value of a given economic action and impacts investors, corporations and governments (Bunn and Mustafaoglu 1974). The condition generally manifests itself as political change – such as a change of government or significant change in government policy - or political instability, often in circumstances where the state is either too weak or unstable to protect property rights and assure political stability or is a source of risk itself through the expropriation of private assets or arbitrary fluctuations in government policy.

Various studies, mostly undertaken by economists (Balkan 1992; Citron and Nickelsburg 1987; Collier, Hoeffler and Pattillo 2004; Davies 2008; De Haan, Siermann, and Van Lubek 1997; Ndikumana, Boyce and Ndiaye 2015) have examined the impact of political risk on capital flight and several have found significant positive links (Gibson and Tsakalotos 1993; Fatehi 1994; Lensink, Hermes, and Murinde 1998). One study on Bangladesh by Alam and Quazi (2003) found that political instability to be the single most important determinant of capital flight while another, by Efobi and Asongu (2016), found domestic terrorism to be a significant driver of increased capital flight in Africa. Fatehi (1994) also found that political strikes, political sanctions and political executions all caused significant capital flight from several Latin American countries. Other studies have found positive and significant links between capital flight and revolutions (Lensink, Hermes and Murinde 2000), military coups (Le and Zak 2006), and sociopolitical crises (Niaye and Siri 2016; Ramiandrisoa and Rakotomanana 2016).

Significant positive links have also been found between external and internal conflict and capital flight (Nyatepe-Coo, 1994; Hermes and Lensink 2001; Lensink, Hermes and Murinde 2000; Fielding 2004; Le and Zak 2006).

Political instability is one important political driver of capital flight in developing countries. Another source is the state itself. This can be due to state intervention in the form of outright seizure of private resources or through “creeping expropriation” achieved by significant tax or regulatory increases. Under these conditions, capital holders are incentivized to respond by becoming non-cooperative (Alesina and Tabellini 1989) and opt to relocate their capital abroad (Eaton 1987; Kant, 2002; Khan and Haque 1985; Rojas-Suarez 1990; Diwan 1989). Political risk may also be present if the state is too institutionally weak to protect property rights (Tornell and Velasco 1992). While governments and groups that do not hold capital may conceive such concerns as political instruments or a “capital strike” directed against government redistribution policies that they favor, those who hold capital may view these measures as hostile to their interests and develop political strategies directed towards hamstringing a government’s capacity to respond to the majority of voters’ needs (Crotty 1993, 1993; Crotty and Epstein 1996; Epstein 2005).

Although the literature on political risk and capital flight provides clear evidence of the relationship between political risk and capital flight it has little to say about underlying conditions that create political instability and thus might shape capital-holders’ perception of political risk and precipitate capital flight. Following North’s seminal work (1990), however, a considerable body of political science literature has emphasized the importance of institutions

and institutionalism in producing political stability. For North, the existence and conduct of political institutions and regularized political processes in democratic societies generate a positive effect on a given country's political stability, which in turn is likely to reduce perceptions of political risk amongst asset-holders:

“Institutions are the rules of the game in society or, more formally, are the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social, or economic” (3-5)

*A “democratic premium”?*

Stemming from this work, various studies have investigated the impact of democratic institutions on political risk (Ahlquist 2006; Busse and Hefeker 2007; Henisz 2000; Hollyner, Rosendorff and Vreeland 2011; Jensen 2003; 2006; Keefer and Stasavage 2002; Li and Resnick 2003; North and Weingast 1989; Staats and Biglaiser 2011). A prominent assertion within this literature is that a so-called “democratic premium” exists. Proponents of this argument insist that democratic institutions reduce political risk and thus provides reassurance to capital holders who develop a weaker proclivity to export their capital as a consequence. Without the institutions associated with democracy, political risk increases and with it the inclination to export capital. In respect of capital flight, Nooruddin (2011) finds that democracy is significantly and positively related to flight patterns. Similar findings can be found in other literature that emphasizes the importance of protecting civil rights. *Ceteris paribus*, democratic countries that respect civil and political rights attract more foreign direct investment (Harms and Ursprung 2002; Busse 2004; and Busse and Hefeker 2005) and are more credit worthy (Biglaiser and Staats 2012). Those with better

human rights records also receive more foreign direct investment (FDI) (Blanton & Blanton 2007) while those participating in international pro-human rights regimes attract more investment (Garriga 2016). Other literature emphasizes democracies' greater transparency, inclusiveness, consensual nature and amenability to sustainable reform, all of which moderate political risk and engender investor confidence (Olson 1993; Bueno de Mesquita 2005; Ehrlich (2007).

Various studies focus on the benefits of particular democratic institutions in inhibiting capital flight. Thus, Staats and Biglaiser (2012) emphasize the importance to judicial independence as well as strong adherence to the rule of law while Cerra, Rishi and Saxena (2008) stress the importance of constraints on executive power prevent capital flight. Still others stress the importance of providing business with good access to government by instilling confidence that political officeholders will afford capital owners protection, reduce political risk, and provide reassurance for higher levels of business investment; Garland and Biglaiser (2009) argue that such access and protection is especially likely to be forthcoming in candidate-centered systems. For Jensen (2003, 2006), the requirement that democratic governments are accountable to voters induces them to make credible commitments because they will suffer "audience costs" in elections if they renege on their promises.

### *Veto player theory*

However, the most common justification for the democratic premium in the literature is the premise that democracies are uniquely effective at safeguarding property rights because of the institutional constraints built into the institutional framework of democracies. These constraints, it is argued, restrict the state engaging in predatory rent-seeking which threatens asset holders (Busse and Hefeker, 2007; Jensen 2003; 2006; Henisz 2000; Li and Resnick 2003; North and Weingast 1989; Persson and Tabellini 2003; Persson 2004; Papaioannou and Siourounis 2008; Staats and Bigslaiser 2011).

Various studies make use of Tsebelis' veto player theory (2002) as a means of quantifying the extent of institutional constraints across different political systems in order to examine the effects of political risk (Busse and Hefeker, 2007; Jensen 2003; 2006; Henisz 2000). In this theory, veto players are individuals or groups, institutions (those officially named somewhere, such as the president or the legislature) or partisan actors (those whose veto arises from the system but is not one of the rules of the system, such as political parties), all of which have policy preferences in respect of political outcomes in a bargaining game. Having many veto players, Tsebelis argues, makes significant policy changes difficult or impossible since the veto players need to be bought off. The higher the number of veto players the fewer significant policy actions are agreed to change the status quo because by spreading the veto players out more (ideologically) reduces the size of the winset of the status quo while increasing the size of the unanimity core: a smaller winset or a larger unanimity core leads to greater policy stability. However, some of these veto players – “agenda setters” may present “take it or leave it” proposals to the other veto players.

Using Tsebelis' schema, Henisz (2000) measures how the number of formal checks affects the policy process (veto players) by taking into account the decreasing marginal impact of added veto players and the policy preferences of each veto player. Using this measure, he argues that political and institutional constraints rather than democracy per se shape cross-national patterns of FDI: transnational corporations are responsive to the level of constraints on politicians when they decide whether or not to enter emerging markets and their entrance strategies are affected by the level of political constraints in a host system. Each additional veto point (a branch of government that is both constitutionally effective and controlled by a party different from other branches) provides a positive but diminishing effect on the total level of constraints on government policy change; and the homogeneity (heterogeneity) of party preferences within an opposition (aligned) branch of government is positively correlated with constraints on policy change. Jensen (2006), however, argues that the links that Henisz and others make between veto players, policy stability and FDI is not as straightforward as these authors contend. It is much easier for countries with extant friendly policies towards FDI to commit to a favorable investment environment whereas those that do not may be constrained to continue to pursue policies that are unfavorable. Thus, although governments may pursue policy stability and lower risks for foreign investors, veto players may not necessarily encourage capital inflows.

In his study of the 2008-09 global financial crisis, however, albeit an analysis of just one event, Pepinsky (2012) is much more skeptical of the impact of the configuration of veto players. From a sample of 47 countries, countries with "better institutions" – those with more (or less) democratic, more (or less) constrained or more accountable political systems – were no less vulnerable to portfolio outflows than countries with "worse institutions."

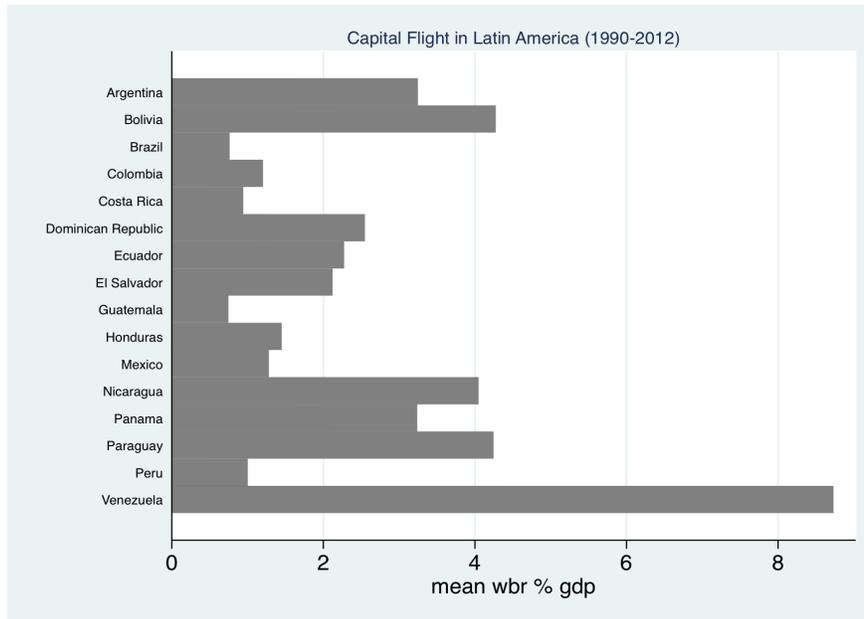


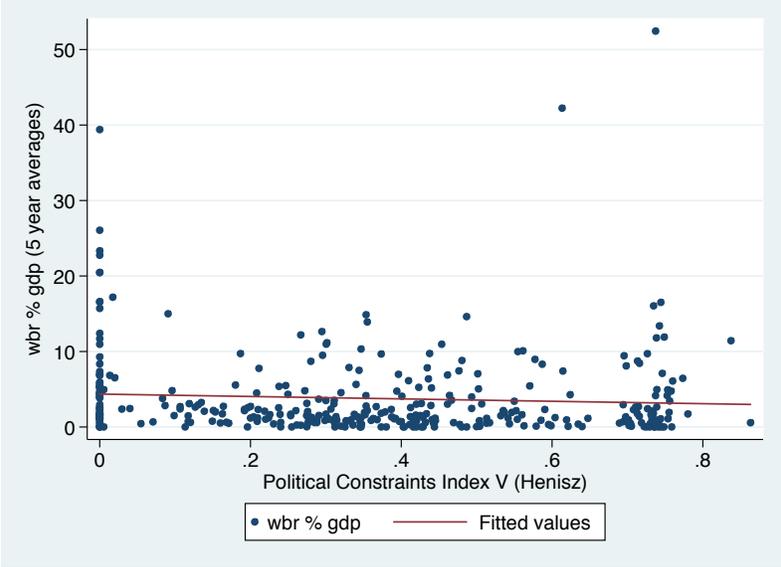
Figure 2.1 (repeat of Figure 1.3) Mean capital flight in Latin America by country, 1990-2012. (WBR's as percentages of GDP)

Data are derived from the World Bank's Development Indicators (WDI), UNCTAD and the IMF

Yet these explanations fail to account for the substantial variation in outcomes *across* democracies. In particular, they cannot account for varying levels of capital flight experienced by democracies in Latin America (see Figure 2.1 a repeat of Figure 1.3).

If, then, we use Henisz's (2000) implementation of Tsebelis' schema to estimate patterns of capital flight across the world (as measured by the World Bank's Residual), we find no significant relationship between the number of veto players and capital flight. As Figure 2.2 shows, the regression line is fairly flat. If, then, we compare the last two decades for Latin American countries – the 1990s being a period generally dominated by rightist governments and 2000s by Leftist governments - we can see that instead of finding the same causal relationship in

both periods, patterns were mixed - with the number of veto players somewhat positively correlated with capital flight in the first period (Figure 2.3) but somewhat negatively correlated in the second period (Figure 2.4).



Data derived from the World Bank’s Development Indicators (WDI), UNCTAD and the IMF.

Figure 2.2. Veto players and capital flight around the world, 1990-2012 (Mean 5-year WBR’s as percentages of GDP)

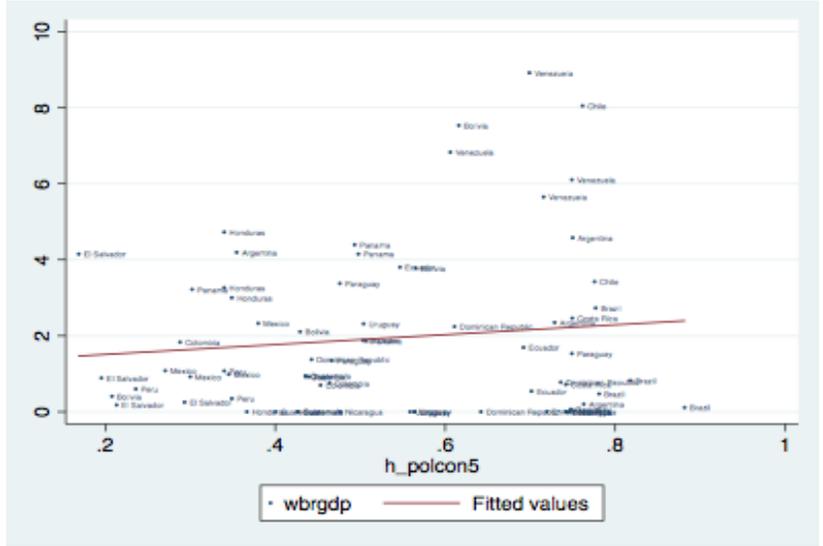


Figure 2.3. Veto players and capital flight in Latin America, 1990-1999 (Annual WBR's as % of GDP) Data derived from the World Bank's Development Indicators (WDI), UNCTAD & IMF

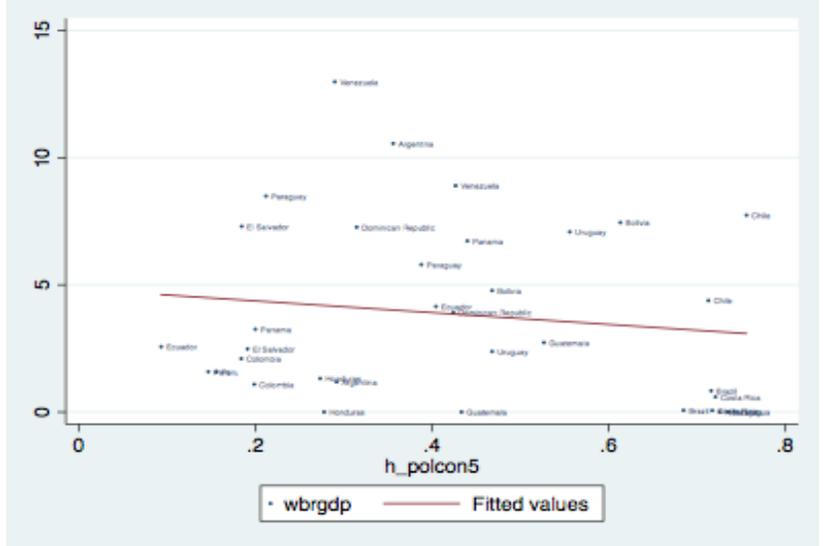


Figure 2.4. Veto players and capital flight around the world, 2000-2009 (Annual WBR's as % of GDP) Data derived from the World Bank's Development Indicators (WDI), UNCTAD & IMF

These data taken together with the previous discussion suggest that the impact of veto players may be contingent on who is in power. *A priori*, although domestic asset holders will likely perceive political advantage from a lack of constraints/fewer veto points and lack of cohesion among veto players within their political system when government policies seek to enhance economic efficiency and reduce market distortions, they are likely to see benefits from strong constraints/many veto points and lack of policy cohesion when governments seek to enact and implement redistributive policies that increase taxation for social expenditures.

Notwithstanding these attempts in the FDI literature to use Tsebelis' veto points theory to examine the effects of political risk (see also Feng 2001; Hermes and Lensink 2001; Jensen 2003, 2006; Kenyon and Naoi 2010; Rodrik 1989), logically, there is no a priori reason to presume policy instability to have exclusively negative effects on risk. Cohesion among veto players may lead to the implementation of policies that investors actually prefer. Thus, Macintyre's study (2001) of the Southeast Asian crisis found that when "the distribution of veto authority" was either too dispersed or too concentrated among the different players, countries tended to experience higher levels of capital flight: that is, wider distributions of veto authority led to greater risk of policy rigidity while tighter concentration led to greater risk of volatility thereby yielding a u-shaped rather than a linear relationship between the number of veto players and investors' policy risk.

Other studies have also shown how larger numbers of veto players actually slow the implementation of redistributive government policies (Rueschemeyer, Stephens and Stephens

1992; Huber and Stephens 2001) whereas those with few or no veto points allow for rapid policy change. Both Huber, Ragin and Stephens (1993) and Huber and Stephens (2000), for example, found their number to be decisive in blocking reductions in social entitlements. Likewise, Alesina and Drazen (1991) explain the delays in implementing economic stabilization programs as a consequence of political instability caused by heterogeneous opposing socio-political coalitions, each trying to impose the cost of debt reduction on the other. Countries with configurations of political institutions/veto points that make it more difficult for competing groups to veto stabilization programs they oppose will stabilize sooner. More recently, in 2011 the United States almost defaulted on its debt because of policy gridlock caused by a veto player. In light of these findings, it is difficult to understand why Jensen (2008) – even after controlling for the number of veto players and making his argument that democratic institutions are a significant determinant of political risk and FDI - concedes that countries with market-friendly policies will reduce political risk for multinational companies while those without will not, but then proceeds to drop considerations of existing policy regimes in his estimates of the impact of the configuration of veto players. Instead his quantitative study assumes that more veto players lead to less political risk regardless of government policy.

### *Democracy and Redistribution*

While the democratic premium is prominent in the political risk literature, there is another strand of literature that argues the polar opposite. They posit that democratic systems may be inherently vulnerable to government policy change and political instability because competing political parties/coalitions alternate in government, ministers are often incentivized to pursue

opportunistic behavior based on short time horizons (Rodrik 1991). Indeed, for Bellin (2000), democracy may “threaten to undermine the basic interests of many capitalists” in certain circumstances because politicians are vulnerable to popular demands for redistribution (Acemoglu and Robinson 2013; Tavares and Wacziarg 2001; Block 2002; Block and Vaaler 2004; Keefer 2005; Brender and Drazen 2005), which may threaten capital holders’ property rights and assets (Barro 1996; Bellin 2000; Meltzer and Richard 1981) leading to capital flight. Thus, Huntington and Dominguez (1975), Rao (1984), and others argue that the key to the superior economic performance of, say, the Asian tiger economies such as Singapore and Taiwan, is state autonomy whereby governments are insulated from particularistic demands. Indeed, several studies have shown that authoritarian regimes are better at maintaining political stability, controlling risk, and attracting more investment than democracies (Huntington 1996; Li and Resnick 2003; Montero 2008; Tuman and Emmert 2004).

A key contention of this literature is that, rather than protecting property rights, democracies pose a threat to asset holders. They argue that this is because democracies are more likely to introduce policies that redistribute income and wealth. This is because democratization entails voting rights and the median voter- particularly in unequal societies- should favor greater redistribution (Boix 2003; Meltzer-Richard 1981). The prospect of the state enacting policies in favor of more redistribution represents a major source of political risk for those with assets. Redistributive policies such as wage-setting, price controls, progressive taxation and expropriation relocate resources away from capital to labor and so constitute a threat to capital’s interests. Capital owners fear redistributive policies because they stand to lose from such policies (Velasco and Tornell 1990). In response, capital holders may call upon their “structural power”

to institute a “capital strike” by withholding investment and/or by remove their assets from the country (Gill 1989).

However, there is no guarantee that democratization will lead to greater redistribution (Huber and Stephens 2001; Korpi 1983, 2001, 2006). Those who own property/capital possess significant material and political resources to draw upon to ensure that their interests prevail long after democratization (Fairfield 2015; Gill 1989; Lindblom 1977; Przeworski and Wallerstein 1988). For a variety of reasons, including that all citizens are not equally powerful in democratic systems and that universal suffrage or democratization does not necessarily lead to the political mobilization of all sectors or classes, democratization and the creation of democratic institutions and the rule of law does not automatically lead to a more equal distribution of power and resources (Huber and Stephens 2012; Keefer 2009; Mulligan, Gil, and Sail-i-Martin 2004: 51–74; Nelson 2007; Ross 2006: 860-74; Scheve and Stasavage 2011: 81–102; Timmons 2010: 741–757). Thus, the trappings of democracy – procedural democracy – may exist alongside unaltered gross economic and social inequality, which in turn may threatened or make fragile extant political stability, even threaten the legitimacy and/or viability of democratic institutions, and in so doing have serious impacts on asset holders’ perceptions of political risk and their proclivity to export their capital. It is hardly a secret that of all regions of the world Latin America has the most unequal distribution of wealth (Ibarra and Byanyima 2016) and, yet democratization throughout the region has failed to deliver a meaningful redistribution of income and wealth (Albertus and Menaldo 2012: 151–169; Ansell and Samuels 2010:1543–1574; Haggard and Kaufman 2012: 495–516; and Houle 2009: 589–622). Mass rural and urban groups typically associated with the Left in these societies, often face structural barriers – poor

education, lack of employment, poverty, disparate geographic locations, poor communications, social isolation, sometimes ethnic divisions, and so forth - that impede democratic inclusiveness, at least in the early stages, if not later. Moreover, although these mass popular groups would gain from greater political power and the redistribution of economic and other resources they are typically politically divided and lack effective leadership that can construct a single cohesive political coalition that can challenge capital's interests.

Even when class-based political cleavages develop and labor becomes politically mobilized in many Latin American countries, the pre-democratic inter-elite basis of their party systems remains (Dix 1989; Levitsky 2001: 104-6) as traditional social elites – for example, in Colombia, Honduras, Paraguay and Peru - have typically been able to coopt new mass constituencies through clientelist linkages (Archer 1990; Brun 2007; Levitsky and Cameron 2003; Taylor-Robinson 2006). It is unsurprising therefore to find that although the Polity IV Project has rated these systems “democratic” for over 20 years, the maldistribution of wealth and income in these countries has hardly changed. Government programs ostensibly directed toward redistribution have yielded scant results at the same time that the prospects for redistribution have receded (Goñi, López and Servén 2008; Lustig 2011). In short, in the absence of significant popular mobilization by the poor in these societies, no significant political threat to capital's interests has developed thereby obviating the need for capital flight.

## Summary

In this chapter I have provided some background on capital flight including the various types of capital flight and the main approaches to its study in the literature. I then shift the discussion to focus on the role of political risk as a driver of capital flight. Drawing on the political risk literature on investment inflows I discuss the role of democratic institutions in mitigating this risk. The literature offers competing arguments. On the one hand, certain scholars contend that democratization will lead to rising popular demands for a greater redistribution of material resources in society which will scare off investors. On the other hand, scholars argue that a 'democratic premium' exists because the institutional constraints germane to democracies serve to protect the security of investors' assets. Key to this is the argument that a greater number of veto players in the political system blocks drastic changes in policy thereby reducing uncertainty for investors.

However, these perspectives cannot account for the substantial variation in levels of capital flight across democracies. Arguments maintaining that democratization leads to greater redistribution, moreover, lack empirical support. While it is certainly true that asset holders fear redistribution and react by engaging in capital flight there is no guarantee that democracies will redistribute more. Even when those in favor of redistribution are in the majority they may encounter significant structural and material constraints while those in opposition may possess significant advantages.

At the same time, while the democratic premium thesis has chiefly been applied to investment rather than capital flight, the argument that veto players in democracies serve to mitigate political

risk has nothing to say with regard to the preferences of the actors involved. Such institutional checks and balances that exist in democratic political systems are contingent on which political forces control the state, with what broad policy orientation policies they seek to govern, and whether or not there is an opposition occupying veto points seeking to check and balance it.

The next chapter presents a theoretical framework that seeks to address the shortcomings of these arguments by making a distinction between fully consolidated and shallow democracies thereby providing significant explanatory leverage for variations in capital flight levels across democracies in Latin America.

## Chapter 3: A theory of democratic consolidation, political risk and capital flight

In the previous chapter, I introduced the question: why do certain democracies experience greater political risk and thus greater capital flight than others? I then reviewed and identified several shortcomings in the existing literature that relate levels of capital flight to the existence and strength of democratic institutions. Specifically, I showed that, contrary to assertions in the literature, democratization does not automatically lead to greater distribution of income and wealth. Nor does a greater number of veto players necessarily benefit capital-holders, as the political risk literature claims, without controlling for the policy *status quo ante* and the particular policy intentions of the executive. In short, the democratic premium argument cannot accommodate how politics plays out, which political forces have the strongest impact on state conduct and policies, and how effective democratic institutions within them (including political parties) are in serving the interests of their populations – all of which influence perceptions of political stability and risk, including those of investors, which may precipitate capital flight.

In this chapter I argue that the problem with the democratic premium debate is that it fails to distinguish between fully consolidated democracies with genuine mass participation and so-called ‘shallow’ democracies which exhibit the formal procedures of democracy despite leaving significant sections of the population disenfranchised from the political system. As such, my

theory provides a framework to account for how the process of democratic inclusion in unconsolidated democracies impacts perceptions of political risk by asset-holders. In the long term, the successful incorporation of these excluded actors serves to reduce political risk by expanding the legitimacy of the political system throughout society and so reducing the likelihood it will be challenged in the future.

For this to happen, however, there must be a reconfiguration of power relations with regard to which groups in society have access to the state. This restructuring poses a threat to existing elites who often respond by removing their assets from the country. Yet whether or not the process of democratic consolidation leads to mass capital flight depends upon how this process of incorporation is managed.

The central contribution of my theory, therefore, is that it delves into the democratic premium debate by demonstrating how the process of democratic consolidation in new -and therefore shallow- democracies affects the level of political risk in a particular country.

In the next section I discuss what distinguishes those democracies that are consolidated from those that are not. I then go on to establish the starting point for this study at the beginning of the 1990s by outlining the shallow nature of democracy across Latin America at that time. Due to the legacies of inequality in the region and the structural changes in Latin American economies, putative political forces which could pose a threat to asset-holders by threatening to enact redistributive policies had been effectively demobilized leaving pro-market coalitions free to dominate politics. As a result, barring external economic shocks, capital flight remained low (no more than 1 or 2% of GDP) across the region. Following on from this, I provide an outline of the

process of democratic deepening which occurred from the late 1990s onwards through the inclusion of excluded political actors and how this impacted the degree of political risk and subsequent capital flight. To do this, I identify three critical points in the process of political inclusion. First, the popular sectors mobilized in reaction to the process of market liberalization being implemented across the region. In this case, mass mobilization only triggered major capital flight when the mobilization reached a scale and level of organization where popular movements were able to bring about significant disruption in the economy and use this newfound bargaining power to pressure the state for greater redistribution. Major capital flight arose in response either to disruption caused by civil disobedience resulting from mass mobilization or by asset-holders perceiving a challenge to their favored market friendly policy agenda. A second critical point occurred if mass mobilization was able to boost electoral support for Leftist parties to the point where asset-holders saw a credible threat to the pro-market coalition's hold on power and reacted accordingly by removing their assets from the country. The third and final critical point arose if the Left was able to win power and enact its redistributive agenda. In this case, asset-holders reacted to the actions of the Leftist coalition rather than the perception of risk.

### Democratic Consolidation

Countries which have only recently undergone the transition to democracy often display characteristics qualitatively different from more established democracies. Transition studies, such as Stepan (1988: Ch. 1), O'Donnell and Schmitter (1986: 7-11), Linz and Stepan (1996: 3), Przeworski (1991: ch. 2) and Huntington (1991: 9) allow for an important distinction between political liberalization and democratization. Political *liberalization* may involve various social

and policy changes, for example, less censorship, greater scope for the organization of autonomous working class activity, various civil liberties safeguards, and even some redistributive policy, and most important the toleration of political opposition. Democratization involves liberalization but is much broader since it requires open contestation over the right to win control of the government, which in turn requires free competitive elections, the result of which determines the political color of the government.

It is important to make this distinction to avoid the “electoral fallacy”, that the introduction of free elections is a sufficient condition for full democracy, as the experience of Latin America (Karl 1986: 9-36; Lowenthal 1991; Carothers 1991a), as well as Erdogan’s Turkey and Putin’s Russia, have demonstrated. Moreover, as Linz and Stephan argue, (1996: 5) even when a democratic transition has been completed, there remain many tasks that need to be completed, democratic conditions that need to be established, and various democratic attitudes and habits that must be cultivated before democracy can be considered fully consolidated. Indeed, Guillermo O’Donnell argues that there are, in fact, two transitions rather than one only: the first leads to the “installation of a democratic government,” and the second to the “consolidation of democracy,” or to “the effective functioning of a democratic regime.” In order for an “unconsolidated” (Burton, Gunther and Higley (1995: 8) or “shallow” (Carothers 2002: 10) democracy to become, in Linz and Stephan’s words, “the only game in town” – so that no significant groups seriously attempt to overthrow the democratic regimes or secede from the state – new, previously excluded, social actors must be meaningfully included in democratic processes, which may have been established some years earlier. Therefore, democratic consolidation entails a widening of the range of political actors who come to assume democratic

conduct (and democratic loyalty on the part of their adversaries). This requires the opening up of political participation and mobilization by marginalized groups (Diamond 1999); that is, an extension of the scope of contestation to incorporate the whole of society (Collier and Mahoney 1997).

Yet, the process of legitimizing these new groups' inclusion in the political system – thereby deepening a country's democracy - will at least to some degree disrupt the extant political, economic and social status quo and restructure power relations inasmuch as new social groups gain access to and influence over the state and government policy. In so doing, the legitimation of new groups' access and influence within a new democratic regime will also likely generate *potential* political risk for those who were substantial beneficiaries of the previous non-democratic regime, including holders of capital.

The maintenance of elite settlements over time requires adaptability on the part of existing elites and the institutions they create as divisions within elites erupt and more and more actors become mobilized, including popular sectors. Whether or not the potential for political risk materializes leading capital owners to relocate their assets outside their host country depends upon how and the extent to which the new social actors are accepted and trusted as legitimate players within the political system.

For democracy to be consolidated, Burton, Gunther and Higley suggest (1995: 22), “insofar as social change mobilizes new groups for active participation in politics, those groups must be brought under the umbrella of the settlement and accepted as full participants in the democratic game of politics.” Where a new settlement can be reached, it will likely serve to stabilize the

political environment by establishing a procedural consensus, by institutionalizing behavioral norms that constrain conflict, and by encouraging patterns of interaction that moderate tensions. In such circumstances, moreover, elites opposed to popular forces are much more likely to stand down their supporters and thus reduce the likelihood of polarizing incidents of mass violence. Conversely, where a settlement cannot be achieved and accommodation between elites and masses cannot be reached, the likely outcome is a breakdown of the existing system and the outbreak of internecine political conflict. On the other hand, if no such pressures for greater inclusion exist, asset-holders in elite controlled democracies with low political participation are likely to experience less political risk and so less capital flight.

### *Shallow Democratization in Latin America*

What then were the conditions that gave rise to the prevalence of shallow democracies in Latin America?

### *The Legacy of Colonialism*

Latin America has a long history of structural inequality. Whereas in Western Europe, the bonds that tied people to the land had to be broken in order to provide emergent capitalist enterprises with a workforce, contrastingly, in Latin America no such agricultural revolution took place. Instead, at the same time that essentially feudal social formations remained, especially in rural areas, capitalism was “implanted” from above and from outside and did not lead to industrialization. Indeed, by the outbreak of World War I, foreign capital – allied with host countries landed oligarchies - controlled most of the modern sectors of the Latin American economy (Cueva 1977: 65-67, 79-80). In the transition to a capitalist social formation, what

Cueva calls a dependent and often brutal *estado oligárquico* (oligarchic state) (127ff.) - supported by an alliance of local landed elites and large commercial and foreign owned corporations - emerged to impose order and advance capitalist development rather than a set of political arrangements that would promote societal consensus and conciliation among competing interests. Although this state was replaced at different points in time in different countries during the twentieth century by an *estado liberal-oligárquico* oligarchic liberal state (41, 142), the flow of foreign capital into Latin America in search of cheap, easily exploitable labor to produce export commodities, remained extremely high at the same time that inequality and poverty increased. As a result, these entrenched structural inequalities have long stood as a significant barrier to political enfranchisement for the region's poor.

#### *Elite-Pacted Transitions/Authoritarian Legacies*

By the early 1990s another wave of democratization engulfed the region so that, with the exception of Cuba, all 20 countries were at least nominally considered to be democratic (Remmer 1992: 5). Despite the incomplete nature of these transitions, many of the democratic reforms were by no means insignificant. Not only did they entail the elimination of prior restrictions on suffrage in countries in which these restrictions existed (e.g. literacy requirements), the reforms also opened up space for citizens to express themselves and organize politically, including through protests thereby raising the cost for incumbent office holders to repress social movements.

Still, while the institutions and processes of democratic government were opened up, competitive (party) government did not follow inexorably, even less the creation of democratic regimes that

were inclusive and based on consensus. While political rights were extended to the masses, popular participation in policymaking processes was heavily circumscribed as the same elite clientelist parties originating from the 19<sup>th</sup> century still dominated politics. These “elite-pacted” democracies remained rigidly hierarchical with traditional elites continuing to monopolize the political process long after the transition to democracy thereby blocking the entry of new or marginal social actors. What is more, outgoing military regimes in the region typically sought to establish the institutional and organizational basis for exercising military control over the democratic process as occurred during the transition in Chile (Petras 1997; Valenzuela 1990). Consequently, these democratic regimes remained unconsolidated and shallow in terms of their legitimation throughout society. There was with little evidence that the masses exerted any political influence with most of the poor effectively excluded from participation and decision-making.

#### *The Debt Crisis and the Washington Consensus*

This dynamic of social exclusion was then further exacerbated by the debt crisis and economic instability the region experience in the 1980s. The structural changes to the region’s economies served to weaken the progressive forces in society which represented the interests of the poor leaving the political Left effectively demobilized. Latin America’s debt crisis and the imposition of the Washington Consensus only served to further weaken countervailing forces that might challenge elite interests. Even in those countries that had seen earlier periods of political mobilization in favor of social inclusion, market liberalization substantially weaken these actors.

Consequently, many observers of Latin America noticed a decline in popular movement activism after democratization in the 1980s and 1990s (Oxhorn, 1996; Hipsher, 1996; Pickvance, 1999).

At the same time, Latin American economies were deindustrializing and declining, regional living standards were falling sharply and inequality was rising. Oil price increases and the growth of the Eurodollar market in the early 1970s had significant destabilizing effects on economic expectations and economic performance in the region. As long as export earnings exceeded debt repayments, reasonable economic stability could be maintained but with the second oil shock of 1979, global interest rates increased sharply, commodity prices fell precipitously, and capital flight accelerated. Reluctant to devalue their currencies and reduce government expenditures, Latin America's authoritarian governments took advantage of their access to international lending and doubled their borrowing between 1979 and 1981, setting in motion a major financial crisis that resulted in major international banks halting their lending in mid-1982. As a result, living standards fell dramatically (CEPAL 1990: 26) and peasant and worker unrest increased helping to undermine authoritarian rule (Booth 1991; Schatzman 2005).

Desperately in need of capital, Latin American governments were forced to accept loans offered by the IMF, the World Bank, and the US Treasury that stipulated a package of policies under the so-called Washington Consensus entailing fiscal austerity, privatization, trade liberalization, deregulation, and pro-market policies (Williamson 1990). In this context, international financial institutions gained huge influence over the conduct of domestic policy, strongly supported by local elites, but at the same time that popular participation was heavily circumscribed with the policymaking process confined to a narrow technocratic elite.

When elected into government, Leftist parties in Argentina, Bolivia, Costa Rica, Ecuador and Venezuela faced large budget deficits and high debt-servicing costs that forced them to undergo what Roberts (2011) calls “programmatically de-alignment” meaning they adopted strict austerity measures and abandoned their preferred redistributive programs in favor of further market liberalization (Murillo, Oliveros, and Vaishnav 2008). Seeking election, presidential candidates of nominally progressive parties, such as Cardoso in Brazil and Menem in Argentina promised explicitly redistributive policies and were successful at building electoral coalitions of the very rich and the very poor. However, once elected, obedience to the demands of privileged groups remained the norm as mildly progressive social programs were abandoned as these successful presidential candidates aggressively embraced pro-market policies interspersed with populist policies. As a consequence, Leftist parties’ core identity as champions of the disenfranchised was undermined paving the way for their subsequent electoral collapse.

Organized labor fared little better. Market reforms led to major disruptions of the labor market—unemployment, underemployment, informality amid declining social protection from the state weakened its bargaining power— the result of which was that organized labor became a substantially diminished political actor across the region (Roberts 2002). Union membership went into steep decline as labor unions were progressively undercut by combination of labor liberalization, trade liberalization and wave of privatizations (Saavedra 2003).

The net effect of these developments was to the continued exclusion of large proportions of Latin American populations from the benefits of any economic growth and meaningful participation and influence in politics. While urban and rural workers in formal sectors had to contend with

flexible labor markets, limited collective bargaining, poor education and a lack of training opportunities, the vast numbers of workers who were unemployed or in informal sectors – as well as their dependents - were excluded not only from the limited formal sector benefits but also from health insurance, pensions and other social security protection that were available to formal workers.<sup>1</sup> In these and other ways, the extant power imbalance between the excluded and socioeconomic elites was reinforced thereby further impeding democratic consolidation (Kurtz 2004: 263-65).

Lacking resources of their own and in the absence of political parties effectively representing their interests, the poor and marginalized were left without a political voice and typically became vulnerable to co-optation by business and the state through clientelist networks (Kitschelt and Wilkinson 2007).

But, the market-led development strategies pursued by the newly democratized governments not only induced greater social and economic inequality, they also served to undermine the legitimacy of the shallow democratic regimes and their political leaders as citizens became disenchanted with democracy's failure to deliver real benefits to them (Hartlyn 2003). Survey research on Latin American public opinion in the late 1990s showed high levels of dissatisfaction with democracy and extremely low levels of trust in government institutions which were significantly lower than those experienced in the United States or Europe (Camp 2001; Norris 1999: 228-33; Payne, Zovatto, Florez, and Zavala 2000: 35-37). The study by Payne, Zovatto, Florez, and Zavala concluded, moreover, that disenchantment with

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<sup>1</sup> Portes and Hoffman (2003: 49) estimated that during the 1990s 45.9 per cent of Latin America's workers remained in the informal sector.

democracy and lack of confidence in key political institutions reflected more than poor economic times or dissatisfaction with policy outputs; it appeared "rooted in a more basic disappointment" in how fundamental processes, actors, and organizations of democratic systems in the region operate (2002: 37).

Under such conditions, democracy represented little risk to business and the wealthy. With their dominance of the political system locked down and the Left demobilized, elites could pursue policies most likely to ensure the profitability and security of their assets. Business was free to continue to exploit its structural advantages with political office holders regardless of whether or not they organized collectively or coordinated with one another (Lindblom 1977, 1982; Offe and Wiesenthal 1980). Elites were free to maintain their hold over Latin American political systems, exploit profit opportunities through political connections, resist redistributive efforts, and ensure that the vast majority of public transfers stayed with the wealthy (Goñi, López, and Servén 2008: 19). Even though most Latin American countries had state social security/welfare, education and health care systems, those systems were significantly regressive in their effects on inequality, as were overall taxes and transfers, which in most Latin American countries had only marginal effects on inequality (Huber, Nielsen, Pribble, and Stephens. 2006; Huber, Mostillo, and Stephens 2008).

### Summary

Evidently, by the 1990s, although most Latin American countries were considered democratic, mass political inclusion was notably lacking. The structural legacies of colonialism, the pacted nature of many of the democratic transitions and the impoverishment of the popular sectors due

to the scaling back of the state and collapse in support for Leftist parties following partisan de-alignment meant that large sectors of Latin American society were effectively excluded from the political system. The result of these developments was that Latin American democracies were undergoing an emerging crisis of representation. Although, citizens had been given political rights, they had lacked the means to articulate their demands and in many ways had become even more excluded. In the meantime, incumbent governments were firmly aligned with the interests of capital (typically transnational).

Therefore, at the starting point for my theory, despite all the countries in the study having undergone democratic transitions- democracy was shallow with the political system dominated by wealthy elites with little threat from the Left or pressures for greater redistribution. Wealthy elites preferred a small state liberalized state with low redistribution so that they could keep their assets within the country with little threat to them. Although, many in these societies would benefit from a more equitable distribution of material resources, they lacked the organizational capacity to pressure elites to make this happen. Consequently, barring external economic shocks, net capital flight at this point was either non-existent or extremely low (at between 1 or 2% of GDP).

How then might popular social actors excluded from existing arrangements within shallow or unconsolidated democracies overcome the structural barriers to political participation to become included in deliberative and decision-making processes thereby broadening the legitimacy of the system throughout society? In the following section I explain how these excluded actors seek to take back control through mass mobilization and the impact this has on political risk.

### *Exclusion, Political Mobilization, and Political Risk*

Whether or not, and the degree to which, redistribution becomes a political issue within a democratic regime depends on the capacity of these popular movements to mobilize into cohesive political coalitions. The popular sectors – comprising those who do not own capital and wish for a more equitable distribution of material resources in society - must rely on their superior numbers to mobilize in order to influence public policy. In Western Europe, labor unions were historically central to popular mobilization. In Latin America, recent popular mobilization has typically occurred through diverse coalitions of popular associations of local NGOs, community groups, indigenous organizations, women’s rights campaigners, informal workers’ and environmentalists (Álvarez and Escobar 1992; Collier and Handlin 2009; Mainwaring, Bejarano and Pizarro Leongomez 2006). Studies by Almeida (2006, 2007), Balderacchi (2015, 2016), Bay-Meyer 2013; Cameron, Hershberg and Sharpe (2012), Cameron and Sharpe (2012), Eckstein (2002), Eckstein and Wickham-Crowley (2003), Hevia and Vera (2012); Lissidini (2012), Mahon (2004), Montambealt (2012), Pogrebinschi (2012); Rodriguez (2012), and Jenkins and Klandermans (1995) have shown that, if they are well-coordinated, disparate, social actors can coalesce into powerful social movements capable of applying significant pressure on governments.

The social movement literature posits that marginalized groups denied access to formal channels of representation are likely to engage in “the politics of contention” through collective action (Avritzer 2002; Collier and Mahoney 1997; Tarrow 1998). This entails non-institutional forms of interaction with elites, opponents, or the state, including protests and civil disobedience (Tarrow 1998: 3).<sup>2</sup> Social movements seek to deepen the quality of democracy through sustained challenges to power holders on behalf of disadvantaged citizens living under their jurisdiction (Tilly 1993: 7).

Central to the effectiveness of social movements is the concept of “political opportunity structures” (Eisinger 1973: 25; McAdam, McCarthy, and Zald 1996; and Tarrow 1994) through which social movements seek to connect to institutional politics. Now recognized as the dominant paradigm in the study of social movements and contentious politics what McAdam, Tarrow, and Tilly (1996b) and Tarrow (1988) call a “political process model” of social movements depends on political opportunities, defined broadly as “consistent but not necessarily formal, permanent, or national signals to social or political actors which encourage them to use their internal resources to form social movements” (Tarrow 1996: 54). Specifically, opportunities are provided by those aspects of the political system that allow the possibilities for challenging groups to mobilize effectively *viz.* opportunities are “options for collective action, with chances and risks attached to them, which depend on factors outside the mobilizing group” (Koopmans 2004: 65).

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<sup>2</sup> Rightly, however, important work by Cornwall and Coelho (2007) points to reforms in governance in many countries that have generated a profusion of new “intermediary” spaces for citizen engagement at the interface between the state and society rather than part of it.

McAdam (1996) identifies four main dimensions of political opportunity: the relative openness or closure of the institutionalized political system; the stability or instability of that broad set of elite alignments that typically undergird a polity; the presence or absence of elite allies; and the state's capacity and propensity for repression. Thus, work by McAdam (1999) and Tarrow (1989), for example, have focused on the "windows of opportunities" that institutionalized political systems provide to allow for changes in a country's configuration of social and political power, which groups of citizens exploit to form social movements or engage in protests, such as the opportunities provided by and for the black civil rights movements in the US in the 1960s. In contrast, other scholars have examined more stable aspects of political opportunity by seeking to explain cross-national differences in the forms, levels and outcomes of social movements and protest activities (Kitschelt 1986; Kriesi et al. 1995). Notwithstanding differences in approach, the guiding assumption here is that movements emerge, evolve, succeed, or fail as a function of changes in political opportunities arising from political rules and institutions, strategic choices, and changes in the forms of contention.

From the early 1990s to the early 2000's, Latin America saw a significant upsurge in social movements and social movement activity (Eckstein 2001; Johnson and Almeida. 2006). Various types of social movements mobilized widespread social protest at the local as well as at the national and supranational level on such diverse themes as free-trade agreements and the privatization of public services. Although these movements have been highly diverse inasmuch as they include those from urban and rural areas, "traditional" labor unions as well as new indigenous movements, their significance for the purposes of our theory is that the primary new concern of those that had suffered from political repression under autocratic regimes shifted

under the new democratic regimes first toward their socio-economic survival and then to resistance against social exclusion resulting from the impact of austerity measures following the implementation of Washington Consensus-induced structural adjustment programs.

Twenty or so years of market “adjustment” and “restructuring” generated widespread disillusion with market-led development strategies. The drastic processes of privatization, the gradual breakdown of institutions, and the regressive distribution of economic growth and public services provided the catalyst for renewed social movement activity, popular mobilization, and protest (Arce and Bellinger 2007; Eckstein 2001; Haber 2006; Petras 1999; Walton and Seddon 1994; Williams 2001). Water privatization in Cochabamba, Bolivia in 2000, Argentina’s peso crisis of 2001-02), and the *Arequipa* revolt against the privatization policies of electricity companies by the Toledo administration in Peru, 2002 are all examples of massive social mobilization to market reform measures and were powered by the conviction that economic growth and increased prosperity had not benefitted those at the bottom. Indeed, during the 1990s Latin American inequality increased to levels higher than in any other region of the world.

Economic crisis, privatization, the gradual breakdown of institutions, and the regressive distribution of economic growth and public services created “windows of opportunities” within newly created shallow democratic political regimes where social movements overcame apparently significant collective action and free rider problems (Lichbach 2004; Muller and Opp 1986; Opp 2009); and Popkin 1979) and launched mass social and political mobilization and protest activity,<sup>3</sup> which over time worked with varying degrees of success to reconfigure social

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<sup>3</sup> See Fiorucci and Klein (2004), Giarracca and Teubal (2004), and Teubal (2004) for applications of this theory to the Argentine crisis of 2001-02).

and political power across different countries. For Onuch (2014: 3-4), these mass mobilization activities – which occurred across many Latin American countries (Eckstein 2001: 3) – tend not only to be proportionately larger than other protest events of between 100,000 to 250,000 people, but 1) the balance of participation shifts away from activists, opposition members and organizations and students to a new protest majority comprising “ordinary” citizens; 2) those participating form a cross-class and cross-cleavage coalition with diverse political preferences; and 3) protests are contemporaneous in the sense that they are in part undirected and, at least at first, lack clear leadership. “moments of mass mobilization”, moreover, “seem to come out of nowhere ... when millions of previously disengaged ‘ordinary’ citizens join activists in protests *en masse*, making regime change likely and systemic (social, economic or political) transformation possible”.<sup>4</sup>

In the recent Latin American context, two additional but related features also distinguished them. First, popular mobilization in the last two decades has been qualitatively different in that the phenomenon emerged from the informal sector rather than organized labor, as in previous periods, and so lacked the hierarchical structures and central organization provided by unions (Collier and Handlin 2009). These recently mobilized groups are far more heterogeneous in origin comprising grass-roots organizations, such as neighborhood associations, communal kitchens, rotating credit associations, local NGO’s, street vendor organizations, etc. They mobilize in pursuit of general socio-political aims beyond their membership constituencies, primarily in opposition to market liberalization; and they operate within very loose

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<sup>4</sup> See also Aya (1990) and Tilly (1995) for the use of the term “revolutionary” moment inducing such a degree of social and political instability as to make revolution possible, but not certain.

organizational networks with no single dominant organization (Diani 2003: 9). As a result, they tend to be more pluralistic and decentralized than their labor-based predecessors (Oxhorn 1998), yet, despite their openness, share a common social policy agenda based on relationships of consumption rather than production; that is, focusing on citizens' access to material benefits from the state rather than workers' rights (Foweraker, Landman, and Harvey 2003:150). Still, although no longer the central actors, labor unions have established mutually advantageous relationships with these new movements, including some that have been incorporated into them (Sader 1988; Seidman 1994: 28).

The second distinctive feature of these movements is their organizational structure, which is geared to maintaining sustained and intense pressure nationally across multiple locations – horizontally, through a proliferation of broad-based networks of popular associations, such as indigenous coca growers', city neighborhood councils, and labor unions; and, vertically, through links to a national organization throughout the country (Garay 2017; Tarrow 2005).

### *Stage 1: The threat of mass mobilization and political risk*

The emergence of mass mobilization generates considerable uncertainty and intensifies perceptions of political risk among those who are members of or beneficiaries of the current regime. The threat of political risk may take the form of mass protests, strikes, rioting, and other forms of civil disobedience that disrupt daily economic and political activity. For example, in Costa Rica, after voting in favor of the privatization of the state telecommunications and electricity company ICE in 2000 the rightist *Partido de Unidad Social Cristiana* government was forced to abandon its plans after a wave of mass protests, including strikes, mass demonstrations,

rallies, roadblocks organized by labor associations, students and members of the Left party *Fuerza Democratica* (Almeida 2014). Demonstrations on one issue may, however, produce a “cascade effect” providing momentum for larger protests in support of other popular demands. Thus, the coalition that blocked privatization in Costa Rica expanded to include more sectors in civil society that organized anti-globalization protests between 2004 and 2007 against the Central American Free Trade Agreement (CAFTA). After several days of protest and public sector strikes against CAFTA between 2004 and 2006, the anti-CAFTA coalition coordinated a massive street march of 150,000 people in 2007, which forced the government to hold a referendum on CAFTA. Although the government won the referendum, the anti-CAFTA regrouped around an electoral strategy that led to the election to parliament of several activists in the Leftist *Frente Amplio* Party (Almeida 2015: 175-76).

The threat of political risk is particularly significant for shallow, nonconsolidated, democratic regimes, such as those in most of Latin America. Mass popular mobilization in the context of economic recessions and against a background of huge inequalities of power, income and wealth is highly likely to intensify perceptions of political risk among the wealthy and beneficiaries of the existing government, and more frequently.

Mass mobilization by popular movements is designed to increase the salience and intensity of redistributive demands, politicize and push socio-economic exclusion up the government’s agenda (Tarrow 1998; Keck and Sikkink 1998), enforce state accountability by establishing regularized channels of communication with officeholders (Mainwaring 2003: 10), and ultimately extract policy concessions in the form of some redistribution of state and societal

resources and the inclusion of “outsiders”/grassroots actors and their concerns within the structures of the state.

Even if mass mobilization does not result in redistribution and increased accountability, contentious activity such as marches, demonstrations, roadblocks, encampments in public spaces, and occupations of buildings, is disruptive, especially for commerce, and costly to asset holders actors and the state (McAdam, Tarrow, and Tilly 2001). The activities of the *piquetero* movement, which mobilized Argentina’s informal sectors even before the country’s economic crisis of 2001-02, provides an excellent example of the disruptive influence of a mass mobilization movement that addressed in new ways the needs of a population previously ignored by Argentine social and labor mobilization. The crisis of December 2001 provided a catalyst for the movement’s immense growth and expansion as the government’s failures became much more apparent so that ultimately the entire country participated in demonstrations for change (Birss 2005; Rossi 2015).

*A priori*, the greater the scale, intensity, duration, and frequency of civil disobedience from below the greater its capacity to disrupt the economy and impose costs on capital through the loss of profit opportunities and overwhelm business power thereby increasing the likelihood that business will withdraw its resources.

But, mass mobilization from below is not only disruptive of a capitalist economy in terms of production and distribution of goods and services, once protests become large-scale and sustained, with thousands in the streets, popular mobilization is capable of extracting significant concessions from the government, even to the extent of placing *de facto* vetoes on policies,

threaten a government's legitimacy, destabilize it, and even threaten its survival. Between 1997 and 2003, three consecutive elected presidents of Ecuador were toppled as a result of intense social movement activities (Silva 1-13, 147-94) while in Honduras the rightist president, Manuel Zelaya, was forced by rising popular mobilization in the form of strikes and protests to raise the minimum wage and substantially increase social spending and other poverty reduction measures (Johnston and Lefebvre 2013). Zelaya's action, however, did not prevent him falling victim in 2009 to another of Honduras' many coups orchestrated by an alliance of political elites.

Under threat of mass mobilization from below, if incumbent governments – including Rightist governments - are to survive, they are likely to seek to maintain “social peace” by responding to popular demands for more redistributive public policies (Burgess and Levitsky 2003; Garay 2016). Indeed, this is precisely the pattern that has unfolded in several middle income countries in Latin America since the 1990s. While previous efforts by established political parties to implement redistributive policies had failed, in the context of intense electoral competition for the votes of the excluded “outsiders”, mass mobilization by social movements from below resulted in governments implementing *inclusive* redistributive policies, especially where those movements were allied with labor unions. What business and the wealthy in these and other Latin American countries regarded as costly social programs were introduced to expand pensions, cash transfers, and health services to millions of previously unprotected outsiders, thereby – at least in the eyes of the wealthy, raising levels of political risk. As a result, by 2010, several middle income countries in the region had expended cash transfers, pensions, and health care services to at least 35 per cent of what Garay calls “the outsider population”, and between

48 and 100 per cent of “outsiders” aged 65 and older were receiving pensions at the same time that transfers to school-age children were provided on a massive scale (Garay 2017: 3).

Inevitably, given the extremely high concentration of income and profits in the hands of the wealthy in Latin America (Alvaredo 2010; Gomez-Sabaini 2006), the introduction and implementation of these redistributive policies has sooner or later increased *perceptions* of political risk amongst the wealthy and business, who have been historically undertaxed, for the obvious reason that taxation of the better off had to be increased to provide the increased state resources to pay for the new enhanced social programs. When mass mobilization produces uncertainty and increases political risk, capital may seek to use its power to reduce political risk but asset holders may very well decide that the safer bet is to export their capital, especially if inflation is high, and opportunities for profit look better elsewhere.

At a more fundamental level, however, mass mobilization and the rise of popular movements are significant developments for political risk because they pose a threat to entrenched elite interests by challenging the prevailing structure and configuration of power in society. More than the threat of increased taxation, mass mobilization threatens major changes in patterns of political behavior in the host society, including importantly the redefinition of the scope of the state’s political constituency, the range of interests and identities that it is required to serve, and the uncertainty surrounding the inclusion within the political system of a new range of political actors. Mobilization also undermines the status of the formal political system as the primary arena for resolving social conflict. By popular movements making new demands on the state for social services they also seek to increase the state’s role in society and the economy; and, in the

extreme, raise the possibility of the state taking over capital assets by, for example, contract renegotiations, the establishment of a minimum wage, greater regulation of business and other economic activity, tax increases, and even redistributive land reform and direct expropriation of private assets. Moreover, should a government then fail to meet these demands once mass mobilization has become part of “normal” politics, popular discontent may against threaten the state’s legitimacy.

In light of the likely effects of mass mobilization within shallow, unconsolidated democracies, and the specific conditions highlighted above in respect of Latin American democracies, my first hypothesis is:

*H1: Ceteris paribus, Latin American democracies that experience extensive popular mobilization will experience higher levels of capital flight*

I define extensive popular mobilization here as a sustained process launched by a coalition of social movements and labor unions with the aim of making coordinated demands on the state for social inclusion/redistribution.

#### *Stage 2: The threat of Leftist parties*

Popular social movements cannot bring seek to win control of state on their own, not matter how intense, extensive and frequent mass mobilization becomes. If they are to achieve their policy goals they need to form a mass based Leftist party capable of being elected, or align with an existing party that can be trusted to implement redistributive agenda (Korpi and Palme 2003; Western 1997). Thus, Huber and Stephens (2012) insist that the re-emergence of democracy in

Latin America was a necessary condition for the implementation of redistributive policies.

Democratization enabled Left-leaning political parties to emerge and win office, and so make progress in reducing inequality in society through social programs for the poor.

Although democracy is a necessary condition for the rise of the Left, it is not a sufficient one.

Even when elections are free and fair, a Leftist party – newly formed or previously established – may lack the political organization, leadership and resources to harness the political momentum engendered by mass mobilization, thereby failing the present a serious threat to capital holders, and allied political parties may be able to win government power, remain politically cohesive, and pursue policies that continue to privilege market-oriented solutions skewed in favor of capital – with the consequence that perceptions of political risk will not be strong, and capital flight will be deterred.

Following the logic of my theory – that mass mobilization will increase perceptions of political risk – it follows that when a Leftist party is perceived by asset holders as endorsing popular movements demands for greater socioeconomic and political redistribution, is effective in cultivating political support from those movements, and seems likely to be able to form a government in the near future, at some *threshold of Leftist party electoral support* capital holders will perceive an increased threat to their interests (political risk) and export their capital, even *before* the Left comes to power when Rightist pro-market parties control the government.

Studies by Eckstein (2002), Eckstein and Wickham-Crowley (2003), Fairfield (2010, 2015: 427-37), and Lobina, Terhorst, and Popov (2011) demonstrate that in the contexts of changing politico-economic conditions and increasingly unpopular Rightist governments, many popular

movements in Latin America have been very effective not only in galvanizing popular support but in alliance with Leftist parties have attained such levels of electoral popularity that the political parties with which they ally with have become serious contenders for government. The possibility of a Leftist party winning power leads to mass capital flight because it threatens the structural foundations of elite power by raising the likelihood that property relations or private control over productive assets will be renegotiated at their expense.

Facing the prospect of a Left government, I suggest then that capital owners come to realize that their power and interests are seriously threatened and so opt to export their capital to a place of greater safety. This line of argument yields my second hypothesis:

*H2: Ceteris paribus, the greater the probability that the Left will win government power the higher the level of capital flight*

### *Stage 3: Leftist Governments in Power*

So far, I have discussed capital flight in reaction to the threat rather than the *actuality* of redistributive policies. The final critical point in my theory occurs if the Leftist party wins power. A considerable body of literature shows that once in power Leftist governments are perceived as risks by investors (Block and Vaaler 2004; Campello 2009; Cho 2008; Hicks 2006; Valero and McNamara 2008) and a threat to their interests (Campello 2009; Mosley and Brooks 2008, Vaaler, Schrage and Block 2005). The rationale is the same as in the previous discussion: Leftist governments generally represent the interests of popular sectors and redistribute national income, wealth and social economic rights towards those interests whereas governments of the

Right favor market policies, promote and defend the interests of capital, exercise fiscal restraint (Alesina and Sachs 1988; Mosely 2003), and emphasize economic and political stability (e.g. Block 2003). In this case, asset holders may react to specific policies enacted by the Leftist government such as expropriations, nationalizations or increases in taxation.

In this light, I propose a third hypothesis:

*H3: Ceteris paribus, Leftist Latin American governments will experience higher levels of capital flight*

*The established Left vs. the new Left*

The Leftist threat to capital is not the whole story, however. Empirical evidence shows substantial variations in outcomes *between* Leftist governments: some Leftist governments opt for radical change while others adopt more incremental, more moderate, approaches (Castañeda 2006; Flores Macias 2010; Garay 2016; Huber and Stephens 2012; Madrid 2010; Weyland 2009). As Figure 3.1, shows the variation in mean levels of capital flight in Latin America under Left and center Left governments. Clearly, levels of flight induced by Left governments are very different from those of center Left governments, whose levels are very close to those induced by Center, Center Right, and Right governments.

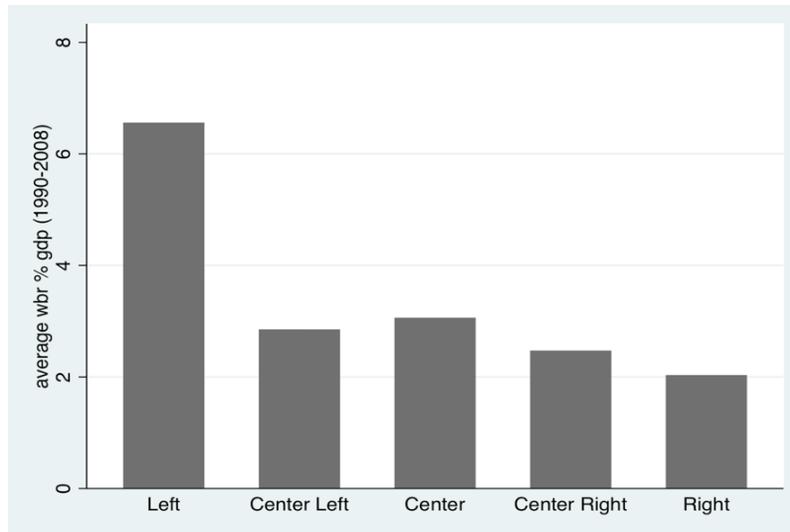


Figure 3.1. Government ideology and capital flight, 1990-2008 (WBR as per cent of GDP)

The designation of political parties into different ideological groups follows Murillo, Oliveros, and Vaishnav 2010

The obvious explanation for these patterns is that investors find center Left governments less threatening than far Left governments. Why this appears to be so may have to do with the age of the Leftist parties. Mainwaring and Scully (1995), for example, suggest that established parties with well-developed organizational structures that shape party policy and leadership have already undergone substantial ideological moderation and organizational professionalization by the time they come to power. In a similar vein, Levitsky (1998: 80-1) suggests such parties have undertaken a process of “behavioral routinization” by which certain modes of behavior and rules and procedures have become accepted, obeyed and entrenched.

Another consideration is that an established party will also have a reputational brand, which may be tarnished, whereas a newly emergent party coming to power at a time of severe economic or

political crisis will be an unknown quantity, and, if also Leftist, be more likely to threaten a more adversarial relationship with capital and thus frighten investors (Levitsky and Roberts 2011). Newly formed parties, such as the Leftist parties that emerged in Venezuela, Bolivia and Ecuador in the 1990s, not only did not experience the institutional learning and ideological moderation processes of established parties, they were also led by personalistic leaders who based their legitimacy on current popular opinion with short term perspectives (Carreras 2012). In other countries, however, established Leftist parties were able to retain their electoral relevance. In Uruguay, for example, although there was mass mobilization against market reforms and the Leftist Uruguayan *Frente Amplio* spent lengthy periods in opposition, like other established Leftist parties in the region, the party retain its strong linkages with important social actors, its candidates continued to winning election to the national assembly and municipal governments where they developed careers and learned to cooperate with other parties. As a result of this institutionalization process, the protest movement that came out of the backlash to market liberalization was easily absorbed into the party and, once elected to government, the FA pursued moderate policies (Hunter 2010). The upshot of all of this is that established Leftist parties are far less likely to adopt more moderate redistributive policies, more likely to accept the pro-market status quo and more likely to eschew radical economic reform (Flores-Macias 2012), and thus are less likely to threaten the wealthy and thus mass capital flight.

*H3b Ceteris paribus, Leftist governments under newly established parties will experience higher levels of capital flight than those under more established parties.*

### *The relative strength of the political opposition to Leftist governments*

Besides postulating that Leftist governments will moderate their policies according to the age of their party, my theory also holds that they will moderate their policies according to the relative strength of the political opposition acting to protect capital's interests. Domestic capital can count on instrumental power with which to counteract redistributive threats to their interests and influence government policy (Fairfield 2010; Miliband 1969). As scholars of business politics have observed, "capital votes twice: once through the organized pressure it can bring to bear on the political process, again through its investment decisions" (Haggard, Maxfield, and Schneider 1997: 38). From this perspective, rightist parties are the first line of defense for capital against calls for redistribution from the Left and in response to popular mobilization. Capital flight is strictly a last resort; being costly in terms of transaction costs and lost investment opportunities. By occupying veto points in significant policymaking arenas within a political system business friendly parties place institutional constraints on Leftist governments and legislatures that seek to enact and implement redistributive policies. By creating a strong and cohesive business party, elites can also coordinate their demands, synchronize their lobbying and so improve their bargaining position *vis-a-vis* the Left. Thus, work by Fairfield (2010) has shown how business organizations with links to rightist parties effectively lobbied to defeat corporate tax increases and proposals to allow tax agencies access to information on their activities held by banks in Argentina and Chile. Cabrera and Schneider (2015) tell a similar story for Guatemala: despite repeated attempts to engage social actors in a fiscal pact in order to implement tax reform, active elite resistance led by the main private-sector confederation, CACIF, brought failure. Conversely, when no such party exists (as, in Bolivia and pre-Chavez Venezuela) the Left has

been able to implement redistributive policies without constraints increasing the likelihood of capital flight (Figure 3.2). For example, in Brazil in the context of strong rightist opposition, the Leftist *Partido dos Trabalhadores* (PT, Brazilian Workers' Party) has frequently adopted pro-capital policies in order to attract foreign investment and prevent capital flight with positive effects on perceptions of economic stability that encouraged economic growth and facilitated some redistribution of wealth and income (Henkin 2014).

Almost all Latin American countries have a pro-business rightist party – the *Partido da Social Democracia Brasileira* (PSDB) in Brazil, the *Propuesta Republicana and Compromiso para el Cambio* in Argentina, the *Coalición por el Cambio* in Chile, etc. These parties and their counterparts in other Latin American political systems are socially, economically and politically linked to powerful business organizations such as Chile's *Confederación de Producción y Comercio*, and business-agriculture confederations, such as Guatemala's *Comité Coordinador de Asociaciones Agrícolas, Comerciales, Industriales, y Financieras*, CACIF), often prevent or reshape legislation that could otherwise damage their members' interests before it becomes public (Mahon, Bergman and Arnson 2015: 14). These and other business organizations heavily influence the party's political agenda, which typically includes pro-market policies that favor greater economic efficiency and oppose redistribution, frequently impose their preferred candidates, and directly participate in policymaking (Pollack 1999).

The presence of a strong and cohesive opposition reduces the impact of popular mobilization on capital flight in two ways. First, such an opposition is able to occupy veto points in the legislature to block redistributive policies pushed for by Leftist governments. Second, significant

electoral competition from a pro-business opposition will force Leftist parties to moderate their demands for redistribution in order to win office.

*Pro-business opposition*

<i>Level of popular mobilization</i>	<i>Weak</i>	<i>Significant</i>
<i>Low or none</i>	Low capital flight	Low capital flight
<i>High</i>	High capital flight	Low/Moderate capital flight

Figure 3.2. Schema for popular mobilization, political opposition, and capital flight

If a Leftist government pursuing redistributive policies is likely to induce capital flight then its relative political strength must also figure in the equation – on the premise that a Leftist party that wins an election by a wide margin (Conley 2001; Fowler 2005; Fowler and Smirnov 2005) and/or is able to sustain a politically strong Leftist government will be better able to implement more radical policies than one that barely wins an election or has proposed more moderate policies in order to appeal beyond its base constituencies (organized labor) to the political center in classic Downsian style (Alesina 1988; Fairfield and Garay 2017), or one that becomes politically weak in office. As mentioned earlier, the Leftist Brazilian *Partido dos Trabalhadores (PT)* spent many years in opposition before winning power with more moderate policies. Similarly, in Peru, having lost the 2006 presidential election against a more conservative, pro-

business, opponent promising radical change in line with Chavez's policies in Venezuela, the "Left-leaning" Ollanta Humala moderated his platform and quite ostentatiously avowed being closer to Lula and the PT in Brazil than to Chavez offering a more incremental approach, and beat the main pro-business candidate in 2011.

I operationalize the general proposition that Leftist governments that face significant political opposition from Rightist parties will experience less capital flight in two separate hypotheses:

*H4a: Ceteris paribus, Leftist governments with greater majorities in the legislature will experience more capital flight.*

*H4b: Ceteris paribus, Leftist governments that experience greater opposition fragmentation will experience more capital flight*

A third hypothesis addresses the above discussion in regard to veto points:

*H4c: Ceteris paribus, Leftist governments will experience less capital flight in political systems with more veto players*

### Summary

This chapter has provided the theoretical framework for the dissertation. Its central contention is that capital flight from Latin American democracies since the 1990s has been driven by asset holders' increased perception of threats resulting from popular movements mobilizing to demand greater socioeconomic and political redistribution. In the context of huge disparities in wealth and income in Latin America, business and the wealthy who controlled most economic and

financial assets eschewed a larger and more redistributive state financed by higher taxation. With a pro-business government in office capital flight remained low as capital owners felt comfortable in keeping their assets within the country. In short, their perceptions of political risk were low.

If, however, popular social movements begin to mobilize on a massive scale and Leftist parties embrace their demands and gain significant electoral popularity promising greater redistributive of societal resources, the balance of political risk perceived by asset holders changes to a condition of greater insecurity. Their perceptions of increased political risk become especially potent because of the shallowness of democracy in Latin America, which makes these countries especially vulnerable to popular political pressures generated through mass mobilization.

Perceptions of risk increase significantly, which in turn increases the incentives for business and the wealthy to export their capital, especially if inflation is high, and opportunities for profit look better elsewhere.

My political theory of capital flight identifies three critical points within a causal sequence which lead to surges in capital flight. First, at the beginning of this sequential process, mass popular mobilization in the form of general strikes, mass protests and other forms of activism becomes so severe as to cause economic disruption that significantly increases asset holders' costs and risks, which in turn leads to rapid increases in capital flight. Without mass mobilization in favor of more redistribution and the consequent disruption, asset-holders do not perceive the need to remove their wealth because they feel their interests will be successfully defended and promoted.

As a consequence, capital flight is either non-existent or relatively low (say, at no more than one or two per cent of GDP).

Second, mass popular mobilization may be so extensive and potent that Leftist parties embrace popular demands and redistributive policies, which may lead to a second critical juncture: asset-holders come to identify a clear and present threat evidenced by the Left becoming sufficiently popular electorally as to present a realistic prospect of being able to win government office and so threaten dominant pro-capital interests. At this second critical point, the threat of redistribution – and therefore enhanced political risk - persuades asset holders to remove their funds abroad. In the absence of a credible electoral threat from the Left, the capital interests continue to prevail obviating the need for capital flight.

The third and final critical point is when the Left is in office and asset-holder react to specific policies which harm their interests by engaging in capital flight.

The threat to asset-holders posed by the Left may be tempered by two factors, however. First, by the extent to which the Leftist party involved in the process of mobilization is an already established actor or a newly formed party. The underlying premise here is that established (as opposed to recently formed) Leftist parties will pose less risk to asset-holders than an emergent new party, and thus engender less capital flight.

Second, the extent to which Leftist office holders may implement their redistribution policies will be tempered by the extent of their legislative majorities and the relative strength of the pro-capital political opposition. When a Leftist government is weakened by a slim legislative majority and facing a cohesive, determined and electorally competitive political opposition

occupying significant veto points within the political system, it will likely be obliged to moderate its policies and in so doing likely reduce asset holders' perceptions of political risk, and persuade them to retain their assets within the host country. Absent such constraints, a Leftist government will enjoy much greater freedom to pursue redistribution unconstrained, and thus much more likely to trigger significant levels of capital flight.

In the final section of this chapter, I now turn to the dissertation's research design.

### Research Design

In order to test my theory, I opt for a mixed methods research design combining quantitative analysis with qualitative case studies, which reflects a growing recognition in the social sciences that qualitative research can usefully complement quantitative studies, given the strengths and weaknesses found in single method designs (George and Bennett 2005; Goertz and Mahoney 2012; Collier, Brady and Seawright 2004). Quantitative studies are only as good as the causal theory underpinning them. Credible causal inferences about decision processes cannot be made, for example, from regression analysis alone (Freedman 1991; Berk 2003). In order to go beyond correlation to causation in causally driven decision processes, statistical methods are not very helpful, whereas case studies can identify causal mechanisms and the conditions under which specified outcomes occur, and the mechanisms through which they occur, rather than uncovering the frequency with which those conditions and their outcomes arise (Alexander and George 2005: 31-32). Besides providing causal leverage to statistical correlations, case studies allow the researcher to posit contingency – “it all depends” – middle range theories that comprise well specified generalizations of limited scope. Where frequency distributions from large samples are

not available, they are suited to testing causal mechanisms in the context of particular cases. However, they are more efficient at discovering the scope conditions of theories and evaluating claims about causal necessity or sufficiency in specific instances than at assessing generalized causal effects or the causal weight of variables across a wide range of cases, which statistical methods provide. Cases may also supplement theories by identifying deviant cases that uncover new or omitted variables, test hypotheses, or discover causal paths and mechanisms.

Taking small-N cases together with large-N statistical analysis in a mixed methods research design thus allows for convergent validation or triangulation; that is, cross validation across methods to ensure that the variance reflected is that of the causal relationship, not of a single method (Denzin 1978; Hickman 2000; Webb, Campbell, Schwartz and Sachrest 1966).

#### *Quantitative Cross-Sectional Times Analysis*

In order to test the predictions of my theory, generally, I created a cross-sectional time series dataset of 18 Latin American democracies covering the period 1990 to 2012 and use four sets of empirical tests to estimate the impact of my independent variables of interest on patterns of capital flight, controlling for a battery of familiar control variables: first, the impact of popular mobilization; second, the balance of power between the Left and opposition forces; third, the effect of specific redistribution policies; and fourth, the relationship between government ideology and the introduction of redistribution policies and pro-business policies. Following these tests of my general theory using a large-N quantitative analysis I then use case studies to test specific causal mechanisms, including whether differences other than those used the large-N

analysis account for differences in outcomes that causal process tracing uncovers in specific cases.

### *Qualitative Case Study Analysis*

The qualitative element of the analysis comprises a single within-case study and a cross-case comparison of two cases, which is now seen by most analysts as “the strongest means of drawing inferences from case studies” (George and Bennett 2005: 18).

Within-case studies focus on the causal path in a single case and provide an effective means of process tracing causes and effects linked to theory testing. One way is the controlled comparison method where the researcher is required to find two cases similar in every respect but one. Since this requirement is difficult to satisfy, an acceptable compromise is what George and Bennett (2005) call the “congruence method” (181-204), where the researcher uses a theory or hypothesis to try to assess its ability to predict the outcome in a particular case. That is, an established theory is imputed to data to evaluate its applicability: whether the theory’s predictions and expectations match the cases outcomes. The theory posits a relationship between variance in the independent variable and variance in the dependent variable. The approach may be deductive or take the form of an empirical generalization. However, case selection is crucial; the chosen case must be representative of a large population and unequivocally serve the purpose of theory testing.

El Salvador was selected as my “most typical” or most representative case. As Beach and Pedersen (2016: 50) have noted, seeking to select the most-likely, least-likely, or crucial case - as

suggested by Eckstein (1975: 118) and Gerring (2007: 231-32) - raise significant *a priori* likelihood problems that are impossible to untangle. El Salvador is a good choice because the country is located outside South America from where much of the inspiration for my theory derives, thereby providing the opportunity for external validation. Patterns of capital flight from El Salvador have also not been studied previously.

Instead of trying to identify two cases that are comparable in all ways but one - to meet the strict requirements of the controlled comparison method - control will be achieved by dividing a single longitudinal case into two subcases (Lijphart 1971: 689). For this quasi-experimental approach to be valid, however, only one variable can change at the moment that divides the case study neatly in two. The values of the observed variables must not only be examined immediately before and after the event, but also well before and well after (Campbell and Stanley 1963; Collier 1993: 119). This before-after methodology is used to observe changes in patterns of popular mobilization and capital flight in El Salvador between 1990 and 2009, when the Leftist *Frente Farabundo Martí para la Liberación Nacional* (FMLN) finally won control of the government. The dividing line occurred in 2000 when sporadic street and individual sector mobilization developed in response to the privatization of ancillary work in the state social security hospital system and dollarization of the Salvadoran economy into much more intense popular mobilization and the creation of a much broader cross-sectional popular movement identified with the *Marchas Blancas* (white marches), who increasingly coordinated their mobilization activities with the Leftist *Frente Farabundo Martí para la Liberación Nacional* (FMLN) (Spalding 2014: 277). Symptomatic in this sea change – and much more serious threat to capital

- was the marginal victory of the FMLN in the 2000 congressional elections, albeit at the same time that the rightist *Alianza Republicana Nacionalista* (ARENA) retained the presidency.

My second study is a cross-case comparison of El Salvador once the FMLN won power in 2009 and Bolivia after the Leftist MAS-IPSP won the presidency and Chamber of Deputies in 2005.

These two cases where the Left was in power were selected using the logic of most similar research design, which requires that the cases are comparable in all areas *except* the independent variable whose variance is considered to account for different outcomes on the dependent variable (capital flight). Specifically, the more cross-case evidence is available, the more the status of the case study shifts from a focus on covariational facts - do popular mobilization (X) and capital flight (Y) co-vary in the predicted direction - to causal mechanisms that explain why X leads to Y.

As with the within-case study, my two cases must be representative of the larger population so I choose two Latin America democracies with similar traits. Both Bolivia and El Salvador have similar economic and political characteristics, especially their levels of economic development (Table 3.1). Both became democracies relatively recently, both have similar Polity IV scores (varying between 7 to 8 over the period of interest), and both are presidential republics.

However, each country has experienced significantly different levels of pro-business political opposition and capital flight under their Leftist governments. The cross-case study evaluates the causal process by which the political strength of the pro-business opposition impacted Leftist governments' policies and thereby reduced the level of capital flight. Having introduced my theory of political risk and capital flight drawing on power resource theory and proposed a series

of hypotheses, in the next chapter I provide a cross country quantitative analysis of patterns of capital flight from 18 Latin American countries to test the implications of the theoretical framework presented here.

Table 3.1. Bolivia and El Salvador: Economic and political characteristics

<i>Characteristic</i>	<i>Bolivia</i>	<i>El Salvador</i>
Democratization	1982	1992
Polity IV score, 2005-15	7-8	7-8
Governmental system	Presidential	Presidential
Population, 2013	10.8 m.	6.1 m.
Gini index, 2013	56.3	48.3
GDP 2013	\$30.6 b.	\$24.4 b.
GDP per capita 2013 (US dollars)	\$2,868	\$3,826
Public debt as % of GDP, 2005-13	45.5%	51.5%
Main components of economy	Agriculture 13.2%; industry 38.3%; services 48.5% (2014 est.)	Agriculture 10.7%; industry 25.5%; services: 63.8% (2015 est.)
Exports	Natural gas, mineral ores, gold, soy beans and products, tin	Offshore assembly exports, coffee, sugar, textiles and apparel, gold, ethanol, chemicals, electricity, iron and steel manufactures

*Sources:* World Bank 2013; [www.tradingeconomics.com](http://www.tradingeconomics.com)

## Chapter 4: Explaining capital flight in Latin America: A quantitative analysis of 18 developing democracies

The previous chapter out the dissertation's central contention: that capital flight from Latin American countries is driven by asset holders' increased perception of threats due to popular movements mobilizing to demand greater socioeconomic and political redistribution, by Leftist parties often cultivating political support from these movements and becoming electoral popular, and by the actuality of Leftist governments elected on platforms of greater redistribution. Taken together, this causal sequence prompts asset holders to export their assets. However, I also suggested that these drivers of capital flight might be mitigated by the extent to which Leftist parties are perceived as committed to radical redistributive policies by the time they are elected to government, and by opposition parties/coalitions favorable to capital's interests having sufficient electoral and positional strength to block or moderate redistributive policies promoted by the Left.

In order to undertake initial tests of my theory, five sets of quantitative empirical tests were conducted on a cross-sectional time series dataset of 18 Latin American democracies covering the period 1990 to 2012 to estimate the impact of a series of independent variables on patterns of capital flight, controlling for a basket of economic variables.<sup>5</sup>

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<sup>5</sup> The Latin American countries in the dataset were Argentina, Brasil, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela.

### Measuring Capital Flight

Measuring capital flight is by no means a straightforward matter, as the discussion in Chapter 2 indicated. Unsurprisingly, the literature has offered a variety of methodologies. Simply using recorded outflows to measure capital flight does not capture *unrecorded* flows and thus is likely to underestimate drastically the real volume of capital flight. Unrecorded flows are qualitatively different from recorded flows since by their very nature they seek to evade government regulation and control. Given that the premise of my theory is that capital owners wish to escape state taxation and/or appropriation and therefore likely will opt for off-the-book transactions to export their assets, and in order to serve my research purposes, the measure of capital flow needs to include unrecorded flows.

Hot money measures of capital flight are based on the net errors and omissions data in countries' balance of payments accounts. Given that quarterly data is typically available, the measure may be appropriate for analyzing flight behavior at specific points in time, such as a *coup d'etat*, but if the research design seeks to address how political processes impact flight over time the measure fails to capture a significant proportion of outflows. Similarly, measures that tap trade mis-invoicing are also inappropriate for present purposes because such practices are driven by corruption and thus more relevant for testing the "dirty money" approach discussed in Chapter 2, rather than the research focus here, which is political risk.

Throughout this dissertation, the analysis provided uses the World Bank Residual (WBR) method, which is also the most commonly used in the scholarly literature (Cuddington 1986; Cumby and Levich, 1987; Dornbusch 1990; and Hermes, Lensink, and Murinde 2002) and the

one widely employed by international organizations, including the Bank of International Settlements, the United Nations, and non-governmental organizations (NGOs), such as the Tax Justice Network (Claessens and Naudé 1993; Henry 2012; UNDP 2011). The WBR also has the advantage of being the broadest measure of capital flight and the one for which data are most readily available.

As discussed in the previous chapter, what matters most for a country's economic development is the stock of capital, which includes funds that leave the country as well as those that come in. Much of the Foreign Direct Investment (FDI) literature fails to address whether or not inflows are accompanied by significant outflows whereas the WBR method captures unrecorded *net* flows. Even if we only take into account *legal* outflows, the resulting calculation overlooks the often comparatively large volumes of *unrecorded* outflows. Additionally, it is important to note that where the residual measure used in this dissertation produces "positive" capital flight (i.e. net inflows) these inflows are discounted for the very good reason that so-called "inward" capital flight is not recorded and thus cannot add to the sum of productive capital or contribute to tax revenues (GFI 2015).

The WBR then measures capital flight by comparing officially recorded changes in gross foreign indebtedness with the net figures for all credit related positions in countries' balance of payments data, as reported in the IMF's Balance of Payments database (see, for example, Ajayi 1997; Erbe 1985; Morgan Guaranty Trust Company 1986; World Bank 1985). For any given country, the extent of flight is the difference between the two aggregates - total capital inflows and recorded foreign exchange outflows. Funds in excess of those recorded indicate a loss in the form of

unaccounted outflows, which is capital flight. The WBR formula is calculated as:

$$\text{Change in External Debt} + \text{Net FDI flows} - (\text{Current Account Balance} + \text{Change in Reserves})$$

### Independent and control variables

The primary purpose of this chapter is to estimate a model for capital flight from Latin American countries over the last several decades. The core thesis is that popular mobilization and the rise of Leftist parties raises elite perceptions of political risk, which leads to increased levels of capital flight. The base model may be represented thus:

$$CF = \alpha + \beta_1 (\text{ECONOMIC CONTROL VARIABLES}_{t-1}) + \beta_2 (\text{POPULAR MOBILIZATION VARIABLES}_{t-1}) + e$$

Given the problems associated with OLS estimates of standard errors in panel data – particularly those arising from panel heteroscedasticity/spatial correlations that lead to inconsistent standard errors - my analysis follows Beck and Katz (1995) in employing OLS coefficient estimates with panel-corrected standard errors (PCSE). The possibility of serial correlation in error terms (in addition to contemporaneous correlation) determined that the dependent variable had to be lagged. Using a lagged dependent variable also solved the potential problem of autocorrelation. Separate regression models were run with and without country dummy variables. The models that excluded country dummies estimated the relationship between capital flight and various baskets of independent variables *across* countries. Those that included country dummies estimated over time variations *within* countries and thus evaluated country specific influences on capital flight.

The dissertation's overarching argument is that Latin American democracies exhibiting greater popular mobilization and rising support for Leftist parties will experience higher levels of capital flight. The impact of these drivers may be tempered by age of the Leftist party which impacts whether or not it will pursue radical or moderate redistributive policies and the electoral and positional strength of pro-market opposition parties. In order to test these contentions and the causal mechanisms underlying them I ran three sets of OLS regressions in line with the three main hypotheses introduced in the previous chapter: 1) political mobilization leads to higher capital flight; 2) a greater likelihood that a Leftist party will win power leads to higher capital flight 3) governments under new Leftist parties experience greater capital flight and 4) where Leftist governments faced with significant political opposition will experience less capital flight.

In addition to these tests I add two more sets of regressions in order to verify the causal processes implicit in my theory. First of all, I test the assumption that redistributive policies do indeed lead to more capital flight. I then run a series of models designed to assess if Leftist governments are more likely to adopt redistributive policies than their counterparts as per my theory.

### *Control variables*

Unless otherwise specified, all the models included a baseline group of six control variables taken from the economic literature in order to account for the role of "push" and 'pull' economic factors that may also drive capital flight. To take into account external conditions - so-called "push" factors that may incentivize capital flight - the 3 month US Treasury bill mean rate and annual global growth, as a percentage of GDP, are included. The US interest rate is used as a measure of relative profitability of returns outside the country in a given year and the global

growth rate accounts for overall profitable opportunities in the world economy at the time.

Five other country level controls taken from the World Development Indicators dataset at the World Bank are also entered:

- 1) Annual growth rate per annum as a percentage of GDP for each country, to allow for capital flight being higher when a country's rate of growth is comparatively low (Pastor 1999; Nyoni 2000).
- 2) A country's annual domestic inflation rate is included to assess high inflation encouraging capital flight. Cuddington (1987), Dooley (1988) and others have found that high domestic inflation has the effect of making locally denominated assets less attractive than those held in foreign currencies and/or acting as a surrogate for poor or mediocre macroeconomic management by government, both of which factors encourage capital flight.
- 3) The tendency for developing countries to run fiscal deficits usually encourages inflationary financing, which increases foreign debt, imposes an "inflation tax" on citizens, and is also thought to drive capital flight by wealthy asset holders who switch to foreign assets (Dornbusch 1985; Conesa 1987). To account for these phenomena, a control for each country's external debt as a percentage of GDP (logged) is entered.<sup>6</sup>
- 4) Fourth, since trade openness has been shown to affect capital flight from the region (Bhattacharya 1999; Avelino, Brown and Hunter 2005), each country's total trade of

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<sup>6</sup> I use external debt as a percentage of GDP rather than fiscal deficits to account for private sector debt as well

goods and services, as a percentage of GDP, is included.<sup>7</sup>

5) Finally, drawing from the economics literature that argues that financial liberalization facilitates capital flight (Cuddington 1986: 33, Pastor 1990), the commonly used Chinn-Ito index (2006) is entered, as a measure of the strength of each country's capital controls.<sup>8</sup> +-

### Regression results

The regression results are divided into five batches to reflect the theory's sequencing.

#### *1. Popular Mobilization and Capital Flight*

The first batch of models estimates the impact of various measures of popular mobilization on capital flight to test *H1: Ceteris paribus, Latin American democracies that experience extensive popular mobilization will experience higher levels of capital flight*. Does the threat of popular mobilization, in favor of redistribution, drive capital flight?

I use three different measures to test *H1*: a composite measure of yearly counts of the number of general strikes, riots and anti-government demonstrations taken from the Cross National Time Series (CNTS) dataset; a dummy variable measuring citizens' perceptions of anti-system popular mobilization derived from Coppedge *et al*'s V-Dem dataset (2006: 239); and another dummy

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<sup>7</sup> The sources for these data are: World Bank (2016) for global economic growth percentage of annual world GDP, annual domestic economic growth rate, annual domestic inflation rate, external debt as percentage of annual GDP (log), and trade openness (goods and services exports and imports annual percentage of GDP); the 3-month US treasury bill mean rate per year is derived from the Federal Reserve Bank of St Louis' Economic Data.

<sup>8</sup> The index measures a country's degree of capital account openness based on coding from the tabulation of restrictions on cross-border financial transactions reported in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*.

taken from the V-Dem dataset measuring perceptions of the presence of a Leftist popular movement (240). Table 4.1 lists these variables and their predicted signs.

Table 4.1. Political mobilization and capital flight: variables and predicted signs.

Description	Source	Predicted signs	
		Non-left government	Left government
Protest (composite measure of number of general strikes, riots and anti-government demonstrations)	Cross-National Time-Series Dataset (CNTS) (Banks and Wilson 2016)	+	No effect
Popular mobilization (Expert perceptions of the intensity of anti-system popular mobilization' Dummy: high and very high values =1; other values = 0)	Variable v2csantimv in V-Dem Codebook v6 (Coppedge et al 2016)	+	No effect
Leftist mobilization. (Expert perceptions of the character of anti-system popular mobilization; Dummy: Leftist =1; other values = 0).	Variable v2csanmvch in V-Dem Codebook v6 (Coppedge et al 2016)	+	No effect

Given that my theory pertains to popular mobilization from the left against typically pro-capital incumbent governments, I estimate the effects of popular mobilization under Leftist and non-Leftist governments. The regression estimates shown in Table 4.2 for six different models provide support for two elements in my theory: that popular mobilization drives capital flight under non-Leftist governments but has no effect under Leftist governments. Anti-regime protests against non-Leftist governments are significant at the .05 level with the sign in the expected direction (Model 1) but, as expected, when the same model is run for Leftist governments the variable is not significant (Model 2). Using popular mobilization rather than protest as the measure, the results are similar: popular mobilization against a non-left government is significant at the .05 level with the sign in the predicted direction but once again insignificant when the left is in office (Models 3 and 4). As Models 5 and 6 demonstrate, it is popular mobilization *from the left* that is the key driver under a non-left government whereas this factor has no effect when the

left is in office: Leftist popular mobilization against non-Leftist governments is significant at the .01 level with the sign in the anticipated direction (Model 5) but not for Leftist governments (Model 6). As will be noted in the results from subsequent models, two control variables (logged external debt and inflation) are significant, the former only under non-Leftist governments, the latter sometimes under both Leftist and non-Leftist governments.

Table 4.2. Popular mobilization and capital flight

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
	Under non-Leftist government	Under Leftist government	Under non-Leftist government	Under Leftist government	Under non-Leftist government	Under Leftist government
US Interest rate	-0.188 (-1.06)	-0.153 (-0.85)	-0.126 (-0.76)	-0.144 (-0.91)	-0.0452 (-0.28)	-0.105 (-0.62)
Global growth	0.396 (1.55)	0.478* (2.39)	0.435 (1.73)	0.480* (2.55)	0.315 (1.27)	0.459* (2.32)
External debt % GDP (log)	0.0127 (1.37)	0.0405** (2.58)	0.0146 (1.57)	0.0407** (2.67)	0.0182 (1.94)	0.0393* (2.49)
Trade openness	0.0148* (2.11)	0.0152 (1.46)	0.0154* (2.03)	0.0152 (1.47)	0.0143* (1.98)	0.0125 (1.18)
Country growth	-0.0505 (-0.45)	0.00726 (0.06)	-0.0510 (-0.45)	0.0214 (0.17)	-0.0372 (-0.32)	0.00397 (0.03)
Inflation	0.00983*** (5.54)	0.0637* (1.97)	0.00987*** (5.69)	0.0547 (1.81)	0.00978*** (5.76)	0.0613 (1.90)
Financial openness	0.344 (1.92)	-0.564 (-1.79)	0.437* (2.10)	-0.590 (-1.96)	0.393 (1.95)	-0.489 (-1.49)
Protest	0.296* (2.43)	0.0154 (0.08)				
Popular mobilization			1.915* (2.34)	2.065 (0.70)		
Leftist mobilization					3.190** (2.63)	-1.504 (-1.01)
Constant	-0.877 (-0.88)	-0.280 (-0.27)	-1.062 (-1.01)	-0.310 (-0.34)	-2.260 (-1.73)	0.447 (0.38)
No. of observations	229	149	229	149	229	149
r <sup>2</sup>	0.4767	0.1205	0.4679	0.1289	0.4740	0.1254

t statistics in parentheses \* p<0.05, \*\* p<0.01, \*\*\* p<0.001

## 2. Rise of Leftist party and Capital Flight

In the previous chapter, I hypothesized that *ceteris paribus*, the greater the probability that the left will win government power the higher the level of capital flight (*H2*). In order to test this proposition, the second set of regression estimates the impact on capital flight of rising support for a Leftist party on capital flight *before* it comes to office; that is, while a non-left government is in office. The task here is to identify the critical moment when the left is perceived to become a credible contender for government; by extension a threat to asset holders and the trigger for capital flight. To operationalize this key period of the left's increased popularity, the effect of impending Leftist electoral victory was imputed by introducing a dummy for each of the three years before the left won election to government, hypothesizing that capital flight would be higher in those years (Table 4.3).<sup>9</sup> Regression estimates for this model shown in Table 4.4 confirm that levels of Leftist electoral support in the three years prior to the left winning government power do have a statistically significant positive effect (at the 95 per cent level of confidence), as *H2* posited.

Table 4.3. Rise of Leftist parties and capital flight

Description	Source	Predicted sign
Rise of Left (dummy variable for 3 year period before Left gains power)	Author's own based off Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+

<sup>9</sup> Ideally, better measures would have been opinion poll data on the electoral popularity of Left parties across these 18 countries. However, these data are generally not available and where they are, they are of variable quality.

Table 4.4. Rise of Leftist parties and capital flight with Non-Leftist incumbent

Capital flight (lagged)	
US Interest rate	-0.0669 (-0.56)
Global growth	0.540** (2.79)
External debt % GDP (log)	0.0123 (1.35)
Trade openness	0.0151* (2.55)
Country growth	-0.101 (-1.21)
Inflation	0.0098 *** (7.32)
Financial openness	0.210 (1.14)
Rise of Left	1.643* (2.40)
Constant	-1.121 (-1.40)
No. of observations	263
r <sup>2</sup>	0.4664

t statistics in parentheses \* p<0.05, \*\* p<0.01, \*\*\* p<0.001

*H3* then extended my theory to posit that, *ceteris paribus*, the actuality of Leftist governments will induce higher levels of capital flight. Ten models were estimated to test *H3* divided into two subgroups, the first five without country dummies in order to estimate the impact of independent variables *across* countries, and the second five, with dummies, in order to estimate *within*-country effects. Table 4.5 details the variables entered: three dummy variables to denote Leftist

governments, two variables to differentiate between far and center Left governments, and one to measure Leftist electoral strength, together with their predicted signs.

Table 4.5. Government ideology and capital flight: variables and predicted signs

Description	Source	Predicted sign
Leftist government dummy1 (Far and Center Left coded 1)	EXECRLC in Database of Political Institutions (Cruz, Keefer and Scartascini 2016)	+
Leftist government dummy 2 (Far and Center Left coded 1)	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+
Governing party's ideology (coded 0, Left, to 20, right)	Baker and Greene (2011).	-
Far left government dummy (code 1)	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+
Center Left government dummy (code 1)	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+
Last Leftist percentage presidential vote	Baker and Greene (2011).	+

Table 4.6 shows the regression estimates from the ten models. Once again, each shows that two of the six control variables are highly significant with signs in the predicted directions.

All estimates in the first five cross-country-effects models show strong support for the notion that Leftist (but not center Left) governments experienced higher levels of capital flight than non-Leftist governments. All three measures of Leftist governments had a highly significant (.01 level of confidence) effect on capital flight, with signs in the predicted directions (Models 1-3). The results for Model 4, however, also reinforce an important element of my theory that postulated that far Left rather than center Left governments induced capital flight. The measure for far Left governments had a highly significant positive effect on capital flight whereas that for

center Left governments did not. It was having a far Left government or the Left candidate winning a high share of the presidential vote (Model 5) that have the greatest effects on capital flight.

Contrastingly, when country dummies were introduced in Models 6 through 10 to allow for those Latin American countries that never experienced a Leftist government during this period, the estimates in Table 4.6 show that with the single exception of Model 9 (where a governing party's ideology is significant at the .05 level), having a Left, let alone, a far Left government had no significant effect on capital flight - most likely due to the lack of within-country variation over time in the occurrence of Leftist governments.

Table 4.6. Leftist governments, Leftist electoral support, and capital flight

Capital flight (lagged)	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10
	<i>Cross country effects</i>					<i>Within countries effects</i>				
US interest Rate	-0.157 (0.156)	-0.098 (0.149)	-0.105 (0.158)	-0.073 (0.154)	-0.113 (0.153)	-0.091 (0.158)	-0.128 (0.158)	-0.116 (0.156)	-0.164 (0.164)	-0.119 (0.158)
Global growth	0.410* (0.224)	0.370* (0.209)	0.311 (0.220)	0.366* (0.212)	0.359* (0.213)	0.312 (0.221)	0.339 (0.228)	0.328 (0.222)	0.344 (0.229)	0.328 (0.221)
External debt as % GDP (log)	0.034** (0.016)	0.033** (0.016)	0.031** (0.016)	0.035** (0.016)	0.030* (0.016)	0.049** (0.023)	0.050** (0.050**)	0.050** (0.023)	0.049** (0.022)	0.050** (0.023)
Trade openness	0.011* (0.006)	0.012* (0.006)	0.015** (0.006)	0.012* (0.007)	0.012* (0.006)	0.037 (0.026)	0.039 (0.025)	0.038 (0.025)	0.034 (0.026)	0.038 (0.025)
Country growth	-0.065 (0.078)	-0.077 (0.075)	-0.063 (0.072)	-0.067 (0.073)	-0.072 (0.079)	-0.062 (0.072)	-0.055 (0.072)	-0.060 (0.071)	-0.057 (0.072)	-0.061 (0.072)
Inflation	1.068*** (0.253)	1.046*** (0.250)	1.147*** (0.287)	0.944*** (0.255)	1.069*** (0.253)	1.023*** (0.267)	1.007*** (0.270)	1.002*** (0.268)	1.147*** (0.313)	1.007*** (0.272)
Leftist government 1	1.320*** (0.472)						0.636 (0.537)			
Leftist government 2		1.656*** (0.580)						0.635 (0.644)		
Governing party ideology			-0.265*** (0.056)						-0.141** (0.068)	
Far Left government				3.217*** (0.848)						0.463 (1.062)
Center Left government				0.924 (0.665)						0.689 (0.680)
Leftist party % vote					0.032*** (0.010)	0.022 (0.015)				
Constant	-2.569** (1.161)	-2.531** (1.110)	1.131 (1.321)	-2.498** (1.119)	-2.863** (1.206)	-7.175*** (2.534)	-6.661** (2.594)	-6.240** (2.582)	-4.209 (3.015)	-6.253** (2.596)
Country dummies	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
No. of observations	365	365	345	365	363	363	365	365	365	365
r2	0.1315	0.1364	0.1770	0.1500	0.1302	0.2646	0.2639	0.2635	0.2635	0.2636

Confidence levels: \*\*\* = 99%; \*\* = 95%, \* = 90%

The theoretical discussion in the previous chapter suggested that capital holders might differentiate between Left and Center Left governments and find the latter less threatening because of the newness of the Leftist party; not having been institutionalized – or institutionalized to the same extent – we theorized that new Leftist parties had not undergone the same processes of ideological moderation and organizational professionalization that older Leftist parties have and, therefore, are more likely to be viewed as a threat to the wealthy, who opt to export their capital from the host country.

In order to test whether capital flight will be higher when asset-holders are faced with the possibility that a new Leftist party is about to win power, a dummy variable was entered into the regressions and coded 1 for each of the three years prior to a new Leftist party being elected to government. To compare the impact on capital flight of established and new Leftist parties, two other dummies were also entered, one for governments dominated by new Leftist parties and a second for governments dominated by established Leftist parties (Table 4.7).<sup>10</sup>

Table 4.7. Leftist party age and capital flight

Description	Source	Predicted sign
New Left party (dummy variable for parties that are younger than 10 years for 3 year period before Left gains power)	Derived from EXECAGE variable in Database of Political Institutions (Cruz, Keefer and Scartascini 2016)	+
New Leftist party in government dummy (for parties that are less than 10 years since founding)	Derived from EXECAGE variable in Database of Political Institutions (Cruz, Keefer and Scartascini 2016)	+
Established Left party in government dummy (for parties that are older than 10 years)	Derived from EXECAGE variable in Database of Political Institutions (Cruz, Keefer and Scartascini 2016)	No effect

<sup>10</sup> A new Leftist party was defined as one founded less than 10 years before elected to government using data from the Database of Political Institutions (2016).

As expected, the regression estimates shown in Table 4.8 show a significant and positive relationship between the rise of the Left and capital flight (Model 1) and that governments under new Left parties are positively and significantly associated with capital flight whereas those comprised of established Leftist parties have no effect (Model 2). Asset-holders were evidently more skittish of an untested new Leftist party being elected to government rather than an established one.

Table 4.8. New Leftist governing party and capital flight (All governments)

Capital flight (logged)	<i>Model 1</i>	<i>Model 2</i>
US interest rate	-0.0612 (-0.50)	-0.0403 (-0.30)
Global growth	0.564*** (3.41)	0.540** (2.70)
External debt % GDP (log)	0.0146 (1.62)	0.0180* (2.23)
Trade openness	0.0125* (2.26)	0.0113 (1.96)
Country growth	-0.137 (-1.72)	-0.0542 (-0.76)
Inflation	0.0100 *** (7.27)	0.0093*** (8.49)
Financial openness	0.199 (1.04)	-0.0622 (-0.42)
Rise of Left	0.199 (1.04)	
Rise of New left party	3.025*** (3.67)	
Established Left party		0.990 (1.52)
New Left party		3.517*** (4.39)
Constant	-0.926 (-1.25)	-0.852 (-1.06)
No. of observations	270	378
r2	0.4727	0.3717

t statistics in parentheses \* p<0.05, \*\* p<0.01, \*\*\* p<0.001

### 3. *Leftist Governments, political opposition and capital flight*

The third part of my theory postulated that Leftist governments that encounter significant (conservative) political opposition would experience less capital flight. I proposed to operationalize this thesis by positing that that *ceteris paribus*, Leftist governments with greater legislative majorities and those encountering greater opposition fragmentation will experience more capital flight (hypotheses, *H4a* and *H4b*). In order to address the literature that holds that the number of veto points in a political system constrains government policies, including their redistributive policies, which in turn is thought to reduce asset holders' perceptions of risk and thus their proclivity to export their capital, I proposed *H3c*: that, *ceteris paribus*, Leftist governments will experience less capital flight in political systems with more veto players.

So, did the strength of (conservative) opposition and the incidence of veto points mitigate capital flight in our 18 Latin American democracies?

Table 4.9 details the measures of opposition strength and veto players, and predicted signs across all, non-Leftist and Leftist governments, which were used to test these three hypotheses.

Table 4.9. Political opposition variables and predicted signs for Leftist governments

Description	Source	Predicted signs by government ideology		
		All governments	Non-Leftist governments	Leftist governments
Difference in seat share between government parties and opposition	V-Dem Codebook v6 (Coppedge et al 2016)	No effect	-	+
The extent of opposition fragmentation (coded from 0 to 1) *	Database of Political Institutions	No effect	-	+
Number of veto points in political system	Database of Political Institutions	No effect	-	+

\* The measure is the probability that two random opposition deputies will be of different parties.

Table 4.10 shows the regression estimates testing three different models for each of the three hypotheses each allowing for comparisons among all, non-Leftist and Leftist governments. As we can see, capital flight is significantly and positively associated with the size of a Leftist government's majority *and* the extent of opposition fragmentation/cohesion; that is, the larger the size of a Leftist government's legislative majority and the higher the extent of opposition fragmentation/weaker opposition the greater the magnitude of capital flight, and *vice versa* Leftist governments facing cohesive oppositions experience less capital flight (Models 3 and 6). As anticipated, the smaller the size of a non-Leftist government's legislative majority (but not opposition fragmentation) is also associated with higher capital flight (Model 2).

Similar dynamics are also evident in the table in respect of the impact of the number of veto points in different political systems on capital flight. While the number of veto points - ostensibly constraining government's redistribution policies - is not significant when governments of different ideological complexions are included (Model 1), when a distinction is made between their impact on Leftist and non-Leftist governments (Models 2 and 3), as predicted, there are significant differences. Under Leftist governments, the fewer the number of veto points the *greater* the extent of capital flight (Model 9) whereas under non-Leftist governments the fewer the number of these constraints the less the extent of capital flight.<sup>11</sup> Once again, two economic control variables (logged external debt and inflation) are highly significant and positively associated; global growth too in several models.

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<sup>11</sup> The same result was achieved using Henisz's Political Constraints V variable, as an alternative measure for veto players. Both mine and Henisz's measures take into account whether the legislature is aligned with the executive or not; that is, if the same party or coalition holds both branches of government the number of veto players is reduced by one. The results of this robustness test are available separately.

In order to estimate how the measures of political opposition, veto points and other independent variables impact *within-country variations* in capital flight over time, country dummy variables were entered into the same models as in Table 4.10. The new estimates in Table 4.11 show that under Leftist governments opposition fragmentation is highly significant and with the correct sign (Model 6) whereas under non-Leftist governments seat difference is highly significant and in the predicted direction (Model 2). That is, capital flight is high when political opposition to a Leftist government is weak (measured by fragmentation), as it is also under non-Leftist governments with small legislative majorities. Conversely, when political opposition is strong, measured by these variables, capital flight is low. The number of veto players is not significant under governments of any ideological color, probably due again to the lack of within country variation in these independent variables.

Table 4.10. Political opposition, veto players, and capital flight

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>	<i>Model 7</i>	<i>Model 8</i>	<i>Model 9</i>
	All govts	Non-Leftist govts	Leftist govts	All govts	Non-Leftist govts	Leftist govts	All govts	Non-Leftist govts	Leftist govts
Capital flight % GDP	-0.238	-0.136	-0.089	-0.242	-0.259	-0.060	-0.226	-0.154	-0.134
US interest rate	(0.156)	(0.208)	(0.133)	(0.148)	(0.206)	(0.137)	(0.158)	(0.218)	(0.154)
Global growth	0.397*	0.193	0.351*	0.422**	0.231	0.468**	0.441**	0.314	0.539**
	(-0.222)	(-0.318)	(-0.192)	(-0.212)	(-0.328)	(-0.209)	(0.222)	(0.321)	(0.241)
External debt (log)	0.033**	0.040*	0.043***	0.058***	0.068**	0.035**	0.033**	0.035*	0.033**
	(-0.016)	(-0.021)	(-0.016)	(-0.021)	(-0.031)	(-0.015)	(0.016)	(0.021)	(0.015)
Trade openness	0.01	0.008	0.006	0.009	0.015*	0.005	0.011*	0.012	0.009
	(-0.007)	(-0.008)	(0.010)	(0.007)	(-0.009)	(0.009)	(-0.007)	(-0.008)	(-0.009)
Country growth	-0.055	-0.088	0.014	-0.038	-0.057	-0.030	-0.077	-0.133	-0.077
	(-0.081)	(-0.117)	(0.125)	(0.077)	(-0.122)	(0.130)	(-0.079)	(-0.117)	(-0.132)
Inflation	1.072***	1.075***	0.821*	1.073***	1.100***	0.598	0.991***	1.097***	0.743
	(-0.258)	(-0.328)	(0.484)	(0.242)	(-0.313)	(0.446)	(-0.251)	(-0.351)	(-0.469)
Difference in seats	-0.004	-0.031***	0.049***						
	(0.009)	(0.010)	(0.015)						
Opposition fragmentation				-0.299	1.850	4.203***			
				(0.913)	(1.482)	(1.213)			
No. of veto players							0.08	0.552**	-0.653***
							(-0.197)	(0.235)	(0.218)
No. of observations	(1.109)	(1.405)	(1.371)	(1.433)	(1.961)	(1.568)	(-1.31)	(-1.699)	(1.631)
	365	221	144	348	209	139	353	218	135
r2	0.1166	0.1602	0.1945	0.1742	0.2077	0.1858	0.1207	0.1470	0.1524

Confidence levels: \*\*\* = 99%; \*\* = 95%, \* = 90%

Table 4.11. Political opposition, veto points, and capital flight (with country dummies)

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>	<i>Model 7</i>	<i>Model 8</i>	<i>Model 9</i>
	All govts	Non-Leftist govts	Leftist govts	All govts	Non-Leftist govts	Leftist govts	All govts	Non-Leftist govts	Leftist govts
Capital flight % GDP	-0.153	-0.146	-0.060	-0.228	-0.349	-0.074	-0.169	-0.245	-0.137
US interest rate	(0.157)	(0.239)	(0.115)	(0.148)	(0.235)	(0.114)	(0.161)	(0.257)	(0.132)
Global growth	0.316	0.095	0.221	0.406*	0.410	0.354**	0.370	0.316	0.366*
External debt (log)	-0.223	-0.347	-0.164	-0.213	-0.306	-0.167	(0.229)	(0.356)	(0.188)
	0.052**	0.059*	0.02	0.099***	0.126**	0.026	0.049**	0.043	0.027
	-0.023	-0.032	-0.026	-0.029	-0.05	-0.025	(0.023)	(0.033)	(0.025)
Trade openness	0.042*	0.05	0.047	0.038	0.032	0.029	0.046*	0.049	0.044
	-0.025	-0.037	(0.029)	(0.025)	-0.032	(0.030)	-0.027	-0.044	-0.029
Country growth	-0.05	-0.079	0.080	-0.029	-0.044	0.015	-0.081	-0.138	0.013
	-0.074	-0.117	(0.097)	(0.073)	-0.112	(0.095)	-0.074	-0.118	-0.102
Inflation		1.920***	0.215	1.156***	1.829***	0.165		1.963***	0.284
	-0.272	-0.386	(0.382)	(0.255)	-0.394	(0.370)	-0.274	-0.421	-0.4
Difference in seats	-0.010	-0.044***	0.021						
	(0.009)	(0.013)	(0.014)						
Opposition fragmentation				-0.929	0.349	4.200**			
				(1.236)	(1.725)	(2.100)			
No. of veto players							-0.135	0.145	-0.255
							-0.207	-0.393	(0.181)
Constant	-3.344**	-3.760*	-4.390*	-4.280***	-6.438***	-2.055	-3.408**	-5.924***	-4.660
	(1.399)	(1.937)	(2.642)	(1.621)	(1.971)	(2.971)	-1.534	-1.859	(4.938)
No. of observations	365	221	144	348	209	139	353	218	135
r2	0.2637	0.2801	0.5266	0.3146	0.3636	0.4773	0.2395	0.2484	0.4536

Confidence levels: \*\*\* = 99%; \*\* = 95%, \* = 90%

#### 4. *Redistributive Policies and Capital Flight*

A key aspect of the theoretical discussion in Chapter 3 was the assumption that popular mobilization leads to increased electoral popularity for Leftist parties and possibly Leftist governments, which in turn are expected to redistribute societal resources downwards and in so doing induce capital flight. Is there, then, statistical evidence that shows that democratic governments that pursue redistributive policies in Latin America do indeed experience higher levels of capital flight?

In this context, it is particularly important to point to the significant increase in social spending by governments in Latin America over the period of research. Between 1990-1991 and 2009-2010, social expenditure - especially spending on social security and education - increased both as a percentage of GDP and as a percentage of total public spending in almost all Latin American countries, growing on average over this period from 9.3 per cent of GDP and 45.7 per cent of total expenditure to 15.4 per cent of GDP and 62.6 per cent of total expenditure (ECLAC/CEPAL. 2012). This growth contributed significantly to indigence reduction over this period, although the region still has the highest levels of inequality in the world.

Table 4.12 provides details and predicted signs for the two variables that will be used to operationalize governments' implementation of redistributive policies and test the relationship with levels of capital flight. Capital flight should be expected to be higher when government social spending and direct taxation is high. Once again, in order to control for *within-country effects* over time, country dummy variables were entered (Models 2 and 4).

Table 4.12. Redistributive policies and capital flight: variables and predicted signs

Description	Source	Predicted sign
Total government social spending as a percentage of GDP	Economic Commission for Latin America and the Caribbean (ECLAC) CEPALSTAT	+
Direct taxation revenue as a percentage of GDP	Economic Commission for Latin America and the Caribbean (ECLAC) CEPALSTAT	+

Regression estimates shown in Table 4.13 generally confirm expectations. Higher capital flight is significantly associated with higher social spending as a percentage of GNP in both the *across-country* and *within-country effects* models (1 and 2). Higher direct taxation, however, is only associated with higher capital in the across-country model (3). Nonetheless, it is reasonable to assume that the link between redistributive policies and capital flight is strong.

Table 4.13. Redistributive government policies and capital flight.

Capital flight % GDP	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>
US Interest rate	-0.300** (0.150)	-0.208 (0.154)	-0.109 (0.110)	-0.167 (0.119)
Global growth	0.481** (0.211)	0.389* (0.217)	0.517*** (0.171)	0.620*** (0.176)
External debt % GDP (log)	0.031** (0.016)	0.045** (0.022)	0.021* (0.013)	0.009 (0.017)
Trade Openness	0.011* (0.007)	0.040 (0.024)	0.006 (0.009)	0.010 (0.026)
Country growth	-0.063 (0.079)	-0.059 (0.071)	-0.000 (0.076)	-0.102 (0.090)
Inflation	1.102*** (0.253)	1.062*** (0.272)	-0.238 (0.225)	0.047 (0.213)
Social spending (change)	0.423*** (0.135)	0.326*** (0.125)		
Indirect taxes			0.126* (0.065)	-0.082 (0.259)
Constant	-1.909* (1.079)	-6.491** (2.532)	-0.611 (1.007)	-0.330 (3.379)
Country dummies	no	yes	no	yes
No. of observations	365	365	188	188
r <sup>2</sup>	0.1455	0.2777	0.1152	0.3119

Confidence levels: \*\*\* = 99%; \*\* = 95%, \* = 90%

### 5. *Government Ideology and Redistributive Policies*

The answer might seem obvious but the relationship should be established by statistical analysis:

Is the production of redistributive policies also associated with Leftist governments in Latin America?

In order to estimate this relationship, the ideological taxonomy devised by Murillo, Oliveiro and Vaishnav (2010) was used to separate governments into five ideological categories - Far Right,

Center Right, Centrist, Center Left and Far Left. Table 4.14 provides details of the variables and the predicted signs.

Table 4.14. Government ideology and redistributive policies variables and predicted signs

Description	Source	Predicted sign
Far Right government dummy	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	-
Center Right government dummy	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	-
Center Left government dummy	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+
Far left government dummy	Dataset on Political Ideology of Presidents and Parties in Latin America (Murillo and Oliveiros 2010)	+
Total government social spending as a percentage of GDP	Economic Commission for Latin America and the Caribbean (ECLAC) CEPALSTAT	+
Progressive taxation revenue as a percentage of GDP	Economic Commission for Latin America and the Caribbean (ECLAC) CEPALSTAT	+
Corporate taxation revenue as a percentage of GDP	Economic Commission for Latin America and the Caribbean (ECLAC) CEPALSTAT	+

The regression estimates are shown in Table 2.15. Unsurprisingly, lower social spending is strongly associated with Far Right and Center Right governments (Model 1) but, surprisingly, higher social spending is not significantly associated with Center- and Far-Left governments (Model 1). These results might be explained by many Leftist parties during the 1990s having been forced to adopt structural adjustment policies by the IMF and other international lending agencies, which placed significant constraints on their social spending, as well as by different Left and Right preferences in the allocation of social benefits to different groups.<sup>12</sup> As the results

<sup>12</sup> Huber, Mustillo, and Stephens (2008: 423-24) argue that following the debt crisis and ensuing neoliberal structural adjustment policies implemented in many Latin American countries reducing social spending became a priority for the Right. Although the Left rejected privatization and preferred reforms aimed at the construction of unified public systems with strong basic benefits both Left and Right governments were constrained in finding resources for social policy. Thus, actual policy differences between Left and Right governments were manifested more in the allocation of social security expenditures more than their magnitude.

for Model 2 show, Center Left but not Far Left governments are highly significantly and positively associated with higher progressive taxation<sup>13</sup> while Center left and Far Left governments are highly significantly and positively associated with higher levels of corporate taxation while Center Right but not far Right governments are negatively associated with this variable thereby confirming the contention that conservative governments favor lower corporate taxation that would contribute revenue for higher social spending (Model 3).

Table 4.15. Government ideology and redistributive policies

	<i>Model 1</i> Social Spending % GDP	<i>Model 2</i> Progressive Taxes % GDP	<i>Model 3</i> Corporate Taxes % GDP
Far Right	-4.674*** (1.165)	0.266 (0.333)	-0.022 (0.175)
Center Right	-3.709*** (1.008)	-0.194 (0.253)	-0.390*** (0.144)
Center Left	-0.369 (1.040)	1.102*** (0.393)	0.650*** (0.196)
Far Left	-0.277 (1.039)	0.781 (0.542)	1.427*** (0.279)
Constant	13.272*** (0.813)	3.439*** (0.277)	1.945*** (0.131)
Country dummies	no	no	no
No. of observations	327	226	157
r2	0.1257	0.0966	0.3471

Confidence levels: \*\*\* = 99%; \*\* = 95%, \* = 90%

<sup>13</sup> The absence of progressive taxation by Far Left governments could possibly be due to these governments enjoying access to huge revenues from resource rents obviating the need for higher and more redistributive income taxes. Center Left governments during this period, moreover, were generally elected in countries like Brasil under the PT that were resource rich but as a percentage of government revenue were less reliant on resource rents.

## Summary

The quantitative evidence provided in this chapter from my panel dataset of 18 Latin American democracies provides strong and consistent support for the theory advanced in this dissertation that capital flight is driven by a chain of political sequences beginning with popular mobilization against incumbent non-Left governments. The threat of Leftist parties winning government office and actually forming a government leads to greater capital flight, although this process is mitigated significantly if a Left party is established and if a Leftist government faces significant political opposition both in terms of its strength in the legislature and its degree of cohesion. Contrastingly, when either Center or Right governments hold office these variables become insignificant, thereby lending support to the proposition that domestic capital will be less worried and less likely to export its capital if a government is aligned with its interests.

The analysis then moved on to evaluate statistically my theory's causal assumptions by estimating the effects of redistributive policies on flight. As anticipated, the regression analysis suggested that levels of government social spending and levels of direct taxation are both positively and significantly associated with capital flight. Again, as my theory predicts, Leftist governments are associated with more redistributive public policy with Far Left governments having the strongest and most statistically significant effects. Centrist and Center Right governments show small effects on redistribution while Far Right governments were significantly associated with less redistribution.

In Chapter 5, the links between popular mobilization, Leftist parties and political opposition on capital flight established statistically in this chapter are explored further in an over-time case study of El Salvador between 1990 and 2009. As the analysis in the chapter will show, as the

dominant elite-backed political parties came under increasing popular pressures and led to increasing electoral support for the Leftist FMLN, capital flight from the country increased significantly.

Table 4.16. Summary statistics

	Variable	No. of observations	Mean	STD	Min	Max
Dependent variable	Capital Flight	414	2.5749	4.8164	0.0000	67.4610
Control variables	US interest rate	414	3.2935	2.1247	0.0500	7.4900
	Global growth	414	2.8278	1.3530	-1.7005	4.4757
	External Debt % GDP (log)	393	37.7616	33.5611	10.0475	246.8589
	Trade Openness	413	64.2462	33.7534	13.7531	198.7668
	Country growth	414	3.8573	3.5311	-10.8945	18.2866
	Inflation	401	2.2445	1.3011	-1.6013	8.7421
	Popular mobilization variables	Level of protest	414	1.6256	2.2896	0.0000
Strikes		414	0.3188	0.7494	0.0000	6.0000
Presence of popular movement		414	-0.9248	1.2838	-2.7261	4.0916
Political instability		252	-0.3570	0.6653	-2.3901	1.0005
Govt. ideology variables	Ruling party ideology	392	12.6973	4.3482	2.6500	18.8000
	Leftist govt (measure 1)	414	0.3889	0.4881	0.0000	1.0000
	Leftist govt (measure 2)	414	0.2826	0.4508	0.0000	1.0000
	Center Left govt	414	0.1908	0.3934	0.0000	1.0000
	Far Left govt	414	0.0918	0.2891	0.0000	1.0000
	Center Right govt	414	0.3599	0.4806	0.0000	1.0000
Political opposition variables	Far right govt	414	0.1763	0.3816	0.0000	1.0000
	Veto players	402	3.5721	1.1906	2.0000	7.0000
	Fragmentation of Opposition	393	0.4947	0.2589	0.0000	1.0000
	Winning margin	411	0.5214	0.1635	0.0928	1.0000
Policy variables	Seat difference	414	10.5389	30.4994	-78.3333	95.2096
	Economic freedom	324	62.2472	7.4821	37.1000	78.6000
	Indirect taxation	226	8.9395	3.2480	2.7098	15.6946
	Corporate taxation	157	2.0865	0.9281	0.3628	5.0258
	Social spending % GDP	372	11.2112	5.4294	2.5143	25.5476
	Progressive taxation	226	3.6622	1.5947	0.7140	7.9772
	Political risk	368	62.8818	8.0606	36.0000	81.0000

## Chapter 5: Within-case analysis:

### Capital flight and the rise of the FMLN in El Salvador, 1990-2009

Between 1997 and 2006, El Salvador lost the equivalent of almost 42 per cent of its national GDP through capital flight, a period that coincided with increased popular mobilization and in 2009 led to the election for the first time since democratization of a Leftist government. Using WBR z scores, Figure 4.1 shows that these flight levels contrasted starkly with the negligible levels the country experienced in the previous decade.

Since the purpose of this chapter is to provide a within case study that examines how changes in levels of popular mobilization in El Salvador affected capital flight from the country. I do this by separating the case study into two periods.

The case study follows the evolving balance of power between the popular sectors and business elite in El Salvador. I trace the relationship between this balance of power and the government policies enacted by consecutive governments and how these factors affected the levels of capital flight the country experienced over time. If we look at figure 5.1 it is clear that the country experienced relatively low levels of capital flight from the period 1984 to 1997 and then rising levels from 1998 onwards peaking at almost 10% of GDP in 2003. Indeed, if we look at figure 5.2 which shows capital reversals (i.e. net *inflows* of capital) for the period from 1998 to 1994. I therefore divide the case study into two periods- the first from 1984-1997 and the second from 1998-2010 in order to ascertain what was so different about each period that led to such drastic variation in levels of capital flight.

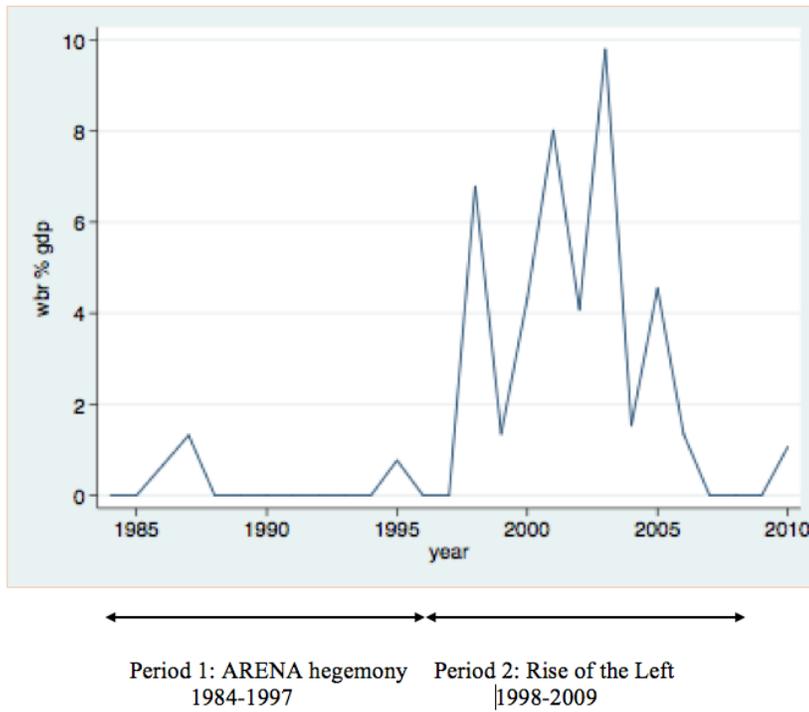


Figure 5.1. Capital flight as a percent of GDP, El Salvador, 1983-2010

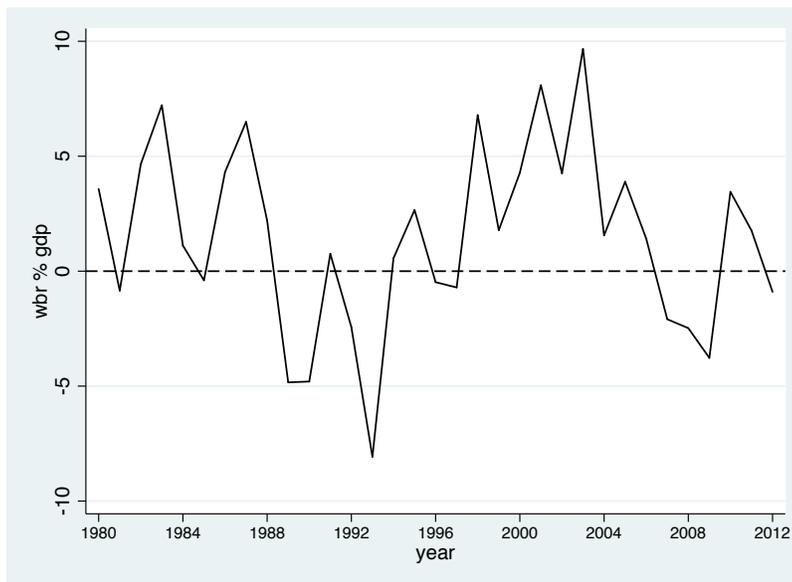


Figure 5.2. Capital flight as a percent of GDP including reversals, El Salvador, 1983-2010

### Popular Mobilization and the Catalytic Events of 1999 and 2000

The two periods are separated by the events of 1999 and 2000. In March 1999, the rightist candidate for the *Alianza Republicana Nacionalista* (ARENA) - a little-known, 38-year-old academic Francisco Flores Pérez - easily defeated the FMLN's uncharismatic candidate, a former guerrilla commander, for the presidency 52 to 29 per cent in the first round, even though ARENA had lost over a quarter of its seats in the 1997 legislative assembly elections. Three months later, Flores Pérez assumed the presidency and a new ARENA government - supported by the centrist *Partido Demócrata Cristiano* (PDC, Christian Democratic Party) - took power committed to the pro-market economic policies of his ARENA predecessors (Robinson 2008), including privatization of state-owned enterprises, tariff reduction and elimination, deregulation, cuts in public spending, and regressive taxation at the same time that minimum daily salaries had declined from 28.18 to 27.27 colons while GDP per head and inflation rose significantly. Beginning in August 1999, with hundreds of former paramilitaries belonging to the *campesino* organization *Asociación de Productores Agrícolas* (APROAS) renewing their protest campaign around the country for a compensation and pensions fund – and supported by the FMLN, who had fought them during the war, popular mobilization gathered steam.

Following Flores Pérez' government introducing new proposals to privatize the health care system it refused to engage in dialog with civic groups and members of the opposition, protest and civil disobedience intensified culminating in a strike by the *Sindicato de Trabajadores del Instituto Salvadoreño del Seguro Social* (Union of Workers of the Salvadoran Social Security Institute, STISSS) in November 1999. With Flores Pérez refusing to negotiate, the strike

continued until 36 hours before new legislative elections in March 2000, which resulted in the FNML winning a small majority of seats in the unicameral *Asamblea Legislativa*. Following a marathon session of the assembly a return to work was renegotiated. Rather than stifle further popular mobilization, however, Flores Pérez' political debacle intensified popular opposition leading to a second health strike in October 2002, over the privatization of ancillary services, collectively referred to as the *marchas blancos*, which led to a second humiliating defeat for the administration nine months later when his government was obliged to concede that the health care system would not be privatized. Fueling the increasing levels of popular mobilization by 2000 (Almeida 2014: 71-78), El Salvador's economy was in dire straits with declining economic growth, which when combined with Flores Pérez' government winning legislative approval for "monetary integration" legislation dollarizing the Salvadoran economy hit poorer sections of Salvadoran society very hard (Wade 2014: 398).

The remainder of this chapter focuses on the "before" and "after" beginning with the period of elite hegemony from 1984 and 1997 and then moving on to the 1998-2009 period that saw the rise of the Left. The final part of the chapter then investigates the causal processes that explain increases in capital flight with increases in popular class mobilization - which the previous quantitative analysis could not elucidate - by explaining the mechanisms by which increased popular class mobilization during the second period coinciding with the rise of the Left in El Salvador during the second period resulting in sharp rises in capital flight. Choosing El Salvador facilitates these purposes well because the country is relatively typical for Latin America in terms of its economic structure, its time as a democracy, its institutional framework, and levels of inequality and poverty; and it exhibits substantial variations on both the dependent and independent variable.

### *A Note on Theory Testing*

Theory testing for case studies is somewhat different from estimating regression equations (Goertz and Mahoney 2012: 185; Mahoney and Goertz 2006). As the discussion in Chapter 2 emphasized, in qualitative analysis, the inference is drawn that A is the cause of B partly by tracing the process that leads from A to B within one or more specific cases: process tracing, which is facilitated by within-case analysis. Thus, a variable shown to exert a significant effect in a regression analysis can be examined further by case studies to determine whether it has the explanatory leverage supposed by the theory being tested. Process tracing is used then to explore whether A contributed to the incidence or level of B, not whether A was necessary for B (Goertz and Mahoney 2012: 110). In short, qualitative research proceed in the manner of criminal detectives: they solve puzzles and explain specific outcomes by drawing on detailed fact collecting, their experience in researching similar cases, and acceptance of general causal principles (George and Bennett 2005; Mahoney 2006: 241; Van Evera 1997).

In order to validate my theory, a series of hoop tests have been identified. A hoop test is where the researcher proposes a minimum threshold in terms what pieces of evidence must be present within an individual case for a hypothesis relating to that case to dismiss the null hypothesis (Van Evera 1997). Failing a hoop test falsifies the hypothesis while passing it does not validate it. Still, the evidence posited by the hoop test yields a necessary condition for the hypothesis to be valid (Bennett 2008; Goertz and Mahoney 2012).

The following hoop tests will be utilized:

In the *absence* of popular mobilization, government policy will favor capital and capital flight will be low.

- *Rising* popular mobilization will lead to more redistributive policies and more capital flight.
- *More redistributive* policies (introduced by Leftist governments) will lead to increased levels in capital flight
- *Rising* popularity for the Left will lead to higher levels of capital flight
- *Falling* popularity for the Right should lead to higher levels of capital flight

Because, however, not all pieces of evidence carry the same weight in constructing an explanation using the so-called “detective method”, it is appropriate to term certain observations as “smoking guns” that may become a substantial part of the qualitative researcher’s conclusion that his/her theory is valid. Conversely, just like the detective, the qualitative researcher’s beautiful theory may encounter an “ugly” fact leading him/her to reject it despite a considerable amount of evidence suggesting its validity. In this important respect, a theory is “only one critical observation away from being falsified” (Maloney 2006: 241). In this light and the context of my enquiry, the research needs to demonstrate the following:

*Capital owners explicitly claim they are engaging in capital flight in response to popular mobilization and increased political risk associated with the rise of the Left*

While it is often extremely difficult to definitely ascertain actors’ preferences in a case study, evidence or absence of public statements in the local media by capital owners on their fears of popular mobilization and/or intention to engage in capital flights can at least give some indication of what factors business owners took into account at a particular moment.

Period 1, “Before”: The Era of Elite Hegemony, 1984-1997

From 1979 until 1992 El Salvador lived a bitterly fought civil war between a military backed conservative government and a Leftist guerilla insurgency which led to the deaths of over 75,000 Salvadorans. From 1979 until 1984 the government was under the control of a military junta and elections were suspended. With the civil war continuing to rage, the government held presidential elections in 1984. Despite the ongoing conflict, the elections were held to be free and fair (Nohlen 2005) and so marked the country’s transition to democracy. For example, *Polity* gives El Salvador a six (on a scale of -10 to +10) which classifies it as a democracy.<sup>14</sup> After years of violence the civil war finally ended eight years later in 1992 following the Chapultepec Peace accords. Peace emerged and sweeping democratic reforms were instituted, including a new civilian police force, a functioning judiciary, a civilian-controlled army and political rights and protections were extended. Despite these steps towards greater democratization, however, traditional Salvadoran elites continued to dominate the political system, principally in the form of ARENA, El Salvador’s elite-backed political party. The party ensured its primacy through well financed election campaigns helped by favorable coverage by the three highest-rated television stations owned by a strong party backer. With a strong electoral base among voters in rural areas with little or no formal education (Koivumaeki 2014: 273-75) ARENA won every presidential election between 1984 and 1999 (Figure 5.1). The party dominated the legislative assembly entering into occasional alliances with the rightist *Partido de Concertación Nacional* (PCN) and center-right *Partido Demócrata Cristiano* (PDC) until 1994 (Figure 5.2). In government ARENA presidents pursued economic liberalization policies in line with the Salvadoran business elites’ preferences. At the same time, few sectors of Salvadoran society

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<sup>14</sup> According to Polity’s schema, any country scoring a five or more is classified as a democracy.

were politically mobilized. In consequence, popular political pressures on these governments to enact redistributive policies were minimal or non-existent and capital flight remained relatively insignificant.

Table 5.1. Vote share for ARENA candidates in El Salvador Presidential Elections, 1984-2009.

Election year	1st round vote share	2nd round vote share
1984	29.8%	46.4%
1989	53.8%	-
1994	49.3%	68.3%
1999	52.0%	-
2004	57.7%	-
2009	48.7%	-

*Source:* Political database of the Americas (2009) accessed at <http://pdba.georgetown.edu/>

Table 5.2. Vote share for ARENA candidates and allies in *asamblea legislativa* elections,

Election year	Vote share	Seats won by			
		ARENA/NRA	PCN	PDC	ARENA and
1985	29.7%	13	12	33	58/60
1988	48.1%	31	7	22	60/60
1991	44.3%	39	9	26	74/83
1994	46.4%	39	4	18	61/83
1997	33.3%	28	11	10	49/83
2000	34.5%	29	13	6	48/83
2003	32.1%	27	16	5	48/83
2006	39.4%	34	10	6	50/83
2009	38.5%	32	11	5	48/83

Source: Political database of the Americas (2009) accessed at <http://pdba.georgetown.edu/>

ARENA/NRA: *Alianza Republicana Nacionalista* (Right); PCN: *Partido de Concertación Nacional* (Right); PDC *Partido Demócrata Cristiano* (Centrist)

Elite domination of Salvadoran society and politics during this period was nothing new. It followed a pattern in existence since Spanish colonial when extremely wealthy and powerful landed elite consolidated its control through oligarchic control of the country's coffee export industry. Many of the business groups that came to dominate society and politics in post-colonial El Salvador – and especially *las catorce familias* (the 14 families) - originated from the traditional coffee elite or were entrepreneurs who migrated to the country in the first half of the twentieth century (Bull 2013).

By the end of the 1980s, powerful landowning agricultural exporters had transformed their businesses into powerful financial consortiums such as *Grupo Cuscatlán*, *Grupo BANAGRICOLA*, *Grupo Banco de Comercio*, *Grupo Banco Salvadoreño*, *Grupo Agrisal*, *Grupo*

*Poma, Grupo Salaverria Prieto and Grupo Quiros* coordinating their activities through extensive family networks and playing leading parts in restructuring and liberalizing the Salvadoran economy in order to attract foreign capital. Their primary objective was turning the country into Central America's main financial center (Robinson 2003; Segovia 2002; Wood 2000; Wood 2001).

It was these new industrial and financial elites' attempts to transform the nationally based agricultural economy into a cross-regional one based on services and finance that helped lay down the groundwork for the end of the country's civil war in 1992: a negotiated peace was seen as a prerequisite for attracting foreign capital. In order to facilitate these structural changes within El Salvador and extend their remit across the whole of Central America, throughout the period from 1984 to the mid-1990s, elites ensured that ARENA enacted public policies that liberalized markets and trade, and privatization of the banking system with the most powerful families securing control as well as access to financial inflows from overseas, including family remittances from Salvadorans living in the United States. Between 1991 and 1995, nine banks were privatized and a number of new banks associated with other domestic elites and foreign owners entered the market. Their dominance of the political system through ARENA, moreover, enabled them to define the direction and implementation of financial and economic policy, including the regulatory policy for the financial system.

#### *Political party-business elite linkages*

ARENA emerged as the elites' pro-business conservative party from the *Partido de Concertación Nacional* (PCN, which had close ties to the military) at the end of the civil war in 1992. The elites' clear intention was to ensure that the state would remain in the hands of

market-friendly political forces following democratization and facilitate their expansionist project. Initially limited in its support base to members of the oligarchy, ARENA successfully transformed itself over time into a cohesive and highly professional party, well financed, and with a well-structured national organization promoting business friendly policies and effective in mobilizing voters in elections. Since its foundation, business members of the Salvador business elite have remained prominent within ARENA's rigid hierarchical organizational structure, including members of the *Asociación Nacional de Empresa Privada* (ANEP, the National Association of Private Business), the country's main business association. The party was also effective in recruiting a broader range of business people from different sectors, including many centrists who were more accepting of democratic norms than the traditional agro-export oligarchy. Three of the four ARENA presidents serving during this period - Alfredo Cristiani (1989-1994), Armando Calderón Sol (1994-1999), and Antonio Saca (2004-2009) - were prominent in business before assuming the office. Key posts in ARENA governments were also drawn from business.

Despite its elite origins, ARENA was very effective at broadening its electoral support through adept media messaging using its vast financial resources, articulating credible policies, and by personalistic networks and clientelism, reaching out to various industrial, agricultural, commercial, professional and cultural groups in Salvadoran society – as well as Salvadorans living abroad - to promote the party and form links (Koivumaeki 2014: 278-83). “Constantly threatened with the possibility it could lose power”, Schneider observes, “ARENA behaved as though every election could be its last, and resisted any attempt to soften its stance during elections or to moderate its policies while in office” (2013: 235). Within a strongly hierarchical structure internal rules were strictly enforced with the result that the party remained highly

disciplined and even today remains a formidable political force (Barahona 2008; Koivumaeki 2010: 99).

ARENA also invested heavily in developing strong research and policy development capacity so that academically trained policy experts have been able to develop coherent policy programs and exert political influence in public and governmental arenas. These policy experts have worked in tandem with the *Fundación Salvadoreña para el Desarrollo Económico y Social* (FUSADES), funded by Salvador business elites, pro-market, think tank, which emerged in 1983 with the explicit objective of promoting a new national economic plan (Rosa 1983: 80). By 1991, it employed 250 people with offices in Miami and New York. FUSADES economists and policy *técnicos* have typically been educated abroad. The think tank provided the party with high quality research, including opinion polling, and research training programs (Johnson 1993). The think tank also served as a rich source of recruitment for ARENA party officeholders and political candidates. Beginning in 1989, members of the FUSADES executive committee put themselves forward and in the person of Cristiani won the Salvadoran presidency through ARENA carrying with him influence into the presidency. FUSADES alumni have also frequently filled the economic ministry positions when the party has been in power as a result of which many of ARENA's economic reform proposals have emanated from FUSADES (Schneider 2012: 118-19).

#### *ARENA's pro-business policies in government*

Throughout the first period of this case study beginning with the administration of the ARENA President Alfredo Cristiani -- a member of one of the major coffee-processing families in El Salvador -- four successive ARENA administrations pursued neoliberal economic policies widely

encouraged by the IMF and other international financial institutions at the time, which strongly favored domestic and foreign capital. These governments used their dominance in the legislative assembly to restructure the state in line with those interests pushing for market liberalization by reducing trade and investment barriers; privatizing public banks, telecommunications, and electricity; increasing prices for other public services; and in 2001 dollarizing the economy (Spalding 2014b; Wade 2014).

The ARENA-led administration between 1989 and 1994 under Cristiani embarked on an extensive program of market liberalization and restructuring the economy away from agriculture towards manufacturing, creating free trade zones for *maquilas* or *maquiladora* plants that imported materials and equipment duty-free for assembly or manufacturing and then re-exported while at the same time systematically de-funding agriculture. Commercial banks, coffee export institutes and sugar refineries were privatized (with Cristiani himself becoming a major shareholder in the privatized Banco Cuscatlan), foreign trade transactions were returned to the private sector, and the exchange rate was allowed to depreciate to market levels. Cristiani's government also lowered import barriers, sharply tightened monetary policy and established central bank autonomy, allowed domestic prices to find market levels, and partially privatized the social security system.

Most of the Cristiani administration's policies were decidedly regressive, actually reallocating resources away from the low-income citizens. A minimally progressive tax regime was transformed into one that was unabashedly regressive. All property taxes (mainly paid by the wealthy) were abolished, export taxes were significantly decreased, income tax rates were halved, and import tariffs were gradually reduced. To make up for the resulting revenue shortfall, the government then introduced a regressive 10 per cent sales tax. His government also closed

the *Instituto Regulador de Abastecimientos* (Regulatory Institute for Grain and Supplies), which sold food at subsidized prices for the poor, and the *Instituto de Vivienda Urbana* (Institute of Urban Housing), which provided social housing. As one economist observed, “the tax regime in El Salvador resembles a Robin Hood in reverse: it takes from the poor to give to the rich” (Villalona quoted in Carrillo 2010).

Following Cristiani, the ARENA administration appointed by President Armando *Calderón Sol* from 1994 to 1999 began the implementation of a second phase of privatization that included the state-owned telephone (*Administración Nacional de Telecomunicaciones*, ANTEL) and electricity distribution companies, as well as the sugar refineries and state pension system, further increased the regressive valued added tax (IVA), lifted more trade restrictions, and dismissed 15,000 state employees (Anner 1996) while at the same time promising more spending for education and health lifting social spending to 50 per cent of the budget. In the event, the promised increases in education and health spending did not materialize (Schneider 2013: 239). Indeed, as living conditions for ordinary Salvadorans continued to deteriorate and costs increased – aided by the continuing marketization program - his administration was forced to continue government subsidies for electricity and telephone services and discounts on pension funds, and in 1992 was obliged to negotiate a new \$1 billion loan from the Inter-American Development Bank, half of which budgeted to health, education, sanitation and urban development, and the other half for modernizing the Salvadoran state. Although Calderón Sol decreed a rise in the minimum wage day to day living costs continued to rise faster for poor families (Editorial 1999). Table 5.3 summarizes the pro-market policies of the Cristiani and Calderon Sol administrations over the period of ARENA hegemony.

Table 5.3. Policies under ARENA Administrations in El Salvador, 1989-2004.

	<i>Period of administration</i>	<i>Policies</i>
Alfredo Cristiani	1989-1994	FUSADES Plan of Government Trade liberalization, Privatization of banking sector Introduction of a regressive sales tax (IVA) Tighter monetary policy/higher interest rates Floating exchange rates Closure of social housing institute Closure of food regulatory institute Central bank autonomy Elimination of export, wealth and stamp taxes Reduction in income and corporate profits taxes
Armando Calderon Sol	1994-1999	Privatization of sugar refineries, telecommunications, electricity and state pensions scheme Sales tax raised from 10% to 13% Introduced a currency board Exchange rate fixed to the US dollar Tariff reduction

Over this first period, then, as the Fraser Institute’s economic freedom index demonstrates (Figure 5.3), the trajectory toward market-oriented public policies was very clear. Hardly surprising then is it that when ARENA *asamblea* members were asked in 1994 to place their party on an ideological scale from left (1) to right (10), their mean score was 7.3, and then rose to 8.6 four years. Asked to place themselves on the same scale, their mean was 6.8 in 1994 and by 1998 had risen to 7.7 (González 2003). Unsurprisingly, ARENA members’ solidly rightist preferences translated into a sharply rising trajectory of pro-market government policies between 1990 and 2000, as measured by the Fraser Institute’s index of economic freedom (Figure 5.3).<sup>15</sup>

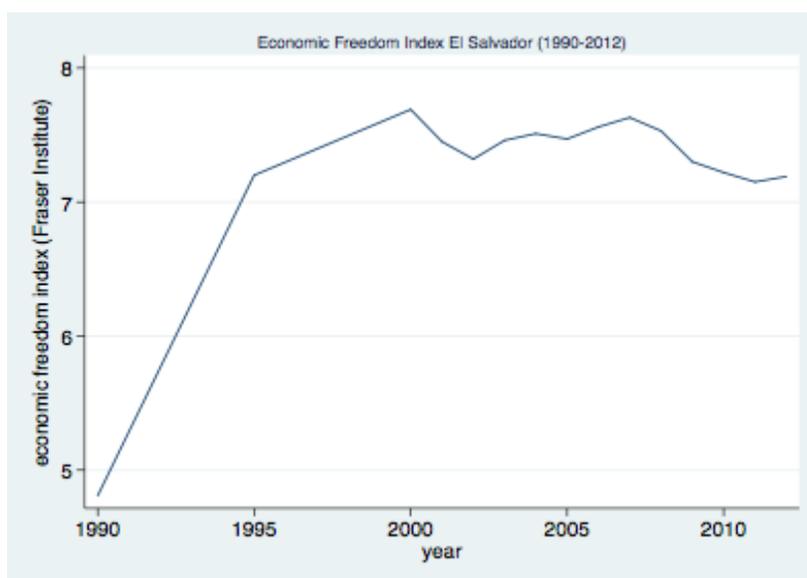


Figure 5.3. The rising trajectory of pro-market government policies in El Salvador, 1990-2012

Source: Gwartney, Lawson and Hall 2015.

<sup>15</sup> The index ranges from 0 to 10 where 0 corresponds to “large general government consumption”, “large transfer sector”, “many government enterprises”, and “high marginal tax rates and low income thresholds”, and 10 to “small general government consumption”, “small transfer sector”, “few government enterprises”, and “low marginal tax rates and high income thresholds”. The index consists of the following indicators: General government consumption spending as a percentage of total consumption; transfers and subsidies as a percentage of GDP; government enterprises and investment as a percentage of total investment; top marginal tax rate (and income threshold to which it applies).

While the Right regrouped after the civil war and institutionalized their political strength, there was little evidence of popular mobilization for most of the pre-2000 period, partly because state repression continued making participation in protests and politics by the poor and unorganized physically dangerous but also because the main opposition based on the FMLN were fractured internally with few signs of increased popularity, and its material and human resources were badly stretched. Unsurprisingly, with traditional economic elites, ARENA and its political allies dominating the political system, redistributive, land reform, land labor rights issues were not on the government's agenda. Apart from the poorly resourced FMLN, El Salvador had the smallest NGO presence in all of Central America (Fundacion Arias 1992) at the same time that ARENA politicians and their allies routinely accused civic institutions of collaboration with the FMLN while at the same time selectively deploying state repression. Mass emigration to the United States also served to weaken the strength of popular sectors weakened by poverty and economic dislocation arising from the market-led reforms. Labor unions, aligned with the FMLN during the civil war, became heavily politicized but typically distanced themselves from the day-to-day concerns of their members.

During this period, although popular sectors remained fragmented and for the most part unable to take concerted action, resistance to government reforms did take place but it was piecemeal and confined to specific sectors of the economy (Almeida 2014). Thus, in 1995 the telecommunication workers' union (ASTTEL) and the public works labor association (ATMOP) launched strikes against privatization, employee layoffs in the state pension systems, and other pro-market reforms proposed by the Calderón Sol administration. Even with a mass march in San Salvador representing diverse sectors, the temporary coalition failed because, at this stage, it lacked the organizational capacity to generate a multi-sector campaign against privatization with

the result that the political effect was minimal. Labor unions and other social actors also lacked the coordination to resist effectively (Almeida 2008: 169). ARENA also dominated the *asamblea* with 39 members (Table 5.4).

At the same time, there was also no significant electoral threat from the left to ARENA's political dominance. Until 1994, the FMLN did not compete in presidential or assembly elections although the Chapletco peace accords recognized the party's reformation into a legitimate political party and then it secured only 24.54 per cent of the vote in the presidential elections that year.

Taking together the near absence of popular mobilization and the lack of viable political intermediaries – the form of the reformed FMLN or civic groups - to channel protest into effective political influence, the period witnessed precious few redistributive policies pursued by the ARENA governments, such as increased social spending or the implementation of more progressive taxation. In the absence of such policies, our first hoop test *H1* should yield positive results. That is, if we take the share of the vote received by ARENA in legislative elections as a measure of the strength of public support for capital (or the absence of serious opposition to capital) and plot patterns of capital flight on the same graph, we find that they track one another fairly closely. In the “before” period (between 1985 and 1994), the years when voter support for ARENA was high coincide with those when capital flight was negative (Figure 5.4) – lending credence to the first hoop test viz. that: *in the absence of popular mobilization government policy will favor capital and capital flight will be low.*

Let us turn now to exploring our “after” period, which is marked by the rise of the Left.

Period 2, “After”: 1998-2009: The Rise of the Left

From the late 1990s onwards, it is clear that the political dynamics that had maintained ARENA hegemony in the “before” period began to change as inequality rose fueling popular discontent combined with declining support for ARENA helped remove the significant extant barriers to mobilization and stimulated increasing popular resistance to the government’s market-oriented reforms. The immediate catalyst was the ARENA government’s privatization of public services at the same time that it had failed to deliver on promises to raise health and social spending, even though international loans had been provided the government to provide for such spending. As a consequence, and as our model predicts, popular mobilization led to increases in capital flight. Figure 5.4 shows, clearly that as ARENA’S share of the vote for the *asamblea* declines after the mid-1990s, capital outflows increase sharply. Indeed, the absolute numbers (not shown in the figure) show that flight rose from one percent of GDP in 1995, to seven per cent in 1997, and then to almost ten per cent by 2003.

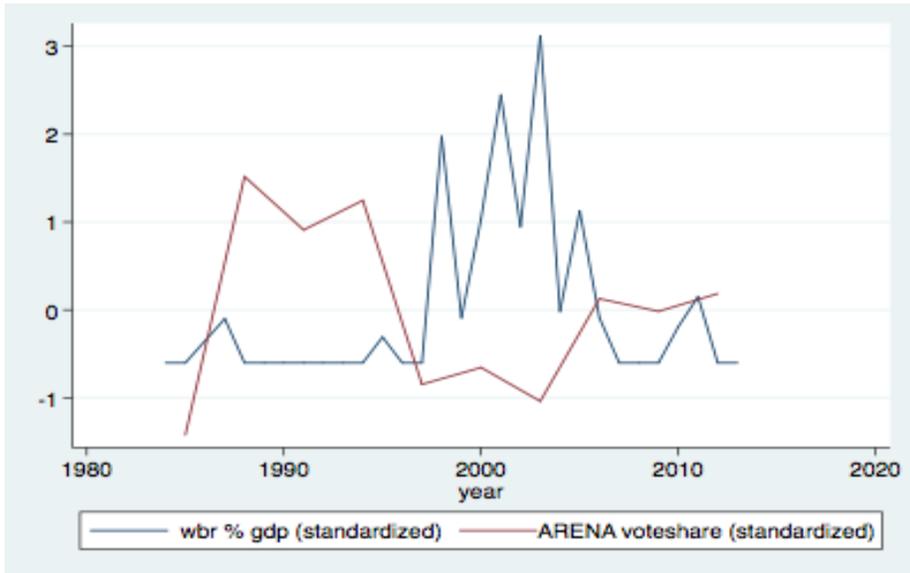


Figure 5.4. Patterns of Popular Support for ARENA in El Salvador *Asamblea* Elections and Capital Flight, 1985-2013 (capital flight is measured by WBR z scores)

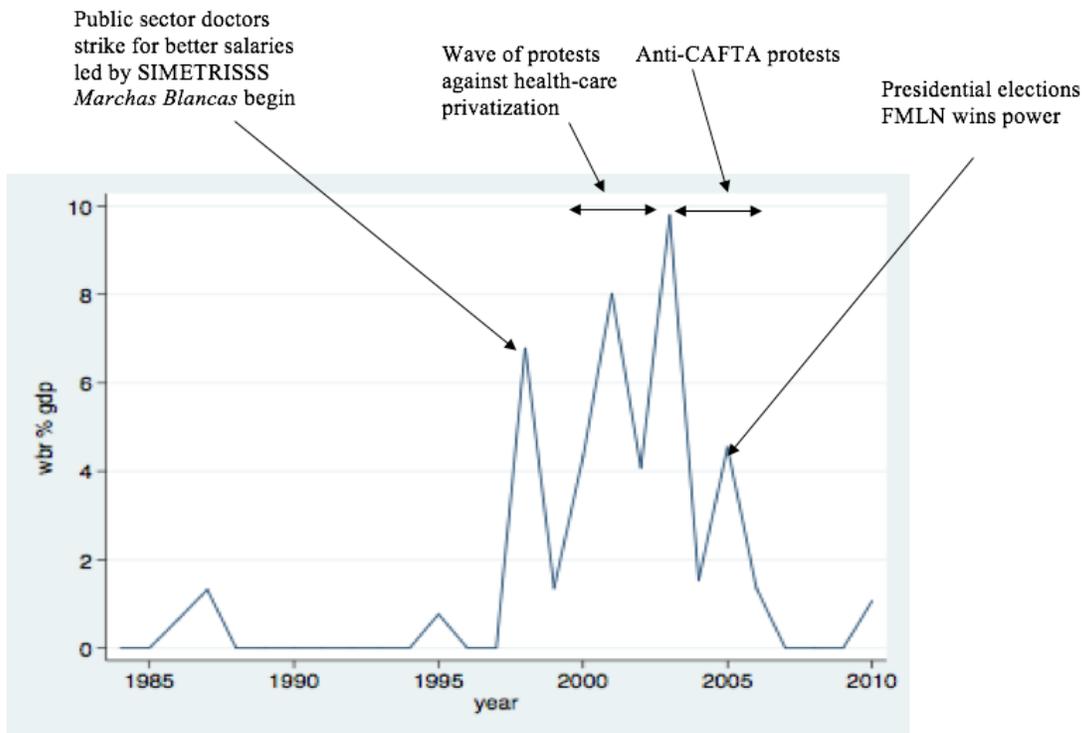


Figure 5.5. Rising Popular Mobilization and Capital flight as a percent of GDP, El Salvador, 1983-2010

### *The emergence of oppositional civil society organizations*

Rueschemeyer, Stephens and Stephens (1992: 49-50) associate transitions to democracy with the expansion of a "dense" network of civic associations. Much of the increased popular mobilization that occurred during the "after" period had its origins in the freeing up of political space thanks to measures adopted as a result of the Chapúltepec peace accords agreed between the government and guerilla movement. A commitment to the slow disbanding of many of the civil war state's instruments of repression, including the Treasury Police, National Police, and National Guard was a key condition of the Leftist guerilla disarmament. The scaling back of state repression meant that citizens were more willing to engage in street protest against the government (Almeida 2014). During this period, oppositional civil society associations slowly began to reemerge and form umbrella organizations such as *Movimiento de Organizaciones Laborales Integradas* (Movement of Integrated Labor Organizations, MOLI), *Comisiona Tripartita* (Tripartite Commission), and *Concertación Laboral y Social* (Labor and Social Encounter, CLS) that facilitated coordination across sectors. The growing acceptance of formal political rights and legal protections for these and other such organizations created political space for the re-invigoration of Salvadoran civil society, including the formation of an inchoate indigenous movement under the aegis of the *Nacional Indígena Salvadoreña* (CCNIS) and comprising 23 organizations (Almeida 2008b).

A similar process of consolidation occurred in the labor movement with the formation in 1997 of new labor unions- notably the *Sindicato Médico de Trabajadores del Instituto Salvadoreño del Seguro Social* (Union of Medical Workers of the Salvadoran Social Security Institute, SIMETRISS) and *Asociación de Médicos Nacionales* (the public health care doctors'

association, AMENA), which won government recognition in 2001. By 2000, six public sector unions led by the *Sindicato de Trabajadores Instituto Salvadoreño del Seguro Social* (Salvadoran Social Security Institute, STISSS) had formed a federation of public sector unions with full legal recognition along with *La Federación Sindical de Trabajadores de los Servicios Públicos de El Salvador* (the United Federation of Public Services Workers, FESTRASPEs), which accounted for over 12,000 union members (Lethridge 2010: 134-38). Beyond the public sector unions, large agricultural worker associations such as the *Asociación Nacional de Trabajadores del Agropecuarios* (National Association of Agricultural Workers, ANTA) and rural cooperative federations such as the *Confederación de Federaciones de la Reforma Agraria Salvadoreña* (National Confederation of Federations for Salvadoran Agrarian Reform, CONFRAS) and the *Confederación de Asociaciones Cooperativas de El Salvador* (the Confederation of Federations of Agricultural Cooperatives, COASCES), were formed or revitalized (Almeida 2008b).

Besides civil social groups and labor unions, aided by developmental groups and international donors, there was a rapid growth in new NGOs, especially development NGOs such as the *Asociación Fundación para la Cooperación y el Desarrollo Comunal de El Salvador* (Foundation For Cooperation and Community Development for El Salvador, CORDES), *Asociación para Desarrollo de El Salvador* (Rural Communities For the Development of El Salvador, CRIPDES), *Centro para la Defensa del Consumidor* (CDC), *Action para la Salud en El Salvador* (Health action in El Salvador, APSAL) and *Unidad Ecológica Salvadoreña* (Salvadoran Ecological Unit, UNES). These organizations often gained legitimacy among ordinary Salvadorans by supplementing services underserved by ARENA governments' retrenchment programs, such as government health programs. In the aftermath of Hurricane

Mitch in 1998, *el Foro de la Sociedad Civil* (Civil Society Forum, CSF), a new encompassing organization, was formed to oversee these new civic organizations (Almeida 2008b: 191; b 2014).

### *The intensification of popular mobilization*

As the earlier discussion indicated, it was the ARENA government's proposal to privatize the public health care system that provided the catalyst for the intensification of vocal and action-based opposition, the rise of the Left, and thus the turning point between the "before" and "after" periods of analysis.

In reaction to the growing pressures on those consumers and workers who bore the brunt of the ARENA governments' privatization and state retrenchment policies, important single sector organizations from labor, indigenous groups, students, professionals and NGOs coalesced to form a powerful multi-sectoral alliance by linking local issues to common unifying themes. From 1997 onwards, this growing movement led to the largest wave of social unrest seen in El Salvador's history and ultimately to the election of the Leftist party FMLN to government.

At the beginning of 1998, led by SIMETRIS, public sector doctors launched a series of strikes, demanding salary increases and greater representation in the restructuring of the public health system. With 90 per cent of the union's members participating in the strikes and striking white uniformed SIMETRIS members parading in mass protests *las marchas blancas* became the iconic symbols of opposition to the ARENA government. In contrast with earlier protests, SIMETRIS effectively forged strong political links with other civil society groups (Kowalchuk 2011) and for the first time ever, for almost five months of 1999 unionized workers in the *Sindicato de Trabajadores del Instituto Salvadoreño del Seguro Social* (Union of Workers of the

Salvadoran Social Security Institute) joined forces with SIMETRIS in work stoppages, street marches and sit-ins to resist healthcare privatization (Letheridge 2010: 137). Other public sector workers, including the *Asociación Nacional de Trabajadores del Ministerio de Salud Pública y Asistencia Social* (National Association of Public Health and Service Workers, ANTMSPAS) along with student organizations from the Universidad de El Salvador joined the protests (Almeida 2014). Meanwhile, the *Movimiento de Organizaciones Laborales Integradas* (MOLI) united public sector unions and the *Coordinadora Sindical de Trabajadores Salvadoreños* (Union Coordinating Committee Salvadoran Workers, CSTS) bringing together 50,000 state, construction and informal workers who joined in a huge march on the Casa Presidencial in San Salvador in August 1999 (Almeida 2006: 66; 2008b: 192).

By March 2000, the threat of losing access to health care serve to galvanize public opposition. Street protests had spread to other areas of the country and reached such magnitude and intensity that doctors and workers threatened to shut down the entire public health system if the government refused to negotiate and halt privatization. Two-thirds of the protests included groups from outside the social security sector (Almeida 2014). As the strike held, making it one of the longest in Salvadoran history, the number involved in protests grew to 200,000 (Smith-Nonini 2010) until finally Flores Pérez' ARENA government was forced in 2003 to abandon healthcare privatization. The government's capitulation represented the first time since the end of the civil war that government policy had been successfully opposed through popular mobilization. Indeed, the government's defeat was so comprehensive in 2003 that the following year Flores Pérez' successor, Antonio Saca, (with the support of business) was obliged to promise that no further privatizations would be entertained by his government (although his government would not reverse previous privatizations), so strong was opposition to privatization.

The defeat of the Flores Perez government's further privatization plans did not lead to a decline in popular mobilization, however. Rather, mobilized widespread opposition mounted toward his and subsequent ARENA governments' globalization policies, which would also impose increased costs on state employees and those dependent on state assistance, notably joining the Central American Free Trade Agreement (CAFTA) and dollarization of the economy. Flores Perez' efforts to align El Salvador closely to the United States, following the 9/11 attacks on New York and Washington, prompted the formation of large multi-sector coalition in opposition to CAFTA which was viewed as serving corporate interests at the expense of the wider population. Led by *El Bloque Popular Social de El Salvador* (BPS) and the *Movimiento Popular de Resistencia - 12 de Octubre* (Oct 12 Popular Resistance Movement, MPR-12) both had links with the FMLN, which was now the largest party in the *asamblea* while ARENA and the Rightist PCN retained control of the government until 2003 when PCN switched to form a loose voting arrangement with the FMLN. Throughout the country, hundreds of protests were organized at the same time that border crossings were blocked (Almeida 2014: 255-56; Spalding 2014a: 95-187). In 2001, concerned about currency volatility which could undermine the local elites' efforts to establish El Salvador as a financial center the country's business and banking establishment pressured president Flores to allow the central bank to migrate the colon to the US dollar. This provoked huge controversy and widespread protests as long-term inflation spiraled to 11 per cent as prices were rounded upwards and the money supply expanded drastically as Salvadoran banks contracted large dollar loans abroad (Towers and Borzutzky 2004). In protests in San Salvador, La Libertad, and other cities, hundreds of inhabitants and merchants, supported by the Association of Salvadoran Women (AMS), the General Association of Public and

Municipal Employees (AGEPYM), and workers and students from the University of El Salvador, FMLN activists marched dressed in black burning copies of dollars.

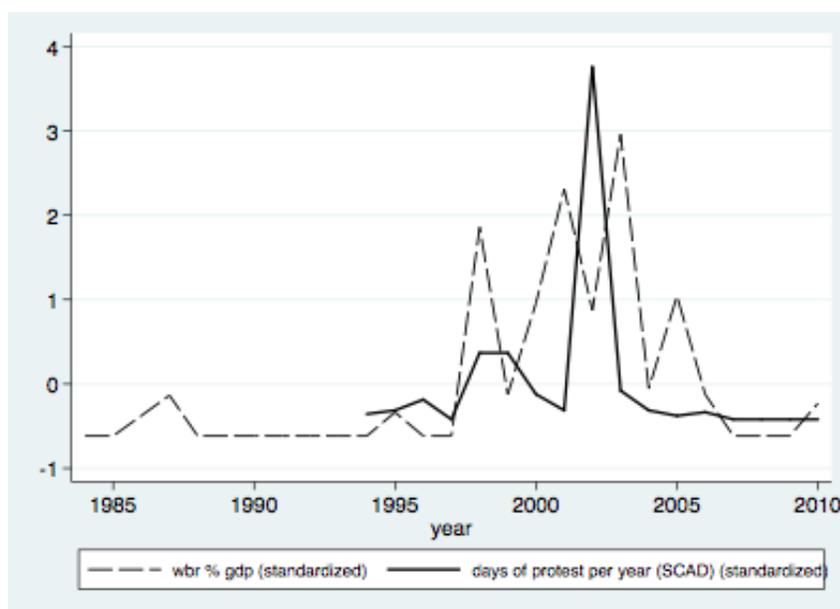


Figure 5.6. Protest and capital flight in El Salvador, 1984-2010.

The y axis shows a standardized z-scores of the number of days in each year that street protests were held using data from Social Conflict Analysis Database (SCAD), Center for International Security and Law, University of Texas. Accessed at <https://www.strausscenter.org/scad.html>

The x axis plots capital flight using z-scores of the World Banks' residual measure (WBR).

Notwithstanding the failure of the protests to prevent either joining CAFTA or dollarization, the extensive popular mobilization resulting from these campaigns – as well as the earlier drives against privatization - had the crucial effect of increasing levels of capital flight. After a dormant period from 1984, the number of street protests began to rise after 1997, fell for a couple of years before spiking sharply in 2002, and as Figure 5.6 shows, that pattern roughly tracks increases in capital flight from the country.

### *Increasing electoral support for the Left and redistribution*

At the same time, however, popular mobilization in opposition to successive ARENA governments translated to increased electoral support for the Left. The FNLM won the mayor's office in San Salvador in 1997 and in 2000 the mayor's office in Santa Tecla as well as the largest number of seats in the *asamblea*. Having made further gains in the 2003 *asamblea* elections (Table 5.5), the general expectation was that the FMLN would finally win the presidency in 2004. This did not happen because ARENA sensed the changed popular mood and electoral context and nominated Antonio Saca, a former sportscaster and media magnate as its candidate. The FMLN's candidate promised to renegotiate free trade treaties, closer relations with Castro's Cuba and Chavez' Venezuela, and higher taxes on the well-off. Although Saca ran a vicious fear campaign and was assuredly a rightist loyal to ARENA's traditional pro-market and tough crime policies, he promised to address the country's problems of severe poverty, especially in rural areas.

Table 5.4. Vote share for FMLN in El Salvador Presidential Elections, 1994-2009.

Election year	1st round vote share	2nd round vote share
1994	25.6%	31.6%
1999	28.9%	-
2004	35.7%	-
2009	51.3%	-

Source: Political database of the Americas (2009) accessed at

<http://pdba.georgetown.edu/>

Table 5.5. Vote share for FMLN candidates and allies in *asamblea legislativa* elections, 1984-2009.

Election year	Vote share	FMLN seats
1985	0%	Not contested
1988	0%	Not contested
1991	0%	Not contested
1994	24.9%	21
1997	33.3%	27
2000	35.2%	31*
2003	34.0%	31*
2006	39.7%	32
2009	42.6%	35*

Source: Political database of the Americas (2009) accessed at

<http://pdba.georgetown.edu/>

\* FMLN won the largest number of seats.

After winning the presidency by a large margin, Saca directed large quantities of international aid provided by the US and the European Union toward rural investment and poverty reduction, especially in rural areas in the north of the country, where more than 50 percent of the population lived below the poverty line. With aid from the Bush Administration's Millennium Challenge program, investment was allocated to agricultural production, transport, water and sanitation infrastructure, rural business development, and education. With European Union financial assistance, the administration also provided families in poor communities with financial assistance of \$15 to \$20 per month. The Saca government also launched the *Fondo Solidario para la Salud* (Health Solidarity Fund, FOSALUD), a public corporation providing 24 hour health care in 66 facilities, especially in rural and poor urban areas financed by taxes on alcohol, tobacco, firearms and munitions (Pan American Health Organization 2007: 36). In other policy areas, Saca began to distance his administration from traditional ARENA positions (Spalding 2014a: 177). At the same time, however, Saca's administration also lowered trade taxes demanded by business and spread the domestic tax burden to a broader base to include the poor through regressive consumption taxes while leaving largely untouched the operation of wealthy Salvadoran financiers outside the county (Schneider 2012: 7, 111).

The threat of popular mobilization and the perception of increasing popular support for the FMLN caused the Saca administration's policies to acquire a somewhat more redistributive tinge than predecessor ARENA administrations. The upshot was that although inequality within El Salvador continued to rise between 2000 and 2008, the percentage of Salvadorans living below the poverty line declined by 33 points (to 35.2 percent) at the same time that economic growth increased by just two per cent after 2004 (COHA 2008). This shows that rightist governments can also adopt redistributive policies *but only when they face stiff electoral competition from the*

*left*. The data also provides strong evidence satisfying my second hoop test viz. *rising* popular mobilization will lead to more redistributive policies and more capital flight.

### *The rise of the FMLN*

Notwithstanding the somewhat redistributive policies of Saca's administration, rising popular mobilization on the streets together with a series of corruption and financial scandals involving ARENA officeholders served to undermine support for ARENA and bolster support for the FMLN, which proved itself capable of successfully transitioning from an insurgency movement to a competitive Leftist political party. As mentioned already, the FMLN had already become a serious competitor to ARENA by the early 2000s and as Figure 5.7 shows it became the largest party in the *asamblea* after the 2000 and 2003 legislative elections ensuring that ARENA and its allies could no longer pass legislation without its agreement. Meanwhile, the party was beginning to acquire a reputation for effective administration in a host of municipalities across the country and following a series of internal expulsions and sanctions on those who refused to toe the party line, it had become much more ideologically cohesive and disciplined (Puyana Valdivieso 2005) so that by 2005 it was even willing to form legislative coalitions with centrist parties in the multi-party assembly, thereby enhancing its prospects of forming a national administration.<sup>16</sup>

In terms of enhancing its popular support, by the mid-2000s the FMLN had already showed its adeptness for linking effectively to rising public discontent against ARENA's pro-market reforms (Latinobarometro 2003) and the Saca administration's growing unpopularity aided in no small measure by its proven ability to develop links with civil associations, including those

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<sup>16</sup> In response to the healthcare strikes, for example, the FMLN entered into ad hoc agreements with the minor conservative PCN to pass legislation restoring strikers' labor rights and providing compensation to make up for lost salaries during the strike.

embedded in the country's major conurbations, and to mobilize the FMLN membership in solidarity with striking workers on the streets. Between 2003 and 2008, the party was instrumental in mobilizing anti-CAFTA street marches, road blocks, and educational workshops - all of which helped the party increase its voter turnout in the 2004 presidential and 2006 legislative elections (see Tables 5.4 and 5.5). The electorate was clearly drifting leftwards (Azpuru 2010) so that by 2004, the FMLN was a clear political threat to ARENA's continued hegemony. By late 2008, 63 percent of Salvadorans believed that ARENA should no longer govern the country, and 80 percent felt that under Saca's administration economic conditions had generally worsened; 65 per cent thought that if ARENA won elections again, "the rich will become richer and the poor will become still poorer" (2009 IUDOP polls quoted in COHA 2008 and Spalding 2014a: 177). It was the political context of growing support for the FMLN in the period from 1997 to 2002 that heightened elites' perceptions of serious threats to their economic and political interests and gave rise to the dramatic increases in levels of capital flight in line with the FMLN's electoral success shown in Figure 5.7. The data in the figure also shows that, rather than taking place once the FMLN was in power, the majority of capital left actually *before* Funes' government took office. Indeed, based upon the timings of the peaks in capital flight it is highly likely that the highest of these coincided with Salvadoran elites' realization that an FMLN victory was now possible, or even probable.

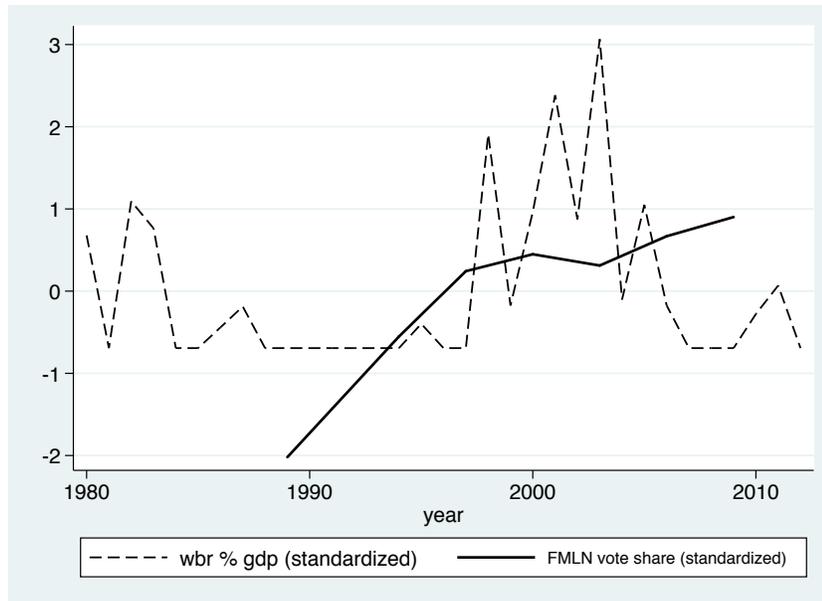


Figure 5.7. FMLN vote share and capital flight (WBR z scores).

The discussion at the beginning of this chapter referred to the need for qualitative researchers who construct explanations using the “detective method” to apply some “smoking gun” tests to the evidence they present in order to validate their central thesis; specifically that capital owners explicitly claim they are engaging in capital flight in response to popular mobilization and increased political risk associated with the rise of the Left, and that these causal connections need to be reported in the news at the time.

Ideally, survey evidence of business/elite perceptions of seriously enhanced political risk arising from the prospect of an FMLN government would constitute the best information to satisfy my smoking gun tests. In their absence, however, I must rely on media reports of such fears expressed by key members of the business community in response to growing popular mobilization in opposition to the ARENA governments and the Left increasing its electoral support from 1997 forward. Spence, who led the Hemisphere Initiatives election observation

team in El Salvador, notes presciently that “[h]ad the FMLN won the [1994] elections in El Salvador, it is not clear that the military ... or powerful business interests [including the large coffee growers] would have been prepared to accept the elections ... there would [also] have been an increase in death squad activity, the military would have pressured the incoming government in numerous ways, and there would have been massive capital flight” (1998: 93). During and after the 2000 legislative elections in which the FMLN gained its highest share of votes to that date, ANEP, El Salvador’s main business association published a list of petitions the main thrust of which was that no law should be decreed that would cause “the flight of national or foreign investment” (Editorial 2000). On the eve of the 2004 presidential election, news outlets warned, “[b]usiness leaders fear mass capital flight in case Handal (the FMLN’s candidate) comes to power, especially because he has expressed admiration for Cuba’s communist leader Fidel Castro and of Venezuela’s populist President Hugo Chavez” (DPA 2004).

The FMLN eventually won the Salvadoran presidency in 2009 with the more centrist Mauricio Funes who was a popular television talk show host. Notwithstanding Funes’ promise of “safe change” and business support from “*las amigas de Mauricio*”, media reports of the period in the run-up to the election again show clear evidence of business’ trepidation at the prospect of a Leftist government.<sup>17</sup> With the Salvadoran media supporting ARENA, television campaign broadcasts were flooded with commercials showing montages of grainy clips of street chaos and camouflaged soldiers, emphasizing long-standing ties between the FMLN and Venezuela’s Chávez, and warning that a Funes victory would turn El Salvador into a Venezuelan satellite

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<sup>17</sup> There can be no question that voting in the election was highly polarized ideologically. The mean self-placement of Funes’ voters was 4.1 on a 10-point scale (Ayala and Moran 2010) whereas those voting for the ARENA candidate Avila had a mean score of 7.3 (Cordova Macias, Cruz, and Seligson 2010: 165).

(Malkin 2009: A6; Millman 2009: A9). In the vein of previous elections, ARENA's presidential candidate Rodrigo Avila warned that "El Salvador [would] become another pawn of Chávez's totalitarianism." (Contrapunto 2009). Predictably, the ARENA-linked think tank FUSADES issued a report blaming a rise in capital outflows prior to the election on fears of an adverse investment climate (Fabeiro 2014). In a similarly alarmist vein, Arnoldo Jiménez, the executive director of El Salvador's largest business association ANEP, warned of "a withdrawal of capital in terms of deposits and investments, simply because business predicts that there will be a dictatorial government in El Salvador" (elsalvador.com 2009). Further, he charged, industrial companies were "looking into moving their investments to Honduras, given the benefits and 'legal certainty' offered by the country" (Fabeiro 2014). Media stories also included reports of business owners threatening employees with losing their jobs if FMLN should win power (Envío 2009).

As the earlier discussion noted, the fundamental point in the detective method is that if the qualitative researcher's beautiful theory encounters an "ugly" fact, the theory must be rejected leading him/her even if a considerable amount of evidence suggests its validity. Using supporting evidence relating to El Salvador, the previous discussion has demonstrated a tangible link between popular mobilization in the form of mass protests and rising support for the Left and capital flight. But, what alternative explanations may be advanced to falsify this theory and explain the variations in capital flight?

Let us consider three alternative explanations for high levels of capital flight offered either in the literature reviewed in the previous chapter or intuitively plausible: unstable macroeconomic conditions in El Salvador; second, the low number of veto players in El Salvador's presidential

political system; and third, that the real stimulus for capital flight from the government was the ARENA governments' history of financial liberalization.

Might capital outflows from El Salvador have been driven more by macroeconomic conditions than by popular mobilization? If we recall the regression results in Chapter 3, almost all the results for the different models showed that two of the control variables, inflation and external debt, were consistently highly significant and positively signed (for example, Table 4.2).

External or foreign debt is often cited as an explanation for capital flight and the analysis in Chapter 3 provided evidence both of cross-case and at times within-case relationships between capital flight and external debt. Figure 5.7 shows that the relationship is more ambiguous, at least for El Salvador. Most significant for present purposes is that external debt continued to rise throughout the period regardless of changing levels of capital flight. Although it might be argued that the increase in capital flight after 1997 fueled an increase in external debt, this result does not do damage to the overall thesis advanced in this dissertation. As the figure shows, external debt continued to rise after 2005 even as capital flight fell. In short, increased capital flight cannot be explained simply by rising external debt alone.

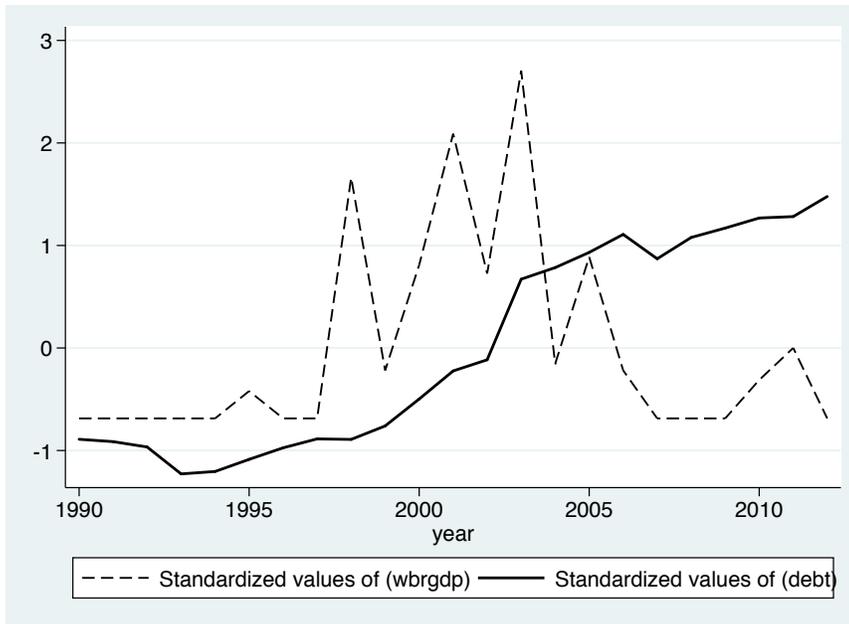


Figure 5.8. External debt as a percentage of El Salvador’s GDP and capital flight, 1990-2012

Capital flight is measured by WBR z scores

Evidence shown in Chapter 3 also shows a strong relationship between inflation and capital flight, both across and within cases. Yet, inflation alone cannot explain El Salvador’s patterns of capital flight. Instead of explaining capital flight patterns, the relationship between the two variables is uneven. If we look at Figure 5.9 we can see that inflation, measured by the standardized annual increase as a percentage GDP, declines after 1995 and remained low throughout the period. The same is also the case for the relationship between capital flight and El Salvador’s annual economic growth increase where high growth is associated with low capital flight in the 1980s and early 1990s, then low growth with high flight between 1997 until 2005, and then mixed growth and low flight thereafter. Still, it is possible that low growth may be a surrogate for the disruptive effects of popular mobilization and the rise of the Left. That is, low growth would likely induce high unemployment and under employment, which in turn would likely stimulate popular discontent.

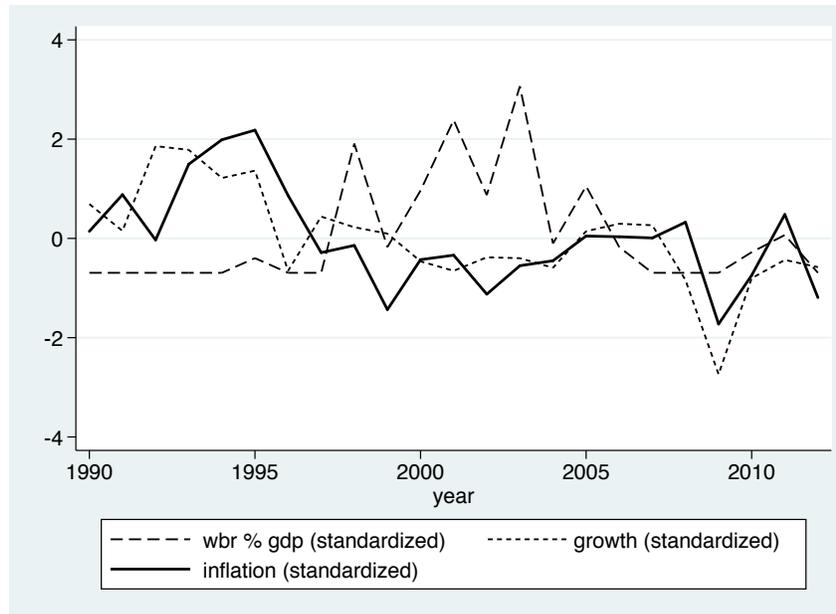


Figure 5.9. Economic growth, inflation and capital flight in El Salvador, 1990-2012.

Capital flight is measured by WBR z scores.

Inflation is measured by the standardized increase in the annual percentage GDP deflator (rate of price change in the economy as a whole annual). Growth is measured by the standardized annual percentage change in the GDP implicit deflator. The GDP implicit deflator is the ratio of GDP in current local currency to GDP in constant local currency. Source: World Bank (2016).

As I discussed in Chapter 2 also rehearsed an argument that levels of capital flight are best explained by particular institutional configurations (Busse and Hefeker 2004, 2007), specifically, that the number of significant veto points (Ahlquist 2006; Henisz 2000; Jensen 2008; Keefer and Stasavage 2002) is related to flight levels. Figure 5.10 plots Keefer and Stasavage's count of veto points (checks on executive power). However, as with the three macroeconomic variables, over the period there is no consistent relationship between the number of veto points and capital flight levels.

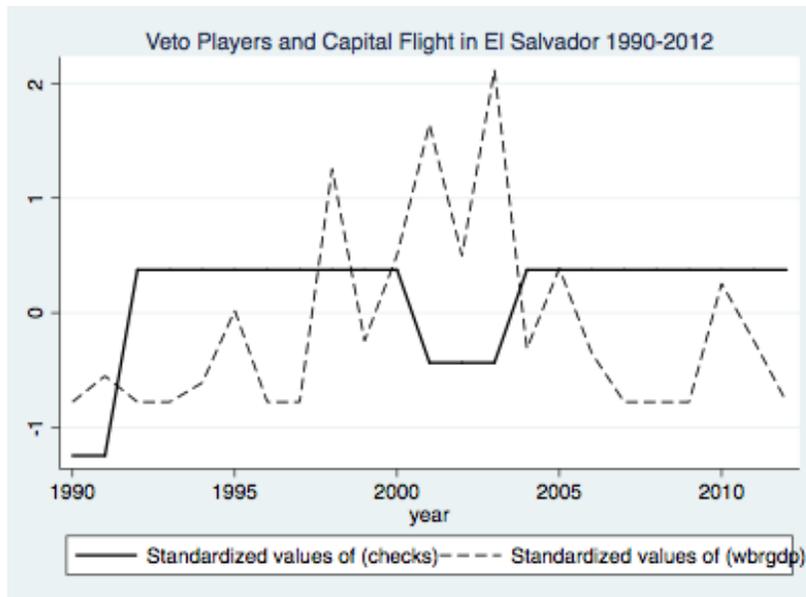


Figure 5.10. Veto players and capital flight in El Salvador. 1990-2012.

Capital flight is measured by WBR z scores.

The CHECKS variable derives from data compiled by Keefer and Stasavage (2003).

A final competing explanation for El Salvador’s patterns of capital flight relates to the earlier discussion of the concerted efforts of Cristiani’s ARENA government and its successors to grow the country’s financial sector into the primary financier for the whole of Central America. The privatization of and deregulation of the banking sector that followed generated huge capital surpluses within El Salvador and encouraged bankers to pursue superior returns from investment opportunities outside the country, opportunities that would otherwise not be available to them if their operations remained primarily based on their home country. In short, the argument is that the increases in capital outflows experienced between 1997 and 2006 were the inevitable consequence of financial deregulation, which may have been undertaken as a precaution against the Left gaining power at some point in the future. Capital invested in banking was by definition

portable in the event of a “predatory” Left government whereas investment in agriculture, for example, was tied to a particular geographic location (Boix 2003).

In order to compare the relationship between El Salvador’s level of financial openness and capital flight over time I make use of the Chinn-Ito index- a commonly used measure for financial liberalization (Chinn Ito 2008). Figure 5.11 plots financial openness against capital flight. A rough association may be detected for the period from 1997 to 2005 but the relationship untangles thereafter as capital flight falls, including – somewhat surprisingly - during the 2008-09 global financial crisis when the US and Salvadoran economies imploded and financiers would have been expected to export their capital even more to invest elsewhere. These evident patterns also beg the question as to whether El Salvador would have experienced comparative levels of capital flight had the economy not undergone substantial financial liberalization. Any answer to this question, however, would need to explain *unrecorded* outflows, which are included in the measure of capital flight used in this research. In order to accept that Salvadoran capital holders preferred to invest vast amounts of money outside El Salvador these sums would need to show up in the recorded capital outflows rather than in the World Bank Residual measure.

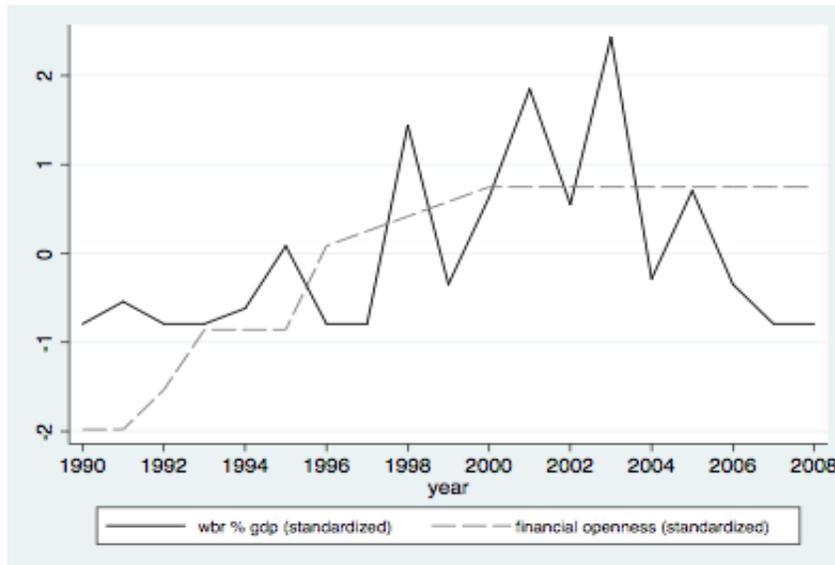


Figure 5.11. Financial openness and capital flight in El Salvador. (WBR z scores)

Financial openness (specifically, capital account openness) is measured by the Chinn-Ito index, KAOPEN, which is a binary dummy variable that codifies the tabulation of restrictions on cross-border financial transactions as reported in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER) (Chinn and Ito 2006).

### Summary

This chapter has provided evidence of the impact of popular mobilization on capital flight in two periods of recent El Salvador history before and after the catalytic events of 1999 and 2000 following the election of President Flores Pérez, the pro-business ARENA candidate, to the presidency. At a time of high inflation and a reduction in living standards, Flores Pérez's embarked on a vigorous program of pro-market economic policies following his election, including privatization of the Salvadoran health care system. The ARENA government's action prompted a large wave of popular protest that lasted for three years before it was forced to

abandon its plans, but not before the country's elite, which had felt its capital was safe under previous ARENA governments between 1984 and 1997, perceived a sharp increase in political risk and relocated large volumes of their capital outside the country. Popular mobilization led to increased electoral popularity for the Leftist FMLN, which eventually replaced ARENA as the most popular party in the country and, in keeping with the dissertation's general theory, led to further significant increases in capital flight. The application of various hoop and smoking gun tests lends support to the general argument, which is developed further in the next chapter in which a cross-national case approach is adopted to examine the effects on capital flight of Leftist governments and rightist opposition after the FMLN gained the presidency in El Salvador after 2009 and *Movimento Al Socialismo* (MAS) won power in Bolivia in 2006.

## Chapter 6: Capital flight and the Left in Power:

### El Salvador and Bolivia compared

The previous chapter demonstrated how popular mobilization prompted by ARENA's vigorous program of pro-market economic policies – and particularly its proposals to privatize the Salvadoran health care system led to increased electoral popularity for the Leftist FMLN, which in turn led to significant increases in capital flight. This chapter looks at the second party of my theory: how- when faced with popular mobilization- the presence of a significant political opposition can serve as a constraint on pressures for redistribution resulting from popular mobilization and so lead to lower levels of capital flight. To do this, I conduct a cross-case comparison of El Salvador and Bolivia once the Left had won power: the FMLN in 2009 and the *Movimiento al Socialismo–Instrumento Político por la Soberanía de los Pueblos* (Political Instrument for the Sovereignty of the Peoples, MAS) in 2005 after winning control of Chamber of Deputies in 2005 while the MAS candidate Evo Morales – an indigenous poor farmer without any college education who suffered torture under previous conservative governments - won the presidency.

Employing the logic of most similar research design, the principal objective is to determine the relative effects of Leftist governments in these two democracies on patterns of capital flight. The logic of most similar research design requires that the cases are comparable in all areas *except* the independent variable the variance of which is considered to explain different outcomes on the dependent variable (capital flight). That is, the objective is not merely to provide covariational findings that address the extent to which popular mobilization (X) and capital flight (Y) covary

in the predicted direction. Rather, it is to provide a case analysis that helps explain why X leads to Y. As in the previous chapter, various hoop and smoking gun tests are applied to the cross-national comparison as part of the effort to marshal support to the dissertation's general argument.

Figure 6.1 presents standardized WBR z scores for Bolivia and El Salvador, as percentages of GDP from 2006 to 2015. Clearly, although both democracies elected Leftist government the patterns of flight are very different. As the figure shows, capital flight levels in El Salvador were fairly stable between 2006 and 2015 with a blip after 2009 whereas patterns in Bolivia were much more erratic, declining immediately in 2007 after MAS took control of government before rising sharply in 2008 and even further in 2010 only to drop sharply in 2011 and then rise even more sharply to record levels in 2012 and 2013, as Morales and the MAS continued its policy of nationalization of private companies.

How can these divergent patterns be explained?

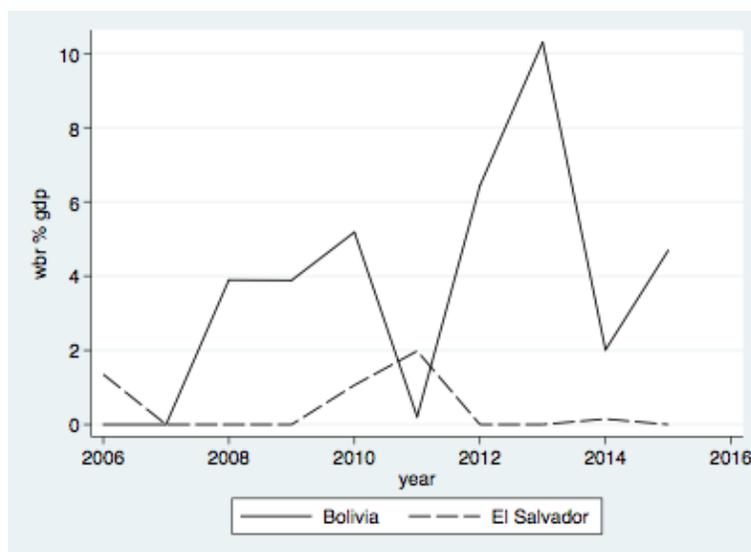


Figure 6.1. Levels of capital flight from Bolivia and El Salvador, 2006-15. (WBR z scores)

This chapter proceeds first with analytical discussion of the political climate that led to the rise of MAS in Bolivia. This discussion is followed with an outline MAS's policies under Morales and an analysis of the extent to which they threatened Bolivian capital's interests and how they contrasted with the comparatively more moderate policies of Mauricio Funes' FMLN administration in El Salvador. The final part of the analysis provides explanations for these differences by comparing the relative political strengths of the opposition to the left in power in both countries. The thrust of the chapter's argument rests on the continued electoral relevance of the conservative ARENA party in El Salvador, opposition to the FMLN, and the absence of an equivalent opposition party in Bolivia – and, as a consequence, the different levels of capital flight experienced by each country. In brief, while ARENA remained significant and mounted continuous opposition after the FMLN came to power in 2009, by the time MAS was elected to government in 2005 the pro-capital Bolivian parties had completely collapsed allowing the mass-based Leftist party to win election unhindered. Deprived of constitutional means to resist MAS's redistributive policies, the Brazilian elites opted for capital flight *en masse*.

### Method

As in the previous chapter, the analysis in this chapter utilizes a number of hoop and smoking gun tests to validate the dissertation's core argument. Failing a hoop test, it will be recalled, eliminates the hypothesis while passing it does not necessarily provide validation although the evidence posited by the test does yield a necessary condition for the hypothesis to be valid (Bennett 2008; Goertz and Mahoney 2012).

The following hoop tests will be utilized:

- *Ceteris paribus, Leftist governments facing a stronger opposition will experience less capital flight.*
- *Ceteris paribus, Leftist governments facing a stronger opposition will pursue weaker redistributive policies and induce less capital flight.*

Because, however, qualitative research relies on solving puzzles and explaining specific outcomes by drawing on detailed fact collecting, experience in researching similar cases, and acceptance of general causal principles (George and Bennett 2005; Mahoney 2006: 241; Van Evera 1997), and not all pieces of evidence carry the same weight, the analysis also needs to look out for smoking guns, which may subsequently form a substantial part of the overall conclusion that our theory is valid. At the same time, however, “ugly” facts may appear leading to theory rejection. In this light and the dissertation’s core theory, the chapter needs to:

- When faced by similar redistributive policies show evidence of capital expressing flight preferences dependent on their relative political strength in the two countries.
- When faced by similar redistributive policies show evidence of capital forces blocking the FMLN in El Salvador and absent in Bolivia

#### *The FMLN in government and political opposition in El Salvador*

The previous chapter rehearsed the historical strength of the Salvadoran business elite, the extent to which it was integrated into its political vehicle, the ARENA party, and the political effectiveness of its electoral campaigns evinced by FMLN’s failure until 2009 to win the

presidency in three successive elections – and then its success in 2009 having adopted an outsider candidate in the person of Funes, a popular television news anchor who was a household name in Bolivia, with more centrist views and supported by “*las amigos de Mauricio*”, a small group of small and medium business, former state officials, and professionals that established its own electoral organization and was able to raise significant campaign funds for Funes (Cáceres 2008). Indeed, it was the three earlier defeats that finally persuaded the FMLN to moderate its policies substantially in order to win election. The FMLN’s candidate in the 2004 presidential elections, the *ex-guerrillero* Schafik Handal’s statements and policies was widely considered too radical by voters and were blamed for the party’s defeat. Indeed, without ARENA’s formidable political presence and vocal opposition in the *asamblea* and outside - reinforced by the activities of the pro-business FUSALES think tank – and effective fear campaigns warning of the prospect of Chavez-style socialism in El Salvador, the former guerilla movement would have had few incentives to moderate its policies. Only by moving nearer the political center in classic Downsian style and by accepting alliances with other groups outside the party, moderates within the FMLN argued, could the *ex-guerrillas* widen their electoral appeal and win the presidency – and then only by a narrow margin (51.3 per cent).

With a limited electoral mandate, a moderate party platform, the party failing to win a majority of seats in the Salvadoran *asamblea* and ARENA winning just three seats fewer (32 to the FMLN’s 35/ 42.6 per cent of the vote), Funes’ new FMLN government was legislatively constrained to adopt more centrist policies. For it to win *asamblea* approval for major radical reforms, it would require a chamber plurality, and to borrow abroad to finance new spending it would require a two-thirds majority, neither of which it ever had. In the absence of an overall majority in the legislature, it had to rely on cross-party dialogs and coalitions with rightist

parties, *Gran Alianza por la Unidad Nacional* (Grand Alliance for National Unity, GANA and *Partido de Concertación Nacional* (PCN) that would not embrace major radical reforms. There was also the continuing risk that ARENA influence on the *Corte Suprema de Justicia* (CSJ) might result in the administration's policies being ruled unconstitutional.

Indeed, throughout Funes' administration the continued strength of ARENA was a major constraint on his administration's actions, which was emphatically demonstrated three years after his election when the party once again capitalized on its professional campaigning style and strong rural voter base built during the civil war to become the largest party in the legislature in the 2012 mid-term elections. ARENA also won landslide victories in the 2012 departmental and municipal elections carrying 9 of the 14 department capitals, including a second consecutive term in San Salvador where the party won its largest margin ever, and 116 mayoralties to the FMLN and GANA's 111. According to polls conducted by the UCA Institute, however, "ARENA did not win because it gained votes, it simply won because the FMLN vote went down too much" and that was because after three years of the FMLN in government, 62 per cent of Salvadorans considered their country to be "equal" or "worse" than it was 20 years after the signing of the Peace Accords in 1992 (Rodriguez 2015). Poverty and crime still remained major problems. The high levels of violence provoked by the incursion of Mexican drug cartels, identified as one of the problems that have grown during the Funes, government combined with a weak economy that failed to generate jobs to lower the high rates of emigration to the United States produced disappointment.

As a consequence of its tenuous electoral position, the need to compromise with the rightist GANA and other smaller parties and counter robust opposition from ARENA, the ex-guerilla FMLN in El Salvador had to adopt an incremental moderate approach to governing and minimal

reform. As the later discussion will show, this approach contrasted sharply with the radical, less compromising, approach of Evo Morales and the MAS in Bolivia.

Unlike Morales, Funes did not campaign on a platform for revolutionary change. Instead, he promised *cambio prudente* ("safe change"). As a party outsider and centrist with strong links with the more progressive business sectors, he was able to draw on support from outside the FMLN. In an interview with *Latin Pulse* a few weeks before he took office, Funes reaffirmed his government's commitment to ensuring "investor confidence" at the same time that he proposed strengthening social policies that benefitted workers and the poor. "My party and my government plan to create the conditions for macroeconomic stability in order to attract more private and foreign investment, as well as stimulate investments from the private sector within the country", Funes declared. "It is not the government that creates jobs; the government must create conditions of macroeconomic stability so that foreign investors feel compelled to invest in the country" (Haglund no date). "*Las amigos de Mauricio*", the business-professional group supporting Funes also made determined positive efforts to reach out to the business sector to reassure them that the FMLN candidate would not become another Chavez and make drastic changes to economic policy (Allison and Alvarez 2012). Moreover, although he repeatedly expressed solidarity with Luiz Inácio Lula da Silva's more moderate approach to social policy in Brazil (Montoya 2013), he also refused to join the Hugo Chávez's regional initiative, the Bolivarian Alliance for the Peoples of Our Americas (ALBA). By publicly associating himself with the US president Barack Obama and by inviting US secretary of State Hillary Clinton and 12 Latin American heads of state (but not Chávez or Morales) to his swearing-in ceremony and their accepting their invitations, Funes also sent a strong signal to the Obama administration and

international investors that he would lead a moderate Leftist government along the lines of those of Lula and Chile's Michelle Bachelet.

Once elected, Funes again emphasized the need for policy continuity not revolutionary change, distancing himself from previous FMLN platforms, promising to adhere to CAFTA and to honor all sovereign debt obligations, and pledging to retain ARENA's dollarization and plans, albeit with an element of public participation. Unlike the MAS government later elected in Bolivia, Funes' new FMLN administration would not attempt any new nationalization nor would it reverse the ARENA government's privatizations nor jeopardize private property (Bowles 2009). Indeed, having won the support of ANEP, the country's largest business association, Funes' government created a Social and Economic Council (CES) to promote policy discussion and facilitate cross-sectoral dialogue between business and various civil society groups in order to reassure the country's skeptical business community. He also distanced himself from the FMLN in his choice of government appointees filling key cabinet positions with moderates from outside the party, including Alex Segovia, an Oxford-trained economist, Finance Minister Carlos Caceres, a businessman who formerly headed the country's banking association, Hector Dada, a moderately Leftist former foreign minister, and Carlos Acevedo, a former economic adviser to the United Nations Development Program (UNDP) in El Salvador, as head of the *Banco Central de Reserva de El Salvador* (BCR, the Central Bank).

Under Funes' FMLN administration, ARENA'S market model based on financial services and liberalized trade would remain untouched, and few attempts at state-led development would be made. At the same time, however, Funes' *Plan Quinquenal* introduced immediately after taking office deployed counter-cyclical policies to check the damage caused by the Great Recession of 2008-9, provided for poverty relief, reduced tax evasion, ended government gas and electricity

subsidies that mainly helped the well-off, used government funding to create jobs for returning migrants, raise health care spending, and created a national development bank. The administration's new house-building program, *Casa para Todos* ("a house for everyone"), which included plans to build homes for 27,000 rural and urban poor families and create around 40,000 short-term jobs, stressed the government's commitment to working with the private sector within private-public partnerships as well as with local governments (EIU 2009).

Rather than seeking to transform state and societal institutions, as Morales would do in Bolivia, the Funes administration's general approach was to reform existing public institutions to widen access to social services (Clark 2015). Expansions in social spending were gradual rather than transformative with incremental innovations in social programs targeting vulnerable groups living in extreme poverty (López, Quinteros and Ramos 2015) and in June 2011 moderate increased the minimum wage across all sectors. The government also emphasized targeted cash transfer programs focusing on human capital development. For example, the government added a universal pension for the low-income elderly (over 70 years of age). Through its *Cuidad Mujer* program (City for Women) project, it created centers in many districts to provide women with a range of social services, including health and childcare. The measures extended health care coverage, assistance with school expenses, feeding programs for schoolchildren, and a minimum old age pension for poor seniors (Perla and Cruz-Feliciano 2013).

Despite the substantial inequality in the country, however, the government steered clear of sweeping transformational policies aimed at restructuring society along more equitable lines (López, Quinteros and Ramos 2015). As in other policy areas, much to the disappointment and hostility of many FMLN stalwarts (Sanz 2013), this approach reflected a recognition by party leaders that their unexpected defeat in 2004 election signaled the long term need for the party to

shift its policy orientation to El Salvador's country's political center in order win majority support.

Given the FMLN's limited electoral mandate, absence of a legislative majority, and thus the need to effect legislative compromises, its legislative record is mixed, as Table 6.1 using data compiled by FUSADES shows. The government began its term with a 70 per cent approval rate of its bills declining to only 20 per cent in its fourth year.

Table 6.1. The FMLN's Legislative Approval Record, 2009-13

Year of Funes administration	Approved	Partly Approved	Rejected
2009-10	70%	15%	15%
2010-11	63%	27%	10%
2011-12	29%	43%	29%
2012-13	20%	40%	40%

Source: Rodríguez (2014)

In 2010, for example, the ARENA opposition blocked a bill calling for inheritance tax reform. On other occasions, including some of its major reforms, including tax overhaul, security policy and foreign debt financing, the FMLN government had to compromise in order to win the support of its coalition partners and, in some cases, appease the ARENA opposition, which remained a formidable and robust force throughout Funes' administration.

Immediately after taking office, Funes began efforts to negotiate a fiscal pact with El Salvador's economic elite in order to fulfill one of main campaign promises. Following nearly two and a half years of fruitless negotiations, the government presented a proposal to the legislative assembly in late 2011 for a series of tax reforms intended to create a more equitable system and

raise revenue in a system with the lowest tax collection rates in Latin America, which helps explain the need for Salvadoran governments to depend on loans from multilateral financial institutions, including the World Bank and International Monetary Fund, to fund basic operational expenses.<sup>18</sup> With a broad array of social movement organizations mobilizing to pressure rightist parties to approve a new progressive income tax structure, Funes' administration finally recognized its failure to reach an agreement with business and quickly presented its own tax reform proposal, which were very similar to those of the FMLN. The main business organization, ANEP expressed opposition, particularly a provision to eliminate a six per cent IVA rebate for exporters. Ultimately, only four of the 12 laws in the administration's tax package were approved as a result of business opposition. Moreover, the most redistributive part of the bill – to do with the creation of tribunals to prosecute tax fraud<sup>19</sup> - was effectively vetoed by private enterprise. In the bilateral meetings between the administration and the different business sectors affected by the government's fiscal proposals were effectively diluted so that the tax take was reduced from US\$250 to \$140 million and the measures were mainly restricted to certain products, such as tobacco and alcoholic beverages. However, legislation totally eliminated income taxes for low paid workers and reduced taxes for middle class workers while increasing business income taxes and for the first time creating a new 5 per cent tax on stock dividends. ANEP staunchly opposed these reforms as well as provisions requiring charges to be brought against individuals or companies who present false tax documents or fail to declare income. All the parties in the asamblea, except ARENA, eventually approved all these measures. Indeed, ARENA's main campaign theme for the 2012 legislative elections was a promise to reverse the

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<sup>18</sup> Conservative estimates show that El Salvador's tax system provides for more than \$600 million a year in tax loopholes that primarily benefit big businesses. Over 80 per cent of all taxes are by working and middle class taxpayers, with the poorest 10 per cent of households paying 30 per cent of their income in taxes while the wealthiest 10 per cent of households pay only 11 per cent of their income in taxes (CISPES 2012).

<sup>19</sup> Endemic tax evasion by the wealthy had ensured that El Salvador's tax system remained regressive (Schneider 2012; 112)

reforms despite television news and newspaper polls showing broad support for the reforms (CISPES 2012). Even so, despite some small incremental adjustments, the overall regressive slant of the tax system inherited from the ARENA governments was not addressed and taxes on exports remained unchanged and progressive measures such as reestablishing the capital wealth tax or establishing a real estate tax were omitted in the approved bill's language. Following legislative approval of the tax reform package, the ANEP president Araujo concluded that "the relations ... with the government are very good, with some very broad lines of communication in which we've been able to participate actively to seek what's best for our country. We just went through this whole tax reform process, in which for the first time the business class is proposing a fiscal pact" (Envio 2010). Meanwhile, Central Reserve Bank president Acevedo, declared the bill "fiscal reform lite" as it contributed little to the state's needs (Envio 2010).

Later in 2012, in line with business elites' preference for low debt, ARENA successfully opposed the Funes administration's proposal to seek an \$ 80 million loan from the World Bank to improve the country's health system. Following almost five hours of heated debates in the plenary session, the proposal failed to win a two-thirds majority even though 55 deputies voted in favor and 29 ARENA representatives voted against. Only after the bill was substantially amended by acceding to ARENA demands that transport subsidies be cut and the size of the loan sought reduced from \$400 to \$200 million – and after three attempts - did the bill received its required two thirds majority (Envio 2010).

### *Elite politics and political opposition under MAS in Bolivia*

In most important respects, Bolivia's long history of exclusionary social, and political practices from the Spanish Conquest forward remains in place and mirrors that of El Salvador, albeit with

an additional racial dimension – about 70 per cent of Bolivia’s population comprises indigenous people who, even gaining the vote after the 1952 Revolution remained socially and culturally subordinate and largely excluded from formal participation in politics and government. Like El Salvador, Bolivia depends heavily on the export of its natural resources, silver, tin and natural gas in Bolivia’s case and especially the latter, which is now the main driver of the economy. Unlike El Salvador’s dynamic and aggressive business elites, which switched their market orientation from agricultural exports to financial services, those in Bolivia have atrophied. From 1985 onwards, the traditional export-oriented mining elites in and around La Paz were gradually displaced by the regional elites around the eastern city of Santa Cruz following the discovery of substantial oil and natural gas reserves, who in the 1980s worked with international energy corporations to orient their activities to the demands of the global economy. In consequence, Santa Cruz became the focal center of the Bolivian economy generating between 2002 and 2004 a mean 30 per cent of GDP, and at 37 per cent of total tax revenue the main source of export income for the Bolivian state (Eaton 2011; Gamarra 2008).

Unsurprisingly, the centrality of the oil and natural gas sectors to the Bolivian economy quickly translated into growing economic clout not only in Santa Cruz but in national politics where cohesive and highly organized peak lobby organizations - notably, the *Federación de Empresarios Privados de Bolivia, Santa Cruz* (Federation of Private Entrepreneurs of Bolivia, Santa Cruz—FEPB–SC), the *Cámara Agropecuaria del Oriente* (Eastern Agricultural Chamber—CAO), and the *Cámara de Industria y Comercio* (Chamber of Industry and Commerce—CAINCO) - lobbied governments for pro-market policies that privileged private capital and exercised considerable political influence. This influence was exercised through a national coalition of all three of the country’s main political parties, the social democratic *El*

*Movimiento de Izquierda Revolucionaria* (Revolutionary Left Movement, MIR) and the rightist *Movimiento Nacionalista Revolucionario* (Revolutionary Nationalist Movement, MNR) rightist *Acción Democrática Nacionalista* (Nationalist Democratic Action, ADN). During this period, the country was ruled through an arrangement that became known as the *democracia pactada* (literally, “pacted democracy”). Within this “pacted” party system and in the context of Bolivia’s hyperinflation and the collapse of global tin prices, the three parties shared a strong commitment to market policies under the aegis of the New Economic Policy, which involved restructuring the erstwhile state-directed Bolivian economy along neoliberal orthodoxy. Economic policy was dominated by businesspeople and/or market-friendly technocrats who sought to scale back the state in line with elite interests (Conaghan 1996; Mayorga 1997). As Arce and Rice note, in the 1990’s “Bolivia was the poster child for economic liberalization policies adopted throughout Latin America since the 1970s” (2009: 88). Unsurprisingly, most of the costs were borne by workers and the poor. Labor union activity was heavily curtailed and thousands of workers previously employed in state industries were dismissed, including 30,000 miners, and as in El Salvador following the democratic transition, the left became demobilized.

Because these market-oriented policies were strongly supported by private capital, levels of capital flight remained low, except for a brief period of financial instability causing by a minor banking crisis in 1994. Nonetheless, the policies generated feeble economic growth and mounting popular resistance to marketization gradually undermining the pacted system until a full blown crisis of governability developed in the 1990s. As a result of the government’s decentralizing reforms during the mid 1990s, however, disparate social groups had been given greater space to operate. The emergence of political and economic crisis galvanized social actors to coalesce into a new popular movement that attracted increasing popular support and eroded

political support for the pacted parties. Social confrontation reached a peak in 2002 when MNR President Gonzalo Sanchez de Lozada provoked indigenous and labor groups to launch mass strikes and roadblocks when he proposed to build a pipeline to pump gas to Chile. With the whole country at a standstill, the MNR-MIR coalition government collapsed, MNR President Gonzalo Sanchez de Lozada was forced to resign and flee the country.<sup>20</sup> Facing nationwide protests, strikes, and widespread civil disobedience, two years later his successor, the independent Carlos Mesa, was also forced to resign despite attempts to make concession to protestors.

Taking together the weakened grasp of the rightist pacted parties and the increased strength of the resurgent social movements seriously threatened the business elite's influence over the choice and policies of national government.

### *The rise of MAS in Bolivia*

The premarket elite's hegemony became even more seriously threatened by the emergence of a new mass-based Leftist political party *Movimiento al Socialismo* (Movement to Socialism, MAS), riding on the back of this wave of popular protest and representing important ethno cultural and peasant demands and supported by a coalition of labor organizations, social movements and indigenous people.

MAS began life as an uncoordinated political force that reignited local traditions of popular mobilization through direct action (protests, marches, road blockades, and so forth) but which was able to transform itself into an effective national level actor. Rejecting the traditional pacted

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<sup>20</sup> In 1999, a so-called "water war" broke out when the government proposed to privatize the Cochabamba municipal water supply. Thousands mobilized in response with resistance so strong that the local executive officers were forced to flee the area. Ultimately, the government was forced to revoke the privatization contract (Assies 2003;

party system, it presented itself as a break from *partidocracia* and thus a serious threat to business influence in the political system. Led by Evo Morales, MAS achieved second position in the 2002 presidential election achieving just under 21 per cent of the national vote, just 1.6 per cent less than the MNR's Sanchez de Lozada, who was subsequently elected president by the Bolivian *asamblea legislativa plurinacional* (Table 6.3). This graphic demonstration of popular support for MAS coupled with an economy barely functioning under the weight of popular protest, and growing calls for greater redistribution and expropriation was enough to persuade numerous Bolivian capital holders to export their capital. Three years later, as the political and economic crises continued, Morales was elected president with 53.7 per cent of the national vote, the largest electoral victory in modern Bolivian history. At the same time, MAS won 72 per cent of the seats in the legislature rising to 89 per cent of the seats four years later (Table 6.3).

Table 6.2. MAS percentage of vote in Bolivian presidential elections, 2002-14.

Election year	Percentage of vote
2002	20.9%
2005	53.7%
2009	64.2%
2014	61.4%

Source: Political Database of the Americas

Table 6.3. MAS percentage of vote in Bolivian national legislative

Election year	Percentage of vote	Percentage of seats (130)
2002	20.9%	27%
2005	53.7%	72%
2009	57.5%	89%
2014	61.36%	88%

Source: Political Database of the Americas source: LAPOP

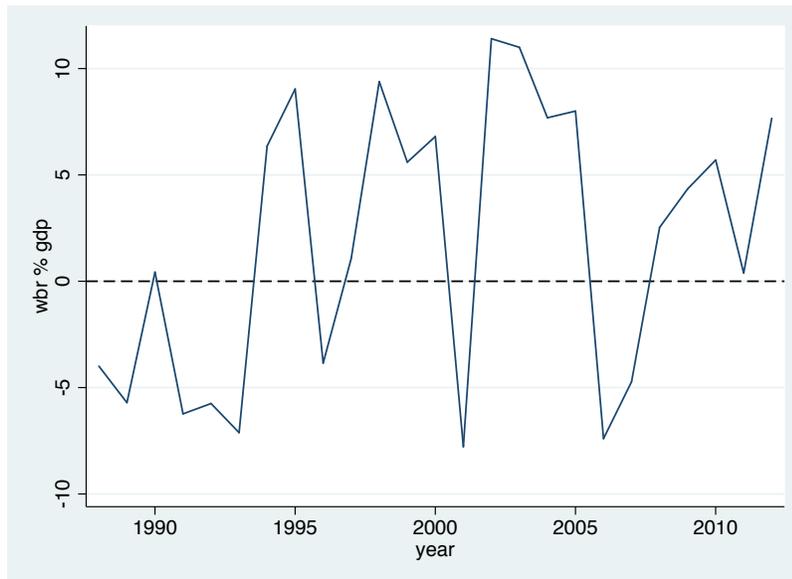


Figure 6.2. Capital flight and electoral support for MAS

Figure 6.2 graphs the dramatic rise both in capital flight and electoral support for MAS in the early 21<sup>st</sup> century. As the El Salvador case showed in Chapter 5, the highest levels of capital flight took place *before* MAS won control of the national government in 2006 as the balance of political power tipped decisively towards Morales' movement.

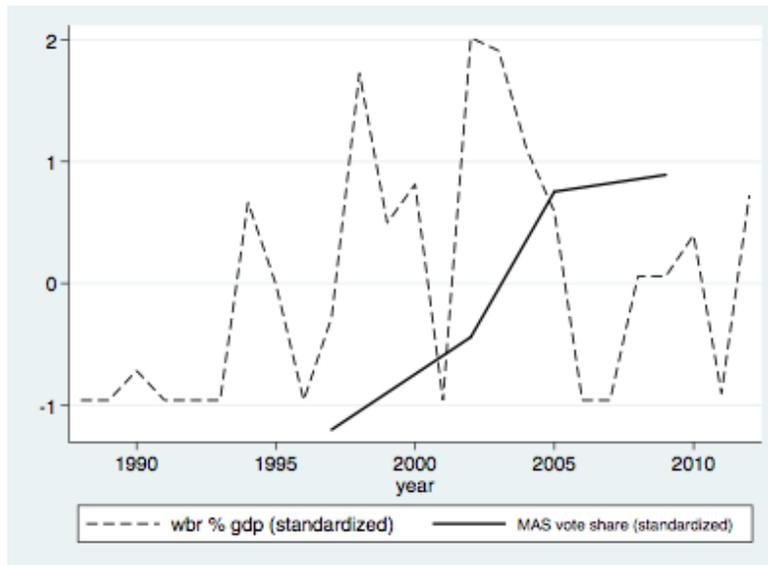


Figure 6.2. MAS share of voting for *asamblea legislativa* and capital flight in Bolivia, 1988-2012.

Source: Political Database of the Americas

As Dangl (2014) notes:

“The upper and middle classes in the country were afraid of his radical rhetoric, and criticized his fiery condemnation of US imperialism and capitalism. These wealthier sectors of society wanted one of their own to run the country - but they had already had their chance, for decades, and the results were disastrous.”

These perceptions mirror closely the experience in El Salvador with the rise of the FMLN.

However, while the pattern of capital flight follows a similar trajectory in both countries, the two left governments in this cross-national comparative case study show substantially different public policies, as the next section will show.

### *The Left in government in Bolivia*

Since gaining power in 2005, MAS calls itself a “revolutionary government”. It self-consciously sees its political goals as transformational rather than incremental in that it seeks a wholesale reconstruction of the state to change it one that was market-based into one that adheres to state-centered development model (Wolff 2012). This transformation extended to embedding MAS influence in state’s administrative, legislative and judicial apparatus from the local level up to the central government by replacing existing state employees with those loyal to MAS with the central objective of fostering major redistributive policies.

Since coming to office in 2006, Morales’ administration has significantly expanded state control over the economy, especially the all-important natural resources sector, which includes the second-biggest gas reserves in Latin America after Venezuela, as well as privately owned mining, water and forest resources. "The looting by the foreign companies has ended", declared Morales (Prada 2006: A9) as the new president proceeded to nationalize previously privatized foreign oil and gas companies, including Brasil's *Petrobras* and Spain’s *Repsol*, to take advantage of Bolivia’s geographic position to develop the sector’s role as the “energy heart of South America”. These companies were ordered to relinquish control of all fields and given 180 days to renegotiate existing contracts so that future sales of hydrocarbons were made through the state-owned energy company. Companies refusing to reach an agreement with the government were taken over by government decree. Morales’ government also renegotiated existing contracts in the gas sector by dramatically increasing the prices, royalties, fees, and taxes paid to the Bolivian state so that state received 54 per cent of profits (after operating costs and funding the

state-owned gas company) (Andean Information Network 2007).<sup>21</sup> The energy companies threatened to take the case to the international courts or cease operating in Bolivia, but ultimately relented. In June 2006, the MAS announced plans to nationalize mining, electricity, telephones, and railroads, and in February 2007 nationalized the Vinto metallurgy plant, refusing to compensate Glencore, whom the government asserted had obtained the contract illegally (Pearce 2011).

Whereas Bolivia had received \$173 million from hydrocarbon extraction in 2002, by 2006 the sum was \$1.3 billion and by 2008, total government revenues had risen to over 48 per cent of GDP, up from almost 32 per cent in 2005 (Weisbrot, Ray, and Johnston 2009). With natural gas revenues and economic growth the strongest in 35 years (CEPAL 2013), by 2014 Bolivia's international reserves had risen to about \$14 billion, equal to more than half of its GDP (the highest for any country in the world) or 17 months of imports the equivalent of about half of the country's GDP. Despite warnings from local and international business inflation was under control, the budget balanced, and government debt drastically reduced. By 2015, the state's take had risen to 82 per cent (Wilson 2015) giving Morales' government the necessary wherewithal to fund planned increases in social spending.

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<sup>21</sup> Morales also sought to write state ownership of land and other natural resources, such as oil and gas, into the constitution in order to prevent these assets from being privatized by future governments.

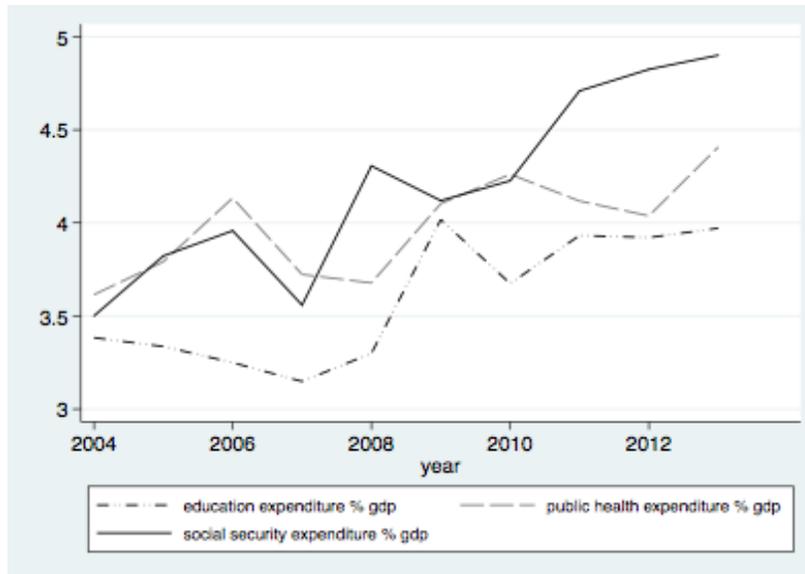


Figure 6.3. Social spending in Bolivia, as percentage of GDP, 2004-2014

Source: ECLAC (2014).

Figure 6.3 shows that spending by the MAS government on programs such as health, education and cash transfer programs to the elderly poor, pregnant women and schoolchildren increased by 45 percent (Neuman 2014: A4). As a result, social protection was provided to close to two million children and approximately 600,000 men and women over the age of 65. Shortly after coming to power in October 2006, MAS introduced the *Bono Juancito Pinto* program to provide small monthly cash payments of 200 bolivianos (approximately US\$29) to families whose children regularly attend school reaching almost 1.8 million children (Organización de Estados Ibero-americanos 2011) at an annual cost about US\$52 million (2010). The MAS government also expanded the only existing universal old-aged pension scheme in Latin American country, the *Renta Dignidad* program, by reducing eligibility to 60 years of age and then in 2010 reduced it again to 58 (Farthing and Kohl 2014: 102; Müller 2009). As a consequence, poverty during Morales' tenure fell by 25 percent, extreme poverty dropped by 43 percent, the inflation-adjusted

minimum wage has increased by almost 90 percent, and in July 2014, UNESCO declared Bolivia free of illiteracy (Carasik 2014).

The MAS government also controlled the prices of gas and many foodstuffs, and required local food producers to sell in local markets rather than export. A new state-owned body was also set up to distribute food at subsidized prices. At a wider level, the MAS government also institutionalized the concept of a plurinational state in Bolivia's 2009 constitution by legitimizing a system of governance that explicitly recognizes the country's multiethnic character, promotes the indigenous majority's participation in the political process, and promotes gender parity, requiring political parties to put forward a gender-balanced ticket.

Beyond these redistributive social programs, an important part of Morales' "socialist revolution" was his government's plan to redistribute 13 per cent of Bolivia's land area amounting to 20 million hectares over the following five years (Hertzler and Ledebur 2007). After a prolonged battle in the Senate, the Morales administration won approval in 2006 for its *La Reconducción Comunitaria de la Reforma Agraria* (Law of the Communitarian Redirection of Agrarian Reform), a land reform initiative the aim of which was to redistribute (expropriate) land not being productively – notably *latifundistas* and states owned by agribusiness elites - used to indigenous people and communities. Three years later, the 2009 Constitution declared land reform to be a major priority with the indigenous majority playing a large role in how the policy was delivered (Gross 2010). By 2013, data from the National Agrarian Reform Institute (INRA) showed that since the election of the MAS government 134 million acres had been redistributed and 290,000 land titles had been issued, more than 90 per cent under the MAS government. Almost one-quarter had been granted to women, and another 37 per cent to men and women

jointly (Achtenberg 2013). The MAS government also invested heavily in infrastructure development and public works projects.

Unsurprisingly, MAS' policies in government generated considerable resistance from elites whose interests have been threatened. Most notably, the readjustment/forced renegotiation of the state's relationship with the country's natural resources sector brought an abrupt halt to the pre-existing pro-market export-led regime created by the pacted system. Business groups in Santa Cruz argued that the new hydrocarbons law was confiscatory and would deter investment in the natural gas industry. "When you cause problems for foreign investors, you cause problems for those who know how to create and develop the industry", warned the co-director of the Institute for the Analysis of Global Security, a consultancy firm in Washington, DC that studies energy issues (Prada 2006: 2006). In a 2014 editorial, the *New York Times* stated that although Morales' MAS government had increased economic growth, reduced inequality and poverty and enhanced living conditions for millions of poor Bolivians, it "damaged the prospects for [US] trade and security cooperation" (Editorial 2014: A30).

Undoubtedly, the MAS government's nationalization and state redistribution programs that embedded the indigenous majority's political influence represented revolutionary changes, typically at the expense of domestic and foreign elites who recognized an existential threat to their hold on power and prompted capital flight. In the first six months of 2005, investment in the oil and gas industry dropped 40 per cent compared with the same period a year earlier (Economist Intelligence Unit 2005). The portion of tax revenue extracted from elites grew phenomenally as did the portion extracted from the rich areas around the Santa Cruz oil and gas industries and redistributed to the central government in La Paz, where the additional revenue would be spent on social welfare expansion. The government's redistributive land reforms also

directly affected large landowners and agribusiness in the country's lowlands, especially around Santa Cruz (Gray Molina 2010; Gross 2010: 14-15).

*The strengths of political opposition to the Leftist governments in Bolivia and El Salvador*

The clear differences between the Funes administration's policies and those of MAS evinced above explain the substantial differences in the respective patterns of capital flight from El Salvador and Bolivia while each Leftist government was in power (Figure 6.1). Morales and the MAS transformed the Bolivian state and took control of Bolivia's primary economic sectors and used resources accruing from these measures to redistribute resources to its political supporters, the indigenous poor, which dramatically increases asset holders' incentives to remove their assets abroad. After gaining a two-thirds majority in the Bolivian legislature in the 2009 and subsequent legislative elections (Table 6.3), MAS's further consolidation of its power led to continuing high levels of capital flight whereas El Salvador's capital flight levels since the FMLN gained office have remained low.

The previous discussion explained how Funes' FMLN government perceived the need to accommodate Salvadoran business elites and centrist voters in order to win the 2009 presidential election whereas Morales' MAS government in Bolivia sensed no such need. The discussion in this section analyses why, focusing specifically on the relative strengths of the political opposition in the respective countries.

Essentially, the elite-backed traditional parties that had dominated Bolivian government since 1985 suffered a catastrophic crisis of legitimacy that ultimately led to the complete collapse in its electoral support. The upshot was that Bolivian business elites were left without the political

means to protect their interests through the national political system thereby affording the insurgent MAS free reign to dictate policy.

No such collapse occurred in El Salvador. Rather, the business elite-backed ARENA party retained a solid base of electoral support, especially in the rural areas, and remained a significant presence in the national legislature. Over time, repeated electoral defeats and the constantly credible electoral threat from ARENA forced the FMLN to adopt more moderate policy positions to attract centrist voters. As a result, the FMLN substantially moderated its redistributive policies thereby reducing the need for elites to engage in capital flight.

Throughout the period from the late 1980s through to 2005, business elites in Bolivia had enjoyed substantial influence over the country's traditional political parties through a combination of partisan linkages, recruitment, and informal ties (Fairfield 2010). As the earlier discussion showed, all three main parties - the ADN, MNR and MIR - enjoyed close ties to the country's dominant economic elites within a "pacted" system based in Santa Cruz, economically the country's most vibrant economic and political department (Eaton 2011), which accounted for over 60 percent of the national vote in elections over the 20 year period following democratization. The period from 2002 to 2005, however, witnessed the unraveling of this pacted system as growing popular opposition mounted to market-oriented policies and led to a collapse in support for the pacted parties that had implemented them lost the trust of voters (Seligson, Moreno Morales, and Blum 2004) and the elite coalition comprising large landowners and dominant social sectors fragmented. Crucially, these elites proved unable to identify a common economic model to promote at a national level, which led to a legitimization crisis and an abrupt and traumatic loss of influence as it became increasingly clear that the traditional parties could no longer govern the country (Fairfield 2010; Regalsky 2010).

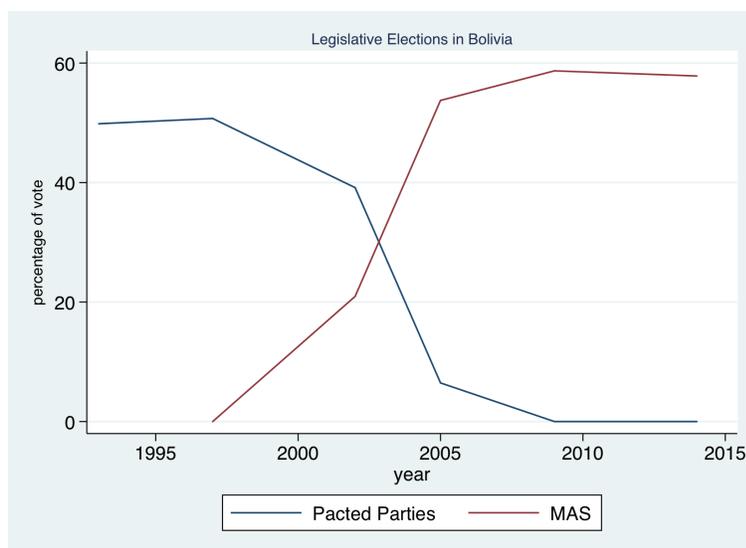


Figure 6.4. Pacted parties' (MIR, MNR, and ADN) combined share and MAS vote share in Bolivian legislative elections, 1990-2014.

Source: Political Database of the Americas

Figure 6.4 shows the dramatic shift in electoral fortunes between the three traditional parties, on the one hand, and the insurgent MAS on the other hand with the critical juncture taking place in 2003 (when Gonzalo Sánchez de Lozada was ousted from power).

As discussed earlier, the beneficiaries of this collapse were Morales and the MAS, who won the 2005 presidential election by a huge margin (Table 6.2) and confirmed to the Santa Cruz business leaders that Morales was a political force to be reckoned with, and that they had become politically marginalized. Seat gains for a new elite backed party, *Poder Democrático y Social* (PODEMOS) in the 2006 legislative elections ended up as a pyrrhic victory compared with the huge gains made by MAS (Table 6.3). Subsequent attempts by the remaining opposition parties (led by PODEMOS) to mount a viable opposition to MAS in the 2009 presidential elections were crippled by internal divisions and led to Podemos' defeat and dissolution.

Effectively, the collapse of the “pacted” party system signaled both the elite opposition's

inability to compete with MAS for the presidency or control of the legislature and the creation of a new party system dominated overwhelmingly by MAS. Effectively, the national elite had been ousted from political power democratically, which also meant that indigenous social movements and labor unions were likely to enjoy better access than elite business associations to ministers and senior officials and those officeholders were likely to have strong anti-market pro-MAS preferences in determining policy (Stefanoni and Do Alto 2006).

Under such conditions, Morales and the MAS had few incentives to accommodate business' preference in policymaking or moderate their policy positions, which constitutes clear threats to elite interests in Santa Cruz (Levitsky and Roberts 2011). Faced by these threats to their interests, business elites reacted in two ways. First, they pushed for regional autonomy (Eaton 2007), notably those from the so-called Media Luna (Half Moon), the gas-rich eastern lowlands of Santa Cruz, Beni, Pando, and Tarija, who reframed their interests as territorial demands. Second, they exported their capital massively in the 1990s as the pacted parties' share of the vote fell (Figure 5.5). Later, during the 2005 presidential campaign, business and other traditionally dominant sectors predicted economic crisis and warned of further outflows. "Bolivia would be shunned by investors", warned one PODEMOS senator (EIU 2006). Indeed, a few hours after the 2005 presidential election results were known, shares in Repsol-YPF, the Spanish-Argentine oil company operating in Bolivia, fell 2.31 points on the Madrid stock exchange. At the same time, the Bolivian capital account recorded net outflows of foreign direct investment (FDI) for the first time since 1989 (EIU 2006). The Panama papers also showed that one of the most powerful Santa Cruz families, the Marinkovic family, with major agricultural interests opened nine offshore companies in 2007, which was a year after MAS came to power (Jiménez, Arnez, and Ramirez 2016). Figure 6.5 shows a clear inverse relationship between pacted parties' decline

in electoral support and increased levels of capital flight for the period 1987 until a peak in 2005 just prior to the presidential elections that Morales and MAS won.

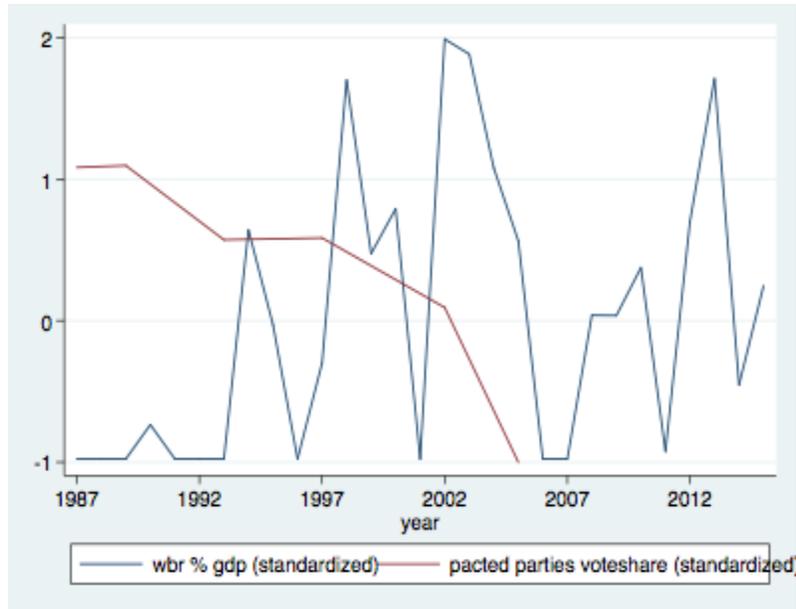


Figure 6.5. Pacted parties' (MIR, MNR, and ADN) combined share of the Bolivia legislative elections and capital flight, 1987-2014

Source: Political Database of the Americas

It is also important to note that, unlike in El Salvador, in Bolivia significant capital flight continued *after* MAS had won power. Figure 6.6 shows peaks in 2008, 2010 and rising to 9 per cent of GDP in 2013. The response to Leftist governments in Bolivia, then, was substantially different from that in El Salvador. Whereas the Bolivian elite parties faced catastrophic collapse from which they did not recover, in El Salvador, ARENA lost power but its electoral and organizational bases remained largely intact. Moreover, while MAS emerged in a short space of time as a movement party promising systemic revolutionary change, the FMLN was continually thwarted by a well-organized electoral professional party with a steady base of support.

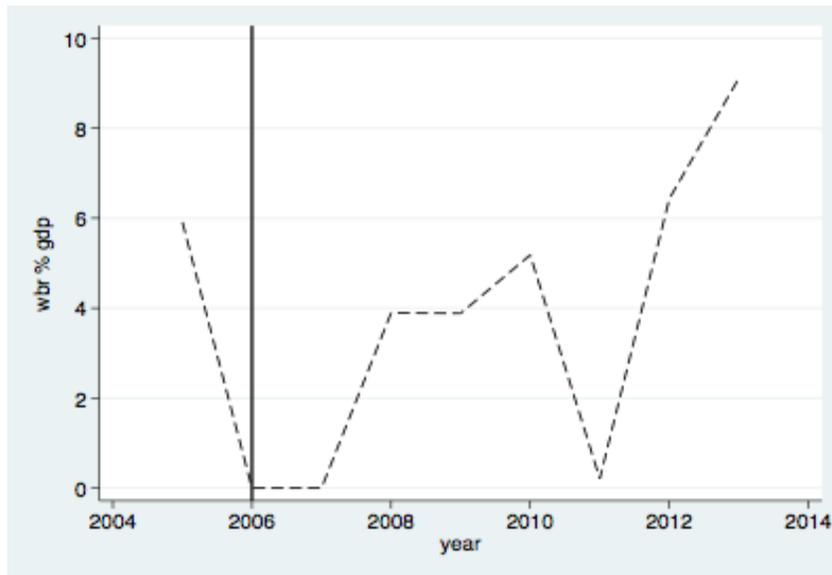


Figure 6.6. Capital flight in Bolivia with MAS in government, 2006-2013

Hoop and smoking gun tests

If we now turn to an examination of the hooped tests identified at the beginning of this chapter, it is evident that the comparisons of the strengths of political opposition in El Salvador and Bolivia provide strong support for the proposition that *ceteris paribus*, Leftist governments facing a stronger opposition will experience less capital flight than those facing weak or no plausible opposition. As the previous discussion has shown, the test is easily passed: while Salvadoran elites retained ample opportunities to exert influence on the new FMLN government, and did so effectively, the completeness of the Bolivian opposition’s defeat by MAS left business elites with little option but to export their capital.

Turning to the second test, that *ceteris paribus*, Leftist governments facing a stronger opposition will experience less political risk, this test may also be passed. Drawing on political risk data provided by the Political Risk Services’ International Country Risk Guide, the MAS government

in Bolivia has been consistently ranked higher than El Salvador's (Table 6.3).

Table 6.3. Comparative levels of political risk, by years of Leftist government, Bolivia and El Salvador.

Year of government	Bolivia	El Salvador
1	56.5	67.0
2	58.0	68.0
3	61.0	68.5
4	60.5	66.5
Mean	59.0	68.0

Source: International Country Risk Guide (ICRG).

Note: A lower number indicates higher political risk.

Finally, there is evidence to support the third loop test that, *ceteris paribus*, Leftist governments facing a stronger opposition will pursue weaker redistributive policies and induce less capital flight. If we take the Fraser Institute's Index of Government, meaning the extent to which a country's government intervene in its economy, which in the context of countries like Bolivia and El Salvador that spend relatively little on national security, is mostly social spending, we see an important divergence in their policies. Figure 6.7 shows changes in the level of government intervention in both countries, by the numbers of years a government has been in office. We can see that while intervention steadily increased during MAS' first three years of government, in El Salvador intervention levels actually *decreased*.

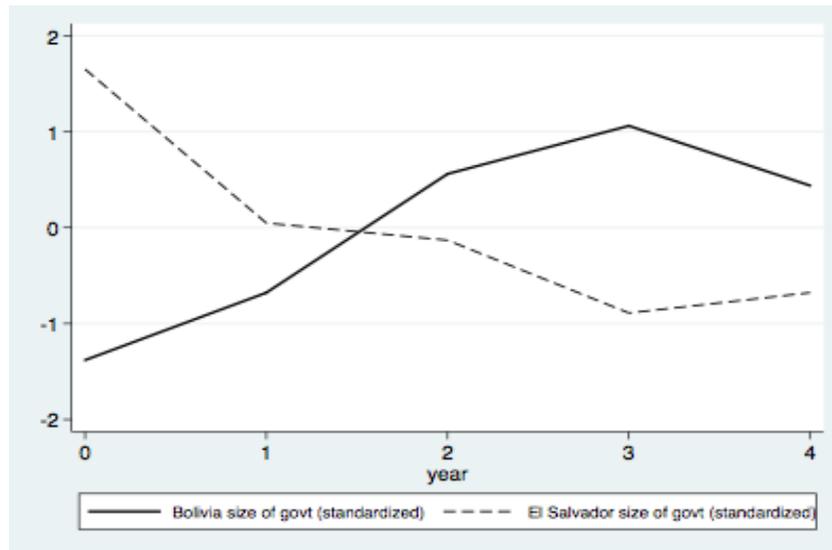


Figure 6.7. Extent of government intervention in Bolivia and El Salvador by year in government

Source: Fraser Institute. The index ranges from 0-10 where 0 corresponds to “large general government consumption”, “large transfer sector”, “many government enterprises”, and “high marginal tax rates and low income thresholds”, and 10 to “small general government consumption”, “small transfer sector”, “few government enterprises”, and “low marginal tax rates and high income thresholds”.

The index consists of the following indicators: general government consumption spending as a percentage of total consumption; transfers and subsidies as a percentage of GDP, government enterprises and investment as a percentage of total investment, and top marginal tax rate (and income threshold to which it applies).

If we examine the extent to which redistributive policies implemented in each country impact income inequality over time, the difference is even starker. As Table 6.4 shows, if we look at changes in each country’s Gini ratios – the standard measure of income or wealth distribution - it is evident that MAS’s policies have reduced inequalities far more than the FMLN government in El Salvador. Indeed, inequality in Bolivia was reduced by almost three times as much as in El Salvador. Clearly, this evidence of Bolivia’s more extensive and effective redistributive policies amounts to passing the third loop test.

Table 6.4. Change in GINI coefficient in Bolivia and El Salvador by year of Leftist government.

Year of government	Bolivia		El Salvador	
	GINI		GINI	
	coefficient	% change	coefficient	% change
0	58.47		46.65	
1	56.87	-1.6	45.93	-0.72
2	55.44	-1.43	44.53	-1.4
3	51.43	-4.01	42.43	-2.1
4	49.65	-1.78	41.8	-0.63
5	..		43.51	1.71
6	46.26	-3.39	41.84	-1.67
Total		-12.21		-4.81

Source: World Development Indicators (World Bank)

Note: Higher coefficients indicate higher inequality. Year 0 indicates the year before MAS and the FMLN took over government in their respective countries.

Finally, let us consider why some competing explanations for the respective patterns of capital flight in these two countries should be rejected, beginning with patterns of annual price inflation. External or foreign debt is often cited as an explanation for capital flight. As shown in the regression estimates provided in Chapter 3, there is a strongly significant and positive relationship between external debt and capital flight across and in some cases within the 18 democracies in the dataset.

Figures 6.8 and 6.9 plot capital flight with external or foreign debt for Bolivia and El Salvador over time. As we can see, although external debt as a percentage of GDP rose sharply prior to MAS gaining power in Bolivia in 2005, debt ratios actually fell afterwards, as capital flight continued to rise. Contrastingly, in El Salvador, foreign debt rose steadily and independent of variations in capital flight.

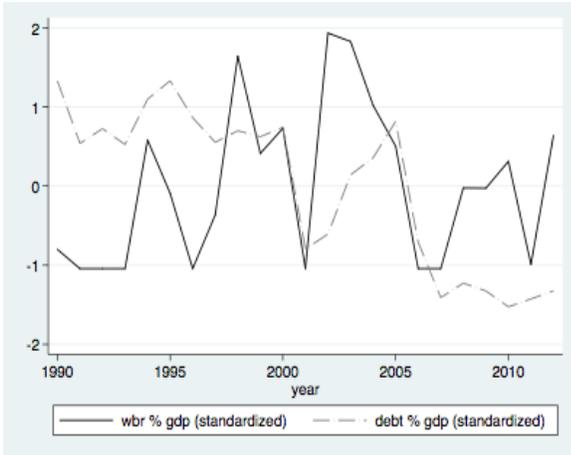


Figure 6.8. Capital flight and external debt  
Bolivia 1990-2014

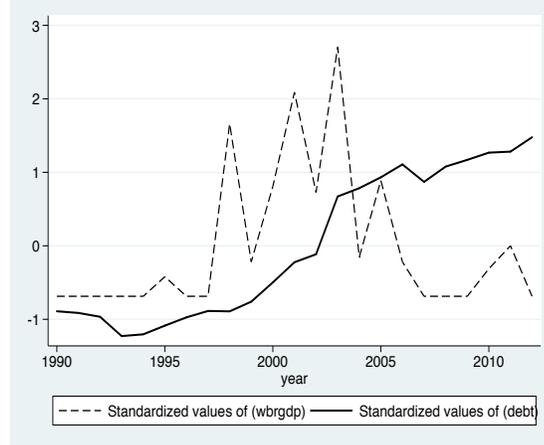


Figure 6.9. Capital flight and external debt  
El Salvador 1990-2014

Do patterns of inflation offer a better explanation for patterns of capital flight since rising prices erodes the value of capital assets? In the regression results reported in Chapter 3, inflation was shown to be highly significant and positively signed across the panel of 18 Latin American countries. Indeed, one would expect rising prices to erode capital assets values and induce capital flight. Figure 6.10 shows, however, that in Bolivia under MAS inflation actually rose in line with capital flight. Still, if we are to accept inflation as the main driver of flight, we should expect to see low capital flight during the earlier period when inflation was low. In fact, we see the opposite. A similar pattern occurred in El Salvador where inflation has been uniformly low despite variations in capital flight (Figure 6.11).

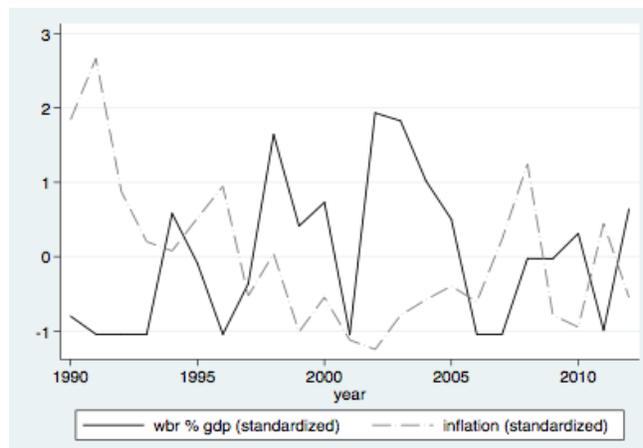


Figure 6.10. Capital Flight and Inflation, Bolivia 1990-2014.

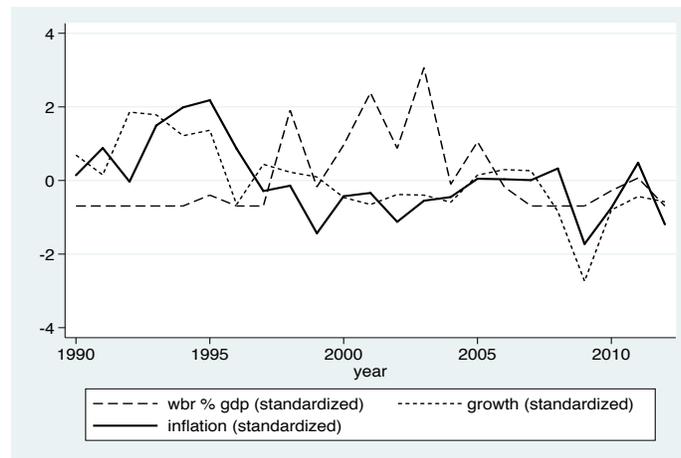


Figure 6.11. Inflation, economic growth, and capital flight in El Salvador, 1990-2012

Variations in economic growth rates also do not offer much explanatory value for variations in capital flight levels between the two cases. Neither in Bolivia nor El Salvador is there a consistent pattern (Figures 6.11 and 6.12). So, although growth and capital flight rose before MAS came to power in 2009, afterwards the patterns diverged, as they did frequently in previous periods as Bolivia experienced high levels of capital flight during periods of low growth and high growth. Similarly, divergent patterns are also evident in patterns of growth and capital flight in El Salvador, including after 2006 when the FMLN took power.

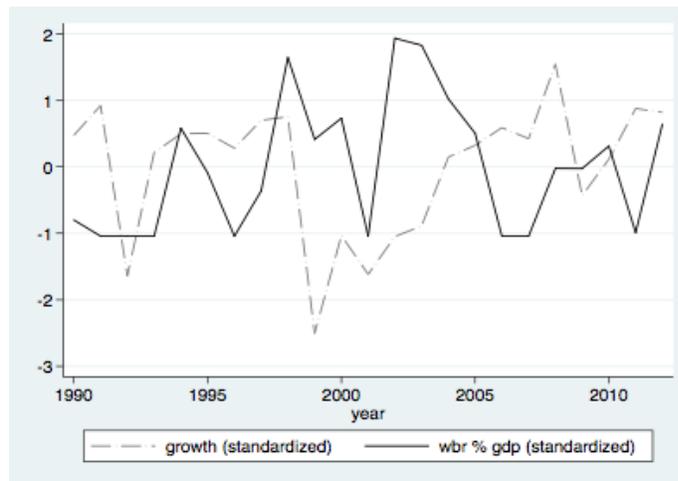


Figure 6.12. Capital flight and economic growth, Bolivia 1990-2014

Fourth, it might be argued that external economic constraints conditioned the behavior of Leftist governments thereby stimulating flight. In El Salvador, Funes was elected in the middle of the Great Recession that arguably might have determined his moderate policy stances and restrained levels of capital flight. In fact, his administration adopted austerity measures, including cuts in social spending in 2009 at the height of the crisis. Still, Funes could have followed nearby Nicaragua's Leftist government and sought alternative funding from Venezuela, which would likely have fueled flight. What is more, if the Great Recession constrained the Funes government in El Salvador, it should have had the same impact on Bolivia as well especially given the sharp fall in commodity prices. Yet unlike El Salvador the MAS government did not moderate its policies and continued to experience significant capital flight throughout this period.

Another possible explanation is that Bolivia's dependence on exports of natural gas made it more vulnerable to capital flight than El Salvador due to the massive revenues from the commodity. El Salvador's economy is built on manufacturing and the service sector where profits were less vulnerable to capture and diversion out of the country. While there is certainly a connection between natural resource exports and capital flight, a causal relationship cannot be assured. It is also the case that since the Recession was caused by a financial crisis, El Salvador's creation of a

regional financial hub could also have made it highly vulnerable to high levels of capital flight given the ease with which funds could be funneled out of the country. Yet this did not take place.

### Summary

In this chapter, I have investigated the implications of the second part of my theory concerning the role of elite-backed political parties as opposition counter-balancers to Leftist governments in power.

By comparing El Salvador with Bolivia under Leftist governments the discussion has shown how the variation in levels of capital flight experienced when Leftist parties were in power can be explained by the existence and relative strength of an opposition party acting in the interests of domestic capital. The analysis provided in the chapter showed substantial differences in levels of capital flight across the two cases: while flight tapered off after the FMLN won power in El Salvador, under MAS in Bolivia, major capital flight has continued. Further, by comparing political conditions in each country, the discussion showed that the variation is best explained by the FMLN facing significant political opposition in El Salvador as a result of which the party in government was obliged to moderate its policies, seek coalition partners, maintain the support of more centrist voters and parties, and seek accommodations with business elites. The discussion also showed ARENA's major role in blocking policies in the legislature. Contrastingly, by the time MAS took over government in Bolivia in 2005, business-friendly parties backed by elites had already collapsed. As a result, MAS was free to enact more radical redistribution policies that had the effect of prompting asset-holders to withdraw their capital from the country.

## Chapter 7: Conclusion

### Democratic consolidation, political risk and capital flight

Why do some countries experience more capital flight than others? The extant economic literature on political risk and capital flight provides clear evidence that capital flight is related to political risk but has little to say about the factors that determine risk. At the same time, the political science literature examines political processes and dynamics underlying political risk but ignores the phenomenon of capital flight. Instead, it focuses exclusively on capital (FDI) inflows using such flows as a vehicle for investigating the dynamics of political risk, the logic being that the presence of significant political risk will deter investors. The justification for focusing specifically on FDI is that it highlights FDI's role in promoting economic growth in capital-scarce developing countries. However, by focusing exclusively on capital inflows and ignoring capital flight, these scholars focus on only one side of the development story: although capital inflows may be desirable for a country to stimulate growth, clearly, the net result for these countries will be negative if they experience capital flight, particularly if flight turns out to be chronic.

Proponents of the democratic premium argument hold that the creation of regularized democratic institutions and processes engender political stability that thereby provides reassurance to capital holders who will likely develop a weaker proclivity to export their capital as a consequence.

Without the development of regularized institutions and processes and the rule of law associated with democracy, they argue, political risk increases and with it the inclination to export capital.

However, a focus on formal democratic institutions alone cannot address the questions of how

political risk arises and develops. This dissertation has sought to address these gaps in the literature by linking the literature on democracy and political risk to the economic literature on capital flight. Its aim has been to identify the political risk conditions in democracies that account for patterns of capital flight in Latin America. More specifically, the study has sought to shed stronger light on the specific causal mechanisms that account for the substantial variation in the levels of political risk and capital flight across the region's democracies.

My core argument is that in an area of the world where wealth, income, and power is chronically unequal, the upheaval during the process of democratic consolidation in new democracies in Latin America has been a key driver of capital flight. Those Latin American democracies that experience extensive popular political mobilization will experience greater capital flight than those that do not. A causal chain that began with mass mobilization by social movements directed towards new redistributive public policies and in opposition to pro-market democratically elected governments stimulated flight. Typically, as mass mobilisation strengthened, Leftist parties embraced the aims of the popular movements whose electoral support subsequently increased to levels sufficiently to enable them to form governments committed to redistribution. Under these conditions, as mobilization and support for the Left strengthened, asset holders' perceptions of risk significantly increased, leading to capital flight.

Two important caveats were entered into this explanation when Leftist parties actually formed governments committed to redistribution *viz.* that the degree of capital flight was mitigated when a Leftist party forming a government had been established for some time, in which case it typically moderated its redistributive policies. Flight was also mitigated by the continued electoral strength of pro-capital parties able to defend the interests of asset holders and

effectively oppose the Leftist government. These findings were subsequently reinforced by the two case studies.

This concluding chapter proceeds as follows. The next section summarizes the theoretical argument highlighting the causal mechanisms at work. This section is then followed by a review of the empirical evidence provided to validate the dissertation's theory. I then follow this with a discussion of the theoretical implications of my findings and propose possible future avenues of research.

### *The core argument*

While most of the existing political risk literature argues that the existence of various institutional constraints within democratic political systems mitigate levels of risk, this dissertation has developed a political economy model that views the unconsolidated condition of democracy in Latin America as central to explaining the rising levels of political risk, which in turn trigger capital flight.

The dissertation hypothesized that in Latin American countries where democracy remains shallow and a significant proportion of the population remains excluded from the political system, the onset of mass popular mobilization in opposition to a pro-business Rightist government heightens capital holders' propensity for flight, as does the realistic prospect of a Leftist government committed to redistribution. Popular mobilization leads to significant increases in capital flight because asset holders in the country perceive demands for greater redistribution by the state as a threat to their property rights and react by reallocating their economic resources abroad.

The flipside of this hypothesis is that in the absence of popular political mobilization - by not presenting a significant political threat to capital's interests – domestic capital will likely ensure that the state enacts policies that suit its interests and political, social and economic outcomes will be highly skewed toward domestic asset-holders' interests. *Ergo*, the incentives for capital flight will either be absent or weaker. In consequence, capital flight will be either non-existent or relatively low (say, at no more than one or two per cent of GDP).

It follows, then, that in the first instance political risk in shallow democracies, such as those in Latin America, should best be evaluated – and best measured – by the degree of popular mobilization and subsequent support for Leftist coalitions. Mass popular mobilization in the form of general strikes, mass protests and other forms of activism, however, only marks the first of three critical stages of a causal sequence in my theory, which explains patterns of capital flight. For capital flight to be triggered at this stage, mass popular mobilization must become so severe as to cause enough economic disruption to increase asset holders' opportunity costs and risks, and generate flight.

At a second stage in the causal sequence, mass popular mobilization may be so extensive and potent that Leftist parties embrace popular demands and redistributive policies, and asset-holders come to identify a clear and present threat evidenced by the Left becoming sufficiently popular electorally as to present a realistic prospect of being able to win government office and so threaten dominant pro-capital interests. At this second critical stage, the threat of redistribution – enhanced political risk - persuades asset holders to remove their funds abroad. In the absence of a credible electoral threat from the Left, capital interests continue to prevail obviating the need for flight. At the third and final stage, asset-holders react to a Left government's policies redistributive policies by removing their assets abroad.

As the discussion in the body of the dissertation showed, however, the perception of threat to asset-holders posed by either the prospect or the actuality of the Left in government may be tempered if the Leftist party in government pursues moderate policies and/or the (Rightist) pro-capital-supported opposition is sufficiently strong.

The underlying premise in the first mitigating factor is that established, institutionalized (as opposed to recently formed) Leftist parties will wish to protect their long term reputation with the electorate, moderate its redistributive and other policies opposed by capital, pose less risk to asset-holders, and thus engender less capital flight. The premise of the second mitigating factor is that through their support for a Rightist opposition party asset-holders will use their instrumental power to block or severely weaken Leftist governments' redistributive policies. Such efforts are likely to be effective if the opposition Rightist party has sufficient seats in the legislature to exercise vetoes or they are able to exercise vetoes at other points in the political system. Under these conditions, Leftist governments will be less likely to trigger the same levels of capital flight as those free to pursue redistribution unconstrained.

Absent these two mitigating factors, then, capital flight becomes the last resort for asset holders who have failed to protect their interests through the political system. In consequence, a Leftist government will enjoy much greater freedom to pursue redistribution unconstrained, and thus much more likely to trigger significant levels of capital flight.

### Findings

Chapters 4 through 6 provided quantitative and qualitative analyses to evaluate the theory's predictions of the theory present in Chapter 3. In Chapter 4, five sets of empirical tests were deployed to test the theory's predictions on a cross-national dataset of 18 Latin America

democracies that measured 30 different variables. The analysis found strong and consistent evidence to support the proposition that popular mobilization led to greater capital flight, that capital flight increased as the prospect of a Leftist government heightened in the three years prior to it taking power, and that Leftist governments experienced higher levels of capital flight.

As my theory predicted, however, Leftist governments dominated by recently formed Leftist parties experienced greater levels of capital flight than those formed from established parties. Importantly, when the Left variable was collapsed into far Left and Center Left-dominated governments, the regression estimates showed that capital flight was much higher under Far Left governments than those of the Center Left. Moreover, Leftist governments facing significant political opposition experienced lower levels of capital flight while those winning office by wider electoral margins and those with larger legislative majorities prompted more capital flight; the same effect was found for Leftist governments facing a fragmented opposition.

My findings also showed that Left governments experienced *less* flight in political systems with higher numbers of veto players whereas under Centrist or Right-leaning governments the number of veto players had no significant effect. Much more important than institutional arrangements was capital holders having a favored party controlling the government. For, consistent with the dissertation's core argument, when (Leftist) governments pursued stronger redistributive policies higher levels of capital flight ensued. Unsurprisingly, the regression estimates showed that the extent of government intervention and levels of government social spending (pursued more by Leftist rather than Rightist government) had positive and significant effects on capital flight while degrees of economic freedom from government intervention had significant negative effects, with the strongest effects found for Far Left governments. Centrist and Center Right governments show little effects on both redistribution and economic freedom while Far Right

governments were predictively and significantly linked with greater economic freedom and less redistribution.

Chapters 5 and 6 provided qualitative case studies to extend and support the quantitative findings in Chapter 4. The “before” and “after” analysis of the effects of popular mobilization over time in El Salvador (Chapter 5) confirmed the theoretical prediction that popular mobilization leads to capital flight while providing a nuanced story on the effects of the mobilization process’ timing: most of the capital flight occurred as a response to popular mobilization *before* the Left won power, not after. Typically, the moment of greatest capital flight occurred when the balance of power tipped away from conservative forces toward the Left when elites came to realize that they could no longer dominate the political system, uphold their policy preferences, and protect their assets. As for the Left and associated popular forces, the evidence in Chapter 5 presented suggests that if popular political mobilization is to threaten capital effectively - and trigger capital flight - popular forces need to coordinate their protest activities across sectors and form a movement that must remain cohesive. In the absence of such coordination, the effects of strikes and other social disruptions will remain localized and unlikely to stimulate significant levels of capital flight.

In Chapter 6, I tested the implications of the second part of the dissertation’s theory through a comparative analysis of El Salvador and Bolivia that examines the respective actions of elite-backed political parties as forces of countervailing power when the Left is in control of government: the FMLN since 2009 and MAS since 2006. The analysis showed how the existence and relative strength of an opposition pro-business party was essential to flight levels: whereas the FMLN was faced with significant political opposition from the business-friendly ARENA party in El Salvador, as a result of which it was obliged to moderate its policies by

forcing the party to seek coalition partners and attract more centrist voters, with predicted effects on capital flight levels, by the time MAS came to power in Bolivia, the country's business-friendly parties had effectively collapsed, with the consequence the Leftist government was free to enact more radical redistribution policies, which in turn led asset-holders to withdraw their capital from the country.

It can be seen then from these two case studies how the political conditions that obtained within in each country critically affected capital flight levels, consistent with the dissertation's theory: that is, when faced with significant popular mobilization and elites see a collapse in the parties that previously represented their interests within the political system, they are liable to react by removing their capital flight abroad, albeit as a second-best option. When, however, they are able to harness effective political opposition and become electorally competitive, they may force Leftist governments to moderate their redistributive programs to compete for centrist voters. In contrast, if a Leftist party rises to power having decimated its rightist opposition – or that rightist opposition has become so fragmented as not to represent a credible political force - it is far more likely to adopt a more radical redistributive agenda that capital holders will perceive as a threat and export their capital flight.

#### *Theoretical implications - capital flight, political risk, and democracy*

Beyond the dissertation's specific focus on Latin America, this dissertation underlines the additional scholarly value gained by delving deeper into the specifically political causal mechanisms stimulating capital flight and the political foundations of political risk. It also provides a coherent theoretical framework through which to address the politics underpinning this causality. Rather than restricting the impact of democracy on political risk to narrow

procedural definitions of democracy and the effects of different political institutions' roles and configurations - which is the focus of most of the existing political science arguments about political risk - this study focuses on the quality of democracy, and democratic consolidation, particularly the effects of excluded sectors demanding and to some extent included in the political system. Essentially, the impact of political institutions is conditioned and dependent on the quality of democracy and the extent of democratic consolidation within the host country. Indeed, from the perspective of capital flight it appears that the existing argument prevalent in the literature that the number of veto players determines the level of risk is less critical so long as pro-market governments in power effectively protect capital interests. Institutions are not enough; the preferences and intentions of competing political actors and how political power is distributed between them also matters. Similarly, arguments that political uncertainty or instability lead to greater political risk fail to account for the respective preferences and intentions of competing political actors and how political power is distributed. If the government is motivated to enact policies that harm specific actors' interests it matters far less that policy is unstable than if whether or not those policies reflect those actors' preferences.

#### *Implications for economic development, policymakers and investors*

A broader implication of this study is that it confirms the importance of balancing the demands of society and capital in order to provide the political stability necessary to generate economic growth. In this sense at least, democracies may have advantages inasmuch as citizens are provided with opportunities to express their preferences and influence government. However, as this dissertation has shown even when formal democratic mechanisms are formally there is no guarantee that societal demands will be heard or met. Nonetheless, given the importance many policymakers and international aid agencies attach to institution strengthening, it is important to

remind them – as this dissertation does – that to be effective their focus on institutions must be placed in the context of the social and political balance of power within the focus country. As for those policymakers and public interest groups that seek to direct attention toward and curtail capital flight, the dissertation points to the need to understand how the domestic institutional context shapes flight incentives and hence shape politically sustainable solutions to halt the devastating leakages from those countries that need it most.

Finally, the dissertation's conclusions should also provide a cautionary tale for international investors who are sometimes blinded to good investment opportunities by their own ideological blinkers or short term perspectives and either neglect the opportunities available in countries governed by Leftist governments and/or are gung ho or do not pay enough attention to popular backlash in harsh pro-market policies pursued by conservative governments. Democracies with governments pursuing pro-market reforms while ignoring popular demands may seem an attractive option today but such conditions may lead to serious unrest and political risk later if governments do not take into account the costs of these policies on society. A consolidated democracy where the government is responsive to society may lead to suboptimal policies as far as investors are concerned but such compromises will likely ensure political stability in the long run.

### *Future research*

The exclusive focus of this research has been on presidential democracies in Latin America. Given ongoing scholarly debates about the efficacy of presidential or parliamentary systems, one obvious area for future research is to examine how the causal drivers of capital flight identified here play out in parliamentary systems (outside Latin America), possibly in Africa where ethnic

divisions play a more important role, or Eastern Europe where inequality and class conflict is more attenuated. Given the rise of nationalism and protectionism and consequent political upheaval in the developed world, however, the tenets of my theory might usefully be explored in these contexts as well. In addition, further investigation of the impact of political institutions on capital flight in non-democracies warrants attention.

Another area of enquiry is the continued need for more research on the nature of domestic and foreign asset holders' preferences, including within Latin America. Sadly, financial restraints precluded field research for this study. Such studies might also provide a valuable corrective for foreign investment analysts who often focus exclusively on institutions, such as rule of law and property rights, possibly because they lack information on domestic capital holders' perceptions of local risk.

### *Concluding remarks*

At a normative level, the theory presented here raises some very uncomfortable questions in regard to democracies' capacities to address structural inequities in their societies. Clearly, capital flight incurs substantial costs on governments seeking to redistribute social resources, often in places that most need them. The levying of these costs imposes constraints that may reduce a government's redistributive "policy space" and force even the most well intentioned governments to become less responsive to their constituents, which in turn may call into question "trust in government", even the legitimacy of democracy itself. The recent political upheavals in Western democracies demonstrate that even the developed world is not immune to such effects as the restraints on democratic government imposed by globalization lead to public disillusionment and increasing support for populist authoritarian leaders who claim that liberal

democracy's institutional constraints inconvenience "serving the people" while those that defend such democratic constraints are subjected to Robespierre's cry of *ennemi du peuple* (enemies of the people). Support for democracy and trust in government and politicians in these societies has declined with younger people in particular expressing a preference for more authoritarian forms of government and a retrenchment of globalization. This development has occurred, moreover, while levels of inequality in these countries continues to grow and social tensions have intensified significantly. For matters to improve political actors need to address these grievances and reconcile different interests without resorting to illiberal measures. Only time will tell if they succeed.

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