

Non-democracies, Audience Costs, and Credible Commitment*

Songying Fang[†]
Erica Owen[‡]

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Abstract

How do non-democratic countries credibly commit to policies in front of domestic and international audiences? Unlike democracies, non-democracies do not have functioning electoral systems and free presses to make their commitment costly thus credible. Yet, the need to credibly commit to a policy arises for all governments, including non-democracies. In particular, when non-democratic leaders push for economic reforms, they need to coordinate the beliefs of domestic groups and attract international resources. How do non-democracies solve the commitment problem and succeed in achieving their policy goals? In this study, we argue that international institutions provide an important mechanism through which non-democratic countries could credibly signal their commitment to open economic policies. Our empirical analysis finds that structural economic reforms often lead to deeper involvement in IMF programs by non-democracies, even though such programs do not seem to have direct positive effect on the countries' economic growth.

*

[†]Department of Political Science, University of Minnesota. Email: sfang@umn.edu

[‡]Department of Political Science, University of Minnesota. Email: eowen@umn.edu

1 Introduction

Can international institutions change the behavior of non-democratic countries? If they do, how? Studies on the influence of international institutions on state behavior have focused largely on democracies and democratizing countries (Cortell and Davis 1996; Dai 2005; Keohane 1984; Pevehouse 2002a, 2002b; Li and Resnick 2003; Fang 2006a, 2006b). To some extent, this reflects the fact that it is relatively easy to identify the causal mechanisms for democratic countries. Specifically, it has been shown that international institutions can change democratic leaders' behavior by influencing voters' perceptions about the leaders thus affect the electoral prospects of the leaders. Such an internal mechanism does not exist for non-democracies, yet empirically we observe that non-democracies pursue the memberships of prominent international institutions and often abide by their principles and rules. What explains such behavior?

In this study, we argue that international economic institutions serve as a costly device by which non-democratic countries can credibly signal their commitment to an open economic policy to domestic and international audiences. To the best of our knowledge, this study is one of the first attempts to understand the mechanisms by which such institutions could influence the behavior of non-democracies. The most intuitive explanation of why non-democracies join international economic institutions such as the International Monetary Fund (IMF) and abide by their agreements is that they can enjoy direct economic benefits from such participation. However, studies on IMF conditionality have repeatedly shown that there is little evidence that IMF programs have positive effects on countries' economic growth (Jensen 2004; Li and Resnick 2003; Mody and Saravia 2003; Przeworski and Vreeland 2003). In particular, Przeworski and Vreeland (2003) find that IMF programs decrease growth rates for countries that implemented the programs. Stone (2002) suggests that IMF programs are not designed to promote short-term growth; in fact, implementation of these programs tends to lead to recession in the short-term. Jensen (2004) looks at foreign direct investment as

a result of having IMF agreements, and finds a negative impact: IMF agreements lead to lower levels of foreign direct investment. If these findings are robust, and they seem to be, then they raise an important question that has not been addressed in the literature: Why do non-democratic countries join international economic institutions when there is no obvious domestic pressure to join and comply with the agreements, and there seems to be no direct benefit, either?

The argument we develop in this study provides a plausible answer to the question, which is that non-democracies join international economic institutions for the costly signaling effect rather than drawing direct benefits. The need to credibly commit to a policy arises for all governments, including non-democracies. In particular, when non-democratic leaders push for economic reforms, they need to coordinate the beliefs of domestic groups and attract international resources by demonstrating their resolve to enact reforms. The importance of domestic political institutions in lending credibility to a government's economic policies has long been recognized (North and Thomas 1973; North and Weingast 1989). Such credibility is central in fostering economic growth, for it reduces the risk associated with long-term economic activities, thus encourages planning and investment. Free media and the electoral process can generate significant costs for a democratic government when it defects from declared policies, thus making its commitment credible. Lacking a similar device, non-democratic regimes are presented with the challenge of making their policy commitment credible through other means. International institutions provide a solution to the problem for such regimes.

An important feature of an agreement made to an international institution is that it creates international audiences for the subsequent compliance behavior. Lohmann (2003) argues that an institutional commitment has bite only if it is made vis-a-vis an audience that can and will punish institutional defections. While the domestic audiences of a non-democracy may not be able to punish their leaders for reneging on a policy, the audience costs incurred

at the international level for such behavior could be significant for the leaders. International economic institutions, such as the World Bank and the IMF, are known to take advantage of the public nature of their interactions with states by adopting “naming and shaming” strategies to further expose countries that fail to live up to their institutional commitments. Bad publicity resulting from a country’s inability to uphold its agreement with an international economic institution could have a long-term negative effect on the country’s ability to forge trade agreements and attract foreign investment. Both other governments and private actors on the international market will have less incentive to establish economic relationships with a country whose government cannot be trusted to honor international agreements. Additionally, a poor track record with one international economic institution may reduce a country’s ability to secure economic assistance from other international institutions. These consequences taken together could do direct damage to a country’s social and economic development and strengthen domestic political opposition, both of which are significant costs for a leader who wishes to stay in power. Therefore, a policy commitment made through international institutions acquires the credibility that a non-democratic government needs to implement its economic reform.

This paper contributes to the study of international institutions in two ways. First, while there is a growing literature that identifies electoral politics in democracies as a source of the influence of international institutions, virtually no study exists that explores the mechanisms by which such institutions could influence the behavior of non-democratic polities. With the result from an empirical analysis that is consistent with our theory, we can begin to understand how international institutions can bring about compliance behavior from non-democracies. Second, the study will shed new light on the strategies for international economic institutions to induce cooperative behavior from non-democratic regimes. This will be a step toward exploring a greater role for international institutions in world politics: empirical observations suggest that there may be a link between economic liberalism and

democratization; if international institutions could promote economic liberalism, then they may also play an important indirect role in peaceful democratic transition.

2 International Institutions and Credible Commitment

Commitments are often necessary in international politics to convince an audience that a government intends to carry out certain actions. A commitment, however, is not automatically believed if circumstances may arise in the future that gives the government an incentive to renege on the commitment. How do countries solve the problem of making a commitment credible? Building on Spence's (1973) seminal work on job market signaling, Fearon (1994, 1997) argues that a commitment may be rendered credible when it creates the possibility that leaders will become locked into their position and so will be unable to back down due to significant costs it will result. In other words, for a governments to credibly commit to a policy in front of domestic and international audiences, its ability to generate costs associated with renegeing on the policy is critical.

Unlike democracies, non-democracies do not have functioning electoral systems and free presses to make their commitments costly thus credible. Thus, non-democracies have to rely on different sources than democracies to generate costs necessary for a credible commitment. It has long been pointed out that international institutions could serve as a commitment device for states (Keohane 1984). The argument often hinges on the costs of participating in such institutions, or the ability of the institutions to impose direct costs on countries when they deviate from agreements. For example, Pevehouse (2002b) argues that because of membership conditionality, states that join an organization are likely committed because they are willing to endure the costs of joining. But such costs are sunk costs; countries do not incur them again when they deviate, thus the costs are not sufficient to deter countries from renegeing. Additionally, enforcement is often a problem for international organizations, especially with regard to large countries that can wield significant political clout (Stone

2002). We argue that more important costs are the audience costs incurred at the domestic and international level when a government backs down from an international agreement.

Domestically, entering an agreement with an international organization can be used to aid in the implementation of unpopular reforms or to “lock-in” policies. For example, with respect to economic reforms, IMF conditionality is not always a “penalty,” rather a mechanism useful to governments for committing to a new policy direction (Vreeland 2003). Mansfield and Pevehouse (2006) argue that joining an international organization can help democratizing countries credibly commit to political liberalization. Given the incentives facing executives to consolidate power for themselves, membership in an international organization can create costs for impeding the consolidation of democracy. This is particularly relevant to the post-communist countries, many of which implemented political liberalization measures in addition to economic ones over the period of the study. Institutions help commit the policies of future governments (Lohmann 2003).

International organizations often provide external monitoring so that defections are likely to be made public. If a government is willing to subject itself to this monitoring, it is more likely that it is the “committed” type. Mansfield et. al (2002) discuss the alarm role of international agreements with respect to the domestic audiences of democracies; however, there is no reason that other audiences are not also the recipient of such a signal. For example, it is expensive for investors to collect information about a country; therefore they could take cues from the IMF and take advantage of the information published by the IMF. More generally, there are three types of audiences at the international level that will pay close attention to the information disseminated by prominent international economic institutions such as the IMF regarding a country’s compliance behavior.

First, market actors are an important audience for all governments, but especially for non-democracies as they are one of the primary audiences capable of punishing a government for defection. Mosely (2000) finds that market actors do respond to (macro) economic indi-

cators in developed countries, especially inflation and to a lesser extent, government fiscal balance. Although she does not test it empirically, she suggests that the range of indicators analyzed by investors is even greater in developing countries because of the increased risk of default. Governments must consider the preferences of investors because they can respond quickly to expected or actual policies. For example, investors may speculate or shift capital to other countries (Lohmann 2003). Because many non-democracies are found in the developing world, this suggests that market actors can be considered an audience. Vreeland (2003) provides further evidence supporting the concept of market actors as an audience. He argues that IMF programs undertaken as a means of tying ones hands in order to implement unpopular reforms can lead to increased investment. IMF programs have positive effects when they are viewed as likely to lead to economic reform (Mody and Saravia, 2003). Edwards (2005) finds that noncompliance with an IMF program leads to significant capital flight, even greater capital flight than occurs in the absence of an IMF program. This suggests that market actors pay attention to not only economic fundamentals, but also signals from the IMF. Indeed, Simmons (2000) argues that competitive market forces are a more likely mechanism of enforcement than IMF policy pressure.

Second, other states may take into account the information revealed by the major international economic institutions when making decision regarding international cooperation. The community of other states can be considered an audience that can impose costs on a state for renegeing. Of course other states are an audience for democracies and non-democracies alike; they are, however, more important to non-democracies with respect to making credible commitments. Because non-democracies do not have an internal enforcement mechanism like a domestic audience, they must be especially careful to take into consideration the reaction of other states when considering the costs of committing to international agreements, and perhaps subsequently renegeing on those promises versus the costs associated with non-cooperation without commitment. Downs and Jones (2002) suggest other states may respond

to renegeing with linkage penalties. For example, economic sanctions were placed on Iraq after it failed to comply with a UN weapons inspection agreement.

Third, a poor track record with one international economic institution may reduce a country's ability to secure economic assistance from other international institutions. Countries generally have ongoing relationships in multiple spheres (Lawrence 2003, 92), other international institutions can join the efforts to punish a country's unruly behavior by linking issues through shared memberships. For example, when Pakistan and India conducted a series of nuclear tests in violation of the nuclear non-proliferation regime, and further refused to sign the Comprehensive Test Ban Treaty suggested by the UN Security Council, the International Monetary Fund, the World Bank, and other international financial institutions halted or curtailed their aid to the two countries (Mistry 1999).

These domestic and international audiences of an institutional commitment provides a mechanism through which a non-democracy could credibly commit to an economic reform policy. Key to a successful economic reform is the convergence of expectations from all relevant actors so that the risk associated with investment and production is minimized. The 'Washington Consensus,' a term coined by John Williamson (1994) has long been the prescription offered to developing countries by the IMF, World Bank and advanced democracies like the US. It focuses on fiscal discipline, exchange rate reform, trade and financial liberalization, tax reform, privatization and secure property rights, all of which critically depend on a government's ability to follow through its public pronouncements. In what follows, we empirically examine the causal relationship between the depth of countries' economic reforms and their involvement in IMF programs.

3 Data and Hypotheses

There is a great volume of theoretical work on economic reform, however, empirical work has been impeded by a lack of quantitative measures of the level of economic reform that has

broad coverage across time and across countries. Our dataset consist of structural reform programs of 25 post-communist countries from 1989 to 2005. The post-communist countries provide an excellent sample on which to test our hypotheses for several reasons. First, these countries have undergone significant economic reforms in a fairly short period of time, while their political institutions have not made a full transition to democracy. Second, the international capital market was not truly international until the fall of the Soviet Union and the rise of the internet, which fits well with the time span of the data. Furthermore, we study the involvement in IMF programs by these countries to test the hypothesis that the IMF is used as a credible commitment device by these countries to implement their economic reforms. Since our theory highlights the importance of publicity at the international level in generating audience costs, we need to look at prominent economic institutions such as the IMF and the World Bank. The IMF is particularly suitable for our analysis in that countries incur costs by taking on IMF programs, and the IMF also makes it part of its strategy to inform market actors about a country's status. In other words, the IMF actively disseminates information to international audiences.

Our dependent variable, *Degree of Involvement*, is an ordered categorical variable. It measures the level of involvement in the IMF. It is coded as follows: 0 if a country is an applicant, 1 if a country is a participant in IMF programs and 2 if a country has graduated from the IMF. A country is an applicant for an IMF program if it has not yet participated in an IMF program. This suggests that a country is not willing to meet the conditions required by the IMF to even get an initial loan. Countries are also coded as applicants when they are between programs. This may indicate that they have not met the conditions to qualify for another loan. Countries are participants in IMF programs during the years when they have programs in place. Finally, a country is a “graduate” of IMF programs when it no longer is applying or participating. Thus, the dependent variable measures the depth of involvement in the IMF. It is a good measure of this because as the studies cited

above show, there do not appear to be direct benefits from participation in IMF programs. Therefore, by coding involvement in the IMF, we are looking at the signal (or lack of signal) to commitment to economic reform.¹ This data is taken from IMF webpages for each country (<http://www.imf.org/external/country/index.htm>).

The main independent variable, *Economic Reform* is the level of structural economic reform. There are two broad categories of economic reform identified in the literature: those intended to address macroeconomic imbalances and structural reforms intended to strengthen weak institutions. “Stabilization consists of short-term measures designed to slow down inflation, reduce the balance-of-payments deficit and cut the government deficit,” while structural adjustments and privatization are meant to make the economy more competitive (Przeworski 1991, 144). Rodrik (1996) aptly distinguishes between macroeconomic and microeconomic reform. Macroeconomic reforms are those which are intended to restore stability through fiscal, monetary and exchange rate policies. On the other hand, structural adjustment (microeconomic) reforms consist of liberalization policies aimed at structural and institutional reform and growth, for example, the removal of relative-price distortions and the reduction of state intervention. Since we are interested in states’ long-term commitment to economic policies, we choose to use measures of structural reforms.

However, it is inherently difficult to measure both the depth and breadth of structural economic reforms for several reasons. Lack of information is an important factor. For example, the passage of a reform package does not mean that all of the reforms are implemented. Therefore, evaluating the implementation of reforms, especially structural, often requires expertise in a particular country or region. Accepting that there is no perfect measure of economic reform, we decide to use the EBRD Transition Indicators which covers the post-communist countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU). It is based on a weighted average of scores in the areas of price liberalization and

¹This is contrast to a dependent variable that codes involvement in the EU, for example, which has clear material incentives. This makes it hard to separate the signal from the desire for funds.

competition policy, trade and foreign exchange liberalization and privatization and banking reform. They have been used in other studies including Dethier et. al (1999) and Fidrmuc (2003), which both look at the relationship between democracy and economic reform. As a result, many reform indexes tend to be subjective, and thus difficult to replicate and extend through time or to other countries.

A few descriptive statistics about our measure of economic reform are helpful. The EBRD index is a cumulative index of structural reform created from the individual components listed below, using EBRD transition indicators (1989-2005). The scores for each component range from 1 to 4+ (plus or minus 0.33). The lowest score is 1.00 and the highest 4.33. There are 8 composite indicators of economic reform. We sum the indicators for the following: large and small scale privatization, enterprise restructuring, price liberalization, trade and foreign exchange system, competition policy, banking reform and interest rate liberalization, and securities and non-bank financial institutions. Therefore, the minimum possible score is 8.00 and the maximum possible score is 34.64 - the minimum realized score is 8.00; 31.66 is the highest realized score. A breakdown of the *Level of Involvement* (IMFstatus) according to quartiles of levels of economic reform can be found in Table 1. The category participant is the modal category as approximately 45 percent of the cases fall into this group.

Table 1. Descriptive Statistics

IMF status	Economic Reform (quartile)				Total	Percent
	1	2	3	4		
Applicant	56	33	22	3	114	28.43
Participant	10	75	78	16	179	44.64
Graduate	0	0	13	95	108	26.93
Total	66	108	113	114	401	100.00

The level of democracy is another important variable. It is measured using the Polity time series scores, which extend from 1989 through 2003.² We do not have a clear expectation

²This set of scores is meant for time series, so “special” scores indicating regime transition, failed state

about the effect of democracy on commitment to economic reform. It is possible that the desire to credibly commit to economic reform necessitates signalling through participation in the IMF because these are new democracies.

We also include several economic variables. It is important to include the economic factors that have been shown to affect participation in IMF programs or influence the catalytic effects of program participation. Therefore, we include inflation, debt service, the current account deficit and the level of reserves. Inflation is measured as the annual GDP deflator. Debt service is measured as a percentage of exports of goods, services and income. The reserves are measured in current US dollars and include gold. The current account deficit is measured as a percentage of GDP. High levels of debt service, low levels of reserves and large CA deficits have been shown to increase the likelihood of requesting IMF assistance (Steinwand and Stone 2006, 16). Finally, we include GDP per capita as a control. All of these variables are taken from the World Development Indicators. We are still in the process of generating hypotheses given the nature of the dependent variable.

Using the dataset described, we will test the following central hypothesis:

Hypothesis. *As the depth of its economic reform increases, a non-democratic country is more likely to increase its level of engagement in IMF programs to signal to the international audiences its resolve to stay on the path of the reform.*

4 Empirical Analysis

We use an ordered probit regression. This is appropriate because there are theoretical reasons to believe that our dependent variable, the level of involvement in the IMF, is ordered.

In applying an ordered probit analysis, it is assumed that the government has an unobservable continuous utility function that affects the government's decision to commit to

etc. have been recoded to fit on the -10 to 10 scale.

economic reform through involvement in the IMF. That is,

$$Y^* = \beta_1 \text{REFORM} + \beta_3 \text{DEMOCRACY} + \beta_2 \text{INFLATION} + \beta_4 \text{RESERVES} + \beta_5 \text{GDPPC} \\ + \beta_6 \text{FSU} + \epsilon$$

where $\epsilon \sim N(0, \sigma^2)$. As researchers, instead of observing the utility function, we observe a categorical variable, the level of involvement in the IMF. Define threshold parameters τ_j ($j = 1, 2$), such that $\tau_1 < \tau_2$. These two parameters group Y^* into three categories. Although the realization, y_i^* , is unobserved, we do know which of the three categories that y_i^* belongs to by observing IMFstatus_i . That is,

$$\text{IMFstatus}_i = \begin{cases} 0 & \text{if } y_i^* \leq \tau_1 \\ 1 & \text{if } \tau_1 < y_i^* \leq \tau_2 \\ 2 & \text{if } y_i^* > \tau_2 \end{cases}$$

for $i = 1, \dots, n$ observations. Thus, the random utility model suggests that non-democracies will signal commitment to economic reform through costly involvement only when the utility to do so is greater than the utility of not taking that action, which is represented by a threshold, τ_j ($j = 1, 2$). Ordered probit models deal with just this sort of ordinal dependent variables.

The results of the ordered probit models are presented in Table 2.³ Model 1 contains the main explanatory variables and Model 2 includes two additional economic variables hypothesized to affect involvement in IMF programs. Both models support our main hypothesis. In particular, the level of economic reform has a significant positive effect on the likelihood of moving to the next level of the dependent variable in both models. However, it is well-known

³Ordered models make a proportional odds assumption that requires the effects of a variable to be the same as an observation moves from one level to the next on the DV. Tests suggest that this assumption may not be valid in this instance. However, the results are similar when a multinomial logit is used. We are currently looking for a model that does not require this assumption but maintains the ordering of the DV as there are strong theoretical reasons to believe it is ordered.

that the interpretation of non-linear models is not straightforward. Unlike logistic models, factor changes in the odds cannot be computed when running an ordered probit. Therefore, we rely on first differences and graphical presentations of the results.

Table 2. Ordered Probit Results

	Model 1	Model 2
Reform	0.18** (0.031)	0.17** (0.032)
Democracy	0.082** (0.028)	0.084* (0.033)
Inflation	$4.28e^{-5}$ ($1.97e^{-4}$)	0.00012 (0.00016)
Reserves	$4.46e^{-11**}$ ($1.35e^{-11}$)	$6.05e^{-11**}$ ($1.63e^{-11}$)
GDP per capita	$-4.39e^{-8*}$ ($1.84e^{-8}$)	$-4.48e^{-8*}$ ($1.76e^{-8}$)
CA Balance		-0.027 (0.021)
Debt Service		-0.0041 (0.017)
χ^2	69.36	81.61
Log Likelihood	-157.87	-136.28
N	265	224

PCSEs in parentheses. ** $p < 0.01$ * $p < 0.05$.

Figure 1 shows how the predicted probability of being in each category changes as the level of economic reform increases. The graph of the predicted probabilities in Figure 1 provides clear support for our hypothesis. The figure shows how the predicted probability of sending each

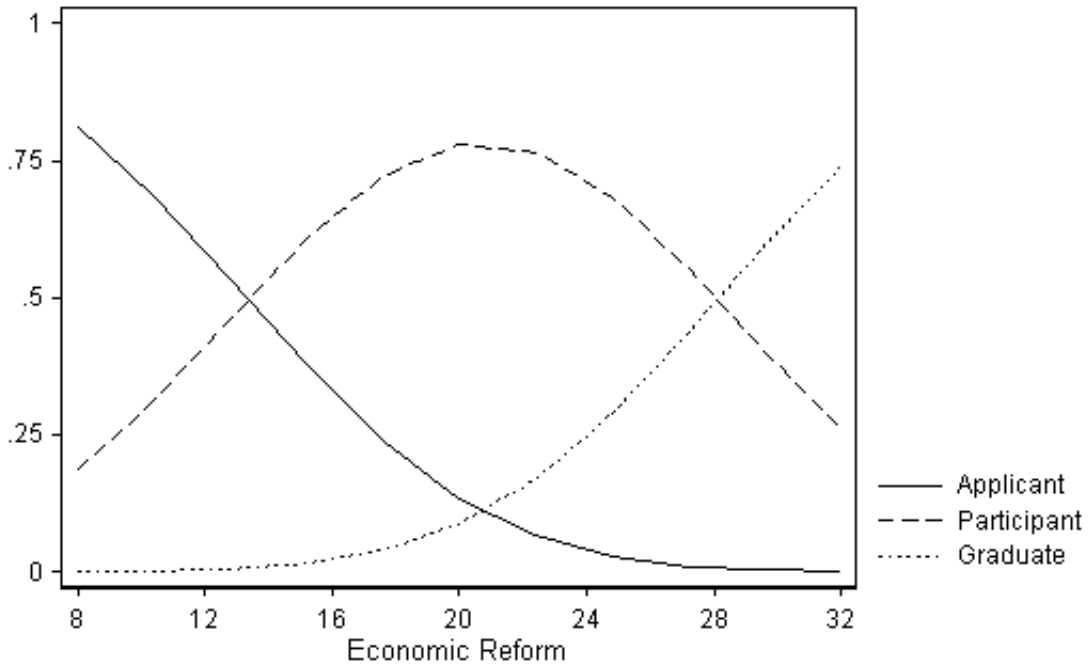


Figure 1: Predicted Probability as a function of Economic Reform

changes as the level of economic reform changes.⁴ As the level of economic reform increases, the probability of being an applicant decreases and the probability of being a graduate increases. As the level of economic reform increases, the probability of participating in an IMF program increases up a point and then the probability decreases.

The level of democracy is significant in both Models 1 and 2.⁵ Figure 2 shows how the predicted probability of being at each level of involvement changes as the level of democracy increases.⁶ The probability of being an applicant decreases as the level of democracy increases. Conversely, the probability of being a graduate increases as the level of democracy increases. The effect of the level of democracy on the probability of being a participant is

⁴The predicted probabilities are calculated from Model 2; all other variables are set at their means.

⁵The effect of democracy is robust when measured as a dummy variable equal to 1 if Polity scores are greater or equal to 6 and 0 otherwise. Quadric and interaction terms with level of economic reform were not significant.

⁶Again the probabilities are calculated from Model 2 with other variables set to their means.

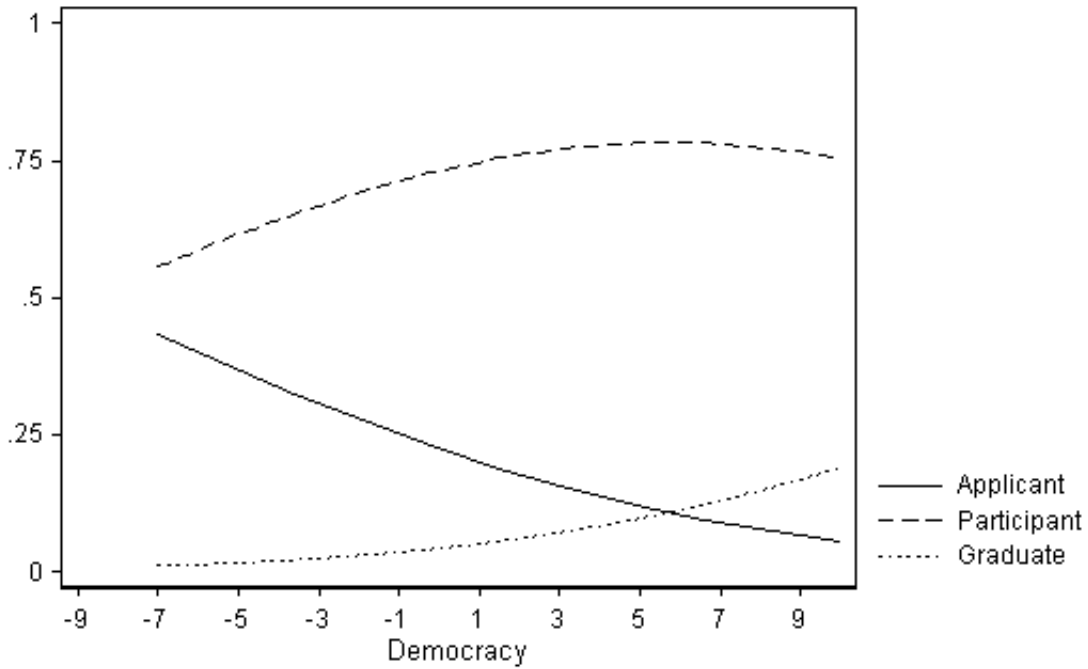


Figure 2: Predicted Probability as a function of level of Democracy

slightly non-linear.

We do not have a clear expectation about the incentives of democracies to signal their commitment. The countries in our dataset all begin as non-democracies and some then undergo political liberalization. However, because they are not mature democracies, their ability to credibly commit is not well established because the mechanisms through which democracies normally create domestic audience costs are new. It is likely that their incentives have not changed much from their previous regime in terms of their desire to make credible commitments. Therefore, intuitively it makes sense that democratizing or newly established democracies would also want to signal commitment to economic reform through higher levels of involvement in the IMF. It is likely that mechanisms through which domestic audience costs occur are not fully established, therefore, signaling to international audiences increases credibility.

Finally, several of our economic control variables were significant as expected. The level

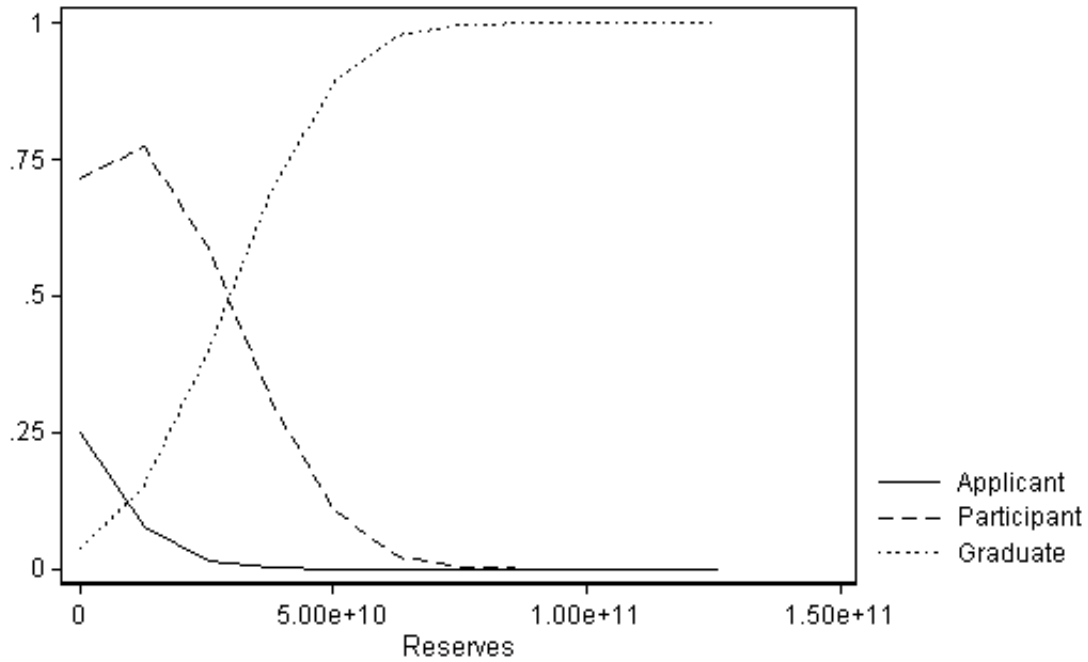


Figure 3: Predicted Probability as a function of Reserves

of foreign reserves had a positive, significant effect, which is consistent with IMF literature. The likelihood of needing an IMF program decreases as the level of foreign reserves increases. In other words, countries are likely to have deeper levels of involvement as the level of reserves increases. In Figure 3, we can see how the predicted probability of being at each level of involvement changes as the level of reserves increases. The picture generally seems to support the expectations in the literature discussed above.

Surprisingly, inflation does not have a significant effect on the probability of moving to the next level of involvement in either model.⁷ Similarly, the current account balance and the debt service ratio are not significant either. GDP per capita has a negative, significant effect in both models. Although we do not at this time have a strong expectation about the effects of GDP per capita, this is slightly non-intuitive as we would expect that richer countries would be more likely to have graduated from participation in IMF programs. Figure 4 shows

⁷This may be addressed when the proportional odds assumption is not imposed.

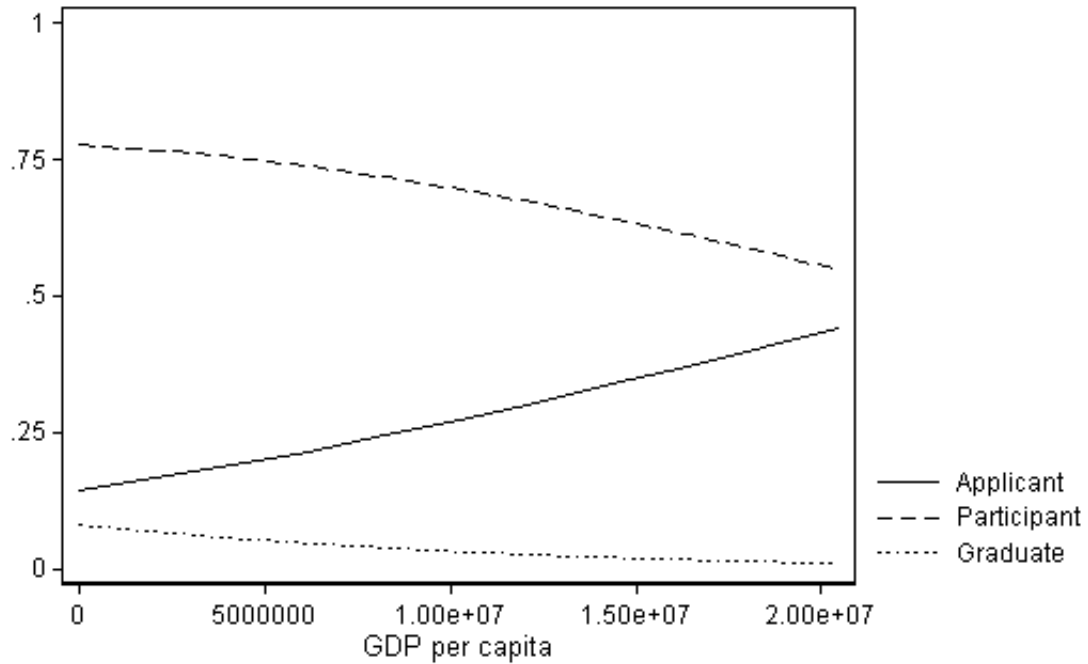


Figure 4: Predicted Probability as a function of GDP per capita

how the predicted probabilities change as GDP per capita increases.

The results of our model support our main hypothesis. The results are also robust to various measures of democracy. The next steps involve formulating specific auxiliary hypotheses about the explanatory variables included other than economic reform. Finally, tests of the appropriateness of the model specification will strengthen the robustness of our results.

5 Conclusions

Few people have looked at the ways in which international institutions affect the behavior of non-democracies. Our preliminary results strongly support our main hypothesis, that as the level of economic reform increases, non-democracies are likely to signal continued commitment to economic reform through involvement in IMF programs. This is significant

because it provides support for our argument that non-democracies use international economic institutions as commitment devices. Because non-democracies do not have domestic audience costs, they can use international economic institutions to create international audience costs. In this way they can signal to market actors and coordinate the expectations of domestic economic actors. This is an important area of research because many developing countries are non-democracies that need to access international capital in order to promote development. One possible next step will be to model formally or empirically whether or not audiences like markets or other states respond to signals made by non-democracies through participation in economic institutions.

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