Do Democracies Dodge the Bullet? Reassessing the Impact of Sanctions on FDI

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Sanctions as a Political Tool

Coercive Policy Instrument

States use sanctions to pressure target nations

Investment Signal

Investors see heightened political risk

Economic Impact

Slowe growth, soaring inflation

Complex Sanction-FDI Relationship

Sanction Effects

Sanctions chill FDI, especially greenfield investments requiring long-term stability.

Democratic Buffers

Checks and balances limit policy disruption, creating stability that investors value.

Transparency Advantage

Free media and elections provide predictability for investors navigating sanctions.

Credible Commitments

Democratic leaders face electoral costs for reneging on investor promises.

While autocracies may offer attractive short-term incentives, these benefits remain tied to individual leaders. Democracies provide enduring property rights protections that better withstand economic pressure.

Complex Sanction-FDI Relationship

Short-Term

Significant short-term reductions in FDI when investors pre-emptively withdraw from target countries

Long-Term

The long-term impact is unclear

Target countries find alternative FDI sources

Non-sanctioning countries may enter market

Sanctions Beyond Autocracy-Democracy Dynamic

Democracy-Democracy Sanctions

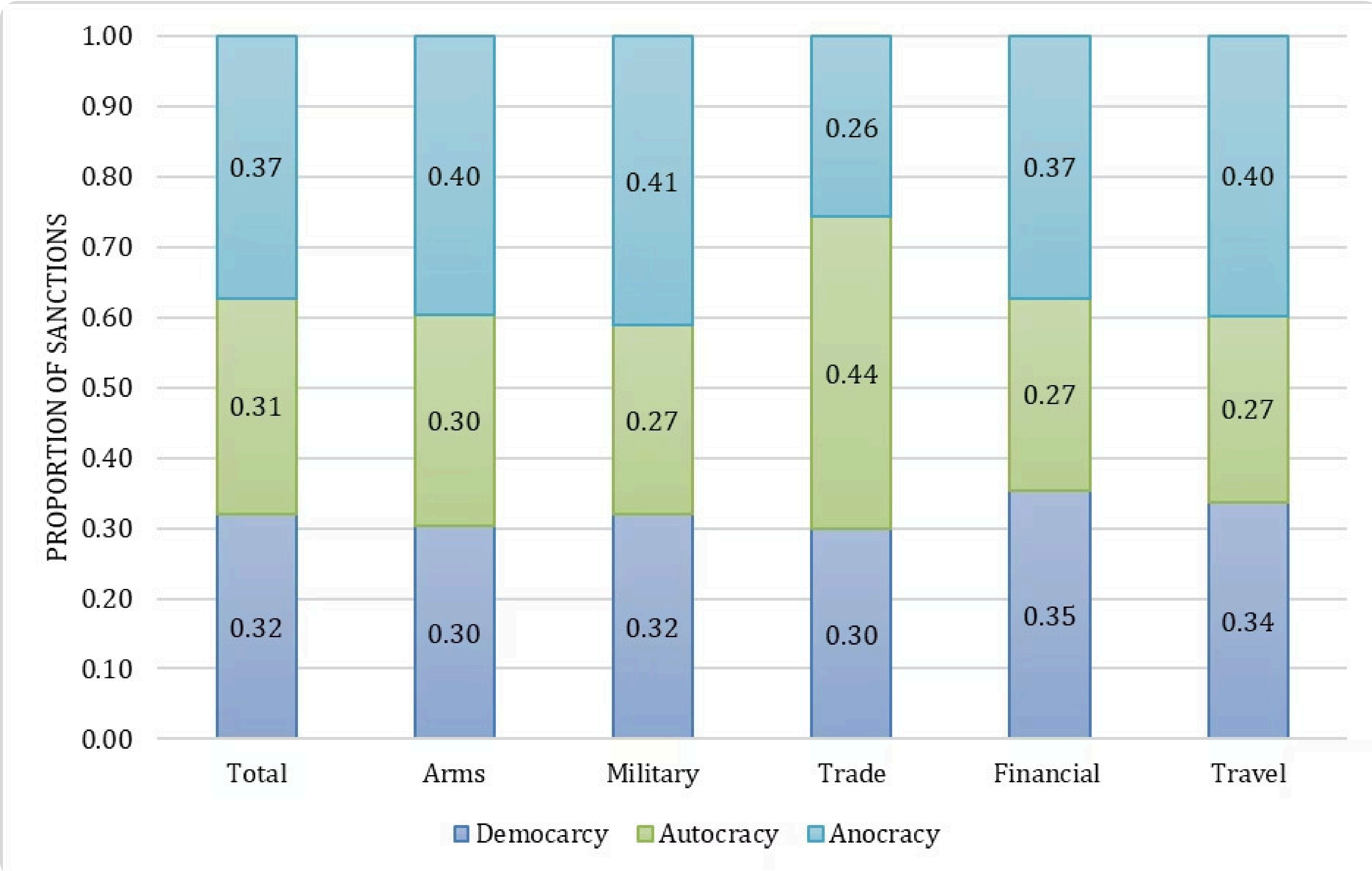
More common than democracy-autocracy sanctions (1945-2005)

Domestic Pressure

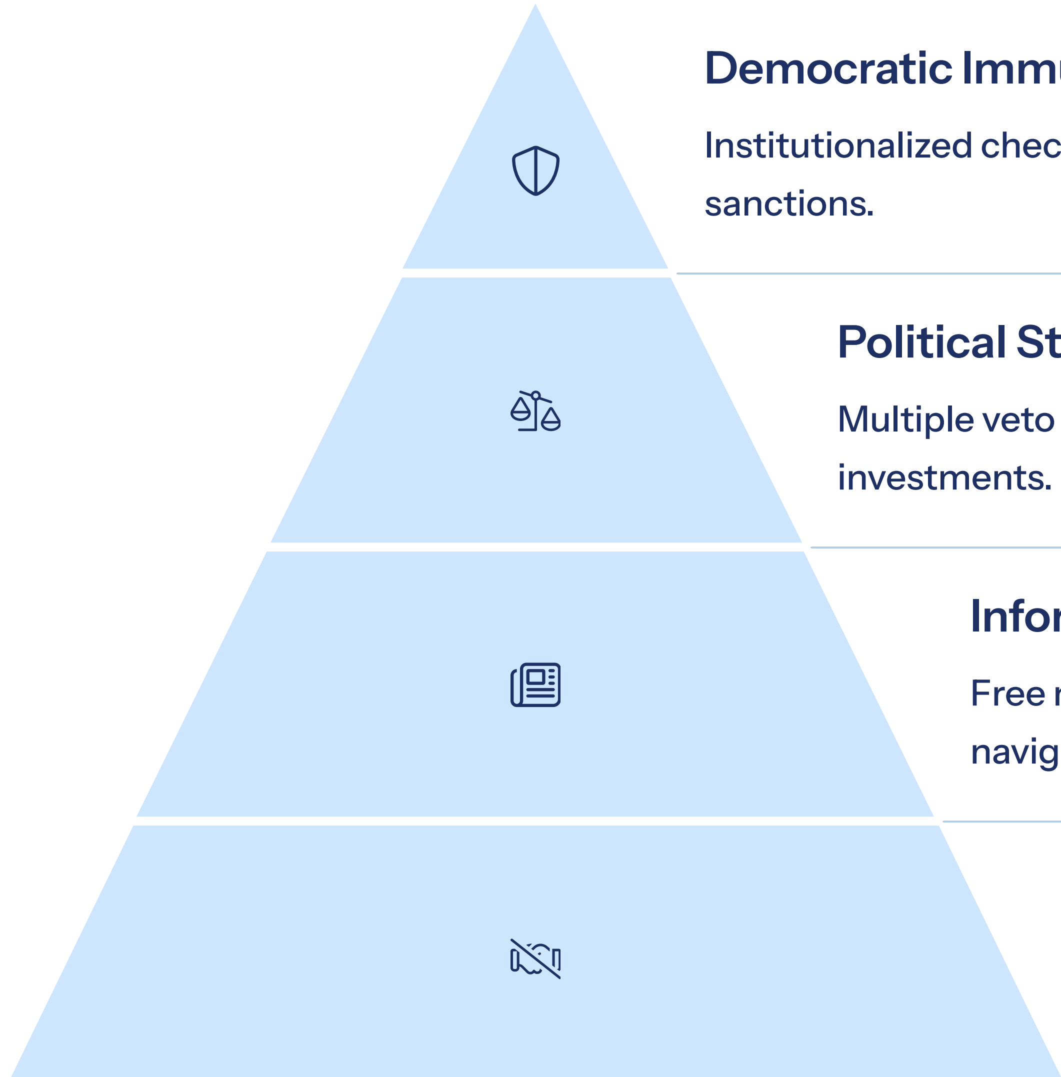
Interest groups and public demands during economic disputes drive sanctions

Symbolic Measures

Often transient and issue-specific with minimal long-term impact



Proportion of Different Types of Sanctions by Political Regime



Democratic Immunity

Institutionalized checks and balances create stability that shields FDI during sanctions.

Political Stability

Multiple veto players prevent radical policy shifts that could harm investments.

Informational Transparency

Free media and elections provide predictability for investors navigating sanctions.

Credible Commitments

Electoral accountability makes democratic leaders maintain investor promises.

While autocracies may offer attractive short-term incentives, these benefits remain tied to individual leaders. Democracies provide enduring property rights protections that better withstand economic pressure.

We argue that democratic political institutions moderate and mitigate the adverse effects of sanctions on FDI inflows, especially Greenfield investments that require long-term political and policy stability.

A Simple Theory of ‘Democratic Immunity’

Democratic institutions provide "immunity" against the negative effects of sanctions on investment flows

Institutional Checks and Balances

Democracies feature veto players like legislatures and independent judiciaries that create status quo bias, reducing radical policy shifts and providing stability for investors.

Informational Transparency

Free media, contested elections, and government accountability provide predictability in decision-making, helping investors anticipate policy responses to sanctions.

Reputation Incentives

Democratic leaders face "audience costs" from voters who value market credibility, making them less likely to renege on commitments to foreign investors.

The Autocratic Alternative

Potential Advantages

Autocrats can offer financial incentives and lax regulations to attract foreign investors, who may view certain autocracies as more favorable than democracies with stronger regulations.

Critical Weakness

While autocracies may offer short-term financial benefits, they lack the policy stability of democracies. This creates uncertainty that worsens during sanctions. In contrast, democracies' commitment to property rights and stable policies better withstand sanctions' effects.

Research Methodology

Data Collection

Panel gravity dataset of 108 sender countries and 110 target countries (2,708 country pairs) from 2003 to 2018

- Greenfield FDI data from Financial Times' fDi Markets
- Sanctions data from Global Sanctions Data Base (GSDB)
- Democracy measures from Polity V, Authoritarian Regime Dataset, and Measures of Democracy

Analytical Approach

Structural gravity model using Poisson Pseudo Maximum Likelihood (PPML) estimator

- Handles zero FDI flows and heteroscedasticity
- Includes target-year, sender-year, and sender-target-pair fixed effects
- Estimated using a user written command in Stata "ppmlhdfe"

Focus Areas

Examines sanctions by type (military, arms, trade, financial, travel)

Analyzes interaction effects between sanctions and democracy

Investigates temporal effects (lead and lag) and specific democratic mechanisms

Empirical Model

Our empirical model examines how democracy moderates sanctions' impact on greenfield FDI flows. The equation measures the interaction effect between sanctions and democratic institutions:

$$GFDI_{odt} = \beta_0 + \beta_1\, Sanction_{odt} + \beta_2\, Sanction_{odt} \times Democracy_{dt} + \delta_{ot} + \theta_{dt} + \rho_{od} + \varepsilon_{odt}$$

Interaction Term

β_2 captures how democratic institutions buffer against negative sanction effects on FDI. Positive coefficient indicates democratic resilience.

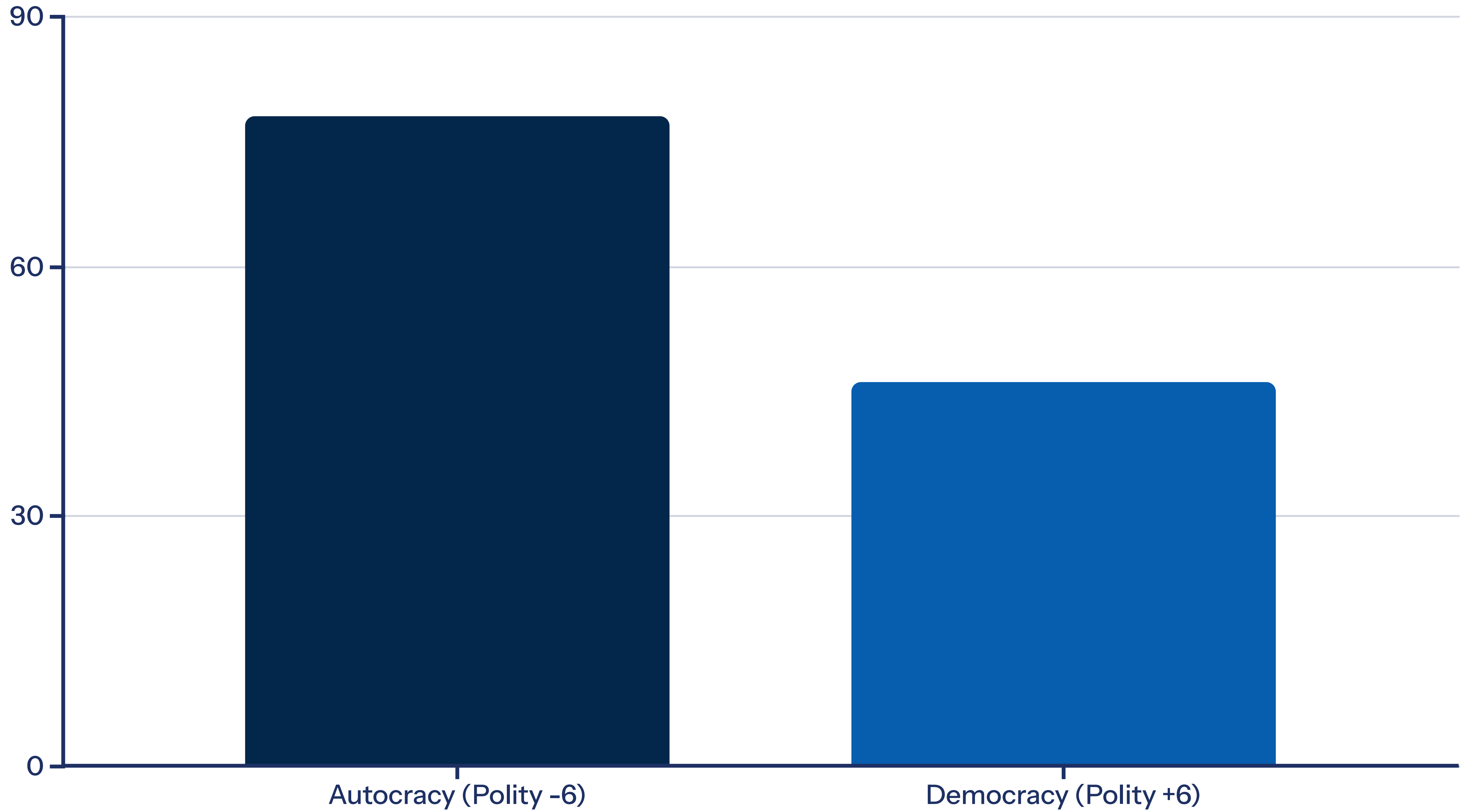
Fixed Effects

Model controls for origin-time (δ), destination-time (θ), and origin-destination pair (ρ) fixed effects to isolate the relationship.

Expected Outcome

We anticipate β_1 will be negative (sanctions reduce FDI) while β_2 will be positive (democracies mitigate this reduction).

Key Findings: Sanctions Impact



Sanctions deter FDI, but democracies are more resilient. Financial sanctions have the biggest impact, reducing FDI by 78% in autocracies, but only 46% in democracies.

Temporal Effects of Sanctions

1

Anticipatory Effects

One year before financial sanctions, non-democracies experience a 47% drop in greenfield FDI inflows

For democracies, the anticipatory impact is statistically insignificant

2

Immediate Impact

Non-democracies see sharper immediate drops in FDI when sanctions are imposed

Democracies experience more moderate immediate effects

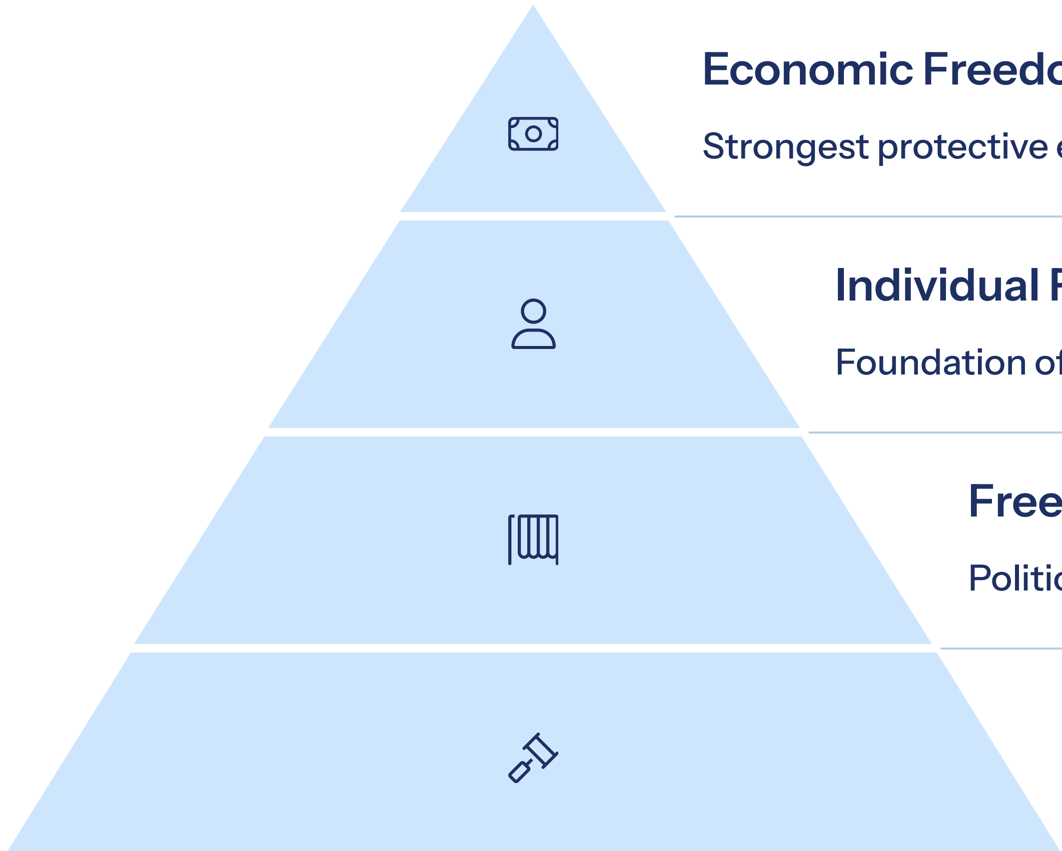
3

Lingering Effects

Negative impacts persist two years longer for non-democracies

One year after financial sanctions, non-democracies see a 69% FDI drop vs. only 12.6% in democracies

Democratic Mechanisms at Work



Economic Freedom

Strongest protective effect against sanctions

Individual Freedom

Foundation of democratic systems

Free and Fair Elections

Political accountability

Rule of Law and Functioning of Government

Insignificant at 5% level

When examining which specific democratic features provide the greatest protection during sanctions, economic freedom emerges as the most powerful factor. This aligns with the theory that freedom in economic markets reflects freedom in political markets, creating the consistency and predictability that investors value.

Conclusions and Implications

Democratic Resilience

Democracies sustain smaller wounds from sanctions and recover more quickly than non-democracies. The political fundamentals that attract long-term investors remain stable despite economic pressures.

Investment Strategy

For firms requiring long-term commitments and policy stability, democratic markets offer greater protection against geopolitical risks, even when sanctions are imposed.

Broader Implications

Democracies succeed because they better solve the commitment problem not just for domestic investors, but also for international ones—a critical advantage in an era of increasing geo-economic rivalry.