Foreign Influence and the Cold War History of Democracy in Latin America

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Abstract

The recent political economy literature on regime change and non-democratic politics has not paid enough attention to the role of foreign influence. I look at the Cold War history of democracy in Latin America and construct a theory of power allocation in the presence of foreign influence. In this theory, the outcome of a distributional conflict between an incumbent group and a challenger is altered by the capacity of the incumbent to obtain external support from a key trading partner. This capacity is grounded in the incumbent's larger exposure to the international economy, which makes him easier to control from the exterior, using the threat of trade sanctions. I also allow for the possibility that there is international competition for the geopolitical alignment of the incumbent's country, and study how this choice of alignment is determined by economic or political self-interest. I argue that this theory can help understand the Cold War history of democracy in Latin America, but that it is useful in a number of other contexts as well.

JEL codes: D7, F10, F23, N46.

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1 Introduction

In recent years, the political economy literature has put considerable effort in studying the economic determinants of regime change and non-democratic politics. For example, a series of papers have studied the transition to democracy in Western Europe and other parts of the World (e.g. Lizzeri and Persico, 2004; Llevador and Hoxoby, 2005; Acemoglu and Robinson, 2006). Other work has focused on the allocation of power within weakly institutionalized polities (e.g. Hellman and Wantchekon, 2000; Padro-i-Miquel, 2007). While some of these papers do consider the effect of changing international economic conditions on regime change and non-democratic politics (see, for example, Chapter 10 in Acemoglu and Robinson, 2006), these are normally seen as shaped by the interaction of domestic players only.[1]

There is, however, considerable evidence that regime change and non-democratic politics are influenced by foreign interventions as well. Looking at democratization, for instance, one finds many examples of how the US supported coups against democracy during the Cold War: to cite but a few, the coups in Iran (1953), Guatemala (1954), and Chile (1973). That Cold War interventions were largely detrimental to democratization is established empirically by Easterly, Satyanath, and Berger (2008), who use recently declassified material to show that covert CIA and KGB interventions resulted in a decline in democracy both in the short and in the long run. On the other hand, recent interventions such as the war on Iraq or Afghanistan have been decisive to the current democratization attempt in these countries. Nor do foreign interventions only seem to arbitrate between democracy and autocracy: for example, the history of post-colonial Africa is full of instances in which former colonial powers supported one group or another at the lead of non-democratic regimes.[2] Finally, foreign intervention is not only limited to full-fledged military operations. For example, Mobutu's long permanence in power was facilitated by the timely release of economic aid in periods of economic distress; in today's Zimbabwe and Sudan, the entrenchment of the ruling elite is made easier by the diplomatic support that these countries receive from China.

In this paper, I look at the history of US interventions in Latin America

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[1]A notable exception to this is Aidt and Albornoz (2009), which I discuss below.

[2]See Waisse (1998, Ch. 10), for a study of French interventions meant to prevent the spread of American influence to French Africa, or extend French influence to parts of British Africa.

to construct a theory of power allocation in the context of foreign influence. This theory helps understand the Cold War history of democracy in Latin America. At the same time, it shed lights on the reasons why, by hindering the democratization process, the US went against its long-standing foreign policy goal of supporting democracy abroad. Finally, while the theory is based on what were the key determinants of foreign interventions in Latin America - the wish to protect and promote foreign investors, and the need to secure the geopolitical alliance of intervened countries - I argue that it is general enough to be useful in other contexts as well.

The model builds on the distributional conflict between two groups, a political incumbent and a challenger, in the context of a small open economy. Part of the value of this economy relies on a peaceful trade relation with a large foreign country, and I assume that members of the incumbent group have a higher per capita stake in this part of the economy than members of the challenging group. International economic relations are shaped by reputation: in particular, a large foreign investment position may force the large country to impose costly sanctions against a government who expropriates. I construct a simple reputation game, and derive conditions under which the threat of sanctions becomes credible: when these conditions are met, the incumbent is blessed with a greater capacity to commit to protecting foreign rents, relative to the challenger. I add to this picture the international competition between two large countries (the one already mentioned, plus another one) who both care about the small country's geopolitical alignment. This is a choice over which the two groups do not have an intrinsic preference, but that can be used to secure economic support from the second large country. Thus, a key cost of sanction for the first large country lies in the risk that the sanctioned government ends up in the opponent's camp.

In this environment, if the large country has the capacity to intervene in the political life of the small country, the incumbent may want to use foreign rents strategically, so as to secure some external support. Such support is motivated by the perspective of a conflictual relation between the large country and a successful challenger: crucially, this conflict is fueled by both economic nationalism and geopolitical adversity, but this second element is entirely driven by economic motivations. I solve for the equilibrium of the model and derive several predictions on the link between the small country's economic and political conditions and the capacity of the incumbent to entrench itself with external support. I argue that the theory can help understand why US foreign policy was largely detrimental to democracy during the Cold War,

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in sharp contrast with one of its most long-standing goals. I illustrate this using a few case studies. I conclude by suggesting that the model provides a good starting point for analyzing these issues in a broader context, as it lends itself to several simple extensions.

The paper adds to the political economy literature on democratization. This can be organized into two main strands, one that focuses on redistribution as a driver for democratization (e.g. Acemoglu and Robinson, 2006), another that postulates that it is economically profitable for the ruling group to share power with a broader sets of citizens, (e.g. Lizzeri and Persico, 2004).[3] I borrow the basic structure of the model from papers in the first group, but innovates on these by specifically looking at the case of foreign influence. To the best of my knowledge, the only paper to have done this before is Aidt and Albornoz (2009), who adapt the Acemoglu and Robinson (2006) model to account for foreign interventions. My paper shares one key element with this paper, namely the incumbent's advantage in committing to a better treatment for foreign investors. It is however quite different in at least two important respects. First, I present an alternative mechanism for why the elite cares about foreign investors, one that puts trade and reputation at centre stage. Second, while Aidt and Albornoz (2009) only look at the protection of foreign investors as a motivation for foreign intervention, I suggest a mechanism that relates protection to a broader set of geopolitical issues. Because of these different modeling choices, the two papers offer sets of results that are largely complementary to each other.

The paper is also related to two very recent strands of literature on foreign influence. The first is an empirical literature based on declassified CIA and KGB materials. Beside the above mentioned Easterly *et Al.* (2008) paper, the two other papers in this literature are Dube, Kaplan, and Naidu (2008) - who look at the effect of covert CIA interventions on the stock market performance of companies involved in the intervened country - and Easterly, Nunn, Satyanath, and Berger (2009), who look at the consequences of CIA interventions for the intervened country's trade relations. The second (to which the paper is more loosely related) is a theoretical literature who studies the efficiency implications of cross-border lobbying (Endoh, 2005; Aidt and Hwang, 2008a, 2008b; Antras and Padro, 2009; Bonfatti, 2010).

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[3]For a detailed discussion of the literature on democratization, the interested reader is referred to Acemoglu and Robinson (2006). A very concise review of the literature using formal modeling can instead be found in Ticchi and Vindigni (2009).

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The paper is organized as follows. Section 2 provides an historical overview of the case of Latin America and sets out he key questions that I want to address. Section 3 develops the theory. Section 4 uses the theory to provide a general interpretation of the Latin American case, and to answer the key questions. Section 5 uses country studies to further illustrate this interpretation. Section 6 summarizes, discusses possible extensions and concludes.

2   Stylized facts and key questions

I begin by providing some background info on the pre-1945 history of representative institutions in Latin America, and on the strengthening of US influence over this period. I then describe how democracy evolved during the Cold War, and how US influence played a role in this. I conclude by setting out the key questions that my model wants to address.

2.1   Historical background

Most Latin American countries established representative institutions during the course of 19th century. These, however, remained firmly in the hands of a small elite of landowners and businessmen until the middle of the 20th century. In fact, a series of electoral restrictions prevented the masses from participating in election (see Hartlyn, 1994). Furthermore, with a few exceptions (such as Chile and Uruguay), these institutions remained very weak relative to the army, and could therefore be overthrown when they did not provide sufficient guarantees of social stability.

In the first half of the 20th century, however, the pressure for social and political change became increasingly strong. On one hand, since the 1890s, labour demonstrations and strikes became widespread. These were normally put down by the army, leading to violent clashes and bloodshed. On the other, from the 1920s onwards a large number of new radical parties were founded (see Angell, 1994), which set out to conquer power through the elite's representative institutions. These parties were very diverse in nature (they were communist, socialist, radical, populist, etc) but shared two common goals: the implementation of domestic redistributive reforms, and the adoption of a nationalistic stance towards foreign investors, which they saw as agents of foreign imperialism.

The first half of the 20th century was also the period in which the US

became extremely influential in Latin American affairs. This had roots in the expansion of the US as the leading political and economic power of the Western hemisphere. On the political side, US supremacy was embedded in the two key principles leading its foreign policy. The first, established by the Monroe Doctrine of 1823, stated that any attempt by a European power to colonize or otherwise interfere with states in the Americas would be taken as act of hostility by the US government. While challenged a few times in 19th century, the Monroe doctrine became largely inviolable by the first half of the 20th century (Brzezinski, 1992, p. 39). The second principle was established by the Roosevelt Corollary to the Monroe Doctrine (1904), and attributed to the US the right to intervene in the domestic affairs of a Latin American country where its investments would come under threat.

On the economic side, US influence was first of all the result of its increasingly important role as Latin America's trade partner. Since the 1860s, the Latin American economies relied heavily on the export of agricultural and mineral commodities or, where industrialization had already taken place, on imported intermediates and machinery.[4] In the first half of the 20th century, the US displaced Europe as Latin America's main trading partner, getting to absorb more than 50% of the trade of many countries by the early 1950s.[5] This made it very influential with the local elite, who controlled a large share of the land farmed for export agriculture and looked to foreign markets for its consumption patterns (see, for example, Feinberg, 1974, p. 31). The US also became the region's leading supplier of private capital: following to two periods of buoyant growth (1914-1929 and 1945-1960) the stock of US FDI grew to US$ 8.8bn by 1960, or almost 40% of all US direct investments outside North America.[6] In many countries, US investments came to dominate the local economy, expanding not only in agriculture and mining but also in manufacturing and utilities. Finally, the US became a leading source of intergovernmental loans and aid.

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[4]The key export commodities were temperate agricultural commodities in Argentina and Uruguay, tropical commodities such as sugar, tobacco, coffee and cocoa and bananas in Brazil, Colombia, Ecuador, Central America and the Caribbean, parts of Venezuela and Mexico. The key exporters of minerals where Mexico, Chile, Peru, Bolivia and Venezuela. Argentina, Mexico, Brazil, Chile and Colombia were the early industrializers.

[5]For example, the average share of the US in total exports and imports in 1950-1954 was 61% and 76% in Cuba, 66% and 45% in Ecuador, 26% and 56% in Venezuela, and 50% and 55% in Chile (Mitchell, 1989.)

[6]This share is much lower today (around 20%). Source: Historical Statistics of the United States, Millennial Edition on line.

In the first three decades of the century, the US intervened militarily in a number of Central American and Caribbean countries, to protect its investments along the lines of the Roosevelt Corollary[7]. Sometimes, these interventions were simply directed at physically protecting American investments during political turmoil. More often, however, the US participated actively in putting down rebellions, helping the local elite to maintain political stability. This pattern of interventionism came to a halt with the onset of the Great Depression, as the inflow of American investments virtually stopped and the Roosevelt Corollary was substituted by (Franklin D.) Roosevelt's "Good Neighbor Policy". This was just a temporary interruption, though.

2.2 US influence and the Cold-War history of democracy in Latin America

After 1945, two key political developments took place. On one hand, the new reformist parties managed to push through electoral reforms that greatly increased voter turnout in most Latin American countries (Hartlyn, 1994, pp. 130-131), and political mobilization increased dramatically. In several countries, the reformists were able to go to power after obtaining an electoral victory: this was for example the case of Guatemala (1945), Venezuela (1944), Costa Rica (1948) and Bolivia (1952). Because of the economic nationalism of the reformist parties, this increased electoral competition brought fresh uncertainty for American investors, and renewed tension with the US government. In Guatemala, for example, American land holdings were expropriated with little compensation. In Venezuela, the government took a series of landmark measures that reduced the privileges of the American oil companies.

On the other hand, the Cold War created a second key tension between the reformist parties and the US government. Initially, the Cold War touched Latin America only marginally, as the key front was Europe and the death of Stalin (1953) put the USSR on the defensive for a few years. With the advent of Khrushchev (1958), however, a distinctively new phase started, one in which "Eurasia was still the central stake but no longer the central front",

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[7]For example, the US sent troops to Cuba (1906-1909, 1912, 1917-1933), Dominican Republic (1903-1904, 1914, 1916-1924), Guatemala (1920), and more than five times in Honduras and Guatemala.

as the Soviet leadership had decided that "Containment was to be defeated by encirclement", (Brzezinski, 1992, p. 38). In this crucial phase - which lasted until about 1979, when the USSR shifted its attention to Afghanistan and Eastern Europe, as well as to internal problems - superpower competition had a significant impact on political evolutions in Latin America.

As part of its plan to "encircle" the West, the USSR launched a large-scale effort to secure alliances in the region. This included the strengthening of ties with communist parties and guerrilla groups, as well as the provision of economic support to governments that rejected American influence. Just how dangerous this could be for US geopolitical interests became soon clear: within three years from the Cuban Revolution (1959) - and one year since Castro had completely nationalized American investments in the island - Soviet ballistic missiles were installed at a short distance from US territory, sparking one of the most dangerous crises of the entire Cold War. Crucially, Soviet activism increased the American diffidence for many reformist leaders with radical views. Whether they were communist or not, these came to be seen as not only a threat to American investors, but also a geopolitical threat.

As its economic and geopolitical interests came under threat, the US intervened a large number of times to tilt the local political balance in favor of conservative/centrist governments. This pattern of interventionism intensified markedly in the 1960s and 1970s, when Cold War competition was at its highest. Among the intervention tools used were aid paid to conservative/centrist governments, trade or aid sanctions against radical governments, and covert CIA interventions to influence the results of elections, support or organize military coups, fight guerrillas, etc. Because many of the radical reformist parties were electorally quite successful, these interventions went systematically against the consolidation of democracy. The most striking examples of this are the coups in Guatemala (1954) and Chile (1973). On the wake of American interventionism, the 1960s and 1970s witnessed a broad reversal of the pattern of democratization that had started after the war. The only three marked exceptions[8] to this were Costa Rica, where democracy was in place since 1946, and Colombia and Venezuela, which became relatively democratic in the early 1960s and remained steadily so through the rest of the Cold War.

The pattern of US interventionism in Latin America is illustrated in the

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[8]Excluding Jamaica, who remained a British colony until 1962.

following figure, which reports the CIA intervention measure constructed by Easterly *et Al.* (2010). The authors use recently declassified CIA material to construct an indicator variable that equals one in all country-year observations where the CIA either installed or supported the leader of a foreign country in office.[9] In the figure, I report the number of Latin American countries where this variable is one in any given year. The series clearly shows that the number of interventions jumped up after 1960, to fall significantly only towards the end of the 1970s. The figure also reports the average Polity IV democracy score for all Latin American countries. This is a variable that takes value between 0 and 10, where 0 is least democratic and 10 is most democratic. Particularly for the case of South America, the series confirms that the intensification of US interventionism in the 1960s and 1970s was matched by a sharp decline in the average level of democracy. This interrupted a positive democratization trend started immediately after World War 2. This finding is consistent with the finding, by Easterly *et Al.* (2008), that CIA interventions around the world had a negative impact on democracy, both in the short run and in the long run.

2.3 Three key questions

At least since Wilson (1913-1921), a recurrent principle of US foreign policy has been that exporting democracy is good, because it stabilizes international relations and increases business opportunities (see Smith, 1994). We would then expect that, on average, US foreign policy should be supportive of democratization attempts throughout the world. While this has been true in a number of occasions during the 20th century, the fact described above suggest that the US went systematically *against* the democratization of Latin America in the 1960s and 1970s. The basic question that we need to address is then why was this so? In other words, why was democracy a threat to US interests in those specific circumstances?

At some level, it is clear from our previous discussion that economic nationalism had a key role. Because this happened to be very strong with the radical parties that were likely to dominate elections, democracy was a direct threat to American investments in Latin America. But this takes us to our first key question: was it just accidental that the radicals were

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[9]They also have a more narrow measure that only looks at cases in which the CIA installed a leader. This follows a pattern similar to that of the broader measure.
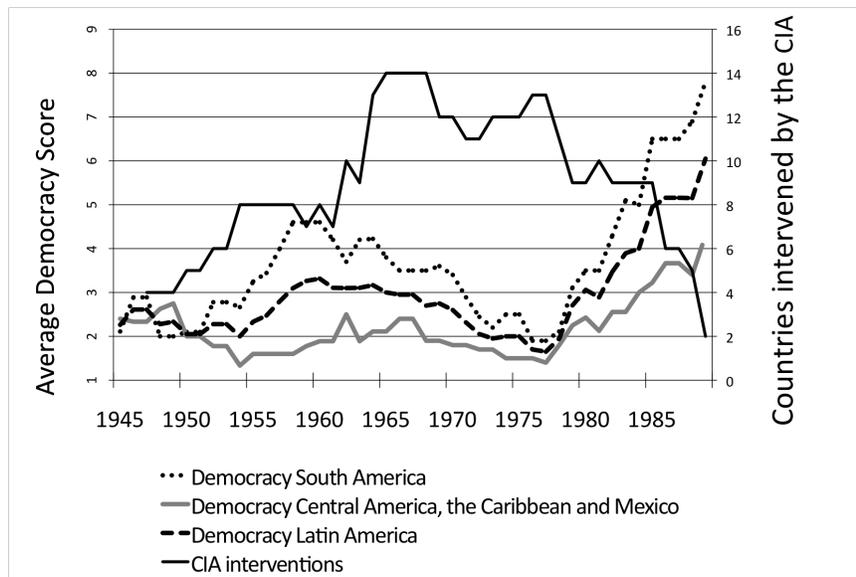
Figure 1: CIA interventions and democracy in Latin America, 1945-1989

Sources: Polity IV (democracy), Easterly, Nunn, Satyanath and Berger (2010) (CIA interventions).

so more nationalistic than the elite, or was this related to the underlying democratization process? And more in general, under what conditions can we expect democracy to lead to nationalistic policies against foreign investors?

Our previous discussion also highlighted the role of the Cold War. Namely, the radical parties were seen as more likely to switch side to the Soviet Union, implying a large geopolitical cost for the US. This explanation is consistent with the fact that American interventionism was most intense - and the fate of democracy bleakest - when Cold War competition was strongest (Figure 1). But then a second key question is: why were the radical parties less willing to (or able) to sign up for a geopolitical alliance with the US? After all, both proximity and for economic complementarity seemed to make this a natural alliance. Notice that ideology is all but a satisfactory answer: many of the most successful reformist parties where not communist, nor did they entertain close ties with Moscow (Angell, 1994). In fact, many of them were opposed to communism in the 1960s and 1970s.

While American interventions in the 1960s and 1970s were mostly detrimental to democracy, we have mentioned a few exceptions. In Colombia, Venezuela and Costa Rica, US foreign policy actively supported the consolidation of democracy. In the case of Venezuela, this was despite the nationalism of the key reformist party (*Alianza Democratica*) which led in 1976 to the nationalization (with little compensation) of the American oil companies. My final question is then: what explains the different experience of these countries?

In the next question, I set up a model that will help us interpret the facts described in this section, and provide an answer to these questions.

3   Model

The section is organized as follows. I begin by modeling a distributional conflict between an incumbent group and a challenger in a small open economy (3.1). I then introduce the possibility that the incumbent may exchange rents to foreign investors for protection from the government of a large trading partner, who may also be competing with a second large country for geo-political predominance in the area (3.2). Crucially, the actions of the trading partner are constrained by the need to preserve a reputation of intransigence towards expropriation (3.3). After summarizing the timing of the model (3.4), I solve for the equilibrium (3.5), and conduct some comparative

statics (3.6). I conclude the section by looking at the welfare consequences of foreign influence (3.7).

3.1   Domestic economy and politics

There is a small country, Home (H), which is populated by a continuum of citizens with mass 1. The economy of this country is such that it generates aggregate (transferable) utility $Y + Y^*$ for its citizens. While Y is not affected by the country's external relations ("autarchy utility"), Y^* relies on a peaceful relations with two large trade partners, A and B ("gains from trade"). I normalize Y^* to 1.

Citizens are split into two groups, called a and b. The two groups have mass δ and $1 - \delta$ respectively. Within each group, citizens are identical. In the aggregate, the two groups initially own Y_a and Y_b of autarchy utility (thus, $Y_a + Y_b = Y$), while trade utility is entirely owned by group a. Thus, group a is more "outward-oriented" than group b.[10]

Initially, group a is in power. However group b can overthrow a at a stochastic, aggregate cost μ. The cost μ is distributed as a uniform over the interval $[0, M]$, with M high enough (so that there is always a positive probability that a is overthrown). This cost does not depend on any other parameter in the model (but notice that I always keep the size of the economy constant at $Y + 1$). If b goes to power, it can change policy in such a way that a looses $X < Y_a$ of its autarchy utility, and its entire trade utility.[11] This results in a gain $\gamma(X + 1)$ for b, where $\gamma \in (0, 1)$ captures the distortions associated with redistribution. Notice that even for γ very close to 1, there is an amount $Y_a - X$ of a's autarchy utility that is non appropriable by b. This could reflect, for example, the existence of non-excludable public goods.

Before the cost of revolution is realized and b decides whether to overthrow a or not, a may decide to award rents R to investors from A. These have an equal cost for all citizens. For example, mineral concessions may be granted to companies from A at excessively favorable terms, therefore decreasing the public funds available for financing various public goods. Alternatively, companies from A may be favored in the allocation of various public contracts, from the management of utilities to the procurement of various government

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[10]To assume that group b owns a share of Y^* does not change qualitatively the results of the model.

[11]To assume that only $X^* < 1$ is lost by a would complicate the analysis without undermining the main results of the model.

purchases. More in general, the government may discriminate in favor of A's companies or goods, therefore creating a loss from reduced competition that is widely spread across the economy.

After rents have been allocated, the cost of revolution realizes. Before b makes a decision on whether to overthrow a or not, A may decide to intervene to hinder b's ascent or consolidation into power. The most intuitive way to think about this is direct military help to the ruling government. However A's intervention may also take the form of economic assistance, for example a loans in the middle of a crisis. I assume that if A invests c to this purpose, the cost of revolution increases to $\mu + c$.

After a revolution decision has been made, whoever is in power may decide to expropriate A by imposing a tax τ on R. For simplicity, I assume that τ is non distortionary, and that it can only take value 0 (no expropriation) or 1 (expropriation).

Assume that citizens within each group are identical. Then, if rents R have been granted, the per capita utility of the two groups in the two political regimes is:

$$y_a(a) = \frac{Y_a + 1}{\delta} - R[1 - \tau(a)]$$

$$y_b(a) = \frac{Y_b}{1 - \delta} - R[1 - \tau(a)]$$

$$y_a(b) = \frac{Y_a - X}{\delta} - R[1 - \tau(b)]$$

$$y_b(b) = \frac{Y_b + \gamma(X + 1) - \mu - c}{1 - \delta} - R[1 - \tau(b)]$$

Where $y_i(j)$ denotes the per capita utility of a citizen from group i when group j is in power, and $\tau(j)$ is the expropriation level chosen by group j when in power.

The ex-ante (per capita) welfare of the two groups is:

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$$W_H^a = (1 - \pi) \left(\frac{X + 1}{\delta} - R[\tau(b) - \tau(a)] \right) + y_a(b) \tag{1}$$

$$W_H^b = \pi \left(\frac{\gamma(X + 1)}{1 - \delta} - R[\tau(a) - \tau(b)] \right) + y_a(a) \tag{2}$$

where π is the (endogenous) probability that b overthrows a. Before proceeding, I make the following key assumption:

Assumption 1

$$\frac{1}{\delta} > \frac{\gamma}{1 - \delta}$$

Assumption 1 requires that a successful challenger group has a lower per capita trade utility than the incumbent group had *when in power*. This could be the case for two reasons: first, group a may be much smaller than group b (δ low), so that the importance of trade utility gets diluted upon b's advent to power, despite the fact that trade utility is fully re-distributed. Second, trade utility could be very inefficient to redistribute, so that not much is left for b to care about (γ low). Both reasons may be valid in the case of Latin America in the 1950s and 1960s. There, on one hand, the value of export crops was largely captured by a handful of landed elite, as was the gain from consumption of luxury import goods; on the other hand, the new industrial sector - that relied on imported intermediates - was probably quite hard to expropriate.

3.2 International economy and politics

The world outside H is made up of two large countries (A and B). As mentioned above, a can affect A's payoff by awarding it rents R. After the revolution decision is made, however, whoever is in power may decide to re-appropriate A's rents. At the same time, however, A can impose economic sanctions against H, therefore destroying its trade utility. Thus, sanctions have a cost 1 for H. They also have a cost $\beta > 0$ for A.

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Besides allocating rents to A (and possibly expropriate them later on) H can affect the two large countries' payoffs by choosing its geopolitical alignment σ. This is chosen after the expropriation and sanctions decision, and can be set to $\sigma = A$ (when H allies itself to A), or to $\sigma = B$ (when it allies with B). The payoffs to A (B) in the two cases are S and 0 (0 and S) where S is the strategic value of H. I assume that the alignment decision has no impact on H's payoff.

When A imposes sanctions against H, B can alleviate their cost by $1 - \phi$, where $\phi \in [0, 1]$. Thus, by resorting to B, H can reduce the cost of sanctions to ϕ. For simplicity, I assume that B can alleviate sanctions at no benefit nor cost. I also assume that for B to be willing to alleviate the cost of sanctions, H must set $\sigma = B$. When sanctions are not imposed, on the contrary, the choice of σ has no effect on H's payoff. There are at least two ways in which this assumption could be justified. First, it could be that H auctions off its geopolitical alignment to the highest bidder. In such an auction, no bidder could outbid the other when sanctions are not imposed, but B would certainly outbid A when sanctions are imposed. This is because B would be in the position of alleviating sanctions at no cost. Alternatively, it could be that the threat of sanction itself is what induces H to aligns itself with A, in that this latter country has a higher capacity than B to create trade disruption in H. Once this capacity has been used, however, B would always have the upper hand, by using the threat of not mitigating sanctions.

To summarize, the payoffs of A and B are:

$$W_A = I(\sigma = A)S + (1 - \tau)R - I(\Gamma = 1)\beta - c \tag{3}$$
$$W_B = I(\sigma = B)S \tag{4}$$

Where Γ takes value 1 if sanctions are imposed, 0 otherwise.

3.3 Expropriation and sanctions: a reputation game

While A can threaten sanctions against an expropriating H, the fact that $\beta > 0$ makes sure that these are never ex-post optimal. In the case of Latin American countries like Cuba or Chile, however (as in many other real world

cases), US sanctions were indeed enforced because of a need by the US to build a reputation as a punisher of expropriating countries. This need was motivated by the ramification of US interests in the American continent, and the risk that other countries could follow suit had the expropriation by these countries not been punished. In this subsection, I enrich the model with a simple reputation game where the threat of sanctions may become credible. The role of this is to uncover a link between the functioning of foreign influence and the parameter β, through the credibility of sanctions.

Suppose that agents estimate that with some small probability p A is "ideological". An ideological A is identical to a "normal" A, except for the fact that it receives a high exogenous benefit $g > S$ from imposing sanctions against an expropriating H. Next, suppose that there are other n small countries, that are identical to H except for the fact that a is firmly entrenched in power, A's rents have been set to some value $\overline{R}$ everywhere, and the cost to A from imposing sanctions is fixed at some low value $\overline{\beta} < g - S$. This captures well the case of Latin America, where US interests were dispersed in a series of small, elite-controlled countries, often in competition among each other to sell agricultural products on the US market.

After H has decided whether to expropriate A or not, A has decided on sanctions against H, and H has possibly secured B's commercial support by setting $\sigma = B$, the "reputation game" takes place. This may extend over up to n periods, and unfolds as follows:[12]

- In period 1, if none of the n countries wants to expropriate, nothing happens, and the game ends. Otherwise, one of the others may expropriate, A may impose sanctions against it, and this may obtain B's help after setting $\sigma = B$.

- In period $s = 2, ..., n$, nothing happens if the game has ended at some earlier period. Otherwise, the same events as in period 1 take place.

3.4   Timing

The timing of the overall game is as follows:

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[12]I could have alternatively modeled this as a infinite horizon game, where the events that regards H take place at period t and at all subsequent periods one of the countries who has not yet expropriated may do so. This, however, would have complicated the structure of payoffs for no additional insight.

1. a awards rents R to A;

2. Nature picks the cost of revolution μ; A observes this, and invests c to increase the cost to $\mu + c$;

3. b decides whether to overthrow a or not;

4. Whoever is in power decides whether to expropriate A ($\tau = 1$) or not ($\tau = 0$);

5. A decides whether to impose sanctions against H, and H sets σ. In the presence of sanctions, H must set $\sigma = B$ to obtain B's help. Otherwise, the choice of σ has no consequences on H's payoff.

6. The reputation game takes place.

7. All payoffs realize.

3.5   Equilibrium

I solve for the equilibrium using backward induction.

Period 6. The role of the reputation game is to derive conditions under which it is optimal for A to impose sanctions against an expropriating H. Because this part of the model has nothing innovative (being largely based on Kreps and Wilson, 1982, and Milgrom and Roberts, 1982) and its technicalities are largely extraneous to the main argument of the paper, I keep the details in the Appendix. Here, I limit myself to describing the main result of the model, and its intuition.

The key assumption of the model is the existence of an ideological version of A, which receives a high enough benefit from punishing expropriation ($g > S$). As long as the economic cost of imposing sanctions is low (and we are assuming $\overline{\beta} < g - S$), the ideological A can be expected to impose sanctions no matter what. Given this, A may want to impose sanctions in order to build a reputation as ideological, and therefore discourage expropriation in other countries. Thus, reputation considerations increase the probability of sanctions above p; and because the value of reputation is increasing in the number of observing countries, the probability of sanctions is highest in the case of the country who expropriates first. But when this probability is high enough - because the overall number of countries is large enough - no

country ever want to *be* first, therefore creating an equilibrium where no one expropriates. If n is large enough, such an equilibrium exists no matter how small is p. This result is reported in Lemma 1:

Lemma 1 *For any arbitrarily small p, there exists a finite $\overline{n}$ such that if $n > \overline{n}$ and no info on the type of A can be extracted from previous rounds, the reputation game ends immediately (none of the countries expropriates). In this case:*

- *If $\beta + S < g$, the unique equilibrium is one where A imposes sanctions against an expropriating H;*

- *If $\beta + S > g$, two equilibria exists, one where A imposes sanctions against an expropriating H, one where it does not.*

The second part of Lemma 1 considers how reputation affect the attitude of A towards expropriation in H. As in the case of all countries where its actions are under scrutiny, A does not want be recognized as non ideological in its response to H. Indeed, because H comes very first in the chain of potential expropriations, A is *always* willing to impose sanctions in this country, provided that these are needed to mask its non-ideological status. Here comes the key point, as sanctions turn out to not always be needed in the case of H. Remember that the cost of sanctions is allowed to take on different values in this country. When the cost is high ($\beta > g - S$), H is strong enough that the ideological type itself would not enjoy punishing it: this generates an equilibrium where A is able to not impose sanctions, and still defend the anonymity of its status.

Thus, the main result of the reputation game is that when enough many countries are watching, the threat of sanctions is always credible when their cost is low. When their cost is high, the threat can or cannot be credible, depending on the equilibrium we are in. In the rest of the paper, I show that the credibility of sanctions may have quite important consequences for the political economy of H. Before moving on, however, I restrict the model to focusing on the case where reputation is very important:

Assumption 2: $n > \overline{n}$.

This fits rather well the case of the US, whose investors had ramified rents in Latin America in the 1950s and 1960s. That reputation was a key element

driving US policy in those years is evident from a number of facts, including the reaction to expropriation in Cuba and Chile and the passing of legislation that forced the President to cutoff aid to countries who expropriated US investments.[13]

Period 5. Whenever sanctions are imposed, it is strictly optimal for whoever is in power to set $\sigma = B$. On the contrary, when there are no sanctions the government of H is perfectly indifferent on its choice of alignment: in this case, I assume that all governments set $\sigma = A$.[14]

Period 4. When we are in an equilibrium with no sanctions, it is clearly optimal for whoever is in power to set $\tau = 1$. When we are in an equilibrium with sanctions, instead, the government sets $\tau = 1$ if and only if the benefits from expropriation are higher than the cost from sanctions. If a is still in power, this requires that:

$$R > \frac{\phi}{\delta} \equiv \overline{R} \tag{5}$$

If, instead, b has replaced a, the requirement is:

$$R > \frac{\phi\gamma}{1 - \delta} \equiv \underline{R} \tag{6}$$

Notice that, under Assumption 1, $\underline{R} < \overline{R}$. This implies that the two groups have a similar attitude towards expropriation for $R < \underline{R}$ and $R > \overline{R}$ - neither of them expropriates in the first case, they both do in the second case - while they differ for $\underline{R} < R < \overline{R}$, with b being pro-expropriation and a pro-foreigners.

Period 3. At this stage, b decides whether to overthrow a or not by comparing the benefit and cost of this. In an equilibrium with no sanctions, the condition for revolution to take place is:

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[13]This was the famous Hickenlooper Amendment of 1962.

[14]This can be rationalized by arguing that the ideological A could also receive a benefit from punishing a country that, while not expropriating, aligns itself with B.

$$\gamma(X + 1) > \mu + c \tag{7}$$

Condition (7) says that b overthrows a if and only if the aggregate gain from domestic redistribution is higher than the aggregate cost from revolution. Notice that the gain from revolution does not depend on R, as revolution brings no policy gain in the domain of expropriation.

Consider now an equilibrium with sanctions. If $R \leq \overline{R}$ (as will be the case in equilibrium), the revolution condition becomes:

$$\gamma(X + 1) + \max[0, (1 - \delta)R - \phi\gamma] > \mu + c \tag{8}$$

The gain from revolution is now the sum of domestic redistribution and a potential gain from expropriation. Looking at (5), it is easy to see that the latter is strictly positive if and only $R \in [\underline{R}, \overline{R}]$. This reflects the fact that, for these intermediate values of rents, revolution becomes a way to impose domestic redistribution *and* a change in policy towards foreign investors. When the level of rents is low, on the contrary ($R < \underline{R}$), the two groups agree on a pro-foreigners stance, and revolution returns to be a purely domestic matter (as it would do when $R > \overline{R}$, as the two parties would then agree on full expropriation).

Thus, while in an equilibrium with no sanctions revolution is only motivated by redistributive considerations, in an equilibrium with sanctions it may be motivated by a conflict over policy towards foreign investors. This resonates well with the case of Latin America in the 1950s, when the key redistributive issue that motivated the opposition to the ruling elite was often intertwined with a conflicting view over economic nationalism. There, the ruling group was blamed for being, out of self-interest, too lenient towards US investors. However beside animating the opposition to the ruling elite, economic nationalism was a key source of tension between the Latin America opposition groups and the government of the United States, whose political influence played a key role in the region. To the study of this tension I now turn.

Period 2. When μ is low enough to result in a revolution, A may choose to intervene to try and keep a in power. For this to be attractive to A, however, it must have a reason to prefer the rule of a to the rule of b. Clearly, in an equilibrium without sanctions, A has no reason to do so, as both parties can be expected to expropriate. Similarly, in an equilibrium with sanctions A has no strict preference for a when $R < \underline{R}$ or $R > \overline{R}$. Thus, in all these cases A sets $c = 0$. Plugging this in (7) and rearranging, the condition for revolution to take place becomes:

$$\mu < \gamma(X + 1) \tag{9}$$

Clearly, the probability that b overthrows a does not depend on R in this case, as rents neither affect the incentives of b to revolt nor induce A to take a's side in domestic politics.

When we are in an equilibrium with sanctions and $R \in [\underline{R}, \overline{R}]$, on the contrary, A has two good reasons to strictly prefer a to b: first, it can be expected that A's rents are safe under a, while they would be expropriated under b's rule. Second, because reputation obliges A to react to expropriation with sanctions, it can also be expected that b will turn its foreign policy alignment to b. The overall loss to A from a change in regime is then $R + \beta + S$, and this is also the maximum that A is willing to spend to keep a in power. Plugging $c = R + \beta + S$ in (8), we find the maximum μ for which revolution takes place, $\overline{\mu}$:

$$\mu < \gamma(X + 1) - \delta R - \phi\gamma - \beta - S \equiv \overline{\mu}(R) \tag{10}$$

Because $\overline{\mu}$ is decreasing in R, the probability that b overthrows a is now decreasing in the amount of rents granted to A. This result may be unexpected, considered that, as we saw above, rents may have an inflammatory impact on revolutionary activity. However two opposite effects are now at play. On one hand, rents do increase the prize from revolution, therefore making revolution more attractive. On the other hand, rents increase the effort put by A in keeping a in power, making revolution harder to accomplish. Because the benefit of expropriation are not fully appropriated by b,

however (they are equally spread across the population) an increase in rents increases the prize from revolution by less than it increases A's willingness to invest in counterinsurgent activities, ensuring that the second effect always dominates.[15] This result suggests that the concessions of rents to American investors could represent a tool of entrenchment for the Latin American elite, despite the fact that it created further discontent among the people.

It is useful to summarize the these results in a proposition:

Proposition 1 *A helps a remain in power if and only if we are in an equilibrium with sanctions, and $R \in [\underline{R}, \overline{R}]$. In this case, the probability that b overthrows a is decreasing in R.*

Proposition 1 implies that the incumbent group may want to strategically set $R \in [\underline{R}, \overline{R}]$ when we are in the equilibrium with sanctions, so as to induce A to take its side in the domestic struggle for political power. This is possible because, under Assumption 1, a has a *commitment advantage* over b, in that it is more sensitive to the conditions of the international economy than b while in government. Having established the relation between R and the probability that a remains in power, I close the model by studying the optimal choice of R in period 1.

Period 1. I begin this section by introducing a final assumption:

Assumption 3

$$\gamma(X + 1) > \phi(1 + \gamma) + \beta + S \tag{11}$$

The assumption asks that the redistributive considerations pushing for regime change $(\gamma(X + 1))$ are strong enough relative to the international determinants of the maximum size of A's intervention $(\beta + S)$. This seems

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[15]Notice that, even if b was able to fully appropriate the benefit from expropriation, a's security in power could still be higher when some rents are granted. To see this, notice that when $R = \underline{R}$ expropriation has value zero, but A is still willing to spend up to $\underline{R} + \beta + S$ to defend a.

plausible in the context of 20th century Latin America, where wealth inequality was huge and redistribution the key goal of the radical opposition parties. As I will clarify shortly, the role of Assumption 3 is to rule out an equilibrium where foreign influence leads to a zero probability that a is overthrown.

In what follows, I will show that there are two types of equilibrium path one of which has foreign influence. I begin by laying out the properties of each path and will then discuss when each of them comes about.

The first equilibrium path has no foreign influence. It has the following properties:

Equilibrium path with no foreign influence:

- a sets $R = 0$;

- A does not support a in power;

- b goes to power when $\mu < \overline{\mu}(0)$, which happens with probability $\overline{\pi} = \frac{\gamma(X+1)}{M}$;

- Whoever is eventually in power aligns itself with A.

The second equilibrium path has foreign influence, and has the following properties:

Equilibrium path with foreign influence

- a sets $R = R^*$, where:

$$
R^* = \begin{cases} \underline{R} & \text{if } \widetilde{R} \leq \underline{R} \\ \frac{[(1+\gamma)(X+1)-\gamma\phi-M-S-\beta]}{2\delta} \equiv \widetilde{R} & \text{if } \widetilde{R} \in (\underline{R}, \overline{R}) \Big/ \\ \overline{R} & \text{if } \widetilde{R} \geq \overline{R} \end{cases} \tag{12}
$$

- A supports a in power whenever there is need, and up to a maximum expenditure $R^* + \beta + S$;

- b goes to power when $\mu < \overline{\mu}(R^*)$, which happens with probability $\underline{\pi} < \overline{\pi}$:

$$
\underline{\pi} = \begin{cases}
\overline{\pi} - \dfrac{\frac{\phi\gamma}{1-\delta} + \beta + S}{M} & \text{if} \quad R^* \leq \underline{R} \\[3ex]
\overline{\pi} - \dfrac{\phi\gamma + S + \beta + (1+\gamma)(X+1) - M}{2M} & \text{if} \quad R^* \in (\underline{R}, \overline{R}) \\[3ex]
\overline{\pi} - \dfrac{\phi(1+\gamma) + \beta + S}{M} & \text{if} \quad R^* \geq \overline{R}
\end{cases}
\tag{13}
$$

- If a remains in power, it does not expropriate and aligns itself with A; if b goes to power it expropriates and aligns itself with B.

The two paths have very different properties. On the path without foreign influence, the incumbent does not seek foreign support, and regime change is not affected by external interventions. In this case, the challenger stages a revolution when the gain from domestic redistribution is larger than the cost of confronting the incumbent. This maps into a probability $\overline{\pi}$ of regime. Along this path, the international relations between H and A are always good: this is because sanctions are never an issue (there are no rents to be expropriated), and no group has any reason not to align itself with A. On the path with foreign influence, on the contrary, the incumbent awards an amount of rents (R^*) to A. This amount is such that the incumbent, but not the challenger, can commit not to expropriate rents in the future. This induces A to intervene in support of the incumbent. In this case, revolution takes place when the prize from redistribution *and* expropriation is larger than the cost of confronting the *joint* forces of the incumbent and A. As we might expect from Proposition 1, this reduces the probability of regime change to $\underline{\pi}$. Along this path, the international relations between H and A are good if the incumbent remains in power. If the incumbent is overthrown, on the contrary, relations with A are conflictual, as the challenger is hit by trade sanctions and aligns itself with B.

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Plugging Assumption 3 in the expression for $\underline{\pi}$ when $R^* = \overline{R}$ reveals that the role of this assumption is to avoid $\underline{\pi}$ going to zero, a case that I want to avoid because of its scarce realism. An obvious substitute of Assumption 3 would have been to model the return to foreign interventions as sufficiently decreasing in the size of the intervention. This, however, would have required giving up the linear structure of the model, a complication that would bring no additional insights. I thus prefer to stick to Assumption 3 in what follows.

The key results of the paper are presented in Proposition 2:

Proposition 2 *Define the following condition:*

$$\beta + S > \phi\gamma \frac{\delta M - (X+1)(1+\delta\gamma) + \frac{\phi\gamma\delta}{1-\delta}}{(1-\delta)(X+1) - \delta\phi\gamma} \tag{14}$$

Then, under Assumption 1-3:

1. *If condition (14) is not satisfied, the unique equilibrium path is without foreign influence.*

2. *If condition (14) is satisfied, the unique equilibrium path is with foreign influence if $\beta + S < g$; it may be with or without foreign influence if $\beta + S > g$.*

Proof. From Lemma 1, we know that equilibria can be of two types: one where A adopts a strategy of reacting to expropriation with sanctions, and one where it adopts a strategy of not reacting (notice that expropriation can remain an off-equilibrium event in both cases). Begin by considering the first type. From Lemma 1, at least one such equilibrium always exists. The first step is to show that, if the optimal choice of R is 0 or R^*, the equilibrium path look exactly like in our two cases. This follows immediately from our backward induction, and from the fact that by plugging R^* and $\overline{\mu}(.)$ in:

$$\Pr\{\text{a is overthrown}\} = \Pr\{\mu < \overline{\mu}(R)\}$$
$$= 1 - \frac{\overline{\mu}(R)}{M}$$

one derives $\underline{\pi}$ as in equation (13).[16] The next step is to show that, in this type of equilibrium, 0 and R^* are, indeed, the only two possible optima. Furthermore, we need to show and that R^* is the optimum when condition (14) is satisfied,0 is the optimum when it's not. The maximand of a is:

$$\Delta W_H^a(R) = \begin{cases} \left(1 - \frac{\overline{\mu}(R)}{M}\right)\left(\frac{X+1}{\delta} - R\right) + y_a(b) \equiv \Phi(R) & \text{if } R \in (\underline{R}, \overline{R}) \\[2mm] \left(1 - \frac{\gamma(X+1)}{M}\right)\left(\frac{X+1}{\delta} - R\right) + y_a(b) \equiv \Psi(R) & \text{if } R \notin (\underline{R}, \overline{R}) \end{cases}$$

I will now separately derive the maximum of $\Phi(R)$ and $\Psi(R)$ and compare them. Because $\Psi(R)$ is strictly decreasing in R, its unique maximum is $R = 0$. As for $\Phi(R)$, its strict concavity[17] ensures that it also admits a unique maximum. Its unconstrained maximum is found by plugging in $\overline{\mu}(.)$ and maximizing with respect to R. This yields:

$$\widetilde{R} = \frac{1}{2\delta}\left[(1+\gamma)(X+1) - \gamma\phi - M - S - \beta\right]$$

The constrained maximum is then:

$$R^* = \begin{cases} \underline{R} & \text{if } \widetilde{R} < \underline{R} \\ \widetilde{R} & \text{if } \widetilde{R} \in [\underline{R}, \overline{R}] \\ \overline{R} & \text{if } \widetilde{R} > \overline{R} \end{cases} \tag{15}$$

Having found the two maxima, I now derive a sufficient and necessary condition for $W_H^a(R^*) > W_H^a(0)$, or $\Phi(R^*) > \Psi(0)$. Clearly, $\Phi(\underline{R}) > \Psi(0)$ is sufficient. But this condition is also necessary: this is immediately evident for the case $R^* = \underline{R}$; but when $R^* > \underline{R}$, it is always $\Phi(\underline{R}) > \Psi(0)$, as $\Phi(R^*) > \Phi(0)$ (by concavity) and $\Phi(0) > \Psi(0)$ (because $\overline{\mu}(0) < \gamma(X+1)$). We can write the condition $\Phi(\underline{R}) > \Psi(0)$ as:

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[16]All calculations for this proof are in the Appendix.
[17]This is also shown in the Appendix.

$$\left(1 - \frac{\overline{\mu}(\underline{R})}{M}\right)\left(\frac{X+1}{\delta} - \underline{R}\right) > \left(1 - \frac{\gamma(X+1)}{M}\right)\frac{X+1}{\delta}$$

Plugging in $\overline{\mu}(.)$ and $\underline{R}$, this becomes:

$$\beta + S > \phi\gamma\frac{\delta M - (X+1)(1+\delta\gamma) + \frac{\phi\gamma\delta}{1-\delta}}{(1-\delta)(X+1) - \delta\phi\gamma}$$

which is the same as condition (14). Thus, we have shown that an equilibrium of the first type - where A adopts a strategy of reacting to expropriation with sanctions - always exists, and this generates our equilibrium path with foreign influence if condition (14) is satisfied, without foreign influence otherwise.

From Lemma 1, an equilibrium of the second type - where A adopts a strategy of not retaliating - exists iff $\beta + S > g$. Clearly, in any such equilibrium the equilibrium path must be identical to our equilibrium path without foreign influence. Thus, even if condition (14) is satisfied the equilibrium path without foreign influence may realize, if $\beta + S > g$. This completes the proof. ■

Proposition 2 admits an intuitive explanation. The key decision for the incumbent is whether to seek foreign protection, or not. From our previous discussion, we know that foreign protection can be obtained if and only if A has a strategy of retaliating to expropriation, and rents have been set in the interval $R \in [\underline{R}, \overline{R}]$. While an equilibrium where A retaliates to expropriation always exists (Lemma 1), a may or may not want to seek foreign protection depending on its cost. In turns out that the optimal way of securing foreign protection is to set $R = R^*$, and that this leaves the incumbent better off than without foreign protection if and only if condition (14) is verified. In other words, there always exists an equilibrium where a may obtain foreign protection, and this puts the country under foreign influence if and only if a *wants* foreign protection. Such an equilibrium is not unique, however: from Lemma 1 we know that, if $\beta + S > g$, there also exists an equilibrium where A does not retaliate to expropriation. In this case, foreign protection cannot be obtained, and the equilibrium path must be without foreign influence.

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In other words, the incumbent is unable to put the country under foreign influence even if it would like to do so.

Many Latin American countries during the Cold War fit rather well the conditions for a country to fall under foreign influence. On one hand, the conditions for the ruling elite to seek foreign protection (as outlined in conditions (14)) were largely in place. First, the elite could rely on a large strategic importance of their countries, at a time when protection of the Americas from a Soviet penetration was a key geopolitical goal for the US. Second, the elite was increasingly under the siege of a rising leftist opposition, had immense fortunes to be lost in a political transition, and was almost always very small. On the other hand, the weak relative economic positions of most Latin American countries - as well as the actual experiences of few of them - suggest that US-Latin America relations were characterized by the need for the US to impose sanctions against expropriation. Thus, if this model is correct, we would expect the Cold War experience of democratization in Latin America to be described by the equilibrium path with foreign influence. Indeed, this seems to fit rather well the stylized facts described in section 2. In the next section, I will bring further evidence in favor of this theory, by looking at the specific experience of a few countries. Before going to the case studies, however, I try to learn more about the equilibrium path with foreign influence by performing some comparative statics.

3.6   Predictions

In the previous section, I have shown that there exist two types of equilibrium path for a country like H, one of which has foreign influence. I have then derived the conditions under which each of these paths comes about or, equivalently, the country falls under foreign influence. In this section, I look at these conditions more closely, as well as at what determines the shape of foreign influence.

The incumbent group is strictly better off by putting the country under foreign influence when condition (14) is satisfied. This is the case when the amplification effect, $\beta + S$ - the extra support that a can expect to receive, on top any value of rents - is high enough. The critical threshold for the amplification effect is increasing in the size of the incumbent group and in the expected cost of revolution for the challenger (M), and increasing in the prize from domestic redistribution ($X + 1$). Notice that the threshold can be negative, in which case the incumbents asks for foreign support even if

the amplification effect is zero. Because the country never falls under foreign influence when condition (14) is not satisfied, we can then write our first prediction:

Prediction 1 - *A country like H is more likely to fall under foreign influence when the size of the incumbent group is small, the challenger has a low expected cost from revolution, and the prize from domestic redistribution is high.*

When condition (14) is satisfied, the country may still not fall under foreign influence if the cost of imposing sanctions against it is too enough $(\beta + S > g)$. This yields our second prediction:

Prediction 2 - *A country that would otherwise fall under foreign influence may not do so if the economic cost of imposing sanctions against it increases.*

The shape of foreign influence is defined by the amount of rents paid to foreign investors (R^*), the probability of foreign interventions $(\frac{R^*+\beta+S}{M})$, and the probability that the challenger goes to power and puts the country on a different geopolitical alliance $(\underline{\pi})$. Using equations (12) and (13), we can now easily work out how this shape depends on the key parameters of the model $(S, M, X$ and $\phi)$.

An increase in S always increases the probability of foreign interventions and decreases the probability that the challenger goes to power. It also decreases the optimal rent if $R^* \in [\underline{R}, \overline{R}]$. Thus, our third prediction is:

Prediction 3 - *When a country is under foreign influence, a higher strategic value of the country implies a higher probability of foreign interventions, and a higher entrenchment of the incumbent group. Furthermore, it may imply lower rents for foreign investors.*

A lower expected cost of revolution (M) and the higher prize from domestic redistribution $(X + 1)$ have the quite standard effect of making the incumbent less entrenched if $R^* \notin (\underline{R}, \overline{R})$. The opposite holds if $R^* \in (\underline{R}, \overline{R})$, however. This can be seen by working out the first derivatives of $\underline{\pi}$ in this case:

$$\frac{\partial \underline{\pi}}{\partial (X+1)}\Big|_{R\in[\underline{R},\overline{R}]} = -\frac{1-\gamma}{2M} < 0$$

$$\frac{\partial \underline{\pi}}{\partial M}\Big|_{R\in[\underline{R},\overline{R}]} = \frac{(1-\gamma)(X+1)+\phi\gamma+\beta+S}{2M^2} > 0$$

This result is due to the role of rents in altering the political equilibrium in H. An incumbent that faces a higher revolutionary threat (because of a higher $X+1$ or lower M) and has more too loose from revolution (higher $X+1$), is more willing to buy external support for two reasons. First, it has a higher expected benefit; second, it also has a lower expected cost, as the probability that a remains in power - therefore bearing the cost of rents - is, initially, lower. Because higher rents map into higher external support, the incumbent ends up being *more* entrenched in equilibrium. Crucially, the benefit of this entrenchment are partly shared with A's investors, as witnessed by the increase in rents. We can summarize this in our fourth prediction:

Prediction 4 - *When a country is under foreign influence, a lower expected cost of revolution and a higher prize from domestic redistribution make the incumbent more entrenched if they also result in higher rents to foreign investors, less entrenched otherwise.*

The parameter ϕ measures the capacity of A to impose *effective* sanctions on A: when this parameter is low, B's intervention can largely outweigh any trade disruption that A is able to inflict. A look at equation (13) reveals that a higher ϕ always result in a higher entrenchment of a. Intuitively, a higher ϕ puts a nationalistic opposition in a more difficult position, in that it increases the cost of expropriating A - therefore decreasing the attractiveness of revolution. Thus, an increase in A's economic power (relative to B) makes the effect of foreign influence larger. This leads to our final prediction:

Prediction 5 - *When a country is under foreign influence, a lower relative importance of the foreign country as a trade partner implies a lower entrenchment of the incumbent.*

3.7 Welfare

In this section, I want to analyze the welfare consequence of foreign influence. My approach is to compare the equilibrium of the game described above to the equilibrium of a different game, where A does not have the capacity to intervene in H. This is a relevant exercise, because it can provide at least some indication on the welfare consequences of explicitly adopting a policy of interventionism, such as that announced by Teddy Roosevelt in 1904. At the same time, it can shed some light on the role of international organizations such as the United Nations or the Organization of American States, which put some constraints on the foreign military activity of their members.

If A does not have the capacity to intervene in H, a is overthrown with probability $\bar{\pi}$ independently on any rent awarded; thus, the equilibrium amount of rent must be zero, and because expropriation is not an issue, the group who rules H must always align itself with A. Define ΔW_J^i as the expected welfare gain to group i in country J from A being endowed with the capacity to intervene. Because this capacity can only affect payoffs if it results in positive rents, or if it is actually used, welfare must be unchanged when the game ends on the equilibrium path with no foreign influence. Thus, $\Delta W_J^i = 0$ for all J and i in this case. When instead the game ends on the equilibrium path with foreign influence, we can write:

$$\Delta W_H^a = [\bar{\pi} - \underline{\pi}(R^*)]\frac{X+1}{\delta} - [1 - \underline{\pi}(R^*)]R^* \tag{16}$$

$$\Delta W_H^b = -[\bar{\pi} - \underline{\pi}(R^*)]\frac{\gamma(X+1)}{\delta} - [1 - \underline{\pi}(R^*)]R^* - \underline{\pi}(R^*)\phi\gamma \tag{17}$$

$$\Delta W_A = -\underline{\pi}(R^*)(\beta + S) + [1 - \underline{\pi}(R^*)]R^* - [1 - \underline{\pi}(R^*)]\Lambda - \int_0^{R^*-\Lambda} \frac{c}{M}dc \tag{18}$$

$$\Delta W_B = \underline{\pi}(R^*)S \tag{19}$$

where $\Lambda \equiv \max[\gamma(X+1) + (1-\delta)R^* - \phi\gamma - M, 0]$. A's capacity benefits a by giving it a higher change to remain in power. This however comes at a cost, as A's support can only be obtained by granting positive rents to A's investors. For b, both of these elements are a cost; in addition, this

group suffers from A's capacity as this disrupts the relations that it has with this country when it goes to power. A benefits from its capacity to intervene because this awards it positive rents when a remains in power (second term on the RHS of (18)). However this comes at the cost of greater geopolitical uncertainty (first term) and at a positive expected cost of intervention (last two terms). In fact, when Λ is positive this latter cost is strictly positive whenever a remains in power. Finally, for B, foreign influence implies a higher probability of securing H's geopolitical alliance, in that when A cannot intervene no group has ever a reason not to align itself with A.

A closer look at the signs of (16)-(19) allow us to summarize the welfare consequences of foreign influence as follows:

Proposition 3 *Endowing A with the capacity to intervene in H has no impact on welfare when the country does not fall under foreign influence. When it does, on the contrary, the welfare effect is the following:*

- *a and B always gain;*

- *b always looses;*

- *A always gains if $\beta + S = 0$; may gain or loose if $\beta + S > 0$.*

Proof. The first sentence is proved by the fact that equilibrium path with no foreign influence is identical to the equilibrium path in the case where A cannot intervene. Next, let's consider the equilibrium path with foreign influence. That ΔW_H^a must be positive follows from the fact that a can always obtain the same payoff as with no foreign protection. The RHS of equations (19) and (17) contain, respectively, only positive and negative terms: thus, ΔW_B must be positive, and ΔW_H^b negative. That ΔW_A must be positive when condition $\beta + S = 0$ holds can be seen from plugging this in (18) and rearranging:

$$
\begin{aligned}
\Delta W_A|_{\beta+S=0} &= (1-\underline{\pi})R^* - (1-\underline{\pi})\Lambda - \int_0^{R^*-\Lambda} \frac{c}{M}dc \\
&> (1-\underline{\pi})(R^*-\Lambda) - \frac{R^*-\Lambda}{M}(R^*-\Lambda) \\
&= (1-\underline{\pi})(R^*-\Lambda) - \min[1-\underline{\pi}, R^*](R^*-\Lambda) \\
&\geq 0
\end{aligned}
$$

where the latter inequality comes from the fact that $\Lambda < R^*$ whenever $M > \gamma(X + 1)$. This finding, together with the continuity of ΔW_A in $\beta + S > 0$, also proves that ΔW_A can be positive for some $\beta + S > 0$. Finally, to see that ΔW_A can also be negative in this case, suppose that $\beta + S = \frac{\phi}{\delta}$. From (12) and (13), it is clear that we can always find $X + 1 < M$ large enough that $R^* = \overline{R} = \frac{\phi}{\delta}$ and $\underline{\pi} > \frac{1}{2}$. But for these values, the sum of the first two terms in (18) is negative, proving the result. ∎

Thus, the fact that a large country has the capacity to intervene abroad does not necessarily affect welfare, as this capacity may simply remain unused. From Proposition 2, this is likely to be the case when the elite is sufficiently entrenched, or geopolitical competition is low. Alternatively, it may also be the case for those countries where the cost of sanctions is very high.

Consider now the welfare effect when the capacity to intervene is actually used, and country H falls under foreign influence. A very intuitive result is that the incumbent always gains from disposing of this additional political tool, while the challenger always looses. More surprising may be the fact that B always gain from A being able to intervene in H. This is due to the fact that A's intervention capacity is used strategically by the incumbent, which intentionally creates a potential geopolitical conflict between A and the challenger. This must go to the benefit of B, who would otherwise have no change of extending its geopolitical influence to H. The consequences of this geopolitical loss are also evident in the impact on the welfare of A. On one hand, if $\beta + S$ is zero (or very small), this impact must be positive: this is because A only bears a cost from protecting rents, and this can at maximum be as high as the value of rents themselves. On the other hand, when $\beta + S$ is large, A must also intervene to protect its geopolitical alliance with H, and this is actually lost whenever the challenger goes to power. When the strategic value of H is high and the incumbent is very fragile, these additional costs may make the overall effect on A negative.

Thus, a policy of interventionism that puts H under foreign influence has the clear effect of favoring the incumbent and damaging the challenger. At the same time, it may well fire back on A, particularly when H is strategically important and the incumbent fragile. This casts a doubts about whether US interventionism in Latin America - as laid out by the Roosevelt Corollary

of 1907 and resumed by Truman and Eisenhower after World War II - was ultimately beneficial to US goals, particularly at times of high political geopolitical competition as the Cold War. To the extent that it allowed the local elite to boast the anti-Americanism of the Latin American left, it certainly contributed to inflating the US military budget, entailing at times a large geopolitical risk (as the case of Cuba well illustrates). This is, of course, on top of any human right cost generated by favoring the entrenchment of autocratic regimes.

4   An interpretation

I now use the results of the model to provide an interpretation of the Latin American case, and answer the questions that I posed in section 2. Because of its involvement in trade, the Latin American elite could be trusted to respect investments from the US, a vital trade partner and a country that could credibly threaten to retaliate to expropriation. When the US became openly interventionist in early 20th century, the elite sought to entrench itself by putting their countries under US influence. Prediction 1 suggests that the small size of the elite, the increasing pressure for social change, and a huge wealth inequality all contributed to making this the optimal choice. This may contribute to explain the large inflow of US investments in 1914-1929 and 1945-1960. Furthermore, in this interpretation the large economic nationalism of the masses and the US attachment to the status quo can be explained as a result of the elite's political maneuvering.

As the Cold War opened up the Western Hemisphere for superpower competition in 1959-1979, the geopolitical value of the Latin American countries (S in the model) increased. As in Prediction 3, this increased the frequency of US interventions, and made it harder for the reformist parties to achieve power. Because the reformists, who enjoyed vast popularity, aimed for achieving power through democratic means, this led to the reversal of democracy in many countries. Thus, Prediction 3 is consistent with the pattern described in Figure 1. At the same time, it is broadly consistent with the fact that many elite-controlled governments (such as Peru') scaled down the amount of US rents through compensated nationalizations in the 1960s and 1970s.

In this interpretation, the fact that the reformists were penalized by geopolitical competition is the result of two elements. First, being accountable to the masses, the reformists had the expropriation of US rents as a top

priority. Second, because of a large investment position in Latin America, the US was in no position to accommodate on nationalistic policies. But because sanctions created the need for alternative external support, the reformists could be expected to seek a Soviet alliance out of sheer economic need. Paradoxically, by making it harder for the US government to accommodate, US economic power strengthened this mechanism.

If this interpretation is correct, the initial distribution of gains from trade and US interventionism in early 20th century are the two fundamental reasons why the US ended up opposing political change and democracy in Latin America. This became particularly bad during the Cold War, when geopolitical competition magnified the interests at stake. Notice that, in this interpretation, the accumulation of US rents in Latin America had costs as well as benefits. Beside the cost from violating a long-cherished principle (and the human rights violations attached to this), it contributed to foster the anti-Americanism of the masses, making Latin America more open to Soviet penetration in the 1960s and 1970s. This carried both a considerable geopolitical risk (as the case of Cuba well illustrates) and a large military cost.

In the next section, I look at a few country studies that illustrate how some of the other predictions of the model may be useful. To address my third key question, I look specifically at the case of Venezuela.

5   Case Studies

I begin by describing the case of Cuba, which perfectly illustrates the huge potential costs of a transition to popular rule at the time of the Cold War. I then study the case of Chile and Venezuela, whose opposite experiences clearly illustrate both the importance of US influence, and its determinants.

5.1   Cuba

The island of Cuba became independent from Spain after a bloody revolution (1895) and a short war between Spain and the United States (1898-1899). Over the next half a century, the economic ties between Cuba and the United States became very strong. On one hand, the US steadily absorbed around 75% of Cuban exports in 1910-1950[18]. Key to this result was the preferential

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[18]This percentage dropped to around 60% in 1945-1960, see Mitchell, 2003.

tariff (later, a quota) accorded to Cuban sugar on the US market. Because of the high price commanded by sugar in the US, this was a very important prize for competing sugar exporting countries in this area. On the other hand, a series of pro-American conservative governments (such as that of Gerardo Machado, 1925-1933, and Fulgencio Batista, 1934-1959) welcomed American investors to control, among other things, a third of the island's sugar economy, all of the country's utilities, a major railroad system, the import, refining and distribution of oil and the country's nickel reserves, most hotels and gambling and various banks. The utilities companies in particular operated in an atmosphere of general public hostility (Bonsal, 1967, p. 265). Overall, US investments stood at about US$ 2bn in 1959 (Sigmund, 1980, p. 43).

Turning to political developments, after a period of military occupation that ended in 1903, the US granted Cuba its independence but retained the constitutional right to intervene to guarantee political stability and the respect of property. The existence of already large American investments in Cuba made the perspective of a radical government in the island very unattractive from a US point of view. In fact, one interpretation of the American-Spanish war is that the US intervened precisely to avoid that the insurgency ended up damaging its investments (Smith, 1960). While several elections took place in the first three decades of the century, opposition parties normally denounced frauds. At the same time, when the opposition outburst into strikes and open rebellion, the US military intervened to avoid a revolution or to protect American investments: this happened in 1906-9 (when the island was again occupied), 1912, 1917, 1919, and in various other occasions during the 1920s. For 20 years after Batista gained power (1934), the political situation became more stable. In the 1950s, however, widespread discontent among the population created a fertile ground for various opposition movements. In 1958, a group of armed revolutionaries led by Fidel Castro managed to stage a full-scale revolution and overthrow Batista on January 1, 1959.

Initially, the relations between the US and Cuba remained good. Eisenhower promptly recognized the new regime, and Castro was cordially received for an unofficial visit in Washington in April 1959. This soft line was strongly supported by the American ambassador to Cuba, Philippe Bonsal. Bonsal was convinced that Castro was not a communist, and that the Cuban society would force him to install a constitutional system respectful of US interests (Bonsal, 1967). Soon, however, it appeared clear how hard would the issue

of US investments make cooperation between the two countries. As Bonsal puts it, "Through all Castro's gyrations, the only constant has been his determination to free Cuba from American influence (which he equates with domination), even at the eventual cost of submitting his country to the Soviet Union" (*Ibid.*, p. 267). This determination resonated well with large sections of the Cuban society, but most crucially it cemented Castro's support by a 15-20% of unemployed, underemployed, subsistence farmers, intellectuals and students from which he drew his strength (*Ibid.*, p. 266).

Despite a May 1959 land reform that led to the confiscation of some American holdings, the US maintained an amicable approach to revolutionary Cuba until the first months of 1960. The hope for continued cooperation was rapidly fading away, however. Castro itself later declared that: "the American reaction to the agrarian reform of May 1959 made me realize that there was no chance of reaching an accommodation with the United States." (*ibid.*, p. 268). Months of escalating tension led to crisis in May 1960, when Castro nationalized the American and British oil refineries in the island. In July, going against Bonsal's advice, the US government suspended the Cuban sugar quota: this led to the expropriation of all remaining American investments, and the formal interruption of Cuban-American relations. In February 1962, US sanctions to Cuba were scaled up to the full-scale embargo that lasts to these days.

Faced with the impossibility to sell its sugar to the US (and with a severe oil shortage), Cuba turned to the Soviet Union for commercial support. This was promptly supplied: in the words of the American ambassador, "the Soviets accomplished the task in such a manner that the Cuban consumers were hardly aware of any change in the source of supply" (*ibid.*, p. 272), and "Cuban planters, cane-cutters, sugar-mill hands, dock workers - all those involved in the industry - went to work for the Russian instead of the American consumer" (*Ibid.*, p. 273). In return for economic assistance, the USSR won an important victory in a region that had become crucial for its broader geopolitical strategy (see section 2; in terms of the model, S had increased). In the summer of 1962, Castro authorized the installation of Soviet missiles bases in the island. These greatly increased the Soviet first-strike capacity, rapidly leading to a major international crisis (October 1962). When the missiles were eventually withdrawn (1963), the US had essentially accepted the establishment of a Soviet stronghold in the region (*Brzezinski*, p. 39).[19]

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[19]This represented the most serious violation of the Monroe Doctrine since its formula-

In terms of the model, it had lost S to the USSR.

The theory developed in the previous section suggests the following interpretation of the Cuban experience. Being largely dependent on the American sugar quota for its well being, the Cuban conservative elite could be expected to sympathize with even large American rents in the island. This was in contrast with the various opposition groups, whose lesser involvement in trade made less willing to accept any excessive American rent. To take advantage of this, the elite deliberately favored the expansion of American rents in the island. By fomenting the economic nationalism of the masses, this tied the US government to the defense of the status quo. In terms of the model, the elite chose to entrench itself in power by strengthening US influence over the island. Notice that, in this interpretation, the large flow of American investments to Cuba in 1925-1959 may in part be explained with the preference of the local elite for the country that had established itself as the region's political leader. While this preference may have had a cost for the elite itself, the fragility of its tenure in power - as suggested by the political instability of the early 20th century - may have warranted this on a strictly political ground, as of Prediction 1.

When revolution finally swept the elite away from power, the US had strong reasons to maintain friendly relations with Cuba. On one hand, enhanced Soviet assertiveness made of any Latin American country a potential Cold War battleground. On the other, the new Cuban government displayed no strong bias in favor of a geopolitical alignment with the USSR. Unfortunately, two key factors made the deterioration of US-Cuban relations unavoidable. First, the Cuban government had become accountable to new social groups, ones whose involvement in trade was much smaller. For these groups, the elimination of American privileges was more important than any cost of incurring into American sanctions. Second, the US could not afford not to retaliate against a small country like Cuba, as this would have given a signal of extreme weakness to other countries in the region. In terms of the model, β was very small. As American investments got expropriated and Cuba lost access to the American sugar market, the economic relations between the two countries ground to a halt. Political relations broke down as a consequence of that, as Cuba's left unserved trade gave to the Soviet Union a competitive hedge in exchanging economic support for the country's geopolitical alliance.

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tion in 1823.

The case of Cuba provided a clear illustration of the risks associated with a leftist shift in Latin America, in a period of intense Cold War competition. These risks induced to US to intervene in a variety of ways to prevent the left from going to power elsewhere, as we shall see for the case of Chile. Various attempts were also made to revert the political evolution in Cuba: beside the continuation of economic sanctions, the US supported an invasion attempt by anti-revolutionary Cuban groups, and various attempts to assassinate Castro. The fact that the new Cuban regime remained firmly in power had much to do with the large economic support that it received from the USSR. To the extent that this reflected a good degree of compatibility between the Cuban trade and the Soviet economy (in terms of the model, a low ϕ), the success of the Cuban revolution is broadly consistent with Prediction 5.

5.2 Chile

Differently from most other Latin American countries, Chile had a long history of constitutional democracy at the onset of the Cold War. With the exception of a turbulent period in 1924-1934, regular election had been held since the 1870s, and different parties had alternated in power. Nevertheless, power had generally been in the hands of the Conservative and Liberal Parties, which represented the elite of a wheat-exporting *latifundista* agriculture, a banking/commercial sector and, later, a burgeoning industrial sector. These groups looked overseas for their markets (first for exported agricultural goods, then for the imported intermediate and capital goods needed in the industrial sector) and consumption patterns (Feinberg, 1974, pp. 31-32). After 1930, the rise of the middle class gave strength to a third party (the reformist Radical Party), who formed two governments in the 1940s without however posing a serious threat to the elite's control of power (Pike, 1963).

The US became Chile's dominant trade partner after World War I. By the early 1950s, 55% of Chilean exports went to the United States, which was also the source of 50% of its imports (Mitchell, 1998). The end of World War I also marked the end of the Chilean nitrates industry, which had been dominated by British interests for the previous half a century. As copper became the key mineral activity - and the key source of foreign exchange - in the 1920s, America displaced Britain as the key source of capital. Total American investments increased from US$ 15 million in 1912 to US$ 451 million in 1929, to US$ 623 million in 1950 (United Nations, 1955, p. 159). Most of these investments went into the copper industry, which resulted extremely

profitable to American investors: between 1910 and 1960, it generated an estimated US$ 4 billion in remitted profits, out of an overall investments of about US$ 1 billion (Cockcroft, 1996, p. 537).

Left wing agitations and strikes had been common in Chile since the 1890s, and had led to violent repression in the first two decades of the century. In 1919 and 1932, the Communist and Socialist parties were formed. Often persecuted and too small to separately stand a chance of electoral success, these parties would often form coalition in the following decades, together with other small parties of the left and, occasionally, with the Radical party. While ideologically differentiated, the left was kept together by the desire to implement radical reforms and by a strong economic nationalism. These themes gave the left a large appeal with the masses[20]. Thus, as a series of electoral reforms increased voter's turnout and improved the quality of the Chilean democracy in the second half of the 1950s (see Harlyn, 1994, p. 130-131, and Figure 2), the candidate of the left (Salvador Allende) got very close to winning the 1958 election.

Faced with the risk of expropriation its copper investments, the US sided clearly with the traditional forces of Chilean politics in the 1950s. Most importantly, US loans helped the rightist government of Ibanez (1952-1958) to tackle a balance of payment crisis whose economic consequences were exacerbating popular unrest. Balance of payments problems were very recurrent in Chile at that time. Because of the long-term decline in agricultural export, the country relied on copper exports to pay for the import of intermediate goods used in the industrial sector. This made the country very vulnerable to volatile copper prices.

As Cold-War competition intensified after 1960 (in terms of the model, S increased), the US effort to avoid the victory of the left in Chile (as in the rest of Latin America) was scaled up. As a result of Kennedy's Alliance for Progress, US aid to Chile increased from a total of US$ 9.2 million in 1951-1960 to US$ 41.4 million in 1961-1962 only. Despite its status of relatively developed country, Chile was the third largest recipient of US aid in the 1960s, after Brazil and Colombia. As highlighted by Jeffrey Taffet in its recent (2007) study of the Alliance for Progress, the role of this aid was essentially to keep the Chilean left out of power. Initially, the US attempted

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[20]Together with Ecuador and Peru (which also had substantial American investments) Chile was one of the Latin American countries where economic nationalism was strongest (Taffet, 2007)

to induce the rightist government of Alessandri (1958-1964) to implement domestic reforms. Faced with a substantial refusal, it shifted its support to Eduardo Frei, the head of a new moderately reformist Christian Democratic party. In the 1964 election, Frei defeated Allende also thanks to explicit and covert US support (see Taffet, 2007, p. 76-77; and Easterly *et Al.*, 2010, p. 5).

The hope that Frei would conquer the "votes, hearts and minds of the poor" (Taffet, 2007) went largely unfulfilled, however. While implementing a series of moderate reforms - among which, a land reform - Frei's popularity declined rapidly. On one hand, harsh policy measures to stabilize the economy reduced the impact of Frei's reforms. On the other, because of widespread economic nationalism, any attempt by Frei to really capture the hearts of the masses was fundamentally in contrast with the interests of its American sponsors. [21] Despite a partial nationalization (with compensation) of the copper mines in 1966 and various attempts by Frei to symbolically flirt with domestic nationalism, the support for the left increased as the 1970 election approached. As Frei's failure appeared clear, the American focus shifted from paying aid to strengthening relations with the military (*Ibid.*).

Allende won the 1970 election with just slightly above 30 per cent of votes, but was then swept into power with the support of the Radical Party. This marked the first serious loss of power of the elite in the history of the country. In keeping with his electoral promises, the left implemented radical redistributive reforms and expropriated the American copper companies with very little compensation. In reaction the expropriation of American investments, the US government interrupted any aid payment, and orchestrated a credit blockade - involving bilateral and multilateral credit - that hit at the heart of Chile's chronic balance of payment problems. This was a major cause of economic distress in the first few years of the Allende government.

As trade between the US and Chile rapidly plummeted, Allende sought commercial support from various European countries and from countries in the Soviet block. While the amount of economic support that he received from the USSR was significative, this was modest compared to the support awarded to Cuba one decade earlier (see Evanson, 1985, pp. 110-112). Still, Allende's foreign policy was one of friendship towards the USSR and its allies.

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[21] For example, the pre-condition for further US aid that the price of copper should be kept low in 1965-1966 (when the war in Vietnam had rapidly increased US consumption of this metal) had an incalculable political cost for Frei (Taffet, 2007, p. 83-84).
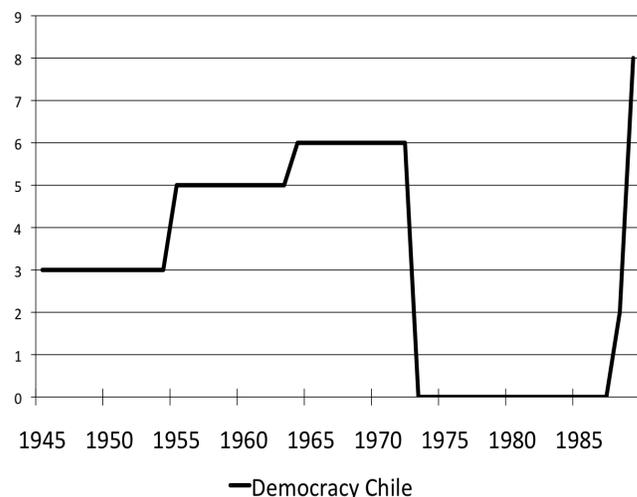
Figure 2: Democracy in Chile, 1945-1989

Source: Polity IV.

For example, he resumed diplomatic relations with Cuba, breaking the *cordon sanitaire* erected by the US against this country. By 1973, however, economic distress created sharp tensions within Chile. In September, a CIA-supported coup (see, for example, Easterly *et Al.*, 2010) overthrew Allende, leading to a 15-years period of military dictatorship (see Figure 2). During this period, much of the privileges of the elite were restored, and so were the expropriated properties of the American copper companies.

Using the model to interpret these facts provides a simple explanation for the link between the Cold War and the collapse of the Chilean democracy. This link had its roots in the accumulation of US direct investments in the first half of the 20th century. Being largely dependent on international markets for its well being, the incumbent elite could commit not to expropriate large domestic rents awarded to the country's most important trade partner. This was in contrast with the left (the challenger) whose support groups, particularly in the countryside, had a more autarchic production and consumption pattern. This difference in commitment capacity created an incentive for the elite to redistribute part of the state-owned copper rents to American investors, thus fostering the economic nationalism of the left.

While this could be expected to exacerbate popular discontent with the incumbent group, it would also tie the US government to the defense of the status quo. Given the growing importance of the US as a source of external economic and military help, the latter effect was strong enough to prevail. In this interpretation, the generous copper concessions granted to American investors since the 1920s can be explained as an attempt by the incumbent elite to entrench itself in power, by putting the country under foreign influence. This can explain the very close alliance between the US government and a series of elite-controlled governments until the 1950s.

As Latin America became an active Cold War battleground after 1960 (in terms of the model, as the S of a typical Latin American country increased), the US effort to keep the left out of power (c in the model) was scaled up (prediction 3). Intuitively, the Cold War increased the cost from having the left in power. Even without assuming any ideological penchant of the left for the USSR, it could be expected that the issue of the US copper mines would make relations between the two countries inherently conflictual. On one hand, elite maneuvering had turned the expropriation of the US rents into a top priority for the groups who supported the left. On the other hand, large Latin American investments and a high economic standing would prevent the US from being able to accommodate to expropriation in a country like Chile. The perspective of conflictual relations with the US made the left very likely to side with the USSR. But this, after 1960, had a very high geopolitical cost for the US. Thus, while the alliance with the incumbent elite was signed in a period of relative quiet international relations (in the Western Hemisphere) renewed international competition strengthened the position of the elite in this alliance. Unfortunately for the fate of the Chilean democracy, this happened at a time when the challenging group was working its way to power thanks to the improvement and consolidation of the country's democratic institutions.

Initially, US effort came mostly in the form of aid, and was concentrated on trying to affect the result of elections. To this purpose, the US used aid to induce Alessandri to domestic reforms and, failing that, to support the victory of the reformist Frei in 1964. These attempts were bound to fail, however. This was for two reasons: on one hand, the elite effectively blocked domestic reforms, possibly relying on the fact that a higher geopolitical stake would help them stay in power (with US support) in any case. Interestingly, one reform that the elite did not block was the partial nationalization of the copper mines: this is very much in the spirit of the model, which predicts

that, under foreign influence, the incumbent will be less lenient towards foreign investors when its entrenchment is guaranteed by strong geopolitical competition (Prediction 3). On the other hand, no democratically elected government could be successful without really bowing to domestic nationalism, but this was not something that a US-sponsored government could do.

As the left went to power and relations between the two country took a "Cuban" path, the only option left for the US was to side with the Chilean military and support the overthrowing of democracy. While the strength of the military was a key difference between Cuba and Chile, one may wonder whether the capacity of Allende to withstand a coup would have been different had the USSR provided the same amount of economic support that it had provided to Cuba. To the extent that a lower economic support was imputable to a lesser compatibility of Chilean trade with the Soviet economy, the different success of regime change in Cuba and Chile are broadly in line with the results of the model (Prediction 5).

The case of Chile offers a good example of how many Latin American countries fell under US influence in the first half of the 20th century, and where US interventions went strongly against democracy during the Cold War. In the next section, I look at a country whose early history was comparable to that of Chile, but had then a very different experience with democracy at the time of the Cold War.

5.3 Venezuela

Venezuela was one of the few Latin American countries (together with Colombia and Costa Rica) where democracy - installed at the end of the 1950s - remained substantially stable during the Cold War (see Figure 3).

The Venezuelan economy had been historically dominated by the export of tropical agricultural commodities. In the first decades of the 20th century, however, oil became the dominant economic sector. Initially, all oil concessions went to European companies. After World War I, however, things changed, as American companies began to compete aggressively to secure overseas supplies. Their effort was strongly supported by the US government, who was increasingly worried that a growing domestic demand for this strategic commodity could not be met with domestic supplies (Venn, 1986).
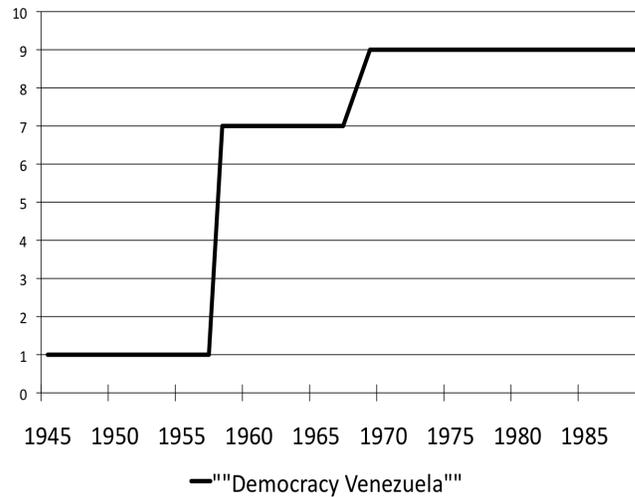
Figure 3: Democracy in Venezuela, 1945-1989

Source: Polity IV

Differently than in other parts of the world - such as the Middle East[22] - the American companies received a very warm welcome in Latin America. In Venezuela, the dictator Vicente Gomez - who ruled the country from 1908 until his death in 1935 - quickly switched its favors to American companies. Between 1925 and 1935, the dictator gave concessions to American companies even when these paid less then their competitors (Rabe, 1982, p. 34). As a results, US companies came to dominate the Venezuelan oil industry by the 1930s, paying royalties that were extremely low for international standards (*Ibid.*, p. 35).

In return for this benevolent treatment of its oil companies, the US helped support the regime of Vicente Gomez. For example, when rumor spread of an imminent revolution in 1923, the US Navy was dispatched to the port of Caracas. This turned out to be the first of a long a series of Navy visits, through which the US signaled its continuous support for the dictator. As a result, the 1920s were - except for a series of student riots in 1928 - a peaceful

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[22]In the Middle East, the penetration of American companies was much complicated by British influence (see Venn, 1986).

period, and the dictator remained in power until his death in 1935.

In 1937, a group of left wingers who had participated in the 1928 riots founded a party, *Accion Democratica* (AD), that would become a key player in the establishment and consolidation of the Venezuelan democracy, as well as a source of inspiration for reformists in other countries. Like all Latin American radical movements, AD stood for domestic reform and a nationalistic approach to foreign investors. However differently from similar movements[23] AD proved to be very successful, possibly because of its remarkable ideological flexibility. For example, many of its founders (including Romulo Betancourt, "the father of the Venezuelan democracy") moved from leftist origins, but later became fiercely anti-Marxist.

In 1945, AD had a first opportunity after a revolution staged by junior military officer and a subsequent election swept it into power. In the three years that followed (often called *el trienio*), AD extended the franchise to universal suffrage and passed an agrarian reform. It also attacked the privileges of the oil companies, by imposing an innovative 50-50 sharing rule for profits (this spread to the Middle East in subsequent years), discontinuing the system of concessions, and taxing the companies in kind. In 1948, however, the AD government was overthrown by a military coup supported by the elite and by the US government (see Cockcroft, 1996), and a new military dictatorship was established.

In 1948-1958, general Perez Jimenez restored many of the privileges of the oil companies and adopted a liberal policy towards foreign investors. So happy were American investors with the new administration that Eisenhower decorated Perez Jimenez with the Legion of Merit for its "contribution to the free enterprise system". In 1958, however, a popular revolution in Caracas overthrew Perez Jimenez and elections were held. Returned from a decade in exile, Betancourt won by a large majority. This marked the beginning of a period of constitutional rule that survived undisturbed through the Cold War. With governments in 1959-1964, 1964-1969 and 1974-1979, AD dominated the political life of this period. At the same time, power was handed over to the centrist Christian Democratic Party in 1969-1974 in the first democratic transition of power in the country's history.

Differently than in the *trienio*, the US provided strong support to the AD governments after 1959. In the early 1960s, AD became a darling of

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[23]A good example of this was Peru's APRA. While similar to AD, APRA was less ideologically flexible, and received much less support from the US.

Kennedy's Alliance for Progress, the aid program launched in response to the Cuban Revolution and the increased Cold War competition for influence in Latin America (in terms of the model, an increase in S). In return for this amicable US attitude, AD adopted a strongly pro-US foreign policy, for example lending its support to the expulsion of Cuba from the Organization of American States. Interestingly, relations between the two countries remained good despite AD's strong economic nationalism. This led to increasingly harsh conditions being imposed on the American companies in the 1960s, and to AD fully nationalizing the American oil companies in 1975, granting only compensation at book value.[24] This level of compensation had been rejected in a number of occasions by the US government. Still, in the case of Venezuela protests were very mild, and were eventually put on a side, for "given the interest of the companies in continuing to do business with Petroven and of the United States government in a continuing and reliable source of oil, the general perception was that a stronger response was neither desirable nor necessary" (*Ibid.*, p. 244).

Importantly, the capacity of Venezuela to re-appropriate its oil concessions was strongly linked to the establishment and consolidation of OPEC in the 1960s. Until the 1950s, Third World oil supplies had remained firmly in a the hands of American, British and Dutch oil companies, who were able to defy expropriation by exploiting their control of processing channels and the capacity to increase production elsewhere.[25] With the formation of OPEC, however, the bargaining power began to shift. In fact, a key achievement of OPEC in the 1960s was to agree that, in case of sanctions against one of its members, the organization would forbid the oil companies from increasing production elsewhere (Venn, 2002). This made sanctions against any OPEC members much more expensive than before, paving the way for the nationalizations of the 1970s. Understanding this, AD became a founding member of OPEC, and one of its strongest supporters.

Prediction 2 suggests that when the cost of imposing trade sanctions against H becomes high, this country may be able to escape the condition of foreign influence. The intuition for this is simple. If the cost of sanctions is high, there exist an equilibrium where A cannot credibly threaten to retaliate to expropriation. In this context, rents are at risk no matter

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[24]This amounted to just about 20% of actual investment, and only 10% of its replacement value (Sigmund, 1980, p. 243.)

[25]For example, this was the response to nationalization in Mexico (1938) and Iran (1951-1953) (see Venn, 2002).

who is in power in H; and - what may be even more important in periods of high geopolitical competition - a nationalistic government does not need to become a geopolitical enemy. Thus, in the model's interpretation, AD's success in consolidating the Venezuelan democracy was, at least in part, a consequence of its success in strengthening OPEC. As the cost of sanctions against Venezuela increased, the question of economic nationalism became less important in the US approach to Venezuelan politics. This was for two reasons: first, nationalization was now a concrete threat independently on who ruled the country. Second, the expectation that sanctions against this country could be waived guaranteed that even a strongly nationalistic party would remain a geopolitical friend. With the hurdle of nationalism out of the way, relations between AD (or the Venezuelan democracy) and the US became much easier to sustain.

This interpretation fits nicely in the different experiences of Venezuela and Chile. Differently from oil, copper-producing countries had not created an international organization that could soften the impact of sanctions against some of its members. Thus, a drop in import from Chile could be safely substituted with imports from a variety of sources, both in developing countries (Peru, Zaire, Zambia) and in developed countries (Canada, Australia, the US itself). More in general, copper was not as important a commodity as oil, and was not so much the focus of public attention in the early 1970s. To the extent that these factors contributed to making accommodation impossible in Chile (differently from Venezuela), this may explain why the US adopted a very different approach to democracy in these two countries. Of course, the different ideological positions of Allende's UP and Betancourt's AD may also have mattered. The key point of this section, however, is that economic frictions may determine ideological frictions in the first place. Thus, AD's unique ideological flexibility - a key determinant of its success - may have been the consequence of Venezuela's unique economic position in Latin America.

6   Conclusions

After looking at the role of US influence on democratization in Latin America during the Cold War, I have constructed a theory of power allocation in the presence of foreign influence. In this theory, the outcome of a distributional conflict between an incumbent group and a challenger is altered

by the capacity of the incumbent to exchange rents to foreign investors for external support from a key trading partner. This capacity is grounded in the incumbent larger exposure to the international economy, which makes him easier to control from the exterior, using the threat of trade sanctions.

My main results are as follows. First, rents have two key effects on the political equilibrium. On one hand, while fueling the economic nationalism of the challenger, they increase what the trade partner is ready to spend to protect its investors by keeping the incumbent in power. I show that the latter effect must dominate if rents are hard enough to expropriate. On the other hand, they create the basis for a geopolitical conflict between the challenger and the trading partner: thus, the higher the country's geopolitical importance, the higher the protection that the incumbent receives, and the lower the price it has to pay for it. Second, in a country where an incumbent does rely on external support, an increase in the country's economic standing - measured as the cost for the trading partner to impose sanctions - may make domestic regime change more likely. Third, in the presence of an external support an incumbent with more to loose and facing a larger revolutionary threat may end up being *more* entrenched, rather than less. This, however, comes at the cost of a larger portion of the domestic economy being awarded to foreigners. At the same time, the larger the importance of the country providing external support as a trading partner, the smaller the probability of regime change. Finally, the theory predicts that the capacity to intervene in other countries' affairs may make a country worse off: this is the case when the maneuvering of the incumbent increases its geopolitical risk to a great extent.

These results can explain the generalized reversion of democratization in the 1960s and 1970s, a period where Cold War competition over Latin America was exceptionally strong. At the same time, they suggest the reason why the US interest in exporting democracy had to be put on a side during the Cold War. Because of her long-standing involvement in international trade, the Latin American elite could credibly share parts of her rents with American investors. As the US became markedly interventionist in early 20th century, the elite welcome American investors as a way to foster the nationalism of the masses, and tying the American government to the defense of the status quo. By the 1950s, economic nationalism was a key obstacle in the relation between the US and the Latin American reformists. The Cold War complicated this relation even further. Because of its large Latin American investments and the strength of its economic status, the US was

in no position to accommodate over expropriation of US property. The risk that a sanctioned government would then turn for economic support to the Soviet Union amplified the diffidence of the US towards the Latin American reformists. In this interpretation, not ideology separated the US from the Latin American left, but the expectation that the left, more than the right, would need economic support from the USSR.

I have shown that the peculiar experience of Venezuela - which, differently from most other Latin American countries, had a stable democracy in the 1960s and 1970s - can be explained with the economic standing of all oil producers in that period, which made it easier for the US to accommodate expropriation.

The two determinants of foreign influence in this model are the wish to protect foreign investors, and the need to secure a country's geopolitical alignment in the face of international competition. While typical of Latin America, these two elements were relevant in many other parts of the world at the time of the Cold War. Also, they may be relevant in the case of several former-Soviet republics, where the protection of large resource investments may be an issue and political sentiments are still marked by a clear pro-West or pro-Russia dichotomy. Finally, there is the perception that global geopolitical competition could become important again over the next decades, as China develops into a new superpower. In that is the case, many countries in Africa - where Chinese trade and investments are rapidly expanding - could also fit the assumptions of the model rather well. Thus, I believe the story I have presented in this paper is broad enough in scope, and could be useful in a number of different contexts.

The model also lends itself to a number of simple extensions. For example, I could allow for the possibility that a challenger is more outward-oriented than the incumbent, and external interventions can also *help* him go to power. Or, by allowing for an independent geopolitical position of the incumbent's country, I could explore the consequences of political nationalism. So extended, the model could be helpful to investigate the case of Iran: there, the big problem of the West seems to be that the ruling elite is too inward-looking to give up the political nationalism common of the Iranian society, while more outward-oriented business and consumer groups are kept out of power by the current political system. I keep these and other extensions for future research.

7 Appendix

Proof of Lemma 1

The strategy for the proof is to show, first, that none of the other other small countries expropriates when n is high enough, if no info on the type of A can be extracted from H's experience; next, to show that the need not to signal itself as normal induces A to react to expropriation in H as specified in Lemma 1.[26]

Take any arbitrarily small p, and denote by n the first country who decides to expropriate after H, $n - 1$ the second, and so on. Also, denote by π_n the probability that A imposes sanctions against country n.

If $n = 1$ and this country expropriates, A has no reputation reason to behave differently from its short run optimum. Thus, because sanctions have a cost $S + \overline{\beta} > 0$ and we are working under the assumption that $\overline{\beta} < g - S$, only the crazy type finds it optimal to impose sanctions. Because no info can be extracted from $H's$ experience, $\pi_1 = p$ in this case. Then, country 1 expropriates iff:

$$\overline{R} - p\frac{\phi}{\delta} > 0$$

or:

$$p < \frac{\delta\overline{R}}{\phi} \equiv \overline{p} \tag{20}$$

Suppose now $n = 2$, and consider the choice by either country to expropriate first. The probability that A imposes sanctions against 2 (π_2) may be higher than p, because the normal type may want to mimic the crazy type to increase π_1. Clearly, the best result that this may yield is to push 1's decision from expropriation to no expropriation: this has a value $\overline{R}$ to A. Thus, because the cost of imposing sanctions is S, a necessary condition for the normal type to be interested in mimicking the crazy type in 2 is:

---

[26]The proof is partly based on Fudenberg and Tirole (1991), pp. 369-374.

$$S + \overline{\beta} < \overline{R} \tag{21}$$

Suppose that (21) holds. We can then distinguish two cases. First, if $p > \overline{p}$, a strategy by the normal type of always imposing sanctions (therefore giving no info on its type to 1) is optimal, as it would recognized as normal if it didn't do so.[27] Second, if $p < \overline{p}$, the only equilibrium is one where the normal type randomizes over whether to enact sanctions against 2 or not, and 1 randomizes over whether to expropriate or not when sanctions are imposed. This latter fact is needed to make the normal type indifferent over whether to impose sanctions against 2 or not. For 1 to be willing to randomize, it must be the case that $\pi_1 = \overline{p}$; this in turn is only possible if the normal type mimic the crazy type with probability ζ_2, where, using Bayesian updating:

$$\frac{p}{p + (1 - p)\zeta_2} = \overline{p} \tag{22}$$

or:

$$\zeta_2 = \frac{p(1 - \overline{p})}{(1 - p)\overline{p}}$$

In turn, for A to be willing to randomize, 1 must expropriate with probability ϕ, where ϕ is such that the normal type's payoff from imposing sanctions is equal to its payoff from not imposing them:

$$-\phi\overline{R} - \beta - S = -\overline{R}$$

$$\phi = \frac{\overline{R} - \beta - S}{\overline{R}}$$

---

[27]Throughout the proof, I am using the "intuitive criterion" proposed by Cho and Kreps (1987) to rule out "unreasonable" off-equilibrium beliefs. In this case, the criterion rules out that if A does not impose sanctions, it is believed to be a the crazy type.

The probability that A imposes sanctions against 2, π_2, is:

$$\pi_2 = p + (1 - p)\zeta$$
$$= \frac{p}{\overline{p}}$$

Now suppose $n = 3$ and consider again the decision by any country to go first. From what we just said, with no info from 3's round 2 decides to expropriate iff $\frac{p}{\overline{p}} > \overline{p}$, or:

$$p > (\overline{p})^2 \tag{23}$$

If (23) is satisfied, $\pi_3 = 1$. If (23) is not satisfied, the only equilibrium is again one where the normal type randomizes over whether to enact sanctions against 3 or not, and 2 randomizes over whether to expropriate or not when sanctions are imposed. Following the same procedure as above, we find:

$$\pi_3 = \frac{p}{(\overline{p})^2}$$

It is now clear that, if (21) holds, π_n is monotonically increasing in n, reaching its maximum value of 1 for n high enough. Now suppose that (21) does not hold. Then, there can be no mimicking in period 2, and both 2 and 1 expropriate as soon as $p < \overline{p}$. There can, however, be mimicking in period 3. Suppose that $\beta + S < 2\overline{R}$. Then, if $p > \overline{p}$ a strategy by the normal type of always imposing sanctions must be optimal, as it would be recognized as normal if it did so and both 2 and 1 would switch from expropriating to not expropriating. If, instead, $p < \overline{p}$, the only equilibrium is one where the normal type randomizes, and so do 2 and 1. The condition for finding ζ_3 is the same as in (22). As for 2 and 1, these countries must expropriate with

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such a probability that the normal type is made indifferent over whether to impose sanctions or not. Contrarily to before these probabilities are not uniquely defined; we can however restrict our attention to the case where 2 and 1 randomize with equal probability ϕ. The relevant condition is then:

$$-\phi 2\overline{R} - (1-\phi)\phi R - \beta - S = -2\overline{R}$$
$$(1-\phi)(2-\phi) = \frac{\beta+S}{2\overline{R}} \tag{24}$$

Clearly, there exist a ϕ such that equation (24) is satisfied. We can now see what happens if $S + \beta > 2\overline{R}$: while there is no mimicking in 3, 2 and 1, there can be mimicking in 4 if $S + \beta > 3\overline{R}$. And so on. Thus, the reputation game that we described initially starts as soon as n is high enough that $S + \beta > n\overline{R}$, which must be the case for n high enough. Notice that for such an n, as ϕ goes from 1 to 0 the gain from imposing sanctions go continuously from 0 to $n\overline{R}$, so the semi-separating equilibrium must exist.

Denote by $\overline{n}^I$ the minimum n needed for which $\pi_n = 1$. Because $1 > \overline{p}$, it is established that, for $n > \overline{n}^I$, none of the other small countries expropriates when no info on A's type can be extracted from H's experience.

Let us now look at the optimal reaction by A to expropriation in H. Assume that $n > \overline{n}$, where $\overline{n} = \max[\overline{n}^1, \overline{n}^2]$ and:

$$\overline{n}^2 \equiv \arg\{\beta + S < n\overline{R}\}$$

We then distinguish two cases. If $\beta < g - S$ (as in all other small countries) the unique equilibrium is a pooling equilibrium where both types impose sanctions. To show that this equilibrium exists, notice that the normal type would loose $n\overline{R} - S - \beta > 0$ from deviating. To see that it is unique, notice, first, that there cannot exist a separating equilibrium where only the crazy type imposes sanctions, as the normal type would gain $n\overline{R} - S - \beta > 0$ from deviating. Second, there cannot exist a pooling equilibrium where neither type expropriates, as the crazy type would gain $(g - S - \beta > 0)$ from deviating.

If $\beta > g - S$, on the contrary, the previous equilibrium exists alongside a pooling equilibrium where neither type imposes sanctions. Furthermore, these are the unique equilibria. The proof of existence of the previous equilibrium, as well as of non-existence of the separating equilibrium, is identical to the previous case. To show that the other pooling equilibrium also exists, notice that the crazy type now has a loss $g - S - \beta < 0$ from deviating.

Thus, it is shown that, if H expropriates, A always imposes sanctions when $\beta < g - S$, while may or may not impose sanctions when $\beta > g - S$.
∎

Derivation of $\widetilde{R}$

After plugging in (10), $\Phi(R)$ becomes:

$$\Phi(R) = \left(1 - \frac{\gamma(X+1) - \delta R - \phi\gamma - \beta - S}{M}\right)\left(\frac{X+1}{\delta} - R\right) \qquad (25)$$

The first and second derivatives of (25) with respect to R are:

$$\frac{\partial W_H^a}{\partial R} = \frac{\delta}{M}\left(\frac{X+1}{\delta} - R\right) - \left(1 - \frac{\gamma(X+1) - \delta R - \phi\gamma - \beta - S}{M}\right)$$
$$\frac{\partial^2 W_H^a}{\partial R^2} = -2\frac{\delta}{M}$$

Proving concavity. Setting the first derivative equal to zero we derive $\widetilde{R}$.

Derivation of Proposition 2

$$W_H^a(\underline{R}) > W_H^a(0)$$

$$\left(1 - \frac{\gamma(X+1) - \delta\underline{R} - \beta - \phi\gamma - S}{M}\right)\left(\frac{X+1}{\delta} - \underline{R}\right) > \left(1 - \frac{\gamma(X+1)}{M}\right)\frac{X+1}{\delta}$$

$$\frac{\delta\underline{R} + \beta + \phi\gamma + S}{M}\frac{X+1}{\delta} - \left(1 - \frac{\gamma(X+1) - \delta\underline{R} - \beta - \phi\gamma - S}{M}\right)\underline{R} > 0$$

$$\frac{\delta\underline{R} + \beta + \phi\gamma + S}{\underline{R}}\frac{X+1}{\delta} + \gamma(X+1) - \delta\underline{R} - \beta - \phi\gamma - S > M$$

$$\frac{\delta\underline{R} + \phi\gamma}{\underline{R}}\frac{X+1}{\delta} + \gamma(X+1) - \delta\underline{R} - \phi\gamma + (\beta+S)(\frac{X+1}{\delta\underline{R}} - 1) > M$$

$$\frac{\delta\frac{\phi\gamma}{1-\delta} + \phi\gamma}{\frac{\phi\gamma}{1-\delta}}\frac{X+1}{\delta} + \gamma(X+1) - \delta\frac{\phi\gamma}{1-\delta} - \phi\gamma + (\beta+S)(\frac{X+1}{\delta\frac{\phi\gamma}{1-\delta}} - 1) > M$$

$$\left(\frac{1 + \delta\gamma}{\delta}\right)(X+1) - \phi\gamma\frac{1}{1-\delta} + (\beta+S)(\frac{1-\delta}{\delta}\frac{X+1}{\phi\gamma} - 1) > M$$

$$\left[M - (X+1)\left(\frac{1+\delta\gamma}{\delta}\right) + \phi\gamma\frac{1}{1-\delta}\right]\frac{\delta\phi\gamma}{(1-\delta)(X+1) - \delta\phi\gamma} < \beta + S$$

$$\frac{\delta M - (X+1)(1+\delta\gamma) + \frac{\phi\gamma\delta}{1-\delta}}{\delta}\frac{\delta\phi\gamma}{(1-\delta)(X+1) - \delta\phi\gamma} < \beta + S$$

$$\phi\gamma\frac{\delta M - (X+1)(1+\delta\gamma) + \frac{\phi\gamma\delta}{1-\delta}}{(1-\delta)(X+1) - \delta\phi\gamma} < \beta + S$$

Derivation of $\underline{\pi}$:

If $R^* = \underline{R}$:

$$\underline{\pi} = \frac{\gamma(X+1) - \delta\underline{R} - \phi\gamma - \beta - S}{M}$$

$$= \frac{\gamma(X+1) - \frac{\phi\gamma}{1-\delta} - \beta - S}{M}$$

$$= \overline{\pi} - \frac{\frac{\phi\gamma}{1-\delta} + \beta + S}{M}$$

If $R^* \in (\underline{R}, \overline{R})$:

$$\underline{\pi} = \frac{\gamma(X+1) - \delta\widetilde{R} - \phi\gamma - \beta - S}{M}$$

$$= \frac{\gamma(X+1) - \frac{1}{2}((1+\gamma)(X+1) - \gamma\phi - M - S - \beta) - \phi\gamma - \beta - S}{M}$$

$$= \overline{\pi} - \frac{\phi\gamma + S + \beta + (1+\gamma)(X+1) - M}{2M}$$

Finally, if $R^* = \overline{R}$:

$$\underline{\pi} = \frac{\gamma(X+1) - \delta\overline{R} - \phi\gamma - \beta - S}{M}$$

$$= \frac{\gamma(X+1) - \phi(1+\gamma) - \beta - S}{M}$$

$$= \overline{\pi} - \frac{\phi(1+\gamma) + \beta + S}{M}$$

Proof that $\frac{\partial \pi}{\partial M} > 0$ when $R \in (\underline{R}, \overline{R})$

When $R \in (\underline{R}, \overline{R})$:

$$
\begin{aligned}
\underline{\pi} = \overline{\pi} &- \frac{\phi\gamma + S + \beta + (1+\gamma)(X+1) - M}{2M} \\
&= \frac{2\gamma(X+1) - \phi\gamma - S - \beta - (1+\gamma)(X+1) + M}{2M} \\
&= \frac{M - \phi\gamma - S - \beta - (1-\gamma)(X+1)}{2M} \\
&= \frac{1}{2} - \frac{(1-\gamma)(X+1) + \phi\gamma + S + \beta}{2M}
\end{aligned}
$$

It is now clear that $\frac{\partial \pi}{\partial M} > 0$.

Proof that $\frac{\partial \Delta W_H^a}{\partial(X+1)} > 0$:

If $R \in (\underline{R}, \overline{R})$:

$$
\begin{aligned}
\frac{\partial \Delta W_H^a}{\partial(X+1)} &= \frac{\overline{\pi} - \underline{\pi}}{\delta} + \frac{\partial \pi}{\partial(X+1)} R^* \\
&> 0
\end{aligned}
$$

because $\frac{\partial \pi}{\partial(X+1)} > 0$. If $R^* \in (\underline{R}, \overline{R})$:

$$
\begin{aligned}
\frac{\partial \Delta W_H^a}{\partial(X+1)} &= \frac{\overline{\pi} - \underline{\pi}}{\delta} + \frac{1+\gamma}{2M}\frac{X+1}{\delta} - \frac{1-\gamma}{2M}R^* + \underline{\pi}\frac{1+\gamma}{2\delta} \\
&= \frac{\overline{\pi}}{\delta} + \frac{1+\gamma}{2\delta}\underline{\pi} - \frac{\underline{\pi}}{\delta} + \frac{1}{2M}\left[\frac{1}{\delta}(1+\gamma)(X+1) - \frac{1-\gamma}{2\delta}\left((1+\gamma)(X+1) - \text{pos. const.}\right)\right] \\
&> 0
\end{aligned}
$$

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because the sum of the second and third term is positive, and so the sum of the terms within square parenthesis.∎

Proof that $\frac{\partial \Delta W_H^b}{\partial (X+1)} < 0$ **if** $R \in (\underline{R}, \overline{R})$

$$
\begin{aligned}
\frac{\partial \Delta W_H^b}{\partial (X+1)} &= -\frac{\partial \Delta W_H^a}{\partial (X+1)} - \frac{\partial \pi}{\partial (X+1)} \phi\gamma \\
&< -\left\{ \frac{1}{2M} \left[\frac{1}{\delta}(1+\gamma)(X+1) - \frac{1-\gamma}{2\delta} \left((1+\gamma)(X+1) - \text{pos. const.} \right) \right] + \frac{\partial \pi}{\partial (X+1)} \phi\gamma \right\} \\
&= -\frac{1}{2M} \left[\frac{1}{\delta}(1+\gamma)(X+1) - \frac{1-\gamma}{2\delta} \left((1+\gamma)(X+1) - \phi\gamma(1-2\delta) - \text{pos. const.} \right) \right] \\
&< 0
\end{aligned}
$$

(notice that the positive constant contains M, so it is always > 1: thus, even without assuming $\delta < \frac{1}{2}$ the terms in brackets is always positive.) ∎

Proof that $\frac{\partial \Delta W_A}{\partial (X+1)} > 0$ **if** $R \in (\underline{R}, \overline{R})$

$$
\begin{aligned}
\frac{\partial \Delta W_A}{\partial (X+1)} &= -\frac{\partial \pi}{\partial (X+1)}(1+R^*) + (1-\pi)\frac{\partial R^*}{\partial (X+1)} - \frac{R^* + \beta + S}{M} \\
&= \frac{1}{2M} \left[(1-\gamma)(1+R^*) - 2R^* - 2\beta - 2S + \frac{1+\gamma}{\delta}(M - \gamma(X+1) + \delta R^* + \phi\gamma + \beta + S) \right] \\
&= \frac{1}{2M} \left[(1-\gamma) + \left(\frac{1+\gamma}{\delta} - 2 \right)(\beta + S) + \frac{1+\gamma}{\delta}(M - \gamma(X+1) + \phi\gamma) \right] \\
&> 0
\end{aligned}
$$

Where the latter inequality comes from assuming $\delta < \frac{1}{2}$ and $M > \gamma(X+1)$. ∎

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