

**High-Income Developing Countries and the IIA Regime:
The Role of Capital Flows, Democracy, and Investment Arbitration**

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Abstract:

The international investment agreement (IIA) regime is composed of more than 3,500 IIAs and 900 investor-state dispute settlement (ISDS) cases. Its evolution is best understood in the context of the North-South divide, as IIAs and ISDS have traditionally protected investors from the North in developing countries. High-income and emerging developing economies are in a curious position vis-à-vis this regime. On the one hand, they are part of the global South and are historically recipients of FDI. On the other, their own investors are gradually engaging in the global economy and in need for protection. This paper asks how this shift, as well as domestic political factors, and experience with investment arbitration affect these countries' policies with respect to their state regulatory space (SRS), as reflected in their IIAs. Employing an original data set of national SRS values for sixty-four high-income developing countries from 1960 to 2017, we demonstrate that there is a great deal of variation across countries and over time on this important dimension. Next, we conduct an empirical analysis of the factors affecting the degree of SRS in this group of countries. The findings indicate that high levels of FDI outflows are associated with lower SRS, while repeatedly responding to investment claims is associated with higher SRS.

The regulation of international investment is currently in flux. Unlike international trade, a multilateral and centralized institution that regulates foreign direct investment (FDI) does not exist. Instead, cross-border capital flows are tackled by more than 3,500 international investment agreements (IIAs), many of which are bilateral investment treaties (BITs) that were signed in the 1990s. In addition, and largely based on these treaties, more than nine hundred investment disputes were (or are) adjudicated by international arbitrators in a decentralized system known as investor-state dispute settlement (ISDS). Taken together, these two features form the so-called IIA Regime.

This regime is traditionally understood in the context of the North-South divide. The stated objective of investment agreements and arbitration is to provide foreign investors with protection against political risk in the host country. Thus, most treaties include provisions that guarantee standards of treatment (e.g. most favored nation (MFN) and fair and equitable treatment (FET)), protection against and adequate compensation in case of expropriation, the freedom to transfer capital, and the like. In addition, many of them allow foreign investors to turn to international arbitration if they believe that the host government has violated the agreement. Given that much FDI flowed from economically developed to developing countries, and given that the latter were associated with heightened political risk, developed countries utilized IIAs to shield their investors from such a risk. It is not surprising, then, that most IIAs are North-South.¹

¹ Former communist countries are subsumed under the South. There are also numerous South-South IIAs, but very few North-North IIAs. With respect to the latter, it is commonly argued that low political risk and independent court systems obviate the need for protection through an international agreement.

Emerging market economies and other high-income developing countries (HIDCs) are in a curious position vis-à-vis the global investment regime.² On the one hand, they are part of the global South and are historically recipients of FDI. On the other hand, their dependence on the global economy for growth, as well as the increasing international exposure of their own multinational corporations (MNCs) might render their preferences more similar to those of the economically developed North. Indeed, according to UNCTAD (2018), eight out of the top twenty capital exporting countries in 2017 were developing and transition economies.³ This paper takes a closer look at this tension by, first, comparing sixty-four HIDCs on the degree of their exposure to the IIA Regime. Taking into account both the number of IIAs concluded by these countries and the degree of state regulatory space (SRS) in each of these agreements,⁴ we show that they vary a great deal on this dimension.

In light of the substantial differences across HIDCs, we contemplate three factors that might explain these countries' approach to the IIA Regime: their experience with investment arbitration, regime type, and the level of FDI outflows and inflows. We then utilize our original measure of the exposure to the Regime to empirically test these conjectures. The findings indicate that being hit by multiple investment claims decreases such exposure and that high levels of FDI outflows increase it. The effect of regime type points in the same direction as the latter, but is much less conclusive.

² These are non-Western countries that belong to the high-income and upper-middle income World Bank's categories, as well as India and Indonesia. The latter two are in the lower-middle income category, but are included due to their economic size. For the sake of esthetics, we label this entire group of countries as HIDCs. We further elaborate on this sample below.

³ These are China, Hong Kong, Russia, South Korea, Singapore, Thailand, the United Arab Emirates, and Taiwan.

⁴ SRS refers to the extent of the ability of governments to freely legislate and implement regulations in given public policy domains. For further elaboration, see Broude et al., (2018).

This paper contributes to the growing body of research on developing countries and the global investment regime in several respects. First, it problematizes the crude distinction between North and South and acknowledges the growing diversity of developing economies, especially in the last two decades. While the importance of HIDCs has been long acknowledged, especially with reference to the so-called BRICS (Brazil, Russia, India, China, and South Africa), scholarly research is yet to offer clear theoretical expectations about the interests and actions of these countries in the international arena. We provide such a framework, which also underscores important differences within this group of states.

Second, this paper adds to our understanding of the IIA Regime more broadly. As several studies have shown, many developing countries rushed to sign IIAs in the 1990s (Elkins et al., 2006; Jandhyala et al., 2011), often with limited understanding of the legal consequences of these agreements (Poulsen, 2015). A growing number of ISDS cases in the 2000s, many of which were very costly to the respondent state, gave rise to criticism and reevaluation of these agreements. Indeed, some countries have begun to look for ways to “rebalance” investors’ rights and host states’ flexibility (Broude et al., 2018; Haftel and Thompson, 2018; Poulsen and Aisbett, 2013; Simmons, 2014; Thompson et al., 2018). This study is the first to examine these developments with respect to HIDCs and the first to develop a comparative measure of exposure to the Regime, based on IIA content.⁵

This paper proceeds as follows. The next section develops several conjectures with respect to the sources of exposure to the IIA Regime, with a focus on FDI outflows and inflows, democracy, and the experience with investment arbitration.

⁵ See also Haftel (2018).

The third section elaborates on our measure, which serves as the dependent variable, and demonstrates the variation in our sample of sixty-four HIDCs. It also discusses the operationalization of independent and control variables as well as our estimation strategy. The fourth section reports the results of the statistical analysis and the fifth section concludes.

Theoretical Framework

This paper's main purpose is to shed light on the "exposure" of HIDCs to the IIA Regime. We conceptualize this term as the degree to which governments embrace the rules and disciplines of this regime (Alvarez & Sauvart, 2011). We operationalize exposure with reference to the number of IIAs a given state has signed and ratified as well as the freedom to regulate and enact domestic policies given up in these treaties. The latter aspect is crucial because IIAs vary a great deal on how they balance host state's flexibility and investors' protection (Broude et al., 2018). We think of these treaties in aggregate as an "exposure" because as states conclude more IIAs, more FDI is subject to their rules. And, as these IIAs relinquish more SRS, they increase the potential for investment claims. To be sure, this exposure is deliberate (even if its consequences are not necessarily intended) and largely determined by states own policy-making. As such, it also reflects their acceptance of the global investment regime and its norms.

The focus on HIDCs emanates from their curious position vis-à-vis global investment rules. As already mentioned, some of these countries were transformed from mostly recipients of FDI to important senders of FDI as well. We therefore begin with pondering the implications of this transformation for their IIA policies. We then turn to two factors that are not necessarily unique to HIDCs, but are likely to play an important role in the context of the IIA Regime. First, we consider the role of

regime type, both with respect to joining the Regime and withdrawing from it.

Second, we contemplate the effect of investment arbitration on the exposure to the IIA Regime. The remainder of the section discusses each factor in turn.

FDI Outflows and Inflows

Historically, HIDCs are members of the global South and are recipients of foreign capital. However, over the past decade, some of these countries' investors are becoming heavily engaged in the global economy. As a result, a number of HIDCs have shown a rapid growth of outwards FDI, most notably China. During the 2000s, China's FDI outflow has begun to climb sharply and quickly, moving from under five billion dollars a year to over one-hundred billion dollars a year in less than a decade. In 2017, it was the third largest exporter of FDI, trailing behind only the United States and Japan. Other countries exhibit similar tendencies. Russia's FDI outflows have increased from three billion dollars in the early 2000s to over sixty billion dollars by 2014. Other, smaller, HIDCs, such as Singapore, South Korea, Chile, and the United Arab Emirates, are also significant sources of outwards FDI. The amount of their capital export is especially notable relative to their economic size. Such countries thus shifted from largely "host" countries, who receive substantial inwards FDI, to both host *and* "home" countries, whose local firms engage in considerable outward FDI.

On the other hand, other HIDCs have shown a more moderate growth of outward FDI, if at all. India's FDI outflows, for example, gradually climbed to twenty billion dollars annually in the early 2000s, but then plateaued. While its position as a home country is evident in the global profile of several Indian MNCs in the information technology (IT) and automotive sectors (Collins 2013, 79-82), it lags well behind countries such as China, Russia, and Singapore. Similarly, Brazil's capital export is smaller than some of its Latin American neighbors, both relative to

economic size and in absolute terms. Various other, smaller countries, such as Turkey, the Czech Republic, Indonesia, and Jordan (to name a few), remain largely FDI recipients.

The sharp shift from a “home” to both “host” and “home” economies, apparent in some HIDCs but absent in others, is likely to have led governments to reconsider their position vis-à-vis the IIA Regime, changing their investment policies accordingly. Home countries wish to protect existing overseas capital, in addition to their interest in attracting foreign capital (Elkins et al. 2006; Allee and Peinhardt, 2010). In doing so, they shield their own businesses from unfair treatment and political risk, not least in other developing countries. They also provide them with access to ISDS, obviating the need to directly engage in the relationships between the private investor and the host state. Thus, HIDCs that send large amounts of capital to the rest of the world are more likely to conclude a greater number of IIAs with less SRS, compared to their peers that remain mostly recipients of FDI. We therefore hypothesize that a high level of FDI outflows should result in greater exposure to the IIA Regime.

The effect of FDI inflows is more ambiguous. On the one hand, we might think that high levels of incoming capital will render IIAs unnecessary. To the extent that these agreements might carry considerable costs to economic sovereignty, host countries that successfully attract FDI should feel less pressure to conclude investor-friendly IIAs as compared to HIDCs that are less successful in doing so. In Brazil, for example, there is a widely held belief that its economy is attractive enough to FDI even without IIAs (Bento, 2013; Collins, 2013). This logic should lead to the expectation that high FDI inflows will be associated with less exposure to the Regime.

On the other hand, an extensive body of research examines the reversed causal relationships, that is, the effect of IIAs on FDI inflows. This is not surprising, given the assumption that the main reason host countries sign these treaties in the first place is to attract foreign capital (Guzman, 1998). Whether IIAs actually boost FDI inflows or not remains a hotly contested question. Nevertheless, much of this research indicates that, indeed, IIAs are associated with more FDI (Aisbett et al., 2017; Allee and Peinhardt, 2011; Haftel, 2010; Kerner 2009; Sauvart and Sachs, 2009). Why should more FDI inflows lead to greater exposure to the global investment regime? One possibility is that more FDI represents greater presence and stakes of MNCs in the host country and, in turn, higher political pressure in both the host and home countries to negotiate investor-friendly IIAs. We therefore have no clear theoretical expectation with respect to the effect of FDI inflows.

Democracy

Much ink has been spilled on the nexus of regime type, most prominently conceptualized as democratic vs. non-democratic political systems, and international behavior and outcomes. With respect to foreign economic policy, this linkage commonly hinges on the relationships between the government, on the one hand, and interest groups and the mass public, on the other. It is therefore worthwhile to explore this factor in relation to the IIA regime. In this context, we distinguish between the decision to increase exposure to the Regime and the decision to reduce it (given a country's participation in the Regime). We conjecture that the effect of democracy is somewhat different in each of these two circumstances.

Starting with the initial decision to conclude IIAs, two contradictory logics may be at work. The first emphasizes the role of domestic political institutions and relies on the assumption that host countries sign these agreements in order to

demonstrate commitment to investor protection (and in turn to attract FDI). From this follows that states that are perceived as riskier to foreign investors are in greater need for these treaties, and will therefore be more eager about them. Assuming that democratic regimes are more stable and predictable than autocratic one, several studies conclude that the latter are more likely to enter into IIAs than the former (Elkins et al. 2006). For example, Arias et al. (2018) show that autocratic governments are more cooperative when it comes to IIAs and the global investment regime, suggesting that international institutions substitute for a poor domestic investment environment. In other words, by signing IIAs leaders in autocracies “import” institutions that can enhance their economic development (Myerson, 2008).

The alternative logic is less concerned with the domestic institutional structure, and highlights the impact of domestic interest groups and voters. In particular, it is assumed that governments in democracies depend more heavily on the support of the mass public, which in turn hinges on the health of the economy. To the extent that liberal economic policies produce economic growth, democracies will be more likely to adopt them. Thus, several studies suggest that democracies are more likely to liberalize trade, capital account, and sign free trade agreements, compared to other regime types (Milner and Kobuta, 2005; Mansfield et al., 2002; Mansfield and Milner 2012; Eichengreen and Leblang, 2008). This logic can be extended to IIAs: to the extent that these agreements increase FDI flows and that FDI brings about growth and employment (or that policy-makers believe that they do), democracies will be more enthusiastic about signing them. Considering the contradictory effect of the two logics, the consequences of regime type for signing and ratifying IIAs remains an empirical question.

That being said, there are good reasons to suspect that public attitudes will also have implications for decisions to remain exposed to IIA Regime, especially in the aftermath of experience in investment arbitration. As we argue in the next subsection, all HIDCs are expected to adjust their exposure to the Regime in light of their involvement in ISDS, but the impact should be much more pronounced in democracies, compared to other regime types. It is now widely acknowledged that the large number of investment claims and the costs associated with them has generated a so-called “backlash” against the global investment regime (Waibel et al., 2010). This opposition was driven, in large parts, by civil society groups that called on their governments to reclaim national sovereignty. For example, after facing costly investment claims, there was political pressure by the public and the media to retain national control over important policy areas in countries such as South Africa and India (Ranjan, 2014).

To the extent that IIAs and international investment arbitration are contested by civil society groups and viewed negatively by public opinion, their ability to affect policy could hinge on the nature of domestic political institutions. Specifically, we should expect that the backlash against the regime, to the extent that there is one, will exert greater pressure on governments in democratic countries, compared to other regime types. Indeed, Simmons (2014) shows that since 2008 democratic governments were more likely to seek annulments of ISDS awards. She argues, plausibly, that such governments face greater scrutiny and higher expectations of accountability to public interests.

A related potential explanation for democracies’ growing misgivings about the IIA Regime may have to do with the growing number of investment claims filed against them. In a recent study, Pelc (2017) demonstrates that in many of these cases

investors complain about indirect expropriation, which in turn revolve around regulation that is deemed unfair in the eyes of the claimant. He further shows that 64% of investment disputes in the last decade targeted democracies (Pelc, 2017), and speculates that they are more likely engage in regulation, compared to non-democracies. Importantly, many times these regulations are viewed as legitimate in the eyes of the public, as they address public health, and sustainable development, and the like. In other words, it appears that democracies pay a higher price for their “membership” in the IIA Regime. As a consequence, the backlash against it should be fiercer in democratic states. We should therefore expect the exposure to the Regime to decline in democracies more than non-democracies in response to its evolution. Before proceeding, a word of caution is in order, however. Much of the public opposition to IIAs has surfaced only in the last decade or so, and governments were slow to respond to this sentiment (especially democratic ones), it is entirely possible that this dynamic will be difficult to observe in the current landscape of IIAs. Nevertheless, if it does hold water, it should be much more visible in years to come.

Experience with Investment Arbitration

In accordance with the growing literature on the effects of arbitration experience, further discussed in this sub-section, we conjecture that HIDCs involved in a larger number of claims have a more limited exposure to the IIA Regime. This factor is expected to influence exposure to the Regime at a later stage, after signing and ratifying a substantial number of IIAs, if only because most of these claims have to be legally grounded in these IIAs.

A growing number of ISDS cases during the first decade of the 21st century, as well as their significant monetary and political implications, has brought the global investment regime to the attention of policy-makers, experts, foreign investors, and

transnational advocacy networks, who have begun reevaluating and debating the merits of the existing system (Haftel, 2018). As foreign investors have begun to slap host governments with claims in international arbitration forums, some governments have responded with greater reluctance to sign new or ratify existing IIAs (Haftel and Thompson 2013; Jandhyala, Henisz and Mansfield 2011; Poulsen and Aisbett 2013), to renegotiate or denounce existing treaties (Haftel and Thompson, 2018; Peinhardt and Wellhausen, 2016; Thompson et al., 2018), or to seek annulment of costly awards handed down by arbitration panels (Simmons 2014).

There is no reason to suspect that this trend skipped HIDs. Indeed, countries such as India, South Africa, and Indonesia have reviewed their IIAs policies after facing costly investment claims. All three largely halted the conclusion of new agreements and began looking for ways to reduce their exposure to the IIA Regime through the renegotiation or termination of investor-friendly IIAs (Poulsen, 2015; Ranjan, 2014). We thus have strong reasons to expect strong negative relationships between investment claims filed against an HID and its exposure to the Regime.

The effect of claims filed by an HID's own investors against other states is less straightforward. On the one hand, such disputes may vindicate these agreements, as they fulfil their intended purpose and protect investors in foreign lands. Thus, governments may conclude that this greater exposure pays off and would like to further increase it. On the other hand, most ISDS cases are contentious and can raise concerns regarding their implications in the home state. In one example, an (unsuccessful) attempt by a Chinese investor to use an MFN clause in the China-Peru BIT to "import" ISDS provisions from other Peruvian treaties caused concerns in China and prompted it to insert a provision that excludes ISDS from the MFN provision in subsequent treaties (Berger, 2015). In addition, even if the home state is

satisfied with the protection provided by IIAs, the responding host state may demand adjustments to the IIA such that exposure to the Regime is reduced. We therefore have no clear expectations with respect to the nexus of HIDCs experience as claimants and exposure to the IIA Regime.

Research Design

The research design employs the state-year as the unit of analysis for a sample of sixty-four HIDCs in the years 1960-2017. This section begins with an elaboration on the definition and operationalization of the dependent variables, and then presents the variation on these variables within our sample. This section continues with the description of the independent variables. All these variables are lagged one year to account for the possibility of reversed causality.

Given the nature of the dependent variables and the sample (discussed next), we use the GMM method with robust standard errors. The empirical analysis employs a panel data model, which includes a lagged dependent variable and implements the augmented Arellano-Bond estimator (Arellano and Bond 1991; Arellano and Bover 1995; Blundell and Bond 1998). This estimator is appropriate for analyzing panel data with a lagged dependent variable on the right-hand side, using lagged values of other independent variables as an instrument. The analysis implements the system-GMM estimator to generate robust and more efficient estimates (Windmeijer 2000).⁶

Dependent Variables

This study aims to account for the exposure of HIDCs to global investment rules through their IIAs policies. Specifically, it begins with the assumption that a larger

⁶ We use the *xtabond2* Stata routine developed by Roodman (2018).

number of IIAs, which forgo higher levels of sovereignty, reflect a greater integration into the IIA Regime, both as a recipient and sender of FDI.

The dependent variables are constructed as follows. First, all IIAs concluded by a given country, as well as their years of signing and entry into force are recorded. Next, all IIAs are coded on their level of state regulatory space (SRS). This variable, described in greater detail elsewhere (Broude et al. 2017, Thompson et al. 2018), ranges from zero for maximum investor protection (at the expense of state sovereignty), to one for maximum SRS. Importantly, a pair of countries that do not have an IIA score a value of one, because they did not give up any SRS vis-à-vis each other. In addition, if an IIA was renegotiated, the value of the new treaty replaces the value of the old one, and if a treaty was terminated, the SRS value switches back to one from the year of termination onwards. After calculating SRS values for all IIAs of a particular country,⁷ we took the average SRS value across all IIAs in effect for a given year (including those countries with which there is no IIA). Finally, the economic size of the partner country has important implications for SRS. Arguably, an IIA with a large developed economy, say Germany, reflects greater loss of state flexibility from a similarly designed IIA with a smaller developing economy, say Egypt. We take this into account by weighting the SRS value for a given IIA by the GDP of the partner country before taking the average across all IIAs.⁸

The two dependent variables, labeled *SRS All Force GDP*, and *SRS All Force*, are calculated as the average of SRS values for all IIAs in force in a given year, weighted and unweighted by the partner's GDP, respectively. For ease of

⁷ In some instances, the text of the IIAs was not available, and their SRS could not be determined. Such IIAs were assigned values of similar IIAs, based on temporal and geographical similarity.

⁸ GDP data are based on the World Development Indicators.

interpretation, the mean value is rescaled to range from zero, for no SRS, to 100, for maximum SRS. In constructing the SRS scores, signed treaties that are not (yet) in force score one on SRS. We prefer mutually-ratified IIAs to signed ones, because only the former indicates a meaningful loss of state sovereignty (Haftel and Thompson 2013).⁹

Sample and Descriptive Statistics

As already discussed, we are interested in developing countries that are not only importing FDI, but can also exporting it, at least potentially. Using the World Bank's classification, we coded most non-Western countries in the high and upper-middle income categories.¹⁰ With two important exceptions, India and Indonesia, we excluded countries in the lower-middle and low income categories.¹¹ The list of sixty-four HIDCs included in our sample is reported in the appendix.

To provide a sense of the variation on the dependent variables, Figure 1 reports the average annual levels of *SRS All Force GDP* and *SRS All Force* for all countries in our sample. As this figure shows, the SRS value is one, or very close to it, in the Regime's early years, as very few countries concluded BITs. Moreover, those treaties that were concluded during this time did not relinquish much regulatory space. In particular, many of them lacked ISDS. SRS decreased very gradually in the 1970s and 1980s, but then dropped much more sharply in the 1990s, especially if one takes into account the economic size of the BIT partner. This decline reflects the rush to sign BITs in the post-Cold War era, many of which embraced investor protection at

⁹ We nevertheless constructed parallel variables for signed IIAs as well as for the subset of provisions addressing ISDS. They are not discussed here due to space limitations.

¹⁰ Several small states are excluded from the sample.

¹¹ Both countries are in the lower-middle income category.

the expense of national sovereignty. Moreover, many of these treaties were signed with large, capital-exporting, countries. SRS begins to level off in the late 2000s and early 2010s, echoing the reality that, following costly investment disputes, many states adjusted their approach to the global investment regime. As several studies demonstrate, governments have stopped signing new IIAs or started to either renegotiate or terminate them during these years (Haftel and Thompson 2018; Poulsen and Aisbett 2014).

[Figure 1]

To be sure, this annual average masks a great deal of variation across HIDCs. To illustrate this variation, Figure 2 depicts the annual values of *SRS All Force GDP* for four countries in our sample. Lithuania's approach to the Regime is, perhaps, representative of the general trend. It signed investor-friendly BITs in droves in the 1990s and early 2000s, but only a handful afterwards. Turkey exemplifies HIDCs that embraced the IIA Regime even more. Like Lithuania, it concluded a large number of IIAs in the 1990s and 2000s. Unlike Lithuania, however, it has continued to do so in the 2010s, giving up more and more regulatory space. In fact, Turkey's SRS value of about thirty-four in 2015 is the lowest in the sample.

Indonesia is one of several countries that were initially very enthusiastic about IIAs, but then had a change of heart. As Figure 2 shows, it not only stopped signing new IIAs after being hit by costly investment claims but also started renegotiating and terminating existing IIAs. As a result, its annual SRS has increased from about sixty in the early 2010s to about seventy-six in 2017. In an extreme case, Brazil remained outside the IIA regime for the entire period. While it signed fourteen BITs in the 1990s, it ratified none. More recently, it signed several IIAs, but only with other

developing countries.¹² Furthermore, these treaties, which are based on a 2015 Brazilian template agreement, do not forgo much SRS. Most notably, they lack binding ISDS provisions. Be that as it may, having demonstrated that the dependent variables vary across time and across countries, we now turn to the independent variables.

[Figure 2]

Independent Variables

We examine four sets of explanations to states' IIA policies: their experience with investment disputes, domestic political factors, FDI flows, and potentially confounding economic factors. Before discussing them in turn, we remind the readers that all models include a lagged dependent variable.

Experience with Investment Arbitration – we account for this factor with two variables. We begin with a state's experience as a respondent to investment claims, which was shown to have considerable impact on national IIA policies. Here, we count the cumulative number of claims submitted against a given country. This variable, labeled *Dispute Respond*, captures the aggregate impact of claims on a state's approach to IIAs. Next, it is possible that states are not only affected by claims against them, but also by claims of their own investors against other countries. We account for this possibility with *Dispute Claimant*, which is the cumulative number of investment claims filed by the country's own investors. Data for these two variables are taken from UNCTAD's Investment Dispute Settlement Navigator.¹³

¹² Only one of these IIAs, the 2015 BIT with Angola, entered into force by the end of 2017.

¹³ <http://investmentpolicyhub.unctad.org/ISDS>. Accessed January 5, 2019.

Regime Type and other Domestic Political Factors – as discussed in the theoretical section, democracies and non-democracies might behave differently with respect to the IIA Regime. We account for this factor with the Polity measure, which varies from 10, for full democracies, to -10, for full autocracies. In line with conventional practice, we turn these values into a dichotomous variable, labeled ***Democracy***. It scores 1 for Polity values of six or higher, and zero otherwise. This measure is based on the Polity 2 variable in the Polity IV Project (Marshall, Gurr, and Jaggers 2017).

We contemplate the impact of two additional variables pertaining to the domestic political environment. First, the level of political constraints on the executive might affect its ability or willingness to enter into international investment commitments. On the one hand, it is arguably difficult to forge international agreements when leaders confront an array of domestic groups with competing preferences. Indeed, previous studies show that political constraints reduce the probability of signing trade agreements (Mansfield et al., 2008, 2015; Mansfield and Milner, 2012) and lead to less legalized dispute settlement mechanism provisions (which is equivalent to more SRS) (Büthe and Milner, 2014).

On the other hand, the inability to freely change economic policies leads to greater predictability in terms of investment-related behavior (Henisz, 2000). Political constraints may therefore reassure foreign investors and their governments, which negotiate these agreements, that their counterparts have stable economic policies, leading to more IIAs (Allee and Peinhardt, 2010). Hence, we do not have a clear expectation with respect to the relationship between political constraints and exposure to the investment regime. We account for ***Political Constraints*** with the POLCON III

measure developed by Henisz (2000). Given that regime type and political constraints conceptually and empirically overlap,¹⁴ they are included in separate models.

Second, respect for the rule of law in a country may be associated with more or less commitment to investor protection (Allee and Peinhardt 2010; Tobin and Rose-Ackerman 2011). From one perspective, we might think that respect for the rule of law will obviate the need for intrusive IIAs, as political risk to foreign investors should be lower. In particular, partner countries might feel confident that any grievances foreign investors might have will be fairly remedied by the local court system. In contrast, more corrupt countries might want to give up greater SRS to compensate for the greater political risk perceived by foreign investors. This logic thus suggests that lower respect to the rule of law will be associated with greater exposure to the IIA regime.

Alternatively, we might expect that countries in which corruption is rampant and the rule of law is frowned upon to be more reluctant to forgo SRS through IIAs. Such countries are much more likely to face investment claims, compared to countries that intend to respect investors' rights regardless of their IIA commitments (Allee and Peinhardt, 2010). Hence, the cost of exposure to the IIA Regime should fall as respect to the rule of law increases. We assess the empirical validity of the divergent expectations with *Law & Order*. This variable is based on the Political Risk Service's (PRS) International Country Risk Guide's (ICRG) measure, which ranges from zero to six for low and high levels of law and order, respectively. Data are taken from Henisz (2000). Data coverage for this variable is relatively limited, resulting in a loss

¹⁴ The bivariate correlation in our sample is about 0.61.

of about twenty percent of the sample. We therefore present models with and without it.

FDI Flows – based on the theoretical framework, we expect high levels of FDI outflows to strengthen commitment to investor protection. While theoretical expectations are less clear with respect to FDI inflows, it is still important to examine their effect. We account for these factors with *FDI Inflows* and *FDI Outflows*, which are based on net annual flows reported by UNCTAD in millions of current US dollars.¹⁵ To account for economic size, both variables are measured as a percentage of the country's gross domestic product (GDP).

Economic Controls – we control for two conventional economic variables that might affect a country's IIA policies. First, economic size might affect a country's capacity to sign investment treaties as well as its bargaining power in treaty negotiations. We account for this factor with *GDP*, measured with the logged GDP in constant 2010 US dollars. Second, the level of economic development might have implications for a state's capacity, need for FDI inflows, and ability to export FDI. This is controlled for *GDPPC*, which is the logged GDP per capita in constant 2010 US dollars. Finally, several states in the sample, e.g. all the Gulf states, Iran, Venezuela, Ecuador, and Russia, are major producers and exporters of energy, especially oil. Such countries may be less dependent on IIAs to attract foreign capital. We control for this possibility with *Oil Rents*, which is the difference between the value of crude oil production at regional prices and total costs of production as a percentage of GDP. Data for these three variables come from the World Bank's World Development Indicators.

¹⁵ UNCTADStat, <http://unctadstat.unctad.org/EN/>.

Results

Tables 1 and 2 report the results of eight GMM models. All models in Table 1 report the results with respect to *SRS All Force GDP*. Model 1 includes *Democracy* and Model 2 includes *Political Constraints*. Models 3 and 4 are similar to the first two models, respectively, with the exception that they also include *Law & Order*. Table 2 presents four robustness checks. First, as the previous section demonstrates, there is not much variation on the dependent variables until the early 1990s. Models 5 and 6 in Table 2 therefore replicate models 1 and 2 for the 1990-2017 time-period. Model 7 adds *Oil Rents* as a control variable and Model 8 substitutes the main dependent variable with the unweighted dependent variable, *SRS All Force*.

[Tables 1 and 2]

The results offer empirical support to some, but not all, of the theoretical expectations. We find strong support for the effect of being on the receiving end of ISDS on the exposure of developing countries to the IIA Regime. It appears that, in particular, states hit by investment claims become less enthusiastic about the global investment regime and work to reclaim regulatory space. *Dispute Respond* is positive and statistically significant across all models. Substantively, a one-unit increase in the cumulative number of claims filed against a state up to a given year is expected to increase its annual SRS score by about 0.2. While this value may seem pretty small on a 0-100 scale, as claims against a particular country pile up, their effect on its policies is likely to be rather meaningful. A country with the maximum value on *Dispute Respond* (Argentina with fifty-nine claims) would see a 11.8-point increase in SRS, which for the average country would mean almost full SRS at 96.41.¹⁶ This finding

¹⁶ The average SRS-score for the sample is 86.41.

reinforces several recent studies that underscore the reality that states begin to rethink their commitment to investor protection after being hit by investment claims (Haftel and Thompson 2018; Poulsen 2015; Poulsen and Aisbett 2013; Thompson et al. 2018). Apparently, this logic also applies in the specific context of HIDCs.

The effect of claims files by local investors against partner countries is quite different. *Dispute Claimant* is always negative, suggesting that, if anything, ISDS cases that advance the protection of their own investors, motivate governments to conclude IIAs that preserve or further enhance these protections. With the exception of the model with the unweighted dependent variable (Model 8), this variable is not statistically significant, however. One possible explanation for this result is that such ISDS experience has countervailing effects. As discussed in the theoretical section, even if states are content to see their investors gaining protection through ISDS, they may be concerned about the possibility that the same system will turn against them in the future. Alternatively, states may be less sensitive to investment arbitration in which they are not directly involved (Thompson et al. 2018).

Turning to domestic political factors, *Democracy* is always negative, but statistically significant only with respect to the unweighted dependent variable. This result suggests that democratic HIDCs were more willing to give up regulatory space in exchange for FDI, but that there may be countervailing factors that weaken this effect. For example, as we noted earlier, several emerging democracies, e.g. South Africa, Indonesia, and India, lead to the backlash against the IIA Regime in recent years. Another explanation is that the *Polity* measure is largely time-invariant for the individual state and that the GMM setup absorbs much of the cross-sectional variation. We find similar results for *Political Constraints*. This variable is always negative and statistically insignificant, pointing to a weak association between greater

constraints on the executive and lower SRS. Thus, in contrast to existing research on trade agreements, there is no clear evidence that more constrained leaders find it more difficult to sign IIAs that forgo national sovereignty.

One potential explanation for this result is that political constraints signal stability of economic policies, making these countries more attractive IIA partners. When considering the sample of this research, an alternative approach which highlights the impact of domestic interest groups in autocracies or weak democracies could be applied. In countries where the winning coalition is similar in size to the electorate, leaders may not be able to pay off all veto players or maintain public support through rent seeking. Hence, they face greater pressure to provide public goods and therefore adopt more open (less SRS) policies (Bueno de Mesquita et al., 2003; Mansfield et al., 2015). Either way, the findings on the relationships between political institutions and IIA policies warrant further investigation.

The third domestic political variable, *Law & Order*, is negative and highly statistically significant. This result suggests that HIDCs with greater respect to the rule of law forgo more SRS through their IIAs, compared to their more corrupt peers. One possible explanation for this finding is that less corrupt states are more willing to commit to hospitable treatment of foreign investors, because they intend to treat them this way regardless of the IIA. They therefore have little reason to worry about claims filed by disgruntled foreign investors (Allee and Peinhardt, 2010). From a similar perspective, it could be that potential partners are more enthusiastic about IIAs with countries that are more likely to respect their international agreements. As Tobin and Rose-Ackerman (2011) have argued, IIAs cannot fully substitute for a poor legal environment. Rather, to attract FDI, IIAs should be complemented with a respect to the rule of law. Perhaps, IIA negotiators take the same view.

Consistent with our theoretical expectations, *FDI Outflows* is negative and statistically significant in all models pertaining to the GDP-weighted dependent variable. Substantively, a one percent increase in the percentage of FDI outflows out of a country's GDP is associated with a two-point decrease in the mean annual SRS score. As we have argued, HIDs that turn from mostly recipients of FDI to senders of significant amounts of capital appear to become more enthusiastic about investor protection through IIAs, presumably as an instrument to reduce the political risk of their own investors abroad. This finding underscores the changing position of several HIDs, such as China, Russia, South Korea, and Singapore, in the global economy. The insignificant coefficient on the SRS measure that does not account for economic size suggests that capital-exporting developing countries are especially interested in concluding IIAs with other large economies, presumably because their investors' stakes are higher in these countries.

FDI Inflows is positive, but statistically insignificant, in all models related to *SRS All Force GDP*. This suggests that, if anything, higher levels of incoming capital are associated with greater regulatory space. Recalling the theoretical discussion, this finding suggests that high levels of FDI obviate the need to conclude intrusive and potentially costly IIAs, rather than the other way around. Nevertheless, the statistical insignificance suggests that other, countervailing, forces are at work as well.

Turning to the control variables, *GDP* and *GDP per Capita* are both statistically significant across all models, with effects going in opposite directions. The negative coefficient of *GDP* indicates that economic size is associated with lower SRS and thus greater acceptance of the IIA Regime. One possible explanation for this result is that larger economies have more capacity to sign and ratify IIAs. Another is that larger economies are more attractive to potential treaty partners. The positive sign

on *GDP per Capita* suggests that more developed HIDCs are less inclined to forgo SRS. Perhaps such countries are in less of a need of foreign capital and therefore face less pressure to offer foreign investors protection through IIAs. As Model 7 shows, *Oil Rents* is statistically insignificant and does not affect the results on other variables. Finally, estimates for the lagged dependent variables are positive and highly statistically significant. This is expected, given the stickiness of the dependent variables: the group of IIAs in force for a given state is likely to persist in subsequent years as these are treaties with a lengthy duration.

Conclusion

In this paper, we examine the exposure of HIDCs to the global regime that consists of IIAs and investment arbitration cases. Of particular interest has been the degree to which this key group of countries is likely to integrate further into or withdraw from this regime, as observed in the degree to which they claim SRS in their IIAs. Major forces for change include the shifting patterns in HIDCs' investment activities, which have transformed them from their historical role as recipients of FDI to active investors in their own right that seek protection of their interests abroad. In addition, regime type as well as involvement of HIDCs in investment arbitration, both as claimants or respondents, further complicate the picture.

The analysis in this paper juxtaposes three main drivers – political, economic, and legal – in HIDCs' institutional preferences in their IIAs for greater or lesser SRS, conceptualized and measured in terms of preferred level of autonomy in determining host country rights. The analytical framework considers the political, in terms of regime type; the economic, as observed in shifts in FDI patterns in inflows and outflows; and the legal, captured by the experience of HIDCs in investment arbitration. The expectations are that each factor contributes independently to the

overall regulatory space states are willing to concede (or not). As investors from emerging markets become significant players on the global scene, they are likely opt for greater exposure to the IIA Regime, while vulnerability in terms of involvement in costly legal proceedings in investment arbitration is likely to push in the opposite direction.

The empirical analysis tests these expectations using an original data set of SRS values at the state level for a large sample of HIDs in the 1960-2017 period. Aside from exhibiting significant variation across space and time, the results also indicate the conditions under which these countries opt for greater or lesser SRS across their investment agreements. They suggest that high levels of FDI outflows, or as HIDs become significant investors on their own, encourages greater exposure of these countries to the IIA regime. Conversely, extensive experience with investment arbitration, especially involvement as a respondent in these cases, are associated with greater state regulatory space in their investment agreements.

However, the weak results with respect to democracy and political constraints certainly call for further research on the relationship between domestic political institutions and the IIAs Regime. As noted in the theoretical section, many of the democratization processes, as well as the public opposition to IIAs, have taken place in the last decade or so. We might therefore speculate that the relationship between democracy and exposure to the IIA Regime will be more apparent in coming years.

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Figure 1: Average Levels of *SRS All Force GDP* and *SRS All Force* for Sixty-Four Developing Countries, 1960-2017

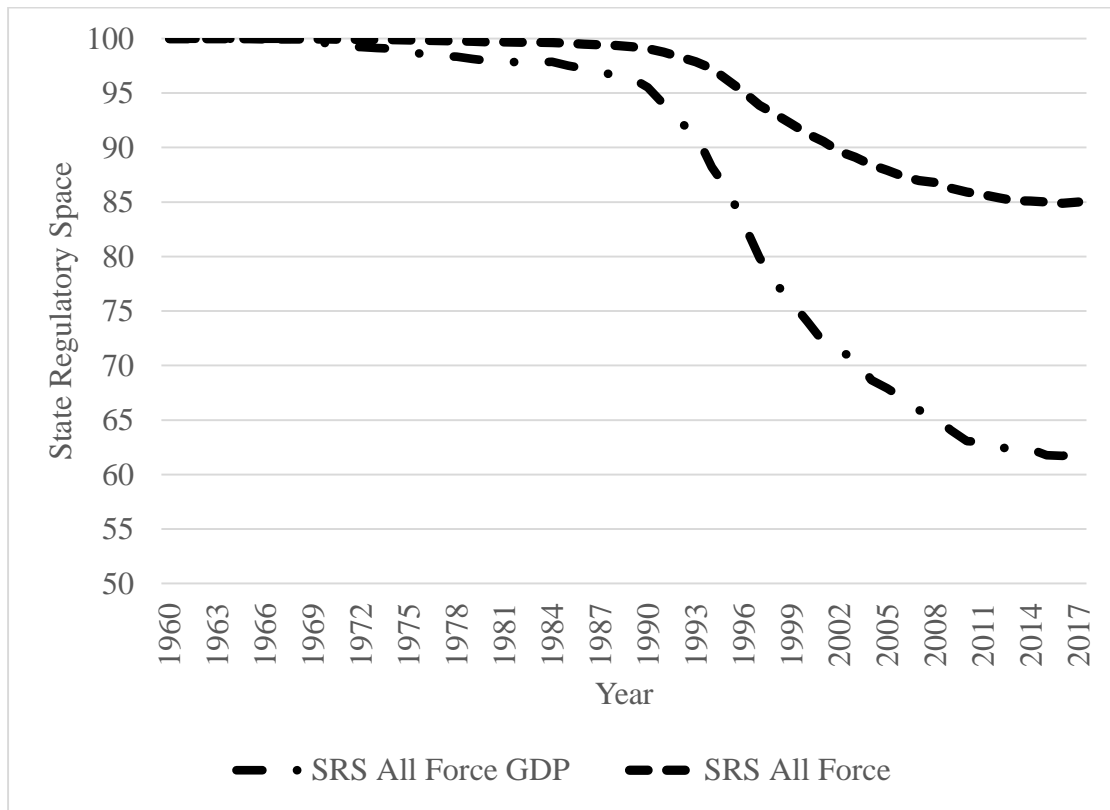


Figure 2: Levels of *SRS All Force GDP* for Brazil, Indonesia, Lithuania, and Turkey, 1960-2017

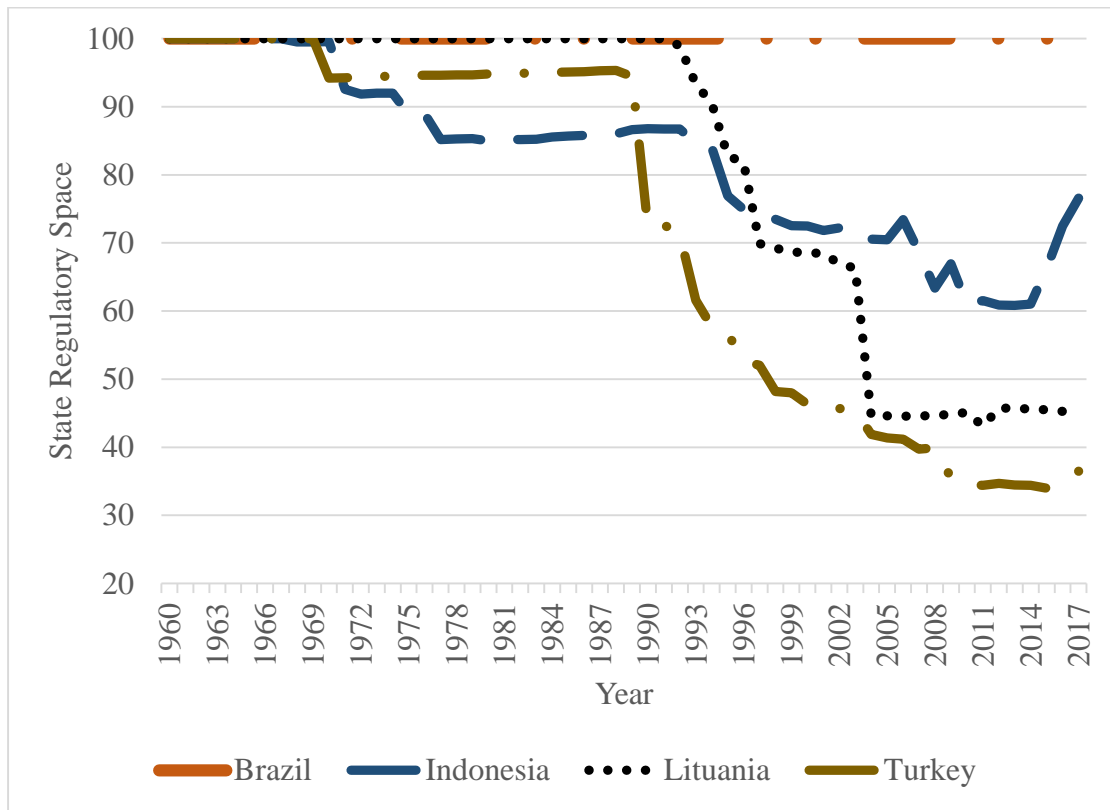


Table 1: GMM Models of the Sources of SRS in Middle-High and High Income Developing Countries

	(1)	(2)	(3)	(4)
	Democracy	Political Constraints	Democracy Law & Order	Political Constraints Law & Order
<i>Lagged SRS (Weighted GDP)</i>	0.916*** (22.30)	0.909*** (20.91)	0.883*** (17.88)	0.884*** (17.78)
<i>Dispute Respondent</i>	0.211*** (2.67)	0.235*** (2.76)	0.146** (2.04)	0.142* (1.96)
<i>Dispute Claimant</i>	-0.0939 (-0.42)	-0.0389 (-0.17)	-0.137 (-0.44)	-0.112 (-0.36)
<i>Democracy</i>	-0.596 (-0.85)		-0.611 (-0.79)	
<i>Political Constraints</i>		-1.571 (-1.29)		-1.523 (-1.09)
<i>Law & Order</i>			-0.622** (-2.41)	-0.648*** (-2.58)
<i>FDI Inflows</i>	0.0926 (1.43)	0.0946 (1.45)	0.0890 (1.33)	0.0889 (1.33)
<i>FDI Outflows</i>	-0.195** (-2.12)	-0.193** (-2.10)	-0.197** (-2.00)	-0.196** (-1.98)
<i>GDP</i>	-4.277*** (-2.64)	-4.542*** (-2.78)	-5.022** (-2.09)	-4.691** (-1.96)
<i>GDP per Capita</i>	4.043** (2.57)	3.791** (2.57)	4.350** (2.22)	3.945** (2.05)
<i>N</i>	61	61	57	57
<i>NT</i>	1,693	1,685	1,303	1,303

t statistics in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table 2: GMM Models of the Sources of Determinants of SRS in Middle-High and High Income Developing Countries, Robustness Checks

	(5)	(6)	(7)	(8)
	Democracy Year > 1989	Political Constraints Year > 1989	Democracy Oil Rents Included	Democracy DV Unweighted
<i>Lagged SRS (Weighted GDP)</i>	0.894*** (19.70)	0.883*** (17.99)	0.913*** (22.25)	
<i>Lagged SRS (Unweighted)</i>				0.917*** (37.84)
<i>Dispute Respondent</i>	0.175** (2.35)	0.192** (2.52)	0.209*** (2.68)	0.0559** (2.20)
<i>Dispute Claimant</i>	-0.0814 (-0.37)	-0.0234 (-0.10)	-0.0888 (-0.39)	0.153** (2.01)
<i>Democracy</i>	-0.692 (-0.89)		-0.640 (-0.91)	-0.664*** (-3.17)
<i>Political Constraints</i>		-1.630 (-1.17)		
<i>FDI Inflows</i>	0.0816 (1.32)	0.0824 (1.34)	0.0906 (1.41)	-0.00209 (-0.21)
<i>FDI Outflows</i>	-0.189** (-2.21)	-0.187** (-2.21)	-0.193** (-2.10)	0.0157 (1.26)
<i>GDP</i>	-4.320** (-1.98)	-4.410* (-1.96)	-4.429*** (-2.64)	-2.168*** (-2.71)
<i>GDP per Capita</i>	3.605** (2.03)	2.911 (1.63)	4.231** (2.56)	1.679** (2.03)
<i>Oil Rents</i>			-0.0157 (-0.86)	
<i>N</i>	61	61	61	61
<i>NT</i>	1,408	1,400	1,686	1,408

t statistics in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table A1: Summary Statistics

Variable	Mean	STD	Min	Max
<i>SRS All Force GDP</i>	86.41	18.57	33.97	100
<i>SRS All Force</i>	95.20	7.66	58.01	100
<i>Dispute Respond</i>	1.12	4.46	0	59
<i>Dispute Claimant</i>	0.24	1.17	0	26
<i>Democracy</i>	0.47	0.49	0	1
<i>Political Constraints</i>	0.22	0.21	0	0.72
<i>Law& Order</i>	3.46	1.35	0	6
<i>FDI Inflows</i>	2.68	3.88	-14.36	45.14
<i>FDI Outflows</i>	0.70	1.93	-13.17	22.71
<i>GDP</i>	24.61	1.77	18.40	29.88
<i>GDPPC</i>	8.54	0.99	4.88	11.64
<i>Oil Rents</i>	6.18	11.54	0	80.94

Table A2: Countries Included in the Statistical Analysis and their World Bank's Income Categorization

Country	WB Income Category	Country	WB Income Category
1 <i>Albania</i>	Upper-Middle	33 <i>Kuwait</i>	High
2 <i>Algeria</i>	Upper-Middle	34 <i>Latvia</i>	High
3 <i>Argentina</i>	High	35 <i>Lebanon</i>	Upper-Middle
4 <i>Armenia</i>	Upper-Middle	36 <i>Libya</i>	Upper-Middle
5 <i>Azerbaijan</i>	Upper-Middle	37 <i>Lithuania</i>	High
6 <i>Bahrain</i>	High	38 <i>Macedonia</i>	Upper-Middle
7 <i>Belarus</i>	Upper-Middle	39 <i>Malaysia</i>	Upper-Middle
8 <i>Belize</i>	Upper-Middle	40 <i>Mauritius</i>	Upper-Middle
9 <i>Bosnia and Herzegovina</i>	Upper-Middle	41 <i>Mexico</i>	Upper-Middle
10 <i>Botswana</i>	Upper-Middle	42 <i>Namibia</i>	Upper-Middle
11 <i>Brazil</i>	Upper-Middle	43 <i>Oman</i>	High
12 <i>Bulgaria</i>	Upper-Middle	44 <i>Panama</i>	High
13 <i>Chile</i>	High	45 <i>Paraguay</i>	Upper-Middle
14 <i>China</i>	Upper-Middle	46 <i>Peru</i>	Upper-Middle
15 <i>Colombia</i>	Upper-Middle	47 <i>Poland</i>	High
16 <i>Costa Rica</i>	Upper-Middle	48 <i>Qatar</i>	High
17 <i>Croatia</i>	High	49 <i>Romania</i>	Upper-Middle
18 <i>Cuba</i>	Upper-Middle	50 <i>Russia</i>	Upper-Middle
19 <i>Czech Republic</i>	High	51 <i>Saudi Arabia</i>	High
20 <i>Dominican Republic</i>	Upper-Middle	52 <i>Serbia</i>	Upper-Middle
21 <i>Ecuador</i>	Upper-Middle	53 <i>Singapore</i>	High
22 <i>Estonia</i>	High	54 <i>Slovakia</i>	High
23 <i>Gabon</i>	Upper-Middle	55 <i>Slovenia</i>	High
24 <i>Guatemala</i>	Upper-Middle	56 <i>South Africa</i>	Upper-Middle
25 <i>Hungary</i>	High	57 <i>Taiwan</i>	High
26 <i>India</i>	Lower-Middle	58 <i>Thailand</i>	Upper-Middle
27 <i>Indonesia</i>	Lower-Middle	59 <i>Trinidad and Tobago</i>	High
28 <i>Iran</i>	Upper-Middle	60 <i>Turkey</i>	Upper-Middle
29 <i>Jamaica</i>	Upper-Middle	61 <i>Turkmenistan</i>	Upper-Middle
30 <i>Jordan</i>	Upper-Middle	62 <i>United Arab Emirates</i>	High
31 <i>Kazakhstan</i>	Upper-Middle	63 <i>Uruguay</i>	High
32 <i>South Korea</i>	High	64 <i>Venezuela</i>	Upper-Middle