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Democracies conclude more and stricter international investment agreements – but why?

by

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Conventional wisdom suggests that strong domestic institutions, measured by indicators of good governance, the rule of law, and the protection of property rights, provide an effective first layer of protection for foreign investors. However, empirical studies reveal that democratic host countries (which on average tend to have stronger domestic institutions) are more likely to conclude international investment agreements (IIAs) than more autocratic countries.[1] Furthermore, recent analyses covering trends since the late 1970s suggest that democratic countries are more likely to agree to stricter IIA provisions related to binding investor-state dispute settlement and pre-establishment national treatment than autocratic countries. Specifically, the likelihood that host countries will conclude IIAs with strict dispute settlement and national treatment provisions increases by about 10% for every step from autocracy to democracy (based on the seven-grade scale of Freedom House).[2] In other words, democratic governments tie their hands particularly tightly in IIAs, even though their domestic framework alone offers security for foreign investors.

Political scientists focusing on international trade agreements have an intriguing explanation to offer; democracies are more likely to conclude international agreements on trade liberalization, in line with the preferences of median voters, since such agreements promote economic growth and, hence, improve policymakers' chances for re-election.[3] However, this theory is unlikely to hold in the context of foreign direct investment (FDI) and IIAs. Compared to trade liberalization, it is less clear what efficient economic policy means in this context. It is hardly disputed that trade agreements stimulate exports and imports between the partners, while empirical evidence is highly ambiguous on whether IIAs are effective in promoting FDI flows to host countries entering into binding commitments. Moreover, the view that trade is good for growth may be hardly contested, but it seems less clear under which conditions FDI will benefit host countries. Skeptics argue that productivity-enhancing effects of inward FDI are least likely where needed most, namely in poor host countries with insufficient endowment of complementary local factors of production. Nevertheless, poor democratic host countries appear to be as eager as more advanced democracies to participate in the IIA boom.

Political scientists and economists are currently not able to provide definite answers to the question of why democracies sign more and stricter IIAs. One might ponder a purely "technical" explanation: the correlation between democracy and increasingly strict IIAs could be a statistical artifact, rather than a causal relationship, considering the coincidence between the longer-term trend toward democratization in large parts of the world and the mushrooming of bilateral investment treaties. However, recent analyses focusing on investment provisions concluded in the context of preferential trade agreements corroborate significant effects of democracy. Alternatively, democracies may simply be more likely to engage in all forms of international co-operation since they see themselves as "good citizens" of the international system. Such unobserved heterogeneity is difficult to control for in the typical research designs employing observational data since it may change over time.

Another possible explanation would be more embarrassing for democratic governments. Their short-sightedness and preoccupation with upcoming elections may render them prone to bounded rationality.[4] Accordingly, host-country governments tend to ignore the "high-impact, low-probability costs" of IIA-related disputes as long as they themselves have not been brought to international arbitration by foreign investors claiming a breach of IIA provisions. As UNCTAD attests, the number of such cases has soared recently. What is more, more cases have been brought against democratic host countries than against autocratic host countries. Although the number of cases does not necessarily imply higher costs of investment disputes for democracies, it does indicate that it may have been naïve for democratic governments to think that they had little to fear from IIAs.

It remains open to debate whether democracies are more short-sighted than autocracies. For one, a refined cost-benefit balance of FDI provisions would be required to assess the economic rationality of IIAs. Furthermore, democracy may be too broad a concept to reveal the complexities under specific governance structures, e.g., there may be differences between parliamentary and presidential democracies. Finally, unidirectional causality from governance structures to international rule making is difficult to establish. New insights may be gained if mainly democratic governments disengage from the global IIA regime by concluding fewer and weaker FDI provisions in the future, or attempt to renegotiate existing ones. In this context, it is telling that investor-state dispute settlement plays a big part in the controversy around the Transatlantic Trade and Investment Partnership negotiations between the United States and the European Union.

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[1] *See,* Eric Neumayer, Peter Nunnenkamp and Martin Roy, "Are stricter investment rules contagious? Host country competition for foreign direct investment through international agreements", *Review of World*

Economics (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2580108, where we offer details on the definition of strict IIA provisions, data sources and related literature.
[2] Freedom House, "Methodology: electoral democracy designation", available at https://freedomhouse.org/report/freedom-world-2012/methodology#.VeW4ZdNVjAY.
[3] Edward D. Mansfield, et. al., "Democracy, veto players and the depth of regional integration", *World Economy*, vol. 31 (2008), pp. 67-96.
[4] Lauge N. Skovgaard Poulsen and Emma Aisbett, "When the claim hits: bilateral investment treaties and bounded rational learning", *World Politics*, vol. 65 (2013), pp. 273-313.

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