

Capital Openness, Bilateral Investment Treaties, and Coups d'état: A Mediation Analysis

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Abstract

Recent studies have investigated how economic openness contributes to political (in)stability due to its distributional effects. In this paper, we examine the relationships between capital openness, bilateral investment treaties (BITs), and the risk of coup in developing countries. We argue that capital account openness increases the risk of coups because it opens a window for capital owners to move their asset abroad and “hollow out” their countries, so other elites act against political leaders and their cliques. By contrast, BITs function as a credible commitment of political leaders to long-term economic growth, which further mitigate the tension between capital owners and non-capital owners. Furthermore, we argue that BITs mediate the relationship between capital openness and coup risks. More specifically, countries with a higher level of capital openness have less incentive to sign BITs, thereby facing more risk of coups. Using data from 1960 to 2009 of 118 developing countries, results of our mediation analysis demonstrate that capital openness increases the risk of coups whereas BITs reduces it.

1. Introduction

Bilateral investment treaties (BITs) have been the most visible and powerful legal protective mechanism underlying the growth of cross-border capital flows since its inception back in 1959 between Pakistan and Germany. According to the current estimates from the United Nations Conference on Trade and Development, 178 countries are involved in at least one BIT, and they have signed more than 2,900 BITs with one another.¹ BITs guarantee certain standards of investment protection in treaty language and implementation, including fair and equitable treatment, national treatment, repatriation of investment and return, compensation for direct and indirect expropriation, and agreement to international dispute arbitration venues such as International Centre for Settlement of Investment Disputes (ICSID).² Since BITs are initiated to overcome the time-inconsistency problem plaguing cross-border foreign direct investment (FDI) by reducing political and regulatory risks for foreign investors, most of scholarships in the literature examine whether conclusion of BITs are able to bring in FDI for developing countries (e.g., Buthe and Milner 2009, Kerner 2009, Allee and Peinhardt 2011, Haftel 2010).

However, the literature has paid little attention to the political consequence of signing BITs in developing countries, particularly in autocratic regimes where the political risk of losing office looms large. In this paper, we focus on coup d'état and ask the following research question: Do BITs reduce the risk of coup d'état in developing countries? We argue that signing BITs is a credible commitment made by political leaders to reduce the risk of coups initiated by other elites in two ways. First, BITs increase inflows of FDI that facilitates economic development of host countries, enriching dictators' economic patronage to maintain their ruling coalition. Second, BITs make it feasible for rich elites to move their financial assets abroad if they are concerned of more economic returns. The larger number of BITs signed by a country, the more opportunities of exiting domestic market and making oversea investment for ruling elites. As a result, elites have fewer incentives to initiate coups against their leaders when their countries signs more BITs. Using data of 118 developing countries between 1960 and 2009, we find evidence supporting our claims. In particular, we find that capital openness increases the rise of coups but signing BITs is associated with fewer coup attempts in developing countries.

¹ These statistics are obtained from UNCTAD's International Investment Agreements (IIAs) database.

² ICSID is a heavily used and widely observed international arbitral institution that is part of the World Bank. 156 countries have signed the ICSID Conventions (Allee and Peinhardt 2010). We will elaborate on those clauses later on in the dissertation.

2. Previous Studies on Capital Openness, BITs, and Risk of Coups

Existing literature examining the effect of capital account openness on coups suggests that capital inflow or outflow openness can either reduce or increase the likelihood of coups. First, on the one hand, capital inflows are likely to reduce the return of the capital for domestic elites and threaten domestic elites (capital owners)' interests. It thus increases elites' incentive to overthrow the regime by staging coup attempts. On the other hand, capital inflows tend to generate economic growth for the regime and hence distribute benefits for domestic elites, reducing their likelihood of challenging the regime (Escribà-Folch 2016). Second, capital outflow openness can increase the chance of coups by hollowing out the country. However, opening up capital outflows can also enable capital owners, usually the elites, to move their assets abroad and increase the level of asset mobility, which in turn reduces their stakes at the current regime and likelihood of coups (Freeman and Quinn 2012).

A second relevant literature studies the BIT. This literature examines how states participate in the global investment regime regulating foreign direct investment and the consequences of signing BITs. Specifically, scholars mainly focus on the following research areas – the signature of BITs, the design of BITs, the ratification of BITs, BITs' impact on FDI as well as outcomes such as human rights and labor rights (Elkins, Guzman, and Simmons 2006; Allee and Peinhardt 2010; Haftel and Thompson 2013; Neumayer and Spess 2005; Bodea and Ye forthcoming; Ye forthcoming). Although the empirical evidence on the impact of BITs on FDI inflows is mixed, most recent studies using various methodology and data coverage do find that BITs increase FDI. The increased inflows of FDI driven by the signature of BITs is likely to consolidate the regime and reduce the likelihood of coups. It is because leaders can use FDI for long-term economic growth and private goods distribution, buying off domestic elites and build up a credible commitment with elites for mutual benefits (Bak and Moon 2016).

One major part of the BIT literature examines how states participate in the global investment regime regulating FDI. Scholars mainly focus on three research areas – the signature of BITs, the design of BITs, and the ratification of these treaties. The first research area treats BITs as a “black box” or undifferentiated treaties and examines the reasons countries come to sign them. This work tries to explain why host countries are willing to tie their hands and submit investor-state disputes to international arbitration authorities. Two main mechanisms are argued to explain the signing of BITs: These investment treaties are argued to be substitutes for the low credibility of domestic commitment to investor rights³. Alternatively, they could be signed in

³ Multinational corporations face time inconsistency problem when investing in other countries. They are concerned about whether the host state would uphold their commitments about property rights protection agreed upon prior to investment. This is because bargaining power would shift towards the host state due to the sunk cost that foreign investors have

response to a competition for capital among developing countries. While scholars find support regarding the mechanism of competition for capital (Elkins, Guzman, and Simmons 2006; Jandhyala, Henisz and Mansfield 2011; Neumayer and Plumper 2010; Lupu and Poast 2013), the empirical evidence is mixed for the other mechanism (Bergstrand and Egger 2013; Jandhyala, Henisz and Mansfield 2011; Lupu and Poast 2013; Swenson 2005; Elkins, Guzman and Simmons 2006; Neumayer and Plumper 2010).

Rather than consider BITs as a ‘black box’ or undifferentiated treaties, another part of the literature explores the variation in BIT designs (e.g., the investor-state dispute settlement clause or the national treatment clause) and examines its causes (Allee and Peinhardt 2010, 2014; Blake 2013). Allee and Peinhardt (2010, 2014), for example, find strong evidence that the preference of home countries to tie host states’ hands (bargaining power) is driving the inclusion of stringent investor-state dispute settlement (ISDS) clause in BITs. Blake (2013) investigates the effect of government time horizons on the scope of national treatment clause in BITs⁴. He finds that governments with longer time horizons are more likely to preserve future policy autonomy by carving out policy areas in which they can deviate from the national treatment commitment. Additionally, some other researchers reveal the contagion mechanism in the literature of BIT designs (Neumayer, Nunnenkamp, and Roy 2014).

A third and the least voluminous research area on BIT participations emphasizes the ratification process of these treaties. This research explores domestic political conditions in order to address variation of the time between signing a treaty and ratifying it. Haftel and Thompson (2013) is the only work that directly examines why countries delay ratifying BITs after signing these treaties. Their theory focuses on three main explanatory variables: the institutional and political constraints that executives face domestically, transparency and predictability of political systems and the bilateral relationship between two states. Using a cross-section of 2,595 BITs signed between 1959 and 2007 and Cox models, and coding all independent variables at the year of signing BITs, they find that the difficulty of ratification increases with the political constraints the executive faces, legislative requirements for treaty ratification, and unpredictability of the political system, while it decreases with government capacity, and cultural and political affinity between two states. This approach, however, is static, looking at the conditions known as treaties were signed. Chapter 2 of this dissertation contributes to this literature by modeling the ratification of BITs as a dynamic process both theoretically and empirically. Such an approach of modeling treaty ratification as a dynamic process is similar

encountered. So, host states may renege on their prior commitment and renegotiate their initial concession agreement afterwards.

⁴ National treatment commitment can be roughly defined as “treating foreign investors in a fair, equitable, and nondiscriminatory manner as domestic investors” (Blake 2013).

to Milner and Rosendorff (1997) and Mansfield and Milner (2012)'s study of the ratification of preferential trade agreements (PTAs). I find strong evidence that BIT claims among peer states delay ratification, while rapid ratification rates among economic competing states facilitate a quicker ratification process of a signed BIT.

Since BITs are created to solve the time-inconsistency problem that plagues the growth of foreign direct investment, the other major part of the BIT literature studies whether signing or ratifying BITs are able to increase FDI inflows into developing states. The empirical evidence on the influence of BITs on investment flows is, however, mixed. While some scholars find a positive effect of BITs on FDI inflows into developing states (Neumayer and Spess 2005; Haftel 2010; Kerner 2009; Buthe and Milner 2009), some other works conclude that BITs have little impact on bringing FDI for developing countries (Hallward-Dreimeier 2003; Tobin and Rose-Ackerman 2005; Yackee 2007). In addition, there are some other researchers who argue that the effect of BITs is conditional on domestic institutional quality (Hallward-Dreimeier 2003; Tobin and Rose-Ackerman 2005; Yackee 2007) or subsequent good behavior of the governments who sign them (Allee and Peinhardt 2011).

However, what is missing in the existing studies is how capital account openness and BITs would interact to affect the likelihood of coups. This is an important question because many developing countries are eager to attract capital to create economic growth. As we have indicated, both capital inflows and outflows may destabilize political regimes via endangering elite capital owners' interests. Although capital openness and BITs can bring in FDI, they also sow the seed of political instability induced by domestic elites' discontent. Thus, we need to comprehensively explore how capital openness and BITs are related to regime (in)stability in developing countries. This paper takes on this task and argues that BITs are likely to mediate the effect of capital account openness on coups. In the empirical setting, we also employ a mediation analysis method to test our hypotheses.

3. Theory

In this article, we take a closer look at the relationship among capital openness, BITs, and risk of coups in developing countries. On the one hand, we argue that capital openness increases the risk of coups because it opens a window for some elites to "hollow out" the country's capital. As capital is relative scarce in developing countries, capital owners would like to move their capital to capital abundant countries for more marginal returns. Other elites, such as land owners, would act against capital outflow by replacing political leaders and their cliques. Meanwhile, capital inflow reduces the return of capital owners, who may also have an incentive

to overthrow their political leaders. As a result, capital openness instigates political discontent among elites and sows seeds of coups against political leaders.

On the other hand, following the insights of previous studies, we argue that BITs reduce the risk of coup because they are credible commitment to long-term economic growth that benefit elites and ordinary citizens. While capital inflow and outflow destabilize the regime, BITs are institutional arrangements of economic interests that can pacify the discontent of losers as a result of economic openness.

Furthermore, we argue that BITs function as a “mediator” that mitigate the positive relationship between capital openness and the risk of coups, as countries with a higher level of capital openness has less incentive to sign BITs. In addition, we further argue signing BITs plays a role of “mediator” among the relationship between capital openness, BITs, and coup risks. According to Hallie and Quinn (2018), BITs “effectively function as a substitute for capital outflows openness in countries with a policy of open capital inflows.” In other words, a country with a higher level of capital openness has less incentive to sign BITs to attract more FDI. As a result, a specific channel for capital openness to increase coup risks is its substitution effects on the signing of BITs, which reduce the coup risks.

Figure 1 summarizes the relationship among capital openness, BITs, and coup risks in our theory.

[Figure 1 here]

Based on our discussions in this section, we empirically test the following three hypotheses in the rest of this paper:

- H1: Capital openness increases the risk of coups.
- H2: BITs reduce the risk of coups.
- H3: Capital openness inhibits the signing of BITs.

4. Research Design

We test the hypotheses using data for 148 developing countries from 1960 to 2012. Following previous studies (e.g., Poulsen and Aisbett 2013), we define developing countries as those that the World Bank does not classify as high-income for the majority of our sample period. The sample size is dictated by the availability of our variables in the empirical analysis.

4.1 Dependent variable

The dependent variable, coup attempt, is taken from the dataset of Powell and Thyne (2011). In their dataset, Powell and Thyne (2011, 252) define coup d'etat as “illegal and overt attempted by the military or other elites within the state apparatus to unseat the sitting executive.” Following conventional studies, we use a binary variable to indicate whether at least one coup attempt occurred or not in the observed year.

4.2 Independent variable

We use two key independent variables. To capture capital openness, we employ capital outflow openness and capital inflow openness indicators from Freeman and Quinn (2012). We also measure the cumulative number of BITs ratified by a country in a given year. The total or cumulative number of BITs that a country is subject to in a given year makes sense because our focus is on the total levels of protections that foreign investor have in investing in host countries via the conclusion of BITs. We use ratified BITs rather than signed BITs because only ratified BITs are legally binding (Haftel 2010, Haftel and Thompson 2013). This variable is constructed using the International Investment Agreements (IIA) database on the UNCTAD website. We further explore the heterogeneity of BITs by differentiating the partner states. It is very likely that the BITs between developed countries on the one hand and developing nations capture an investment relationship characterized by de facto flows of capital to the capital poor developing country. Unlike North-South BITs, it has also been argued that “South-South” BITs are concluded for reasons other than investment protection, making those BITs irrelevant for my theory (Elkin, Guzman, and Simmons 2006; Jandhyala, Henisz, and Mansfield 2011; Poulsen and Aisbett 2013). We therefore also count the number of BITs a host country has ratified with developed countries (North-South BITs).

4.3 Control variable

Following previous studies on coups, we include a battery of standard control variables. We construct a variable to measure the number of PTAs (*No. of PTAs*), using the dataset on the content of preferential trade agreements recently constructed by the World Bank (Ruta, Hofmann, and Osnago 2017). This dataset covers the entire set of PTAs in force and notified to the World Trade Organization (WTO) as of 2015. Specifically, it includes 279 PTAs signed by 189 countries between 1958 and 2015. Based on this dataset, we calculate the cumulative number of PTAs signed by a country in the observed year. The distribution of this PTA variable is right-skewed with many zeros because many countries signed no PTAs until the 21st century. To address the skewness, I follow previous studies and take the natural logarithm of the cumulative number of PTAs plus one (Chang and Wu 2016; Hollyer and Rosendorff 2012). We also control for a country’s level of democracy. We use the polity score to measure its level of democracy (Marshall and Jaggers 2002). We also include a country’s military size and total

population. The data on both variables are taken from the COW Project. We control for a country's economic development by including a country's GDP per capita. The data on GDP per capita are taken the Penn World Table (version 9.0) and log-transformed. We also consider the role of natural resources in coup attempt. We expect that more natural resources would be associated with coup attempts because the opposition have a stronger incentive to use coups to replace the incumbent if the endowment of natural resources is more abundant. Additionally, we control for a country's history of coup attempts because some countries, like Thailand, tend to experience coups more often than others. As a result, we include the number of times a country previously experienced coups attempts.

4.4 Model specification

We employ a mediation analysis developed by Imai et al. (2011). This approach examines the direct of capital openness as well as indirect effect of capital openness through the signing of BITs on the likelihood of coups. The mediating variable is conclusion of BITs. Stata command "medeff" is used for the analysis (Hicks and Tingley 2011).

5. Empirical Results

Our empirical results are shown in Tables 1-3. Before conducting the mediation analysis, we first estimate a basic logit model proposed by Beck, Katz, and Tucker (1998) to investigate the impact of capital account openness on coups. We employ three different measures of capital account openness – Chinn and Ito (2006), capital inflow openness, and capital outflow openness. As shown in Models 1-3 of Table 1, we find that capital account openness tends to increase the likelihood of coups. We then proceed to the mediation analysis to examine how BITs mediate the effect of capital inflows openness and capital outflows openness on coups, respectively. Results of the mediation analysis for capital inflow openness are shown in Table 2 while results for capital outflow openness are reported in Table 3. Model 4 runs an OLS regression predicting the conclusions of BITs while Model 5 a probit estimation for explaining coups. The results are consistent with our theoretical argument. We find that capital inflow openness substitutes for conclusion of BITs (Model 4) and conclusions of BITs increases the likelihood of coups (Model 5). Both the indirect effect (mediation effect) and direct effect of capital inflow openness on coups are positive and statistically significant at conventional levels. Models 6 and 7 in Table 2 use an alternative measure of BITs, that is, the North-South BITs rather than the simply count of BITs ratified by developing countries. The results are substantially similar. In addition, we examine whether BITs would mediate the impact of capital outflow openness on coups. Models 8 and 9 use a simple count of all types of BITs while Models 10 and 11 use a count of North-South BITs. As shown in Table 3, we find that capital outflow openness is negatively associated with BITs and BITs reduce the likelihood of

coups. As expected, the indirect as well as the direct effect of capital outflow openness on coups are positive and statistically significant.

As suggested by Imai et al. (2011), we further perform a sensitivity analysis using Stata command “medsens”. Figure 2 indicates that the mediation effect remains positive and statistically significant as long as the correlation between the error term for the mediation model and that of the outcome model is above about -0.1⁵. To sum up, the mediation analysis provides evidence for our theoretical argument that BITs mediate the impact of capital inflow as well as outflow openness on the likelihood of coups. The results for the control variables are broadly in line with previous studies. We find that number of PTAs, the level of democracy and GDP per capita reduce the chance of coups while military size and number of previous coups increase the likelihood of coups.

[Table 1 here]

[Table 2 here]

[Table 3 here]

[Figure 2 here]

6. Conclusion

The past few decades have witness the increasing intensity of global economic integration and the legal mechanisms such as PTAs and BITs governing the cross-border flow of goods and capital. There are a number of scholars examining the impact of economic globalization on developing countries which tend to capital receivers or export platform for multinational corporations. This paper aims to investigate how opening up the economy would affect the domestic instability, in particular coups in develop countries. Specifically, this article takes a closer look at the relationship among capital openness, BITs, and risk of coups in developing countries. We attempt to examine how capital account openness and BITs would interact to affect the likelihood of coups. Although capital account openness is likely to increase the risk of coups by reducing the returns of capitals for domestic elites and increasing the chances of “hollowing out” a country’s capital, we argue BITs play a role of “mediator” among the relationship between capital openness and the risk of coups. For leaders in developing countries, BITs can function as a substitutive mechanism for capital account openness to attract foreign capital. At the same time, BITs are able to increase FDI inflows into developing countries which as a result reduce the likelihood of coups due to the fact that FDI-driven economic growth can be used by leader to buy off elites and establish a credible commitment of mutual benefits between the leaders and elites. Therefore, there is a positive mediating effect (indirect

⁵ Please be noted that the sensitivity analysis does not provide us with an objective criterion that can be used to determine the robustness of our results.

effect) of the impact of capital account openness on coups via the signing of BITs. Using a sample of about 148 developing countries from 1960 to 2012 and a mediation analysis method developed by Imai et al. (2011), we find support for our argument.

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Table 1. Capital Account Openness and Coup Attempts in Developing Countries

	Model 1	Model 2	Model 3
	Chinn and Ito	Inflow	Outflow
	Index	Openness	Openness
Capital Account Openness	0.003 (0.033)	0.230** (0.106)	0.188* (0.098)
No. of PTAs (Logged)	-0.208** (0.093)	-0.215** (0.089)	-0.214** (0.089)
Polity2	-0.019** (0.007)	-0.016** (0.006)	-0.016** (0.006)
Military Size	0.024 (0.026)	0.052*** (0.020)	0.054*** (0.020)
Population	-0.036 (0.045)	-0.059 (0.036)	-0.066* (0.036)
GDPpc	-0.195*** (0.053)	-0.190*** (0.049)	-0.188*** (0.050)
Natural Resources	-0.003 (0.006)	-0.001 (0.005)	-0.001 (0.005)
No. of Previous Coups	0.044*** (0.013)	0.053*** (0.011)	0.050*** (0.010)
No. of Countries	116	118	118
Observations	3,994	5,038	5,038

Note: Robust standard errors clustered at the country level are reported in parentheses. Three time polynomials are not shown in the table. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 2. Capital Inflow Openness on Coup Attempts: A Mediation Analysis

	All Types of BITs		North-South BITs	
	Model 4 No. of BITs (logged)	Model 5 Coup Attempt	Model 6 No. of BITs (logged)	Model 7 Coup Attempt
Capital Inflow Openness	-0.163*** (0.033)	0.206** (0.088)	-0.115*** (0.028)	0.211** (0.088)
No. of BITs (logged)		-0.099** (0.042)		-0.095** (0.047)
No. of PTAs (Logged)	0.804*** (0.021)	-0.136 (0.091)	0.603*** (0.018)	-0.157* (0.089)
Polity2	0.010*** (0.002)	-0.016*** (0.006)	0.009*** (0.002)	-0.016*** (0.006)
Military Size	0.002 (0.008)	0.049** (0.024)	-0.005 (0.007)	0.049** (0.024)
Population	0.080*** (0.014)	-0.048 (0.037)	0.064*** (0.012)	-0.050 (0.037)
GDPpc	0.118*** (0.019)	-0.184*** (0.049)	0.045*** (0.016)	-0.190*** (0.049)
Natural Resources	0.008*** (0.002)	-0.001 (0.004)	0.006*** (0.001)	-0.001 (0.004)
No. of Previous Coups	0.021*** (0.005)	0.055*** (0.011)	0.020*** (0.004)	0.055*** (0.011)
No. of Countries	148	148	148	148
Observations	5,038	5,038	5,038	5,038
ACME	0.0015 [0.0003, 0.0030]		0.0010 [0.00005, 0.0022]	
Direct effect	0.0188 [0.0041, 0.0326]		0.0192 [0.0046, 0.0331]	
Total effect	0.0741 [0.0446, 0.2593]		0.0504 [0.0302, 0.1777]	

Note: Performs a mediation analysis of the effect of capital inflow openness on coups. The mediating variable is BITs. Standard errors are reported in parentheses. Three time polynomials are not shown in the table. 95% confidence interval are shown in brackets. *** p<0.01, ** p<0.05, * p<0.1

Table 3. Capital Outflow Openness on Coup Attempts: A Mediation Analysis

	All Types of BITs		North-South BITs	
	Model 8 No. of BITs (logged)	Model 9 Coup Attempt	Model 10 No. of BITs (logged)	Model 11 Coup Attempt
Capital Outflow Openness	-0.318*** (0.031)	0.156* (0.085)	-0.246*** (0.026)	0.162* (0.085)
No. of BITs (logged)		-0.098** (0.042)		-0.094** (0.048)
No. of PTAs (Logged)	0.814*** (0.021)	-0.135 (0.091)	0.611*** (0.018)	-0.157* (0.089)
Polity2	0.009*** (0.002)	-0.015*** (0.006)	0.009*** (0.002)	-0.015*** (0.006)
Military Size	-0.002 (0.008)	0.051** (0.024)	-0.008 (0.007)	0.051** (0.024)
Population	0.081*** (0.014)	-0.055 (0.037)	0.063*** (0.012)	-0.057 (0.037)
GDPpc	0.128*** (0.019)	-0.183*** (0.049)	0.053*** (0.016)	-0.189*** (0.049)
Natural Resources	0.007*** (0.002)	-0.001 (0.004)	0.006*** (0.001)	-0.001 (0.004)
No. of Previous Coups	0.019*** (0.005)	0.053*** (0.011)	0.019*** (0.004)	0.053*** (0.011)
No. of Countries	148	148	148	148
Observations	5,038	5,038	5,038	5,038
ACME	0.0030 [0.0005, 0.0056]		0.0022 [0.00008,0.0045]	
Direct effect	0.0144 [-0.0002,0.0284]		0.0150 [0.0004,0.0290]	
Total effect	0.1677 [0.0927, 0.8306]		0.1257 [0.0680,0.6282]	

Note: Performs a mediation analysis of the effect of capital outflow openness on coups. The mediating variable is BITs. Standard errors are reported in parentheses. Three time polynomials are not shown in the table. 95% confidence interval are shown in brackets. *** p<0.01, ** p<0.05, * p<0.1

Figure 1: Capital Openness, BITs, and Coup Risks

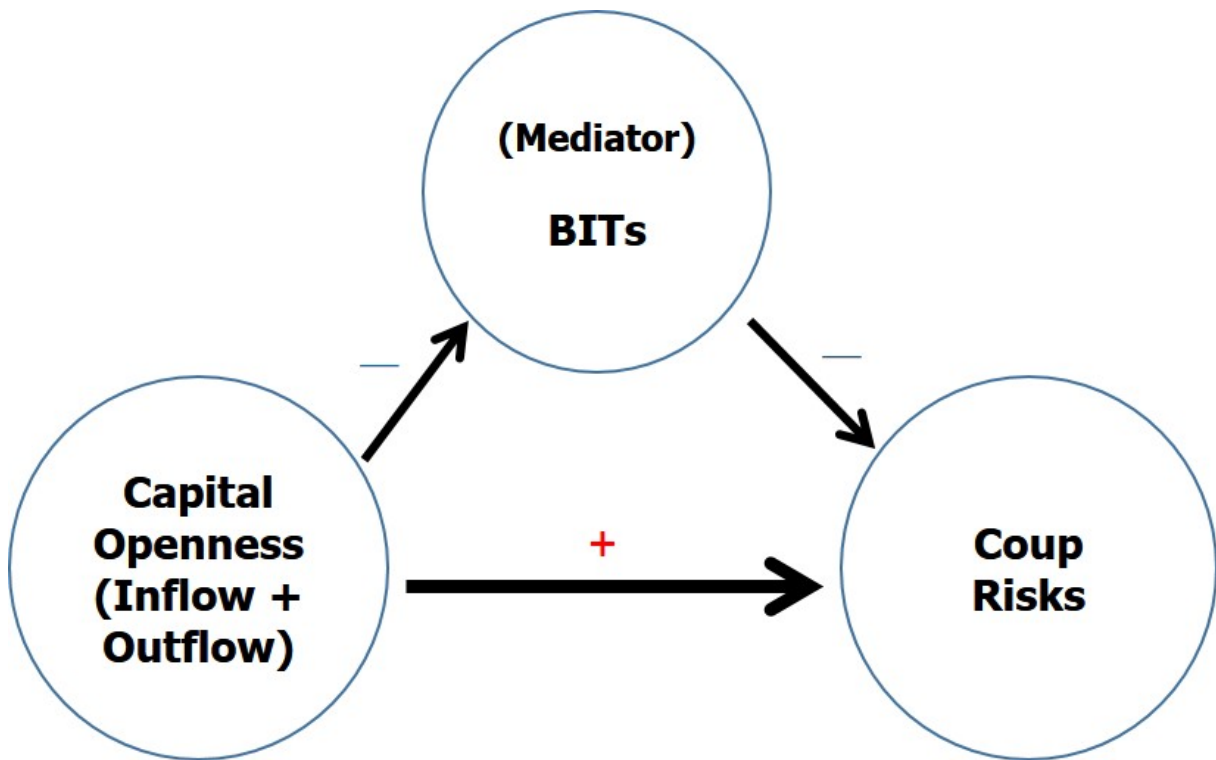
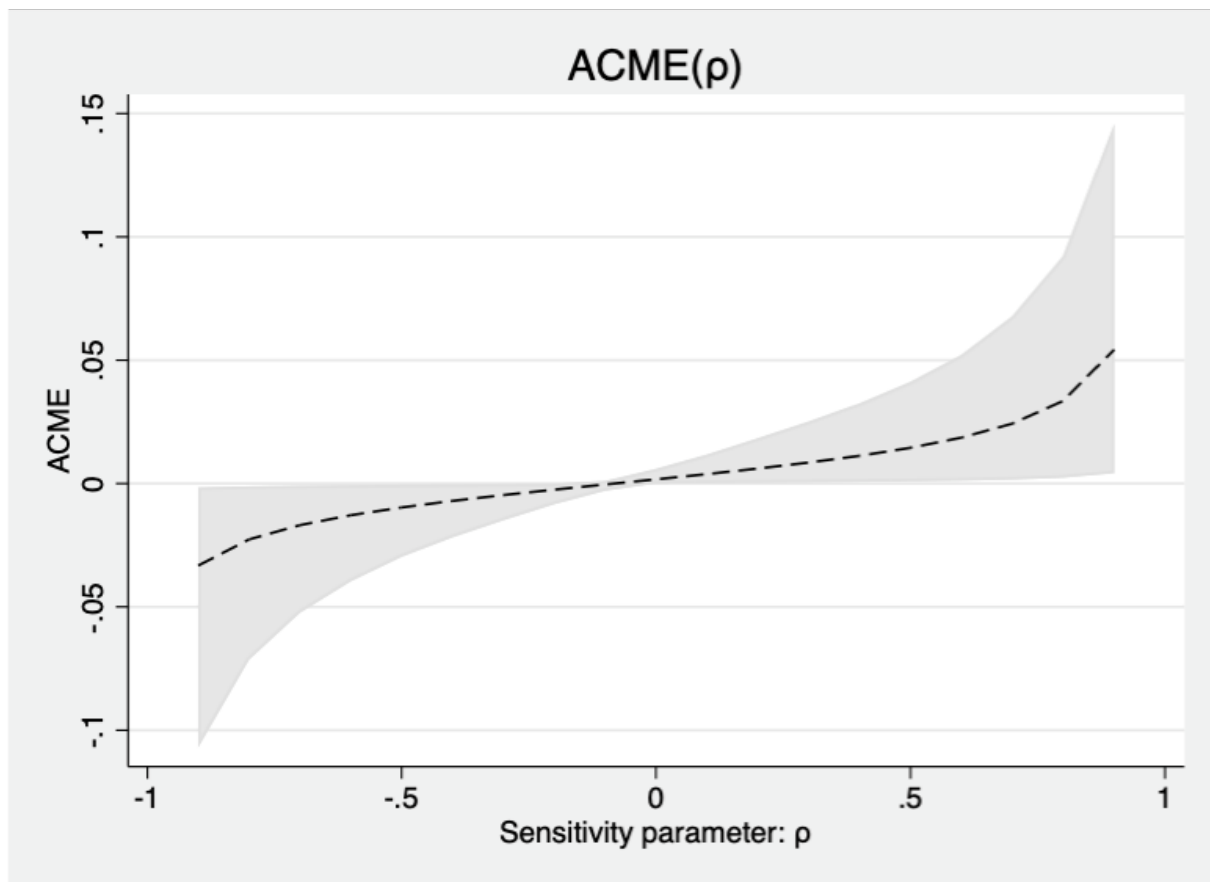


Figure 2. Sensitivity Analysis based on Models 4 and 5



Note: Dash line is ACME, plotted against sensitivity parameter. The shaded areas represent 95% confidence intervals. When Rho is about -0.1, ACME = 0.