

THE INTERNATIONAL INVESTOR RIGHTS REGIME:  
DOMESTIC SOURCES OF COMMITMENT AND COMPLIANCE

by

NATHAN FREEMAN

(Under the Direction of Douglas Stinnett)

ABSTRACT

This dissertation examines the relationship between international investment-related legal commitments, embodied in bilateral investment treaties (BITs), and national regulatory regimes governing foreign direct investment (FDI). I argue that the relationship between international commitments and national regimes is complementary, as evidenced by the timing and sequencing of domestic reforms and international commitments, and by the pattern of investor-state arbitral disputes. Governments seeking to promote FDI tend to undertake liberal reforms domestically before making international commitments. These domestic policy changes are subsequently or simultaneously locked-in through BITs, thereby enhancing the credibility of such reforms by tying the hands of future governments. In addition, the timing of commitments suggests that countries which possess weak institutions for the protection and enforcement of property rights tend to avoid entering into BITs because of concerns about compliance. As a result, the types of countries that are most likely to enter into BITs are precisely those whose domestic policies and institutions are most favorable to FDI, and for whom the costs of complying with BITs are much lower, suggesting that the decision to commit is endogenous to expectations about a state's capacity to comply with such commitments. An analysis of BIT signings provides evidence in support of my argument, suggesting that a state's likelihood of

entering into a BIT increases as its domestic regime becomes more favorable to FDI. An analysis of the determinants of investor-state arbitral disputes suggests that countries with greater institutional capacity for protecting and enforcing property rights experience fewer disputes than countries with relatively low institutional capacity, suggesting that the quality and strength of a country's domestic institutions significantly affects its ability to comply with its BIT-related obligations. These findings support the proposition that international commitments are largely a function of state preferences and expectations about the capacity for compliance. They also highlight the importance of a country's institutional capacity as a determinate of BIT-related compliance costs, revealing an unappreciated paradox. While BITs are putatively intended to substitute for weak domestic institutions, it is precisely those countries with weak institutions for which the costs of compliance are likely to be the highest.

INDEX WORDS:      bilateral investment treaties, BITs, compliance, foreign direct investment, FDI, less developed countries, LDCs, international law, investor rights, investor-state arbitration, liberalization, property rights

THE INTERNATIONAL INVESTOR RIGHTS REGIME:  
DOMESTIC SOURCES OF COMMITMENT AND COMPLIANCE

by

NATHAN W. FREEMAN

B.A., The University of South Alabama, 2001

M.A., The University of Georgia, 2003

A Dissertation Submitted to the Graduate Faculty of The University of Georgia in Partial  
Fulfillment of the Requirements for the Degree

DOCTOR OF PHILOSOPHY

ATHENS, GEORGIA

2009

© 2009

Nathan W. Freeman

All Rights Reserved

THE INTERNATIONAL INVESTOR RIGHTS REGIME:  
DOMESTIC SOURCES OF COMMITMENT AND COMPLIANCE

by

NATHAN W. FREEMAN

Major Professor:	Douglas Stinnett
Committee:	Christopher S. Allen Jeffrey D. Berejikian Maurits van der Veen

Electronic Version Approved:

Maureen Grasso  
Dean of the Graduate School  
The University of Georgia  
December 2009

*I dedicate this dissertation to my parents, Harry and Helen, whose ceaseless love, support, and encouragement have helped to sustain me in all my endeavors. Words cannot express the love and appreciation I have for them. They are the two most important individuals in my life.*

## ACKNOWLEDGEMENTS

I would first like to thank the members of my committee—Chris Allen, Jeff Berejikian, Maurits van der Veen, and especially Doug Stinnett, my committee chair—for the patience they have shown me during the course of this endeavor and for the critical feedback which they provided me with during the entire process. Second, I would like to thank Regina Baker, John Doces, Christopher Joyner, and Dale Smith, each of whom offered useful feedback on various parts of this project which I presented at various conferences. Thanks also go to Zachary Elkins, Eric Neumayer, and Mark Souva for sharing data and answering my questions. Finally, I would like to thank Howard Wiarda and the School of Public and International Affairs at the University of Georgia for their generous financial support. The input, advice, and support of each of these individuals and institutions have been indispensable to the success of this enterprise. Any remaining faults with the final product are my sole responsibility.

## TABLE OF CONTENTS

	Page
ACKNOWLEDGEMENTS .....	v
LIST OF TABLES .....	viii
LIST OF FIGURES .....	ix
LIST OF ABBREVIATIONS .....	x
CHAPTER	
1 INTRODUCTION .....	1
Research Question .....	5
Argument and Findings .....	8
Defining Domestic and International Regimes .....	10
Contributions and Implications .....	12
Organization of the Dissertation .....	28
2 THE INTERNATIONAL REGIME FOR INVESTOR RIGHTS .....	32
Historical Antecedents .....	35
A Story of Repeated Failure .....	39
Bilateral Investment Treaties .....	56
ICSID .....	59
The Trend towards Liberalization .....	65
Conclusion .....	66
3 DOMESTIC SOURCES OF COMMITMENT .....	68
Policy Preferences and International Legal Commitments .....	70



	Institutional Capacity and Compliance with BITs .....	81
	Taking the Plunge and Tying the Knot: BITs as Marriages.....	89
4	THE DETERMINANTS OF BIT SIGNINGS .....	96
	Research Design .....	97
	Results of the Analysis .....	123
	Qualitative Evidence: India .....	151
	Discussion .....	163
5	THE DETERMINANTS OF INVESTOR-STATE ARBITRAL DISPUTES .....	169
	Investor-State Arbitration and Compliance with BITs.....	174
	The Determinants of Investor-State Disputes .....	179
	Research Design .....	194
	Results of the Analysis .....	210
	Summary and Discussion .....	221
6	CONCLUSION.....	234
	Summary of the Argument and Findings .....	235
	Implications .....	240
	Are BITs a Good Idea?.....	252
	REFERENCES .....	259
	APPENDICES .....	272
A	LIST OF COUNTRIES INCLUDED IN ANALYSES .....	272
B	THE DETERMINANTS OF INVESTOR-STATE ARBITRAL DISPUTES: ALTERNATIVE ESTIMATORS .....	274

## LIST OF TABLES

	Page
Table 4.1: The Relationship Between Policies, Institutions, and BITs: Hypotheses.....	84
Table 4.2: Explanatory Variables and Expectations.....	106
Table 4.3: Descriptive Statistics. ....	107
Table 4.4: Cox Proportional Hazard Model of BIT Signings.....	110
Table 4.5: Alternative Indicators of a Country's Domestic Regime for FDI. ....	124
Table 4.6: Alternative Measures of Competition: Regional and Global BITs. ....	145
Table 4.7: Marginal Effects of Domestic Investment Regime as Regional Competition Intensifies.....	150
Table 4.8: BITs Concluded by India with High-Income OECD Countries.....	152
Table 5.1: The Determinants of Investor-State Arbitral Disputes: Hypotheses. ....	194
Table 5.2: Investor-State Arbitral Disputes By Venue, 1970-2007.....	197
Table 5.3: Explanatory Variables and Expectations.....	206
Table 5.4: Descriptive Statistics. ....	207
Table 5.5: Population-Averaged Model of Investor-State Arbitral Disputes. ....	211
Table 5.6: Percentage Changes in Expected Count of Arbitral Disputes. ....	214
Table B.1: Negative Binomial Model of Investor-State Arbitral Disputes. ....	275
Table B.2: Random Effects Model of Investor-State Arbitral Disputes.....	277
Table B.3: Fixed Effects Model of Investor-State Arbitral Disputes. ....	279

## LIST OF FIGURES

	Page
Figure 2.1: Growth in Contracting Members of the ICSID Convention .....	61
Figure 2.2: Growth of ICSID Cases.....	64
Figure 4.1: Survival Estimates According to Host Country's Score on ICRG Index.....	142
Figure 4.2: Survival Estimates According to Host Country's Investment Profile.....	142
Figure 4.3: The Effects of Regional Competition Given an Unfavorable Domestic Regime .....	148
Figure 4.4: The Effects of Domestic Regime in the Absence of Regional Competition.....	149
Figure 4.5: FDI Inflows to India, 1976-1985.....	158
Figure 4.6: FDI Inflows to India, 1976-2005.....	160
Figure 4.7: India: FDI Inflows and BITs, 1990-2005 .....	160
Figure 5.1: Investor-State Arbitral Disputes, 1970-2007.....	197

## LIST OF ABBREVIATIONS

ASEAN	Association of South East Asian Nations
BIT	Bilateral Investment Treaty
CAFTA-DR	Central American—Dominican Republic Free Trade Agreement
CUSFTA	Canada—United States Free Trade Agreement
DC	Developed country
EU	European Union
FDI	Foreign Direct Investment
FERA	Foreign Exchange Regulation Act of 1973
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariffs
ICSID	International Center for the Settlement of Investment Disputes
IMF	International Monetary Fund
IPE	International Political Economy
ITO	International Trade Organization
LDC	Less developed country
MAI	Multilateral Agreement on Investment
MFN	Most-favored-nation
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development

PTA	Preferential Trade Agreement
TRIMS	Agreement on Trade-Related Investment Measures
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UNCITRAL	United Nations Commission for International Trade and Law
UNCTC	United Nations Centre on Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

## CHAPTER 1

### INTRODUCTION

Foreign direct investment (FDI) has in recent decades become a chief source of long-term, productive investment for developing countries. As a source of external finance, the relative importance of FDI for less developed countries (LDCs)<sup>1</sup> cannot be overstated: Net inflows of FDI to developing countries averaged roughly \$203 billion between 1998 and 2006 compared to just \$30 billion for net inflows of portfolio equity, \$66 billion in net debt flows, and \$56 billion in bilateral aid grants. The average sum of FDI flows alone during this nine year period was more than equal the average sum of portfolio capital, debt, and foreign aid *combined*—\$203 billion versus \$146 billion—and nearly double that of combined debt and aid—\$203 billion versus \$122.<sup>2</sup> As these figures attest, FDI represents a vital source of capital for the developing world.

The increased importance of FDI to developing economies is in part a function of its spectacular growth over the last two decades. The absolute amount of FDI has increased dramatically since the 1980s. Between 1980 and 2006, the global stock of FDI grew from roughly \$551 billion to nearly \$12 trillion.<sup>3</sup> During this same 27-year period, the developing

---

<sup>1</sup> Throughout this dissertation, the term less developed countries is used in its broadest sense, encompassing both middle and lower-income countries as well as other distinct categories such as newly-industrializing countries, post-communist transitional countries, and the least developed countries.

<sup>2</sup> World Bank 2007, 173. The conventional threshold for distinguishing FDI from portfolio investments is 10 percent equity ownership in a firm or enterprise. An ownership stake of 10 percent or more is thought to give the foreign investor a significant degree of control or influence in terms of the way a firm is managed.

<sup>3</sup> UNCTAD 2007.

world's share of FDI stocks grew from approximately \$140 billion to over \$3 trillion.<sup>4</sup> In addition, the rate of growth in FDI flows since the 1980s has consistently outpaced that of international trade, making it arguably the more important of these two key drivers of global economic growth and leading one scholar to describe it as the “neglected twin” of trade.<sup>5</sup> Between 1980 and 1997, FDI flows grew at an average annual rate of 13 percent compared to 7 percent for exports.<sup>6</sup> FDI has to some extent even subsumed trade. Intra-firm trade between parent companies and their foreign affiliates and subsidiaries now accounts for at least 40% or more of world trade.<sup>7</sup> It is the tremendous growth of FDI both in absolute terms and relative to trade and other types of international financial flows that has made it one of the most salient dimensions of economic globalization.<sup>8</sup>

Given the increased magnitude, saliency, and relative importance of FDI in recent decades, particularly within the developing world, the competitive struggle to attract it which has broken out among LDCs during this same period should come as no surprise. Over the course of the past two decades, LDC governments have adopted a variety of policies both at the domestic and international level aimed at stimulating increased inflows of FDI to their economies. These include the provision of tax subsidies to foreign investors as well as efforts to upgrade the skills of workers and improve domestic infrastructure, among others. More importantly, since the 1980s most developing countries have significantly liberalized their regulatory regimes governing inward FDI. Of 1,035 policy changes pertaining to FDI which governments reported making between 1991 and 1999, 94 percent of these made FDI easier, including the

---

<sup>4</sup> Ibid.

<sup>5</sup> Julius 1990.

<sup>6</sup> Jensen 2003, 589.

<sup>7</sup> Cohn 2005. The figure may be even higher. Gilpin (2001, 297) claims that intra-firm trade constitutes half of all world trade, while Li and Resnick (2003, 175) claim that the activities of multinational enterprises “now account for about 70 percent of world trade.”

<sup>8</sup> Li and Resnick 2003, 175. Ostry (1997a, 5) even goes so far as to suggest that the term globalization owes its genesis to the spectacular surge in FDI flows that began in the second half of the 1980s.

dismantlement of investment screening mechanisms, the elimination of so-called performance requirements, the easing of ownership and foreign-exchange restrictions, and the opening up of economic sectors that were once closed to foreign investment.<sup>9</sup>

In addition to these domestic policy changes, most LDC governments have also formally committed themselves to an international investor rights regime which emerged in piecemeal fashion during the second half of the twentieth century. Since 1959, nearly 2,600 treaties designed to guarantee certain legal rights for foreign investors have been concluded between capital-importing countries looking to enhance their attractiveness in the eyes of foreign investors and capital-exporting countries seeking enhanced protection for their nationals' investments abroad. The vast majority of these treaties have been concluded on a bilateral basis between one of the advanced industrialized countries (the capital-exporter) and an LDC (the capital-importer). Though framed in reciprocal terms, these so-called bilateral investment treaties (BITs) are in practice intended to govern the behavior of only one of the parties—namely, the LDC government—toward foreign investment from the capital-exporting country.<sup>10</sup> They are essentially designed to prevent host governments from violating the property rights of foreign investors as defined by the treaties themselves. By entering into these treaties, LDCs have surrendered a significant amount of sovereignty over FDI. They have in effect given up their right to regulate FDI in ways that would ensure that such investment contributes to these countries' economic development. The question is: *Do the benefits of such treaties outweigh their costs?*

---

<sup>9</sup> UNCTAD 2004.

<sup>10</sup> Though the number of BITs concluded between LDCs (i.e., BITs in which both parties are considered to be LDCs) has increased over time, the vast majority of BITs have been concluded between high-income developed countries and LDCs. As of July 2004 there were at least 653 so-called “South-South” BITs, representing 28% of the then 2,300 existing BITs (UNCTAD 2004, 6).



In addition to establishing substantive rights for foreign investors such as national and most-favored-nation (MFN) treatment, many BITs also contain binding procedural commitments on the part of host states to submit their disputes with foreign investors to arbitration. As such, they are commonly portrayed as commitment devices which allow LDC governments to make a credible commitment to respecting the rights of foreign investors, thereby making their country a presumably more appealing location for such investors. The past decade and a half has witnessed a veritable explosion in the use of arbitration by multinational corporations (MNCs) and other foreign investors as a means of settling their disputes with host states, a direct result of the proliferation of BITs which occurred in the first half of the 1990s. The International Centre for the Settlement of Investment Disputes (ICSID), which was established in 1966 under the auspices of the World Bank, has proven to be the most popular venue for investor-state arbitration. Since 1992, investors have registered 228 arbitral claims with ICSID. In the preceding 25-year period, the organization had only handled 24 such claims. A database constructed by the United Nations Conference on Trade and Development (UNCTAD) containing information on 289 investor-state disputes submitted for arbitration between 1987 and 2007 shows that 277 of these disputes occurred within the last decade since 1997. These kinds of international legal disputes impose significant financial costs for LDCs, again raising the question of whether the benefits a country purportedly derives from formally committing itself to this international regime outweigh the costs of complying with the regime.

Thus, developing countries seeking to secure a larger share of the global FDI pie have seemingly pursued a two-level strategy: At the domestic level, they have liberalized their policies toward inward FDI. At the international level, they have made formal treaty-based commitments which obligate them to respect the rights of foreign investors and settle disputes

with these investors through arbitration. Therefore, in any given country, FDI is now likely to be governed by two distinct kinds of regimes—one national, the other international. Yet the relationship between national and international investment regimes remains an open question. The purpose of this dissertation is to break new ground by exploring the relationship between these two types of regimes. What types of countries are more likely to commit themselves to international legal rules concerning the treatment of foreign investors, what are the costs of complying with such rules, and for which kinds of countries are these costs likely to surpass the benefits of compliance? The answers to these questions, as I try to show in this dissertation, can in large part be found at the domestic level by looking at a country's institutions and the policy preferences and incentives of governments.

In seeking answers to the questions posed above, my primary aim is to achieve a greater understanding of the costs associated with the international investor rights regime embodied in BITs and similar investment agreements. I want to know whether the costs associated with this increasingly important regime outweigh its purported benefits. The picture which emerges from my research suggests that the costs of complying with the investor rights regime may indeed exceed the alleged benefits, especially when a country lacks the institutional capacity to comply with the regime's dictates.

## **RESEARCH QUESTION**

The general question which this dissertation addresses is this: *What is the relationship between a country's domestic regime for FDI—that is, its regulatory policies toward inward FDI as well as its institutional infrastructure for protecting and enforcing private property rights—and its international investment-related legal commitments, particularly BITs?* I address this

question from two different angles. First, I explore the relationship between changes in a country's domestic regime for FDI and its decision to make investment-related commitments at the international level. What I am chiefly interested in discovering is whether domestic reforms precede, coincide with, or follow international commitments. I find that LDC governments tend to enter into BITs *after* undertaking significant liberalization of their regulatory frameworks governing FDI, *not before*. At the very least, BITs tend to coincide rather than preceded liberal reforms at the domestic level. I also find that the kinds of countries most likely to enter into a BIT are precisely those whose domestic property rights institutions are already relatively strong as indicated by both objective and subjective measures.

While the first part of my dissertation builds upon existing research on the determinants of BIT signings, the second part breaks entirely new ground by exploring the relationship between the strength and quality of a country's domestic institutions and its capacity to comply with its international investment-related commitments. This is the first study to directly address the issue of compliance with BITs, particularly the significant costs stemming from such compliance. It is also the first study to treat investor-state arbitrations as a dependent variable—one that is not only worth explaining in its own right, but also a variable that, as I explain later, helps us to measure the costs of complying with the international investor rights regime embodied in BITs and other legal instruments across different countries. Having introduced this new and innovative measure of BIT-related compliance costs, my dissertation goes one step further in identifying some of the more important cross-national determinants of investor-state arbitrations, again, the first study to do so.

As a method of dispute resolution, arbitration represents the principal enforcement mechanism within the BIT-based international investor rights regime for ensuring compliance

with the regime's rules. Many BITs contain provisions which give foreign investors direct access to the dispute settlement process, meaning any investor who feels that its rights (as defined by a BIT) have been violated by the actions of a host state can initiate arbitration proceedings against that state without having to appeal to its home government for support or approval. Assuming BITs represent meaningful treaties and not mere scraps of paper, persistently noncompliant behavior on the part of host states will eventually lead to arbitral disputes. Therefore, using the number of investor-state arbitrations as an indicator of noncompliance, I am interested in how a country's institutional capacity for protecting and enforcing private property rights affects the number of disputes it becomes party to over time. Controlling for differential degrees of commitment (i.e., the number of BITs a country has entered into), the amount of FDI a country hosts, and other factors influencing the incentives and capacity of governments to engage in expropriatory actions toward foreign investments, I find that countries which lack strong domestic property rights institutions have a significantly greater number of arbitral claims brought against them by foreign investors than do countries whose institutional infrastructure for securing property rights is comparatively stronger.

In short, my interest in the relationship between national and international investment regimes centers upon the issues of *commitment* and *compliance*. I seek to understand the effects of a country's domestic policies and institutions on its *willingness to commit* itself to the rights of foreign investors at the international level as well as the *timing* of such commitments. I further seek to understand the impact of a country's domestic institutions on its *capacity to comply* with such international legal commitments and the resulting *costs* of such compliance. My goal is to explicate the domestic-level sources of states' commitments to, and compliance with, the international investor rights regime.

## ARGUMENT & FINDINGS

I argue that the relationship between national FDI regimes (defined as both policies and institutions) and the international investor rights regimes represented by BITs is *complementary* in two important respects. First, in terms of the sequencing of domestic-level policy changes on the one hand and the formation of BITs at the international level on the other, governments looking to promote FDI tend to undertake liberal reforms at the domestic level before making commitments at the international level. These internal changes are subsequently locked-in through the conclusion of BITs, thereby enhancing and corroborating the credibility of such reforms by tying the hands of both the current government that has made the commitments and its successors. In addition, the governments of countries which lack strong institutions for the protection and enforcement of private property rights tend to refrain from entering into BITs out of concerns about their capacity to comply with the terms of such agreements. As a result, the types of countries that are most likely to sign and ratify BITs are precisely those whose domestic-level policies and institutions are most favorable to investor rights, and for whom the costs of complying with BITs are presumably much lower as a result. Therefore, BITs end up functioning as a screening mechanism, separating countries that are both open to FDI and which have relatively strong institutional mechanisms for upholding private property rights, including those of foreign investors, from countries that maintain restrictive policies toward FDI and which lack strong property rights institutions. Simply put, governments are more likely to sign BITs when they have some interest in complying with such treaties, as well as some degree of institutional capacity necessary to minimize the costs of compliance.

Second, in terms of a state's capacity to comply with its BIT-related obligations, I argue that compliance is less problematic for countries that possess relatively strong property rights

institutions. These countries' institutional endowment gives them the capacity to resolve disputes between the state and foreign investors at the domestic level, thereby decreasing the likelihood that such disputes become the subject of international arbitration. In countries with strong legal institutions, investors who feel their BIT-related rights have been violated can more easily and effectively obtain relief for their grievances through local courts. As a result, we should expect such countries to have less arbitral claims brought against them compared to those countries whose indigenous legal institutions are considerably weaker.

The findings of two empirical analyses provide evidence in support of my arguments regarding the complementary relationship between a country's domestic regime for FDI, its propensity to make international investment-related commitments, and its capacity to comply with such commitments. First, the results of an event history analysis of BIT signings and ratifications suggest that a state's likelihood of entering into a BIT increases as its domestic policies and institutions become more favorable toward FDI. This statistical analysis is complemented by a qualitative case-study analysis tracing the process through which India came to liberalize its policies toward FDI in the early 1990s. These reforms were then followed by the conclusion of several BITs with major capital-exporting countries beginning in the mid-1990s. This process-tracing demonstrates what I argue is a fairly common pattern in which exogenous crises create an opportunity for reform-minded governments to liberalize their country's domestic regulatory regime governing FDI. These liberalizing governments then lock-in their reforms by concluding BITs with developed countries. Second, an analysis of the determinants of investor-state arbitral disputes reveals that countries with greater institutional capacity for protecting and enforcing property rights experience significantly fewer disputes than do countries where such institutions are weak or nonexistent, suggesting that a country's domestic

institutions have a complementary impact on its ability to comply with its BIT-related obligations. This finding has important practical and theoretical implications.

## DEFINING DOMESTIC & INTERNATIONAL REGIMES

Before proceeding, it is worth clarifying what I mean by a *regime*. International regimes have been defined as “sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge in a given issue-area”—in this case, the issue-area of FDI.<sup>11</sup> They are sets of inter-related institutions, both formal and informal, which regulate the behavior of states. While the regime concept, as described here, was originally formulated within the field of international relations (IR), particularly within the sub-field of international political economy (IPE),<sup>12</sup> primarily as a way of describing and explaining patterns of international cooperation (as well as changes in such patterns), and has since become a core component of the theoretical canon of both IR and IPE, in a more generic sense, the concept is frequently applied in other areas of social life and at various levels of analysis, including the national level.<sup>13</sup> Institutions (i.e., norms and rules) obviously exist at multiple levels, including the domestic and international levels. For instance, when political scientists speak of a country’s “regime type,” they are referring to fundamental norms regarding where power resides in a society and for what purposes that power is to be used as well as the rules and procedures

---

<sup>11</sup> Krasner 1982.

<sup>12</sup> See, e.g., Ruggie 1975; Krasner 1983; Keohane 1984; Young 1979, 1980, 1982, 1986; Rittberger 1993; and Hassenclever, Mayer, and Rittberger 1997. See Cohen 2008 for a discussion of the intellectual origins of the regime concept within the field of IPE. See Haggard and Simmons 1987 and Cohn 2005 for critiques of the regime concept as it has been used in the fields of IR and IPE.

<sup>13</sup> As some scholars have suggested, it is unproductive to treat IR as if it were a *sui generis* field by drawing a sharp distinction between domestic and international politics, and in the context of the current discussion, domestic and international institutions. Instead, political scientists should develop concepts and hypotheses that are equally valid across domestic and international contexts. See, e.g., Milner 1992.

governing the use of such power. These norms, rules, and procedures determine whether a country is authoritarian or democratic.

The regime concept is frequently used by legal scholars to describe institutionalized rules and policies in a variety of different issue-areas at the domestic level. Furthermore, it is precisely the degree to which national policy regimes (and therefore, state behavior) are congruent with or diverge from international regimes that is one of the chief concerns for students of both IR and IPE. For instance, to what degree does a country's political regime conform to international norms regarding basic human rights? Similarly, to what degree are a country's regulatory practices congruent with the rules of various international environmental regimes? More generally, why in some instances do we observe a relatively high level of congruence between national and international regimes, while in other instances, there may be sharp inconsistencies between domestic policies and institutions and international regimes?

In the next chapter, I will provide a detailed account of the substantive and procedural elements which make up the international investor rights regime that has emerged since the end of World War II. Here, I will define what I mean by an individual country's domestic regime for FDI. Broadly speaking, I conceive such regimes as consisting of two closely related, but analytically distinct, components. First, there are the actual policies, often, if not always, embodied in domestic legislation, which a state adopts toward FDI. These policies can be situated along a continuum ranging from strict regulation of inward FDI to significant liberalization entailing minimal regulation. Second, there is the larger institutional environment in which FDI takes place. For instance, in some countries there is a strong rule of law, while in others, legal institutions are relatively weak. Institutions may be formal (e.g., an independent judiciary) or informal (e.g., robust societal norms that minimize corruption). Institutions which



protect and enforce private property rights are commonly regarded as an indispensable ingredient for achieving high levels of investment (both foreign and domestic), and therefore economic growth.<sup>14</sup> Countries with strong indigenous property rights institutions represent a more hospitable and secure environment for foreign investors than countries in which such institutions are either weak or nonexistent.

Thus, a country's domestic regime for FDI consists of both *policies* and *institutions*. I assume that policies are easier to change than institutions. Significant organized political opposition notwithstanding, democratic governments that possess a strong electoral mandate or authoritarian governments unencumbered by democratic constraints are more or less free to change their country's regulatory policies toward FDI. Changing the larger institutional milieu in which investment takes place, however, is considerably more difficult given the durability or "stickiness" of institutions, especially societal norms.

## CONTRIBUTIONS & IMPLICATIONS

This dissertation makes several contributions to the rapidly growing literature on BITs.<sup>15</sup> The research presented here also has several important theoretical and practical implications. These contributions and implications can be summarized as follows:

- Although commonly portrayed as substitutes for weak domestic institutions, BITs are more likely to be concluded by countries with strong indigenous institutions.

---

<sup>14</sup> See, e.g., North 1990; Goldsmith 1995; Knack and Keefer 1995; Leblang 1996; Kaufmann, Kraay, and Zoido-Lobaton 1999; de Soto 2000; Rodrik, Subramanian, and Trebbi 2002.

<sup>15</sup> See, e.g., Guzman 1998; Vandevelde 1998; Hallward-Driemeier 2003; Egger and Pfaffermayr 2004; Bütte and Milner 2005; Ginsburg 2005; Neumayer and Spess 2005; Salacuse and Sullivan 2005; Swenson 2005; Tobin and Rose-Ackerman 2005, 2006; Elkins, Guzman, and Simmons 2006; Aisbett 2007; Haftel 2007; Peinhardt and Allee 2007; Tobin 2007; Yackee 2007a, 2007b, 2008; Allee and Peinhardt 2009; Tobin and Busch 2008; Kerner 2009; Allee and Peinhardt 2009.

- The fact that BITs are more likely to be concluded by countries that already offer the most favorable environments for FDI calls into question both the necessity and efficacy of BITs.
- Any distinction between BITs as signals versus BITs as credible commitments is a false one. BITs perform both functions.
- BITs do not represent a substantial departure (in terms of policy) from what a country would have done in the absence of any formal commitment. Hence, BITs represent screening mechanisms, distinguishing states for which compliance can be expected from those for which compliance is problematic.
- If the policy preferences of incumbent governments are what drive countries to conclude BITs, then compliance with BITs is also likely to be driven by changing preferences. Once governments with radically different preferences come to power, compliance may suffer.
- While BITs may be intended to substitute for the lack of strong domestic institutions, it is precisely those countries with weak institutions that are likely to face the highest costs in terms of complying with such treaties as indicated by the greater number of arbitral claims brought against such countries.
- BITs represent “hard law.” While hard legal commitments may make a country’s international commitments more credible by ensuring better compliance through stronger enforcement mechanisms, to the extent that such an approach generates greater compliance *costs* by reducing flexibility, it may undermine the legitimacy and acceptance of the entire regime. Hence, a “softer” approach may in fact be superior.

*Contributions to the Literature on BITs*

My research sheds light on some unresolved questions in the literature on BITs. “The conventional wisdom is that BITs help to remedy local institutional deficiencies.”<sup>16</sup> Thus, some scholars have wondered whether countries that lack strong property rights institutions are more prone to enter into BITs as a way of compensating for their institutional shortcomings.<sup>17</sup> I do not find any evidence for this hypothesis. Instead of functioning as a substitute for weak domestic institutions, BITs are just as likely—in fact, more likely—to be concluded by LDCs whose institutional endowment is relatively strong. The reason for this pattern, I argue, lies in the fact that countries with weak institutions may experience greater difficulties complying with BITs and are therefore deterred from making such commitments until the strength of their domestic institutions has passed a certain threshold.

But why is this finding important, the reader may ask? First and foremost, it means that BITs do not actually function in the way that the conventional wisdom suggests. Those countries that would presumably benefit most from BITs—in the sense of finding a way to compensate for their lack of a strong domestic institutional framework for securing the property rights of foreign investors—are significantly less likely to conclude such treaties, while those countries that arguably benefit the least from BITs—because they already possess a strong institutional capacity for protecting and enforcing property rights—are the most likely to actually make such commitments. This empirical pattern flies in the face of the popular “BITs as substitutes” story. More importantly, this finding bears upon two closely-related questions concerning whether the alleged benefits of BITs outweigh their known costs.

---

<sup>16</sup> Ginsburg 2005, 107.

<sup>17</sup> See, e.g., Hallward-Driemeier 2003; Ginsburg 2005; Neumayer and Spess 2005; and Tobin 2007.

First, are BITs really necessary? If BITs tended to be concluded by countries with weak property rights institutions, then to the extent that such treaties helped these countries attract more FDI than would otherwise be the case, their costs could conceivably be justified. However, if it is precisely those countries that provide the most favorable environment for FDI that are concluding BITs, then we have to ask whether such treaties are necessary given their significant costs, both in terms of financial liabilities and the loss of regulatory sovereignty.

Second, do BITs really work? Empirically, I find that BITs are most likely to be concluded around the same time as a country is liberalizing its policies toward FDI. As a result, how can we know that any subsequently observed increases in FDI inflows are a direct consequence of the BIT and not the product of domestic reforms? As a strictly empirical matter, my finding suggests that any study attempting to find a positive link between BITs and FDI flows must address the possibility of a spurious correlation arising from the simultaneity of domestic reforms and BIT signings. Extant research has consistently failed to address such a simultaneity bias.

From a more practical standpoint, the more important issue is this: How do we know that liberalization alone would not work to increase FDI inflows, while avoiding the adverse costs associated with BITs? Consider the counterfactual: Would the distribution of FDI among LDCs in the 1990s have looked much different had no countries concluded any BITs? I would argue that when we take into account the effects of domestic liberalization programs (while controlling for critical determinants of FDI share such as market size), the distribution of FDI flows would have looked very similar, and that the marginal effects of BITs on FDI inflows have probably served as a proxy for domestic reforms, having therefore been overstated by existing studies. My case-study of India provides some evidence in support of this contention.

Another unsettled question in the literature on BITs is whether such agreements represent devices for signaling liberal policy preferences or making a credible commitment to such policies.<sup>18</sup> I argue that BITs are largely intended to perform *both* of these functions. On the one hand, I find that governments that have liberalized their country's regulatory regime governing FDI are significantly more likely to enter into BITs than are governments which maintain illiberal investment policies. Therefore, BITs represent a mechanism through which governments that have adopted a liberal policy orientation toward FDI can signal their "type" to foreign investors. On the other hand, since most BITs include binding commitments to investor-state arbitration, thereby imposing significant ex post costs for noncompliance, and because most BITs are eventually ratified and put into force, they also represent credible commitments. Furthermore, it is precisely the credibility of liberal reforms that is in question and which is enhanced by BITs. In addition, in the context of democratic countries, BITs represent a device through which pro-FDI governments can "lock-in" liberal policy changes, and in so doing, institutionalize their own policy preferences, tying not only their own hands, but the hands of their successors who may not share their preferences.

### *The Relationship between Commitment and Compliance*

Beyond providing a deeper, more precise understanding of the relationship between domestic and international regimes governing FDI, this study treats the proliferation of BITs among LDCs as a testing ground for existing theoretical debates within the fields of IR & IPE concerning the nature of international law, the conditions under which states are most likely to make international legal commitments, and those factors effecting or determining state compliance with international regulatory agreements.

---

<sup>18</sup> See, e.g., Elkins, Guzman, and Simmons 2006; Haftel 2007.

Does international law represent an effective constraint on the behavior of the states?

While many studies have found that states generally comply with the treaties they sign,<sup>19</sup> some scholars question the causal significance of this observation.<sup>20</sup> Before a verdict can be rendered on whether treaties effectively limit the behavior of sovereign states these scholars argue, an important question must be answered: *Do treaties require a significant departure from what a state would have done in the absence of any formal commitment?*<sup>21</sup> Do such commitments cut against or coincide with the policy preferences of the states that make them? In other words, do international agreements actually alter state behavior, or do they merely reflect or ratify the existing distribution of preferences among states?

The results of my analysis of the pattern of BIT signings support the notion that states are more likely to undertake formal international commitments when they have at least some prior interest in complying with them. In most cases, compliance with BITs does not require a significant change in the policies of those countries that enter into them (though this is not to suggest that BITs do not have unanticipated consequences or costs). Instead, BITs represent a ratification of prior policy changes made on a voluntary, unilateral basis. These policy changes are themselves the product of important changes in the preferences of LDC governments toward FDI and their strategies for attracting such investment. In short, I find that compliant behavior is positively related to the decisions of LDCs to conclude BITs.<sup>22</sup> To get states to make binding international commitments without cheating on those commitments, suggests one scholar, the agreements in question “must not ask them to change their behavior much from whatever they

---

<sup>19</sup> See, e.g., Henkin 1979; Young 1979; Chayes and Chayes 1993, 1995; and Simmons 2000.

<sup>20</sup> See, e.g., Downs, Rocke, and Barsoom 1996; and von Stein 2005.

<sup>21</sup> von Stein 2005, 611.

<sup>22</sup> von Stein (2005, 2008) reports similar findings for international monetary and environmental regimes.

are already doing.”<sup>23</sup> During the 1960s, 70s, and much of the 80s, when most LDCs maintained restrictive and discriminatory policies toward FDI, BITs would have required a dramatic change in the behavior of host governments. Consequently, the growth in BITs was very slow during these decades. Governments simply had no interest in them. However, by the 1990s, when most countries had begun to liberalize their regulatory regimes governing FDI, the costs of BITs, defined in terms of the degree of change in policy which they required, came down significantly. It is the sea-change in attitudes toward FDI which does the most to explain the proliferation of BITs in the 1990s. Thus, those countries that are most likely to enter into BITs are precisely the ones whose policies and institutions are most congruent with the behavioral dictates of the international investor rights regime which BITs represent. In those instances in which states do engage in ex post noncompliant behavior, such behavior usually represents not only a violation of the terms of BITs but also the norms and rules embodied in a country’s own domestic legislation and institutions.

If international investment-related legal commitments, as embodied in BITs, are a function of the policy preferences of governments—that is only governments that hold favorable preferences toward FDI are likely to conclude BITs in the first place—then it also follows that compliance with such treaties will itself be dependent upon favorable government preferences. When preferences change as a result of a transition from one government to another—one whose partisan orientation or attitudes toward FDI differ significantly from those of its predecessor, for instance—a state’s propensity to continue complying with its BIT-related obligations may diminish. This possibility can clearly be seen in recent indications of a renewed willingness on the part of some LDCs to nationalize foreign investments as well as a growing dissatisfaction among some LDCs with the international investor rights regime embodied in BITs and

---

<sup>23</sup> Bueno de Mesquita 2009, 81.

institutions such as ICSID. This potential trend is most evident in the conspicuous leftward partisan shift that has taken place in many Latin American countries in recent years. Between April 2006 and May 2007, the government of Hugo Chávez seized control of oil projects controlled by American and European energy companies, touching off a protracted dispute between itself and MNCs such as Exxon Mobil and ConocoPhillips.<sup>24</sup> On May 2, 2007, ICSID received written notice of Bolivia's "denunciation" of the ICSID Convention, becoming the first state to formally withdraw from the convention.<sup>25</sup> While experts on international investment law disagree over the implications of Bolivia's withdrawal for the rights of foreign investors in that country, the message being sent by the Morales government could not be clearer. Venezuela and Nicaragua have both announced their intention to withdraw from the convention, though neither has made any formal moves to do so as of yet. There is speculation that Ecuador may also withdraw from the convention or at least attempt to limit its applicability after the Correa government expelled a World Bank representative from the country in April 2007.<sup>26</sup> The Correa government has already announced its intention to withdraw from nine of its BITs, citing a lack of evidence of any positive effect of BITs on FDI inflows which would counter-balance the

---

<sup>24</sup> In April 2005, the Chávez government gave foreign oil firms one year to convert 32 operating service agreements governing oil fields representing roughly one-fifth of Venezuela's total oil production into joint-ventures with the state-owned oil company *Petróleos de Venezuela (PDVSA)*. None of the contracts were due to expire until 2012. Sixteen companies, including Chevron, Royal Dutch Shell, and Repsol, agreed to new terms giving PDVSA at least a 60 percent equity stake. In April 2006, the government seized control of two oil fields owned and operated by France's Total and Italy's ENI after both firms refused to renegotiate the terms of their contracts. The government then turned its attention to projects in the heavy oil fields of the Orinoco River basin owned and managed by British Petroleum, Chevron, Conoco Phillips, Exxon Mobil, Statoil, and Total, once again demanding a majority ownership stake in these companies' operations. After negotiations between these companies and the government failed to produce a consensual deal, the government ended negotiations in January 2007, setting May 1 as a deadline for its takeover of the projects in question. That same month, Chávez announced plans to nationalize companies in the telecommunications, electricity, and natural gas sectors in which American corporations like Verizon Communications, AES Corporation, and CMS Energy have large stakes. Following the seizure of their assets in May 2007, Exxon Mobil and ConocoPhillips both filed arbitral claims with ICSID later that year. Exxon has adopted the most uncompromising and aggressive stance of any of the major international oil companies in its dealings with the Chávez government, securing orders in British, Dutch, and American courts freezing as much as \$12 billion in oil assets held by PDVSA. Many companies like Chevron and BP continue to operate in the country.

<sup>25</sup> Prior to this, the Morales government decreed the nationalization of Bolivia's natural gas industry on May 1, 2006.

<sup>26</sup> The Correa government has also indicated that it will not renew its BIT with the United States.



enormous pecuniary costs associated with BIT-related arbitral claims. The Morales government has also declared its intention to renegotiate the terms of its BITs.

In short, recent events suggest that the compliance of host states with their BIT-related obligations cannot be taken for granted and that an investigation into the conditions under which states are more or less likely to comply with BITs is warranted. The leaders of many current Latin American governments feel that their predecessors “sold out” their own countries by concluding BITs, thereby tying the hands of future governments with respect to FDI policy. These governments seek to reassert their regulatory sovereignty over FDI. It is precisely this sort of political dynamic at the domestic level which this dissertation highlights as one of the most important sources of both commitment to, and (non)compliance with, the international investor rights regime.

### *Hard vs. Soft Law: Which Is Better?*

My research also has implications for other issues within the field of IR. One such issue is the supposed trade-off between so-called “hard” and “soft” forms of international law. It has become commonplace to compare and contrast international treaties and other types of agreements according to their degree of “legalization.”<sup>27</sup> Legalization has been defined in terms of three key dimensions: (1) *obligation*—the degree to which states (or other actors) are legally bound by a set of rules or commitments, (2) *precision*—the degree to which rules unambiguously define the conduct they require, authorize, or proscribe, and (3) *delegation*—the degree to which third parties have been granted authority to implement, interpret, and apply rules; resolve disputes; or make new rules.<sup>28</sup> Agreements that can be characterized as entailing a relatively

---

<sup>27</sup> See, e.g., Goldstein et al. 2000.

<sup>28</sup> Abbott et al. 2000.

high level of obligation, precision, and/or delegation are said to represent “hard law,” while agreements that register low levels on all three of these dimensions are commonly portrayed as “soft law.”<sup>29</sup>

Each form of law is thought to carry its own advantages and disadvantages. Hard legal commitments, for instance, enable states to enhance the credibility of their commitments by strengthening enforcement mechanisms. They also help states reduce transaction costs and resolve problems of incomplete contracting.<sup>30</sup> These benefits, however, are not costless. The biggest drawback of hard law is the significant sovereignty costs which it entails. Soft legal commitments, on the other hand, provide states with greater flexibility in the face of significant uncertainty regarding the consequences of an agreement. Soft agreements generally entail substantially lower sovereignty costs making them easier to reach (i.e., the contracting costs associated with such agreements is lower). The question, then, is not necessarily which form of law is better—both forms entail certain costs as well as benefits—but rather, which form helps states achieve their individual and collective objectives. As Abbott and Snidal (2000) suggest, rational states “choose to order their relations through international law and design treaties and other legal arrangements to solve specific substantive and political problems.” The choice between hard and soft law, then, depends on which form offers the “superior institutional solution.”<sup>31</sup> It is clear, however, that in many instances, the costs of a particular form of law may outweigh the benefits. This I argue has probably been the case for BITs, at least in terms of the interests of LDCs.

In committing themselves to an international regime that provided a clear-cut set of rules governing their relations with foreign investors—rules that were both legally binding and

---

<sup>29</sup> Abbott and Snidal 2000.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid., 421.

enforceable—LDCs essentially chose hard law over soft law. Most BITs represent hard commitments, particularly insofar as they entail significant delegation in the form of binding commitments to arbitration.<sup>32</sup> As such, they have imposed enormous sovereignty costs on LDCs, stripping them of their ability to regulate FDI. Perhaps more importantly, BITs enable foreign investors to bring expensive treaty-based arbitral claims against LDCs. The pecuniary costs of defending one's self and, if found to have violated an investor's rights (as defined by the treaty), complying with an arbitral tribunal's decision are by no means trivial. Why were LDCs willing to accept these costs? Why did they opt for hard rather than soft commitments? As I argue in chapter 3, most LDCs suffered from a severe credibility problem in the eyes of foreign investors. Until the 1990s, many, if not all, LDCs had heavily regulated FDI. Some had even expropriated foreign investments in the past. Hence, any government that embarked on a program of liberalizing its country's foreign investment regime had to wonder whether these reforms would be viewed as credible in the eyes of investors. BITs, with their hard commitments to investor-state arbitration, offered a mechanism for enhancing the credibility of domestic reforms. By linking reforms to strong international legal commitments—particularly, a binding commitment to arbitrate disputes with foreign investors—reformist governments tied both their own hands as well as those of future governments, thereby presumably decreasing the likelihood of policy reversals or that the property rights of foreign investors would be violated. The hope was that such hard commitments combined with domestic liberalization would serve to stimulate greater inflows of FDI by reducing expropriation risks.

---

<sup>32</sup> Following other analytical treatments of BITs (e.g., Yackee 2007a), I focus on the degree of delegation in BITs. BITs also can be said to generally entail a high degree of obligation, though some BITs may contain various exceptions or reservations which soften the level of obligation. It is unclear, however, where most BITs stand in terms of their degree of precision. While the substantive rules contained within most BITs are fairly straightforward, a certain degree of ambiguity remains as evidenced by contradictory interpretations rendered by arbitration tribunals in recent years.

While it remains to be seen whether BITs have any real impact on FDI flows, the costs of investor-state arbitration are readily apparent. Every month, new arbitral claims amounting to millions of dollars are brought against host countries by foreign investors. If an investor's claims are upheld by an arbitral tribunal, the errant host state is obligated to compensate the aggrieved investor by paying whatever amount of money is awarded to the investor by the tribunal, or risk damaging its reputation in the eyes of other foreign investors. Even if a government manages to win a dispute with an investor, oftentimes it will have expended a tremendous sum of money defending itself.

The investor-state arbitration system which BITs helped create has produced numerous controversial cases which have served to undermine the legitimacy of the entire international investor rights regime in the eyes of many developing countries. Some investment disputes have arisen, not from opportunistic behavior on the part of host states, but rather unforeseen circumstances or exogenous shocks such as currency crises. Argentina and Indonesia, for instance, were both subjected to multiple arbitral attacks by foreign investors in the aftermath of severe economic crises which forced both countries to devalue their currencies. Many of the arbitral claims brought against both countries involved questionable or dubious contracts involving infrastructure projects (e.g., power plants) in which the governments were expected to bear the entire burden of exchange rate volatility. In the wake of their respective economic crises both countries were forced to devalue their currencies, thereby increasing the amount of money owed to foreign investors. Under the circumstances, neither country had the ability to pay what was owed, and when it became apparent that neither government intended to do so, at least some investors turned to the arbitration system as a way of forcing the countries to pay up rather than trying to reach a negotiated settlement with either government. While many of the

cases in question are still pending, in those that have gone forward, some arbitrators have taken a hard-line position in interpreting the host states' obligations, adopting a rather inflexible, "sanctity of contracts" view. Yet, many of the contracts in question, having been reached through bribery and other questionable practices, are therefore tainted by corruption, giving them the same quality as "odious" debts. It is this lack of flexibility in the face of exceptional or extraordinary circumstances which has caused many LDC governments to question the legitimacy of the international investor rights regime.

The legitimacy crisis which now confronts the BIT-based investor rights regime could have been avoided if states had chosen a softer approach. While it is easy to understand the incentives which liberalizing governments had to make hard legal commitments in order to enhance the credibility of liberal reforms, as well as the desire of rich countries to lock-in these reforms through hard treaties, the decision to accept and promote such commitments was arguably short-sited. As my analysis of investor-state arbitrations demonstrates, those countries that lacked the institutional capacity to protect and enforce private property rights were essentially setting themselves up for failure by concluding hard, inflexible BITs. Without a strong rule of law or robust norms against corruption, it was inevitable that these countries would run afoul of the investor rights regime. Furthermore, given that the strength of a country's domestic property rights institutions are probably correlated with a country's income level, this means that the poorest countries—i.e., those countries least capable of defending themselves from the claims of foreign investors and for which the burden of paying compensation is highest—have probably been disproportionately affected.

While the kind of tough enforcement mechanisms which hard law entails may be good for ensuring that foreign investors make a profit, such an approach may very well be sowing the

seeds of its own demise. The rigid nature of the investor-state arbitration system, while intended to deter and punish opportunistic behavior on the part of host states, has failed to account for exceptional situations such as those faced by countries like Argentina and Indonesia. As a result, it has left a very bad taste in the mouths of many developing country governments, even sparking an outright backlash in some cases. Consequently, more LDCs could conceivably follow the lead of Latin American countries like Bolivia and Ecuador and withdraw from BITs and associated institutions like ICSID. If this trend were to continue, the security of foreign investments might be worse than before. This would be, to say the least, an undesirable outcome from the perspective of the rich, capital-exporting countries, but one that could have been foreseen and can still be avoided if these countries act responsibly by working to soften the regime which they helped create.

### *The Importance of Institutional Capacity*

The choice between hard and soft law plays a central role in a debate within the field of IR, already alluded to, regarding the nature of compliance with international regulatory agreements and the most appropriate methods for ensuring compliance on the part of states. Two competing schools of thought have emerged around these issues. The so-called “management school” sees states as inherently prone towards honoring their international commitments. When noncompliance does occur, it is thought to be the unintentional result of capacity limitations, including financial, technical, and institutional limitations.<sup>33</sup> In contrast, the so-called “enforcement school” tends to regard acts of noncompliance as being willful and deliberate.<sup>34</sup> From their respective assumptions regarding the nature of noncompliance, each school derives

---

<sup>33</sup> See, e.g., Chayes and Chayes 1995.

<sup>34</sup> See, e.g., Downs, Rocke, and Barsoom 1996.

alternative solutions to the problem of ensuring compliance. The management approach emphasizes the need for flexibility and calls on richer countries to assist poorer ones by undertaking capacity-building efforts. In essence, the idea is that compliance can be improved by enhancing a state's financial, technical, and/or institutional capacity for compliance. In contrast, the enforcement approach, as its name suggests, regards strong enforcement mechanisms as essential for ensuring compliance, especially when an agreement requires substantial changes in the behavior or policies of states. In terms of the choice between hard and soft law, the management school implies a much softer approach than the enforcement school which would seem to entail a harder approach.

The design of BITs would seem to be inspired by the enforcement approach to compliance. Yet, my analysis of investor-state arbitrations demonstrates the importance of institutional capacity in determining a state's ability to comply with such treaties as well as the costs of compliance. In short, I find that compliance tends to be more difficult, and the costs of compliance significantly higher, for countries with low institutional capacity (i.e., a weak rule of law, rampant corruption, etc.) as indicated by the greater number of arbitral claims brought against such countries by foreign investors. This empirical finding is more in line with the expectations of the management school which emphasizes capacity limitations as the most important source of noncompliance with international regulatory agreements. BITs essentially mandate rule of law, yet in many of the countries that concluded such treaties, the rule of law is weak or nonexistent. No government can create a strong rule of law overnight. Building durable and robust institutions takes time.

As my analysis of the pattern of BIT signings shows, countries with low institutional capacity for protecting and enforcing the property rights of foreign investors tended to avoid

making commitments that they knew they could not keep. However, this simply explains the *timing* of commitments. It explains why countries that already possessed strong institutional infrastructures for securing property rights tended to enter into BITs significantly earlier than those countries with poor institutional endowments. However, intense international competition to attract FDI eventually drove countries of all stripes, including those with severe institutional shortcomings, to conclude BITs out of fear of losing FDI. The consequences of accepting such hard legal commitments have, I would argue, been disastrous for those countries that lacked the institutional capacity to comply with such commitments. Although the merits of certain arbitral claims brought by foreign investors against developing host countries can be questioned, the simple fact is this: if BITs are functioning as they are intended to, then countries with weak domestic property rights institutions will inevitably experience a greater number of claims than countries whose institutions are comparatively stronger. As a result, these countries should have not have assumed such commitments. This is what I refer to as “the paradox of institutional capacity.” From the perspective of foreign investors (and the governments that represent them), the kinds of external protection and enforcement mechanisms which BITs provide are probably most necessary in those countries where there is a weak institutional infrastructure for securing private property rights. However, it is these types of countries against which the greatest number of treaty-based arbitral claims are likely to be brought precisely because of the lack of strong domestic institutions capable of providing such property rights protection. The costs of compliance will be significantly higher for such countries.

What are the practical implications of my research? I will postpone engaging in an in-depth discussion of the specific policy prescriptions which flow from my research, leaving that for the concluding chapter. However, a few points are worth raising here. First and foremost,



LDCs should reduce their exposure to arbitral claims by renegotiating or withdrawing from BITs. Second, LDCs would be better served by improving the strength of their domestic institutions rather than tying their hands with costly international legal commitments. Finally, the international investor rights regime should be reformed and reconstructed so as to account for the capacity limitations of developing countries. All of these proposals are likely to be met by strong resistance on the part of major capital-exporting countries. However, these reforms are arguably necessary to avoid a more widespread backlash on the part of LDCs, one that could conceivably produce a more radical response on the part of host governments, and to ensure that FDI contributes to development rather than exacerbating the debt burdens of host countries.

## **ORGANIZATION OF THE DISSERTATION**

The organization of the dissertation is as follows: In the next chapter, I offer a historical account of the evolution of international principles and norms concerning the rights of foreign investors. This survey includes an account of the repeated but ultimately failed efforts to establish a multilateral treaty regime for FDI in the post-World War II era as well as the gradual diffusion of BITs as an alternative source of governance during this same period. I also recount the intense ideological conflict between developed countries (DCs) and LDCs over the substantive content and orientation of an international investment regime throughout much of the postwar period and the subsequent liberalization of LDC policies toward FDI since the 1980s. My review of the history of international rule-making efforts with respect to FDI provides the necessary context for understanding the dramatic increase in BITs which occurred in the 1990s and the role which these agreements played in the strategies of LDC governments looking to attract FDI.

In Chapter 3 I construct my argument regarding the complementary relationship between national and international FDI regimes. I begin with a general theoretical discussion of the dynamic inconsistency and credibility problems confronting LDC governments in their relations with foreign investors as well as the functions BITs serve in helping LDCs to overcome these problems. I then go on to explicate a two-level model of commitment, in which states commit themselves to certain principles, norms, rules, and policies at the domestic level before making similar commitments at the international level. This model explains why countries with liberal FDI policies and strong property rights regimes are more likely to commit themselves to the international investor rights regime by entering into BITs than are countries with illiberal policies and weak property rights institutions, and why the latter group of countries is more likely to experience trouble complying with BITs. I derive specific falsifiable hypotheses from this theory which are then subjected to empirical testing in chapter 4.

Chapter 4 considers the relationship between national and international FDI regimes by addressing the question of which type of country is more likely to conclude BITs—those with liberal FDI policies and relatively strong property rights regimes or those with illiberal policies weak or nonexistent property rights institutions. The results of my empirical analysis suggest that countries with favorable FDI regimes are significantly more likely to formerly commit themselves to the international investor rights regime by entering into BITs than are countries with unfavorable FDI regimes. Chapter 5 builds upon the findings presented in chapter 4 by examining the relationship between national FDI regimes and countries' capacity to comply with their BIT-related obligations. The results of an empirical analysis of investor-state arbitral disputes suggests that countries with liberal FDI policies and strong property rights regimes experience significantly fewer investment disputes than do countries with illiberal policies and

weak property rights institutions. In other words, countries that have adopted FDI-friendly policies and which have a stronger institutional capacity to protect and enforce private property rights would appear to have an easier time complying with their international investment-related legal commitments, as evidenced by a significantly lower number of arbitral claims being brought against these countries. This finding has enormous practical implications, which I spell out in the chapter's conclusion.

Finally, chapter 6 provides a summary of my argument regarding the complementary relationship between national and international FDI regimes along with a review of the body of evidence supporting this argument. The chapter goes on to raise additional issues, including important normative considerations. Chief among these is the long-term consequences of the proliferation of BITs and the international investor rights regime which they embody. Does such a regime provide tangible benefits to developing countries, and if so, do these benefits outweigh the significant costs associated with BITs and other international investment agreements? Few scholars have been willing to give serious or sustained attention to these issues despite their critical importance to the welfare of developing nations. Yet these issues are of critical importance to the legitimacy, and hence, the long-term stability, of the contemporary international investor rights regime. There is a growing sense among observers and proponents of this regime, including many arbitrators themselves, that the regime may be losing what little legitimacy it may have once had among LDC governments. If the system of investor-state arbitration is not reformed in such a way as to address some of the needs and concerns of developing countries, suggest some of these commentators, these countries may abandon their international commitments to investor rights. The findings of this dissertation speak directly to these concerns, highlighting the role of changing preferences among governments as a key

determinant of both commitment to, and compliance with, international rules governing the rights of foreign investors.

## CHAPTER 2

### THE INTERNATIONAL REGIME FOR INVESTOR RIGHTS

Unlike the areas of trade and money, there has never been a multilateral treaty regime for FDI, despite its ever-increasing importance to the economies of DCs and LDCs alike and the larger global economy.<sup>35</sup> It is certainly not for a lack of trying. There have been repeated calls for, and concerted efforts to establish, such a regime since the end of World War II, but all of these initiatives have ultimately failed. One reason for this consistent failure is that states disagree over whose behavior should be regulated by such a regime. Should it regulate the activities of foreign investors (i.e., MNCs) or should it govern the behavior of host states? Should the conduct of home states be subject to certain norms or rules? Even if the behavior of all three groups were covered, the question would still remain: which group should receive the most attention?

At least three different perspectives have been brought to bear on this issue. The state-centric or realist perspective suggests that the conduct of MNCs should be regulated in order to ensure that their activities do not undermine the national interest (defined in terms of national power and/or security) of the states that play host to them.<sup>36</sup> Similarly, for those on the left, including Marxists, Dependencistas, World-Systems theorists, and others adopting an anti-capitalist or historical-structuralist view of international economic relations, the behavior of

---

<sup>35</sup> The regulatory scope of the international trade regime has continued to grow since its establishment after World War II, addressing an ever widening-range of issues, many of which go “beyond the border” such as intellectual property rights and trade in services. The trade regime has also arguably been strengthened by the establishment of the World Trade Organization. See Barton et al. 2006. The international monetary regime has in contrast been described as a “non-system” since the collapse of the Bretton Woods system in the early 1970s. Thus, international monetary relations could arguably benefit from the creation of a new multilateral treaty regime as much as international investment relations. See Gilpin 2001 and Cohn 2005.

<sup>36</sup> See, e.g., Gilpin 1975.

MNCs and their home states should be regulated in order to prevent or minimize the exploitation of peripheral countries by the core. In sharp contrast, liberals believe the conduct of host states should be regulated in order to prevent them from diminishing the efficiency of MNC operations through mercantilist policies which liberals regard as misguided or ill-conceived, and to prevent host states from violating the property rights of foreign investors. While most DCs have adopted a liberal perspective on the issue of whose behavior should be regulated by an international investment regime, preferring a regime that emphasizes the property rights of foreign investors and which limits the ability of host states to regulate MNCs, most LDCs have historically subscribed to a combination of mercantilist and structuralist ideas, preferring a regime that legitimizes the right of host states to regulate the activities of MNCs in a manner which promotes economic development and social welfare, and which constrains the ability of home states to intervene in the affairs of host countries on behalf of the interests of their own MNCs.<sup>37</sup>

Given these fundamental, ideological divisions concerning the essential purpose of an international regime for FDI, the failure to establish a multilateral treaty regime in this issue-area—i.e., a single set of mutually agreed upon, universal rules—should come as no surprise. Nonetheless, an institutional infrastructure does exist in the area of international investment relations, albeit one that is fragmented and disjointed. As one observer puts it, “over the years, a wide range of international initiatives [have] succeeded in adding incrementally to a regime governing [FDI] issues that, while incomplete and not universally applied, does provide more order and stability than is often assumed.” While some of these efforts have either “failed or have lapsed into obscurity; others remain on the books.” And while some of the agreements resulting from these initiatives “enjoy the force of law; others serve little more than hortatory, exemplary, or other purposes.” “Together, they provide a hodgepodge of sometimes conflicting,

---

<sup>37</sup> Cohn 2005.

sometimes complementary endeavors to bring order and stability into international investment issues,” constituting what many proponents of a more binding, multilateral investment agreement regard as a “less-than-satisfactory regime.”<sup>38</sup>

This chapter traces the historical evolution of international principles, norms, and rules concerning the rights of foreign investors. Although it is by no means exhaustive, this account provides some insight into the origins of the latent international investor rights regime which can be said to govern contemporary international investment relations and the constituent elements that make up this regime. The chapter is divided into five parts. The following section discusses some of the historical antecedents of the two competing paradigms regarding the treatment of foreign capital which have provided the ideational basis for North-South conflict over the content of an international regime for FDI since World War II. The second section provides a detailed account of the many repeated efforts to establish a multilateral treaty regime for FDI in the postwar era, including why each of these initiatives ultimately failed. The third section describes the gradual diffusion of BITs as an alternative source of governance in the realm of international investment relations since the 1960s, including a thorough description of the substantive and procedural content of these treaties which constitutes the current investor rights regime governing the treatment of FDI by host states at the international level. The fourth section discusses a key centerpiece of the contemporary international investor rights regime—ICSID—and its relationship to BITs. Finally, the chapter concludes with a discussion of the significant changes that have taken place in the orientations of LDCs toward FDI since the 1990s and the implications of such changes for the prospects of creating a multilateral regime for FDI.

---

<sup>38</sup> Hart 1996, 37-38, 46. For a critique of the status quo, see Ostry 1997a.

## HISTORICAL ANTECEDENTS

The earliest antecedents of what we might now recognize as an international investment regime can be traced back to the seventeenth century when European states first began engaging in diplomatic efforts to ensure the protection and security of their respective nationals who were engaged in commercial activity or who held property in foreign lands. Many states negotiated bilateral commercial agreements—so-called Friendship, Commerce, and Navigation (FCN) treaties—that protected the capital of their own nationals from interference and expropriation by states who played host to these investments.<sup>39</sup> These treaties—precursors to modern-day BITs—were “essentially the legal expression of reciprocal interests among European states” and helped to form the first genuine international investment regime. As Lipson (1985) explains,

The ground rules for [the treatment of] foreign capital were well defined by the mid-nineteenth century. They grew out of numerous commercial treaties among European states, treaties whose provisions ultimately hardened into general principles of international law... Foreigners were deemed subject to local laws, as they had been since the Middle Ages, but national jurisdiction over aliens and their property had to comply with a variety of international standards. Interference with foreigners' property was permissible, but only in exceptional cases involving a clear and limited public purpose. Both independent judicial review and full compensation had to be provided. Without these procedural and substantive remedies, any taking was an illegal confiscation and an international tort. In such cases, the investor's home state could choose whether or not to pursue the claims of its nationals once local remedies had been exhausted.<sup>40</sup>

Thus, a foreign investment regime emerged over the course of the seventeenth and eighteenth centuries among European states, a regime that was largely sustained by the

---

<sup>39</sup> A 1667 treaty between Great Britain and Spain, for instance, “prohibited the mistreatment or seizure of ships and merchandise in each other's territory” (Lipson 1985, 37). The United States negotiated its own FCN treaties with countries such as France beginning in 1778. The purpose of such agreements was to provide US nationals “with access to foreign ports and markets on a reciprocal basis” and to guarantee national and MFN treatment for their possessions (Hart 1996, 56). Britain, France, Holland, and Spain “all played important roles” in the development of such treaties, while the German Empire, Sweden, and Russia “were involved to a lesser extent” (Lipson 1985, 9). In addition, see Fry 1983, 27-29 for a brief discussion of the Hanseatic League which the author refers to as the “first institutionalized arrangement providing the necessary economic and political infrastructures for investment links to be established with some degree of permanency” and whose “primary purpose was to protect mutual commercial interests” from “the whims of foreign rulers.”

<sup>40</sup> Lipson 1985, 8-9.



reciprocal interests of its adherents.<sup>41</sup> However, as Lipson points out, the extension of the regime's norms and rules beyond Europe during the nineteenth century "involved few reciprocal relationships, considerably more coercion, and constrained bargaining among radically unequal states."<sup>42</sup> In Africa, Asia, and Latin America, the European powers resorted to direct colonial annexation, capitulation treaties, and ad hoc diplomatic intervention in an effort to ensure the security of their respective nationals' investments when local legal structures or political remedies proved inadequate.<sup>43</sup> When these methods faltered, the European powers often resorted to the use of overt force, letting their gunboats guarantee investment protection and security where customary international law failed. Thus, the investment regime that emerged between the states of Europe and the less developed nations and colonies of Africa, Asia, and Latin America represents what Young has referred to as an "imposed order."<sup>44</sup> Ultimately, the rights of European investors rested upon an implicit awareness (on the part of host countries or colonies) of the willingness of these investors' home states to employ coercive means (i.e., gunboat diplomacy) to uphold these rights.<sup>45</sup>

---

<sup>41</sup> As Lipson (1985, 12) suggests, because their own nationals were abroad and therefore vulnerable to arbitrary seizures which could disrupt commercial relations, the European trading powers exercised "self-restraint" with respect to foreign investors. This self-restraint was "pledged in treaty form" and "was supported by their self-interest." The "potential withdrawal of normal reciprocities" functioned as a "powerful sanction" against would-be violators of the norms of the regime.

<sup>42</sup> *Ibid.*, 12.

<sup>43</sup> For a more thorough and detailed discussion of the various approaches to investment protection employed by European states in different regional contexts, see Lipson 1985, particularly chapters 1 (pages 12-19) and 2. On the relationship between colonialism and international investment, see Frieden 1994.

<sup>44</sup> See Young 1982 (282-85). Young identifies three general categories of international regimes: spontaneous, negotiated, and imposed orders. Imposed orders, according to Young, "are fostered deliberately by dominant powers or consortia of dominant actors." Such orders "typically do not involve explicit consent on the part of subordinate actors, and they often operate effectively in the absence of any formal expression. In short, imposed orders are deliberately established by dominant actors who succeed in getting others to conform to the requirements of these orders through some combination of coercion, cooptation, and the manipulation of incentives."

<sup>45</sup> See, e.g., Finnemore 2003. Tomz (2007) questions the commonly held view that home states frequently employed so-called gunboat diplomacy as a means of protecting the commercial interests of their nationals. However, his analysis only considers sovereign bonds and not FDI.

Despite the occasional need to employ force in order to resolve intractable disputes, the real challenge confronting European states with respect to international investment relations during the nineteenth century was to somehow supplant collectivist or ambiguous forms of property ownership which existed in many non-European social and cultural milieus with the liberal ideal of individual ownership and appropriation upon which Western capitalism is based.<sup>46</sup> Whether through colonialism, imperialism, or more subtle means, the major European powers largely succeeded in securing the “juridicial dominance of individual possession on a worldwide basis” throughout most of the nineteenth century.<sup>47</sup> Prior to World War I, “there simply were no large-scale takings of foreign property.” Those expropriations and confiscations that did take place (most of which were limited in scope) “were vigorously (and successfully) repulsed by Great Britain and the other European states.”<sup>48</sup> This soon began to change, however, with the emergence of communist regimes beginning in the early twentieth century and the rise of Third World nationalism following the dismantlement of colonial empires after World War II.

### *Normative Challenges*

The earliest normative and legally articulated challenges to the regime that had been imposed upon less developed countries and colonies by the European powers came in the form of the so-called Calvo and Drago Doctrines. Named for the Argentinean jurist Carlos Calvo who first articulated it in 1868, the Calvo Doctrine “asserts that as a matter of international law, no state may intervene diplomatically or otherwise, to enforce its citizens’ private claims in a foreign country.” Such intervention, Calvo argued, would violate the sovereignty of the host nation and, assuming that foreigners in the host country were treated equally to that country’s

---

<sup>46</sup> See Lipson 1985, 20-21.

<sup>47</sup> Ibid., 21.

<sup>48</sup> Ibid., 19-20.

own nationals, would be unnecessary.<sup>49</sup> Named after another Argentinean jurist and foreign minister, Luis Drago, the Drago Doctrine was “prompted by the British and German blockade of the Venezeula coast in 1902 and 1903 in an effort to force the settlement of the financial claims of their citizens against Venezuela.” Drago argued that public debt was neither “an acceptable pretext for armed intervention nor the material occupation of the soil of any Latin American nation by a European power.”<sup>50</sup>

The Calvo and Drago Doctrines were soon followed by further normative challenges in the form of the Mexican Constitution of 1917 and the Russian Revolution. The Bolshevik Revolution resulted in large-scale nationalizations of foreign-owned property, most of which was unaccompanied by any form of compensation whatsoever, resulting in heavy losses for foreign investors who had invested in the former Czarist regime, particularly among the British and French. Despite the radical orientation of the Mexican Constitution of 1917 with its relatively stringent and largely unprecedented restraints on the activities of foreign corporations, Mexico did not engage in any large-scale expropriations of foreign-owned property until 1938 when it wrested control of its oil fields from foreign oil companies.<sup>51</sup>

By the beginning of the post-World War II era, the international regime that had governed the treatment of what was mostly European investment by lesser developed host countries, a regime that had largely been imposed upon these countries by the implicit threat of force by the major European powers, had broken down. Nonetheless, many of the essential elements of this regime—nondiscrimination, noninterference, anti-expropriation, and compensation—continued to function as important principles and behavioral norms with respect to the treatment of FDI.

---

<sup>49</sup> Lipson 1985, 282, note 51.

<sup>50</sup> Fry 1983, 34.

<sup>51</sup> Fry 1983, 31; Lipson 1985, 18-19.

## A STORY OF REPEATED FAILURE

As has already been noted, since the end of World War II, there have been numerous efforts to establish a formal, multilateral treaty regime for FDI, thereby providing an explicit institutional infrastructure for the governance of international investment relations. The first such initiative came in the form of efforts to create an International Trade Organization (ITO) in the latter half of the 1940s. Despite its eventual abandonment to the scrap-heap of history, the ITO Charter remains notable for its inclusion of explicit rules pertaining to the treatment of foreign investment. In the decades following the ITO's demise, similar investment-related initiatives were undertaken under the auspices of a variety of international organizations, including the United Nations Conference on Trade and Development (UNCTAD), the Organization for Cooperation and Development (OECD), and the World Bank. The latest and most ambitious attempt to construct a comprehensive, multilateral treaty regime for FDI was the OECD-sponsored (and aptly named) Multilateral Agreement on Investment (MAI) negotiated between 1995 and 1998. Like the ITO, the MAI was eventually aborted.

### *Drawing the Lines of Conflict: The ITO Charter*

As stated above, the ambitious but still-born ITO Charter represents the first notable attempt to develop multilateral rules on FDI in the postwar era. According to Diebold (1996), the “negotiation of language about investment became one of the most contentious issues during the final negotiations” to establish the ITO.<sup>52</sup> The movement to create an ITO began in the spring of 1943 with consultations between the US, British, and Canadian governments. By February 1946, a Preparatory Committee for an International Conference on Trade and

---

<sup>52</sup> Brewer and Young (1998, 66) similarly describe the ITO Charter's investment provisions as “among the most important and controversial issues” in the ITO negotiations.

Employment had been established at the request of the US under the auspices of the Economic and Social Council of the UN. Its task was to draft a charter for the proposed ITO. The US got the ball moving, producing a document entitled *Suggested Charter for an International Trade Organization of the United Nations* which became the basis for discussions at the first meeting of the Preparatory Committee which took place in London later that year. The document included seventy-nine different articles, none of which addressed foreign investment. At the second meeting of the Committee which took place in 1947 in Geneva, the US introduced an additional article on investment containing many of the same kinds of provisions which would later show up in BITs, including national treatment; most favored nation (MFN) treatment; compensation in the event of expropriation; and explicit recognition of the role FDI should play in promoting development. The incorporation of investment issues into the ITO Charter represented a response to questions that had been raised by LDCs during the first meeting of the Preparatory Committee regarding the rights and obligations of host states toward FDI and the role of foreign capital in economic development.<sup>53</sup>

While some countries, including Australia, Belgium, France, and the Netherlands, supported the US in its advocacy of nondiscriminatory treatment for FDI, embodied in national treatment and MFN provisions, other governments, such as India voiced strong objections to such provisions. The resulting compromise left the ITO Charter's investment provisions significantly weaker than what the US had originally proposed, just as it had feared would happen as a result of addressing investment issues in a multilateral forum. Language requiring "prompt, adequate, and effective compensation," for instance, was replaced by a statement requiring "just compensation," a significantly weaker and more ambiguous standard. Supported by several European governments and Canada, the US made a last ditch effort to strengthen the

---

<sup>53</sup> Brewer and Young 1998, 66-7.

ITO Charter's investment provisions during the final negotiations in Havana in 1948 but was blocked by India and several Latin American countries.

The ITO Charter was never ratified by any country. The efficacy of any international organization of the ITO's magnitude and scope would be highly dubious without the participation of the world's most powerful state. Recognizing this, other governments waited for the agreement to be ratified by the US, but ratification proved far more difficult than US negotiators had anticipated. Eventually concluding that Congress would never accept the ITO Charter, on December 6, 1950, the Truman administration officially announced that it would no longer seek congressional approval. The Charter was killed by what Diebold (1952) describes as a "perfectionist/protectionist" coalition.<sup>54</sup> It sanctioned far too much state intervention for liberals, while promoting too much free trade for protectionists. Many American businessmen believed that the Charter did not go far enough in removing other countries' trade barriers, containing too many exceptions, escape clauses, and other loopholes. Protectionist groups asserted that it was unconstitutional to delegate decision-making authority to an international body.<sup>55</sup> Without the US, the ITO Charter was effectively dead in the water.

Hart (1996) suggests that the ITO Charter's "language and the obligations" concerning investment "were vague and unlikely...to give private investors the confidence that their investments would be treated fairly and without discrimination." Nonetheless, he claims that the ITO Charter "remains the only serious multilateral effort to negotiate a comprehensive agreement addressing the full range of issues that arise from the pursuit of transborder business" and that even "the successful implementation" of the WTO in 1995 "leaves many gaps in the

---

<sup>54</sup> Diebold 1952, 14.

<sup>55</sup> Cf., Ostry 1997b, 61-7.

international governance of transborder business activities” which the ITO Charter would presumably have taken care of.<sup>56</sup>

In the end, the ITO’s rules on investment died along with the rest of the charter. Within the GATT-based trade regime which took the place of the proposed ITO and which was narrowly focused on the reduction of tariffs, investment would remain an untouchable issue until the 1980s when it was first addressed during the Uruguay Round of trade negotiations.<sup>57</sup> Despite its demise, as Brewer and Young (1998) argue, the ITO Charter had “important consequences” for the way in which investment would be addressed in subsequent years both in the context of international organizations like the OECD and UN as well as BITs. First, “consideration of investment issues was frequently undertaken in relationship to economic development issues.” Second, the ITO negotiations foreshadowed the enduring conflict between DCs and LDCs that has characterized all attempts to create universal rules on investment, a fundamental division which persists to this day. Finally, the “issue of whether to seek international cooperation through multilateral or bilateral agreements was ‘resolved’ (at least temporarily)” in favor of a bilateral approach.<sup>58</sup>

#### *A Code of Conduct for Multinational Corporations: UN Initiatives*

Within the UN efforts to develop rules on investment have largely been driven by the interests and concerns of developing countries. Until the 1990s, the primary focus of such initiatives, “integrally related to broader questions of economic development and north-south

---

<sup>56</sup> Hart 1996, 54-6.

<sup>57</sup> For a discussion of the ITO and its place in the historical development of investment rules, see Hart 1996, 50-56 and Brewer and Young 1998, 66-68. The ITO’s investment rules can be found in Chapter 3 of the ITO Charter, of which Article 12 contains “the most specific provisions” (Hart 1996, 53).

<sup>58</sup> Brewer and Young 1998, 68.

relations,” was the development of a code of conduct for MNCs.<sup>59</sup> In the immediate postwar era, relations between MNCs and host states were relatively favorable. However, by the end of the 1960s, the “honeymoon” was over.<sup>60</sup> In the 1970s, LDCs began calling for greater international regulation of MNCs. This was but one plank in a much larger program known as the New International Economic Order (NIEO).<sup>61</sup> Some of the more significant demands associated with the NIEO bearing on the treatment of FDI included limits on the ability of MNCs to repatriate profits and the assertion of permanent state sovereignty over natural resources. The latter, affirmed in a resolution passed by the UN General Assembly in 1974, was also intended to grant host states the right to expropriate foreign property in order to regain control over their resources. In addition, the Calvo doctrine would apply to potential disputes over compensation, meaning the only legal recourse available to MNCs whose property had been taken would be the host country’s own court system. Although none of the NIEO-related resolutions or declarations had any real force as a matter of international law, they clearly revealed the collectively-held preferences of LDCs toward MNCs and FDI, which had become increasingly hostile. Even DCs like Canada and France had begun to express concerns over the presence of MNCs in their economies, as evidenced by their establishment of bureaucratic mechanisms to screen out investments deemed to contribute little to these countries’ economic development.

In the early 1970s the American MNC ITT financially supported efforts to, first, undermine the election of Salvador Allende, and then later, oust him through a military coup.<sup>62</sup> This particular episode only exacerbated the growing controversy over MNCs, especially among

---

<sup>59</sup> Brewer and Young 1998, 87. For a discussion of these efforts, none of which have succeeded in attracting enough support to conclude any formal or binding agreement, see Hart 1996, 62-4 and Cohn 2005, 343-4.

<sup>60</sup> Brewer and Young, 1998, 86.

<sup>61</sup> Hart 1983, Krasner 1985.

<sup>62</sup> In a speech before the UN General Assembly in 1972, Allende “made a considered but virulent attack” on MNCs. Brewer and Young 1998, 86.



LDC governments, prompting the UN Secretary General to appoint a Group of Eminent Persons to conduct a study of the impact of MNCs on host countries in 1972. This resulted in a June 1974 report condemning the kind of subversive and undemocratic activity which ITT had engaged in and which was highly critical of MNCs in general. The report led to the establishment of the UN Commission on Transnational Corporations later that year. Its principal purpose was to develop a code of conduct for MNCs. A Centre on Transnational Corporations (UNCTC) was also established. The Centre was intended to function as the Commission's secretariat, conducting research, and serving as a repository of information, on the activities of MNCs as well as working to build a consensus on international investment rules. The actual task of formulating a code of conduct was assigned to the Centre by the Commission.<sup>63</sup>

By 1982, the UNCTC had finally produced a Draft Code of Conduct on Transnational Corporations. The code sought, among a variety of other goals, to prevent MNCs from engaging in tax evasion, transfer pricing, and restrictive business practices.<sup>64</sup> However, it remained unclear whether the proposed code would be legally binding or whether it would function as a set of voluntary guidelines or recommendations, as evidenced by its indeterminate language.<sup>65</sup> The proposal received strong support from LDCs, many of whom wanted it to be a binding agreement. Not surprisingly, the code was fiercely opposed by DCs who felt that it did not adequately address the behavior of host states towards foreign investors. The opposition of DCs therefore produced a standstill.

While LDCs had gained some momentum during the 1970s in their efforts to transform the international economic order and the liberal principles upon which it was (and continues to

---

<sup>63</sup> For a detailed discussion, see Brewer and Young 1998, 88-9 and Cohn 2005, 345-6.

<sup>64</sup> The Draft Code also included provisions concerning human rights, technology transfer, and consumer and environmental protection.

<sup>65</sup> For instance, paragraph 6 states that: "Transnational corporations *should/shall* respect the national sovereignty of the countries in which they operate" (emphasis added). See UNCTAD 1996 for the complete text of the draft code.

be) based, the advent of a global recession beginning in the late 1970s (precipitated by oil price hikes) and the subsequent debt crisis of the 1980s ultimately shifted the weight of bargaining power back to DCs, forcing LDCs to abandon the NIEO program, including attempts to impose international regulations on MNCs. By the late 1980s and early 1990s, LDCs had become desperate for FDI as a result of the drying up of private bank loans and a precipitous decline in foreign aid. In 1992, “after years of sporadic negotiations, the UN finally abandoned its efforts to form a consensus on a code of conduct for MNCs.” Having spent a decade trying to get the Draft Code of Conduct ratified, the UN eventually decided to cut its losses, dissolving the UNCTC. As a result of these developments, the idea that MNCs should be subject to international regulation has largely disappeared.

In 1993, UNCTAD took over those functions which the UNCTC had performed. Its Division on Investment, Technology and Enterprise Development continues to monitor MNC activity and FDI trends to this day. It also collects data on BITs and other international investment agreements as well as exploring various policy options toward FDI. Since 1993, UNCTAD has developed a high level of expertise and regard for its work on FDI-related issues, but one thing remains clear: the North will probably never submit to having UNCTAD (or the UN more broadly) serve as a site for the negotiation of a multilateral treaty for FDI. While the UN has continued to promote the idea of a voluntary code of conduct for MNCs and has tried to work one-on-one with MNCs by establishing various certification programs, it simply does not have any real power to significantly constrain MNC behavior, without the support of powerful DCs.

*Counterbalancing the Demands of LDCs: OECD Initiatives*

Throughout most of its existence, the OECD has played the role of proselytizer for a multilateral investment regime, promoting liberal norms, advocating the establishment of international rules regarding the treatment of foreign investment, and affirming the benefits that would flow from adherence to such rules. Since the 1960s, it has developed and hosted a number of codes and initiatives with the intention of “deepening its members’ commitments to market-based disciplines.”<sup>66</sup>

At the time of its establishment in 1961, the OECD adopted two investment-related codes—the Code on the Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations. Both codes entailed legally binding commitments to liberalize the entry of FDI and permit capital transfers between resident and nonresident investors. The Code on the Liberalization of Capital Movements encourages member states to progressively liberalize their policies toward capital movements (i.e., eliminate capital controls). In addition, the code precludes the introduction of new restrictions or the reinstatement of old ones. It also encourages states to grant foreign investors the right to establish enterprises in their countries. But the code only applied to the then nineteen members of the OECD and contained numerous “reservations” (i.e., specific sectoral exceptions). By the mid-to-late 1980s, most OECD members had removed most of their capital controls. Still, an up-to-date copy of the Code contains roughly 90 pages of remaining reservations, a list that was considerably much longer over four years ago. In 1967 OECD members developed a draft for a Multilateral Convention on the Protection of Foreign Property (an early forbear to the Multilateral Agreement on Investment discussed below) which,

---

<sup>66</sup> Hart 1996, 59. For an interesting take on the OECD’s role as a proselytizer of international norms, see Abdelal 2007.

although it was never formally adopted or implemented, served as an important model for the negotiation of countless BITs.

By the 1970s the OECD had begun to expand its work within the realm of investment issues. As Hart explains, OECD members “soon found themselves considering both rules governing the behavior of multinational enterprises and those on liberalization and protection of [FDI]—that is, rules governing [both] the behavior of firms [as well as] their treatment by governments.”<sup>67</sup> This activity was largely a response to the demands of LDCs within the UN for a code of conduct for MNCs and a noticeable increase in the expropriation of foreign assets in these countries. At the urging of the US, the OECD began trying to develop a more comprehensive framework for FDI, one that would balance the concerns of LDCs and DCs alike, imposing behavioral obligations and responsibilities for host states as well as MNCs. The result was the 1976 Declaration on International Investment and Multinational Enterprises along with the establishment of a Committee on International Investment and Multinational Enterprises charged with overseeing the Declaration’s operation and implementation.<sup>68</sup>

The OECD Declaration has been ratified by all thirty OECD member governments “representing not only the most important countries of origin but also of destination” for FDI.<sup>69</sup> The Declaration has been described by one scholar, “as a common definition of the way these governments want foreign investors to be treated and to behave,” an “expression of will” that has had “a spreading effect.” In this manner, the Declaration has helped to shape customary

---

<sup>67</sup> Hart 1996, 60.

<sup>68</sup> The OECD Declaration is composed of five parts: (1) Guidelines for Multinational Enterprises, (2) National Treatment, (3) International Investment Incentives and Disincentives, (4) Consultation Procedures, and (5) Review. See the OECD website for more details:

[http://www.oecd.org/document/24/0,3343,en\\_2649\\_34887\\_1875736\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/24/0,3343,en_2649_34887_1875736_1_1_1_1,00.html)

<sup>69</sup> Eleven nonmember countries have also subscribed to the Declaration: Argentina (April 22, 1997), Brazil (November 14, 1997), Chile (October 3, 1997), Egypt (July 11, 2007), Estonia (September 20, 2001), Israel (September 18, 2002), Latvia (January 9, 2004), Lithuania (September 20, 2001), Peru (July 25, 2008), Romania (April 20, 2005), Slovenia (January 22, 2002)

international law regarding foreign investment, albeit through a “slow” and “ongoing evolutionary process.”<sup>70</sup> Yet, despite the apparent influence it has had on those countries that are the most important recipients and sources of FDI, without any formal enforcement mechanisms, the OECD Declaration ultimately “has the force of moral suasion and little more.”<sup>71</sup> Hart provides a succinct evaluation of the OECD’s activity within the area of international investment issues:

Valuable as the OECD’s work has been in deepening members’ understanding of the issues, defining the issues, providing peer pressure, developing common positions, and more, its contribution to rulemaking has been rather limited. The combined impact of a lack of dispute settlement and enforcement procedures, a limited membership, and the ease with which members can determine unilaterally which parts of a code to accept and which to ignore, has made the OECD codes at best “soft” law, exercising a certain level of moral suasion and providing models for bilateral and other intergovernmental agreements. More fundamentally, the OECD codes, because they are limited to OECD members, do not address a growing concern—namely, the role of investment in relations between developing and developed countries.<sup>72</sup>

### *Regional Initiatives*

Beyond the rule-making activities of intergovernmental organizations like the UN and OECD, states have also addressed their investment relations through PTAs and various regional integration schemes. However, the investment provisions of PTAs have varied both in terms of their purposes (regulation of investors vs. regulation of host states) and their degree of legalization. The Andean Common Market, for instance, originally sought to enhance its members’ bargaining power vis-à-vis MNCs, while also promoting technology transfer, preventing the use of transfer pricing by MNCs, and imposing ownership restrictions. Many other regional groupings have simply aimed at establishing a common regulatory framework for

---

<sup>70</sup> Levy 1983, 61 (quoted in Hart 1996, 61).

<sup>71</sup> Hart 1996, 60.

<sup>72</sup> As Hart 1996, 61.

FDI (e.g., Arab Economic Union, ASEAN, the Caribbean Community, the Central American Common Market, and the East African Community). In contrast, the investment rules found in PTAs concluded by the United States are designed to regulate the behavior of member states toward FDI from other members, and are among the strongest and most precise of all international investment agreements (as are US BITs). Given the importance and relevance of the US model for other international investment-related initiatives such as the TRIMS agreement and the MAI, a closer look at the origins of the model is warranted.

The US investor rights model first manifested itself in the form of a PTA in the Canadian-United States Free Trade Agreement (CUSFTA) and was later replicated in CUSFTA's successor, the North American Free Trade Agreement (NAFTA). NAFTA's investment chapter, Chapter 11, is basically a US-style BIT in trilateral form. It is notable for its ban on the imposition of performance requirements and its requirement that all such existing requirements to be phased out after 10 years. Performance requirements are "laws governing such matters as the obligation to have a certain level of local content, exports, local hiring, local research and development, transfer of technology, and domestic equity participation, among others."<sup>73</sup> Chapter 11 also requires countries to grant foreign investors national treatment in the pre-establishment phase of an investment as well as the post-establishment phase. This effectively means that host states must grant foreign investors a right of establishment. In other words, states cannot deny entry to investors through the use of bureaucratic screening procedures.

---

<sup>73</sup> Braunstein and Epstein (1999, 118) define performance requirements as "any laws that require investors to invest in the local economy or to meet social and environmental goals in exchange for market access."

### *Investment Rules and the International Trade Regime*

For the first three and half decades of its existence, investment issues were largely ignored within the GATT/WTO trade regime. Any effort to address such issues was implicitly forestalled by the anticipated opposition of the regime's developing country members. However, with the advent of the Uruguay Round in the 1980s, this neglect of international investment relations was overturned. The strongest proponent of broadening the GATT/WTO agenda to include investment issues at this time was the United States whose insistence that investment rules be included in both CUSTA and NAFTA (and in other PTAs since) had been interpreted as an attempt to make progress on investment-related issues at the regional level in the face of sluggish multilateral negotiations.

Along with protection of intellectual property rights, investment rules would prove to be one of the more controversial topics on the negotiating agenda of the Uruguay Round. Many LDCs "were of the view that attempting to" reach an agreement on "broad-ranging multilateral disciplines" governing investment policies "went far beyond" the proper scope of the GATT, questioning whether the GATT was an appropriate forum for addressing such issues.<sup>74</sup> However, despite the strong opposition of most LDCs, particularly larger states like Brazil and India, the Round managed to produce a limited agreement on investment, the Agreement on Trade-Related Investment Measures (TRIMS). Yet the fierce opposition of LDCs did succeed in significantly narrowing the scope of the TRIMS agreement. For instance, the agreement does not require states to grant MFN or national treatment to foreign investors: "countries can still decide to favor domestic over foreign investment, and from which countries to accept investment."<sup>75</sup> The US sought an agreement that would place significant limitations on the

---

<sup>74</sup> Hoekman and Kostecki 2000, 202.

<sup>75</sup> Barton et al. 2006, 146.

ability of host countries to impose performance requirements on MNCs.<sup>76</sup> Yet, the final agreement did not cover all types of performance requirements. It prohibits the use of local content requirements, but not export-based requirements.<sup>77</sup> Once again, fundamental differences between DCs and LDCs produced an agreement based on the “lowest common denominator.”<sup>78</sup> From the US’s perspective, one scholar describes the outcome as such:

While the experience of the United States at the GATT was one of success in linking trade and FDI, it was one of failure, too, in that only a limited agreement resulted, largely because of the determined opposition of a number of developing countries and the pressures to solve other higher priority items within the Uruguay Round package. Few disciplines were imposed on members as a result of the TRIMs agreement and the United States was forced to recognize that progress within [the] WTO...on investment issues was likely to be slow.<sup>79</sup>

Yet by the time the Uruguay Round had concluded in 1994, many LDCs had begun to significantly liberalize their regulatory regimes governing FDI in an effort to attract more foreign capital. They also demonstrated a greater willingness to enter into BITs, formally committing themselves to many of the same disciplines which they had consistently opposed on a multilateral basis throughout the postwar period, including during the Uruguay Round, commitments which the US and other DCs had long sought going all the way back to the ITO negotiations. The liberalization of FDI policies and diffusion of BITs represented a sudden and dramatic turnaround in attitudes toward foreign investment among LDCs. As a result, despite the failure of the Uruguay Round to produce a strong investment agreement, there was a growing sense among DCs that the time was ripe for creating a comprehensive multilateral agreement on

---

<sup>76</sup> The US also sought rules that would govern the use of investment incentives, limit ownership restrictions, allow firms to freely repatriate their profits, and grant foreign firms a right of establishment. None of these issues were addressed by the TRIMS agreement.

<sup>77</sup> Another agreement that emerged from the Uruguay Round, the General Agreement on Trade in Services (GATS), also addressed investment issues.

<sup>78</sup> Smythe 1998, 98.

<sup>79</sup> *Ibid.*, 99. For discussions of the TRIMS agreement as well as the incorporation of investment issues into the negotiating agenda of the GATT and WTO, see Hart 1996, 69-71; Smythe 1998, 93-100; Hoekman and Kostecki 2000, 201-4; Barton et al. 2006, 145-6.



FDI, one that would establish permanent, legally-binding protections for foreign investment as well as strong mechanisms for enforcing investor rights, and in doing so, lock-in liberal policy changes among both DCs and LDCs. By the end of the decade, this optimism regarding the prospects for establishing a multilateral treaty regime for FDI had disappeared as yet another set of negotiations ended in failure.

### *The Multilateral Agreement on Investment*

The most recent attempt to create a multilateral treaty regime for FDI took place between 1995 and 1998, during which the OECD served as the site of negotiations for a treaty which was aptly dubbed the Multilateral Agreement on Investment (MAI). The OECD was selected as a negotiating venue for three reasons. First, it seemed to be a natural venue given the fact that its membership accounted for roughly 87% of global FDI outflows and about 65% of global FDI inflows. Second, it had prior experience in developing international rules on investment, having adopted investment-related codes in 1961 and in 1976. Finally, the US wanted a strong, binding, comprehensive, high-standard investor rights agreement. Given past experience, it believed that such an agreement would be impossible to reach within the context of the WTO because of the large number of LDCs among its membership. By negotiating the MAI within the more exclusive OECD, the US believed that it could by-pass the opposition of LDCs to its preferred agreement.<sup>80</sup>

---

<sup>80</sup> The EU Commission preferred the WTO as a negotiating venue because this would have allowed it to represent all of the EU's members, thereby presenting a unified front in support of its own preferred agreement. Canada also preferred the WTO because it had already dealt with its most important investment relationship (i.e., with the US) through CUSFTA/NAFTA and now sought a multilateral agreement that would protect its own investors in Latin America and Africa. See Smythe 1998. At any rate, it has proven impossible to negotiate a multilateral treaty within the WTO because of continuing LDC objections.

The substantive and procedural content of the MAI was largely based on the existing practice of BITs and other investor rights agreements. The US investor rights model, exemplified by NAFTA's Chapter 11, served as an important template for the agreement. However, the MAI went significantly beyond existing agreements both in terms of its scope and the strength of its provisions. Some of the more important provisions included:

- National treatment—contracting parties would be required to treat foreign investors at least as well as domestic firms (i.e., host states would be prohibited from discriminating between foreign and domestic firms in terms of taxation, regulation, or any other policy).<sup>81</sup>
- MFN treatment—contracting parties would be required to treat all foreign investors the same regardless of their country of origin.
- A broad definition of investment, encompassing both FDI and portfolio investments (i.e., stocks and bonds) as well as contract rights, intellectual property, real estate, and “claims to money.”
- Strict limits on performance requirements of all types.
- Limits on expropriation subject to certain justifications and conditions, including a public purpose; nondiscriminatory application (in accordance with national treatment); due process; and prompt, adequate, and effective compensation.<sup>82</sup>
- Free transfer or repatriation of capital, profits, interest payments, expropriation settlements, and the like, “ensuring that corporations and individuals can move their assets more easily.”
- Dispute settlement provisions granting investors the standing to sue a country in its courts for breach of the agreement or to initiate international arbitration proceedings.
- “*Rollback*” and “*standstill*” provisions requiring nations to eliminate laws violating MAI rules and to refrain from passing any such laws in the future. State and local, as well as

---

<sup>81</sup> Countries would be under no obligation to grant foreign investors more favorable treatment, but as Braunstein and Epstein (1999, 131, n9) conclude, “nowhere does the MAI [expressly] bar countries from treating foreign investors better than locals.”

<sup>82</sup> The exact phrasing, however, was quite broad, covering both direct expropriations (i.e., nationalization) as well as indirect expropriation defined as “any...measure having equivalent effect.” Hence, “certain forms of regulation could be argued to be expropriation, potentially requiring governments to compensate investors for lost revenue.” See Braunstein and Epstein 1999, 118. The experience of investor-state arbitration under NAFTA's Chapter 11, which prohibits host states from adopting measures that are “tantamount” to expropriation, supports the validity of this interpretation.

federal laws, would have been affected, though many existing laws specifically acknowledged by “reservations” to the agreement would be exempted.

- Specific application of nondiscrimination or national treatment to privatization, monopoly regulation, and access to minerals and raw materials.

The MAI would have established a “strong nondiscriminatory legal regime for the treatment of investors and investments.” Its “core principles” were national treatment, MFN treatment, and transparency. It would have been “comprehensive in its scope and coverage of investors and investments,” covering all economic sectors and “extending disciplines to special topics such as privatization and monopolies and providing mechanisms for further liberalization.”<sup>83</sup> While exceptions would have been allowed, the MAI’s “roll-back” and “standstill” provisions were designed to eventually phase out all exceptions. Finally, once a country entered into the MAI, it would have been irrevocably bound to the agreement’s terms for at least twenty years.<sup>84</sup>

A confluence of factors contributed to the eventual collapse of the MAI negotiations. First, there were obvious divisions among the OECD states themselves. The negotiations employed a negative list approach which led states to lodge a multitude of sectoral exceptions.<sup>85</sup> France and Canada, for instance, refused to open their “cultural” industries (i.e., media such as television, movies, music, books, magazines, etc.) to foreign investment, fearing that American media conglomerates would take over such industries and “Americanize” the culture. The EU

---

<sup>83</sup> “Main Features of the Multilateral Agreement on Investment.” Note by the Chairman to the Negotiating Group on the Multilateral Agreement on Investment. February 5, 1998. [DAFFE/MAI (98) 4].

<sup>84</sup> Contracting parties would have only been allowed to express their desire to back out of the treaty after they had been subject to its rules for at least five years. They would then have had to wait an additional fifteen years before being able to legally withdraw from the agreement.

<sup>85</sup> Unlike the GATT/WTO which operates on the principle of “positive lists” or “offers,” meaning that negotiating countries provide lists of those economic sectors which they are willing to open up to liberalization, the top-down or “negative lists” approach utilized in the MAI negotiations meant that every economic sector would be open to liberalization unless a sector was specifically put on a country’s exemption list. The difficulties of this method became readily apparent after participating countries began creating enormous lists of exceptions.

and Canada also objected to the US's use of extraterritorial measures such as the Helms-Burton Act which penalized their firms for doing business in Cuba.

Second, the number of BIT-related, and particularly NAFTA-related, arbitration disputes between host states and foreign investors suddenly spiked around 1996-7—right in the middle of the negotiations—perhaps causing some states to become wary of the MAI's own dispute resolution mechanisms while at the same time arousing the hostility and opposition of civil society groups (e.g., environmental and public-interest groups) in North America, Europe, and elsewhere. When these groups got their hands on a leaked copy of the draft text of the MAI, they quickly posted it on the web, sparking the mobilization of a global anti-MAI campaign. While most groups called for the complete abandonment of the MAI, some demanded that binding commitments relating to both labor and environmental policy be included in the agreement. But OECD members could not see eye to eye on this point either. Finally, despite the fact that a handful of LDCs were participating in the MAI negotiations as official observers, other LDCs such as Egypt, India, Pakistan, and Malaysia expressed significant hostility towards the negotiations.

The MAI negotiations were to be completed in 1997 but a consensus agreement had not materialized by this time. A one year extension was requested to give the states time to resolve their remaining differences, but by October of 1998, France had officially withdrawn from the negotiations citing concerns over sovereignty and domestic opposition. The talks were then suspended, never to be revived, leaving yet another aborted agreement on FDI. Just as the ITO Charter had died in the early postwar period, so too had the MAI.

In spite of the dismal failure of the MAI negotiations, DCs have not given up hope on creating a universal investor rights regime. Following the MAI's demise, the focus of this

ongoing effort has turned to the WTO. Even before the MAI negotiations had collapsed, the US, Canada, and EU had tried to get investment rules put on the negotiating agenda at the WTO's first ministerial meeting in Singapore in 1996, but managed only to secure the creation of a working group on investment policies. After the MAI talks broke down at the end of 1998, these countries tried again at the WTO ministerial meeting in Seattle in 1999 to put investment issues on the agenda as part of a broader effort to launch a new round of trade negotiations. The Seattle meeting of course failed to produce a solid consensus on anything, including investment rules. Most recently, at the WTO's 2003 ministerial meeting in Cancun, a group of more than twenty LDCs blocked inclusion of investment issues as part of the Doha Round.

## **BILATERAL INVESTMENT TREATIES**

In the absence of a multilateral treaty regime such as the MAI, BITs have served as, and continue to represent, the primary source of governance in the issue domain of FDI. Over 2,500 BITs were concluded between 1959 and 2006.<sup>86</sup> The first BITs were pioneered by Germany “as a vehicle for promoting and protecting the flow of investment capital to developing countries.”<sup>87</sup> The number of BITs grew at a “largely desultory pace” during the 1960s but began to increase substantially starting in the mid-1970s. However, the largest growth in BITs occurred in the 1990s, during which the number of BITs exploded. Between 1959 and 1968, only seventy-four BITs were concluded, fewer than eight per year worldwide, half of which were concluded by Germany. Several other developed countries inaugurated BIT programs in the 1970s, including Austria, France, Japan, and the United Kingdom. The United States started its own BIT program

---

<sup>86</sup> At the end of 2006, the number of BITs stood at 2,573. UNCTAD 2007.

<sup>87</sup> Hart 1996, 57. The first BIT was concluded between Germany and Pakistan and was signed on November 25, 1959. This was quickly followed by another BIT between Germany and the Dominican Republic, which was signed on December 16, 1959.

around 1982. Between 1977 and 1986, 153 BITs were concluded, double the rate of the 1960s. By 1988, some 270 BITs were in force. The pace of BIT negotiations then increased dramatically starting in the early 1990s as a result of the collapse of the Soviet Union and the transition of many Eastern European countries and former Soviet republics away from command economies toward more market-based systems. In addition, several Latin American countries expressed an increasing willingness to negotiate BITs beginning in the 1990s, after years of resisting such commitments.<sup>88</sup> Sixty-four BITs were concluded in 1993 alone. Another 196 were signed in 1996. According to the UNCTC, at the end of 1996, over 160 countries had entered into at least one BIT. Over two-thirds of the total number of BITs which existed at this time had been concluded since 1990. The number of BITs continued to grow throughout the remainder of the decade.<sup>89</sup>

BITs have traditionally been concluded between a developed source (or home) country and a developing host (or recipient) country, though the number of BITs between LDCs has grown over time.<sup>90</sup> Although most BITs are framed in reciprocal terms, in practice they tend to be asymmetrical insofar as they are largely designed and intended to govern the behavior of only one of the parties—namely, the developing country which plays the role of host state toward foreign investors from the developed country. In other words, most BITs govern relationships in which the flow of FDI is *unidirectional*.<sup>91</sup> Furthermore, BITs do not in any way address the

---

<sup>88</sup> This “change of heart” was especially significant given the fact that Latin American countries had been at the forefront of the NIEO movement, including efforts to impose a code of conduct on MNCs.

<sup>89</sup> Hart 1996, 57; Vandevelde 1998, 627-8.

<sup>90</sup> The first BIT between two developing countries was concluded between Iraq and Kuwait in 1964. By 1990 there were 44 so-called “South-South” BITs. By July 2004 this number had grown to 653, representing 28% of the then 2,300 existing BITs. UNCTAD 2004, 6.

<sup>91</sup> This could, of course, change in the future as a greater number of firms in developing countries continue to grow, eventually becoming multinational. However, thus far, most FDI originating from LDCs flows to other LDCs, not DCs.

behavior of foreign investors in the host country nor do they contain any binding rules of conduct to that effect.

BITs represent a latent international regime for FDI. The purpose of this regime is to establish certain substantive rights for foreign investors as well as procedural mechanisms for enforcing these rights. The fundamental norm around which the regime has been constructed is the same as that which underlies the international trade regime, namely, *non-discrimination*. This norm manifests itself in BIT provisions which require host states to accord national treatment as well as MFN treatment to the other party's foreign investors. Many BITs also require host states to adhere to some minimum standard of "fair and equitable" treatment of foreign investors in accordance with generally recognized principles of international law. In addition, most BITs prohibit the host state from expropriating foreign investments (either directly or indirectly through various tax or regulatory measures), or in the event of expropriation, require the host state to compensate investors whose investments have been expropriated. The typical BIT also includes rules which allow foreign investors to freely repatriate profits as well as make other types of monetary transfers with limited restrictions or interference.

Finally, many (though not all) BITs provide some form of dispute resolution allowing foreign investors who believe their rights under the treaty have been violated to directly initiate arbitral proceedings against the host state without appealing to their home state for assistance in pursuing such claims. In other words, foreign investors are given direct access to dispute settlement procedures.<sup>92</sup> These advanced consents to arbitration on the part of host states are

---

<sup>92</sup> Because it gives non-state actors direct access to the dispute resolution process, allowing private investors to pursue claims against host states without the assistance or approval of their home state, investor-state arbitration represents what some scholars refer to as transnational dispute resolution and can be distinguished from the interstate dispute settlement system of the international trade regime. See Keohane, Moravcsik, and Slaughter 2000.

perhaps the most important element to be found in BITs, offering a procedural mechanism through which the substantive rules of BITs can be enforced.<sup>93</sup> Investor-state arbitration is most commonly carried out within the framework of rules provided by ICSID or the United Nations Commission on International Trade Law (UNCITRAL), although some BITs specify additional alternative venues for arbitration such as the International Chamber of Commerce (ICC), the Arbitration Institute of the Stockholm Chamber of Commerce (SCC), and the Permanent Court of Arbitration (PCA), each of which has its own unique (but comparable) framework for the arbitration of investor-state disputes. ICSID clearly stands out as the most popular arbitration regime. Of the 289 disputes included in an UNCTAD database of investor-state disputes, 184 (approximately 64%) of these were either directly registered with ICSID or arbitrated in another venue using ICSID arbitration rules. The UNCITRAL Arbitration Rules are the second most popular regime accounting for 78 (approximately 27%) of these disputes. Together, the ICSID and UNCITRAL regimes account for roughly 91% of the disputes included in the UNCTAD database. Given its popularity as a venue for investor-state arbitration, it is worth taking a closer look at ICSID as a key component of the international investor rights regime.

## ICSID

The World Bank has played host to the successful negotiation of two multilateral instruments, both of which were designed to address the security of foreign investments in the Third World.<sup>94</sup> The first set of negotiations led to the creation of the International Centre for the

---

<sup>93</sup> See Salacuse 1990 and Dolzer and Stevens 1995 for more detailed discussions of the substantive and procedural content of BITs, including representative language from actual BITs, as well as discussion of important variations among BITs.

<sup>94</sup> For a discussion of these instruments and their significance, see Hart 1996, 64-66 and Baker 1999.



Settlement of Investment Disputes (ICSID) in 1966. The second set of negotiations led to the creation of the Multilateral Investment Guarantee Agency (MIGA).

The Convention on the Settlement of Investment Disputes between States and Nationals of Other States (commonly referred to as the ICSID Convention) was submitted to World Bank members for ratification on March 18, 1965 and came into force on October 14, 1966. Since that time, the number of states which have become contracting members of the Convention has grown steadily from an initial membership of 23 to 143 contracting states as of November 4, 2007 (see Figure 2.1).<sup>95</sup> ICSID was established under the Convention as an autonomous international organization. Its sole purpose is to facilitate the conciliation and arbitration of disputes between foreign investors and host states.

The ICSID Convention was created in response to an upsurge in expropriatory activity on the part of Third World states occurring in the 1950s and 1960s, including the Castro government's nationalization of foreign investments in Cuba and the Tunisian government's nationalization of largely French-owned farmland.<sup>96</sup> As Baker (1999) puts it, as a result of actions such as these, a "crisis of confidence had materialized between foreign investors and host state governments in the developing world."<sup>97</sup> On a number of occasions, the World Bank had been asked by holders of expropriated property to assist in the mediation or conciliation of their disputes with foreign governments. The Bank was neither equipped to handle such situations nor did it desire to become directly involved in such disputes. In 1962, the Bank's Board of

---

<sup>95</sup> 155 states have signed the ICSID Convention. States attain the status of contracting member only after they have deposited their instruments of ratification. Notable hold-outs include Brazil, Canada, India, and Mexico. Canada recently signed the Convention but has not yet ratified it. ICSID maintains a list of contracting states and other signatories to the Convention (including signature and ratification dates) on its website: <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=ContractingStates&reqFrom=Main>

<sup>96</sup> This account of the origins of ICSID is drawn from Baker 1999, 39-43.

<sup>97</sup> Baker 1999, 39.

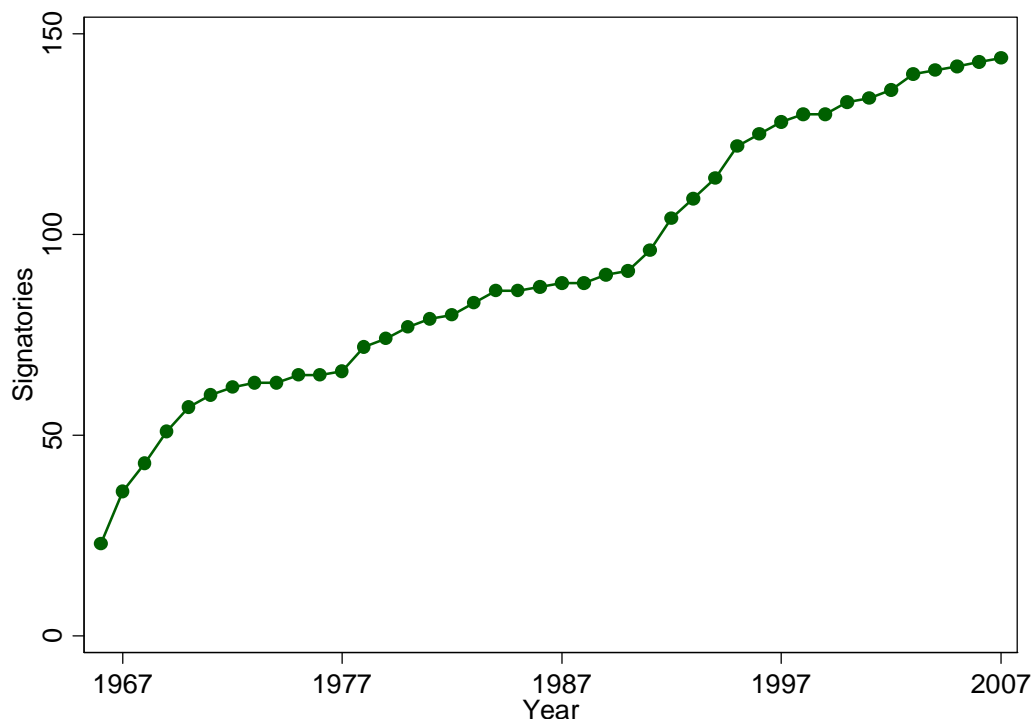


Figure 2.1 Growth in Contracting Members of the ICSID Convention

Governors initiated a study which was intended to determine the feasibility of establishing an agency that could facilitate the arbitration and conciliation of investment disputes between private foreign investors and host states. The need for such an institution had been previously recognized by the United Nations, but its own efforts to create some type of investor-state arbitral mechanism were consistently thwarted by Communist bloc countries.<sup>98</sup> The Bank's study resulted in the creation of the ICSID Convention.

Although ICSID is considered to be an autonomous international organization, it is actually an affiliate of the larger World Bank Group and has close ties to the Bank. ICSID's

<sup>98</sup> At a conference in 1960, UN Secretary-General Dag Hammarskjöld suggested: "It is becoming apparent that, if a system commanding wide acceptance in the United Nations could be set up for the arbitration of disputes arising between governments and private foreign investors in connection with such matters as the amount of compensation in the case of appropriation, the investment climate would be considerably improved." Quoted in Baker 1999, 39-40.

organizational structure consists of an Administrative Council and a Secretariat. The Council is chaired by the President of the World Bank and includes one representative from each state that has ratified the ICSID Convention. The Council's annual meetings are held in conjunction with the joint annual meetings of the Bank and International Monetary Fund (IMF). All ICSID members are also members of the World Bank, and unless a government makes a contrary designation, its Governor for the Bank sits *ex officio* on the ICSID Administrative Council. Finally, the expenses of the ICSID Secretariat are financed out of the Bank's budget, although the costs of individual proceedings are borne by the parties themselves.<sup>99</sup>

As an organization, ICSID itself does not arbitrate disputes. In other words, it does not function as a standing arbitral body. Instead, it provides the institutional and procedural framework through which independent arbitral tribunals are constituted on a case-by-case basis. ICSID has two sets of procedural rules that may govern the initiation and conduct of proceedings under its auspices: (1) the ICSID Convention itself and (2) the ICSID Additional Facility Rules.<sup>100</sup> The ICSID Convention provides the basic procedural framework for the arbitration of investment disputes arising between contracting states and investors that qualify as nationals of other contracting members. This framework is supplemented by a detailed set of Regulations and Rules adopted by the ICSID Administrative Council pursuant to the Convention. Arbitration under the Convention is entirely voluntary, but once the parties have given their consent, neither may unilaterally withdraw it as a matter of international law. The Convention also requires that all contracting states, whether or not they are parties to a dispute, recognize and enforce arbitral awards rendered by tribunals constituted under the auspices of ICSID.

---

<sup>99</sup> For more information on ICSID, see its website: <http://icsid.worldbank.org/ICSID/Index.jsp>

<sup>100</sup> The Additional Facility Rules were established in 1978 in order to authorize the ICSID Secretariat to administer proceedings which fall outside the scope or jurisdiction of the ICSID Convention, particularly disputes in which either the host state or the home state of the investor is not a contracting member of the Convention.

By its own estimation, ICSID “is considered to be to be the leading international arbitration institution devoted to investor-state dispute settlement.” It is clearly the most popular venue for handling such disputes. Provisions providing for ICSID arbitration are commonly found in investment contracts between contracting states and investors from other member countries. Advanced consents by governments to submit investment disputes to ICSID arbitration can also be found in national investment laws as well as BITs. ICSID arbitration is also widely used as a method of dispute resolution in PTAs, most notably NAFTA and the Colonia Investment Protocol of Mercosur, as well as plurilateral agreements such as the Energy Charter Treaty.

Despite the fact that ICSID arbitration clauses were included in countless investment contracts as well as numerous BITs, ICSID remained an obscure and relatively underused international institution for the first three decades of its existence. Between 1966 and 1996, only 35 disputes were registered for arbitration through ICSID. However, this situation has dramatically changed over the course of the past decade as the number of ICSID cases suddenly exploded. 1997 appears to mark the turning point. Since then there have been 234 cases registered with the ICSID. Of these, 123 are still pending. Figure 2.2 provides a graphical depiction of the growth in ICSID cases over time, measuring the number of new cases annually between 1966 and 2007. The sudden exponential growth in ICSID’s caseload suggests that ICSID has finally overcome its obscurity and that there is an increased awareness of ICSID among MNC officials. It is also likely a function of the proliferation of BITs and an expansion in the number of contracting members of the ICSID Convention. It is surely no coincidence that

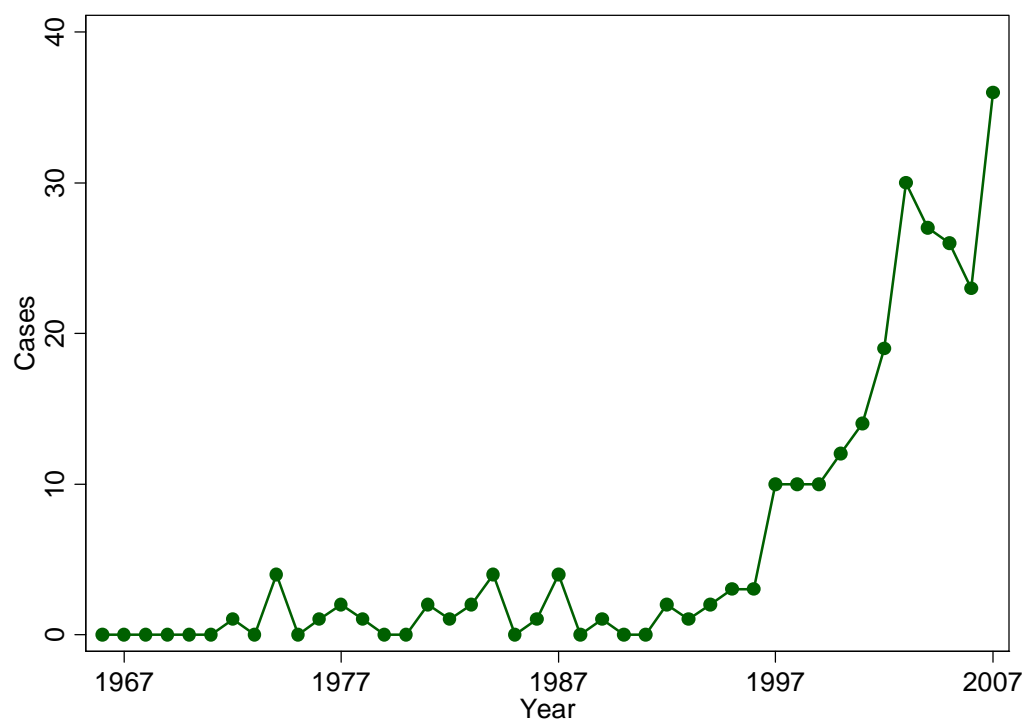


Figure 2.2 Growth of ICSID Cases

a dramatic increase in the number of BITs and ICSID signatories beginning in the early 1990s preceded a concomitant increase in the number of ICSID cases beginning in the second half of that decade. It is also worth mentioning that many early BITs did not contain viable arbitration provisions.<sup>101</sup>

ICSID remains voluntary, but according to Hart, “as governments and investors have gained experience with its provisions, the number of participating governments has steadily grown to the point where it forms a critically important part of the environment conditioning the conduct of international business.”<sup>102</sup> Based on “a set of underlying assumptions and basic

<sup>101</sup> The first BIT containing an effective arbitration provision was not signed and did not enter into force until 1969. See Yackee 2007 for a discussion of the degree to which BITs vary in terms of procedural strength—i.e., the extent to which BITs contain binding commitments to arbitration.

<sup>102</sup> Hart 1996, 65.

principles of international law that are critical to the future development of a more widely applicable and accepted [investment] regime,” including nondiscrimination, transparency, and enforceable dispute settlement, ICSID, suggests Hart, “should be viewed as important building [block] for a more comprehensive universal regime for the conduct of business in the global economy.”<sup>103</sup> In combination with BITs, ICSID represents a critical component of the international investor rights regime that has emerged over the course of the postwar era. While BITs establish the substantive rights of foreign investors, including the right to arbitration, ICSID provides the procedural framework under which investors can pursue such rights. Over time, the number of BITs which include advanced consents on the part of host states to submit any irresolvable disputes with foreign investors to arbitration under the auspices of ICSID has grown significantly. Nearly every modern BIT contains such a clause.<sup>104</sup> Thus, ICSID does in fact appear to be playing the role ascribed to it by scholars such as Hart (1996).

## **THE TREND TOWARDS LIBERALIZATION**

The proliferation of BITs which occurred in the 1990s is largely the product of, and cannot be fully appreciated without considering, the dramatic turn around in the attitudes and policy orientations of LDCs toward FDI which began in the late 1980s. Since then, most LDCs have greatly liberalized their regulatory regimes governing inward FDI. This revolution reflects a broader shift in the development strategies of these countries away from approaches calling for heavy state intervention in all facets of the economy (import substitution industrialization) to a “neoliberal” approach emphasizing deregulation, privatization, and openness to both trade and foreign investment—the so-called “Washington Consensus” model promoted by the United

---

<sup>103</sup> Hart 1996.

<sup>104</sup> Dolzer and Stevens 1995.

States and international financial institutions such as the IMF and World Bank. Of the 1,035 FDI-related policy changes that governments reported making between 1991 and 1999, 974 (94 percent) of these changes made FDI easier, while only 61 (less than 6 percent) were less favorable.<sup>105</sup> Sectors previously closed to foreign investment, such as natural resources and telecommunications, have been opened. Restrictions on foreign ownership and the repatriation of profits have been lifted or eased.

What explains this dramatic turnaround? The advent of the 1980s debt crisis, which led to severe cutbacks in commercial bank lending to LDCs, forced many LDC governments “to reconsider the role of FDI as a source of” external finance. As Brewer and Young (1998) explain:

During the remainder of the 1980s and into the 1990s...scores of governments shifted from an attitude of ambivalence or hostility toward FDI to a more positive attitude, and they accordingly adopted more open and welcoming policies toward [MNCs]...In short, liberalization replaced regulation and control as the dominant approach to FDI...in developing countries.<sup>106</sup>

## CONCLUSION

This chapter has provided a comprehensive look at the history of international rule-making efforts with respect to FDI. The focus of the story has been on efforts since World War II to establish universal rules determining the proper treatment of FDI and the countervailing proposals of DCs and LDCs pursued in competing organizational venues such as the UN and OECD. I have recounted a tale of repeated failure to establish a multilateral treaty regime for FDI in the face of fundamental differences between DCs and LDCs regarding the basic purpose of such a regime. Given these persistent differences, the proliferation of BITs among LDCs,

---

<sup>105</sup> UNCTAD 2004.

<sup>106</sup> Brewer and Young 1998, 113-4.

many of which are substantively and procedurally identical to the numerous multilateral proposals discussed in this chapter, is somewhat ironic. While LDCs have collectively and consistently opposed a multilateral regime, they have nonetheless formally committed themselves individually (through BITs) to a latent regime that for all intents and purposes performs the same function as the kind of multilateral arrangements envisioned by DCs. The next chapter unravels the puzzle of why LDCs have consistently opposed (and continue to oppose) a multilateral investor rights regime while at the same time committing themselves to such a regime on a bilateral basis. More importantly, the following chapter develops a theory which explains the relationship between changes in the domestic policies and institutions of LDCs and the decisions of these countries to enter into BITs.



## CHAPTER 3

### DOMESTIC SOURCES OF COMMITMENT

In this chapter, I develop several theoretical expectations concerning the relationship between national and international investment regimes, laying out a two-level logic of commitment in which a state's decision to formally commit itself to international norms and rules regarding the rights of foreign investors follows or coincides with a shift in its policy preferences toward FDI and the establishment or strengthening of property rights institutions at the domestic level. The story centers around two key variables: (1) the preferences of LDC governments and (2) the relative strength of a country's indigenous institutions. My argument, in short, is that the decisions of states to make external commitments to the international investor rights regime are preceded by an internal transformation of preferences and institutions within these states. As a result, the relationship between domestic and international investment regimes is complementary.

The chapter is organized in three parts. First, I consider the role which state preferences toward FDI, and uncertainty regarding such preferences on the part of foreign investors, play in driving states to make international investment-related legal commitments. I begin by highlighting the well-known time-inconsistency problem that characterizes the host state-foreign investor relationship, the significant political risks which this problem entails for investors, and the resulting credibility problem that this creates for LDCs. I then proceed to a discussion of the functions which BITs serve in helping LDC governments overcome this problem. Three distinct but closely-related functions are identified. First, BITs provide a mechanism through which FDI-friendly governments can signal their preferences to uncertain investors. Second, BITs help

LDC governments overcome their credibility problem by creating a costly and therefore credible commitment to investor rights. Finally, BITs are a device through which pro-FDI governments can tie not only their own hands, but those of their successors, thereby locking-in liberal policy changes with respect to FDI, further enhancing the credibility of a state's commitment to liberal international norms.

In the second half of the chapter, I consider how the strength of a country's indigenous institutions influences a state's decision to formally commit itself to the rights of foreign investors by entering into a BIT. This section opens with a general discussion of property rights and the role which institutions play in securing such rights at both the domestic and international level. I then consider two competing views of the relationship between domestic and international institutions pertaining to the rights of foreign investors.

On the one hand, the level of expropriation risk is prohibitively high in those countries which lack a strong institutional infrastructure for the protection and enforcement of private property rights, making them unattractive destinations for FDI. Accordingly, such countries are arguably the ones that could benefit most from entering into BITs. For these countries, BITs could function as a substitute for the lack of strong domestic property rights institutions. Conversely, those countries with strong institutions may be less willing to pay the sovereignty costs associated with BITs given the fact that their superior institutional endowment makes them a significantly less risky environment for FDI.

On the other hand, countries with weak institutions are also likely to experience greater difficulties complying with their BIT-related obligations and may be deterred from making such commitments, whereas the costs of compliance will presumably be much lower for countries with strong institutions. Ultimately, consideration of the relationship between the strength of a

country's domestic institutions and its resulting capacity to comply with the kinds of hard legal commitments embodied in BITs leads me to expect that countries with strong institutions will be more likely to make such commitments than those with weak institutions.

Building upon these theoretical considerations, I conclude the chapter by explaining why certain types of LDCs—namely, those which have already liberalized their regulatory regimes toward FDI and which already possess the institutional capacity to protect and enforce property rights at the domestic level—are more likely to make and accept international investment-related legal commitments. In doing so, I draw an analogy between BITs and the institution of marriage.

## **POLICY PREFERENCES AND INTERNATIONAL LEGAL COMMITMENTS**

Why have LDC governments voluntarily chosen to surrender their regulatory sovereignty over FDI by entering into BITs and other international investor rights agreements? To put it another way, why have LDC governments made international legal commitments which place significant limitations on their freedom to regulate FDI in ways that not so long ago were deemed legitimate by these same governments? The short answer to this important question is that LDC governments have sought to increase the amount of FDI flowing into their countries by any means necessary. Many governments came to believe that BITs were an effective means for achieving this goal. Before examining the basis for this belief (which seems to be waning as of late), it is worth highlighting the benefits which host countries derive from FDI.

### *The Benefits of FDI*

There are a number of tangible benefits to be had from playing host to FDI. First, FDI produces the same conventional gains commonly associated with international trade. For instance, insofar as foreign firms are able to provide products of higher quality at lower prices, FDI can be seen as benefiting consumers. Moreover, “to the extent that FDI facilitates trade in goods, services, and knowledge, it magnifies the gains from trade.”<sup>107</sup> Second, FDI generates positive externalities. The foreign firm, Graham and Krugman explain, “is not able fully to appropriate the benefits of its activities; some of the benefits ‘spill over’ to the economy at large, without the foreign firm receiving compensation.” Examples of such benefits include the introduction of new technologies, the diffusion of superior management practices which “can be emulated by [domestic] firms,” and “the training of workers who may then transfer their skills elsewhere” within the host economy.<sup>108</sup> Third, in the developing world at least, multinational firms tend to pay higher wages than indigenous firms.<sup>109</sup> Hence, not only does FDI create new jobs, from a developing country perspective, it tends to create relatively high-paying jobs. Finally, FDI represents an important source of tax revenues for host country governments.

Unlike portfolio investment, FDI entails substantial managerial control as well as ownership.<sup>110</sup> Perhaps more importantly from an LDC perspective, FDI tends to have a much longer time-horizon. In contrast to financial capital which can be quickly and easily withdrawn from a country (assuming the country maintains a free and open capital account), FDI is

---

<sup>107</sup> Graham and Krugman 1995, 58.

<sup>108</sup> Ibid.

<sup>109</sup> Graham 2000.

<sup>110</sup> Formally, FDI refers to the establishment or acquisition of a foreign affiliate or subsidiary in one country by a firm from another country. The current consensus threshold for distinguishing FDI from portfolio investment is 10% equity ownership, a threshold which numerous governments as well as international organizations such as the IMF, OECD, and UNCTAD have adopted for purposes of collecting data on FDI. Affiliates (sometimes referred to as associates) are firms in which a foreign firm holds a minority ownership stake (10% or more but less than 50%), while subsidiaries are those in which a foreign firm has majority ownership (greater than 50% but less than 100%). A wholly-owned subsidiary is one in which a foreign firm enjoys complete ownership.

relatively illiquid ex post. For instance, once a factory or some other physical facility has been constructed in a particular location, a firm cannot simply move it to another locale in response to a perceived worsening of local political conditions. In other words, once costs are sunk, FDI is in some sense stuck, at least in the short-term. For this reason, FDI is arguably a more desirable form of investment than portfolio capital because under conditions of economic strain, or in the event of a full-blown economic crisis, FDI is much harder to withdraw, and therefore more stable. Yet this same unique characteristic of FDI can also serve to frustrate the efforts of LDC governments to attract it.

### *The Time-Inconsistency Problem*

While the relative immobility of FDI compared to portfolio capital may make it a more preferable form of investment, it also creates enormous political risk for those firms that choose to make such investments. From an investor's perspective, once costs are sunk, there is nothing to stop a host country government from expropriating the firm's assets, either directly or indirectly through onerous regulation or excessive taxation. In short, there is nothing to prevent the host state from violating a foreign firm's property rights. This dilemma is commonly referred to as a time-inconsistency (or dynamic inconsistency) problem.<sup>111</sup> As Neumayer and Spess (2005) explain, the problem "arises from the fact that although host countries have an incentive to promise fair and equitable treatment beforehand in order to attract foreign investment, once that investment is established and investors have sunk significant costs, the host country's incentive is to exploit or even expropriate the assets of foreign investors."<sup>112</sup> In other words, because of the relative immobility of FDI, a host state's optimal ex post policy toward

---

<sup>111</sup> Kydland and Prescott 1977.

<sup>112</sup> Neumayer and Spess 2005, 1570.

such investment may differ significantly from its optimal *ex ante* strategy for attracting it. LDC governments may promise investors the world in order to get them to invest in their country, but once costs are sunk, these governments have strong incentives to renege on or reopen their contracts with foreign investors in order to extract or capture additional benefits from the relationship. Vernon (1971) dubbed this phenomenon (as it manifested itself in the natural resources sector) the “obsolescing bargain.” Ultimately, the time-inconsistency problem creates significant political risk for foreign investors and may deter them from investing in LDCs. The risk of expropriation is especially high in those countries where the rule of law is weak and there are very few institutional constraints on executive power.

How can host countries overcome this problem? “Potential solutions” to a “genuine time-inconsistency problem,” suggests Rodrik (1989) “can be found in commitments and reputation-building.”<sup>113</sup> Both methods entail costs. The principal drawback of the latter approach is that reputations take significant *time* to build. Commitments, on the other hand, have the negative effect of reducing a government’s flexibility in the face of unforeseen circumstances, though this is precisely the point of such measures. BITs have typically been portrayed as commitment devices which help LDCs overcome the dynamic inconsistency problem which characterizes their relationship with foreign direct investors.<sup>114</sup> Toward this end, BITs perform three distinct, but closely related functions by enabling governments to (1) signal their policy preferences to foreign investors, (2) make a credible commitment to a pro-FDI policy stance, and (3) lock-in pro-FDI policies by tying the hands of future governments. I discuss each of these functions in turn.

---

<sup>113</sup> Rodrik 1989, 757.

<sup>114</sup> See, e.g., Guzman 1998; Hallward-Driemeier 2003; Buthe and Milner 2005; Ginsburg 2005; Neumayer and Spess 2005; and Elkins, Guzman, and Simmons 2006.

### *BITs as Signals*

As Rodrik (1989) explains, “incomplete or asymmetric information” can serve as a “source of credibility problems.” The private sector “may not be able to tell how serious [a] government really is about the reform process. In other words, they may be in the dark about the true objectives of the government in power, or may ‘confuse’ it with an alternative government whose objectives differ. Imperfect information of this sort is likely to be particularly prevalent...in developing countries.” “The resolution of the credibility problem in such instances will require the government to ‘signal’ its true type.”<sup>115</sup> BITs provide a mechanism through which FDI-friendly governments can signal their “type”—i.e., as a state that welcomes foreign investment and is serious about respecting the property rights of foreign investors—thereby reducing uncertainty on the part of prospective investors regarding what type of government they are confronting and what the government’s true policy preferences toward FDI are. Neumayer and Spess (2005), for instance, suggest that “the signing of BITs sends out a signal to potential investors that the developing country is generally serious about the protection of foreign investment.”<sup>116</sup> Similarly, Salacuse (1990) asserts that “the signing of a BIT by a host country is a clear signal to investors from a treaty partner that their investment is welcome.”<sup>117</sup> BITs arguably provide one of the single best, objective indicators “of a host state’s overall FDI policy orientation,” claim Keele and Yackee (2008).<sup>118</sup> Thus, BITs help to distinguish governments that are intent on pursuing liberal FDI-related policy reforms from those that simply feign interest in reform.<sup>119</sup>

---

<sup>115</sup> Rodrik 1989, 757.

<sup>116</sup> Neumayer and Spess 2005, 1571.

<sup>117</sup> Salacuse 1990, 674.

<sup>118</sup> Keele and Yackee 2008, 4.

<sup>119</sup> “The signaling story,” suggests Ginsburg (2005, 117), “is one in which BIT adoption may be the result of policy changes rather than the embodiment of them. Some evidence for this proposition can be seen in the fact that, at the

### *BITs as Credible Commitments*

By raising the ex post reputational and diplomatic costs of “bad behavior” (as defined by the treaty), BITs allow host states to credibly commit themselves to the rights of foreign investors.<sup>120</sup> As Simmons (2000) explains, the “acceptance of treaty obligations raises expectations about behavior that, once made, are reputationally costly for governments to violate.” Governments make such commitments in order to “further their interests and comply with them to preserve their reputation for predictable behavior in the protection of property rights.”<sup>121</sup> Similarly, Lipson (1991) suggests that “treaties are designed, by long-standing convention, to raise the credibility of promises by staking national reputation on adherence to them.”<sup>122</sup>

To be an effective solution to the time-inconsistency problem, the costs of violating a BIT must outweigh the short-term gains from abnegation. Elkins, Guzman, and Simmons (2006) suggest three ways in which BITs raise the credibility of a host country’s commitment to the property rights of foreign investors by increasing such exit costs. First, BITs reduce the ambiguity of a host government’s obligations toward investors. “BITs are much more precise than customary international law” in defining what constitutes a violation of investor rights,

---

same time countries were adopting BITs, they were also adopting internal regulatory changes that made foreign investment more liberal.”

<sup>120</sup> The extant literature has tended to treat these two functions of BITs—signaling and credible commitment—as distinct or even competing mechanisms (see, e.g., Haftel 2007). However, in practice, it is difficult to separate the two. For instance, what are BITs meant to signal if not the credibility of a government’s commitment to a certain policy stance? In other words, the “type” which BITs are intended to signal is that of a government whose commitments are in fact credible. Similarly, as signals, BITs are unlikely to be effective unless they entail some kind of costly commitment. See Rodrik 1989. Therefore, I largely treat the signaling and commitment functions of BITs as complementary rather than competing mechanisms. In other words, I assume that BITs are intended to perform both functions—i.e., to signal a government’s type and to make a credible commitment.

<sup>121</sup> Simmons 2000, 819.

<sup>122</sup> Lipson 1991. Even in the absence of a formal, treaty-based commitment, reputational concerns can operate as a mechanism for inducing compliance as demonstrated by Tomz 2007.



thereby removing “potential avenues of plausible deniability.”<sup>123</sup> Second, BITs involve the investor’s home government. Violations of an investor’s rights under a BIT could conceivably damage a host government’s relations with the investor’s home government in other areas, giving it an incentive to refrain from taking such actions. In other words, BITs implicitly entail potential issue-linkages which may deter host states from engaging in noncompliant behavior.<sup>124</sup>

Finally, BITs raise the ex post costs of noncompliance by significantly enhancing enforcement mechanisms. As previously stated, most BITs entail “hard” legal commitments. “Legalization,” suggests Abbott and Snidal (2000), “is one of the principal methods by which states can increase the credibility of their commitments.”<sup>125</sup> Most BITs entail significant delegation. Most contain mandatory dispute settlement provisions which give investors direct access to the dispute resolution process, thereby allowing them to launch arbitration proceedings without the approval or support of their home government. The host state “can neither prevent the legal proceeding from going forward, nor control the final decision of the international arbitration tribunal.”<sup>126</sup> Host states found to be in violation of their BIT-related obligations may be (and often are) required to pay substantial monetary damages to the foreign investor whose rights have been violated as determined by an arbitral panel.<sup>127</sup> Thus, according to Elkins et al., BITs raise the credibility of a host state’s commitment to respect the property rights of foreign investors by imposing a wide range of actual and potential costs—sovereignty, diplomatic,

---

<sup>123</sup> Elkins, Guzman, and Simmons 2006, 823. On the importance of rule precision as a dimension of variation among international regimes, see Abbott et al. 2000 and Abbott and Snidal 2000.

<sup>124</sup> Keohane and Nye 1977, Keohane 1984.

<sup>125</sup> Abbott and Snidal 2000.

<sup>126</sup> Elkins, Guzman, and Simmons. 2006, 824.

<sup>127</sup> ICSID maintains a database of investor-to-state arbitration cases which have been conducted under its auspices. This database includes links to published decisions and awards for some cases and can be accessed at the ICSID website: <http://icsid.worldbank.org/ICSID/Index.jsp>.

reputational, and arbitration costs. By raising the costs of reneging on such a commitment, BITs raise the expected value of returns to investments.<sup>128</sup>

Hence BITs serve two closely related (but analytically distinct) functions. First, in the face of significant uncertainty on the part of foreign investors regarding a government's policy preferences or "type," BITs represent a device through which liberalizing governments can send a positive signal to foreign investors. Second, given the time-inconsistency problem to which the relative ex post immobility of FDI gives rise, BITs represent a device through which liberalizing governments can enhance the credibility of their commitment to maintaining an open, liberal investment regime. By raising the ex post costs of reversing course, BITs make liberal reforms more credible than they would otherwise be in the absence of any formal international commitment. What are the empirical implications of a theoretical depiction of BITs as mechanisms for signaling policy preferences and making credible commitments? Given these functions of BITs—signaling and credible commitment—we would expect the formation of BITs to follow or coincide with liberal reforms at the domestic level. That is, if BITs provide a mechanism for signaling preferences and making credible commitments, then we would expect that states are more likely to conclude such treaties *when they have something that they want to signal and/or credibly commit themselves to*—namely, liberal reforms pertaining to the regulation of inward foreign investment. This leads to the what I refer to as the liberalization hypothesis:

**Hypothesis 1:** *BITs should be preceded by or coincide with the liberalization of the host country's policies toward FDI.*

---

<sup>128</sup> A similar interpretation of the role of BITs is offered by Büthe and Milner 2005.

### *BITs as Locking Mechanisms*

By increasing the ex post costs of noncompliance, BITs offer pro-FDI governments a device for “locking-in” investment-friendly policies, thereby institutionalizing the current government’s policy preferences and preventing “back-sliding” or policy reversals by future governments which may not share the current government’s policy preferences.<sup>129</sup> “Regardless of the level of trust among the parties at the time of the investment,” explains Ginsburg (2005), “the investor will be concerned that a future government may break the current government’s promise. Furthermore, the investor may not trust future governments to refrain from interfering with local courts.”<sup>130</sup> Therefore, BITs enhance the credibility of a country’s commitment to investor rights by tying not only the hands of the current government which has concluded the treaty, but the hands of future governments as well, thereby locking-in liberal policies.

Similarly, BITs may also provide governments with an excuse for maintaining a liberal policy orientation toward FDI in the face of significant opposition from domestic producers who may be hurt by competition from MNCs or other groups that are opposed to liberal FDI policies. Indeed, demands for protectionism may be the proximate source of a government’s temptation to engage in time-inconsistent policies. From this perspective, BITs represent a solution to “an intractable domestic problem,” placing “a desired constraint on policy where domestic politics alone has proved socially suboptimal.”<sup>131</sup> The ability of BITs to lock-in FDI-related policy reforms and provide governments with “cover” against the countervailing demands of domestic groups serves to further enhance the credibility of such reforms. “An international

---

<sup>129</sup> A similar argument has been made to explain the proliferation of PTAs. See, e.g., Fernandez and Portes 1998.

<sup>130</sup> Ginsburg 2005, 113.

<sup>131</sup> Simmons 1998.

commitment,” suggests Ginsburg (2005), “can be a domestic defense mechanism to insulate the state from local rent-seeking efforts.”<sup>132</sup>

The ability of BITs to act as a mechanism for locking-in liberal policy changes is likely to be an especially significant function in a democratic context or where the number of veto players and the preference heterogeneity among them is relatively high. Liberalization of FDI policies carries distributional consequences which may result in significant political opposition from those sectors—principally, domestic producers—which stand to lose from such policy changes.

As Li and Resnick (2003) explain:

[MNCs] are typically more competitive than indigenous firms in the developing host country...foreign firms typically displace local businesses and even compete for loans in the host country. Just as with trade, the growing presence of more-competitive foreign firms often turns less-competitive local firms into losers. Local business owners and the unemployed, suffering concentrated losses, are likely to get organized and lobby for protective industrial policy from the government...Grievances are likely to be more pronounced in developing countries, where social welfare systems are not well developed and provide limited compensation for displacement. *Where democratic institutions are strong, the opponents of FDI have multiple avenues to influence public policymaking.* Domestic interests that lose out to...[MNCs] can resort to elections, campaign finance, interest groups, public protests, and media exposure. Under such pressures, the host government is compelled to cushion the blow to domestic losers by subsidizing less competitive indigenous firms, imposing more restrictive entry conditions on [MNCs] such as joint ownership, limiting sectors open to foreign capital, or demanding solely foreign financing of initial investments. It also could pose more restrictive operating requirements in terms of local purchases of capital goods and raw materials, local employment, the proportion of output to be exported, and the use of technology. These policies reduce the [MNC's] degree of control over its overseas production and weaken its competitiveness.<sup>133</sup>

In a democracy, leaders that wish to liberalize FDI policies are likely to face considerable difficulty enacting such policy changes. For those that succeed in achieving significant liberalization, BITs offer a way for these leaders to “lock-in” such reforms, thereby preventing back-sliding. Many of the “industrial policies” demanded by protectionist interests identified by

---

<sup>132</sup> Ginsburg 2005, 119.

<sup>133</sup> Li and Resnick 2003, 183 (emphasis added).

Li and Resnick represent violations of investor rights as defined by BITs. For example, subsidies to domestic firms could be challenged by foreign firms as a violation of national treatment rules commonly found in BITs. Similarly, at least some BITs (particularly, those concluded by the United States) prohibit the imposition of performance requirements or restrictions on entry by host states. These are precisely the kinds of policies which Li and Resnick suggest that protectionist interests would demand of their government. Whether or not BITs represent a meaningful or effective constraint on host state behavior, they do raise the ex post costs of policy reversals, thereby making it more difficult for subsequent governments to change course.<sup>134</sup> Hence, governments whose policymaking ability is highly constrained by democratic institutions and/or a large number of veto players will want to ensure that any reforms which they succeed in enacting are not quickly undone by future governments that may be more sympathetic to the demands of protectionist groups. By making a return to illiberal policies more difficult, BITs offer a mechanism through which liberalizing governments can make their reforms more durable in the face of domestic opposition. This leads to what I refer to as the domestic constraints hypothesis:

**Hypothesis 2:** *Countries in which the government confronts significant political constraints should be more likely to sign BITs than those countries in which the government is relatively unconstrained.*

---

<sup>134</sup> My argument does not assume that BITs represent an effective constraint on host state behavior. The recent actions of some governments (e.g., Venezuela and Bolivia) call such an assumption into question. Governments that have an intense preference for asserting their regulatory sovereignty over FDI may choose to ignore the negative ex post consequences of violating BITs. What my argument does assume is that governments that have liberalized FDI policies see BITs as a mechanism for decreasing the likelihood of dramatic policy reversals by institutionalizing liberal reforms with an international legal commitment, thereby placing additional constraints on the ability of successor governments to change policy.

*BITs as Screening Mechanisms: Corroborating Credibility*

A story in which BITs serve important functions for liberalizing governments—signaling preferences, enhancing the credibility of liberal reforms, and tying the hands of successor governments—and in which the formation of BITs follows or coincides with the liberalization of domestic regulatory regimes governing FDI, suggests that BITs are best viewed as screening mechanisms. Some scholars have suggested that international legal commitments, such as those embodied in BITs, function as a screening mechanism, enabling states to credibly signal their intention to engage in compliant behavior in the future, not because the commitment generates ex post reputational costs for noncompliance, but because the ex ante costs of becoming a signatory are high enough to deter noncompliant “types” from signing in the first place.<sup>135</sup> Therefore, the relatively high rate of compliance with international legal commitments which IR and legal scholars have observed is due to the fact that such commitments screen out “bad apples”—that is, states for which compliance is problematic. This is not to say that BITs do not represent costly commitments or invoke concerns about reputation. It simply means that the sovereignty costs of compliance are paid up front. It also means that BITs are not a device for *changing* a state’s policies or altering its preferences. Instead, BITs reflect prior changes in the policy preferences of states. They represent a ratification of previous policy changes at the domestic level.

## **INSTITUTIONAL CAPACITY AND COMPLIANCE WITH BITS**

A property right explains Armen Alchian, “is the exclusive authority to determine how a resource is used, whether that resource is owned by government or by individuals.” A *private* property right, suggests Alchian, entails the exclusive right to derive income from the use of a

---

<sup>135</sup> von Stein 2005.

resource as well as “the right to delegate, rent, or sell any portion of the rights” to that resource at a mutually agreeable price.<sup>136</sup> The security of private property rights in any society is dependent upon the existence of a strong institutional infrastructure that can support and provide some degree of enforcement of such rights. Where such institutions are noticeably absent, private actors, be they domestic or foreign, will be hesitant to invest their full resources in the local economy. Therefore, institutions that promote the protection and enforcement of private property rights are held to be a vital ingredient in determining a country’s level of investment, and hence, its level of economic growth, a proposition to which numerous empirical studies attest.<sup>137</sup>

Institutions are “the rules of the game in a society” or “the humanly devised constraints that shape human interaction,” including economic and political exchange.<sup>138</sup> Institutions can be formal or informal, ranging from specific rules embodied in laws or constitutions to various societal norms, customs, traditions, taboos, or codes of conduct. At the international level, institutions have been described as regimes consisting of “implicit or explicit sets of principles, norms, rules, and decision-making procedures around which actors’ expectations converge.”<sup>139</sup> According to the standard rationalist account, institutions matter when transaction costs—i.e., the ex ante and ex post costs of negotiating, implementing, and enforcing cooperative transactions, be they economic or political—are significantly greater than zero. The principal function of institutions, whether at the domestic or international level, is to reduce these transaction costs by defining the range of acceptable behavior, thereby establishing mutual expectations, reducing

---

<sup>136</sup> Alchian 2002.

<sup>137</sup> See, e.g., Goldsmith 1995, Knack and Keefer 1995, and Leblang 1996.

<sup>138</sup> North 1990, 3.

<sup>139</sup> Krasner 1982. Although international regimes and international law are not necessarily synonymous (e.g., informal regimes can exist in the absence of any hard law), they often go hand and hand, with formal legal commitments constituting the specific rules of a given regime. Indeed, regimes can be thought to vary according to their degree of so-called legalization. See Abbott et al. 2000.

uncertainty, and averting market failures (i.e., non-cooperative outcomes).<sup>140</sup> In a world of complete information and zero transaction costs, institutions would be superfluous. In a world of incomplete information and positive transaction costs however, cooperative outcomes “will break down unless institutions are created that provide sufficient information for individuals to police deviations.”<sup>141</sup> By decreasing information asymmetries and solving enforcement problems, institutions discourage opportunism, shirking, and cheating, thereby facilitating economic exchange and political cooperation.

### *BITs as Substitutes*

Domestic and international institutions pertaining to the security of property rights are functionally similar. Laws that establish rights for private actors, as well as procedural mechanisms for enforcing these rights, are essentially the same whether crafted at the domestic level or embodied in an international treaty. However, though functionally identical, domestic and international institutions may differ in terms of their strength, and therefore their power to constrain would-be violators of the property rights of foreign investors. Concomitantly, domestic and international institutions may differ in their ability to stimulate investment by assuaging the fears of investors regarding the security of their property and investments. As a result of this variation in the strength of institutions at the domestic and international level, it is possible for strong international institutions to serve as a substitute for weak or non-existent domestic institutions.

BITs are intended to enhance the security of foreign investors’ property rights by regulating the behavior of states and providing external enforcement mechanisms (i.e.,

---

<sup>140</sup> See, e.g., Keohane 1984; North 1990; and Bergara, Henisz, and Spiller 1998.

<sup>141</sup> North 1990, 57.



arbitration). Given this function, we might expect LDCs which *lack* a strong institutional infrastructure for the protection and enforcement of property rights at the domestic level to be more eager to conclude BITs at the international level as a way of compensating for their lack of home-grown property rights institutions. In other words, those countries which have a significant “credibility gap” are the ones in most need of the alleged credibility-enhancing effects of BITs, and for which BITs are presumably most likely to have a positive impact in terms of attracting FDI by substituting for a lack of strong domestic property rights institutions.<sup>142</sup>

Neumayer and Spess (2005), for instance, suggest that BITs may serve as a substitute for weak indigenous institutions, and that those countries “with particularly poor domestic institutional quality possibly stand the most to gain from BITs.”<sup>143</sup> If this were true, then we would expect such countries to exhibit a greater propensity to enter into such treaties. Conversely, governments “with greater indigenous credibility,” speculate Elkins, Guzman, and Simmons (2006), may “be less willing to pay the sovereignty and other political costs associated with concluding BITs.” Ginsburg (2005) spells out the empirical implication: “We might thus expect non-signers to have better quality governance than signers, at least at the time of signing.”<sup>144</sup>

BITs could then be regarded as a device through which LDCs with weak or nonexistent domestic

---

<sup>142</sup> It is worth pointing out that the credibility problem resulting from a country’s lack of strong institutions is analytically distinct from the credibility problem described above which results from changing policy preferences on the part of governments concerning the treatment of FDI. For instance, a country with relatively strong property rights institutions which has historically maintained restrictive policies toward FDI would still suffer from a credibility problem even if its government undertook significant liberalization of investment policy. Investors might be skeptical about the sincerity or permanence of the government’s commitment to a liberal policy stance. They might also worry about the possibility of a government with radically different policy preferences coming to power in the future. Conversely, a country that has historically maintained liberal policies toward FDI would still suffer from a credibility problem if it lacks the institutional capacity to protect and enforce the property rights of foreign investors. Although the two types of credibility problems are distinct, in many cases, they are probably positively correlated.

<sup>143</sup> Similarly, Ginsburg (2005, 113) suggests that given “low observed levels of judicial independence in courts in many developing countries, and an information problem regarding foreigners’ ability to observe the quality of such courts, third party dispute resolution...apparently substitutes for poor institutional environments.”

<sup>144</sup> Ginsburg 2005, 115.

property rights institutions attempt to compensate for their poor institutional endowment with an international substitute. I refer to this as the substitution hypothesis:

**Hypothesis 3:** *Countries that possess relatively strong domestic property rights institutions will generally be less inclined to enter into BITs than those with weak or non-existent institutions.*

#### *Domestic Institutions and Compliance with BITs*

Countries with weak or nonexistent domestic property rights institutions may have a difficult time convincing foreign investors of the security of their property rights. In contrast, countries which possess strong property rights institutions will presumably have an easier time persuading foreign investors of the security of their investments, government policies toward FDI notwithstanding. Hence, as the substitution hypothesis suggests, we might expect countries with weak domestic property rights regimes to be more likely to conclude BITs as a way of compensating for their institutional deficiency. However, it is exactly these types of countries that may experience the greatest difficulty in complying with their BIT-related obligations precisely because of the fact that they lack strong indigenous institutions for the protection and enforcement of property rights in the first place.

A country in which property rights institutions are relatively weak or nonexistent is an environment that is considerably more permissive of behavior which violates the property rights of both domestic and foreign capital. Regardless of the preferences of host states, a weak or nonexistent institutional infrastructure incapable of guaranteeing the security of private property rights may inevitably produce compliance problems. States are not unitary actors. Even if government leaders have adopted a favorable orientation toward FDI and have formally committed themselves to uphold the property rights of foreign investors by entering into an

investment treaty, the absence of strong indigenous institutions (e.g., a strong rule of law, an independent judiciary, norms against corruption) may still generate noncompliance by creating an environment in which other actors (e.g., local authorities) remain relatively unconstrained in their treatment of foreign investors. The lack of strong indigenous institutions means that there are no formal legal rules or informal norms, to circumscribe the behavior of these actors toward foreign investors. For instance, a country in which corruption is pervasive could encounter compliance problems even though its leaders have embraced pro-FDI policies at the national level—that is, despite a change in the government’s preferences toward FDI.

Thus, a country’s institutional endowment for the protection and enforcement of property rights is to some extent exogenous to the preferences of host states and the policies which these states have adopted toward FDI, including international investment-related legal commitments in the form of BITs. The reason is simple: institutions, by their very nature, are sticky. Though a government may recognize that the existing institutional infrastructure is suboptimal, institutional change does not happen over night. It takes time to replace inefficient institutions (e.g., norms of corruption) with new and better ones (i.e., norms against corruption). Therefore, a country’s institutional milieu must be regarded, at least to some degree, as an exogenous constraint on a state’s capacity to comply with international legal commitments such as those contained within BITs.<sup>145</sup> An inferior institutional endowment may deter LDC governments from making investment-related legal commitments, especially given the prospect of becoming involved in costly arbitration proceedings with foreign investors as a result of unavoidable

---

<sup>145</sup> In chapter 5, I explain in further detail why weak domestic institutions are likely to generate compliance problems in the form of a greater number of arbitral claims being made against a host state by foreign investors.

instances of noncompliance.<sup>146</sup> In short, for countries with weak or nonexistent property rights institutions, the costs associated with BITs is likely to be higher.

While a country's institutional endowment is to some extent exogenous in relation to the preferences and policies of host states, the latter can obviously have a profound impact on the former. States exert a determinant influence on the broader institutional environment in which both domestic and foreign investment takes place. "Governments that protect private property, enforce contracts, [and that] have transparent administration procedures and low levels of graft and bribery...enhance a firm's ability to profit by decreasing transaction costs."<sup>147</sup> If a state decides to make a firm commitment to the rights of investors, both foreign and domestic, it can take steps to change the institutional environment of its country in accordance with this preference. But again, this will take time, and though states may have embarked on a program of institutional improvement, they may be hesitant to make international commitments until after their domestic institutions have passed a certain threshold in terms of their strength.

If LDCs with weak domestic property rights regimes are more likely to experience difficulties complying with BITs—in other words, if compliance problems are to some degree unavoidable for such countries—then the expected ex post compliance costs associated with such treaties will be significantly higher for these countries, discouraging them from formally committing themselves through such agreements. Such countries may actually be deterred from

---

<sup>146</sup> This of course assumes that all BITs are essentially the same. More specifically, it assumes that all BITs contain viable commitments to arbitration. Recent research conducted by Yackee 2007a calls this assumption into question. As Yackee's research shows, the first BIT with an effective and enforceable commitment to arbitration did not enter into force until 1969. See also Allee and Peinhardt 2009. It could be that LDCs with weak domestic property rights regimes simply conclude BITs that are substantively and/or procedurally shallow in order to decrease the ex post costs of noncompliance. However, according to Dolzer and Stevens 1995, most modern BITs contain advanced consents to submit investment disputes to arbitration. Furthermore, the possibility that some BITs are substantively or procedurally shallow only becomes an issue if it is found that countries with weak domestic property rights regimes are just as likely to enter into BITs of any type as those with strong domestic regimes. To the contrary, the results of my empirical analysis (in chapter 4) suggest that countries with weak domestic regimes are actually less likely to conclude BITs of any type.

<sup>147</sup> Souva, Smith, and Rowan 2008.

entering into BITs because of the seemingly higher compliance costs resulting from their weaker institutional capacity to respect and enforce the rights of foreign investors. They may fear the damage to their reputation that would result from noncompliance with a BIT. They therefore refrain from entering into such agreements until the domestic institutional environment has reached a certain level of strength, thereby reducing the likelihood of noncompliance, and therefore the price of the treaty. In other words, states avoid making treaty-based, investment-related commitments until they can afford to do so.<sup>148</sup> Therefore, a weak domestic institutional framework may act as an exogenous constraint which discourages LDCs from formally committing themselves to the international investor rights regime.

The logic of this argument suggests that countries which already possess a strong institutional infrastructure for the protection and enforcement of property rights will be more likely to sign and ratify BITs than those which lack such institutions. In other words, we should observe a selection bias in which LDCs with significantly better domestic property rights regimes should be more likely to conclude BITs than those with weak or nonexistent property rights institutions. Because the compliance costs of signing a BIT are presumably lower for LDCs in which there is already a strong domestic property rights regime in place, these countries should be more prone to conclude BITs. “If a BIT is a signaling device,” admit Elkins, Guzman, and Simmons (2006), “we would expect more reliable rather than less reliable property rights protectors to sign them.”<sup>149</sup> According to this line of reasoning, not only do BITs help to distinguish governments who *intend* to respect the rights of foreign investors from those who do not, they may also distinguish governments which possess the *institutional capacity* to comply

---

<sup>148</sup> Of course, reputational concerns may serve to sustain compliance with international legal commitments after such commitments have been made in the manner hypothesized by scholars such as Simmons 2000, and Simmons and Hopkins 2005.

<sup>149</sup> Elkins, Guzman, and Simmons 2006, 831.

from those whose institutional infrastructure is too weak to ensure compliance. This is what I will refer to as the capacity hypothesis:

**Hypothesis 4:** *Countries that possess relatively strong domestic property rights institutions will generally be more inclined to enter into BITs than those with weak or non-existent institutions.*

## **TAKING THE PLUNGE AND TYING THE KNOT: BITS AS MARRIAGES**

This chapter has highlighted two important variables which must be given careful consideration by anyone seeking to explain the pattern of international investment-related legal commitments among developing countries: (1) changing preferences toward FDI on the part of governments and (2) variation in the institutional capacity of countries to comply with BITs. First, only certain types of governments are likely to formally commit themselves to the international investor rights regime which BITs represent—namely, those that have some interest in complying with those commitments. These governments hold distinctly favorable preferences toward FDI, preferences which are reflected in significant policy changes at the domestic level (i.e., liberalization). They conclude BITs as a way of signaling their preferences to foreign investors, enhancing the credibility of their policy stance, and institutionalizing their policy preferences by tying the hands of their successors. Second, a country's institutional endowment may act as an exogenous constraint on its willingness to enter into BITs. Countries with weak or nonexistent domestic property rights institutions may be deterred from making international investment-related legal commitments because they realize that the likelihood of experiencing difficulties complying with such commitments is greater for them compared to those countries possessing relatively strong institutions, for which compliance is presumably less difficult.

Both of these explanations are grounded in a consideration of compliance with international legal commitments. The first is based on a state's *intentions* regarding compliance, while the other is based on a state's *expectations* about its *institutional capacity* to comply with such commitments. Taken together, both explanations suggest that the relationship between a country's domestic regime for FDI—its regulatory policies and institutional endowment—and its propensity to make international commitments pertaining to FDI should be complementary. A useful analogy can be drawn between this relationship and the institution of marriage.

States are like single people looking to attract a long-term partner—namely, a foreign investor. Beyond those qualities which make a person or country inherently attractive (e.g., natural beauty, intelligence, reliability, or other qualities in the case of people; a large or growing consumer market, a beneficial factor or natural resource endowment, or other qualities in the case of countries), persons or states may take certain steps to make themselves more attractive to their potential partners (e.g., an individual might try to get in shape or get plastic surgery to make themselves more attractive; states will change their policies).

Assuming there is some mutual attraction, two people may move to establish a closer, more intimate relationship. One partner may be uncertain as to the long-term intentions of the other partner—specifically, the seriousness of the other's commitment to the relationship. The first partner may eventually demand some form of commitment on the part of the other. At first, this commitment may take the form of an informal, nonbinding (in a legal sense) commitment. The partner from whom the commitment is demanded commits to abide by certain implicit rules and norms (like remaining faithful, or in the case of host states, not expropriating the foreign investor's property). Yet this informal commitment may not be enough to satisfy the other partner, so they may demand a more formal, legally-binding commitment, one that significantly

raises the stakes of violating the rules and norms that now define the relationship. In other words, a formal commitment which raises the transaction costs of withdrawing from the relationship and which is externally enforceable. This is precisely what both the institution of marriage and BITs do. Marriage imposes a certain degree of ex post legal costs for retreating from one's commitment. For example, if a man divorces his wife, then he may have to pay his ex-wife alimony. If a host state that has ratified a BIT with a foreign investor's home country decides to violate the rights of that foreign investor as defined by the BIT, then the state may end up having to compensate the investor millions of dollars as the result of an arbitration decision. At the very least, the state will have to pay the transaction costs of defending itself from the claims of the foreign investor as well as its reputation in the eyes of other investors.

According to this analogy, the decision by some states to revolutionize their national FDI policy regimes can be thought of as an effort to attract foreign investors. The decision to sign a BIT could then be thought of as the engagement stage preceding a full-blown marriage between foreign investors and host states, which is itself achieved by ratification of said BIT by the host state. Only certain types of individuals will be willing to undertake the serious commitment and level of obligation entailed by the institution of marriage. While imprudent marriages no doubt occur as well as opportunistic ones (e.g., marrying someone for their money), in general we would expect less than fully committed individuals to avoid getting married, thereby potentially subjecting themselves to a whole host of presumably unpleasant consequences (e.g., having to pay for a divorce lawyer or paying alimony). A similar logic, I would argue, applies to the decisions of LDCs to conclude BITs which entail relatively hard legal commitments. Only those that are truly committed to maintaining liberal investment policies and which have the institutional capacity to protect and enforce the property rights of foreign investors will be likely



to sign and ratify BITs. Thus, BITs end up corroborating the credibility of LDCs which have already established a strong commitment to investor rights, as evidenced by the character of their policies and domestic institutions.

The analogy breaks down to some extent, when we consider the peculiar characteristics of the host state-foreign investor relationship. First, only one partner (the LDC) is required to make a serious commitment to the other. The other partner (the foreign investor) is free to leave at any time (through divestment). Indeed this is one of the explicit stipulations of most BITs which require states to allow investors to freely repatriate their profits, and generally speaking, BITs do not impose any behavioral obligations on, or entail any substantive commitments for, on foreign investors. This is especially true if the BIT limits the host state's ability to impose performance requirements on FDI which would ensure that foreign investment contributes to the host country's economic development. Nonetheless, given the relative immobility of FDI (the ultimate source of the commitment problem itself), foreign direct investors are likely to stay in the relationship for the long haul, so long as a country's policy regime does not threaten the bottom line. Second, the relationship between foreign investors and host states is by no means a monogamous one. It should be conceived as a polygamous marriage. In practice, host states make commitments to a multiplicity of foreign investors from numerous countries by concluding BITs with multiple countries.

### *Rationalist vs. Constructivist Explanations*

The liberalization and capacity hypotheses (hypotheses 1 and 2) can be understood in purely rationalist terms. LDCs that maintain illiberal policies toward FDI refrain from entering into BITs because they have no intention or desire to be limited in their ability to regulate FDI.

Similarly, the reason why LDCs with weak domestic property rights institutions avoid signing BITs is in order to avoid the presumably higher costs of compliance which such treaties would impose on these types of countries. In other words, the decision to sign or not to sign a BIT is the result of a government's preferences as well as a simple, cost-benefit analysis. For governments that wish to have a free hand in regulating FDI, BITs represent an undesirable arrangement. Similarly, for countries which lack strong property rights institutions, the price of BITs (in terms of the costs associated with and the likelihood of noncompliance) is simply too high to pay. In contrast, BITs make sense for governments that have already made a commitment to liberal norms concerning the treatment of FDI. BITs are also relatively cheaper for those countries which already possess strong domestic property rights institutions—i.e., countries that have the institutional capacity to comply with their BIT-related obligations.

Yet, both the liberalization and capacity hypotheses are compatible with a constructivist approach which highlights the importance of *identity* as a determinant of state preferences, and therefore state behavior.<sup>150</sup> The liberalization hypothesis implies that BITs are devices through which countries that have already made a firm commitment to respect the property rights of foreign investors, as evidenced by the adoption of FDI-friendly policies or the cultivation of a strong institutional infrastructure for the protection and enforcement of property rights, not only signal, but confirm, this prior commitment. According to this view, BITs are a way in which LDCs can signal and corroborate a liberal identity (and hence liberal preferences) including respect for the rights of foreign investors as well as a desire to be law-abiding members of the emerging international regime for investor rights and the larger liberal economic order of which this specific regime is a derivative. This line of reasoning is also compatible with a so-called normative (or cultural) model such as that which Maoz and Russett (1993) offer for the

---

<sup>150</sup> Wendt 1992, 1999; Finnemore 1996.

democratic peace. They suggest that, to the extent possible, states will “externalize the norms of behavior that are developed within and characterize their domestic political processes and institutions.”<sup>151</sup> Concluding BITs allows LDCs with strong domestic property rights institutions to externalize their commitment to the rights of all investors, both domestic and foreign. It also allows them to transmit an image of themselves as being a hospitable environment for foreign investors. Along these same lines, Ginsburg (2005) offers a sociological account of the diffusion of BITs, suggesting that “BITs became ‘the thing to do’ for developing countries in the 1990s, and spread through a desire to seem modern. In addition, the role of ‘norm entrepreneurs’ such as ICSID, the UN and the ICC, who have promulgated codes and model rules that have articulated the low regulation standard, may also have played a role in spreading BITs among developing countries,” by shaping or changing state preferences.

The problem with rationalist approaches is that they often fail to specify the source of actors’ preferences. Preferences are assumed to be fixed and are treated as an exogenous factor. The content of preferences may be inferred from the actions one is trying to explain which risks engaging in tautology. As has already been noted, a sea-change has occurred in the attitudes and orientation of most LDCs towards FDI since the early 1990s. After years of imposing strict regulations on inward FDI, many LDCs began to liberalize their policies toward FDI. Whether this profound policy shift is the result of changing ideational beliefs (perhaps in response to a serious crisis) among state leaders (e.g., acceptance of liberal ideas and principles) as emphasized by some constructivists, or a rational and pragmatic response to the drying up of alternative sources of external finance (i.e., private bank loans as well as foreign aid) as a result of the 1980s debt crisis, is debatable. What is certain is that LDC preferences have changed as

---

<sup>151</sup> Maoz and Russett 1993.

evidenced by the fact that they have for some time now been actively competing with each other for FDI.

My argument assumes that the majority of LDCs which formally commit themselves to the international investor rights regime by entering into BITs hold distinct preferences toward FDI. The specific hypotheses which I derive from this assumption is that these unique set of preferences will manifest themselves at the domestic level in both policies and institutions that provide relatively strong property rights protection, particularly with regard to foreign capital. I also hypothesize that countries will undergo an internal transformation as a result of changing preferences toward FDI and this transformation will precede or coincide with the decision of states to externalize their commitment to investor rights. What is the source of this global shift in preferences toward FDI? It is very likely the result of external shocks such as the 1980s debt crisis for many Latin American states and other LDCs which precipitated significant structural adjustment, or internal shocks such as the dramatic transition away from communism which occurred in many Eastern European countries at the end of the 1980s, again entailing massive structural adjustment. Indeed, we can clearly observe spikes in the number of BITs which roughly correspond to these events. It could also be that, as Elkins, Guzman, and Simmons (2000) argue, competition for foreign capital has created an interdependent situation in which the decisions of a state's competitors change its own preferences. As I show in the next chapter, in the case of India, it was a balance of payments crisis in the early 1990s (brought on in part by the collapse of the Soviet Union which had served as a vital source of foreign aid for India) which prompted a shift in India's policies toward FDI. The crisis provided a window of opportunity for reform-minded politicians to begin substantial liberalization of their country's regulatory regime governing FDI. These leaders then pursued BITs as a way of locking-in their reforms.

## CHAPTER 4

### THE DETERMINANTS OF BIT SIGNINGS

Which countries are most likely to formally commit themselves to the international investor rights regime? Which countries are most likely to conclude BITs, thereby surrendering their regulatory sovereignty over FDI? Chapter 3 offered a theoretical rationale for why countries whose governments have embarked programs of liberalization with respect to FDI policies, and which possess relatively strong property rights institutions, should exhibit a greater propensity to enter into BITs than countries whose governments maintain illiberal policies toward FDI, and which lack the institutional capacity to protect and enforce property rights. Countries within the former group tend to hold distinct preferences toward FDI which are reflected in their policies toward FDI. Because of their strong preference for attracting FDI, the governments of these countries are more willing to surrender their sovereignty over FDI by formally committing themselves to the international investor rights regime. These governments see BITs as a means of enhancing the credibility of their policy stance toward FDI by tying their own hands as well as the hands of future governments. BITs complement and corroborate these governments' existing commitment to investor rights by externalizing and institutionalizing such commitments at the international level. Moreover, to the extent that these countries already possess a relatively strong institutional infrastructure for the protection and enforcement of private property rights, it is easier for them to comply with the behavioral dictates of BITs. In short, these countries both *intend*, and possess the *institutional capacity*, to comply with their international investment-related commitments. We should therefore expect such countries

to exhibit a greater propensity to commit themselves to the international investor rights regime by concluding BITs.<sup>152</sup>

This chapter offers an empirical test of the hypotheses developed in chapter 3. Table 4.1 provides a summary of those hypotheses. I find fairly robust evidence in support of both the liberalization and capacity hypotheses (hypotheses 1 and 4). Evidence for the domestic constraints hypothesis (hypothesis 2) is somewhat weaker but suggestive. I find no evidence that those countries with relatively weak property rights institutions are more likely to conclude BITs as a way for substituting for their poor quality of their indigenous institutions (hypothesis 3). The results of my analysis lend support to my primary argument regarding which types of countries are more likely to conclude BITs.

The chapter is organized as follows. I begin by describing the research design for my analysis of BIT signings. I then present and interpret the results of this analysis. I then offer some qualitative evidence in support of my argument through a case-study of India which traces the process through which India came to conclude its own BITs with major capital-exporting countries. I conclude with a discussion of the findings and their implications.

## **RESEARCH DESIGN**

In an effort to gauge the validity of my argument regarding the relationship between a country's domestic policies and institutions and its propensity to conclude BITs with capital-exporting countries, I conduct an event history analysis of BIT signings between 1985 and

---

<sup>152</sup> Although the two may go hand and hand with each other, policy preferences and institutional capacity should be regarded as analytically distinct sources of commitment which could pull a government in different directions. For instance, liberal policy preferences may drive a government toward making an international commitment, whereas low institutional capacity would make it hesitant to enter into BITs.

Table 4.1 The Relationship Between Policies, Institutions, and BITs: Hypotheses

**Hypothesis 1: Liberalization**

BITs should be preceded by or coincide with the liberalization of the host country's policies toward FDI.

**Hypothesis 2: Domestic Political Constraints**

Countries in which the government confronts significant political constraints should be more likely to sign BITs than those countries in which the government is relatively unconstrained.

**Hypothesis 3: Substitution**

Countries that possess relatively strong domestic property rights institutions will generally be less inclined to enter into BITs than those with weak or non-existent institutions.

**Hypothesis 4: Institutional Capacity**

Countries that possess relatively strong domestic property rights institutions will generally be more inclined to enter into BITs than those with weak or non-existent institutions.

2000.<sup>153</sup> Event history models are specifically designed to capture an explanatory variable's influence on the length of time before the onset of an "event"—in this case the formation of a BIT between two countries. Hence, the dependent variable for my analysis is the duration of time before two countries sign a BIT. The unit of analysis is the country dyad-year. Each dyad is comprised of a home or source country (i.e., DCs) and a potential host country (i.e., an LDC).<sup>154</sup>

<sup>153</sup> See Box-Steffensmeier and Jones 1997 for a useful introduction to event history analysis, also commonly referred to as survival analysis (e.g., in biomedical research) or duration analysis.

<sup>154</sup> The sample of home/source countries includes 23 high-income OECD countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States. The analysis includes as many developing host countries for which complete data on my key explanatory variables are available, where "developing" status is determined by having a per capita GDP income of less than \$6,000 (in 1987 US\$), a conventional threshold. See the appendix for a complete list of host countries included in the sample.

### *Measuring Domestic Investment Regimes*

The central explanatory variables of interest are a country's policy regime for FDI and the relative strength of its domestic property rights regime at time  $t - 1$ .<sup>155</sup> My notion of a country's property rights regime is equivalent to Souva, Smith, and Rowan's (2008) notion of "market protecting institutions." Together, a country's policies toward FDI and its institutions pertaining to the protection and enforcement of property rights constitute its regime for FDI. I attempt to capture the effects of this variable by employing an index measure similar to that which was first developed by Knack and Keefer (1995). This index is constructed by combining a country's scores on four variables taken from the International Country Risk Guide (ICRG).<sup>156</sup> The index ranges from a minimum score of 0 to a maximum score of 28 (however, none of the observations in my sample score higher than 25). Higher values indicate a more favorable environment for FDI (i.e., liberal policies and stronger property rights institutions), while lower values indicate a less than favorable investment climate (i.e., restrictive policies and weak institutions). The four component variables which make up the index are: (1) investment profile, (2) corruption, (3) law and order, and (4) bureaucracy quality. A brief description of each of these variables follows.<sup>157</sup>

---

<sup>155</sup> Most of my explanatory variables are lagged by one period in order to avoid problems of reverse causality, with a few exceptions (explained below). While this may not be an ideal solution to this potential problem, I have chosen to follow conventional practice in lagging my explanatory variables by one period. Indeed, the study of BIT signings by Elkins et al. (2006) which I seek to replicate adopts this same approach.

<sup>156</sup> The ICRG dataset is published by the PRS Group, a political risk assessment and consulting firm, and can be purchased at the company's website: [www.prsgroup.com](http://www.prsgroup.com).

<sup>157</sup> In choosing to employ an index measure I am following the practice of Knack and Keefer (1995) and others who have used the ICRG data. As Knack and Keefer note, aggregating the ICRG variables into a single index helps to avoid the risk of multicollinearity which including each indicator separately in the same regression equation would entail given the fact that these variables are all strongly correlated with one another. The risk of multicollinearity is perhaps somewhat overstated by Knack and Keefer, at least in this instance. None of the correlations among the four component variables is greater than .52. Regardless, I also test the separate, individual effects which each of these four variables have on the propensity of LDCs to sign BITs in order to assess the relative importance of each factor and in keeping with the analytical distinction that I have drawn between policies and institutions.



The first component variable in my investment regime index is the ICRG investment profile variable. A country's investment profile represents an assessment of factors affecting the risk to foreign investments, including expropriation risk, contract viability, the ability to repatriate profits, and payment delays. This variable captures many of the risk factors which are of primary concern to foreign investors and which much of the substantive content of BITs is designed to address. It ranges from a minimum score of 0 to a maximum score of 12 (however, none of the observations in my sample score higher than 11) with higher values indicating a more favorable profile.<sup>158</sup> In contrast to the other three component variables which are entirely institutional in nature, a country's investment profile to some extent captures the policy preferences of LDCs. For the most part, host states are free to decide whether or not they want to expropriate foreign investments, repudiate contracts with foreign investors, or place restrictions on profit repatriation, though in some instances, these results may be unintentional. Indeed, a foreign firm's ability to make remittances and other types of monetary transfers is largely a function of national statutes. Governments restrict or liberalize such transactions by changing existing laws or adopting new legislation—in other words, by changing *policy*. Thus, this particular component of my investment regime index is ideal for testing the screening hypothesis by measuring the extent to which BITs require a substantial departure from the current practice of LDCs, an issue which, as has already been discussed, gets at the heart of debates about compliance in IR.

---

<sup>158</sup> It is worth noting that a country's investment profile is weighted more heavily than the other three components of the index (the maximum score for the corruption and law and order variables is 6, while that of the bureaucracy quality variable is 4). This is appropriate given the kinds of investor concerns which the investment profile variable is designed to capture and which BITs are intended to address, and given the basic aim of the analysis—i.e., determining whether countries with more overall favorable regimes for FDI are more likely to sign BITs than countries whose investment regimes are less favorable.

The second component variable of my property rights index is a country's level of corruption. Systemic corruption "is a threat to foreign investment" because "it distorts the economic and financial environment...reduces the efficiency of government and business by enabling people to assume positions of power through patronage rather than ability...and introduces an inherent instability in the political process."<sup>159</sup> The ICRG measure captures "financial corruption in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans" which "make it difficult to conduct business effectively, and in some cases may force the withdrawal or withholding of an investment." The corruption variable also attempts to account for more "insidious" forms of corruption, such as "excessive patronage, nepotism, job reservations, 'favors-for-favors,' secret party funding, and suspiciously close ties between politics and business." The corruption variable ranges from a minimum score of 0 to a maximum score of 6, with higher values indicating less corruption.

"In countries where ICRG records high levels of corruption," assert Knack and Keefer, "entrepreneurs [including foreign investors] are...beset by greater uncertainty regarding the credibility of government commitments."<sup>160</sup> However, as suggested in the previous chapter, a society in which corruption is pervasive may produce violations of a foreign investor's property rights irrespective of the preferences of, or any international legal commitments made by, the central government. In other words, corruption is a phenomenon that is to some extent exogenous in relation to a host state's preferences or external commitments. Realizing this, governments that preside over societies lacking strong norms against corruption may rationally forego entering into BITs for fear of leaving themselves vulnerable to extensive arbitral claims

---

<sup>159</sup> PRS Group 2004, 31.

<sup>160</sup> Knack and Keefer 1995, 211.

on the part of aggrieved foreign investors (the capacity hypothesis). Alternatively, governments that are desperate to increase FDI inflows but who confront extensive corruption may be more likely to conclude BITs as a way of overcoming their institutional deficiency. By providing foreign investors with an external mechanism for securing their property rights (i.e., a BIT), these governments may hope to alleviate the fears of investors concerning corruption (the substitution hypothesis).

The third component variable in my property rights index is the ICRG law and order variable which represents an assessment of the strength and impartiality of a country's domestic legal system and popular observance of the law. Like the corruption variable, it ranges from a minimum score of 0 to a maximum score of 6, with higher values indicating a strong rule of law. Like corruption, a country's legal institutions are at least partially exogenous in relation to the preferences or international commitments of its government. Where the rule of law is relatively weak, it cannot be strengthened overnight. Hence, governments that confront a situation in which domestic legal institutions are not strong enough to uphold the property rights of private actors, including foreign investors, may be reluctant to enter into BITs (the capacity hypothesis). Because their country's legal system is less capable of redressing abuses perpetrated by other societal actors against foreign investors, such abuses are more likely to lead to arbitral claims. Of course, BITs are principally designed to prevent abuses perpetrated by host governments themselves. From this perspective, the principal threat to investor rights stemming from a weak rule of law lies in the incapacity of the country's judicial system to constrain the executive. Thus, governments that wish to attract more FDI may conclude BITs as way for compensating for the lack of such legal constraints at the domestic level by establishing similar mechanisms externally through the provision of arbitration (the substitution hypothesis).

Finally, the fourth component variable of my property rights index is the ICRG bureaucracy quality variable. “The strength and quality of the bureaucracy [is] another shock absorber that tends to minimize revisions of policy when governments change.” The bureaucracy quality variable measures the degree to which a country’s bureaucracy possesses “the strength and expertise to govern without drastic changes in policy or interruptions in government services,” the bureaucracy’s insulation from political pressures, and the presence of an “established mechanism for recruitment and training.”<sup>161</sup> Bureaucracies “where corruption is higher or competence is low are less likely to provide a strong bulwark against infringements on property rights.”<sup>162</sup> The bureaucracy quality variable ranges from a minimum score of 0 to a maximum score of 4, with higher values indicating a higher quality bureaucracy.

In addition to the index just described, I employ a second measure of the relative strength of a country’s domestic property rights regime—the quantity of contract-intensive money (CIM) in circulation within a country’s economy—as a robustness check. The CIM measure has been described as an “objective measure of the enforceability of contracts and the security of property rights,” first developed by Clague, Knack, Keefer, and Olson (1996, 1999) and has been used by other scholars to capture the strength of countries’ domestic property rights institutions.<sup>163</sup> The rationale behind this variable is simple: if property rights are secure, then there will be less reliance on hard currency. Countries that rely more on currency tend to have more extensive black markets, an indicator of a weak property rights regime. CIM is essentially “the ratio of non-currency money to the total money supply.”<sup>164</sup>

---

<sup>161</sup> PRS Group 2004, 34.

<sup>162</sup> Knack and Keefer 1995, 211.

<sup>163</sup> See, e.g., Souva, Smith, and Rowan 2008.

<sup>164</sup> Clague et al. 1999, 188. More specifically, CIM is defined as  $(M2-M1)/M2$  where M2 represents the total money supply in the domestic economy and M1 represents currency held outside of the domestic banking system. Data for this variable are derived from the IMF’s *International Financial Statistics* database.

### *Measuring Domestic Political Constraints*

As suggested in chapter 3, governments seeking to liberalize their country's policies toward inward FDI are likely to encounter significant resistance from domestic firms who stand to lose from increased competition from MNCs as well as other organized groups opposed to such policy changes. Under certain conditions, such as those provided by an economic crisis, reform-minded governments may be able to overcome such political opposition and succeed in pushing through significant liberalization of FDI-related policies. However, there is nothing to prevent a future government from overturning these policy changes in response to the demands of opposition groups.<sup>165</sup> Hence, governments that wish to give liberal policies a more permanent basis may attempt to institutionalize such policies by tying them to an international legal commitment, thereby tying the hands of their successors. This incentive to conclude BITs should be stronger in a democratic context in which those groups that oppose liberalization presumably have a greater voice. More precisely, the incentive to enter into a BIT should increase as the number of veto players which a reform-minded government confronts increases and as the degree of preference heterogeneity among these veto players rises.

In order to test this hypothesis, I employ Henisz's (2002) political constraints index (POLCONIII), a popular measure of the number of veto players in a country and the degree of preference heterogeneity among them. Li (2009) offers a justification for the use of this measure: "Although it is difficult...to measure the distribution of preferences toward FDI among...veto players, one may reasonably surmise that the larger the number of veto players in a country, the more likely competing interests over FDI are represented."<sup>166</sup> The POLCONIII index accounts for (1) the number of independent branches of government with veto power over

---

<sup>165</sup> That being said, liberal investment policies may create their own constituency among the beneficiaries of FDI (e.g., those employed by foreign firms), thereby creating a counter-balance to the demands of protectionist groups.

<sup>166</sup> Li 2009, 11.

policy change (including the executive branch and the upper and lower legislative chambers), (2) the degree of alignment across branches of government based on the party composition of each branch, and (3) the degree of preference heterogeneity within each legislative chamber. Given my hypothesis regarding the relationship between domestic political constraints and the incentives of liberalizing governments to sign BITs, I expect the POLCONIII index to have a positive effect on the likelihood that a country enters into a BIT.

*Additional Hypotheses: The Effects of Partisanship and Societal Conflict*

In addition to the four hypotheses developed in chapter 3, I also consider two additional hypotheses which can be derived from the same logic of credibility and capacity from which the former set of hypotheses were derived. First, what is the relationship between a government's partisanship and its propensity to conclude BITs? Because of the "left's historical attachment to the ideas of dependency," suggest Keele and Yackee (2008), leftist governments may "be more sensitive than rightist governments to" the potential costs associated with both "greater FDI inflows" as well as liberal policies intended to promote increased FDI inflows. These include "political costs" such as "the perception that foreign companies are exercising undue control over symbolically or economically important sectors of the domestic economy" as well as the "sovereignty costs" associated with liberal investment policies which "unduly limit the state's ability to regulate the domestic economy."<sup>167</sup> As a result, leftist governments may exhibit a significantly greater reluctance to enter into BITs than their rightist counterparts.

Despite the left's traditional suspicion of FDI, as Keele and Yackee note, the 1990s witnessed an apparent convergence in economic thinking among elites within the developing world. This ideational convergence toward the so-called "Washington Consensus" resulted in a

---

<sup>167</sup> Keele and Yackee 2008, 10.

policy convergence among countries which arguably transcended traditional partisan divisions. Thus, both right-wing and left-wing governments adopted liberal economic policies during this period, including policies lifting restrictions on FDI. Given the left's traditional suspicion of, and in many cases, outright hostility toward FDI, leftist governments which seek to attract increased FDI inflows may suffer from a credibility problem. Any liberal policy reforms which these governments adopt may not be viewed as credible by foreign investors. Therefore, left-wing governments may feel compelled to enter into BITs as a way of compensating for their inherent lack of credibility by making a costly commitment to a liberal policy stance, thereby signaling their true policy preferences to uncertain investors. If this were true, then we would expect left-leaning governments to exhibit a greater propensity to conclude BITs than rightist or centrist governments.

In order to test these competing hypotheses regarding the relationship between a government's partisanship and its willingness to sign BITs, I include a dichotomous variable, which is coded as 1 if the chief executive's party is leftist, 0 otherwise. Data for this variable come from the World Bank's Database of Political Institutions (DPI).

Second, what is the relationship between the degree of internal conflict within a country and its propensity to conclude BITs? Countries that are experiencing a high level of societal conflict (e.g., a civil war) may be deterred from entering into BITs for fear of experiencing significantly higher compliance costs as a result of such conflict. Many BITs include provisions which explicitly specify that foreign investors which experience significant property losses resulting from riots, rebellions, or other forms of civil conflict must be compensated for those losses by the host state.<sup>168</sup> Therefore, the governments of countries where societal conflict is

---

<sup>168</sup> Consider the following clause from a BIT concluded between the United Kingdom and India, article 6, section 1 of which states: "Investors of one Contracting Party whose investments in the territory of the other Contracting

endemic (and perhaps shows no sign of dissipating in the short term) may be deterred from formally committing themselves to an international regime that requires them to compensate foreign investors for property losses resulting from events that are both beyond these governments' control and for which there is a high probability of occurrence. Furthermore, countries which suffer from pervasive civil conflict are not likely to receive much FDI in the first place, obviating the need for BITs. Moreover, such countries are probably unattractive BIT partners from the perspective of home country governments.

In order to capture the effects of societal conflict on a government's propensity to enter into BITs, I include a measure of such conflict from the Major Episodes of Political Violence (MEPV) dataset compiled by Marshall.<sup>169</sup> This variable combines magnitude scores for four forms of societal conflict, including civil violence, civil war, ethnic violence, and ethnic war.<sup>170</sup> Higher values indicate greater societal conflict. I expect this variable to have a negative effect on the likelihood that a country signs or ratifies a BIT in keeping with a compliance-based understanding of BIT signings in which expectations regarding the capacity to comply influence a government's decision to commit in the first place.

### *Control Variables*

The only existing empirical studies of the factors which influence the decision of LDCs to conclude BITs are those conducted by Swenson (2005) and Elkins, Guzman, and Simmons

---

Party suffer losses owing to war or other armed conflict, a state of national emergency or civil disturbances in the territory of the latter Contracting Party shall be accorded by the later Contracting Party treatment, as regards restitution, indemnification, compensation or other settlement, no less favorable than that which the latter Contracting Party accords to its own investors or to investors of any third State."

<sup>169</sup> See Marshall 2002. The MEPV dataset can be downloaded from the Center for Systemic Peace's (CSP) Integrated Network for Societal Conflict Research (INSCR) Data Page:

<http://www.systemicpeace.org/inscr/inscr.htm>.

<sup>170</sup> The specific variable name is CIVTOT and is equal to the sum of the following MEPV variables: CIVVIOL, CIVWAR, ETHVIOL, and ETHWAR. Magnitude scores for each of these variables range from 1 to 10, with higher values indicating greater conflict.



(2006, hereafter referred to as EGS). The analysis presented in this chapter largely replicates the latter of these two studies. Like EGS, I regard the formation of BITs as a largely host-driven process in which LDCs are usually the ones who initiate BIT negotiations rather than capital-exporting states. Both the pattern of BIT signings and the observed content of BITs are consistent with the “notion that home countries make take-it-or-leave-it offers to potential hosts and that hosts eventually decide to sign BITs.”<sup>171</sup> This kind of pattern is also consistent with the liberalization hypothesis developed in chapter 3 in which a state’s decision to enter into a BIT follows or coincides with a decision to liberalize its policies toward FDI. Hence, the majority of control variables included in both the EGS model, and therefore my own model, are intended to capture host country considerations, though certain source country, dyadic, and systemic-level factors are also controlled for. A discussion of each specific control variable included in my analysis, most of which are taken directly from the event history dataset used in the study by EGS, follows.<sup>172</sup>

---

<sup>171</sup> Elkins, Guzman, and Simmons. 2006, 822. The EGS study provides both graphical and statistical evidence of concerted, programmatic BIT activity on the part of LDCs (i.e., a pattern of clustered BIT signings).

<sup>172</sup> The EGS dataset can be accessed at the homepage of Zachary Elkins: <https://netfiles.uiuc.edu/zelkins/www/research.html>. The empirical analysis reported here is not an exact replication of the analysis in EGS. First, the time period for my analysis (1985-2000) is significantly shorter than that of the EGS study (1959-2000) because data for my key explanatory variable, the ICRG index, do not begin until 1984, and I have elected not to interpolate the data in order to fill in the missing values. However, a more important reason for limiting the analysis time period is that not all BITs contain binding or enforceable commitments to investor-state arbitration, particularly the earliest BITs. The first BIT to include a prior consent to such arbitration on the part of the host state does not occur until 1969. It is only since the 1980s that BITs have consistently provided arbitration as an effective enforcement mechanism. See Yackee 2007a. This also provides a robustness check against the findings of the EGS study by demonstrating whether or not those findings are dependent on the length of the time-period being analyzed. Second, I also include some additional variables in my model which EGS do not consider. Including or dropping these variables from the model does not dramatically alter any of the statistical findings or substantive conclusions reached. Finally, whereas EGS include the ICRG law and order and corruption measures as separate variables in the same regression, my own model consolidates these two variables into my index measure of the strength of a country’s investment regime.

### *FDI Flows and Host Country Attractiveness*

Scholars disagree over the causal relationship between BITs and FDI. While many scholars argue that BITs should have a positive impact on the amount of FDI inflows a country receives and have found empirical evidence to support this hypothesis,<sup>173</sup> other researchers have suggested that these findings are spurious, and that in fact, an increased level of FDI inflows may lead countries to conclude BITs.<sup>174</sup> Thus, the relationship between BITs and FDI flows suffers from a serious endogeneity problem. It is worth pausing to give this issue further consideration.

On the one hand, the governments of countries that are receiving significant amounts of FDI may not feel the need to tie their hands with BITs. If these countries are fairly successful at attracting FDI without making any kind of formal international commitment to the rights of foreign investors, then why pay the sovereignty costs associated with such commitments? On the other hand, the governments of countries that are recipients of large amounts of FDI may confront greater pressures from home states to enter into a BIT. In other words, home states may apply extra pressure to those countries in which their own nationals are heavily invested. This would seem to be the logic behind EGS's decision to include a country's net FDI inflows (as a percentage of GDP) in their model of BIT signings. They describe this variable as "a rather direct measure" of a country's attractiveness to foreign capital, and therefore, its attractiveness as a potential BIT partner from the perspective of home governments. Conversely, home governments may have little interest in concluding BITs with the governments of countries which receive little or no FDI due to various structural factors (e.g., a small domestic market). Furthermore, the governments of these inherently "unattractive" countries may not feel much of

---

<sup>173</sup> See, e.g., Salacuse and Sullivan 2005, Bütte and Milner 2005, and Neumayer and Spess 2005.

<sup>174</sup> See, e.g., Swenson 2005 and Aisbett 2007.

an incentive to tie their own hands with a BIT since they are unlikely to receive much FDI in the first place.

Following the lead of EGS, I include a host country's net inflows of FDI as a percentage of GDP in my own model.<sup>175</sup> This variable represents a measure of how important FDI is to, as well as the degree to which it has penetrated, a host country's overall economy, making it an ideal candidate for capturing the kinds of home country pressures described above. However, the relationship between this variable and the formation of BITs is statistically insignificant in EGS's own model. Although it is lagged by one period (as are all of the explanatory variables in the EGS study), this variable is probably incapable of solving the endogeneity problem described above. Regardless, I leave it unchanged since my primary purpose is to replicate the EGS model.<sup>176</sup>

There are a number of factors which make countries more or less attractive destinations for FDI. These include the size of a country's domestic market (measured as the log of its GDP), its level of economic development (measured by the log of its per capita GDP), its rate of economic growth (measured by the annual percentage change in its GDP), and the quality of its workforce (as measured by the country's illiteracy rate).<sup>177</sup> To the extent that these variables determine a country's degree of attractiveness as a potential site for investment, we might expect

---

<sup>175</sup> Data for this variable are taken from the WDI database.

<sup>176</sup> There are a variety of ways to measure the amount of FDI a country receives in a given year or plays host to over time. In order to capture the potential effects of source country pressures as well as the overall relationship between FDI and BIT signings, one might include the stock of FDI (measured in millions of current US dollars), a cumulative measure of the total amount of FDI which a country plays host to over time. Regressions which included this variable suggested that the amount of FDI a country plays host to actually has a negative effect on the likelihood of it signing a BIT. This result was statistically significant, though its substantive significance was uncertain. Besides FDI stocks, the absolute amount of FDI inflows (usually measured in millions of US dollars; sometimes logged) would seem to be useful for assessing the relationship between FDI and BIT signings. It is also worth noting that bilateral data on FDI stocks and flows are obviously the most appropriate type of data with which to test the hypothesis regarding home/source countries. That is, as a home/source country's level of investment in a particular host country increases, the greater is its incentive to conclude a BIT with that country in order to protect its investors. However, bilateral data is notoriously spotty. Therefore, as a first cut at the relationship between FDI flows and BIT signings, I employ an aggregate measure in my own analysis as do EGS in theirs.

<sup>177</sup> Data for all four of these variables are taken from the WDI database.

each of them to have a *negative* effect on a country's propensity to conclude BITs. Insofar as larger, richer, economically growing countries with high quality workforces are more attractive sites for FDI, these countries conceivably have less of a need to commit themselves to the international regime for investor rights because they are presumably already the recipients of a large amount of FDI. Conversely, small and/or poor countries with minuscule or even negative growth rates and low quality workforces may be so desperate for foreign capital that they are more than willing to sign away their regulatory sovereignty over such capital. In short, countries which possess characteristics which already make them attractive destinations for FDI, will feel less compelled to enter into BITs precisely because they are already likely to be the recipients of a large amount of FDI, whereas countries which lack these characteristics will feel a greater need to compensate by surrendering their sovereignty over FDI in the hopes of attracting more of it.

However, it might be the case that these variables have a positive impact on a country's propensity to conclude BITs. It is precisely large, relatively rich, and economically dynamic countries among which the competition to attract FDI may be most intense, and among which the kind of competitive BIT signings hypothesized by EGS may occur. Because small, relatively poor, economically stagnant countries with low quality workforces are not likely to receive much FDI to begin with, these countries may have less of an incentive to tie their hands with BITs. Also, it is precisely large, rich, growing countries which may be the most attractive BIT partners from the perspective of home country governments, and thus subject to greater pressures from these countries to conclude BITs as hypothesized by EGS.

Thus, the relationship between a country's attractiveness to FDI (as captured by the amount of FDI inflows it receives, its market size, level of economic development, economic growth, and the quality of its workforce) is theoretically indeterminate. On the one hand, the

more attractive a country is, the less need it has to enter into BITs as a way of promoting FDI. On the other hand, because more attractive countries are also more likely to play host to a large amount FDI, they also represent more attractive BIT partners for home countries, and may therefore be subject to greater pressures from the governments of these countries. Yet, their inherent attractiveness to foreign investors presumably gives them enough bargaining leverage to resist such pressures. Therefore, I expect inherently attractive host countries to be less likely to sign BITs.

### *Competing for Capital*

EGS argue that BITs are devices which allow LDC governments to credibly commit themselves to respect the property rights of foreign investors. BITs, therefore, represent one of a variety of policy options (e.g., tax incentives) which LDCs can adopt in order to increase their attractiveness as a destination for FDI. BITs give their signatories “a ‘reputational advantage’ over otherwise comparable rivals in the competition for” FDI flows. “It is the ability of a BIT—or at a minimum, its perceived ability—to give one country an advantage over other similarly situated countries in the competition for capital” which causes LDCs to sign BITs and which explains the diffusion of BITs over time suggest EGS. They derive three specific hypotheses from this “competitive” account of BITs.

First, EGS argue that as the pool of global FDI has increased, potential host countries have become more willing to enter into BITs because the competitive struggle to increase one’s share of this investment has intensified. The results of their study confirm this interpretation: as average annual net inflows of FDI (measured as a percentage of GDP) increase, the propensity of LDCs to sign BITs also increases. I therefore include this variable in my own model.

Second, BITs should diffuse among countries that are close competitors for FDI—“countries that, from an investor’s point of view, are closely substitutable venues for investment.”<sup>178</sup> EGS develop three alternative measures of the “competitive distance” between host countries. The basic idea behind these variables is that countries feel compelled to sign BITs when their closest competitors or rivals do so. The variables used to identify competitors include: (1) similarity of export markets, (2) similarity of export products, and (3) similarity of infrastructure. Employing data related to each of these variables, EGS construct spatial lags which capture the effects of BIT signings by a country’s competitors on its own decision to sign BITs.<sup>179</sup> They find that each of these three measures of competitive pressures has a positive impact on the likelihood that a BIT is formed amongst a particular dyad. In other words, the results of their analysis suggest that host countries are more likely to sign a BIT with a particular source country when their closest competitors (in terms of export market, export product, and/or infrastructure similarity) have done so. In order to control for the effects of such competitive pressures, I include one of these competition variables in my own model.<sup>180</sup>

Finally, EGS argue that competition for FDI is likely to be most intense among countries competing for manufacturing FDI. Countries endowed with an abundance of natural resources or which depend primarily upon extractive industries will be less subject to the pressures associated with international competition for manufacturing FDI and will therefore be less likely to sign BITs. Congruent with this logic, EGS find that the degree to which a country depends on

---

<sup>178</sup> Elkins, Guzman, and Simmons 2006, 825-6.

<sup>179</sup> As they explain, spatial lag models “treat spatial dependence in the same way time-series models treat serial correlation.” “Instead of lagging the value of the dependent variable one unit in time...one ‘lags’ it one (or more) units in space to capture the behavior of neighbors” or competitors. For a more detailed explanation of how these variables were constructed, see Elkins, Guzman, and Simmons 2006, 829-31. For an introduction to spatial econometrics as a way of modeling policy diffusion processes, see Anselin 1988 and Beck, Gleditsch, and Beardsley 2006.

<sup>180</sup> Following EGS, I only include one of these three competition variables in my own model at a time. Therefore, I run three different versions of my model, one for each of the three competition variables.

extractive industries has a negative and significant effect on a country's propensity to sign BITs. Their measure of extractive industry dependence is constructed by summing the share of a country's exports accounted for by fuel, ores, and metals.<sup>181</sup> I include this variable in my own model.

One factor which EGS do not consider, but which their competition story implies should affect a country's propensity to conclude BITs, is the systemic density of BITs—i.e., the total, cumulative number of BITs worldwide between capital-exporting countries and LDCs. If governments regard BITs as a device through which they can gain a competitive edge over other countries in their quest to attract more FDI, then the incentive to enter into BITs should be greatest when the number of existing BITs is relatively low. This incentive should gradually decline as the total number of BITs in the international system rises, thereby presumably diminishing the effectiveness of BITs as a mechanism for stimulating FDI inflows. In other words, once all countries have entered into BITs, the value of such agreements as a device for distinguishing one country from another should decline. Therefore, I include the total, cumulative number of enforceable BITs in the international system in my model of BIT signings.

#### *Home Country and Dyadic-Level Factors*

Many of the variables described thus far are intended to account for differences in the “demand” for BITs among LDCs. However, we must also control for the “supply-side” of BITs by including a variable which accounts for differences among source countries. Obviously, countries which have a larger amount of capital invested abroad will have a greater interest in concluding BITs with the countries that play host to this investment. Therefore, both the EGS study and my own analysis control for the total FDI exposure of source countries—that is, the

---

<sup>181</sup> Data for this variable are taken from the World Bank's *World Development Indicators* (WDI) database.

degree to which a source country's capital is actually invested abroad—as measured by net FDI outflows as a percentage of the source country's GDP.<sup>182</sup> In their own analysis, EGS find that BITs are significantly more likely to be concluded with those source countries whose net FDI outflows are relatively large.

Following EGS, I also control for three dyadic-level variables: trade, cultural distance, and alliances. First, firms “are likely to want to invest in or near their export markets and to otherwise take advantage of vertical downstream linkages,” suggest EGS.<sup>183</sup> Following them, I control for the intensity of business transactions between the countries in a particular dyad, as indicated by the extent of trade between them, measured as a percentage of the host country's GDP. However, the findings of EGS suggest that this variable is not significantly related to the formation of BITs.

Second, the degree of cultural similarity between potential BIT partners may affect the likelihood of a BIT being formed amongst a particular dyad. “On the one hand,” note EGS, “it may be easier for states with cultural similarities to negotiate successfully. On the other hand, if cultural similarities also reduce the perceived risks of investment, a common culture might operate in the opposite direction, reducing the need for a BIT” from the perspective of the home country.<sup>184</sup> In order to capture the effects of the degree of cultural similarity that characterizes a dyad, I include a dichotomous variable indicating whether the countries in a particular dyad share a common language.

Finally, it is possible that BITs may have a foreign policy or security rationale. Regardless of whether or not this is true, BITs may be more likely to be concluded among allies.

---

<sup>182</sup> Data for this variable are taken from the WDI database.

<sup>183</sup> Elkins, Guzman, and Simmons 2006, 836.

<sup>184</sup> Ibid.



I therefore include a variable which measures the intensity of the alliance relationship which characterizes a dyad.<sup>185</sup>

### *Alternative Diffusion Mechanisms*

EGS consider a number of alternative mechanisms other than global competition through which BITs may have diffused among LDCs. One such mechanism is coercion. As they explain, potential hosts may be “coerced or at least strongly encouraged to enter into BITs. If so, a likely juncture for the application of such pressure is at the time a country seeks International Monetary Fund (IMF) credits.”<sup>186</sup> A dichotomous variable indicating whether or not a country has drawn on IMF resources in a given year is shown to have a positive effect on the likelihood that a country signs a BIT in the analysis conducted by EGS. I therefore include this variable in my own analysis.<sup>187</sup>

Another possible explanation for the diffusion of BITs is that countries have derived important “lessons” from the experiences of their peers, specifically those which have entered into BITs. Thus, states may be motivated to conclude BITs because of their demonstrative benefits—namely, their capacity to stimulate increased inflows of FDI. In other words, policymakers are capable of assessing the success of BITs in attracting FDI. In an effort to “replicate this cognitive process,” EGS carry out a series of simple regressions. For each year for which data on FDI flows is available, the average FDI inflows as a percentage of a country’s GDP for the previous five years is regressed on the average number of BITs in force for that country during the same period as well as its average GDP per capita. The standardized

---

<sup>185</sup> Data for this variable are derived from the Correlates of War (COW) database.

<sup>186</sup> Elkins, Guzman, and Simmons 2006, 833. While EGS do not believe that entry into BITs is an “explicitly stipulated,” formal condition of IMF loans, they suggest that “there may be more subtle pressures on a state in balance-of-payments difficulties to use these treaties to attract foreign capital.”

<sup>187</sup> Data for this variable are taken from the WDI database.

regression coefficient for the BITs variable in each of these yearly equations is taken to be the indicator by which LDC policymakers judge the “success” of BITs in stimulating increased FDI inflows. EGS “assume that each year decision makers observe and draw conclusions about the effects of BITs on investment, controlling for a country’s level of development, and that all actors observe the same signal.”<sup>188</sup> The results of their analysis suggests that countries are significantly more likely to sign BITs during years in which states that have already signed BITs appear to be benefiting from such treaties in terms of increased FDI inflows (as indicated by the regression coefficient for BITs for that year) than when they are not.

Finally, besides competition, coercion, and learning, one last causal mechanism through which BITs may have diffused among LDCs which EGS consider is cultural emulation. The idea behind this mechanism is that countries are more likely to adopt certain policies (such as concluding BITs) when their cultural peers have done so. EGS again develop three different measures of the “cultural distance” between countries and use these measures to construct spatial lags similar to those which they develop to capture the effects of competition (discussed above). I include one of these variables in my own analysis—the conclusion of BITs by countries which share the same predominant religion as a potential host country.<sup>189</sup>

### *Additional Controls*

In addition to the variables discussed thus far, EGS control for a number of other host country and systemic-level factors. First, EGS’s analysis suggests that countries that have an export orientation, as evidenced by a current account surplus, are significantly more likely to conclude BITs, but they offer little in the way of a theoretical rationale for this conclusion.

---

<sup>188</sup> Elkins, Guzman, and Simmons 2006, 833.

<sup>189</sup> This is the only measure of cultural emulation included in the replication dataset provided on Elkins’ website. See note .

However, presumably such countries are seeking to attract export-oriented FDI and see BITs as a way of enhancing their attractiveness as a potential export platform for MNCs. Therefore, following EGS, I include the value of a country's current account as a percentage of its GDP in my model.<sup>190</sup>

Second, it is possible, suggest EGS, that the pattern of BIT signings is driven by a few countries' aggressive privatization programs. However, they did not offer any kind of theoretical rationale beyond this statement. Presumably, BITs are likely to coincide with privatization programs because those states which are undertaking such programs are trying to entice foreign investors to purchase newly privatized assets by enhancing the credibility of their commitment to the property rights of prospective investors. Regardless, EGS include the value of privatized assets in a country in a given year in their model and find that it has a statistically significant effect on the likelihood of a BIT being formed among two countries. Therefore, I include this variable in my own model.

Third, the conclusion of BITs, note EGS, "requires a certain degree of diplomatic capacity." A country "with extensive diplomatic representation is more likely to have the international political and legal capacity to conclude a larger volume of treaties."<sup>191</sup> Thus, I control for the total number of embassies a country has established in other countries and plays host to.

Fourth, some research, note EGS, "suggests that common law systems tend to provide better property rights protections" whereas "civil law systems are more likely...to implement regulatory solutions to perceived social conflict—arguably, the kind of approach likely to make

---

<sup>190</sup> In the actual published version of the EGS study, this variable is labeled as a country's capital account as a percentage of GDP. However, having contacted Elkins with questions regarding this variable, he revealed that this was a typo.

<sup>191</sup> Elkins, Guzman, and Simmons 2006, 835.

external capital flinch. If civil law systems are less oriented toward credible rules of capital protection, governments in those systems should more frequently reach for an external commitment mechanism, such as a BIT.” However, the results of their analysis contradict this expectation: common law countries would appear to be more likely to refrain from entering into BITs, perhaps reflecting a negative “orientation toward international treaties of all kinds,” as speculated by EGS.<sup>192</sup> Regardless, for the purposes of replicating the EGS study, I include an indicator of whether or not a country has an English common law tradition.

Fifth, some countries may have refrained from signing BITs during the Cold War. This was certainly the case with many Eastern European countries and former Soviet republics. EGS find that the propensity to sign BITs is significantly lower during the Cold War era. I therefore include a dummy variable for the Cold War period in my own model to capture the effects of this systemic-level factor.

Lastly, EGS also include a simple count variable which measures the number of BITs signed in a given year. This is intended to capture any “temporal clustering” or “period effects.” This systemic-level variable is never statistically significant in any of EGS’s reported models, but I include it in my own model for the purposes of replication. Table 4.2 provides a summary of the explanatory variables included in my model of BIT signings, including the effect which each variable is expected to have on the likelihood of a BIT being formed amongst a given dyad. Table 4.3 provides summary statistics for each variable.

---

<sup>192</sup> Along these same lines, Simmons (forthcoming) finds that common law countries are much less likely to sign human rights treaties.

Table 4.2 Explanatory Variables and Expectations

Variable	Measures	Expected Effect	Data Source
Investment Regime	ICRG Index / CIM	Positive	PRS Group / IMF International Financial Statistics
Political Constraints	POLCON III	Positive	Henisz (2002)
Partisanship	Left Executive	Indeterminate	World Bank Database of Political Institutions
Societal Conflict	Magnitude of civil & ethnic violence/war	Negative	Marshall (2002)
Inward FDI	Net FDI Inflows (% GDP)	Indeterminate	World Development Indicators (WDI)
Host Market Size	GDP (Ln)	Indeterminate	WDI
Host Economic Development Level	GDP per capita (Ln)	Indeterminate	WDI
Host Economic Growth	GDP Growth Rate	Indeterminate	WDI
Host Workforce Quality	Illiteracy Rate	Indeterminate	WDI
Home Country FDI Exposure	Net FDI Outflows (% GDP)	Positive	WDI
Global FDI Flows	Average Annual Net FDI Inflows (% GDP)	Positive	WDI
Competition (BITs Among Competitors)	Spatial Lags (Based on Export Market, Export Product, & Infrastructure Similarity)	Positive	Elkins, Guzman, & Simmons (2006)
Host Dependence on Extractive Industries	Fuel, Minerals, & Ores Export Share	Negative	WDI
Systemic BIT Density	Total Number of BITs in Force Worldwide	Negative	UNCTAD
Trade	Dyadic Trade (% Host GDP)	Positive	IMF Direction of Trade Statistics / WDI
Cultural Similarity	Common Language Dummy	Positive	
Alliance	Alliance Dummy	Positive	Correlates of War
Subtle Coercion	Host Use of IMF Credits	Positive	WDI
Learning from Success	See Text	Positive	EGS (2006)
Cultural Emulation	BITs Among Countries with Same Religion (Spatial Lag)	Positive	EGS (2006)
Host Export Orientation	Current Account (% GDP)	Positive	WDI

Host Privatization Record	Value of Privatized Assets	Positive	EGS (2006)
Host Diplomatic Representation	Number of Embassies	Positive	EGS (2006)
Host Legal Tradition	Common Law Dummy	Indeterminate	EGS (2006)
Cold War	Cold War Dummy	Negative	
Period Effects	Total Number of BITs Per Year	Positive	UNCTAD

Table 4.3 Descriptive Statistics<sup>193</sup>

<b>Variable</b>	<b>Mean</b>	<b>Standard Deviation</b>	<b>Minimum</b>	<b>Maximum</b>
ICRG Index	13.48	4.15	0.75	25
Investment Profile (ICRG)	5.73	1.94	0	11
Law & Order (ICRG)	3.12	1.34	0	6
Corruption (ICRG)	2.89	1.11	0	6
Bureaucracy Quality (ICRG)	1.73	1.03	0	4
CIM	0.72	0.17	0	0.99
POLCON III	0.13	0.19	0	0.69
Societal Conflict (MEPV)	0.85	1.87	0	11
Net FDI Inflows (% GDP)	1.29	3.52	0	145.13
GDP (Ln)	22.68	2.28	17.33	29.79
GDP Per Capita (Ln)	3.90	6.77	0	52.71
GDP Growth Rate	3.36	2.67	-7.28	13.06
Illiteracy Rate	0.34	0.28	0	0.99

<sup>193</sup> Dummy variables not shown.

Net FDI Outflows (% GDP)	0.82	1.98	-7.35	14.65
Average Annual Net FDI Inflows (% GDP)	1.12	1.29	-1.17	3.90
BITs Among Export Market Competitors	2.55	3.60	0	36.57
BITs Among Export Product Competitors	3.38	4.01	0	19.20
BITs Among Infrastructure Competitors	3.24	3.93	0.03	18.21
Fuel, Minerals, & Ores Export Share	0.24	0.29	0	1
Total Number of BITs in Force Worldwide	301.99	297.79	2	1021
Dyadic Trade (% Host GDP)	0.01	0.05	0	3.05
Learning from Success	-0.13	0.22	-0.59	0.17
BITs Among Countries with Same Religion	2.47	3.40	0	32
Current Account (% GDP)	-3.63	7.36	-120.60	58.56
Value of Privatized Assets	0.18	0.80	0	14.8
Number of Embassies	43.39	34.85	0	158
Total Number of BITs Per Year	4.05	4.96	0	17.72

### *The Model*

I begin by estimating a simplified model which includes only those variables whose effects on BITs signings I am primarily interested in gauging. I then include additional control

variables in order to check the robustness of these relationships. The equation for the full model is:

$$\begin{aligned}
Y_{ijt} = & \beta_1 * \text{ICRG index}_{i, t-1} + \beta_2 * \text{POLCONIII index}_{i, t-1} + \beta_3 * \text{Left executive}_{i, t} + \\
& \beta_4 * \text{Societal conflict}_{i, t-1} + \beta_5 * \text{Net FDI inflows/GDP}_{i, t-1} + \beta_6 * \text{Ln(Host GDP)}_{i, t-1} + \\
& \beta_7 * \text{Ln(Host per capita GDP)}_{i, t-1} + \beta_8 * \text{Host GDP growth}_{i, t-1} + \\
& \beta_9 * \text{Host illiteracy rate}_{i, t-1} + \beta_{10} * \text{Source FDI outflows/GDP}_{j, t-1} + \\
& \beta_{11} * \text{Global FDI Flows}_{t-1} + \beta_{12} * \text{BITs among competitors}_{t-1} + \\
& \beta_{13} * \text{Host fuels \& minerals/exports}_{i, t-1} + \beta_{14} * \text{Total BITs Worldwide}_{t-1} + \\
& \beta_{15} * \text{Dyadic Trade/GDP}_{ij, t-1} + \beta_{16} * \text{Common language}_{ij, t-1} + \beta_{17} * \text{Alliance}_{ij, t-1} + \\
& \beta_{18} * \text{Host use of IMF credits}_{i, t-1} + \beta_{19} * \text{Learning from success}_{t-1} + \\
& \beta_{20} * \text{BITs among religious peers}_{t-1} + \beta_{21} * \text{Host current account/GDP}_{i, t-1} + \\
& \beta_{22} * \text{Price of host privatized assets}_{i, t-1} + \beta_{23} * \text{Host diplomatic representation}_{i, t-1} + \\
& \beta_{24} * \text{Host legal tradition}_{i, t-1} + \beta_{25} * \text{Cold War}_t + \beta_{26} * \text{Number of BITs Signed Globally}_t \\
& + \varepsilon_{ij}
\end{aligned}$$

where  $Y_{ijt}$  is the number of years until a BIT is formed between countries  $i$  (the host) and  $j$  (the source). This equation is estimated using a Cox proportional hazard model, an appropriate estimator in the absence of strong assumptions regarding the effect of time on the baseline hazard.

## RESULTS OF THE ANALYSIS

The results of my analysis are presented in Table 4.4. The parameters derived from these estimations are hazard ratios. A hazard ratio of more than 1 represents a positive effect of some independent variable on the odds of two countries signing a BIT, while a ratio of less than 1



Table 4.4 Cox Proportional Hazard Model of BIT Signings

Explanatory Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
<b>DOMESTIC SOURCES OF COMMITMENT</b>						
Investment Regime (ICRG Index)	1.10*** (0.01)	1.16*** (0.02)	1.16*** (0.02)	1.06*** (0.02)	1.06*** (0.02)	1.06*** (0.02)
Political Constraints (POLCON III)	2.35*** (0.49)	0.95 (0.21)	1.00 (0.24)	1.03 (0.29)	1.03 (0.28)	1.01 (0.28)
Partisanship (Left Executive)	1.42*** (0.12)	1.20** (0.12)	1.18* (0.12)	1.21* (0.14)	1.23* (0.14)	1.23* (0.14)
Societal Conflict	1.00 (0.02)	0.95* (0.03)	0.95** (0.03)	0.93*** (0.03)	0.93*** (0.03)	0.93*** (0.03)
<b>HOST ATTRACTIVENESS</b>						
Net FDI Inflows (% GDP)		0.97 (0.02)	0.98 (0.02)	0.99 (0.02)	0.99 (0.02)	0.99 (0.02)
Market Size (GDP (Ln))		1.30*** (0.04)	1.29*** (0.04)	0.91 (0.06)	0.90* (0.05)	0.90* (0.05)
Economic Development (GDP Per Capita (Ln))		0.92*** (0.02)	0.93*** (0.02)	0.93*** (0.02)	0.93*** (0.02)	0.93*** (0.02)
GDP Growth		0.89*** (0.02)	0.89*** (0.02)	0.91*** (0.02)	0.91*** (0.02)	0.91*** (0.02)
Workforce Quality (Illiteracy Rate)		0.11*** (0.03)	0.16*** (0.05)	0.11*** (0.04)	0.11*** (0.04)	0.10*** (0.04)
<b>HOME COUNTRY NET FDI OUTFLOWS (% GDP)</b>		1.14*** (0.02)	1.16*** (0.02)	1.19*** (0.02)	1.19*** (0.02)	1.19*** (0.02)
<b>COMPETITION</b>						
Average Annual Global FDI Flows			1.11 (0.27)	1.73* (0.54)	1.75* (0.54)	1.77* (0.54)
BITs Among Export Market Competitors			1.06*** (0.02)	1.00 (0.02)		
BITs Among Export Product Competitors					0.97 (0.07)	
BITs Among Infrastructure Competitors						0.98 (0.06)
Host Extractive Industries (% Exports)			0.72* (0.13)	0.59*** (0.12)	0.59*** (0.12)	0.59*** (0.12)
Total BITs in Force Worldwide			0.99 (0.00)	1.01** (0.00)	1.01*** (0.00)	1.01*** (0.00)

**DYADIC-LEVEL FACTORS**

Trade (% Host GDP)	0.87 (0.35)	0.88 (0.36)	0.88 (0.36)
Common Language	2.17*** (0.40)	2.14*** (0.40)	2.14*** (0.39)
Alliance	1.73*** (0.34)	1.70*** (0.33)	1.70*** (0.33)

**ALTERNATIVE DIFFUSION MECHANISMS**

Coercion (Host Use of IMF Credits)	1.36*** (0.18)	1.39*** (0.18)	1.38*** (0.18)
Learning from Success	0.71 (1.14)	0.69 (1.12)	0.65 (1.05)
BITs Among Those with Same Religion	0.98 (0.02)	0.98 (0.02)	0.98 (0.02)

**ADDITIONAL CONTROLS**

Host Export Orientation (Current Account % GDP)				1.03*** (0.01)	1.03*** (0.01)	1.03*** (0.01)
Host Privatization Record				1.06* (0.03)	1.06* (0.03)	1.06* (0.03)
Host Diplomatic Representation (Embassies)				1.02*** (0.00)	1.02*** (0.00)	1.02*** (0.00)
Host Legal Tradition (Common Law)				0.50*** (0.06)	0.51*** (0.07)	0.51*** (0.07)
Cold War				1.11 (0.59)	1.16 (0.62)	1.16 (0.62)
Period Effects (Total BITs Per Year)				0.51*** (0.09)	0.51*** (0.09)	0.51*** (0.09)
Observations	29,521	24,806	24,198	22,495	22,730	22,730
Number of Dyads	2,270	1,919	1,865	1,718	1,738	1,738
Number of BITs	592	520	508	450	458	458
Log-likelihood	-4171.543	-3473.990	-3371.773	-2895.157	-2954.884	-2954.883

Notes: estimates are hazard ratios; standard errors in parentheses.

\*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%.

indicates a negative effect.<sup>194</sup> I estimated six different specifications. Model 1 includes only those variables of primary interest—(1) the host country’s investment regime (as captured by the ICRG index described above), (2) the degree of political constraints which the host government faces, (3) the partisan orientation of the host government, and (4) the magnitude of societal conflict within the host country. Model 2 includes all four of these variables plus those which determine a host country’s relative attractiveness as a destination for FDI as well as the home country’s relative importance as a source of FDI. Model 3 adds those variables intended to capture the effects of FDI-related competition among LDCs. Finally, models 4, 5, and 6 represent three different versions of the full model containing all of the control variables described in the previous section, one for each of the three measures of competitive BIT signings developed by EGS.

My main explanatory variable of interest, the ICRG index, is statistically significant at the 1% level in all six specifications. The hazard ratio of 1.06 for this variable in models 4, 5, and 6 suggests that countries with relatively favorable regulatory regimes for FDI, including liberal FDI policies and comparatively stronger domestic property rights institutions, are significantly more likely to conclude BITs than are countries with less than favorable investment regimes (i.e., illiberal policies and/or weak property rights institutions). More specifically, for every additional one point increase in a country’s score on the ICRG index, its risk of signing a BIT increases by 6%. A one standard deviation increase in a country’s score on the ICRG index results in a 25% increase in the risk that it enters into a BIT. This finding is consistent with what I have referred to as the liberalization hypothesis, which suggests that BITs function as a screening mechanism, distinguishing countries with liberal policy preferences toward FDI from

---

<sup>194</sup> This analysis was performed using Stata 8.0. Diagnostic examination of the Schoenfeld residuals indicates that the overall model does not violate the proportional hazards assumption, as indicated by the global test. Covariate-specific tests indicate that none of the primary variables of interest violate the proportionality assumption.

those whose investment policies remain relatively restrictive, as well as reliable property rights protectors from countries which lack a robust institutional endowment for the protection and enforcement of property rights.

In contrast to the liberalization hypothesis, the domestic political constraints hypothesis receives very little support from the analysis. Although the political constraints variable is statistically significant at the 1% level in model 1 and in the hypothesized direction in five of the six models, it fails to achieve statistical significance once other variables are included in the model.<sup>195</sup> It remains to be seen then whether governments that confront significant political constraints in the form of a large number of veto players (some of whom likely represent protectionist interests or other groups opposed to liberal investment policies), are more likely to enter into BITs as a way of overcoming such domestic opposition. It may be the case that broad measures of the number of institutional veto players or a country's political regime type are inappropriate for capturing the effects of the kind of "domestic blockage" suggested by the constraints hypothesis. A more appropriate measure might be a history of failure to enact liberal policy reforms.<sup>196</sup> My case-study of India offers some qualitative evidence in support of this conjecture.

Turning to my additional hypotheses regarding the effects of partisanship and societal conflict, I find that a government's partisan orientation is significantly related to its propensity to conclude BITs with capital-exporting countries, though the level of statistical significance becomes progressively weaker as more control variables are included in the model. More

---

<sup>195</sup> I re-ran all six models using the widely-used "polity score" measure of a country's political regime type from the Polity IV dataset and the "checks and balances" variable from the World Bank DPI as substitutes for the POLCON III index. The results were virtually identical. Both substitute measures were statistically significant at the 1% level in model 1 and signed in the hypothesized direction in a majority of the models, but failed to achieve statistical significance in those models in which additional control variables are present.

<sup>196</sup> In a different issue area, Simmons (2002) finds that states that have consistently failed to ratify a treaty resolving a border dispute are significantly more likely to negotiate treaties that commit themselves to arbitration of such disputes. Simmons treats a history of "ratification failures" as an indicator of "domestic political blockage."

specifically, I find that left-wing governments are significantly more likely to enter into BITs than their centrist or rightist counterparts. The hazard ratio of 1.23 in models 5 and 6 indicates that leftist governments have a 23% higher risk of signing a BIT in a given year than other types of governments. This finding lends support to the hypothesis that leftist governments feel more compelled to tie their hands with BITs, thereby making a credible commitment to the property rights of foreign investors, as a way of compensating for what they perceive as an inherent skepticism on the part of foreign investors towards these government's policy stances. Whether or not foreign investors actually view the commitments of left-wing governments to liberal investment policies as inherently suspect, what matters, according to this interpretation, is that leftist governments at least *think* that their policy commitments are seen as less than credible by foreign investors. These beliefs are presumably based on an appreciation for the historically bad treatment which foreign investors have received from leftist host governments.

The finding that left-wing governments are significantly more likely to sign BITs than rightist or centrist governments contradicts the notion that leftist governments remain suspicious of, or hostile toward, FDI as well as liberal investment policies. This finding probably reflects the substantial ideational convergence toward neoliberalism among LDCs which began in the 1980s and continued into the 1990s, the exact period being analyzed. Hence, this finding is probably temporally dependent. Recent episodes of conflict between foreign investors and left-wing governments in Latin American countries like Venezuela and Bolivia suggest that a shift toward what Moran (1974) referred to as the "traditional pattern," in which leftist governments exhibit greater apprehension or antagonism towards FDI, may be occurring.

I find strong and robust evidence that the degree of societal conflict within a host country significantly reduces the likelihood that its government enters into BITs. This variable actually

gains greater statistical significance as more control variables are added to the model. It is statistically significant at the 1% level in models 4, 5, and 6 which represent alternative versions of the full model. The hazard ratio of 0.93 in these three models means that for each additional one point increase in the magnitude of societal violence or war within a country (as captured by the MEPV measure), the country's risk of signing a BIT decreases by 7%. A one standard deviation increase in the magnitude of internal conflict results in a 13% decrease in the risk that a country enters into a BIT. This finding is consistent with a compliance-based interpretation of BIT signings in which a government's decision to undertake international investment-related legal commitments is influenced by its expectations regarding its ability to comply with such commitments. Many BITs contain provisions which obligate host governments to compensate foreign investors for property losses resulting from civil violence and strife. Therefore, it is perhaps no surprise that the governments of countries in which such conflict is endemic appear to be deterred from undertaking such obligations. This finding lends additional credence to the supposition that governments avoid making commitments which they know they will have a hard time living up to.

Consider the case of Colombia where internal violence has been an ongoing problem since as far back as 1948 when the populist political leader Jorge Eliécer Gaitán was assassinated, sparking a ten-year period of rural warfare known as *La Violencia*. Since the mid-1960s, the government of Colombia has continuously been engaged in a sustained, low-intensity, armed conflict with guerrilla insurgents. The growth of the illegal drug trade in Colombia beginning in the 1980s has only served to fuel the conflict. While Colombia's significant endowment of natural resources, including both minerals and energy resources, particularly coal and oil, make it an attractive destination for FDI, it is precisely these sectors that are perhaps

most at risk of being attacked by insurgents.<sup>197</sup> For instance, the Revolutionary Armed Forces of Colombia (FARC) and the National Liberation Army (ELN) have both carried out repeated attacks on Colombia's Cano Limón-Covenas oil pipeline. Despite these risks, Colombia has in recent years witnessed "a veritable flood" of investment by foreign oil companies, particularly from Canadian and American firms, many of whom "are involved in oil exploration and development in regions of the country where conflict is most intense."<sup>198</sup> Not surprisingly, Colombia has not provided foreign firms with any legal guarantees of compensation (at least in the form of BITs) in the event of property losses stemming from civil conflict.<sup>199</sup> Among South American countries at the end of 2005, the average number of signed BITs with high-income OECD countries was around eleven. In comparison, prior to 2005, Colombia had concluded BITs with only two OECD countries, the United Kingdom and Italy. Neither treaty, both of which were signed in 1994, has been ratified. Since 2005, Colombia has entered into BITs with both Spain and Switzerland. The treaty with Spain remains the only BIT with an OECD country which Colombia has ratified. Only Suriname has signed fewer BITs with OECD countries than Colombia.<sup>200</sup> A similar story could probably be told for many African countries that have experienced significant levels of societal conflict.<sup>201</sup>

---

<sup>197</sup> In 2006, Colombia ranked fifth among South American countries in terms of the amount of FDI stock it hosted (valued at approximately \$44 billion according to UNCTAD's online Handbook of Statistics), behind Brazil (\$222 billion), Chile (\$80 billion), Argentina (\$58 billion), and Venezuela (\$45 billion).

<sup>198</sup> Pearce 2002.

<sup>199</sup> It is possible that the Colombian government could have made such guarantees in the form of investment contracts with foreign firms. However, the fact that Colombia does not appear to have had any arbitral claims brought against it ever would suggest that it has not in fact made any such commitments (although at least some arbitrations are never made public).

<sup>200</sup> In terms of the number of signed BITs with high-income OECD countries, the countries of South America rank as follows (through 2005): Argentina (19), Chile (19), Peru (15), Uruguay (14), Bolivia (13), Paraguay (12), Venezuela (12), Brazil (11), Ecuador (11), Colombia (3), Guyana (3), and Suriname (1).

<sup>201</sup> Among all LDCs at the end of 2005, the average number of signed BITs with high-income OECD countries was around eight. Several conflict-ridden African countries stand out as being significantly below this average. For example, Rwanda has only signed three BITs with OECD countries, Sierra Leone has only signed two, and Somalia has only signed one. All of these treaties were concluded well before civil conflicts erupted in these countries.

Turning to the remaining explanatory variables, the effects of which are fairly consistent across the various different specifications of the model, the results of my analysis are for the most part identical to those of EGS, despite the inclusion of some additional variables and a drastic reduction in sample size owing to the fact that their analysis begins in 1958 and extends to 2000, while my own analysis begins in 1985.<sup>202</sup> The first set of control variables worth noting are those which are intended to capture a host country's attractiveness to foreign capital, and therefore its attractiveness as a potential BIT partner from a home country perspective, including the size of its market (as measured by its GDP), its level of economic development (as indicated by its GDP per capita), its rate of economic growth (as measured by the annual percentage change in its GDP), and the quality of its workforce (as captured by its illiteracy rate).

Substantively, the results for these variables are mixed. On the one hand, countries with relatively low quality workforces (as indicated by higher illiteracy rates) are significantly less likely to sign BITs, lending support to the notion that countries which represent unattractive destinations for FDI also make less attractive BIT partners. On the other hand, the results imply that wealthier, more economically developed and dynamic countries are significantly less likely to surrender their sovereignty over FDI by entering into BITs, as evidenced by the direction of the hazard ratios for the per capita GDP and GDP growth variables, both of which are statistically significant at the 1% level across all specifications. The potential incentive of home country governments to conclude BITs with these types of countries notwithstanding, this finding is consistent with the notion that because relatively wealthy, economically developed and growing countries are more likely to attract a large amount of FDI, they have less of a need to make themselves *more* attractive to foreign investors by tying their hands with BITs and are

---

<sup>202</sup> The number of observations analyzed by EGS is over 200,000, while the number of observations in my own analysis ranges from 29,521 to 22,495.



better able to resist the pressure (both from home country governments and competitive dynamics) to make such commitments. Conversely, relatively poor, economically underdeveloped countries with small or perhaps negative growth rates may be in such dire need of foreign capital that their governments are more willing to enter into BITs in a desperate bid to make their countries at least marginally more attractive in the eyes of foreign investors. These countries may also be more susceptible to pressure from home country governments. Lastly, the GDP variable, typically regarded as a good indicator of the size of a country's domestic market, and therefore its attractiveness as a destination for FDI, has a positive effect on a country's likelihood of signing a BIT in models 2 and 3. However, the effect turns negative once all control variables are included (in models 4, 5, and 6), and the variable loses much of its statistical significance.<sup>203</sup>

There is no apparent or discernable relationship between the importance of FDI to a host country's economy (as measured by net FDI inflows as a percentage of GDP) and its propensity to sign BITs. This may be an artifact of the endogenous relationship between BITs and FDI or the way in which FDI flows are operationalized. Regardless, it remains to be seen whether there is any truth to the claim that capital-exporting states are more likely to seek BITs with LDCs in which their own companies are heavily invested.<sup>204</sup> The results do suggest, however, that a source country's level of outward FDI exposure (as measured by net FDI outflows as a percentage of GDP) has a positive and significant effect on the likelihood of a BIT being formed

---

<sup>203</sup> It is worth mentioning that a country's level of economic development, as measured by its GDP per capita, is also a determinant, and therefore an indicator, of its market size which is at least partially a function of the degree of purchasing power among the country's population (in addition to the actual size of the population), making GDP and GDP per capita interchangeable as indicators of market size. I include both variables in my models in order to make my results as comparable as possible to those of the EGS study.

<sup>204</sup> Again, as previously suggested, the most appropriate way to test the hypothesis that FDI flows have a positive effect on the likelihood that a BIT is formed between two countries is with data on bilateral FDI flows. Unfortunately, such data is much spottier than data on aggregate FDI flows. I substituted absolute FDI inflows, as well as the total stock of FDI a country plays host to, but neither variable was statistically significant.

amongst a particular dyad, a finding that is consistent across all specifications and with the EGS study.

Turning to those variables designed to capture the effects of competition for FDI on BIT signings, perhaps the most interesting difference between the analysis presented here and the findings of the EGS study is the failure of all three spatial lag variables to achieve statistical significance once all control variables are included in the model. Whereas EGS find a positive and statistically significant association between all three variables and the likelihood that a BIT is formed between two countries, suggesting that LDCs are more likely to sign BITs when those countries with which they compete (in terms of export markets, export products, and infrastructure) have done so, the results of my own analysis do not demonstrate any such effect.

How might we account for this discrepancy of findings? Clearly, the same kinds of competitive pressures to attract FDI which the EGS study highlights have not only compelled LDCs to enter into BITs, but also to liberalize their own national regulatory regimes governing inward FDI, and possibly to undertake substantial efforts to improve their domestic property rights regimes as well. As was suggested in the previous chapter, BITs should be regarded as an external indicator of what is actually largely an internal process or transformation, particularly in terms of the policy preferences of incumbent host governments, but perhaps also a transformation of the institutional framework governing private property rights within a country. The simultaneity of these domestic-level changes and BIT signings may have created a spurious correlation in the EGS study. However, this does not mean that competition for foreign capital is not the driving force behind the diffusion of BITs. It simply means that competition is driving countries to change their domestic policies (and again perhaps their institutions as well) and these changes are subsequently (if not simultaneously) locked-in and institutionalized at the

international level through BITs. In the robustness checks that follow, I employ two alternative measures of competition. Although methodologically less sophisticated than EGS's "competitive distance" variables, these considerably simpler measures yield statistically significant results, thereby confirming the importance of both regional and global competition to attract FDI as determinants of BIT signings.

Aside from the effects of the spatial lag variables, the results of my analysis are largely congruent with EGS's competitive theory of BIT signings. First, as the global pool of FDI has increased, LDCs have exhibited a greater willingness to sign BITs, lending support to EGS's conjecture that "the expectation of greater payoffs" resulting from a larger FDI "pie" have compelled LDCs to conclude more BITs as a means of securing a share of this bigger pie.<sup>205</sup> However, this variable is only statistically significant at the 10% level. Second, countries which rely more heavily on extractive production rather than manufacturing are significantly less likely to enter into BITs as hypothesized by EGS, lending support to the notion that these countries are to some degree insulated from the kinds of competitive pressures associated with manufacturing FDI. Another possible reason for this finding, which EGS do not consider, lies in the inherently greater expropriation risk that characterizes natural resource industries. It is precisely this sector in which foreign investors have suffered (and as recent events in Venezuela, Bolivia, and elsewhere attest, continue to suffer) from a "secular obsolescence" of bargaining power as originally recognized by Vernon (1971). Perhaps realizing their intrinsic, long-term bargaining advantage with respect to such investments, governments that play host to a significant amount of extractive FDI may avoid committing themselves to a strict standard of compensation (which most BITs establish) which would offset any advantages to be had from reopening concessionary contracts with foreign firms. Although the time-inconsistency problem is perhaps at its worst for

---

<sup>205</sup> Elkins, Guzman, and Simmons 2006, 826-7.

these governments, foreign firms seeking to profit from the extraction of valuable natural resources have no real choice but to deal with these governments if they wish to acquire access to such resources.

Finally, in keeping with the logic of competition proposed by EGS, I hypothesized that as the total number of BITs in force across the globe increased, the incentive of any one LDC to enter into another BIT would correspondingly decline. Contrary to this expectation, the systemic density of BITs has a positive and statistically significant effect on the likelihood that a BIT is formed between two countries. However, this variable is likely capturing the general upward trend in BIT signings over time, so it is unclear whether it provides the best means by which to test the diminishing incentives hypothesis.<sup>206</sup>

Turning to the dyadic-level control variables, the results suggest that BITs are more likely to be concluded among countries which share a common language and among allies. Of the latter finding, EGS speculate that it could indicate “a somewhat coercive element” in the process by which BITs are formed.<sup>207</sup> I do not find any evidence to support a link between the amount of trade within a dyad and the formation of a BIT between two countries

Looking at those variables designed to capture alternative mechanisms through which BITs may have diffused among LDCs, the results indicate that countries that have received credits from the IMF are significantly more likely to conclude BITs, suggesting one of two things: that states which seek assistance from the IMF are strongly encouraged (or pressured) to make international investment-related legal commitments, or that there is significant overlap between the conditionality of IMF loans and the behavioral requirements of BITs which would

---

<sup>206</sup> I also included the squared term for this variable in order to capture the potential curvilinear relationship. Both variables had the correct sign (the original variable was positive, while the squared term was negative), but neither was statistically significant.

<sup>207</sup> Elkins, Guzman, and Simmons 2006, 841.

substantially reduce the prospective costs associated with the latter agreements.<sup>208</sup> Like EGS, I find no evidence to support a sociological account of the diffusion of BITs resulting from a country's emulation of its cultural peers. The likelihood of a country signing a BIT does not seem to be effected when other countries with which it shares the same predominant religion have done so. I do, however, find some evidence of learning as a diffusion mechanism. The results of my analysis indicate that BITs are significantly more likely to be signed during periods in which signatory states appear to be materially benefiting from such treaties in terms of increased FDI inflows.

Finally, turning to the remaining control variables, the results of my analysis indicate that host countries with an export orientation (as indicated by a current account surplus) are significantly more likely to sign BITs as are countries with substantial diplomatic resources (as indicated by the number of embassies a country has established abroad and plays host to). The results also suggest that BITs seem to coincide with the implementation of privatization programs by host states, though this finding is considerably less significant than in the EGS study. The results of my analysis lend additional support to the proposition that common law countries show a general reluctance to undertake international legal commitments of any kind.<sup>209</sup> Looking at the two systemic-level variables, the Cold War variable does not have any impact on the likelihood of BIT signings, though this is probably the result of the truncated time period being analyzed compared to the EGS study. In contrast to EGS, I find a negative statistically significant relationship between the total number of BITs signed in a given year by all countries and an individual country's propensity to conclude BITs of its own.

---

<sup>208</sup> Elkins, Guzman, and Simmons 2006, 840.

<sup>209</sup> Elkins, Guzman, and Simmons 2006, 840; Simmons forthcoming.

### *Robustness Checks*

How robust is the finding that countries with relatively favorable domestic regimes for FDI are more likely to formally commit themselves to the international investor rights regime by entering into BITs than are countries whose policies and institutions are less than favorable to FDI? In order to gain some leverage on this question, I estimated some additional models employing alternative measures of a country's domestic investment regime, my primary explanatory variable of interest. Table 4.5 presents the results of five different alternative specifications of my model of BIT signings. Models 7, 8, and 9 each include one of three components of the ICRG index. The investment profile variable (model 7) is statistically significant at the 1% level; the law and order variable (model 8) is significant at the 5% level; and the corruption variable (model 9) is significant at the 10% level. All three variables are in the same direction as the ICRG index, indicating a positive effect on the likelihood that a host country enters into a BIT with a capital-exporting country.<sup>210</sup> Model 10 includes an alternative indicator of the strength of a host country's investment climate and the quality of its domestic property rights institutions, the CIM measure. The measure is statistically significant at the 5% level and in the hypothesized direction, further attesting to the robustness of the positive association between the favorability of a country's domestic investment regime and its propensity to conclude BITs.

Of particular interest is the isolated effect of the investment profile variable (model 7) since it is the one variable which captures many of the specific concerns of foreign investors which BITs are intended to address. It can also be regarded as a good indicator of the degree to which a country's policies toward FDI have been liberalized since one of its own subcomponents

---

<sup>210</sup> I estimated a fourth model which included the ICRG bureaucracy quality variable, the fourth component of my index measure, but it failed to achieve statistical significance.

Table 4.5 Alternative Indicators of a Country's Domestic Regime for FDI

Explanatory Variables	Model 7	Model 8	Model 9	Model 10	Model 11
<b>DOMESTIC SOURCES OF COMMITMENT</b>					
Investment Profile (ICRG)	1.15*** (0.04)				1.14*** (0.02)
Law & Order (ICRG)		1.11** (0.06)			1.04 (0.06)
Corruption (ICRG)			1.10* (0.06)		1.04 (0.06)
CIM				2.50** (0.02)	
Political Constraints (POLCON III)	1.06 (0.29)	1.13 (0.31)	1.09 (0.30)	0.98 (0.25)	1.05 (0.29)
Partisanship (Left Executive)	1.19 (0.14)	1.26** (0.14)	1.23* (0.14)	1.09 (0.14)	1.18 (0.14)
Societal Conflict	0.92*** (0.03)	0.93*** (0.03)	0.92*** (0.03)	0.92*** (0.03)	0.93*** (0.03)
<b>HOST ATTRACTIVENESS</b>					
Net FDI Inflows (% GDP)	0.98 (0.02)	0.99 (0.02)	0.99 (0.02)	1.01 (0.02)	0.98 (0.02)
Market Size (GDP (Ln))	0.90 (0.06)	0.95 (0.06)	0.94 (0.06)	0.98 (0.06)	0.91 (0.06)
Economic Development (GDP Per Capita (Ln))	0.93*** (0.02)	0.93*** (0.02)	0.93*** (0.02)	0.93*** (0.02)	0.93*** (0.02)
GDP Growth	0.91*** (0.02)	0.91*** (0.02)	0.91*** (0.02)	0.90*** (0.02)	0.91*** (0.02)
Workforce Quality (Illiteracy Rate)	0.09*** (0.03)	0.11*** (0.04)	0.11*** (0.04)	0.09*** (0.04)	0.10*** (0.04)
<b>HOME COUNTRY NET FDI OUTFLOWS (% GDP)</b>	1.19*** (0.02)	1.19*** (0.02)	1.19*** (0.02)	1.17*** (0.02)	1.19*** (0.02)
<b>COMPETITION</b>					
Average Annual Global FDI Flows	1.85** (0.58)	1.61 (0.50)	1.63 (0.51)	2.02* (0.53)	1.84** (0.58)
BITs Among Export Market Competitors	1.02 (0.02)	1.01 (0.02)	1.01 (0.02)	0.99 (0.02)	1.02 (0.02)
Host Extractive Industries (% Exports)	0.59*** (0.12)	0.56*** (0.11)	0.57*** (0.12)	0.64** (0.13)	0.60*** (0.12)

Total BITs in Force Worldwide	1.01*** (0.00)	1.01** (0.00)	1.01** (0.00)	1.01*** (0.00)	1.01*** (0.00)
<b>DYADIC-LEVEL FACTORS</b>					
Trade (% Host GDP)	0.85 (0.35)	0.89 (0.36)	0.90 (0.36)	0.94 (0.37)	0.85 (0.35)
Common Language	2.20*** (0.41)	2.16*** (0.40)	2.14*** (0.39)	1.78*** (0.32)	2.20*** (0.41)
Alliance	1.81*** (0.35)	1.70*** (0.33)	1.73*** (0.34)	1.23 (0.24)	1.79*** (0.35)
<b>ALTERNATIVE DIFFUSION MECHANISMS</b>					
Coercion (Host Use of IMF Credits)	1.38*** (0.18)	1.31** (0.17)	1.31** (0.17)	1.45*** (0.19)	1.39*** (0.18)
Learning from Success	0.58 (0.94)	0.81 (1.31)	0.69 (1.12)	1.43 (2.14)	0.64 (1.03)
BITs Among Those with Same Religion	0.98 (0.02)	0.98 (0.02)	0.98 (0.02)	0.98 (0.02)	0.98 (0.02)
<b>ADDITIONAL CONTROLS</b>					
Host Export Orientation (Current Account % GDP)	1.03*** (0.01)	1.03*** (0.01)	1.03*** (0.01)	1.02*** (0.01)	1.03*** (0.01)
Host Privatization Record	1.04 (0.03)	1.06** (0.03)	1.06** (0.03)	1.07** (0.03)	1.05 (0.03)
Host Diplomatic Representation (Embassies)	1.02*** (0.00)	1.02*** (0.00)	1.02*** (0.00)	1.02*** (0.00)	1.02*** (0.00)
Host Legal Tradition (Common Law)	0.50*** (0.06)	0.50*** (0.07)	0.50*** (0.07)	0.64*** (0.07)	0.50*** (0.07)
Cold War	1.09 (0.57)	1.11 (0.60)	1.19 (0.62)	0.82 (0.41)	1.10 (0.58)
Period Effects (Total BITs Per Year)	0.49*** (0.08)	0.52*** (0.09)	0.54*** (0.09)	0.44*** (0.07)	0.50*** (0.09)
Observations	22,495	22,495	22,495	25,622	22,495
Number of Dyads	1,718	1,718	1,718	1,967	1,718
Number of BITs	450	450	450	514	450
Log-likelihood	-2891.815	-2899.412	-2899.840	-3243.505	-2891.249

Notes: estimates are hazard ratios; standard errors in parentheses.  
 \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%.



captures the degree to which foreign investors are free to repatriate their profits.<sup>211</sup> The statistically significant, positive impact of this variable on the likelihood that an LDC signs a BIT indicates that the types of states that are more likely to formally commit themselves to the international legal regime for investor rights are qualitatively different in terms of the investment climate which they offer than those states that refrain from making such commitments.<sup>212</sup> For each additional one point increase in a country's score on the investment profile variable, its risk of signing a BIT increases by 15%. A single standard deviation increase in a country's score on this variable results in a 29% increase in the risk that it enters into a BIT. Results for most of the control variables in models 7-11 are consistent with those of models 4-6 in Tables 4.4.

Which of the two factors highlighted by my argument in chapter 3—the policy preferences of incumbent host governments or the larger institutional framework in which investment takes place—is more important in influencing a country's decision to commit itself to the international investor rights regime? While it is difficult to tease out the separate effects of policy preferences and institutions, the results for model 11 are suggestive. Model 11 includes the investment profile, law and order, and corruption variables as separate indicators of a country's domestic investment regime. While the profile variable is intended to capture the effects of policy changes (i.e., liberalization), the law and order and corruption variables can be regarded as indicators of the relative strength of both formal and informal institutions (i.e., the rule of law and norms against corruption). As the results show, when all three of these variables are included in the same model individually, only the profile variable retains its significance.

As suggested in chapter 3, institutions are at least partially exogenous to the preferences of government leaders. Although governments can take steps to improve their country's

---

<sup>211</sup> See the description of this variable above.

<sup>212</sup> This result is consistent with an analysis of the characteristics of BIT participants conducted by Aisbett 2007.

institutional capacity (e.g., by supporting the rule of law or fighting corruption), they cannot change the quality of institutions overnight. Therefore, it remains to be seen whether institutional capacity acts as an exogenous constraint on the propensity of states to commit themselves through BITs. In other words, it is not clear whether states whose institutional capacity is relatively low are deterred from entering into such treaties as hypothesized. The results from models 8, 9, and 10 are certainly consistent with such an interpretation, but we cannot rule out the possibility that a government with strong preferences for attracting and adopting a liberal policy stance toward FDI might not enter into BITs despite lacking the institutional capacity to fully comply with the behavioral demands which such treaties impose on their signatories—i.e., despite the potentially higher costs of compliance. Thus, as the results from model 11 suggest, policy preferences may be a more important determinant of a country's international commitments than institutional factors. What does seem clear, however, is that there is no real support for the substitution hypothesis. Countries with bad institutions (i.e., a weak rule of law and/or significant levels of corruption) do not in any way appear to be more likely to conclude BITs as a way of compensating for their institutional deficiency.

Collectively, the results of my analysis provide consistent support for the hypothesis that BITs function as screening mechanisms. In all of the models presented in Tables 4.4 and 4.5, as the favorability of a host country's domestic investment regime (as indicated by various measures) increases, so does the propensity of countries to conclude BITs, suggesting a consistent causal relationship. The magnitude of these effects is graphically illustrated in figures 4.1 and 4.2 for two different measures of the relative favorability of a host country's investment regime. Figure 4.1 plots the survival curve for two different values of the ICRG index. This graph indicates that a country which scores a 25 (the maximum value among LDCs) on the

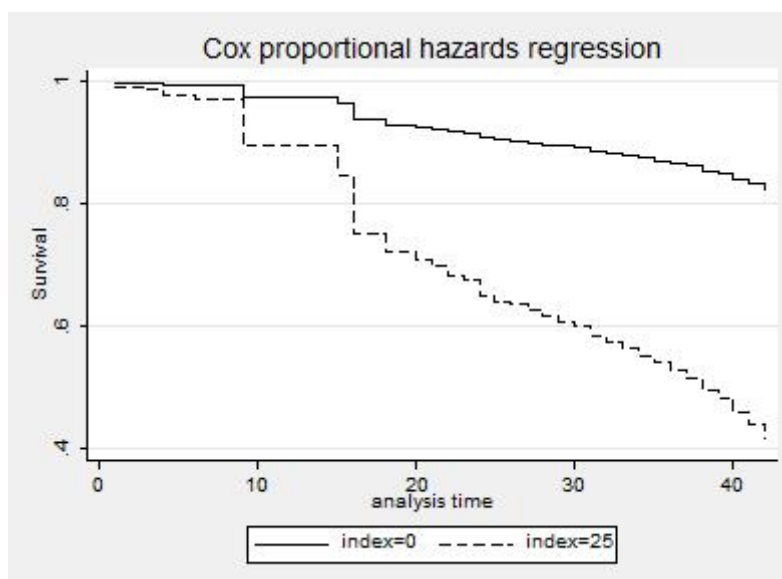


Figure 4.1 Survival Estimates According to Host Country's Score on ICRG Index.

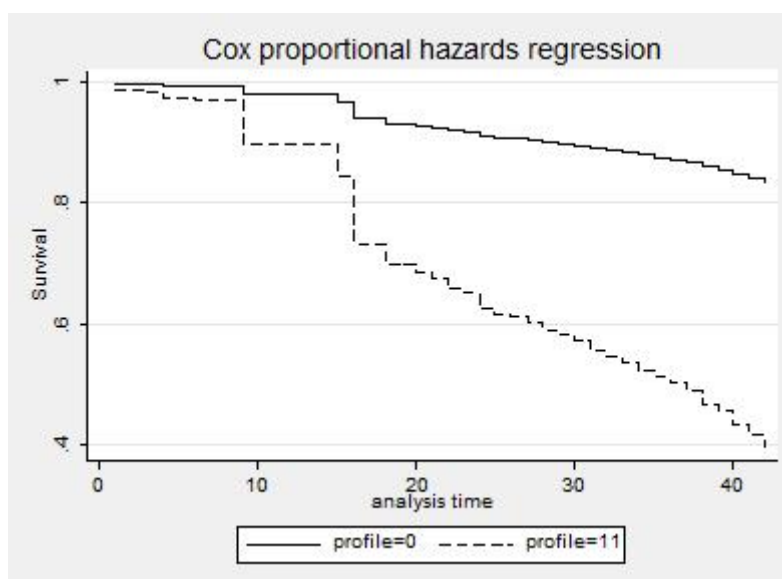


Figure 4.2 Survival Estimates According to Host Country's Investment Profile.

ICRG property rights index has a decidedly increased risk of signing a BIT compared with a country that scores a 0 (the minimum value) on the ICRG index. Similarly, figure 4.2 plots the

survival curve for the maximum and minimum values of the ICRG investment profile variable. This graph indicates that a country which scores an 11 on the investment profile measure has a markedly increased risk of signing a BIT compared with a country that scores a 0 on this measure. The two graphs are virtually identical, attesting to the robustness of the empirical relationship between a country's domestic investment regime (i.e., the favorability of its policies and institutions) and its propensity to conclude BITs.

### *The Effects of Competition Reconsidered*

As has already been noted above, none of the three measures of “competitive distance” developed by EGS were statistically significant in any of the full versions of the model of BIT signings which I estimated. While the EGS approach to measuring competitive dynamics can be applauded for its innovativeness, it may very well be a bit too sophisticated. As an additional robustness check, I substituted two alternative measures of the kinds of competitive pressures which EGS identify as one of the key motivations driving countries to conclude BITs with developed countries. A more straight-forward approach to capturing the effects of such competition on the propensity of states to conclude BITs is to measure (1) the number of BITs that have been concluded with a particular capital-exporting country *within a given geographic region* and (2) the number of BITs that have been concluded with that same country *globally*. The logic behind these variables is simple: as the number of BITs that have been concluded with a particular capital-exporting country increases both amongst a country's *closest neighbors* (i.e., regionally) as well as amongst *all countries* (i.e., globally), the more any one individual state will feel compelled to conclude its own BIT with that country so as to avoid losing out in the competition to attract FDI from that country.

In constructing the first variable, I defined six regions: (1) Latin America and the Caribbean, (2) Eastern Europe, (3) Africa, (4) North Africa and the Middle East, (5) Central Asia, and (6) Asia and the Pacific. I then counted the number of BITs that had been concluded with each of the capital-exporting countries in my sample<sup>213</sup> within each region for each year in the analysis. For example, take the following dyad-year observation: Paraguay-Canada-1993. The value for my regional BITs variable is the number of BITs among all Latin American and Caribbean countries and Canada as of 1992 (recall that all explanatory variables are lagged by one period). Obviously, as time progresses, the number of BITs within a given region typically increases for most capital-exporters and for most regions. I then created a second variable which counts the number of BITs for a particular capital-exporting country worldwide. Again, using the above observation—Paraguay-Canada-1993—as an example, the value for my global BITs variable is the number of BITs which Canada has concluded with all LDCs as of 1992.

Table 4.6 presents the results for the full version of my model of BIT signings when these alternative indicators of competitive pressure are included along with the ICRG index. I estimated three different specifications. Model 12 includes the regional BITs variable, while model 13 includes the global BITs variable. Model 14 includes both the regional and the global variable in the same model. The table displays the hazard ratios for these variables as well as for the ICRG index (for the sake of space, I do not show the hazard ratios for the remaining explanatory variables, the results of which are consistent with those reported in Tables 4.4 and 4.5).

In contrast to the spatial lags employed by EGS which failed to achieve statistical significance in the models reported above, both alternative measures of competition, regional and global, are statistically significant at the 1% level in all three specifications. The hazard ratio of

---

<sup>213</sup> See note 154.

Table 4.6 Alternative Measures of Competition: Regional and Global BITs

Explanatory Variables	Model 12	Model 13	Model 14
Investment Regime (ICRG Index)	1.07*** (0.02)	1.08*** (0.02)	1.08*** (0.02)
Regional BITs	1.11*** (0.01)		1.05*** (0.28)
Global BITs		1.03*** (0.00)	1.02*** (0.00)
Observations	22,730	22,730	22,730
Number of Dyads	1,736	1,736	1,736
Number of BITs	458	458	458
Log-likelihood	-2847.636	-2844.486	-2833.380

Notes: estimates are hazard ratios; standard errors in parentheses. \*\*\* significant at 1%;

1.11 for the regional BITs variable in model 12 suggests that for each additional BIT that is formed with a particular capital-exporting country within a given region, the risk of for any one country within that region of concluding its own BIT with the capital-exporting country in question increases by 11%. A single standard deviation increase in the number of BITs within a given region increases this risk by approximately 55%. Similarly, the hazard ratio of 1.03 for the global BITs variable in model 13 suggests that for each additional BIT that is formed with a particular capital-exporting country among all LDCs worldwide, the risk for any one developing country of concluding its own BIT with the capital-exporting country in question increases by 3%. Although this appears at first to be a substantively smaller effect than the regional BITs variable, when we take into account the different range of values for each variable, the global BITs variable appears to have a larger effect. Whereas the regional BITs variable ranges from 0

to 34 with a standard deviation of approximately 5, the global BITs variable ranges from 0 to 121 with a standard deviation of roughly 21. A single standard deviation increase in the global BITs variable increases the risk of concluding a BIT by 63% (based on the hazard ratio reported in model 13) compared to just 55% for a similar increase in the regional BITs variable (based on the hazard ratio reported in model 12). However, when both variables are included in the same model, the substantive difference between the two variables diminishes, with the regional BITs variable having a slightly greater impact than the global BITs variable. Given the respective hazard ratios for each variable reported in model 14, a single standard deviation increase in the number of regional BITs increases a country's risk of concluding a BIT by approximately 25% while a similar increase in the global BITs variable increases this risk by roughly 21%.

Despite the inclusion of these two new variables, both of which are highly significant, my key variable of interest—the favorability of a country's domestic regime for FDI, as measured by the ICRG index—remains statistically significant at the 1% level. In fact, the reported hazard ratio for the ICRG index, which ranges from 1.07 to 1.08 across models 12-14 is slightly greater than the ratio of 1.06 reported for models 4-6 in Table 4.4 above. However, it is worth assessing the substantive significance of a country's domestic regime for FDI relative to the effects of competition. I have argued that countries with weak domestic property rights institutions will refrain from entering into BITs out of concerns about their capacity to comply with such treaties. However, over time competition to attract FDI has probably pushed countries of all types to conclude BITs regardless of their institutional capacity for compliance. Therefore, as the number of BITs increases, both within a particular region as well as globally, a country's "risk" of entering into its own BITs should increase commensurately, even if that country's domestic property rights institutions are relatively weak. Conversely, when the level of BIT-based

competition is relatively low (i.e., few countries have entered into BITs), a country's risk of entering into any BITs should increase as its domestic regime for FDI improves—i.e., as its policies toward inward FDI become more liberal and as the quality and strength of its property rights institutions increases.

To see whether this is true, I conducted two post-estimation analyses. First, I constructed survival curves based on certain substantively relevant combinations of values for both the ICRG index and the regional BITs variable.<sup>214</sup> I set the ICRG index at zero, indicating a country with the most unfavorable domestic regime for FDI possible. Then, while holding this variable constant, I constructed several survival curves in which I allowed the regional BITs variable to vary from its lowest level to its highest level. Since the regional BITs variable ranges from 0 to 34 with a standard deviation of 5, I used a 5-point interval, which yielded eight different curves in which the regional BITs variable takes on the following values: 0, 5, 10, 15, 20, 25, 30, and 35. These curves are shown in Figure 4.3.<sup>215</sup>

Next, I created a similar set of survival curves based on reversed values for the ICRG index and regional BITs variable. I now held the regional BITs variable at zero while allowing the ICRG index to vary, again using 5-point intervals (roughly equivalent to the index's 4.15 standard deviation), which yielded six different curves in which the ICRG index takes on the following values: 0, 5, 10, 15, 20, and 25. These curves are shown in Figure 4.4.

The survival curves seem to illustrate and confirm the story suggested above. As Figure 4.3 illustrates, a country's risk of entering into a BIT tends to increase as the number of BITs among countries within its region increases, regardless of whether the environment it offers for

---

<sup>214</sup> For the sake of space, I have chosen to limit my analysis to the effects of regional competition, and because I believe that regional competition is more important than global competition in driving states to conclude BITs.

<sup>215</sup> The global BITs variable and all other control variables were held at their means.



FDI is favorable or unfavorable. In contrast, as Figure 4.4 demonstrates, when no other countries within a region have concluded any BITs with a particular capital-exporting country,

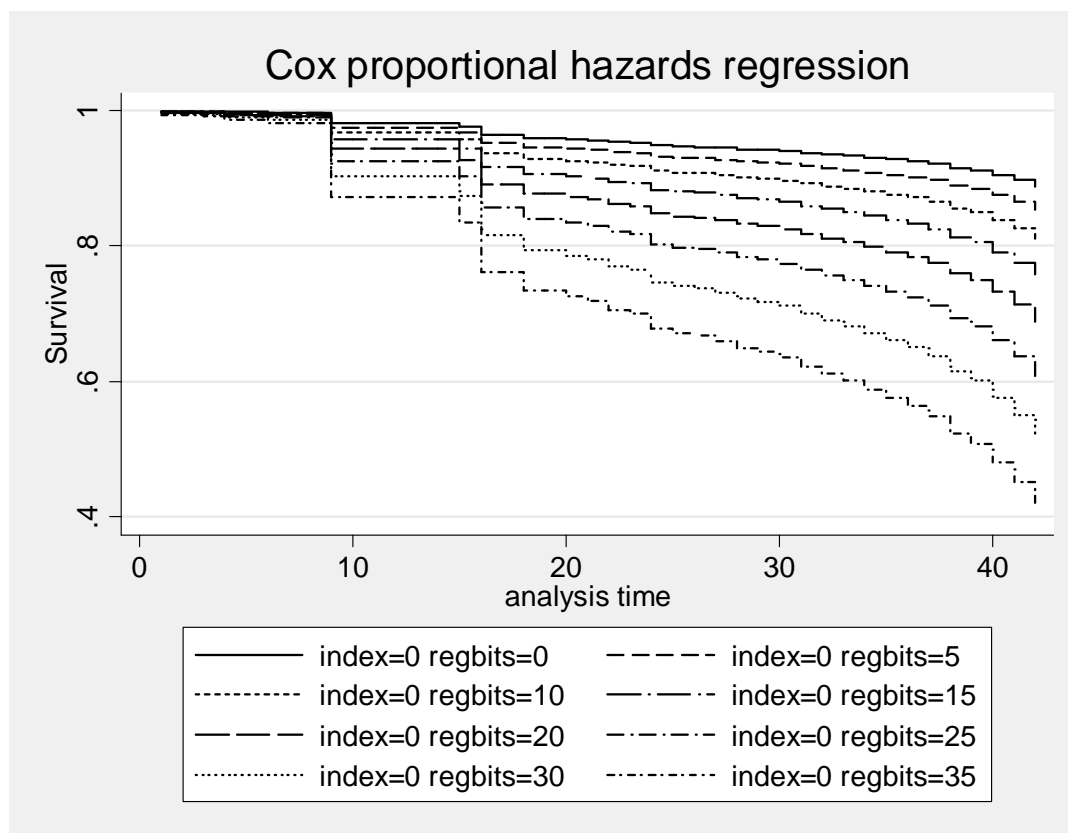


Figure 4.3 The Effects of Regional Competition Given an Unfavorable Domestic Regime

the risk of any one country doing so tends to increase as its domestic regime for FDI improves, and therefore, the costs of compliance diminish. Comparing the two sets of curves, it seems that the impact of a country's domestic regime is somewhat greater than the number of BITs within a region, given the relatively sharper drop-off that occurs in the survival curves as a country's domestic regime improves, holding the regional BITs variable at its minimum value (Figure 4.4). The slope of the curves in Figure 4.3 is considerably less sharp. Moreover, these curves are more closely bunched together indicating a less dramatic increase in the risk of signing a BIT for

each standard deviation increase in the number of BITs within a region given an unfavorable domestic regime.

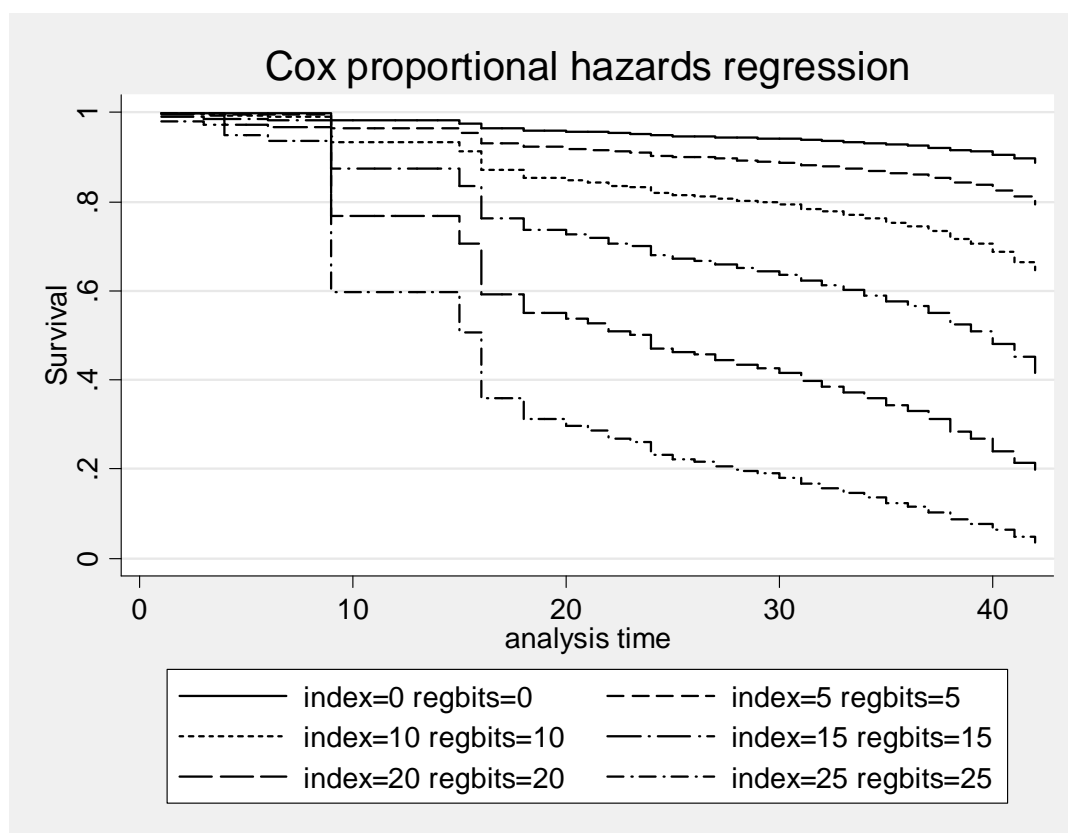


Figure 4.4 The Effects of Domestic Regime in the Absence of Regional Competition

Finally, in addition to constructing survival curves, I also computed the marginal effects of the regional BITs and ICRG index variables, holding the index variable at zero (its lowest possible value), while allowing the regional BITs variable to vary in the same manner as in Figure 4.3. I held all of the dummy control variables at zero and all other continuous control variables at their means. The marginal effect represents the change in a country's risk (expressed as a hazard ratio) of entering into a BIT given a change in the independent variable (in this case, either the ICRG index or the regional BITs variable) holding all other independent variables at

certain values (those indicated above). Table 4.7 shows the change in hazard ratios for both the ICRG index and the regional BITs variable as the number of regional BITs increases from 0 to 35.

Table 4.7 Marginal Effects of Domestic Investment Regime as Regional Competition Intensifies

Number of Regional BITs	Hazard Ratio for ICRG Index
0	1.006***
5	1.007***
10	1.01***
15	1.01***
20	1.02***
25	1.02***
30	1.03***
35	1.04***

\*\*\* significant at 1%

The results shown in Table 4.7 are interesting insofar as they suggest that the substantive impact of a country's domestic regime for FDI gradually increases (as indicated by an increasing hazard ratio) as regional competition intensifies (as indicated by a growing number of BITs within a given region). It seems to suggest that a certain amount of regional competition must first exist before the relationship that I have posited between a country's domestic investment regime and its propensity to conclude BITs takes hold. Substantively, this makes sense. My argument does not suggest that the strength of a country's domestic property rights causes it to *want* to sign a BIT. The motivation to sign a BIT lies elsewhere (e.g., competition to attract FDI). However, the strength or weakness of a country's domestic regime does affect the *timing*

of its commitments, and this is what the event history model is designed to capture. Countries with strong institutions tend to have a higher risk of entering into BITs, meaning they are likely to commit *earlier* than their weaker counterparts who will generally refrain from making commitments until regional competition becomes so overwhelming as to force them to do so.

### **QUALITATIVE EVIDENCE: INDIA**

The results of the event history analysis presented above indicate a strong and robust positive correlation between the favorability of a country's domestic regime for FDI and its propensity to conclude BITs with capital-exporting countries. However, in order to fully substantiate the hypothesized causal mechanisms underlying this relationship, it is necessary to move beyond a quantitative analysis. This section offers some qualitative evidence derived from the experience of India which illustrates the conditions under which many countries have committed themselves to the international investor rights regime.

The circumstances under which India made its own international investment-related commitments provide a good illustration of the causal sequence implied by the screening hypothesis. According to the hypothesis, countries are more likely to enter into BITs at the international level *after* implementing liberal reforms at the domestic level. At the very least, BIT signings should *coincide* with the liberalization of national FDI policies. India fits the pattern well. India signed its first BIT on March 14, 1994 with Britain, its most important source of inward FDI. Since then, it has concluded sixty-three additional BITs, including fourteen with other upper-income OECD countries. Table 4.6 provides a chronological listing of the BITs India has concluded with high-income OECD countries. Before signing its first BIT with Britain in 1994, India had already undertaken significant liberalization of its domestic regulatory regime

governing FDI. These efforts began in earnest in 1991 amidst a balance of payments crisis. By the time the treaty with Britain entered into force at the beginning of 1995, India's laws and

Table 4.8 BITs Concluded by India with High-Income OECD Countries

<b>Partner</b>	<b>Date of Signature</b>	<b>Date of Entry into Force</b>
1. United Kingdom	March 14, 1994	January 6, 1995
2. Germany	July 10, 1995	July 13, 1998
3. Denmark	September 6, 1995	August 26, 1996
4. Netherlands	November 6, 1995	December 1, 1996
5. Italy	November 23, 1995	March 26, 1998
6. Switzerland	April 4, 1997	February 16, 2000
7. France	September 2, 1997	May 17, 2000
8. Spain	September 30, 1997	December 15, 1998
9. Belgium & Luxembourg	October 31, 1997	January 8, 2001
10. Australia	February 26, 1999	May 4, 2001
11. Austria	November 8, 1999	March 1, 2001
12. Portugal	June 28, 2000	July 19, 2002
13. Sweden	July 4, 2000	April 1, 2001
14. Finland	November 7, 2002	April 9, 2003
15. Greece	April 26, 2007	Not yet ratified

Source: UNCTAD BIT database available at: <http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>

regulations governing FDI had undergone what amounts to a complete 180 degree turn. A closer look at the historical evolution of FDI policy in India can provide a deeper appreciation for the causal mechanisms underlying the screening hypothesis.

Upon achieving independence from Britain in 1947, India hosted a large stock of FDI, mostly of British origin. The Indian government's policy stance toward FDI was initially quite liberal. A 1949 industrial policy statement promised nondiscriminatory treatment for foreign investors, freedom to remit profits and repatriate capital (conditional upon the country's foreign exchange position), and fair and equitable compensation in the event of nationalization of foreign undertakings.<sup>216</sup> However, beginning with the Nehru government's first five-year plan adopted in 1951, the Indian government pursued a policy of import substitution industrialization, a development strategy which prescribed a strong role for the state in managing the economy. India's commitment to statist policies would last for an entire generation, from the 1950s through the 1980s, punctuated by only a few brief episodes of limited liberalization.<sup>217</sup> In keeping with this interventionist orientation, the Indian government eventually established a relatively restrictive regulatory regime for FDI. Encarnation (1989) provides a concise portrait of India's policy regime prior to the reforms of the early 1990s:

Multinationals, as a rule...never enjoyed unlimited access to the Indian market. Instead, quotas and tariffs...restrained their imports, while capital controls restricted their ownership of local enterprises. Moreover, such strict regulation of foreign trade and investment...remained in place for nearly four decades of political independence, well into the 1980s.<sup>218</sup>

The turn towards a highly restrictive policy regime for FDI began in the late 1960s. Between 1957 and 1978, India confronted repeated foreign exchange crises. While foreign exchange problems had initially led the Indian government to adopt a relatively liberal approach to FDI, by the mid-1960s, this approach had resulted in "a significant outflow of foreign exchange in the form of remittances of dividends, profits, royalties, and technical fees."<sup>219</sup>

---

<sup>216</sup> Gakhar 2006, 69.

<sup>217</sup> See, e.g., Denoon 1998.

<sup>218</sup> Encarnation 1989, 169.

<sup>219</sup> Gakhar 2006, 69-70.

Against the backdrop of yet another foreign exchange crisis in the late 1960s, these outflows caught the attention of the government, prompting it to establish a Foreign Investment Board (FIB) in 1968 as a mechanism for screening prospective foreign investments. However, the most significant policy development pertaining to FDI occurred five years later, when the Indian Parliament passed the Foreign Exchange Regulation Act (FERA) of 1973. Determined to reduce the role of large foreign firms in the Indian economy, the government sought to restrict new investments while “dislodging” existing investments. FERA established a general ceiling of 40 percent on foreign equity participation, forcing enterprises in which foreign ownership exceeded this amount “to choose between selling equity to Indian firms or leaving India altogether.”<sup>220</sup> Exceptions were made only for firms operating in “high-priority industries,” employing “sophisticated technologies,” or exporting a “significant proportion” of their output.<sup>221</sup>

FERA became the “cornerstone of the Indian regulatory framework for FDI.”<sup>222</sup> In part, it represented an attempt by the Indian government to deal with the country’s chronic shortage of foreign exchange. By forcing MNCs to dilute their equity participation, Indian policymakers hoped to reduce the outflow of foreign exchange through dividends and other foreign remittances.<sup>223</sup> Perhaps more importantly, by imposing equity dilution on MNCs, “the government satisfied a widely shared and long-standing belief in India that domestic ownership of assets and control over their use brought the nation both material and symbolic benefits. To many Indians, these gains seemed well worth subsidizing, even at the expense of higher prices, reduced quality, and supply scarcity.”<sup>224</sup> As a result of FERA, “India experienced a net capital

---

<sup>220</sup> Oatley 2006, 193.

<sup>221</sup> According to exemptions outlined in FERA, foreigners could retain up to 74 percent equity in subsidiaries that employed “sophisticated technology” or exported a “significant proportion” of output. Subsidiaries that exported all of their output were permitted to be wholly-owned (i.e., 100 percent foreign equity). Encarnation 1989, 68.

<sup>222</sup> Gakhar 2006, 72.

<sup>223</sup> Encarnation 1989, 67.

<sup>224</sup> Ibid., 76.

outflow during the 1970s as some MNCs, such as Coca-Cola and IBM, left and few new investments arrived.”<sup>225</sup> However, most MNCs with existing investments stayed on after FERA because their affiliates, now minority-owned joint ventures, remained highly profitable.<sup>226</sup> Furthermore, whereas foreign equity tended to be tightly held by a single firm, local equity tended to be widely distributed, thus allowing MNCs to continue exercising substantial managerial control despite equity dilution.<sup>227</sup>

Beginning in 1985, India began to turn away from its socialist tradition. The government Rajiv Gandhi initiated a broad program of liberalization which “took many skeptics by surprise,” and “looked as if it would transform Indian economic policymaking.”<sup>228</sup> Specific policy changes included adoption of less restrictive licensing procedures for industrial investments and replacement of some import quotas with tariffs, thereby easing trade barriers. However, by 1989, a confluence of factors brought this reform movement to a halt, including significant increases in inflation and India’s external debt. In addition, Gandhi’s former finance minister, V. P. Singh, had managed to construct a political alliance—the so-called National Front—consisting of seven opposition parties. As inflation “accelerated, many of the country’s lower income groups felt threatened, and the National Front mounted a broad-scale attack on Rajiv Gandhi personally and on his economic policies.” After suffering “a resounding defeat” in the November 1989 election, the Gandhi government’s liberalization program was “quietly interred.”<sup>229</sup>

The liberalization episode of 1985-7 foreshadowed an even broader and lengthier program of economic liberalization beginning in the summer of 1991, one of considerably greater scale and complexity, largely adopted in order to avoid an impending default on India’s

---

<sup>225</sup> Oatley 2006, 193.

<sup>226</sup> Encarnation 1989, 73.

<sup>227</sup> Ibid., 71.

<sup>228</sup> Denoon 1998, 51.

<sup>229</sup> Ibid., 52.



international debt.<sup>230</sup> The government of P. V. Narasimha Rao came into office in July of 1991, confronting an annual inflation rate of 13 percent, a current account deficit of about \$10 billion, and the first real economic recession since 1980. The Soviet Union had just collapsed, leaving India without an important source of foreign aid, forcing it to undertake significant steps to attract FDI as a new source of both capital and technology. On July 24, 1991, the Rao government proposed a sweeping set of reforms, including the lifting of restrictions on investment by large firms, both domestic and foreign. Later that year, the government instituted a policy of automatic approval for FDI projects in 34 industries, permitting up to 51% foreign equity. It also reduced or eliminated a number of FDI-related performance requirements, reducing local content requirements and abolishing technology transfer requirements. In 1992, the government opened up the energy sector to foreign investment and reduced restrictions on foreign ownership in mining operations. Then in 1993, the Indian government established a policy of national treatment for foreign-owned enterprises, *a year before signing a BIT with Britain which would obligate it to provide such treatment to British investors.*<sup>231</sup> That same year, the government stated that it would consider permitting the establishment of wholly-owned subsidiaries by foreign firms on a case-by-case basis. In 1994, the government removed restrictions on the repatriation of profits by foreign firms, again, *before its BIT with Britain, which entered into force in January of the following year, obligated it to do so.*<sup>232</sup>

Thus, two and a half years before signing its first BIT with a country representing one of its most significant sources of FDI and three and a half years before that treaty entered into force,

---

<sup>230</sup> Brewer and Young 1998, 115; Denoon 1998, 46.

<sup>231</sup> Article 4, section 1 of the BIT between the United Kingdom and India states that “Each Contracting Party shall accord to investments of investors of the other Contracting Party...treatment which shall not be less favorable than that accorded...to investments of its own investors.” A copy of the BIT text is available at: [http://www.unctad.org/sections/dite/ia/docs/bits/uk\\_india.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/uk_india.pdf).

<sup>232</sup> Article 7 of the BIT between the United Kingdom and India states that “Each Contracting Party shall...grant to investors of the other Contracting Party the unrestricted transfer of their investments and returns.”

India had achieved significant liberalization of its regulatory regime governing FDI. These changes reflected a dramatic shift in the larger Indian political economy from a *dirigiste* regime towards a more liberal regime with significantly less state intervention.<sup>233</sup> International legal commitments in the form of BITs *largely complemented what were ultimately voluntary, unilateral changes in India's policies toward FDI*. They did not, however, fundamentally add anything to these policies, *nor did they require additional changes* on the part of the Indian government. India's BITs with Britain, Germany, the Netherlands, and other upper-income, capital-exporting countries essentially ratified and institutionalized a historic shift in the policy preferences of Indian leaders and at least some intellectuals. As Denoon (1998) notes, by the early 1990s, many of India's "top economists" had simply "lost confidence in India's controls system and supported the move toward a market-oriented policy," having become "convinced that centralized management of the Indian economy was a mistake."<sup>234</sup> Indeed, the Indian government's "principal motivation" in pursuing liberalization was its desire to "accelerate the Indian rate of economic growth, implicitly acknowledging that its micromanagement was inhibiting performance."<sup>235</sup>

Did the Indian government need to tie its hands with BITs in the 1990s in order to attract FDI? Much of the literature on BITs which tries to estimate the potential effects of such treaties in terms of their ability to stimulate increased inflows of FDI to the countries that enter into them fails to account for the effects of liberal reforms which, as this study demonstrates, are often, if not always, undertaken at the same time as a country concludes BITs. Therefore, it remains to be seen whether subsequent increases in inward FDI are a consequence of liberal policy changes,

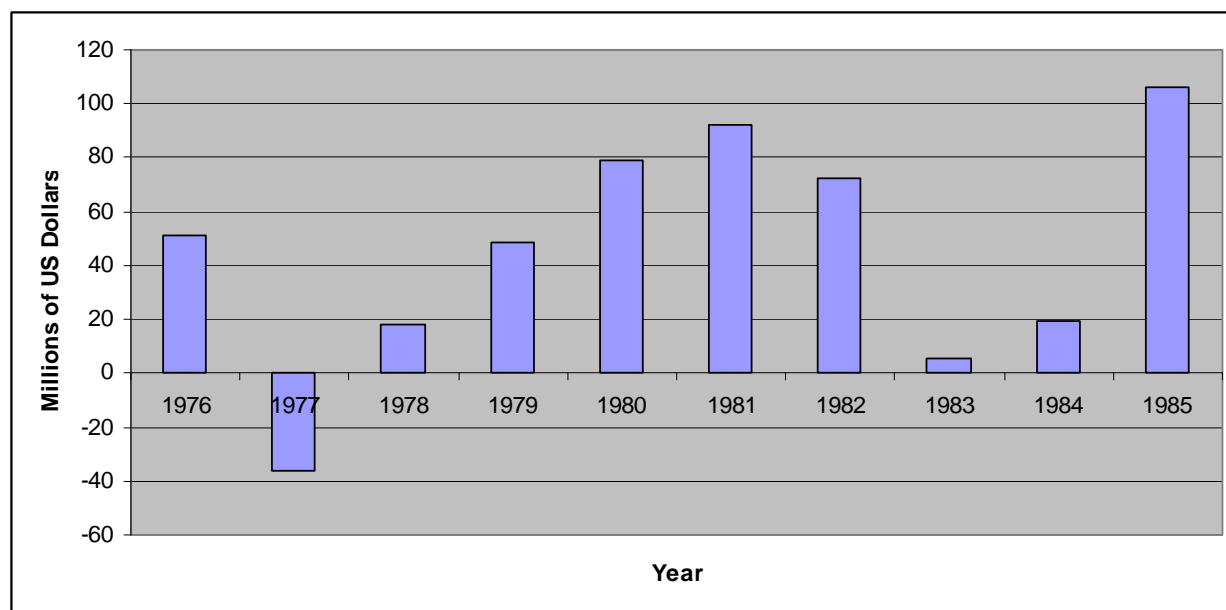
---

<sup>233</sup> In addition to liberalizing policies toward FDI, the Indian government had also undertaken considerable deregulation of the domestic economy and significant trade liberalization.

<sup>234</sup> Denoon 1998, 53.

<sup>235</sup> Ibid., 46.

BITs, or some combination of the two. Consider the effect of liberalization in the absence of concomitant treaty commitments. Despite the establishment of a highly restrictive regulatory regime in the 1960s and 1970s, India's market remained highly profitable from the perspective of MNCs. As a result, as Encarnation (1989) points out, "only a slight liberalization in government policy" in the early 1980s "was required to revive foreign investments once again. In fact, the response from multinationals followed immediately: between 1981 and 1982 the number of new direct investments nearly tripled, while in rupee value, equity inflows grew sixfold...Japanese multinationals now joined a new wave of American and German enterprises."<sup>236</sup> The apparent effects of this limited liberalization, which occurred in the absence of any international legal commitments, are revealed in figure 4.5.



Source: UNCTAD Handbook of Statistics

Figure 4.5 FDI Inflows to India, 1976-1985

<sup>236</sup> Encarnation 1989, 75.

Comparing FDI inflows over a longer time span, we see that the more extensive and sustained reforms of the 1990s had an even bigger apparent impact on FDI inflows than the meager changes of the early 1980s discussed by Encarnation, as revealed by figure 4.6. However, the role which BITs played in this outcome cannot be entirely dismissed. As figure 4.7 shows, the cumulative number of BITs which India signed with high-income OECD countries beginning in the second half of the 1990s closely follows the dramatic increase in inward FDI which began during this same period. Nonetheless, the upward trend in FDI inflows begins around 1991, three years before India signed its first BIT.

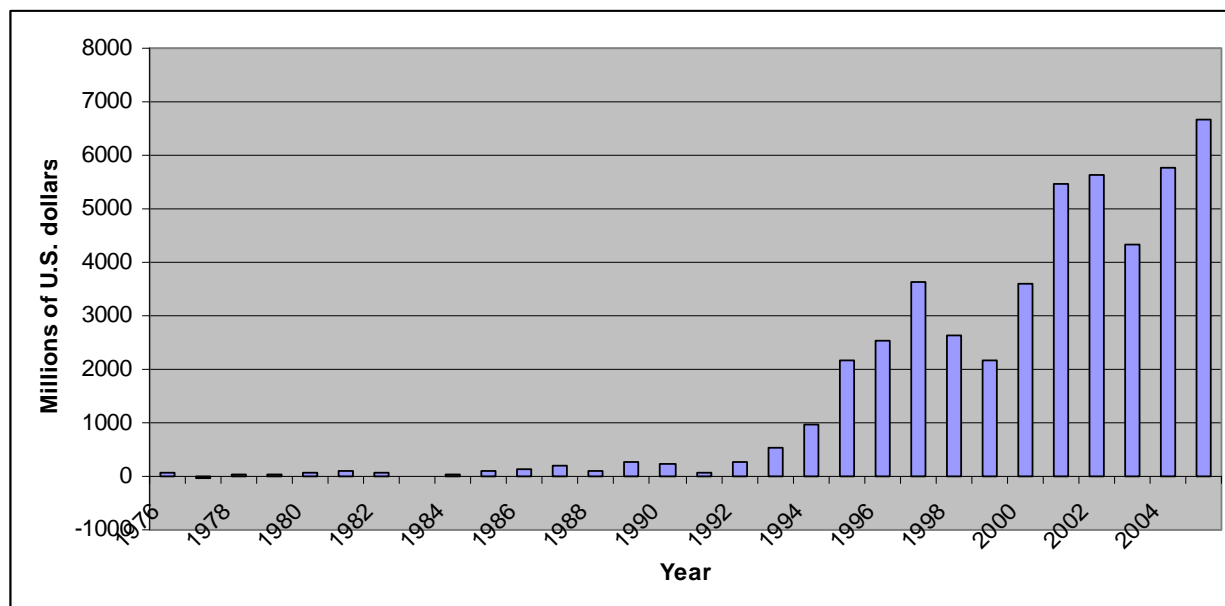
Therefore, it remains to be seen whether India would have received less FDI inflows had it chosen not to enter into any BITs. Given core economic fundamentals such as the size of the Indian market, its continuing profitability, and India's rate of economic growth during the 1990s,<sup>237</sup> as well as the scope of its liberalization program, it seems highly unlikely that India would have received significantly less FDI had it refrained from concluding BITs. Furthermore, it had already begun to see a significant increase in inward FDI immediately after lifting restrictions on foreign ownership. So, we are left with the question: Why did the Indian government choose to tie its hands by entering into BITs? This outcome is especially puzzling given India's historic hostility toward a multilateral treaty regime for FDI which would protect the rights of foreign investors by regulating the behavior of host states.<sup>238</sup>

A possible solution to this puzzle can be found by examining the domestic political context in which the Indian government's liberalization efforts took place and the distributional implications of those policies. As Denoon (1998) explains, India's "intricate web of controls

---

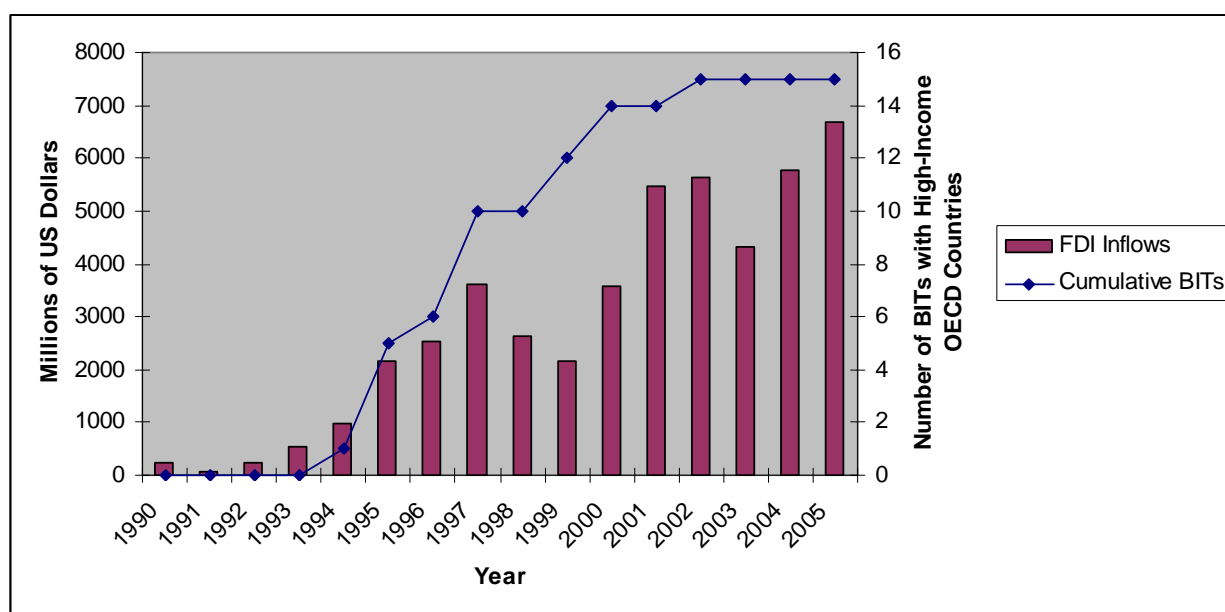
<sup>237</sup> Between 1990 and 2000, India's annual GDP growth rate averaged 5.8 percent. During the middle of that decade, between 1995 and 1997, its growth rates exceeded 7 percent.

<sup>238</sup> Recall India's opposition to rules requiring nondiscriminatory treatment of foreign investments during the ITO negotiations as well as its more recent opposition to the TRIMS agreement and MAI.



Source: UNCTAD Handbook of Statistics

Figure 4.6 FDI Inflows to India, 1976-2005



Source: UNCTAD Handbook of Statistics; UNCTAD BIT database available at:  
<http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>

Figure 4.7 India: FDI Inflows and BITs, 1990-2005

created an interlocking set of powerful groups,” including businessmen, civil servants, and politicians, “that each stood to lose if controls were substantially reduced or eliminated.” The “persistence of extreme poverty, widespread illiteracy, distrust of business, and a high level of politicization of economic policy in India has made it possible for advocates of controls to present their actions as designed to improve” the societal distribution of income.<sup>239</sup> Major political parties such as the Bharatiya Janata Party have often portrayed foreign investment “as a threat to sovereignty and the viability of local firms.”<sup>240</sup> Previous attempts at liberalization had “never been fully successful because there is no sufficiently powerful coalition willing to push consistently over long periods to achieve a decontrolled economy” which could balance the “broad coalition of government officials, businessmen in protected industries, and academics and members of the press” which “have always been available to criticize steps toward market-oriented policies.”<sup>241</sup> Consistent with this pattern, the Rao government’s liberalization program was met by deep resistance by left parties, the press, and academic commentators.

Against this backdrop, the Rao government’s decision to conclude BITs with Britain, Germany, and other important sources of FDI can be explained as an attempt to tie the hands of its successors, thereby locking in liberal investment policies which it deemed to be in the country’s long-term interest against the contrary preferences of groups favoring a return to a more restrictive and protectionist investment regime. Coming to power during an emerging economic crisis, the Rao government was able to expeditiously push through extensive liberal reforms toward FDI. Believing that FDI represented a critical source of capital and technology given the disappearance of a vital source of foreign aid (the Soviet Union), the Rao government institutionalized its policy preferences by entering into BITs. The scope of India’s first BIT with

---

<sup>239</sup> Denoon 1998, 46.

<sup>240</sup> Ibid., 47.

<sup>241</sup> Ibid., 57.

Britain, for instance, applied to both existing and future British investments.<sup>242</sup> Furthermore, the treaty ultimately represents a 26-year commitment on the part of India. Its initial duration was set at ten years, after which either state could give written notice of its desire to terminate the agreement. The agreement would then remain in force for another year from the date on which it was terminated. However, its provisions would continue to apply to any investments made while the agreement remained in force for a period of fifteen years after the date of termination.<sup>243</sup> Therefore, the India's legal commitment to the rights of British investors would last far beyond the Rao government's tenure in office.<sup>244</sup>

However, perhaps the most important mechanism through which the Rao government tied the hands of its successors, thereby locking-in its policy preferences, was to include a binding commitment to arbitration. Article 9 of India's BIT with the United Kingdom includes an advanced consent on the part of both states to investor-state arbitration under either the ICSID regime or UNCITRAL rules. With respect to the latter set of rules, the treaty states that the decisions of any arbitral tribunal established under UNCITRAL rules "shall be final and binding and the parties shall abide by and comply with the terms of its award."<sup>245</sup> By making a binding

---

<sup>242</sup> Article 2 of the BIT between the United Kingdom and India states that the agreement "shall apply to all investments made by investors of either Contracting Party in the territory of the other Contracting Party, *whether made before or after the coming into force of this Agreement*" (emphasis added).

<sup>243</sup> See article 15.

<sup>244</sup> A virtually identical "duration and termination" article can be found in India's second major BIT with Germany, the text of which is available at: [http://www.unctad.org/sections/dite/ia/docs/bits/germany\\_india.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/germany_india.pdf). India's fourth major BIT with the Netherlands represents a potentially lengthier (though admittedly, also a potentially shorter) commitment. Article 16, section 1 of that treaty states: "This Agreement shall remain in force for a period of ten years. Unless notice of termination has been given by either Contracting Party at least six months before the date of the expiry of its validity, the present Agreement shall be deemed to have been extended for periods of ten years at a time, each Contracting Party reserving the right to terminate the Agreement upon notice of at least six months before the date of expiry of the current period of validity. In respect of investments made before the date of the termination of the present Agreement the foregoing Articles shall continue to be effective for a further period of fifteen years from that date." The text of this BIT is available at: [http://www.unctad.org/sections/dite/ia/docs/bits/netherlands\\_india.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/netherlands_india.pdf).

<sup>245</sup> India has never become a contracting member of the ICSID Convention. Hence, all of its arbitral disputes have been governed by UNCITRAL arbitration rules. It has had nine arbitral claims brought against it by foreign investors, including two by British investors, two by Dutch investors, two by French investors, one by an Austrian investor, and one by a Swiss investor.

commitment to arbitration, the Rao government was essentially providing foreign investors with a weapon through which they could legally challenge any attempt by future governments to adopt discriminatory policies toward foreign investment or restrict a foreign firm's ability to repatriate its profits. There is of course no guarantee that future governments would respect these commitments, but at the very least, by concluding BITs with major capital-exporting countries, the Rao government has raised the transaction costs associated with a return to a discriminatory and protectionist investment regime.

## DISCUSSION

If an LDC ratifies a BIT with a capital-exporting country and then violates the rights of that country's investors (as outlined in the treaty), either intentionally or inadvertently, then the aggrieved investors can initiate costly arbitration proceedings against the host state. If the state refuses to participate in these proceedings or refuses to pay the damages which may have been awarded to an aggrieved investor by an arbitration tribunal, then it risks damaging its reputation as an attractive or hospitable site for foreign investment.<sup>246</sup> In addition, it puts itself at odds with its treaty partner. On the other hand, if the state complies with the decisions of the arbitral panels constituted to hear and decide such cases, then it could end up owing substantial amounts of

---

<sup>246</sup> Anecdotal evidence for such reputational damage can be found in the Jamaican government's decision, under the leadership of Michael Manley, to unilaterally withdraw from ICSID arbitration proceedings in 1974 despite having given prior consent to ICSID arbitration and being a signatory to the ICSID convention. As a result of its decision to withdraw from ICSID proceedings, Baker 1999, 75 suggests that the Jamaican government "probably lost...credibility in the international investment community." Prior to the disputes, President Manley "had stated that contractual obligations and treaty commitments were merely scraps of paper" and that "the thought of a sovereign government submitting to international arbitration is unrealistic" (quoted in Baker 1999, 75). Following Jamaica's decision to flout their obligations, international business consultants S. J. Rundt & Associates warned investors "to be very careful of any investment contemplated in Jamaica," and many "economic analysts at that time forecast that the Jamaica Government's actions in this area would be costly to that country's development." "The international stigma attached to the withdrawal by a government from an internationally sanctioned procedure after accepting that procedure," concludes Baker 1999, 75, "certainly had long term ramifications for Jamaica." The validity of this assertion would seem to be confirmed by Jamaica's subsequent inability to attract FDI after 1974 as indicated by several consecutive years of negative inflows.



money to foreign investors. In short, BITs are not cheap. They carry significant ex post costs, including the loss of regulatory autonomy with respect to FDI and the financial costs associated with investor-state arbitrations. Why then have some governments been willing to accept these costs by concluding BITs with major capital-exporting countries, while others have refrained from making such commitments? What explains cross-national variation in the timing of such commitments? My argument has highlighted two key variables which explain the pattern of BIT signings—changing policy preferences among LDC governments and the strength of a country’s institutional infrastructure for the protection and enforcement of property rights.

First, my argument suggests that BITs function as a screening mechanism which distinguishes governments that are committed to liberal investment policies from those who remain committed to protectionist, and therefore discriminatory, FDI policies. Countries are more likely to conclude BITs when the incumbent government has embarked on a program of liberalization of the regulatory regime governing inward FDI. BITs help liberalizing governments to signal their favorable policy preferences toward foreign investment and make a credible commitment to the property rights of foreign investors, thereby resolving the time-inconsistency problem. These governments also use BITs as a mechanism for “locking-in” investment-friendly policies and for preventing institutional “back-sliding” by future governments which may not share their policy preferences, thereby raising the credibility of their commitments to such policies.<sup>247</sup> The results of my empirical analysis of BIT signings suggests that those countries most likely to conclude such treaties are precisely those whose policies are most open to FDI, thus confirming the expectations of my argument. Investment-friendly policies tend to be established at the domestic level first, while external investment-related legal

---

<sup>247</sup> See Fernández and Portes 1998 and Moravcsik 2000 for discussions of international treaties as “locking” mechanisms.

commitments tend to be made *after* these domestic-level changes have taken place. The experience of India provides a nice illustration of this recurrent pattern. A similar story could be told for many Latin American countries such as Argentina, Bolivia, and Mexico, all of whom abandoned statist and protectionist policies beginning in the late 1980s and early 1990s in response to economic crises (especially hyperinflation), as well as many Eastern European countries such as the Czech Republic, Hungary, and Poland whose economies experienced revolutionary transformations from communist to capitalist systems which left these countries more open to foreign capital than at any point since the advent of the Cold War.

Second, violations of the rights of foreign investors—acts which constitute noncompliance with BITs—are presumably more likely to occur in countries with relatively weak institutions for the protection and enforcement of private property rights. In other words, it is precisely those countries with weak domestic property rights regimes which are more likely to “get into trouble” if they commit themselves to the kinds of legal rules and procedures found in BITs. Therefore, I have argued that governments that preside over countries with an inferior institutional endowment will rationally avoid making such commitments. The results of my analysis lend support to this expectation as well. The fact that countries with weaker property rights institutions are significantly less likely to even *sign* BITs, much less ratify them, implies that these types of countries tend to avoid committing themselves to something which they realize could be very costly for them. At the very least, the results of my analysis contradict the idea that countries with greater “indigenous credibility” (i.e., stronger domestic property rights regimes) are less likely to sign BITs. Instead, countries with significant “credibility gaps” (i.e., weak property rights regimes) are the ones that are less likely to conclude BITs. This evidence goes against the prediction of what I have referred to as the substitution hypothesis. It would

seem then that instead of functioning as a device through which those countries that lack institutional credibility in the eyes of foreign investors attempt to gain greater credibility, BITs actually serve, again, as a screening mechanism, distinguishing the truly credible from the incredible. It would appear that states actually refrain from formally committing themselves to the international legal regime for investor rights until they have developed the institutional capacity necessary to assure a reasonable level of compliance with such commitments, thereby reducing the potential costs or price of such commitments.<sup>248</sup>

Taking a broader perspective, the research findings reported here suggest that the relationship between a country's domestic policy regime for FDI and its international investment-related legal commitments (as embodied in BITs) has in practice tended to be complementary. This finding has relevancy for a larger debate within the field of IR regarding the behavioral significance of international legal commitments. Do international legal commitments as embodied in formal treaties represent a significant constraint on the behavior of sovereign states? This question, notes Simmons (2000), "is at the root of major disagreements between realist and institutionalist theorists in international relations."<sup>249</sup> Numerous studies conducted by both IR and legal scholars have found that states generally comply with the treaties they sign. As Henkin puts it, "almost all nations observe almost all principles of international law and almost all of their [treaty] obligations almost all of the time."<sup>250</sup> The causal significance of this observation has been challenged, however, by other scholars who have argued that a state's decision to make an international legal commitment in the first place may be endogenous

---

<sup>248</sup> That being said, competition for FDI has obviously driven almost all LDCs to conclude BITs regardless of their institutional capacity to comply with the legal obligations which such treaties impose on host countries, as my analysis of the effects of regional and global competition in the presence of an unfavorable domestic regime for FDI demonstrates. However, in terms of the timing of such commitments, my analysis clearly suggests that a longer span of time will ordinarily pass before countries with weak institutions enter into BITs compared to those countries possessing a superior institutional endowment.

<sup>249</sup> Simmons 2000, 819.

<sup>250</sup> Henkin 1979, 47.

to its preferences and expectations about future compliance.<sup>251</sup> As von Stein puts it, “compliance data alone do not tell us whether states abide by the treaties they sign because the legal commitment compels them to do so, or because they sign treaties that do not require significant departure from what they would have done in the absence of the treaty...Any theory of treaty compliance must recognize that...states are only likely to invest their time and resources in agreements with which they have at least some interest in complying.”<sup>252</sup>

The research findings of this paper are more congruent with this latter view of international legal commitments. The countries that sign BITs are precisely those which we would expect to respect the rights of foreign investors even in the absence of an international legal commitment to do so. India, for example, granted national treatment to all foreign investors before concluding a treaty with Britain that would obligate it to grant such treatment to British investors. This does not necessarily mean that international investment-related legal commitments are somehow meaningless. Nor does it mean that such commitments do not impose significant ex post reputational and diplomatic costs on the states that sign them. “Even for the committed,” suggest Simmons and Hopkins, “there may be conditions under which it would be tempting to renege on a treaty commitment. Many of these conditions will not have been fully anticipated by the government.”<sup>253</sup> Yet, “a legally committed government,” they assert, “will still rationally want to avoid the inconsistency costs of reneging.” More importantly, by imposing such ex post costs on themselves, pro-FDI governments are also decreasing the likelihood that liberal reforms pertaining to foreign investment will be undone by future governments with less than favorable policy preferences toward FDI. In short, the

---

<sup>251</sup> Downs, Rocke, and Barsoom 1996.

<sup>252</sup> von Stein 2005, 611.

<sup>253</sup> This would certainly seem to be the case for the Argentinean government which has had over three dozen arbitration disputes initiated against it since 2001, many of which resulted from its decision to devalue its currency.

findings presented in this chapter suggest that investment-related treaty commitments are not random. The pattern of BIT signings exhibits a distinct screening effect; presumably “because only those governments that are willing and think they will be able comply” are likely to “sign on.”<sup>254</sup>

---

<sup>254</sup> Simmons and Hopkins 2005, 624.

## CHAPTER 5

### THE DETERMINANTS OF INVESTOR-STATE ARBITRAL DISPUTES

The previous chapter examined the relationship between a country's domestic regime for FDI (specifically, its policies governing foreign investment inflows and its institutional infrastructure for protecting and enforcing private property rights) and its propensity to formally commit itself to the international investor rights regime by concluding BITs. The results of the empirical analysis conducted in that chapter suggested that countries that have substantially liberalized their regulatory regime governing FDI and which already possess relatively strong property rights systems are significantly more likely to conclude BITs than are countries that maintain illiberal policies or whose property rights institutions remain comparatively weak. Thus, in terms of the timing of LDC commitments, the relationship between national and international investment regimes appears to be complementary. This chapter further explores the relationship between these two types of regimes by addressing the issue of compliance with BITs and by identifying the determinants of one of the principal sources of BIT-related compliance costs—namely, investor-state arbitrations.

Although the findings presented in chapter 4 suggest that countries with liberal policy regimes and strong property rights institutions—in other words, those countries that arguably represent the least risky destinations for FDI—are more likely to enter into BITs than their more illiberal or institutionally inferior counterparts, the difference is mainly one of *timing*. Over time, competition for foreign capital has driven LDCs of all stripes to make investment-related legal commitments at the international level, including those with poor institutions. Hence, the

primary question which this chapter seeks to address is this: *Do countries with superior institutional endowments have an easier time complying with their BIT-related obligations than those countries whose institutional capacity is considerably lower?* In other words, is the relationship between a country's domestic property rights regime and its international investment-related commitments complementary, not only in terms of its propensity to *make* such commitments, but also its *capacity to comply* with those commitments? To put it another way, do the costs of compliance with the international investor rights regime tend to be higher for those countries that lack the institutional capacity to protect and enforce private property rights?

The extant literature on BITs has (with only a small handful of exceptions) been chiefly concerned with two issues: (1) the impact of BITs on the distribution of FDI flows among developing countries and (2) the conditions under which countries are more or less likely to conclude BITs. The primary objective of the first stream of research, which constitutes an overwhelming majority of the literature, has been to establish whether BITs stimulate increased inflows of FDI to those countries that enter into such treaties relative to those that do not.<sup>255</sup> The second stream has attempted to identify the circumstances under which LDCs formally commit themselves to the international investor rights regime (or refrain from making such commitments) in an effort to explain the timing and pattern of investment-related legal commitments.<sup>256</sup> Whereas the first stream of research treats BITs as a key explanatory variable (which may or may not influence FDI flows), the second stream treats BITs as the dependent variable.

---

<sup>255</sup> See, e.g., Hallward-Driemeier 2003; Egger and Pfaffermayr 2004; Büthe and Milner 2005; Neumayer and Spess 2005; Salacuse and Sullivan 2005; Tobin and Rose-Ackerman 2005, 2006; Aisbett 2007; Haftel 2007; Peinhardt and Allee 2007; Yackee 2007a, 2007b; Kerner 2009.

<sup>256</sup> See, e.g., Swenson 2005; and Elkins, Guzman, and Simmons 2006. The research presented in chapter 4 obviously falls within this second stream.

Both streams of BIT-related research rely on theoretical arguments which emphasize the capacity of BITs to constrain the behavior of host states toward foreign investments. Most scholars agree that it is the binding commitment to arbitration included in most BITs which makes the substantive commitments found in such treaties credible. Without this important enforcement mechanism, the capacity of BITs to constrain state behavior would be significantly weaker, or so the arguments go.<sup>257</sup> Yet, despite the prevalence of such compliance-based arguments, hardly any attention has been paid to the issue of compliance itself as it pertains to BITs. Do host states actually comply with their BIT-related obligations in practice? What is the rate of compliance with the decisions of tribunals constituted to arbitrate investor-state disputes arising from BITs? Are there significant instances of noncompliance? Questions such as these have simply not been raised in the extant literature. This chapter takes a first step toward filling this noticeable gap in the literature by exploring the issue of compliance with BITs both theoretically and empirically. Whereas the analysis in chapter 4 builds upon existing research on the determinants of international investment-related legal commitments, this chapter breaks entirely new ground by exploring the nature and costs of compliance with such commitments.

Determining a country's degree of compliance with BITs is by no means an easy task. Such an assessment would first require an extensive and detailed examination of a country's regulatory regime governing inward FDI. The researcher would then have to make a judgment as to the degree to which the country's policies conformed to the terms of not just one, but *multiple* treaties, some of which might vary in terms of their substantive obligations.<sup>258</sup> The country's policies might be more congruent with some BITs and less congruent with others. The researcher would then have to conduct a similar policy review for other countries before being

---

<sup>257</sup> See, e.g., Elkins, Guzman, and Simmons 2006, and Yackee 2007.

<sup>258</sup> Although some scholars have tried to highlight the importance of such variation, BITs are remarkably uniform in terms of both their substantive and procedural content.



able to make cross-national comparisons, making for an enormous and lengthy project.<sup>259</sup> Given these obvious difficulties, my first contribution is a methodological one. I propose a relatively easy way of measuring noncompliance with BITs, albeit an imperfect one: *the number of arbitral claims that are brought against a country by foreign investors over time*. Investor-state arbitration represents the principal mechanism for enforcing BIT-related obligations. Each time a foreign investor initiates arbitration proceedings against a host state using a BIT between that state and the investor's home state as the legal instrument for pursuing its arbitral claims, they are essentially calling into question the host state's compliance with the substantive commitments embodied in the BIT. In other words, the investor is alleging that the host state's policies or actions have violated the investor's rights as defined by the BIT. While we cannot assume that such claims will always be upheld, they do represent the primary mechanism through which noncompliance, if it has in fact occurred, is brought to light. Therefore, the number of arbitral disputes which a country becomes involved in over time can at least be regarded as a good indicator of *potential* noncompliance with BITs. Perhaps more importantly, the number of arbitral claims that are brought against a country by foreign investors represents one way of measuring the costs of complying with the international investor rights regime and for determining how these costs vary among countries.

Thus, this chapter is largely devoted to explaining cross-national variation in the number of arbitral claims brought against individual countries over time. Aside from its possible contribution to our understanding of the sources of noncompliance with BITs and other international investor rights agreements, as well as the costs of complying with BITs, the determinants of investor-state arbitral disputes are a worthy object of study in their own right,

---

<sup>259</sup> The task would be equivalent to the trade policy reviews which the WTO periodically conducts for all of its members.

especially given the spectacular increase in the number of such disputes which occurred during the past decade and a half. *This is the first ever study to address the determinants of investor-state arbitral disputes.* My principal theoretical contribution is to highlight the importance of a country's institutional endowment or capacity as a key determinant of the number of arbitral disputes launched against it by foreign investors. I hypothesize that countries which lack strong domestic property rights institutions are more likely to experience greater difficulties complying with their BIT-related obligations. This was one of the untested propositions underlying the institutional capacity hypothesis developed in chapter 3 which suggested that countries with inferior institutional endowments are deterred from entering into BITs because of the presumably higher compliance costs resulting from their lack of institutional capacity. If it is true that countries with weak domestic property rights regimes have a harder time complying with their BIT-related commitments, then these countries should have a significantly greater number of arbitral disputes initiated against them by foreign investors. Using an original dataset, I test this hypothesis regarding the relationship between a country's domestic institutions and its ability to comply with BITs. The results of this empirical analysis lend support to my hypothesis.

The chapter is organized as follows. I begin by offering additional justification for my decision to use the number of arbitral claims that are brought against a host country over time as an indicator of that country's degree of potential noncompliance with its BIT-related commitments along with some important caveats. This is followed by a theoretical discussion which identifies some of the determinants of arbitral disputes between foreign investors and host states, including the host country's institutional capacity for resolving investment disputes and the incentives foreign investors have to pursue arbitral claims at the international level, the incentives of host states to engage in expropriatory behavior, and the political factors

constraining such behavior. I then discuss my research design and present the results of my analysis. The chapter concludes with a discussion of the findings.

## **INVESTOR-STATE ARBITRATION AND COMPLIANCE WITH BITS**

Anarchy, or the absence of a central authority capable of enforcing promises and contractual commitments, ultimately makes compliance with international regulatory agreements problematic. A large literature has therefore been devoted to identifying the conditions under which states are more or less likely to comply with their treaty commitments. Two competing approaches to explaining compliance have emerged—an “enforcement” approach which emphasizes the necessity of monitoring and sanctions as mechanisms for ensuring compliance (especially in those cases in which agreements require substantial changes in state behavior), and a “management” approach which stresses the tendency for states to comply with their international treaty obligations and which sees noncompliance, when it does occur, as resulting, not from “deliberate decisions to violate treaties,” but “capacity limitations and rule ambiguity.”<sup>260</sup> Both schools offer insights which are useful for understanding compliance with BITs and other investor rights agreements. The enforcement approach highlights the role of investor-state arbitration as a solution to the monitoring problem which confronts home states and as a mechanism for detecting and punishing noncompliance. The management approach points to a country’s institutional capacity as a potentially important factor determining whether a foreign investor decides to pursue arbitration at the international level as a means of resolving its dispute with a host state, and therefore a potentially significant determinant of the actual

---

<sup>260</sup> Tallberg 2002, 613. The enforcement approach is exemplified by Downs, Rocke, and Barsoom 1996, while the management approach is typified by Chayes and Chayes 1993, 1995. As Tallberg notes, the enforcement and managerial approaches “are widely regarded as competing, both in theory and practice.” However, Tallberg argues that the two approaches are in fact complementary since the “strategies for achieving compliance” which each approach advocates “are most effective when combined.” Tallberg 2002, 609-10.

number of arbitral claims a state has brought against it over time. Here I consider the functions of investor-state arbitration from an enforcement perspective.

In its efforts to understand regime compliance, the enforcement approach relies on a rationalist “logic of consequentiality.”<sup>261</sup> States are treated as rational actors confronting a mixed-motive situation in which there are countervailing incentives to comply and renege. The fact that states have agreed to impose explicit limitations on their behavior by establishing a regulatory regime presumes some sort of material benefit to be had from such behavioral constraints. By formally committing themselves to a set of rules that are intended to guarantee certain legal rights for foreign investors, LDCs hope to stimulate increased inflows of FDI, a much needed source of external finance for such countries. However, regime compliance also entails costs, creating an incentive for states to shirk on their obligations. BITs, for instance, impose significant sovereignty costs, limiting the ability of LDCs to regulate FDI in ways that might promote development objectives.<sup>262</sup>

According to the enforcement approach, compliance decisions are the result of a conscious, cost-benefit calculation. States comply with the behavioral dictates of international regulatory regimes for instrumental reasons and only when the long-term benefits of compliance outweigh the short-term benefits of noncompliance. If there are no significant consequences associated with noncompliance or if noncompliant behavior is difficult to detect, then states may regard cheating as both feasible and profitable. “Compliance problems are therefore best remedied by increasing the likelihood and costs of detection through monitoring and the threat of

---

<sup>261</sup> March and Olsen 1989.

<sup>262</sup> For example, by limiting or banning the use of performance requirements intended to ensure FDI-related spillovers or backward linkages to the domestic economy, or by curbing the use of discriminatory policies intended to promote domestic industries or firms.

sanctions.”<sup>263</sup> In the context of BITs, investor-state arbitration offers a solution to the problem of cheating, providing a simple mechanism for detecting and punishing noncompliance. As such, it represents a critical element of the investor rights regime embodied in the diffuse web of BITs, PTAs, and other international agreements.

Unlike some regimes in which monitoring compliance may be difficult (e.g., environmental regimes or the nuclear nonproliferation regime), the monitoring problem would seem to be partially (if not fully) resolved in the case of BITs and other investor rights agreements by the availability of the victims of noncompliance as low-cost monitors.<sup>264</sup> Under an investor rights regime, foreign investors are the victims of noncompliant behavior on the part of host states. Who better to monitor compliance than those whose rights have been violated by the actions or policies of a host state? The effects of noncompliance (e.g., expropriation, decreased profitability) are immediately felt by investors. Furthermore, large MNCs will usually possess both the financial and legal resources necessary to pursue arbitral claims. Granting investors direct access to the dispute settlement system also means that home states do not have to bear the costs of monitoring host state behavior themselves. The pursuit of arbitral claims can therefore be regarded as a convenient (though for reasons that will be outlined below, imperfect) indicator of the degree of potential noncompliance on the part of host states. Given an equivalent level of commitment (i.e., states have entered into an equivalent number of BITs and those BITs contain equivalent substantive and procedural commitments), states that have few or no arbitral claims brought against them are presumably maintaining a high level of compliance with their BIT-related obligations, while states that become party to a relatively large number of arbitral disputes are presumably engaging in a significant amount of questionable, if not entirely

---

<sup>263</sup> Tallberg 2002, 611.

<sup>264</sup> Dai 2002.

noncompliant, behavior. At the very least, when noncompliance has occurred, investor-state arbitration represents the principal mechanism through which it is most likely to be brought to light.

The past decade and a half has witnessed a veritable explosion in the use of arbitration by MNCs and other foreign investors as a means of settling their disputes with host states. Since 1992, investors have registered 228 arbitral claims with ICSID. In the preceding 25-year period, the organization had only handled 24 such claims.<sup>265</sup> A database constructed by UNCTAD containing information on 289 treaty-based investor-state disputes submitted for arbitration between 1987 and 2007 shows that 277 of the disputes occurred within the last decade since 1997.<sup>266</sup> Increasingly, the legal instruments used to pursue such claims are BITs or other interstate agreements such as PTAs (e.g., NAFTA). The dramatic rise in the number of investor-state arbitral disputes since the mid-1990s is in part a function of the corresponding increase in the number of BITs and other investor rights agreements which directly preceded it in the early 1990s.

Although investor-state arbitration represents the principal device through which violations of investor rights are brought to light, making the number of arbitral claims a host country becomes involved in over time an expedient indicator of potential noncompliance with BITs on the part of host states, a few important qualifications must be made. First, just because

---

<sup>265</sup> For a list of concluded and pending ICSID arbitration cases, see the ICSID website: <http://icsid.worldbank.org/ICSID/Index.jsp>.

<sup>266</sup> See <http://www.unctad.org/ia-dbcases/index.html>. The UNCTAD database includes information on investor-state disputes arbitrated under a number of different venues and rules, including the United Nations Commission on International Trade Law (UNCITRAL), the International Chamber of Commerce (ICC), the Arbitration Institute of the Stockholm Chamber of Commerce (SCC), and the Permanent Court of Arbitration (PCA), in addition to ICSID. ICSID stands out as the most popular arbitration regime. Of the 289 disputes included in the UNCTAD database, 184 (approximately 64%) of these were either directly registered with ICSID or arbitrated in another venue using ICSID arbitration rules. The UNCITRAL Arbitration Rules are the second most popular regime accounting for 78 (approximately 27%) of these disputes. Together, the ICSID and UNCITRAL regimes account for roughly 91% of the disputes included in the UNCTAD database.

an investor has decided to pursue an arbitral claim against a host state, this does not necessarily mean that the state has in fact engaged in noncompliant behavior, although the investor may genuinely believe that its BIT-defined rights have been violated. Ultimately, only an arbitral body can determine whether an actual transgression on the part of the host state has in fact taken place. Tribunals sometimes rule in favor of states, finding the claims of investors to be groundless or inaccurate.<sup>267</sup> Second, under certain circumstances, investors may have an incentive to forego arbitration as a means of resolving their disputes with host states. Given the long-term nature of FDI and the importance of certain host country markets to foreign investors, some investors may wish to avoid pursuing an arbitral claims for fear of jeopardizing their relations with the host state which might in turn threaten their future access to the host country's market. For many investors, arbitration may represent an option of last resort. Hence, the number of arbitral claims brought against a host state might underestimate the actual degree of noncompliant behavior on the state's part.<sup>268</sup> Finally, the procedural rules of every arbitration venue except ICSID allow for absolute privacy if at least one of the parties requests it, meaning not all arbitrated disputes between foreign investors and host states are publicly known. Therefore, the number of known arbitral claims brought against a state may again be

---

<sup>267</sup> Of the treaty-based arbitral disputes contained in the UNCTAD database referenced above whose outcomes were not still pending or unknown and in which a tribunal rendered a final decision, a slight majority were won by states. Out of 79 cases, states won 43, or 54%, while investors won 36, or 45%. Another 40 cases from the database were settled "out of court," meaning the parties reached an agreement before a final decision was rendered by the arbitral body. It is difficult to interpret the meaning of such "settlements" in terms of potential noncompliance. On the one hand, a settlement implies some sort of concession on the part of the host state to the foreign investor, suggesting that the state may have believed its actions or policies might not withstand the scrutiny of a tribunal. However, even "innocent" states may have an incentive to settle with investors in order to avoid the potentially higher pecuniary costs stemming from an arbitral award, especially if they believe that the arbitral system is biased against them. A large number of treaty-based arbitral disputes between foreign investors and host states are still pending. As a result, it is still too early to tell whether investor-state arbitration as an institution exhibits any bias towards states or investors.

<sup>268</sup> I give further consideration to the shadow of the future and the resulting incentives investors have to pursue or avoid pursuing arbitral claims against host states below.

underestimating the actual degree of noncompliance. With these important caveats in mind, I now proceed to consider the determinants of investor-state arbitral disputes.

## **THE DETERMINANTS OF INVESTOR-STATE DISPUTES**

A theory of how investor-state disputes turn into arbitral disputes must account for the opportunities and incentives foreign investors have to pursue arbitral claims as opposed to settling their disputes with host states outside of the international arbitration system. The opportunity to pursue arbitration is largely dependent on a host state's willingness to consent to arbitration as a means of resolving its disputes with foreign investors. However, an investor's incentive to pursue arbitration largely depends on the availability of alternative means by which to settle disputes with host governments such as the host country's domestic legal system. Foreign investors are more likely to find relief in host countries where the level of corruption is low and whose domestic legal systems are relatively strong and independent. In countries where the rule of law is weak and corruption is pervasive, investors may be forced to turn to treaty-based arbitration as a means of settling their disputes with host states. Therefore, the strength of the host country's domestic institutions represents a critical determinant of the number of arbitral disputes it experiences over time.

Identifying the conditions under which arbitral disputes between foreign investors and host states are most likely to occur also requires a theory about how such investment disputes arise in the first place. Arbitral claims are ultimately the result of actions taken by host states, actions that are regarded by one or more foreign investors as being discriminatory or which have the effect, either through direct seizure or indirectly through taxation or regulation, of depriving investors of their property—i.e., an expropriation. The essential purpose of BITs is to prevent



such discriminatory treatment or expropriations from taking place, or, in the event of an expropriation, to ensure that the investor is adequately compensated. Hence, any theory of investor-state disputes must account for the incentives of host states to discriminate against foreign investors, and, perhaps more importantly, to expropriate foreign investments. Such a theory should also account for those factors which constrain host states from engaging in expropriatory actions.

This section considers the effect which a host country's institutional endowment—specifically, its capacity for resolving investment disputes at the domestic level—has on the number of arbitral claims brought against the country by foreign investors at the international level. I also consider the incentives of host states to engage in expropriatory behavior, thereby potentially provoking arbitral disputes, and the political-institutional factors constraining such behavior

### *Institutional Capacity*

In the previous section, I discussed the role of investor-state arbitration as a mechanism for monitoring and fostering compliance with BITs and other investor rights agreements from an enforcement perspective. In order to understand the role which a country's domestic institutions play in determining the number of arbitral disputes which the country becomes party to over time, it is helpful to adopt a management perspective. The starting point for the management approach is best captured by Louis Henkin's famous observation that "almost all nations observe almost all principles of international law and almost all of their obligations almost all of the time."<sup>269</sup> For management theorists, noncompliance is rarely the result of "willful

---

<sup>269</sup> Henkin 1979, 47.

disobedience.”<sup>270</sup> Instead, it is usually the unintentional or inadvertent product of capacity limitations or ambiguous treaty provisions. I focus here on capacity limitations as a potential source of noncompliance.<sup>271</sup>

“A treaty,” assert Chayes and Chayes, “is an agreement among states and is an undertaking by them as to their future conduct. The object of the agreement is to affect state behavior.” Each state, “by governing its own actions...determines whether it will comply with the undertaking or not. Moreover, there is no doubt about the state’s capacity to do what it has undertaken.”<sup>272</sup> While this may be an accurate description of compliance for some international regulatory agreements, a state’s capacity to comply with its international obligations may, in some instances, be limited by a variety of factors. Compliance will often require a state “to establish and enforce a full-blown domestic regime.” Yet, among LDCs, “the characteristic situation is a severe dearth of the requisite scientific, technical, bureaucratic, and financial wherewithal to build effective domestic enforcement systems.”<sup>273</sup> In addition, political “capacity limitations” may “arise when a government lacks the ability to ensure that public and private

---

<sup>270</sup> Chayes and Chayes 1995, 22.

<sup>271</sup> There is reason to believe that at least some investment disputes have arisen from a lack of clarity in the language found in some investor rights treaties. For example, the phrase “tantamount to expropriation” which is found in many investment agreements concluded by the United States has been used by some investors to attack certain host country regulations on the grounds that such regulations had the same effect on an investment as if the host state had seized the investor’s assets. See, e.g., the case between the Ethyl Corporation and the Canadian government. However, the overall degree to which BITs vary in terms of their rule precision remains a matter of uncertainty. Both commentators and researchers have tended to emphasize the uniformity of BITs (See, e.g., Dolzer and Stevens 1995). To date, most efforts at determining the degree to which BITs vary in terms of their legalization have focused on the dimension of delegation—i.e., whether a BIT includes a binding commitment to investor-state arbitration. See, e.g., Yackee 2007a, 2007b, 2008a, 2008b; Allee and Peinhardt 2008, 2009. Investment treaties concluded by the United States do tend to exhibit greater rule precision than the average BIT. For instance, the definition of what qualifies as an investment and is therefore entitled to the protections afforded by the treaty tends to be much more exhaustive.

<sup>272</sup> Chayes and Chayes 1993, 193.

<sup>273</sup> *Ibid.*, 193-4.

actors meet international commitments. The government may be unable to...command compliance from subnational entities, or muster the necessary administrative capacity.”<sup>274</sup>

What kinds of capacity limitations might prevent LDCs from complying with their BIT-related obligations? Arguably, the most important source of capacity limitations in the context of investor rights regimes is a country’s institutional infrastructure for the protection and enforcement of private property rights. The essential purpose of BITs and other international investment agreements is to protect the property rights of foreign investors and to provide an external mechanism (i.e., arbitration) for enforcing those rights. This implies the absence of any institutions within the host country itself capable of ensuring such rights. BITs are therefore intended to substitute for the absence of strong domestic property rights institutions within a host country. Indeed, if such institutions already existed in the capital-importing LDCs with whom BITs are concluded, these countries would presumably have no need for entering into such agreements, nor would capital-exporting home countries seek them. The contrast between developed countries and LDCs is instructive. Because “their domestic legal systems are typically up to the task of handling investor disputes,” suggest Tobin and Busch (2008), BITs impose few costs on developed countries. “BITs impose few additional obligations on rich governments, given that curbs on expropriation are already in place, and the efficacy of their courts in handling such cases is seldom called into question.”<sup>275</sup> Consequently, DCs, as a rule, have not concluded BITs with each other.<sup>276</sup>

The obligations, and hence, the costs, which BITs impose on LDCs is akin to those which the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) imposes on

---

<sup>274</sup> Tallberg 2002, 613.

<sup>275</sup> Tobin and Busch 2008, 7-9.

<sup>276</sup> The one notable exception to this rule is the PTA concluded between Canada and the United States in the 1980s which included a chapter on investor rights equivalent to a BIT. This agreement was of course later subsumed by NAFTA which encompasses the same investment-related obligations.

WTO members. As Barton et al. (2006) explain, “the TRIPS agreement requires means of effective enforcement of intellectual property rights in all WTO member countries.”

Such a requirement demands the development of national institutions that can protect intellectual property rights and their enforcement—the establishment of a patent office, education of lawyers and judges about the nature of IP rights, constraints on the corruption of judges and other officials who administer and adjudicate IP rights and enforcement. Ultimately, TRIPS *mandates rule of law, which history has proven difficult to achieve in most of the world.*<sup>277</sup>

In those cases in which a country’s domestic legal regime fails to protect or enforce the intellectual property rights of foreign firms, the WTO system provides home states with an external mechanism in the form of its state-to-state dispute settlement process for ensuring compliance. Like TRIPS, BITs essentially mandate the rule of law in host countries and offer investor-state arbitration as an external mechanism for protecting and enforcing the rights of foreign investors in the event that the domestic legal system fails to uphold those rights.

We are left with a paradox: Those countries with weak or nonexistent domestic property rights institutions are the ones most in need of BITs as an institutional substitute, particularly from the perspective of both home countries and foreign investors. Yet these same countries are likely to experience the greatest difficulty complying with their BIT-related obligations precisely because of the fact that they lack strong indigenous institutions for the protection and enforcement of property rights. A country in which such institutions are relatively weak is an environment that is considerably more permissive of behavior which violates the property rights of both domestic and foreign capital. Regardless of the preferences or the political will of host governments, a weak or nonexistent domestic property rights regime may inevitably produce compliance problems in the form of arbitral claims. States are not unitary actors. Even if government leaders have adopted a favorable orientation toward FDI and have formally

---

<sup>277</sup> Barton et al. 2006, 142 (emphasis added).

committed themselves to uphold the property rights of foreign investors through domestic legislation and by entering into investment treaties, the absence of strong indigenous institutions—e.g., a strong rule of law, an independent judiciary, norms against corruption—may still generate noncompliance by creating an environment in which other actors—e.g., judges or other local officials—remain relatively unconstrained in their treatment of foreign investors. The lack of strong indigenous institutions means that there are no formal rules or informal norms to circumscribe the behavior of these actors toward foreign investors. A country in which corruption is institutionalized, for instance, could encounter compliance problems even though its leaders have embraced pro-FDI policies at the national level—that is, despite a change in the government’s preferences toward FDI.

As was suggested in chapter 3, a country’s institutional endowment for the protection and enforcement of property rights is partially exogenous to the policy preferences of host states. Institutions, by their very nature, are sticky. Even if a government’s preferences toward FDI change, prompting it to adopt policies that favor the rights of foreign investors, the larger institutional framework needed to reinforce and make such policies effective may be absent. Moreover, institutions cannot be created overnight. While a formal change in the statutory rules of the game may be effected rather easily, it takes time to establish informal behavioral norms. Therefore, a country’s institutional milieu can be regarded, at least to some degree, as an exogenous constraint on a state’s capacity to comply with international legal commitments such as those contained within BITs.

Countries vary in terms of their institutional endowments. If the number of arbitral claims represents a valid indicator of potential noncompliance with BITs, cross-national differences in domestic institutional capacity should be correlated with cross-national variation

in the number of arbitral disputes initiated against host countries over time. However, in order to fully appreciate the role which a country's domestic institutions play in determining the number of arbitral claims brought against it, we must consider the incentives which foreign investors have to pursue such claims. In contrast to portfolio investment, FDI tends to be more long-term. MNCs usually make direct investments with the intention of remaining in the host country for a fairly lengthy period of time, either for the purpose of directly competing within the country's domestic market or using the country as a low-cost production site, exploiting its favorable factor endowments. This is especially true of greenfield investments which result in the creation of new physical assets (e.g., a new factory), therefore entailing significant sunk costs. Hence, direct investors tend to hold relatively long time horizons. As a result, there is a shadow of the future which gives them an incentive to avoid making their relationship with host governments antagonistic or adversarial, thereby putting the relationship on a bad footing and potentially damaging the firm's ability to continue doing business in the host country unimpeded by host government interference or harassment.<sup>278</sup> Perhaps more importantly, arbitration is financially costly, not only for the country against which an arbitral claim is brought, but for the investor who chooses to pursue such a claim. Therefore, it is reasonable to assume that investors will want to resolve their disputes with host governments without having to resort to arbitration *if possible*. Arbitration very likely represents a last ditch effort to obtain compensation or some other remedy. In countries with strong legal institutions, local courts are capable of handling the majority of investment disputes. However, in countries with underdeveloped institutions (i.e., a weak rule of law or a corrupt legal system), investors may not have any other choice or recourse but to initiate arbitration proceedings at the international level. In fact, it could be the case that

---

<sup>278</sup> Although BITs are intended to prevent "vindictive" behavior on the part of host states, providing foreign investors a mechanism (i.e., arbitration) for defending themselves against such behavior, from an investor's perspective, there is no guarantee that the host state will respect its international commitments.

countries with strong institutions are just as prone to engage in discriminatory or expropriatory behavior, but because of their strong legal systems—i.e., because of their superior institutional endowment—investors are able to obtain relief in the host country's courts without having to resort to arbitration.

Consideration of the strength of a country's institutional infrastructure for the protection and enforcement of property rights and the confidence of foreign investors in the capacity of the host country's domestic legal system to afford them relief suggest the following hypothesis regarding cross-national variation in the number of arbitral claims brought against host countries:

**Hypothesis 1:** *Countries in which there is a strong rule of law and corruption is relatively low should have significantly fewer arbitral claims brought against them than countries in which corruption is rampant and the domestic legal system is weak.*

### *Exposure*

As has just been suggested, arbitral claims are in part a function of the *willingness* of foreign investors to pursue arbitration as a means of resolving disputes with host states.

However, we must also account for differences in the *opportunity* to pursue such claims. As an international institution, investor-state arbitration ultimately rests on the voluntary *consent* of host states. At the end of the day, a foreign investor's ability to pursue arbitral claims against a host state depends on whether or not that state has formally consented to such arbitration.<sup>279</sup>

Host countries vary in terms of the number of advance consents to investor-state arbitration that they have granted, and hence, their exposure to potential arbitral claims by foreign investors.

The probability of becoming involved in an arbitral dispute should be significantly higher for a

---

<sup>279</sup> Advanced consents by governments to submit investment disputes to arbitration are commonly found in one of three places: (1) contracts directly negotiated between host states and foreign investors (e.g., a concession agreement), (2) national laws pertaining to the treatment of foreign investment, and (3) BITs, PTAs, or other international agreements establishing investor rights.

country that has ratified a relatively large number of BITs containing binding commitments to arbitration with numerous home countries than for a country that has ratified few or no BITs or whose BITs do not contain a binding obligation to arbitrate investment disputes, *ceteris paribus*. By concluding a larger number of BITs with a wider range of capital-exporting countries, the former country has exposed itself to the potential claims of a relatively larger pool of investors. This leads to a rather straight-forward hypothesis:

**Hypothesis 2:** *As the number of binding international commitments to investor-state arbitration a country has made increases, so too should the number of arbitral claims that are brought against it.*

In addition to the number of formal commitments to arbitration, a country's exposure to arbitral claims is also a function of the amount of FDI it actually plays host to. A country that plays host to a larger number of foreign investors consequently confronts a larger number of opportunities to become involved in an investment dispute than one that plays host to little FDI, *ceteris paribus*. A country that hosts a miniscule amount of FDI, for instance, is not likely to experience many arbitral disputes regardless of how many BITs it may have concluded. This leads to another simple hypothesis regarding a host country's exposure to arbitral claims:

**Hypothesis 3:** *The number of arbitral claims that are brought against a country should increase as the amount of FDI it hosts increases.*

#### *A Theory of Expropriation: Host State Incentives and Constraints*

Arbitral claims are ultimately the result of actions taken by host states which result in the violation of a foreign investor's property rights. Expropriations represent the most significant and egregious form of infringement of an investor's property rights. Therefore, any theory of investor-state disputes should account for the actions of host states and the incentives giving rise to expropriatory behavior. Li (2009) provides a theoretical framework that is useful for



identifying the circumstances under which host governments are likely to expropriate foreign investments, thereby triggering an arbitral dispute.<sup>280</sup> His theory assumes that leaders wish to remain in office and that they can use expropriation “as a policy instrument” for achieving this goal. He further assumes that “variations in the time horizons of leaders lead to different expropriation behaviors,” and that a leader’s time in office and “past leadership turnover are good predictors of the risk of losing office.” Finally, he assumes that “leaders are often institutionally constrained to varying degrees.” On the basis of these assumptions, Li argues that host governments are most likely to expropriate foreign investments “when they sense political insecurity, have short time horizons, and confront few institutional constraints.”<sup>281</sup> A closer look at Li’s argument suggests several testable hypotheses regarding cross-national variation in the number of arbitral claims brought against host states.

A host government’s “expropriatory incentive” ultimately depends on the difference in gains between expropriation and nonexpropriation. Whereas the gains from expropriation tend to concentrate in the short run, the gains from nonexpropriation tend to accumulate over time. Expropriation “creates an immediate windfall” that can be instantly “applied to strengthen the leader’s political position.” However, the benefits of expropriation “tend to dwindle over time,” especially when the host government lacks “the necessary human capital and bureaucratic expertise to manage expropriated assets as efficiently as the” foreign firm from which they were taken, which has often been the case for LDC governments. “Although physical assets can be taken relatively easily (i.e., coercively), the intangible assets that make foreign affiliates efficient

---

<sup>280</sup> Following Kobrin (1980, 1984) and Minor (1994), Li (2009, 5) defines expropriation as “the forced divestment of equity ownership of a foreign direct investor.” This definition does not capture instances of so-called “creeping expropriation” in which host governments alter tax rates, regulations, market access, or laws, thereby decreasing the profitability of a foreign firm’s investments. The discussion of expropriation that follows largely applies to the more direct form of expropriation to which Li refers, although the logic of Li’s argument could conceivably explain creeping expropriation as well.

<sup>281</sup> Li 2009, 6-7.

and competitive are difficult to appropriate.” When left unmolested, “foreign investments are likely to generate a larger stream of revenue and, arguably, more technology spillovers that benefit the host economy.” Moreover, “expropriation tarnishes the host’s reputation among foreign investors and so reduces future investment inflows.”<sup>282</sup>

Because the benefits of FDI are ultimately realized over the long run, whereas the gains from expropriation are concentrated in the short term, the incentive to expropriate largely depends on the host government’s time horizon. Governments with long time horizons are more likely to leave foreign investors alone, whereas governments with relatively short time horizons “may pursue expropriation for immediate payoffs,” given the realization that they may not be around long enough to reap the long-term rewards which unmolested FDI brings. Hence, the length of a host government’s time horizon is inversely related to its incentive to expropriate foreign assets. Li argues that a government’s time horizon is largely a function of its sense of political security. “When leaders feel politically secure, they tend to adopt a long-term view (and vice versa).” Leaders that have been in power for a relatively long time, suggests Li, “are likely to feel politically secure and thus hold long time horizons.” This leads to the following hypothesis regarding cross-national variation in the number of arbitral claims brought against host states:

**Hypothesis 4:** *The longer a country’s government has remained in power, the less incentive it has to expropriate foreign investments, and so the fewer arbitral claims should be brought against it.*

According to Li’s argument, the host government’s incentive to expropriate FDI depends on its time horizon, which is in turn a function of its sense of political insecurity. Given this formulation, what other factors might cause a government to feel insecure, perhaps prompting it to expropriate, thereby sparking an arbitral dispute? Governments that confront unfavorable or

---

<sup>282</sup> Ibid., 7-8.

deteriorating economic conditions (e.g., low or stagnant growth, a recession, or rising inflation) are likely to feel very insecure. Regardless of whether a government is directly responsible for its country's poor economic performance, it nonetheless is likely to bear much of the blame. As a result, governments facing economic turmoil may choose to treat foreign investors as scapegoats for their own domestic political problems. They may try to use expropriation as a tool for regaining the support of a public that has lost its faith in the incumbent government's ability to manage the national economy. A host government that feels politically insecure may see expropriation as a way to tap into the country's latent nationalism, directing it at foreign investors, producing a sort of "rally around the flag" effect. Insecure governments may be able to exploit a palpable mood of resentment towards foreign firms, especially on the part of domestic businesses that have to compete with MNCs as well as among the general public, who may hold a lingering sense of foreign control and domination stemming from a country's colonial heritage.

Governments that confront significant internal resistance to their power and authority are likely to feel highly insecure. Governments that are fighting a full-blown civil war against armed insurgents may see expropriation of foreign-owned assets as a way to stave off defeat either by augmenting their material resources or increasing domestic support, again through a "rally around the flag" effect. In addition to the incentives which these governments have to engage in expropriation, countries in which there is significant societal conflict may have arbitral claims brought against them by foreign investors who suffered property losses as a result of such conflict.<sup>283</sup> Consideration of those factors which may exacerbate a government's sense of political insecurity leads to two additional hypotheses regarding cross-national variation in the number of arbitral claims brought by foreign investors against host states:

---

<sup>283</sup> See the discussion on page 94.

**Hypothesis 5:** *The more unfavorable are economic conditions within a host country, the more incentive its government has to expropriate foreign investments, and so the more arbitral claims should be brought against it.*

**Hypothesis 6:** *As the intensity of societal conflict within a host country increases, the incentive of its government to expropriate foreign investments also increases, and so the more arbitral claims should be brought against it.*

Incentives to expropriate notwithstanding, in order to undertake a controversial policy such as expropriation, a government must inevitably overcome various political constraints. “When the number of veto players is large and their preferences are heterogeneous, policy change is difficult...As the number of veto players with divergent preferences toward MNCs rises, the likelihood of expropriation should decline.”<sup>284</sup> As Li suggests,

FDI produces stakeholders with competing interests in the host economy...Certain individuals and groups in the host country benefit from the foreign capital of MNCs, their advanced technology and managerial skills, the higher employment and wage rates that they arguably bring to the host economy...Yet, FDI marginalizes and harms certain individuals and groups in the country because MNCs threaten rival host firms, increase the economic insecurity of workers, and widen income inequality.<sup>285</sup>

Consideration of the political hurdles host governments face in their efforts to expropriate foreign investments leads to another hypothesis regarding cross-national variation in the number of arbitral claims brought by foreign investors against host states:

**Hypothesis 7:** *The greater the political constraints facing a host country’s government, the less likely it is that the government will succeed in expropriating foreign investments, and so the less arbitral claims should be brought against it.*

Highlighting the incentives host states have to expropriate foreign investments and the political and institutional constraints mitigating such behavior, Li’s model offers a persuasive account of the determinants of expropriation. Employing data on expropriation activity between 1960 and 1990, he tests his model and finds strong and robust support for it. Yet, it remains to be seen whether the model can provide any explanatory leverage with respect to arbitral disputes.

---

<sup>284</sup> Li 2009, 10.

<sup>285</sup> Ibid., 10-11.

There are important reasons to question its applicability. First and foremost, Li's model is intended to explain *direct* expropriations. However, since the mid-1970s, direct expropriations have become increasingly rare.<sup>286</sup> Rather than directly seizing foreign-owned assets or forcing foreign firms to divest, host states are today more likely to engage in so-called "creeping expropriation," employing tax policy, regulation, or other, more subtle policy instruments to extract a larger share of the profits generated by FDI.<sup>287</sup> This is why many BITs explicitly prohibit actions or policies that could be considered "tantamount to expropriation." As a result of this secular decline in direct expropriations, Li's model may be irrelevant for the time period under investigation here.<sup>288</sup> In addition, it is not clear whether Li's model can explain "creeping expropriation." If the incentives which host governments have to engage in indirect expropriation are the same as those that give rise to direct expropriation, then the model could be relevant. Finally, while it is true that at least some arbitral disputes have resulted from direct expropriation,<sup>289</sup> it is unclear whether such expropriations constitute a significant proportion of known arbitral disputes. Despite these important caveats, I attempt to incorporate as much of Li's model as possible into my own model of arbitral disputes.

### *Partisanship*

Finally, before proceeding to the discussion of my research design, it is worth pausing to consider the possible effects of a host government's partisan orientation on the likelihood that a country becomes involved in an arbitral dispute and the number of such disputes. Despite the

---

<sup>286</sup> Kobrin 1984, Minor 1994.

<sup>287</sup> Jensen 2006.

<sup>288</sup> Depending on data availability for my key explanatory variable—the strength of a country's domestic property rights regime—my analysis covers the periods 1981-2001, 1985-2005, and 1997-2005.

<sup>289</sup> E.g., following the seizure of their assets by the Chavez government in May 2007, Exxon Mobil and ConocoPhillips both filed treaty-based arbitral claims against Venezuela. Both cases were registered with ICSID.

history of suspicion and hostility which has characterized relations between MNCs and left-wing governments in the Third World, the results of my analysis of BIT signings conducted in chapter 4 suggested that leftist governments were more likely to conclude BITs than their centrist or rightist counterparts.<sup>290</sup> Given their turbulent history with foreign investors, the commitment of left-wing governments to respect the property rights of foreign investors might be seen as less than credible by these same investors. Therefore, during the 1990s when governments of all partisan stripes began furiously competing to attract foreign capital, leftist governments may have felt compelled to enhance the credibility of their commitments to investor rights by entering into BITs. Given this potential explanation for the pattern of BIT signings suggested by the analysis conducted in chapter 4, it is worth examining the relationship between government partisanship and the number of arbitral claims brought against a country by foreign investors. Given possible concerns about their reputation in the eyes of foreign investors and their greater propensity to enter into BITs, have leftist governments also exhibited a higher rate of compliance with their BIT-related commitments? If so, then we would expect such governments to experience fewer arbitral disputes than their centrist or rightist counterparts. However, given recent experiences in Latin America in which avowedly leftist governments have expropriated foreign-owned assets, thereby provoking arbitral claims (e.g., the Chavez government's seizure of foreign-controlled oil projects), it is possible that we may be witnessing a return to the "traditional" pattern of relations between foreign investors and left-wing governments. Thus, the relationship between a host government's partisan orientation and the number of arbitral disputes it becomes involved is uncertain. Table 5.1 summarizes my hypotheses.

---

<sup>290</sup> However, in terms of statistical significance, this finding was less than fully robust. In a majority of models, the partisanship variable was only significant at the 10% level.

Table 5.1 The Determinants of Investor-State Arbitral Disputes: Hypotheses

**Dependent Variable:** The number of arbitral disputes a country becomes party to in a given year

#### **Institutional Capacity**

**Hypothesis 1:** The strength of a country's domestic property rights institutions should be negatively correlated with the number of arbitral disputes.

#### **Exposure**

**Hypothesis 2:** The number of binding commitments to investor-state arbitration that a country has made should be positively correlated with the number of arbitral disputes.

**Hypothesis 3:** The amount of FDI a country hosts should be positively correlated with the number of arbitral disputes.

#### **Expropriation Risk**

**Hypothesis 4:** The length of time that a government has remained in power should be negatively correlated with the number of arbitral disputes.

**Hypothesis 5:** Favorable economic conditions within a country should be negatively correlated with the number of arbitral disputes.

**Hypothesis 6:** The intensity of societal conflict within a country should be positively correlated with the number of arbitral disputes.

**Hypothesis 7:** The degree of institutionalized political constraints confronting a country's political leaders should be negatively correlated with the number of arbitral disputes.

## **RESEARCH DESIGN**

I have hypothesized that countries with strong domestic property rights regimes should experience fewer difficulties complying with their BIT-related obligations than those countries whose institutions are relatively weak. The overall frequency of property rights violations should be lower for those countries in which there is a strong rule of law, an independent judiciary, and minimal corruption. Moreover, when violations do occur, the more efficacious is the host country's domestic legal system, the more likely it is that foreign investors will search

for, and find, relief for their grievances at the local level rather than requesting international arbitration. If these propositions hold true, we would expect countries with high institutional capacity to have fewer arbitral claims made against them over time. To test this hypothesis regarding the relationship between a country's institutional capacity for compliance with BITs and the number of arbitral claims brought against it by foreign investors I conduct an empirical analysis of arbitral disputes between foreign investors and host states using data from an unbalanced panel of countries. The dependent variable for this analysis is the number of arbitral claims brought against a state by investors in a given year. The unit of analysis is the country-year. Depending on data availability for my key explanatory variables and model specification, the time period under analysis ranges from 1981 to 2002, while the number of countries ranges from 100 to 123. If my hypothesis regarding institutional capacity is correct, compliance with BITs should be easier for countries whose domestic institutional infrastructure is most conducive to the protection and enforcement of private property rights. These countries should therefore experience fewer arbitral disputes over time, while countries with weak property rights institutions—i.e., low institutional capacity—for which compliance is presumably more problematic, should experience more arbitral disputes.

### *Dependent Variable*

The dependent variable for my analysis is the number of arbitral disputes initiated (or claims brought) against a state by foreign investors in a given year. Data for this variable were derived from two sources. First, ICSID provides a complete and up-to-date list of investor-state arbitral disputes that have occurred under its auspices (including cases that are still pending or



that were handled through its Additional Facility) since its inception in 1966.<sup>291</sup> Second, as mentioned above, UNCTAD has created an online database of treaty-based investor-state arbitral disputes occurring between 1987 and 2008.<sup>292</sup> The UNCTAD database provides information on arbitral disputes occurring in venues other than ICSID, including UNCITRAL, the Permanent Court of Arbitration (PCA), and the Arbitration Institute of the Stockholm Chamber of Commerce (SCC). Using these two sources, I collected data on the number of arbitral claims brought against 180 middle and lower-income states between 1970 and 2007. Out of 5,343 country-years, a total of 318 arbitral disputes were identified. Table 5.2 shows the distribution of arbitral disputes in my dataset by venue. The vast majority of these disputes have occurred since the mid-1990s. Figure 5.1 shows the total number of arbitral disputes each year between 1970 and 2007. With the exception of Jamaica which had three ICSID disputes initiated against it in 1974, between 1970 and 2001, the maximum number of disputes experienced by any state was two. However, in 2002, Mexico became involved in five arbitral disputes, and in 2003, a record 21 arbitral disputes were launched against Argentina, largely in response to the Argentinean government's decision to devalue the peso. The total number of arbitral disputes globally hit an all-time high of 41 in 2007.

---

<sup>291</sup> <http://icsid.worldbank.org/ICSID/Index.jsp>

<sup>292</sup> <http://www.unctad.org/iia-dbcases/index.html>

Table 5.2 Investor-State Arbitral Disputes By Venue, 1970-2007

Venue	Number	Percentage
ICSID	228	72
ICSID Additional Facility	19	6
UNCITRAL	52	16
PCA	14	4
SCC	6	2
Total	319	100

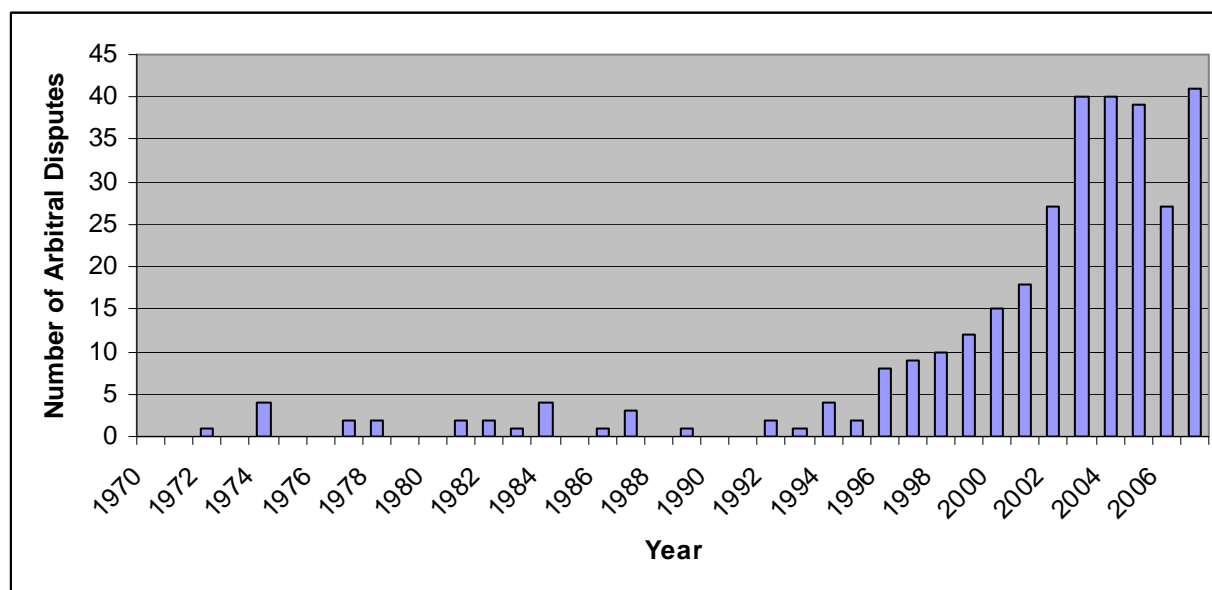


Figure 5.1 Investor-State Arbitral Disputes, 1970-2007

### *Measuring Institutional Capacity*

The central explanatory variable of interest is the relative strength of a country's domestic property rights regime at time  $t - 1$ .<sup>293</sup> In order to fully assess the robustness of the relationship between a country's domestic institutions and the number of arbitral disputes it becomes party to over time, I employ numerous different measures of institutional capacity, including the ICRG *Law and Order* and *Corruption* variables and CIM measure employed in chapter 4. I also make use of the World Bank's Governance Indicators (WBI)—specifically, the *Rule of Law* and *Control of Corruption* variables.<sup>294</sup> The *Rule of Law* indicator measures “the extent to which agents have confidence in and abide by the rules of society, in particular the quality of contract enforcement, the police, and the courts,” while the *Control of Corruption* indicator captures “the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as ‘capture’ of the state by elites and private interests.”<sup>295</sup> Both variables range from a minimum value of roughly -2.5 to a maximum value of 2.5, with higher values indicating stronger institutions. I expect all five measures of institutional capacity to have a negative impact on the number of arbitral claims brought against a state, meaning as the strength and quality of a country's institutional infrastructure for the protection and enforcement of property rights increases, as indicated by a given measure, the expected number of arbitral disputes which it experiences in a given year should decrease.

---

<sup>293</sup> All explanatory variables are lagged by one period in order to avoid problems of reverse causality.

<sup>294</sup> <http://info.worldbank.org/governance/wgi/index.asp>. These variables were not employed in chapter 4 because of their limited time range, which does not include the late 1980s and early 1990s, a critical period in terms of the proliferation of BITs. The earliest year for which data is available is 1996. However, the time range for these variables is ideal in the context of investor-state arbitral disputes given that such disputes did not begin occurring with significant frequency until around 1997.

<sup>295</sup> See Kaufmann, Kraay, and Mastruzzi 2008. Data for both variables are only available for 1996, 1998, 2000, and 2002-2007. In order to address missing data for 1997, 1999, and 2001, I calculate the average of a country's score on a given variable for the adjacent years (i.e., the years before and after the missing year. For example, a country's score for 1997 would be the average of its score for 1996 and 1998.) I ran the analysis both with and without this correction for missing data. The results are virtually identical. The results reported below are those in which missing data are filled in using the method described.

### *Measuring Exposure*

In order to capture the effects of a country's degree of exposure to arbitral claims from foreign investors, it is necessary to account for the cumulative number of advanced consents to arbitration that a state has made. Although BITs and other interstate agreements (e.g., PTAs) represent the principal legal instrument upon which most of the arbitral claims included in my dataset were based, at least some of the cases included arose from an advanced consent to arbitration included in a contract between a host state and a foreign investor. Advanced consents can also be found in national statutes. Ideally, we would want to measure the total number of advanced consents to arbitration which a state has granted, not only through international treaties, but also through national laws and contracts with foreign investors. Unfortunately, data on investment contracts does not exist and, although information on national investment laws is obtainable, there is no single reliable source of data on advanced consents granted by statute. Therefore, I include the number of BITs that a country has concluded with high-income OECD countries that are in force (*BITs*) and the number of PTAs to which a country belongs (*PTAs*) in my model of arbitral disputes as proxies for a country's degree of exposure to arbitral claims.<sup>296</sup> As suggested by Hypothesis 2, the more BITs and PTAs a country enters into, the larger the pool of foreigner investors who could potentially bring arbitral claims against it. Countries that have concluded a large number of BITs and PTAs should therefore experience a greater number of arbitral disputes, all else being equal, than countries which have concluded few or no BITs or

---

<sup>296</sup> Data on the number of BITs a country has concluded with upper-income OECD countries is derived from UNCTAD's BIT database: <http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1> . Data on the number of PTAs to which a country belongs is derived from the WTO's database of PTAs: <http://rtais.wto.org/UI/PublicSearchByMember.aspx> .

PTAs.<sup>297</sup> I expect both variables to be positively associated with the number of arbitral disputes a country becomes party to over time.

I also include a country's total accumulated stock of FDI (*FDI Stock*) in my model of arbitral disputes in order to test Hypothesis 3.<sup>298</sup> Similar to the effect which the number of BITs and PTAs has on the number of arbitral claims, a country that plays host to a larger number of foreign investors consequently confronts a larger number of opportunities to become involved in an investment dispute than one that plays host to only a small amount of FDI, *ceteris paribus*. I therefore expect this variable to have a positive effect on the number of arbitral disputes a country becomes party to in a given year.

### *Measuring Expropriation Risk*

In order to test Hypotheses 4-7, I include five variables intended to measure the degree of expropriation risk within host countries. The first four variables—*Tenure*, *Growth*, *Inflation*, and *Internal Conflict*—are all intended to capture variation in a host government's sense of political insecurity, and hence, its time horizon. Governments that feel they are relatively secure politically tend to have longer time horizons, and governments with relatively long time horizons, according to Li's (2009) model of expropriation, have less incentive to expropriate foreign investments, and, by extension, should also experience fewer arbitral disputes. *Tenure* is the number of consecutive years that a government has remained in office or power, and is intended to test Hypothesis 4, which suggests that the longer a government has remained in power, the longer its time horizon, and hence the less incentive it has to expropriate FDI. I

---

<sup>297</sup> This of course assumes that the PTAs to which a country belongs address investment relations among PTA members. Although not all PTAs address investment, many do (e.g., NAFTA, CAFTA-DR, ASEAN). It also assumes that both the BITs and PTAs which a country has concluded contain advanced consents to arbitration. Although not all BITs contain such consents, the vast majority do. See Dolzer and Stevens 1995 and Yackee 2007a.

<sup>298</sup> Data for this variable are taken from UNCTAD's *Handbook of Statistics*.

expect this variable to have a negative effect on the number of arbitral disputes a country experiences in a given year.

*Growth* is a country's annual GDP growth rate, while *Inflation* is a country's annual inflation rate as indicated by its consumer price index.<sup>299</sup> Both variables are intended to capture macroeconomic conditions within a host country in order to test Hypothesis 5, which suggested that governments confronting a less than favorable domestic economy may have shortened time horizons, and hence, a greater incentive to expropriate FDI, perhaps as a way of diverting the public's attention away from the government's handling of the economy, thereby making scapegoats out of foreign investors. I expect *Growth* to be negatively correlated with the number of arbitral claims that are brought against a country in a given year. I expect *Inflation* to be positively correlated with the number of arbitral claims.

*Internal Conflict* is a measure of the severity of conflict within a host country, including civil and ethnic violence or war.<sup>300</sup> It is included as a test of Hypothesis 6, which suggests that governments whose power or authority are subject to significant challenges from internal opposition groups (in the extreme case, an armed insurgency) are likely to have shortened time horizons, and may therefore have an incentive to expropriate FDI, thereby triggering arbitral disputes with foreign investors. In addition, the likelihood of foreign investors suffering property losses is probably higher in countries where there is substantial civil violence or armed conflict. I expect this variable to have a positive effect on the number of arbitral claims brought against a country in a given year.

Finally, according to Hypothesis 7, expropriation risk should generally be lower in countries where the executive faces significant institutionalized political constraints in the form

---

<sup>299</sup> Data for both variables are from the World Bank's *World Development Indicators* (WDI).

<sup>300</sup> This is the same measure of societal conflict employed in chapter 4.

of numerous veto players having heterogeneous policy preferences with respect to FDI. In order to test this hypothesis, I include *Constraints* which is Henisz's political constraints index (POLCON III).<sup>301</sup> I expect this variable to be negatively correlated with the number of arbitral disputes a country becomes party to in a given year.

### *Additional Control Variables*

I include several additional control variables in my model of arbitral disputes. *Left Executive* is a dummy variable, coded 1 if the chief executive's party is leftist, 0 otherwise.<sup>302</sup> This variable is intended to reveal the relationship (if any) between a government's partisanship and its compliance with BITs as indicated by the number of arbitral claims brought against it by foreign investors. *Resource Rents* is intended to measure a country's abundance of natural resources and concomitant dependence on extractive industries. As famously noted by Vernon (1971), bargains between foreign investors and host states tend to "obsolesce" over time as host governments seek to capture a larger share of the gains from foreign investments by reopening or abrogating their contracts with investors. According to the literature on bargaining dynamics between foreign investors and host states, this problem tends to most acute in the natural resources sector.<sup>303</sup> Therefore, in countries where the extractive sector is comparatively large, governments may exhibit a greater tendency to break contracts with foreign investors, thereby triggering arbitral disputes. *Resource Rents* is equal to the sum of rents which a country derives from mineral and fossil fuel resources divided by the country's gross national income, where rents are estimated as price minus average costs multiplied by the amount of resources extracted,

---

<sup>301</sup> See Henisz 2000. This is the same measure of political constraints employed in chapter 4.

<sup>302</sup> Data for this variable come from the World Bank's *Database of Political Institutions*.

<sup>303</sup> Vernon 1971, Kobrin 1987.

or  $(P - AC) \times R$ .<sup>304</sup> I expect this variable to have a positive effect on the number of arbitral disputes a country experiences in a given year.

*Market Size* is the natural log of a country's GDP.<sup>305</sup> I include this variable to account for the fact that countries such as Brazil and China, whose gigantic domestic markets have made them among the most attractive destinations for FDI, have not experienced any arbitral disputes. Despite signing several BITs with high-income OECD countries in the mid-1990s, Brazil has never ratified any of its BITs, nor has it become a contracting member of the ICSID Convention.<sup>306</sup> Not surprisingly, Brazil has never been involved in any arbitral disputes with foreign investors. Although China concluded several BITs with major capital-exporting countries in the 1980s and, in contrast to Brazil, subsequently ratified each of those treaties, it too has never had any arbitral claims brought against it by foreign investors. It is possible that China's BITs, while containing advanced consents to arbitration, are substantively shallow, leaving significant room for the Chinese state to regulate FDI in ways that might infringe upon the property rights of foreign investors, but which do not violate China's BIT related obligations. Including both Brazil and China in my sample might mask the effects of *FDI Stock*, which, as I hypothesized, should be positively correlated with the number of arbitral disputes a country becomes party to in a given year. Therefore, I include *Market Size* as a way of controlling for these exceptional cases.

*Income* is a country's GDP per capita.<sup>307</sup> According to the literature on expropriation, the relationship between a country's level of economic development (as indicated by its GDP per

---

<sup>304</sup> Data for this variable are from Neumayer and Spess 2005.

<sup>305</sup> Data for this variable are from the WDI.

<sup>306</sup> There is apparently an ongoing debate among Brazilian leaders and policymakers as to whether investor-state arbitration represents a violation of Brazil's constitution. Efforts to ratify the BITs which Brazil has signed have been met by significant opposition from politicians who subscribe to the view that international arbitration is incompatible with Brazil's constitution.

<sup>307</sup> Data for this variable are from the WDI.



capita) and the likelihood of expropriation is curvilinear.<sup>308</sup> In other words, the chance of expropriation increases at low levels of development then begins to decline after surpassing a certain threshold. Therefore, I include both *Income* and its squared term in my model of arbitral disputes in order to control for the effects of development on the likelihood of expropriation, and by extension, the number of arbitral claims brought against a country in a given year.

*Devaluation* is the absolute change in a country's official exchange rate.<sup>309</sup> After devaluing its currency in 2002 in response to an ongoing financial crisis, a record 21 arbitral claims were brought against Argentina by foreign investors in 2003. The basis for these claims was that the Argentinean government's actions reduced the value of the investments in question. Moreover, the decision to devalue the peso represented a reversal of the Argentinean government's previously stated official commitment to a fixed exchange rate, amounting to a breach of contract, entitling the investors to compensation. These cases have since generated a significant amount of controversy, causing many leaders in the developing world and other observers to question the very legitimacy of investor-state arbitration as an international institution. Although the time period for my sample ends in 2002, and therefore does not include Argentina in 2003 as a significant outlying observation, I include *Devaluation* in order to control for the possibility that similar currency devaluations on the part of host states may have provoked foreign investors to initiate arbitral proceedings.

*ICSID Member* is a dummy variable indicating whether or not a country is a contracting party of the ICSID Convention. I include this variable in order to account for the fact that a majority (72 percent) of the disputes in my dataset were arbitrated under the auspices of ICSID, meaning the states against whom arbitral claims were brought in these cases were contracting

---

<sup>308</sup> Jodice 1980; Li 2009.

<sup>309</sup> Data for this variable are derived from the IMF's *International Financial Statistics*.

members of the ICSID Convention. Any disputes involving states that were not party to the ICSID Convention would have had to be arbitrated in ICSID's Additional Facility or a non-ICSID venue. Cases such as these constitute a minority of the cases in my sample. Finally, I include a lagged dependent variable in order to control for a host states actions and policies toward FDI in the previous period and other potentially important but unknown variables not included in the model. I also include a trend variable and two polynomials in order to control for temporal dependence in the data given its panel structure.<sup>310</sup> The following equation is estimated:

$$\begin{aligned} Disputes_{it} = & \beta_1 * Capacity_{i,t-1} + \beta_2 * BITs_{i,t-1} + \beta_3 * PTAs_{i,t-1} + \beta_4 * FDI Stock_{i,t-1} + \\ & \beta_5 * Tenure_{i,t-1} + \beta_6 * Growth_{i,t-1} + \beta_7 * Inflation_{i,t-1} + \beta_8 * Internal Conflict_{i,t-1} + \\ & \beta_9 * Constraints_{i,t-1} + \beta_{10} * Left Executive_{i,t-1} + \beta_{11} * Resource Rents_{i,t-1} + \\ & \beta_{12} * Market Size_{i,t-1} + \beta_{13} * Income_{i,t-1} + \beta_{14} * Income^2_{i,t-1} + \beta_{15} * Devaluation_{i,t-1} + \\ & \beta_{16} * ICSID Member_{i,t-1} + \beta_{17} * Disputes_{i,t-1} + \beta_{18} * t + \beta_{19} * t^2 + \beta_{20} * t^3 \end{aligned}$$

where *Disputes* is a count of arbitral disputes to which country *i* becomes party in period *t* and *Capacity* denotes one of five different measures of a country's institutional capacity for compliance with BITs. Table 5.3 provides a summary of the explanatory variables included in my model of arbitral disputes, including the effect which each variable is expected to have on the number of disputes a country experiences in a given year. Table 5.4 provides summary statistics for each variable.

---

<sup>310</sup> Beck, Katz, and Tucker (1998) recommend including period dummies or cubic splines to account for temporal dependence. However, including dummy variables for over twenty periods obviously eats up a lot of degrees of freedom. Moreover, cubic splines represent a technically complicated

Table 5.3 Explanatory Variables and Expectations

Variable	Measures	Expected Effect	Data Source
<i>Capacity</i>	CIM, Law and Order, Corruption, Rule of Law, Control of Corruption	Negative	IMF International Financial Statistics / ICRG / World Bank Governance Indicators (WBGI)
<i>BITs</i>	Number of BITs with high-income OECD countries in force	Positive	UNCTAD BIT database
<i>PTAs</i>	Number of PTA memberships	Positive	WTO Regional Trade Agreements database
<i>FDI Stock</i>	Natural log of inward FDI stock	Positive	UNCTAD Handbook of Statistics (online edition)
<i>Tenure</i>	Number of years a government has been in office	Negative	World Bank Database of Political Institutions (DPI)
<i>Growth</i>	GDP growth rate	Negative	World Development Indicators (WDI)
<i>Inflation</i>	Consumer price index	Positive	WDI
<i>Internal Conflict</i>	Magnitude of civil & ethnic violence/war	Positive	Marshall (2002)
<i>Constraints</i>	POLCON III	Negative	Henisz (2000)
<i>Left Executive</i>	Dummy variable, coded 1 if executive's party is leftist	Indeterminate	DPI
<i>Resource Rents</i>	Sum of rents from minerals and fossil fuels divided by GNP	Positive	Neumayer and Spess (2005)
<i>Market Size</i>	Natural log of GDP	Indeterminate	WDI
<i>Income</i>	GDP per capita	Positive	WDI
<i>Income<sup>2</sup></i>	GDP per capita <sup>2</sup>	Negative	WDI
<i>Devaluation</i>	Absolute change in exchange rate	Indeterminate	IMF International Financial Statistics
<i>ICSID Member</i>	Dummy variable, coded 1 if country is a contracting party of the ICSID Convention	Positive	ICSID website

Table 5.4 Descriptive Statistics<sup>311</sup>

<b>Variable</b>	<b>Mean</b>	<b>Standard Deviation</b>	<b>Minimum</b>	<b>Maximum</b>
Disputes	0.02	0.21	0	5
CIM	0.74	0.15	0	0.99
Law and Order	3.22	1.30	0	6
Corruption	2.67	1.07	0	6
Rule of Law	-0.35	0.78	-2.57	1.81
Control of Corruption	-0.34	0.72	-2.09	2.39
BITs	2.69	4.04	0	19
PTAs	0.90	0.99	0	7
FDI Stock (Ln)	6.35	2.46	0	12.58
Tenure	8.47	8.45	0	47
Growth	3.65	6.90	-51.03	106.27
Inflation	60.41	606.27	-31.90	26762.02
Internal Conflict	0.88	1.89	0	11
Constraints	0.16	0.20	0	0.69
Resource Rents	6.61	12.23	0	91.8
GDP (Ln)	22.41	2.00	17.39	28.26
GDP Per Capita	2506.34	4295.74	56.52	52943.34
Devaluation	-22.20	211.54	-6201.03	1460

---

<sup>311</sup> Dummy variables not shown.

### *Estimation Issues*

Because the dependent variable is an event count, ordinary least squares regression may produce inefficient, inconsistent, or biased estimates.<sup>312</sup> Visual inspection of histograms confirms that the data are not normally distributed, indicating a Poisson or negative binomial distribution.<sup>313</sup> The Poisson regression model (PRM) imposes the restrictive assumption that the dependent variable's conditional mean is equal to its conditional variance. Because the variance for *Disputes* exceeds its mean, indicating overdispersion in the data, the PRM may underestimate the amount of dispersion in the outcome.<sup>314</sup> The negative binomial regression model (NBRM) is therefore the more appropriate estimator. The NBRM addresses the failure of the PRM by adding a dispersion parameter  $\alpha$  which models unobserved heterogeneity among observations, thereby allowing the conditional variance to exceed the conditional mean.<sup>315</sup>

Another issue concerns the pooled time-series cross-sectional (TSCS) arrangement of the data. TSCS tend to suffer from both heteroskedasticity and autocorrelation, both of which make it difficult to draw accurate inferences.<sup>316</sup> To address these problems, I employ the population-averaged negative binomial estimator with semi-robust standard errors clustered on country. Population-averaged models, also referred to as generalized estimating equations (GEE) or marginal models, are a commonly used estimator when the data are correlated (e.g., when the data represent repeated observations over time) and the dependent variable is noncontinuous (e.g., a dichotomous variable or an event count). The “marginal” approach to estimation represented by population-averaged models can be contrasted with so-called “cluster-specific” or

---

<sup>312</sup> Long 1997.

<sup>313</sup> This is true of both the histogram for all countries as well as histograms for each individual country.

<sup>314</sup> The mean for *Disputes* is 0.02 while the variance is 0.21.

<sup>315</sup> Long 1997.

<sup>316</sup> Beck and Katz 1995. Time-series count data, in particular, tend to exhibit autocorrelation stemming from temporal dependence in the rate at which events occur, contagion effects, and heterogeneity.

“conditional” approaches to estimation which “model the probability distribution of the dependent variable as a function of the covariates and a parameter specific to each cluster.” As Zorn (2001) explains, population-averaged and cluster-specific models “represent two fundamentally different ways of thinking about the covariate effects on the phenomenon of interest and about the nature of the correlation among observations within a cluster.” Conditional models include unit-specific (in this case, and in most IR applications, country-specific) effects. “These individual effects can be thought of as latent, subject-specific propensities towards the outcome variable which are independent of the model’s covariates.” Fixed effects models estimate these unit-specific effects directly, while random effects models assume that these parameters follow some stochastic (usually, a Normal) distribution, the variance of which is estimated along with the other parameters of the model. In contrast, population-averaged models do not include these unit or cluster-specific effects. Instead, they model “the average response over the sub-population that shares a common value” for the independent variable.<sup>317</sup>

“The distinction between conditional and population-averaged models is critical,” suggests Zorn, because the  $\beta$  parameters represent “completely different” quantities. Whereas the coefficients from a conditional model (i.e., a random or fixed effects model) represent the effect of a one-unit shift in the independent variable on the dependent variable *for the same individual country  $i$*  (i.e., for an observation with the same unit-specific effect), the coefficients from a population-averaged model represent the *average* effect of a one-unit change in the independent variable on the dependent variable *across the entire population of countries*. The choice between conditional and population-averaged models “should thus be seen as primarily a substantive, rather than a statistical, one.” Conditional models “are more useful when the

---

<sup>317</sup> All quotes in this and the following paragraph are from Zorn 2001, 474-5.

primary question of interest is the effect of changes in covariates within a particular observation” (i.e., country), while population-averaged models “are more valuable for making comparisons across groups” (i.e., countries) which is precisely my intent with respect to the effects of institutional capacity on the number of arbitral disputes a country experiences in a given year. Rather than the effects which differences in capacity have on the expected number of disputes for a particular country, I am interested in evaluating the average effect of capacity limitations on the number of disputes across all LDCs.<sup>318</sup>

## RESULTS OF THE ANALYSIS

Table 5.5 presents the results of my analysis of investor-state arbitral disputes.<sup>319</sup> I report incidence rate ratios (IRRs) instead of coefficients. IRRs represent the percentage change in the expected count of arbitral disputes given a one-unit increase in the explanatory variable, holding all other variables constant.<sup>320</sup> An IRR greater than 1.0 indicates an increase in the expected count, while an IRR less than 1.0 indicates a decrease in the expected count. An IRR of 1.0 is equal to no change.

The results provide consistent evidence in favor of my hypothesis regarding institutional capacity. I estimated five different specifications of the complete model, one for each of my five indicators of institutional capacity (i.e., the strength and quality of a country’s domestic institutions)—*CIM*, *Law and Order* (ICRG), *Corruption* (ICRG), *Rule of Law* (WBG), and *Control of Corruption* (WBG). The estimates for these models suggest that countries with

---

<sup>318</sup> Zorn (2001, 475) discusses the “democratic peace” as a useful example for understanding the substantive difference between the two types of models: “If one were interested in, say, the effect of democratization on the propensity for a particular nation or pair of nations to go to war, then the conditional approach would be more appropriate. If, instead, we wished to assess the general propensity of autocracies and democracies to engage in interstate conflict, a marginal approach (such as GEE) would be called for.”

<sup>319</sup> This analysis was performed using Stata 8.0, specifically the `xtnbreg` command.

<sup>320</sup> The IRR is the exponentiated coefficient (i.e., given the estimate  $b$ , the  $IRR = e^b$ ).

Table 5.5 Population-Averaged Model of Investor-State Arbitral Disputes

Explanatory Variables	Model 1	Model 2	Model 3	Model 4	Model 5
<b>INSTITUTIONAL CAPACITY</b>					
<i>CIM</i>	0.06*** (0.06)				
<i>Law &amp; Order</i> (ICRG)		0.74* (0.11)			
<i>Corruption</i> (ICRG)			0.88 (0.13)		
<i>Rule of Law</i> (WBGi)				0.32*** (0.13)	
<i>Control of Corruption</i> (WBGi)					0.32*** (0.11)
<b>EXPOSURE</b>					
<i>BITs</i>	1.09* (0.05)	1.09*** (0.04)	1.06 (0.04)	1.09** (0.04)	1.07* (0.04)
<i>PTAs</i>	1.14 (0.16)	1.13 (0.13)	1.15 (0.16)	1.20* (0.11)	1.19* (0.12)
<i>FDI Stock</i>	1.10 (0.12)	1.07 (0.13)	1.08 (0.14)	1.38*** (0.18)	1.37*** (0.18)
<b>EXPROPRIATION RISK</b>					
<i>Tenure</i> (WBDPI)	0.99 (0.01)	0.99 (0.02)	0.99 (0.01)	1.00 (0.03)	1.00 (0.02)
<i>Growth</i>	1.00 (0.02)	1.02* (0.01)	1.02 (0.01)	1.00 (0.01)	1.00 (0.01)
<i>Inflation</i>	1.00 (0.00)	1.00 (0.00)	1.00** (0.00)	0.98* (0.00)	0.98** (0.00)
<i>Internal Conflict</i> (MEPV)	0.95 (0.08)	0.81** (0.07)	0.85 (0.08)	0.89 (0.09)	0.90 (0.09)
<i>Constraints</i> (POLCON)	0.76 (0.57)	0.27 (0.22)	0.32 (0.25)	1.72 (1.75)	1.42 (1.42)
<b>ADDITIONAL CONTROLS</b>					
<i>Left Executive</i>	0.91 (0.31)	0.58 (0.20)	0.59 (0.20)	0.61 (0.20)	0.63 (0.20)



<i>Resource Rents</i>	1.00 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)
<i>Size</i>	1.18 (0.19)	1.20 (0.17)	1.19 (0.18)	0.97 (0.17)	0.98 (0.17)
<i>Income</i>	1.00** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00** (0.00)	1.00** (0.00)
<i>Income</i> <sup>2</sup>	1.00** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00** (0.00)	1.00** (0.00)
<i>Devaluation</i>	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)
<i>ICSID Member</i>	1.56 (0.51)	1.55 (0.54)	1.41 (0.52)	1.10 (0.39)	1.15 (0.40)
Lagged Dependent Variable	1.14 (0.30)	1.51** (0.27)	1.52*** (0.27)	1.14 (0.17)	1.20 (0.16)
Observations	1,954	1,465	1,465	702	679
Countries	119	100	100	123	123
Periods	1981-2001	1985-2002	1985-2002	1997-2002	1997-2002
Wald $\chi^2$	261.82	267.64	251.22	162.31	164.29

---

NOTE: estimates are incidence rate ratios from a GEE population-averaged negative binomial regression; semi-robust standard errors clustered on country shown in parentheses. All models contain polynomial time counters  $t$ ,  $t^2$ , and  $t^3$  (not shown). \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10% (one-tailed tests).

strong property rights institutions—i.e., a strong rule of law and minimal corruption, as indicated by the five alternative measures—become involved in significantly fewer arbitral disputes than countries with relatively weak institutions. This finding is fairly consistent across all five models. In all five models, the measure of institutional capacity is signed in the hypothesized direction—i.e., all five measures have a negative effect on the number of arbitral disputes, meaning as capacity increases, the number of disputes declines. This relationship is statistically significant at the 1% level in models 1, 4, and 5, and significant at the 10% level ( $p > 0.07$ ) in

model 2. In only one of the five models (model 3), does the capacity variable (*Corruption*) fail to achieve statistical significance.

The results are not only statistically significant but substantively significant as well. Table 5.6 shows the substantive impact of four alternative measures of institutional capacity on the expected count of arbitral disputes given a one standard deviation increase in a given explanatory variable, a two standard deviation increase, and a shift from the variable's minimum value to its maximum value. Depending on the particular measure, a single standard deviation increase in the strength and quality of a country's domestic institutions decreases the expected number of arbitral disputes by as much as 58%, while a two standard deviation increase in a country's institutional capacity decreases the expected number of disputes by as much as 82%. Depending on the particular measure, the percentage difference in expected disputes for a country that scores the lowest possible value on a given measure of institutional capacity and one that scores the maximum value is between 82 and 99%. That is, as a country moves from having the weakest possible domestic property rights regime to the strongest possible regime as captured by the *CIM*, *Law and Order*, *Rule of Law*, or *Control of Corruption* variables, the expected number of arbitral disputes which it experiences in a given year decreases by as much as 99%.

Turning to the other explanatory variables, I begin by discussing those variables which capture a country's degree of exposure to arbitral claims by foreign investors—*BITs*, *PTAs*, and *FDI Stock*. All three variables have a positive effect on the number of arbitral disputes a country experiences in a given year, as hypothesized. The IRR of 1.09 for *BITs* (in models 1, 2, and 4) suggest that each additional BIT that a country enters into with a high-income OECD country which enters into force produces a 9% increase in the expected number of arbitral claims brought

Table 5.6 Percentage Change in Expected Count of Arbitral Disputes

<b>Variable</b>	<b>Standard Deviation</b>	<b>2 Standard Deviation</b>	<b>Minimum-Maximum</b>
<i>CIM</i>	-36%	-58%	-94%
<i>Law &amp; Order</i> (ICRG)	-32%	-53%	-82%
<i>Rule of Law</i> (WBGI)	-58%	-82%	-99%
<i>Control of Corruption</i> (WBGI)	-56%	-80%	-99%
<i>BITs</i> (model 2)	44%	106%	448%

against the country by foreign investors in a given year, holding all other variables constant. As Table 5.6 shows, a one standard deviation increase in the number of BITs produces a 44% increase in the expected number of arbitral disputes, while a two standard deviation increase results in a 106% increase in the number of disputes. A change from the minimum number of BITs (zero) to the maximum number (19) results in a 448% increase in the expected number of arbitral disputes. Moreover, BITs is statistically significant at the 10% level in four of the five models and significant at the 5% level in two of the five models. The results suggest that the more BITs a country concludes with major capital-exporting countries, the more susceptible it becomes to having arbitral claims brought against it by foreign investors from the countries with which those BITs were concluded. In other words, countries that have ratified numerous BITs with upper-income OECD countries (i.e., those countries with greater exposure) experience a significantly greater number of arbitral disputes than countries which have concluded few or no

BITs (i.e., those with low exposure). A greater number of enforceable BITs means a larger proportion of foreign investors have the legal standing to pursue arbitral claims against states which they believe have violated their BIT-defined rights (assuming those BITs contain binding commitments to investor-state arbitration, an assumption which seems to be borne out by these results).

The results for *PTAs* and *FDI Stock* are similar to those for *BITs* but less robust to alternative specifications. *PTAs* is statistically significant in only two of the five models, and then, only at the 10% level. However, the substantive impact of each *individual* PTA on the number of arbitral disputes is somewhat larger than that of an individual BIT. The IRR of 1.20 (in model 4) suggest that each PTA that a country enters into increases the expected number of arbitral disputes which it becomes party to in a given year by 20%. *FDI Stock* also has a positive effect on the number of arbitral disputes. It is statistically significant at the 1% level in two of the five models, but, like *PTAs*, fails to achieve statistical significance in the remaining three models. A single standard deviation increase in the stock of FDI a country plays hosts to produces a 124% increase in the expected number of arbitral disputes, while a two standard deviation increase in the amount of FDI a country hosts results in a 401% increase in the expected number of disputes.<sup>321</sup> On the whole, the results of my analysis suggest that countries that have concluded a large number of BITs and PTAs and which host a significant amount of FDI are significantly more likely to become involved in arbitral disputes with foreign investors than countries whose exposure to arbitral claims, as captured by these three variables, is comparatively lower.

Turning to those variables intended to measure the degree of expropriation risk within a host country, I find very little evidence to support a rationalist theory of expropriation based on

---

<sup>321</sup> These calculations are derived from model 4.

the time horizons of host governments or the number of veto players constraining would-be expropriators. I find no support at all for Hypotheses 4 and 7. The variables used to test these hypotheses, *Tenure* and *Constraints*, are statistically insignificant in all five models.<sup>322</sup> *Growth* is statistically significant in only one of the five models (model 2) and only then at the 10% level, while *Inflation* is statistically significant at the 5% in two out of five models (models 3 and 5), and at the 10% level in a third model (model 4). However, in those models in which both variables manage to achieve a minimum level of statistical significance, their impact is substantively small and in the wrong direction, directly contradicting Hypothesis 5 which suggested that under favorable national economic conditions, host governments are less likely to expropriate FDI, thereby triggering an arbitral dispute. *Growth* has a small and minimally significant positive effect on the expected number of disputes in model 2, suggesting that economic growth actually increases the likelihood of an arbitral dispute, while *Inflation* is negatively correlated with the expected number of disputes in models 3-5, suggesting that as

---

<sup>322</sup> With respect to *Constraints*, as a robustness check, I substituted both the composite indicator of political regime type from the Polity IV database and the *Checks and Balances* measure of veto players from the World Bank's Database of Political Institutions for Henisz's political constraints index, but neither variable was statistically significant. I also dropped the institutional capacity variable from the model given the possibility of multicollinearity between my capacity measures and the political constraints index (indeed, some researchers would no doubt regard political constraints as another measure of institutional capacity), but the index remained insignificant. According to Li (2009), the effects of leadership tenure and political constraints should differ across democratic and autocratic political regimes. More specifically, he argues that the length of time that a government has remained in power (tenure) has a negative effect on a government's incentive to expropriate in autocracies (based on Olson's (1993) "stationary bandit" thesis) but not in democracies, and that, while political constraints should reduce expropriations in both regime types, this effect should be greater in democracies, which tend to impose more constraints on leaders than autocracies. To test these more nuanced hypotheses, Li creates four different variables to measure the effects of leadership tenure and political constraints: *Autocracy Leader Tenure*, *Democracy Leader Tenure*, *Autocracy Constraints*, and *Democracy Constraints*. He constructs these variables using the dichotomous measure of regime type from Alvarez et al. (1996) and Przeworski et al. (1996, 2000). Because data for this measure are not available past 1990, I am unable to replicate Li's variables for my own dataset. I therefore created analogous variables using the Polity IV database to separate democratic and autocratic countries. A country is defined for a given year as a democracy (or autocracy) if the composite indicator of regime type from Polity IV, computed as the difference between the 10-point democracy index (DEMOC) and the 10-point autocracy index (AUTOC), is greater than or equal to 6 (or smaller than or equal to -6). Using these cutoff values, which follow conventional practice in the political science literature (see, e.g., Dixon 1994, Li 2006), I created two dummy variables, one indicating whether a country is a democracy and another indicating whether a country is an autocracy. I then created four new variables based on interactive terms between my democracy and autocracy dummies and *Tenure* and *Constraints*. Despite this refinement, none of these variables ever achieve statistical significance.

inflation increases, the likelihood of an arbitral dispute decreases. Finally, in contrast to the expectations expressed in Hypothesis 6, *Internal Conflict* has a negative impact on the expected number of arbitral disputes which a country experiences in a given year. One explanation for this finding can be found in the results of my analysis of BIT signings in chapter 4, which suggested that countries in which there is a nontrivial amount of ongoing civil or ethnic violence are significantly less likely to enter into BITs, thereby limiting their exposure to arbitral claims. This effect is more directly captured by the variable *BITs*. Not surprisingly then, *Internal Conflict* only manages to achieve statistical significance in one of the five models.

Collectively, the results for my five measures of expropriation risk lend credence to the doubts expressed above regarding the applicability of a model which was largely intended to explain *direct* expropriations (i.e., direct seizure or forced divestment) as opposed to instances of indirect or creeping expropriation which may constitute the principal source of arbitral claims. This suggests that greater theoretical attention needs to be given to the underlying motives which host governments have to engage in creeping expropriation and how these differ from those that give rise to direct expropriations.

Turning to the remaining control variables, I do not find any evidence to suggest that the partisan orientation of host country governments is significantly related to the number of arbitral disputes a country becomes involved in over time. Although the variable *Left Executive* has a consistent and substantively large negative effect on the expected number of disputes across all five models, suggesting that leftist governments have had a better record of respecting investor rights and complying with their BIT-related obligations than their rightist or centrist counterparts, the variable fails to achieve statistical significance. The variable *Resource Rents*, intended to capture the obsolescence of bargains between foreign investors and host states in the

natural resources sector, also fails to achieve statistical significance as does *Market Size*. In contrast, the effect of *Income* (GDP per capita) is positive and statistically significant, whereas that of its squared term is negative and significant (as indicated by the direction of the z-values for both variables<sup>323</sup>), suggesting that as a country's level of economic development rises, the number of expropriation acts first increases, generating a corresponding increase in the number of arbitral disputes a country becomes party to, and then declines, leading to a parallel decrease in the number of disputes. This finding is consistent across all five models.

*Devaluation*, which is the absolute yearly change in a country's exchange rate, has a consistent and statistically significant positive effect (as indicated by the direction of its z-values) on the expected number of arbitral disputes, indicating, contrary to my expectations based on the experience of Argentina, that as a country's currency appreciates or is revalued, it experiences a greater number of arbitral disputes. It is unclear exactly what kind of causal process this variable might be capturing.<sup>324</sup> *ICSID Member* is not statistically significant in any of the models, though it is in the hypothesized direction.<sup>325</sup> Finally, the lagged dependent variable has a positive effect, suggesting that countries that did not experience an arbitral dispute in the previous year are less

---

<sup>323</sup> The direction of each variable cannot be gleaned from the IRRs presented in Table 5.5.

<sup>324</sup> This finding is robust across a variety of alternative model specifications and the inclusion of Argentina's outlying observations for 2003-5. In models not reported here, I included a dummy variable designed to capture the occurrence of a currency crisis, rather than devaluations. The variable was constructed using exchange rate data from the IMF's *International Financial Statistics* database and is based on Frankel and Rose's (1996) definition of a currency crisis as a depreciation of the nominal exchange rate by at least 25 percent that also exceeds the previous year's depreciation by at least 10 percent. The variable was coded 1 if these conditions were met, 0 otherwise. Like *Devaluation*, this variable was consistently statistically significant at the 1% level, but in contrast, had a negative impact. This result also runs counter to my expectations based on the experience of Argentina, suggesting that countries experience significantly fewer arbitral disputes when confronted with a currency crisis. It is worth mentioning that neither *Devaluation* nor my currency crisis variable take into account formal commitments on the part of host states to certain exchange rate regimes (i.e., whether the government has made a formal, public commitment to a fixed exchange rate, as was the case with Argentina, or allows its currency to float). The results for both variables suggest that exchange rate policies may be an important source of arbitral disputes, but further research must be done to untie the precise causal mechanisms.

<sup>325</sup> Arguably, a country's status as a contracting party of the ICSID Convention should only affect a country's likelihood of experiencing *any* arbitral disputes in a given year, but should not influence the actual *number* of disputes. I have more to say about this in the discussion of the ZINB model in the appendix.

likely to experience one during the current year, but the variable is only statistically significant in models 2 and 3.

### *Robustness Checks*

In order to test the robustness of my results, I conducted numerous robustness checks. First, I re-estimated models 1-5, dropping several variables which failed to consistently achieve statistical significance, including all five measures of expropriation risk (*Tenure*, *Growth*, *Inflation*, *Internal Conflict*, and *Constraints*) as well as *PTAs*, *Left Executive*, *Resource Rents*, *Market Size*, and *ICSID Member*. The results for the remaining explanatory variables (not shown), including my five measures of institutional capacity, *BITs*, *FDI Stock*, *Income*, *Income*<sup>2</sup>, *Devaluation*, and the lagged dependent variable, are largely similar to those in Table 5.5, with a few important exceptions. Most of the capacity measures as well as *BITs* and *FDI Stock* increase in terms of their statistical significance. *CIM*, *Rule of Law*, and *Control of Corruption* are all statistically significant at the 1% level as is *Corruption*, which was not significant in the full model. Only *Law and Order* fails to increase its statistical significance. *BITs* is statistically significant at the 1% level in all five models, while *FDI Stock* is significant at the 1% percent level in four of the five models, and at the 5% level in the fifth model. *Income* and its squared term are no longer statistically significant in any of the models. However, *Devaluation* remains statistically significant at the 1% in all five models, while the lagged dependent variable is significant at the 1% level in three out of the five models.

Second, there is obviously a strong correlation between a country's level of economic development and its institutional capacity—i.e., the more developed a country is, the stronger or better are its institutions in most cases. Given the possibility that multicollinearity might be



driving the results for my measures of institutional capacity, I also re-ran all five models excluding *Income* and its squared term. The results for all five capacity measures remain unchanged in terms of their direction and statistical significance, indicating that the original results reported for these variables are not dependent on the inclusion of *Income* in the model. I also re-ran all five models without *Devaluation*. Again, the results for all five measures of institutional capacity were largely identical to those reported in Table 5.5. All in all, these robustness checks indicate that the results for my key explanatory variable—institutional capacity—are not dependent on the inclusion of any of the other independent variables.

Finally, I also re-estimated my five original models using four alternative statistical estimators—the standard NBRM with robust standard errors (clustered on country), the random effects negative binomial estimator, the conditional fixed effects negative binomial estimator, and the zero-inflated negative binomial (ZINB) estimator. The results using these alternative estimators are presented in Appendix B. With the exception of the fixed effects and ZINB estimators (which, for reasons that I outline in the appendix, are arguably inappropriate estimators given the qualities of my data and theoretical considerations), a majority of my measures of institutional capacity retain their significance (and none change direction) when these alternative estimators are employed. The same can be said of my chief indicator of exposure to arbitral claims, *BITs*, which is consistently significant and signed correctly. Thus, my principal finding regarding the effects of a country's institutional capacity on the number of arbitral disputes it experiences over time is robust, not only to alternative specifications, but also different statistical estimators, as is my regarding the relationship between the number of BITs a country has entered into and the number of arbitral claims it has brought against it in a given year.

## SUMMARY AND DISCUSSION

The extant literature on BITs implicitly assumes that such agreements have the capacity to constrain the behavior of host states toward FDI by imposing a variety of ex post costs on these states in the event of noncompliance. Yet, even with these incentives in place, compliance is by no means guaranteed. Inevitably, states will vary in terms of their compliance with the international commitments they have made. The absence of any sustained discussion of the nature of compliance with BITs therefore represents a rather conspicuous gap in the growing literature on such agreements. In this chapter, I have taken a tentative first step towards filling this important gap.

I have suggested that, in the context of the international investor rights regime represented by BITs and other interstate agreements, the number of foreign investment disputes which a state becomes involved in which are submitted for arbitration at the international level can be treated as a convenient (albeit imperfect) indicator of the degree of *potential* (if not *actual*) noncompliance with this regime. As I have explained, the investor rights regime has been constructed in such a way that the two key functions which, according to one school of theorists, are critical for fostering compliance with international regulatory agreements—namely, monitoring and enforcement—are placed into the hands of those actors directly affected by noncompliance—namely, the foreign investors whose property rights BITs are designed to protect. In the context of a regime that is intended to uphold the property rights of foreign investor by regulating the behavior of host states toward FDI, foreign investors are the principal victims of noncompliance. As such, they are capable of recognizing when their BIT-related rights have been violated by a host state's actions or policies. Hence, there is no real monitoring or detection problem in the context of this unique regime. Consequently, enforcement becomes

the real issue. Unlike other international regimes in which states bear most of the responsibility for ensuring compliance, the investor rights regime confers this responsibility on the investors themselves. Instead of lobbying their home government to launch a dispute against another state on their behalf, as is the case with the international trade regime, most BITs grant foreign investors direct access to the dispute settlement process, permitting them to initiate arbitral proceedings against host states (with or without the consent of their home governments) if they feel that their property rights (as defined by a BIT) have been violated by a host government's actions or policies.

Given the role which investor-state arbitration plays as an enforcement mechanism in the investor rights regime, in a world of zero transaction costs and complete transparency we would expect noncompliant governments to have a significantly larger number of arbitral claims brought against them by foreign investors over time than governments whose behavior largely conformed to the regime's norms and rules. However, it is possible that the transaction costs associated with bringing an arbitral claim against a host state (particularly the substantial financial costs involved) may prevent some investors, who might otherwise pursue such a claim, from doing so. Furthermore, because of the secrecy with which many investor-state arbitral disputes are shrouded, the exact number of arbitral claims brought against host countries represents an unknown quantity. For these reasons, as an indicator of potential noncompliance, the number of *publicly known* arbitral disputes to which a state has been party may significantly underestimate the degree of actual noncompliant behavior among states.

On the other hand, just because an investor *believes* its BIT-related rights have been violated by the actions or policies of a host government, this does not necessarily mean that the government's behavior was in fact noncompliant. Ultimately, only a tribunal of arbitrators can

make this determination. However, in the absence of a single, multilateral agreement, such as the MAI, which, like the GATT in the arena of trade relations, can be built-upon and amended over time through continuous bargaining and negotiation among states—in other words, in the absence of a single set of universal rules—the decisions of arbitral panels are likely to remain inconsistent (as they have, in fact, been). This obviously makes it difficult to precisely define what constitutes compliance and noncompliance with respect to the international investor rights regime, especially when that regime is embodied in nearly 2,600 separate treaties. In short, our definition of what constitutes compliance is a moving target. For these reasons, the number of arbitral disputes which a state becomes party to over time cannot be regarded as a completely reliable indicator of compliance with BITs. At best, the number of disputes a country becomes involved in should be used as an indicator of potential not actual noncompliance.

Yet, regardless of what it tells us about compliance with BITs, explaining cross-national variation in the number of arbitral claims brought against states by foreign investors represents a worthwhile pursuit in its own right, especially given the enormous costs which these disputes entail for developing host countries. In fact, the number of arbitral claims represents one way to gauge the costs of complying with the international investor rights regime embodied in BITs and how these costs vary among countries. In this chapter, I have taken the first step towards systematically explaining this variation. My principal argument is that a country's institutional capacity for protecting and enforcing private property rights represents a significant determinant of the number of arbitral disputes which it is likely to experience, and therefore the costs of complying with BITs, controlling for differential degrees of exposure to arbitral claims. I have hypothesized that countries in which the rule of law prevails and corruption is minimal should experience significantly fewer arbitral disputes than those in which corruption is rampant or

pervasive and in which legal institutions are comparatively weak. The frequency of property rights violations is likely to be much lower in countries with strong institutions. More importantly, when such violations do occur, they are more likely to be settled outside of the international arbitration system when the host country's domestic institutions, especially its courts, are relatively strong, and therefore capable of resolving investment disputes. For most foreign investors, international arbitration probably represents a means of last resort for obtaining recompense from a recalcitrant host state. Investors whose property rights have, in fact, been violated by the actions or policies of a host government are, first, more likely to pursue, and second, more likely to find relief for their grievances, in countries with strong domestic legal systems than in countries whose legal systems are corrupt and ineffective. Using a variety of different measures of institutional strength and quality, and controlling for a number of other potentially important factors, I find strong and robust support for this hypothesis.

### *The Paradox of Institutional Capacity*

What are the implications of my findings? The apparent relationship between a country's institutional capacity for resolving foreign investment disputes, and the number of arbitral claims brought against it by foreign investors, presents something of a paradox. From the perspective of home country governments and the MNCs whose interests these governments represent, it is precisely those host countries that *lack* a strong institutional infrastructure for the protection and enforcement of property rights for which BITs are seen as an essential prerequisite for investment. In other words, it is exactly those countries with weak institutions for which BITs can play their commonly presumed and ascribed role as *substitutes*, providing an external mechanism for guaranteeing the rights of foreign investors. By entering into BITs, these

countries can compensate for their institutional deficiency, thereby assuaging the concerns of foreign investors, and, in doing so, stimulate increased inflows of FDI. At least this was the hope of those governments in the developing world that made such commitments. Yet, as my research suggests, it is precisely this same group of countries—those with low institutional capacity—for whom the compliance costs associated with BITs is likely to be the highest, at least in terms of the likelihood of becoming involved in costly arbitral disputes, an outcome that could potentially offset many of the gains that BITs might bring in the form of increased FDI.

The frequency of property rights violations is likely to be higher in countries with inferior institutional endowments, and when violations do occur, foreign investors may be hesitant to pursue their case in the local courts because they simply do not have faith in them. Moreover, when investors do decide to pursue their claims at the local level, they are less likely to find relief for their grievances if the host country's legal system is corrupt and ineffective. Therefore, the number of arbitral disputes is likely to be significantly greater for countries that lack strong property rights institutions than for countries whose institutional capacity for compliance is comparatively higher. Hence the paradox: those countries for whom BITs represent an essential functional substitute for deficient domestic institutions are the ones most likely to experience significant difficulties complying with their BIT-related obligations. A greater number of arbitral claims are likely to be brought against these countries *as a result of those same institutional deficiencies which their international commitments were intended to address.*

My findings serve as an important warning to those countries with limited institutional capacity that might be considering either tying their hands with a BIT for the first time or increasing their existing exposure to arbitral claims by entering into additional BITs. Given the increased likelihood of having arbitral claims brought against them by foreign investors, these

countries should probably avoid entering into BITs. Unfortunately, this warning probably comes too late for most countries. As of 2007, the last year for which I collected data, the average developing country was party to roughly 6.5 BITs with high-income OECD countries, and many LDCs have entered into more than this.<sup>326</sup> Moreover, most, if not all, BITs, particularly those in which at least one of the partners is a rich country, entail lengthy commitments, binding both countries for as long as a quarter century. Consider the BIT concluded between India and the United Kingdom discussed in the previous chapter. The treaty's initial duration was set at ten years, after which either state would have the opportunity to submit a written notice of its desire to terminate the agreement. The agreement would then remain in force for another year from the date on which it was terminated, but its provisions would continue to apply to any investments made while the BIT remained in force for another fifteen years after the date of termination. The India-United Kingdom BIT entered into force on January 6, 1995. India's first opportunity to withdraw from the agreement, then, was not until January 6, 2005. The Indian government has not yet chosen to exercise this option, but if it notified the British government tomorrow of its intent to scrap the BIT, it would nonetheless continue to be bound by the agreement, at least with respect to any existing British investments made in the past fifteen years or so, through 2020.

Given these sorts of survival provisions, countries should act with the utmost caution when considering whether or not to enter into a BIT. Yet, the reality is that intense competition for FDI has led many countries to throw caution to the wind in an effort to "keep up with the Joneses." Even where the opportunity exists for a state to begin minimizing its exposure to arbitral claims by formally withdrawing from BITs or letting them expire, many governments would no doubt be very reluctant to do so for fear of the negative signal which such actions

---

<sup>326</sup> The figure of 6.5 is for those BITs that have entered into force, not simply the number of BITs a country has signed which may or may not have been ratified by both parties.

might send to the international business community. It would seem that, despite years of collective resistance to the repeated efforts of DCs to establish a multilateral investor rights regime, LDCs have voluntarily trapped themselves by accepting BITs, having succumbed to the logic of defection as a result of the extreme competition for foreign capital that emerged among these countries in the 1990s.

My findings also suggest that, independent of a country's degree of institutional capacity, BITs appear to have a positive impact on the number of arbitral disputes a country experiences over time. In fact, along with a country's institutional capacity, the number of BITs with rich countries in force was the one variable whose impact and degree of statistical significance was robust across almost all specifications and estimators. The implication is that by entering into BITs even countries that have good institutions may be exposing themselves to costly arbitral claims. Consider the cases of Canada and the United States. As developed countries with minimal corruption and high-quality domestic legal systems, both countries obviously rank near the top in terms of their institutional capacity. Yet, as a result of their binding commitments to investor-state arbitration under NAFTA, the governments of both countries have had to deal with arbitral claims which have been brought against them by the other country's investors.<sup>327</sup> As a result of these investment disputes, there is some indication that the governments of Canada and the United States are beginning to question the appropriateness of investor-state arbitration as an international institution.<sup>328</sup> Furthermore, this sudden skepticism would appear to be manifesting

---

<sup>327</sup> Canada has had thirteen arbitral claims brought against it under NAFTA's investment chapter. Two of these cases were settled "out of court" before an award could be rendered by an arbitral panel, two were awarded in Canada's favor, one was awarded in favor of the investor, seven are still pending, and the status of one case is unknown. The United States has had twelve arbitral claims brought against it as a result of its commitments under NAFTA. Five of these cases were awarded in the United States' favor, while the remaining seven are still pending.

<sup>328</sup> Wells and Ahmed (2007, 11) go so far as to suggest that the era of U.S. support for its foreign investors which began in the early 1980s "may well be drawing to a close." It is interesting to note that, during the 2008 presidential campaign, one of the two leading candidates for the Democratic Party's nomination, Hillary Clinton, made a direct reference to the practice of investor-state arbitration under NAFTA in her criticisms of the agreement. On February



itself in the actual practice of these countries. Consider a recent PTA concluded between the United States and Australia.

Since concluding its first noteworthy PTA with Canada in the mid-1980s, the United States has consistently insisted that such agreements also address investment relations among the parties, and more specifically, that its PTA partners make a binding commitment to submit their disputes with foreign investors to arbitration if the investor requests it. It is notable then to observe the conspicuous absence of this sort of commitment in the recent PTA between the United States and Australia. The agreement's investment chapter contains many of the same substantive commitments (e.g., national and MFN treatment; anti-expropriation provisions; freedom to repatriate capital; etc.) that have become standard fare among BITs. However, Article 11.16 explicitly negates any intent on the part of either government to be bound by the practice of investor-state arbitration. Instead, in the event that a dispute arises between one of the governments and an investor from the other country, all that the agreement provides for are consultations between the two governments aimed at determining whether they are willing to allow the dispute to be submitted for arbitration. In other words, before a dispute can be arbitrated, the government that is involved in the dispute must first give its consent. In short, the

---

26, 2008, at the Democratic presidential debate in Cleveland, Ohio, Clinton stated that, if elected, she would seek to renegotiate the terms of NAFTA, and in doing so, would "take out the ability of foreign companies to sue us because of what we do to protect our workers." A copy of the debate transcript is available at: <http://www.nytimes.com/2008/02/27/world/americas/27iht-26textdebate.10457266.html>. Although the other top contender for the Party's nomination, Barack Obama, never made any explicit reference to the practice of investor-state arbitration, it is reasonable to assume that he too questioned its legitimacy. It remains to be seen whether the Obama administration will seek to renegotiate the US's commitment to investor-state arbitration under NAFTA. Considering their own exposure to, and experiences with, NAFTA-based arbitral claims, it seems reasonable to assume that both the Canadian and Mexican governments would be responsive to any US proposals to limit the practice, though both governments might be reluctant to agree to such negotiations for fear of opening up other parts of the agreements unrelated to investor rights.

PTA does not contain an advanced consent to investor-state arbitration on the part of either state.<sup>329</sup>

### *Suggestions for Future Research*

Future research on the determinants of investor-state arbitral disputes should move beyond the quantitative methodology adopted here. A more qualitative, case-study approach would complement a large-N analysis in several ways.<sup>330</sup> First, case studies could be used to substantiate some of the assumptions which have been made here regarding the motivations of both investors and host states. For example, I have assumed that foreign investors will usually be reluctant to pursue arbitral claims against host states, both because arbitration is costly, and out of fear of damaging their relationships with these governments, thereby potentially jeopardizing their ability to continue doing business in the host country. As a result, investors will prefer, whenever possible, to resolve such disputes amicably either through negotiation or through the host country's own domestic legal system. However, this assumption may not always hold true.

Consider the case of Indonesia which in the mid-1990s negotiated contracts with several foreign firms resulting in 27 different infrastructure projects in the electricity sector. These contracts subsequently fell apart when the Suharto government which had concluded them collapsed as a result of the Asian financial crisis of 1997. In the chaos and turmoil that followed as Indonesia struggled to make the transition to democracy, Indonesian officials "feared that the investors in the 27 projects would unite against the government" by bringing arbitral claims

---

<sup>329</sup> The text of the investment chapter of the Australian-US PTA is available at the website of the Office of the US Trade Representative:

[http://www.ustr.gov/sites/default/files/uploads/agreements/fta/australia/asset\\_upload\\_file248\\_5155.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/australia/asset_upload_file248_5155.pdf)

<sup>330</sup> For a good example of a case study approach as applied to the topic of investment disputes, including investor-state arbitration, see Wells and Ahmed 2007.

against it. “In fact, they did nothing of the sort: Different investors went their own ways.” While some investors pursued arbitration, others chose not to, despite having the right to do so. “In the end,” suggest Wells and Ahmed (2007), “it seems that the investors who were committed to the power business in developing countries or to other businesses in Indonesia drew only cautiously from the new safeguards. *Arbitration...would have left so much bitterness that the investors’ futures would be in jeopardy.* In contrast, some other power investors appeared to have decided that their ventures into the Third World had been mistakes; they turned to [arbitration] to collect what they could and run.”<sup>331</sup> How can we explain these different time horizons and associated responses on the part of foreign investors? While some of this variation is probably due to factors within the host country itself, at least some of the variation in investor strategies is likely to a function of the characteristics of individual firms and the unique beliefs or preferences of management, factors which can only be captured by in-depth case studies.<sup>332</sup>

Case studies can also be used to corroborate the causal mechanisms hypothesized to explain the relationship between domestic institutions and arbitral disputes which was revealed by my quantitative analysis as well as other potentially important relationships revealed by this analysis. Moreover, a case study approach can be used to refine causal explanations, generate new hypotheses, and identify other potentially important covariates which can then be tested using a large-N approach. Hence, the relationship between quantitative and qualitative methodologies should be viewed as complementary and reinforcing. Until recently, however, a major obstacle to case study analysis of investor-state arbitral disputes was a severe scarcity of

---

<sup>331</sup> All quotes in this paragraph are from Wells and Ahmed 2007, 10 (emphasis added).

<sup>332</sup> On the basis of their own case studies, Wells and Ahmed (2007, 11) identify several firm-level factors which they believe can account for variation in the approaches investors take in handling their disputes with host states: “The cases convince us that it matters...whether a company’s managers look down on nationals where they have invested, and whether a company has other investments in the country and rich experience in the Third World.” A foreign firm’s degree of exposure to retaliation on the part of the host government in the form of having multiple investments is likely to be a very important consideration with respect to the decision as to whether or not to pursue an arbitral claim, but obviously one that is not very amenable to a large-N analysis.

information on such disputes. Arbitral disputes between foreign investors and host states have traditionally been shrouded in a veil of secrecy and continue to be insulated from public scrutiny. Despite this lack of transparency, an increasing amount of information about individual cases has become available in recent years. ICSID, for instance, has established an online database which provides access to publicly available information on the decisions and awards rendered in ICSID cases.<sup>333</sup> Furthermore, as a result of the enormous controversy which many investor-state arbitral disputes have generated since the mid-1990s, many outside observers, including intergovernmental organizations such as UNCTAD as well as nongovernmental organizations and anti-globalization activists, have turned their attention towards keeping up with both the occurrence and outcomes of individual arbitral disputes as well as broader developments in the investor-state arbitration system. The system has therefore become the subject of intense outside scrutiny and surveillance by a number of groups who have made the gathering and disclosure of information on investor-state arbitrations a top priority. The result is a substantial increase in the amount of information regarding individual disputes.<sup>334</sup> It should now therefore be much easier for researchers to conduct case studies of arbitral disputes than was the case in the not-too-distant past.

Beyond explaining cross-national variation in the *occurrence* and *number* of arbitral disputes, the next logical step for this research is to begin examining the actual *outcomes* of

---

333

<http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&reqFrom=Main&actionVal=OnlineAward>

<sup>334</sup> In addition to the UNCTAD database of treaty-based investment disputes referenced earlier, three sources of information on individual investor-state arbitral disputes are worth mentioning. Perhaps the two best sources are *Investment Arbitration Reporter* (IAR, <http://www.iareporter.com/>) and *Investment Treaty News* (ITN, <http://www.investmenttreatynews.org/>). ITN, which is published by the International Institute for Sustainable Development, has been offering news, analysis, and opinions on international investment law and individual arbitral cases since 2001. It began as a list-serve before becoming an electronic newsletter produced by a small editorial team. Similarly, IAR is an electronic bi-weekly newsletter (and an off-shoot of ITN) published and edited by Luke Eric Peterson. Finally, in 2004, *bilaterals.org*, a website largely dedicated to opposing BITs, PTAs, and other international agreements related to trade and investment, was created by several activist groups. It too offers news and analysis of investor-state arbitral disputes.

concluded cases. For example, why are some arbitral disputes settled “out of court” before an award can be rendered by a tribunal? In those cases in which a decision or award is rendered, what kinds of factors determine the outcome? Is there any noticeable bias in terms of who wins arbitral disputes? Do states win more often than investors, or does the reverse hold true? Are poorer countries less likely to win their disputes with foreign investors as a result of their limited financial and legal resources? Are such countries more likely to settle “out of court” than those countries possessing a greater capacity to defend themselves against arbitral claims?<sup>335</sup> These are but a small sample of the questions for which we lack answers. Together, they constitute a potentially fertile research agenda. The growing literature on GATT/WTO disputes could serve as a potentially useful source of theoretical and empirical insights into these questions.<sup>336</sup>

Although the state-to-state dispute settlement system of the WTO obviously differs in important ways from the investor-state arbitration of BITs, there may be important similarities in the way the two systems function.

Finally, in keeping with the focus and purpose of this dissertation, the analysis conducted in this chapter has only considered the experiences of LDCs. However, at least some developed countries have also had treaty-based arbitral claims brought against them by foreign investors.<sup>337</sup> If it is true that countries with strong property rights institutions have a greater capacity to resolve investment disputes, then we would expect the number of arbitral claims brought against developed countries to be very low compared to most developing countries. Therefore, an

---

<sup>335</sup> The question of whether or not a country’s legal capacity matters in terms of its ability to win international disputes has also been raised in the context of the WTO dispute settlement system. Given the fact that

<sup>336</sup> See, e.g., Brewer and Young 1999; Horn, Mavroidis, and Nordstrom 1999; Park and Umbricht 2001; Reinhardt 2001; Busch and Reinhardt 2002, 2003; Guzman and Simmons 2002; Holmes, Rollo, and Young 2003; and Bown 2004.

<sup>337</sup> In addition to Canada and the United States whose exposure to such claims, as has already been noted, is largely a function of their commitments under NAFTA, Germany, Portugal, Spain, and the United Kingdom have all been respondents in BIT-related arbitral disputes.

additional test of the institutional capacity hypothesis would include all countries in the analysis, thereby leveraging a wider range of variation on this key explanatory variable.

## CHAPTER 6

### CONCLUSION

Since the 1980s, the relative importance of FDI as a source of capital, employment, and technology for developing countries has substantially increased, fueling an intense and fierce competitive struggle among these countries to attract such investment. In their efforts to stimulate increased inflows of FDI, most LDCs have adopted a two-track approach, adopting pro-FDI policies at both the domestic and international level. Domestically, many LDCs have undertaken significant liberalization of their regulatory regimes governing inward FDI. They have made it easier for foreign firms to invest by lifting ownership restrictions and eliminating screening mechanisms, thereby signaling a more welcoming posture toward foreign capital. They have made it easier for MNCs to repatriate their profits. Many governments moved toward a more nondiscriminatory approach to regulating FDI, granting national and MFN treatment to some, if not all, foreign investors. At least some governments have passed legislation providing for the arbitration of disputes between themselves and foreign investors. At the international level, these domestic policy changes have been complemented by, and locked-in through, formal treaty commitments. The principal vehicle through which these commitments have been made has been the BIT.

In this dissertation, I have pursued a deeper understanding of the relationship between domestic regimes for FDI and the international investor rights regime represented by BITs. In doing so, one of my objectives was to shed some light on a lingering issue within the extant literature on BITs—i.e., whether such agreements serve as a substitute for the absence of a strong institutional framework for the protection and enforcement of private property rights at the

domestic level, or whether such treaties tend to complement a country's domestic policies and institutions pertaining to FDI. I have argued that the relationship between national and international investment regimes should be viewed as being largely complementary and have provided evidence in support of this argument. As my research suggests, it is precisely those countries whose domestic policies are most congruent with the behavioral dictates of the international investor rights regime, and whose institutional milieus are most conducive towards a high degree of compliance with this regime, that are most likely to commit themselves to it by concluding BITs with rich countries. Furthermore, in a world in which the enormous pressures of unbridled competition for foreign capital have driven almost all LDCs to tie their hands with BITs, having relatively strong domestic property rights institutions appears to reduce the costs of complying with BITs. My research therefore reveals important domestic-level determinants of both a state's decision to formally commit itself to the international investor rights regime and its capacity to comply with these commitments.

In this concluding chapter, I provide a brief summary of my argument and findings. I then spell out some of the more important theoretical and practical implications of my research. I end with a discussion that addresses one of the core questions that have motivated this project—namely, whether BITs are a good idea for developing countries given their significant costs.

## **SUMMARY OF THE ARGUMENT AND FINDINGS**

The overarching question which this dissertation has sought to answer is this: What is the relationship between a country's domestic regime for FDI—that is, its policies and institutions—and its FDI-related legal commitments at the international level? I approached this



question from two separate angles. First, I sought to understand the relationship between a country's domestic regime for FDI and its propensity to make investment-related legal commitments at the international level (i.e., sign BITs). Second, I explored the relationship between a country's institutional capacity for protecting and enforcing property rights and its ability to comply with its international commitments. Hence, I focused on two inextricably linked dependent variables: commitment and compliance. The two key explanatory variables which my argument and analysis highlight are the policy preferences of host governments and the larger institutional framework for private investment.

### *Explaining Commitments*

Under what kinds of conditions are LDCs more or less likely to make investment-related legal commitments at the international level? What kinds of factors drive countries to enter into BITs and other, similar investor rights agreements? What kinds of factors cause them to hesitate or refrain from making such commitments? In chapter 3, I argued that states are more likely to conclude BITs when the costs of doing so are relatively low.

First, states are more likely to enter into BITs when their policy preferences are relatively congruent with the behavioral requirements which such treaties impose on them as host states. In other words, governments are more likely to conclude BITs when the demands of such agreements no longer represent a substantial departure from what the government would have done in the absence of any international commitment. Hence, in terms of the timing of commitments, BIT signings tend to follow a shift in the preferences of LDC governments towards FDI. More specifically, BITs tend to be preceded by, or coincide with, the liberalization of a country's policies toward FDI. BITs perform several functions for liberalizing governments.

They allow reform-oriented governments to signal their “type” (i.e., their policy preferences) to foreign investors. Perhaps more importantly, BITs enhance the credibility of a government’s commitment to a liberal regulatory regime for FDI by raising the ex post reputational and diplomatic costs of reneging, thereby tying the government’s hands, thus resolving the time-inconsistency problem. Moreover, BITs not only tie the hands of the current government, but those of future governments as well, thereby providing a mechanism through which liberalizing governments can lock-in liberal FDI policies, hence lowering the likelihood of policy reversals on the part of their successors. In short, BITs allow pro-FDI governments to institutionalize their policy preferences.

Second, governments are more likely to conclude BITs when they possess the institutional capacity to comply with such agreements. In countries that already possess a strong institutional infrastructure for the protection and enforcement of private property rights, the frequency of property rights violations is likely be much lower than in countries where the rule of law is fragile, local courts are weak, and corruption is pervasive. Consequently, countries with strong indigenous property rights institutions should experience fewer difficulties complying with their BIT-related obligations than countries with weak institutions. The principal source of compliance-related difficulties, as I have argued, is the investor-state arbitration system embedded in BITs. The lower a country’s institutional capacity for compliance, the more hesitant it will be to make such commitments for fear of subjecting itself to countless arbitral claims on the part of foreign investors whose BIT-defined rights may have been violated. Hence, countries with superior institutional endowments should exhibit a greater propensity to enter into BITs than countries with significant institutional shortcomings.

Empirically, I find strong support for my argument. The analysis of BIT signings in chapter 4 suggests that the more favorable a country's domestic regime for FDI, both in terms of policies and institutions, the more likely it is that the country enters into a BIT. A case study analysis of India traces the sequence of events, from liberal reforms at the domestic level to international investment-related commitments at the international level, revealing a pattern with potentially wide applicability, capturing the experiences of many, if not all, LDCs:

- First, exogenous forces—e.g., severe balance of payments difficulties, the 1980s debt crisis, or some other economic crisis combined with a reduction in alternative sources of external finance—prompt a change in the ideas, and hence, the policy preferences of at least some of a country's leaders and elites regarding the desirability of FDI.
- Second, a reform-minded government acquires the reins of power. Crisis conditions grant it a (perhaps small) window of opportunity to liberalize FDI policies in spite of the continuing opposition of groups who oppose or stand to lose from such policy changes.
- Finally, after the process of liberalization has gotten under way, the government begins concluding BITs with major capital-exporting countries, thereby raising the costs of back-sliding, thus tying the hands of future governments.

Thus, as my research shows, BITs are most likely to be concluded by those governments that both *intend* to comply with such agreements as a result of their policy preferences towards FDI, and which *expect* to be able to comply with such agreements as a result of their superior institutional endowments. Like marriages, BITs represent significant, long-term commitments. Only those governments that are serious about complying with such commitments are likely to make them.

### *Explaining Compliance*

An underlying assumption of the theoretical argument forwarded in chapter 3 (and summarized above) is that the lower a country's institutional capacity for protecting and enforcing property rights, the more difficulties it is likely to experience complying with its BIT-related commitments. To test this assumption, we need a way of measuring compliance with BITs. I have argued that the number of arbitral claims brought against a state by foreign investors offers a convenient indicator of the degree of potential noncompliance with the international investor rights regime represented by BITs. Countries that score high in terms of their institutional capacity to protect and enforce property rights should become involved in significantly fewer arbitral disputes than countries whose institutional capacity is substantially lower. Moreover, given that arbitral claims represent one of the principal costs of BITs, the number of arbitral claims a country experiences over time represents a relatively straight-forward way of gauging the costs of complying with BITs as well as the degree to which these costs vary among countries. For those countries that experience a greater number of arbitral disputes, the costs of complying with the international investor rights regime is undoubtedly higher. It is therefore important to identify the cross-national determinants of such disputes in order to reduce these costs.

How does a country's institutional capacity for protecting and enforcing property rights influence the number of arbitral disputes? First, the frequency of property rights violations is likely to be higher in countries where the rule of law is nonexistent, courts are weak, and corruption is rampant. Second, when property rights violations do occur, the weaker a host country's domestic legal system is, the greater is a foreign investor's incentive to find relief for its grievances at the international level. Foreign direct investors tend to have long horizons.

They will normally prefer to continue doing business in the host country. Launching arbitral proceedings against the host government could conceivably jeopardize their ability to do so. Moreover, arbitration is costly. Therefore, I assume that arbitration represents an option of last resort for most investors. Whenever possible, investors will seek to resolve their disputes with host states either through negotiation or in the host country's legal system. However, the likelihood of finding relief at the local level is likely to be much lower in countries with weak and corrupt legal institutions. Thus, investors will be more likely to pursue arbitral claims at the international level when they are unable to resolve their disputes with host governments at the domestic level, and their ability to do so is a function of the strength and quality of the host country's institutions, including the rule of law and the level of corruption.

Empirically, I again find strong and robust support for my expectations. An analysis of the determinants of investor-state arbitral disputes reveals a consistent and significant difference between countries in which the rule of law prevails and corruption is minimal and those countries whose institutional capacity is considerably lower. This finding presents us with an important paradox: Countries with relatively low institutional capacity are the ones in most need of BITs as a substitute for their institutional inferiority. Yet these same countries are likely to experience the greatest difficulty complying with their BIT-related obligations, at least in terms of their likelihood of becoming party to costly arbitral disputes with foreign investors.

## **IMPLICATIONS**

The research presented in this dissertation speaks directly to a larger issue within the field of international relations regarding the nature of treaty compliance. Some scholars have argued that international agreements do not have the capacity to constrain state behavior. Instead,

treaties function as a screening mechanism, distinguishing those countries that are already committed to those policies which a treaty demands, and therefore which are already predisposed toward compliant behavior, from countries that have no interest in undertaking such obligations, and who therefore refrain from making any international commitment. In other words, the countries that actually enter into treaties tend to be the ones that are most likely to comply *ex post*.<sup>338</sup> Other scholars have argued that international agreements do represent a substantively significant constraint on state behavior by raising the *ex post* costs of renegeing.<sup>339</sup> Directly addressing this debate in the context of BITs, Kerner (2009) claims that, contrary to the “claim that international agreements are entered into by the countries that are already predisposed to the prescribed actions, my results support the idea that BITs are ratified by countries because they are not viewed as being predisposed to protecting foreign investment.”<sup>340</sup> The findings of this dissertation directly contradict Kerner’s claim. The results of the analysis conducted in chapter 4 suggested that as a host country becomes a more reliable protector of private property rights, including the rights of foreign investors—as indicated by its policies toward FDI, the degree of expropriation risk, and its institutional capacity for protecting and enforcing property rights—its chances of signing a BIT increase significantly. In other words, it is precisely those countries that would be most likely to respect the property rights of foreign investors *in the absence of any*

---

<sup>338</sup> Downs, Rocke, and Barsoom 1996; von Stein 2005, 2008.

<sup>339</sup> Abbott and Snidal 2000; Simmons 2000; Hopkins and Simmons 2005.

<sup>340</sup> Kerner 2009, 97. Kerner’s claim is based on an analysis of the effects of BITs on FDI inflows. Although his research design represents one of the more methodologically sophisticated treatments of the relationship between BITs and FDI flows, his reasoning about what kinds of countries are more likely to conclude BITs seems suspect. Finding that BITs have a positive impact on the amount of FDI a country subsequently receives, he concludes that the kinds of countries that enter into BITs must represent unreliable property rights protectors in the eyes of foreign investors, contrary to the results of my own analysis of BIT signings which suggests that those countries whose domestic regimes are most favorable to FDI exhibit the greatest propensity to enter into such agreements. The problem lies in Kerner’s failure to control for the effects of liberalization at the domestic level. I return to this point momentarily.

*international commitment* that are most likely to enter into BITs, a finding which supports the arguments of Downs, Rocke, and Barsoom (1996) and von Stein (2005).

This finding is somewhat ironic if we buy into the conventional wisdom regarding BITs as well as the results of other BIT-related studies. As I have noted, most of the extant literature on BITs has been directed toward determining whether BITs “work”—i.e., whether or not they actually stimulate increased inflows of FDI to the countries that conclude them. Beyond examining the absolute effect of BITs on FDI flows, at least some studies have tried to determine whether there is an interactive, substitution effect between BITs and domestic policies and institutions on FDI flows. In other words, assuming that BITs have a positive impact on FDI inflows, is this effect larger for countries with relatively low institutional capacity (e.g., countries in which the rule of law is weak or nonexistent or where corruption is rampant, therefore contributing to a higher risk of expropriation) than countries with relatively good institutions (i.e., low expropriation risk)? Of those studies that have explored the empirical relationship between BITs and FDI flows, one of the more prominent studies finds evidence that would suggest that BITs do in fact function as substitutes for weak domestic institutions, at least in terms of their capacity to attract FDI.<sup>341</sup> That is, BITs have a larger stimulating effect on FDI for those countries in which the risk of expropriation is highest.

Yet, from the perspective of the decisional calculus of host governments, I do not find any evidence of a substitution effect. After controlling for numerous other factors which might affect a state’s decision as to whether it wants to tie its hands with a BIT (such as competition for FDI), I find that countries with weak institutions—i.e., those countries that are most in need of a BIT to compensate for their institutional deficiencies—are actually less inclined to conclude such agreements. In contrast, those countries that already possess comparatively strong property

---

<sup>341</sup> Neumayer and Spess 2005.

rights institutions are significantly more likely to surrender their regulatory sovereignty over FDI by entering into BITs. The irony then is this: In terms of the apparent or purported capacity of BITs to stimulate increased investment from abroad, *those countries that would benefit the most from BITs are significantly less likely to enter into such agreements, whereas those countries that arguably benefit the least from BITs are the ones most likely to conclude them.*

My findings become even more relevant when one considers how much of the literature on BITs has been devoted to the question of whether or not BITs lead to increased inflows of FDI. Given the finding that countries are significantly more likely to conclude BITs *after* having undertaken significant liberalization of their domestic regulatory regimes toward FDI, or at the very least, *at the same time* as they are undertaking such reforms, is it not reasonable to conclude that it might be these domestic-level policy changes, and not the BITs themselves, which are responsible for any subsequent increase in inward FDI? Yackee frames the issue as follows: “how are we to statistically disentangle the effects of favorable changes in the domestic legal regime governing foreign investment from the effects of signing...BITs when most developing countries were dramatically liberalizing the former precisely at the same time that they were beginning to embrace the latter?”<sup>342</sup> The findings presented in chapter 4 lend credence to Yackee’s concerns. The implication is this: Before we can accurately assess whether BITs “work,” we must first find a way to separate the effects of domestic-level reforms from those of BITs in our statistical analyses. Most studies fail to do address the simultaneity of domestic liberalization of FDI policies and BIT signings at the international level. Therefore, future research on the relationship between BITs and FDI flows should be devoted to determining which of these variables is a more important determinant of investment decisions—international legal commitments in the form of BITs or domestic reforms. In seeking an answer to this

---

<sup>342</sup> Yackee 2007b, 22.



empirical question, researchers should ask themselves the following counterfactual question: What would the distribution of FDI flows among LDCs have looked like in the 1990s had none of these countries concluded any BITs? Arguably, it would have looked very similar.

### *Endogenous Preferences and the Prospects for Compliance*

What does my research say about the future prospects for compliance with BITs? I have compared BITs to the institution of marriage. Only certain people are likely to undertake the substantial commitment which marriage entails—namely, those that intend and expect to remain married indefinitely. While at least some people may get married for opportunistic reasons, making their commitments less than genuine, most people do not get married with the expectation that they will eventually break that commitment. Similarly, only those states that have a sincere interest in complying with BITs are likely to tie their hands with such agreements. Yet, as we all know, not all marriages last. Over time, one person's feelings toward the other can change for the worse, leading them to seek an end to the relationship, thereby breaking the commitment, even though that was not their original intention. The same may very well hold true with respect to LDCs and BITs. The preferences of governments can change over time. More importantly, *governments change*, particularly in terms of ideology and partisanship.

I have argued that part of the motivation behind the wave of BIT signings in the 1990s was the desire of liberalizing governments to tie, not only their own hands with respect to the regulation of FDI, thereby enhancing the credibility of FDI-related reforms, but also to tie the hands of their successors, thus lending additional credibility to these commitments. By concluding BITs, governments that had succeeded in fundamentally transforming their country's orientation towards FDI could lock-in these reforms against any possible back-sliding on the part

of future governments which might not share the current government's pro-FDI policy preferences. By raising the ex post reputational and diplomatic costs of a return to restrictive policies, BITs would decrease the likelihood of such policy reversals. However, while this may explain the decision of certain governments to enter into BITs, my argument does not assume that BITs will necessarily be effective at preventing a return to illiberal policies by governments with less than favorable preferences toward FDI. If international commitments are a function of the policy preferences of states, the same is true of compliance.

Thus, compliance with BITs is likely in part a function of state preferences, raising an important point: *when preferences change, behavior is likely to change, putting compliance in question*, as illustrated by the cases of Bolivia, Ecuador, Venezuela, and other Latin American countries in which leftist governments holding drastically different attitudes toward foreign investment than their predecessors have recently come to power. Furthermore, the increasing resort to international arbitration on the part of MNCs has already generated significant resentment and dissatisfaction on the part of LDCs. It may eventually engender significant political resistance on the part of these states. If the number of arbitral disputes continues to grow, the burden of pecuniary damages could become both unbearable and unmanageable for LDCs, perhaps thereby effecting a large-scale shift in the preferences of these countries against the international investor rights regime embodied in BITs and related institutions like ICSID.<sup>343</sup> Even developed countries seem to be having second thoughts about investor-state arbitration.

The true test of the capacity of BITs to constrain the behavior of host states is to identify situations in which there is a large gap between what a government would prefer to do (with

---

<sup>343</sup> Consider the case of Argentina. Since ratifying the ICSID Convention in 1994, 39 disputes have been initiated against the government of Argentina, 35 of which are still pending. Given Argentina's economic troubles of late, it is difficult to see how the Argentinean government would be able to pay all of the damages that could potentially be awarded in these cases.

respect to FDI) and what the international investor rights regime obligates it to do. We can at least point to anecdotal evidence in support of those who argue that international treaties represent a significant constraint on state behavior. In 2008, the leftist government of Ecuador announced its intention to withdraw from nine of its 25 BITs. It is interesting to note which countries these nine BITs are with: El Salvador, Cuba, Dominican Republic, Guatemala, Honduras, Nicaragua, Paraguay, Romania, and Uruguay. None of these countries represent significant sources of inward FDI for Ecuador. Terminating these BITs therefore arguably entails minimal costs for Ecuador in terms of its relationship with foreign investors. If the Correa government were serious about extracting Ecuador from the international investor rights regime, why would it not withdraw from *all* of its BITs, including those with major capital-exporting countries? Ecuador has BITs with Canada, Finland, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States which it presumably intends to keep intact, implying that it wishes to avoid paying the significant transaction costs which withdrawing from these treaties would entail compared to those which it has sought to terminate.<sup>344</sup>

### *A Softer Touch?*

As indicated in the introductory chapter, the research presented herein touches upon a debate within the field of IR regarding the best way to ensure compliance with international regulatory agreements. Those who subscribe to the so-called “enforcement approach” advocate hard law, including significant delegation and strong enforcement mechanisms, as the only way to prevent states from cheating on their commitments. “Management” theorists, on the other

---

<sup>344</sup> That being said, the Correa government has made significant moves to withdraw Ecuador from the ICSID Convention, sending a clear signal to foreign investors of its questionable commitment to the practice of investor-state arbitration.

hand, tend to see noncompliance as arising less from deliberately opportunistic behavior on the part of states and more from significant capacity limitations. As such, they prescribe a softer, more flexible approach and emphasize the need for capacity-building measures and other forms of assistance, especially for LDCs.

As I have noted, most BITs represent hard law insofar as they entail significant delegation with their advanced consents to investor-state arbitration. In stark contrast to the WTO dispute settlement system in which only states may bring claims, BITs grant foreign investors direct access to dispute resolution mechanisms, allowing them to initiate arbitral disputes. From an enforcement perspective, this kind of hard law approach is only necessary when an agreement requires states to significantly change their policies—changes which might cut-against the preferences of governments. But as I have demonstrated in this dissertation, in terms of their substantive requirements, BITs did not require a substantial departure from what many LDC governments would have done in the absence of any formal treaty commitment. India, for instance, had already granted foreign investors national treatment and freedom to repatriate profits before entering into a BIT with the United Kingdom (followed later by additional BITs with other major capital-exporting countries) which would have required it to grant this same kind of treatment. This is in keeping with the theoretical expectations of the enforcement paradigm which says that states tend only to enter those agreements that are congruent with their preferences and with which they intend to comply with. Of course, it is a matter of *timing*. During the 1970s, for instance, BITs would have required a significant change in the policies of most LDCs toward FDI, but by the 1990s, this was no longer the case. But this leaves us with an important question: *Why was a hard law approach necessary if BITs did not*

*require dramatic changes in the policies of LDCs at the time in which the treaties were concluded?*

Again, time represents the key factor—more specifically, the fact that preferences can change over time. As I have explained, hard legal commitments represent *costly* commitments. As such, they enable states to credibly commit themselves to a certain policy stance.<sup>345</sup> Whether or not foreign investors regarded the kinds of liberal reforms adopted by many LDC governments beginning in the late 1980s and early 1990s as less than credible, governments themselves seemed to believe that their reforms might be viewed with suspicion, especially given a not so distant past in which most LDCs engaged in extensive discrimination against, and regulation of, FDI. Prior to the 1990s, India had, for example, imposed extensive restrictions on FDI. In an effort to assuage any fears foreign investors might have regarding the security of their investments given an implicit time-inconsistency problem, and demonstrate the sincerity of their commitment to pro-FDI policies, the Indian government along with countless other LDC governments voluntarily chose to enter into hard BITs as a way of enhancing the credibility of liberal policy changes pertaining to FDI. In doing so, they not only tied their own hands, but those of their successors. Although the passage of time might bring about a shift in the preferences of states as a result of a change in government, BITs would raise the costs of reneging on the commitments of previous governments. As a result of the signaling and credibility-enhancing functions which BITs could serve, some governments saw BITs as a way to gain a competitive advantage over other countries in the intense competition to attract FDI. Once some governments had made such commitments, others felt compelled to do the same or risk losing out in the competition for foreign capital.<sup>346</sup> The results of this proliferation of hard,

---

<sup>345</sup> Abbott and Snidal 2000.

<sup>346</sup> Elkins, Guzman, and Simmons 2006.

inflexible BITs, I would argue, have been disastrous for developing countries as a result of the exponential increase in arbitral claims that has occurred since the 1990s, a direct consequence of the growth in the number of BITs which represented the opening of a Pandora's Box.

While it may be easy to understand the incentives which LDCs, desperate to attract vital FDI, had to voluntarily enter into BITs, developed countries bear much of the responsibility for the hard nature of BITs. Legalization, suggest Abbott and Snidal (2000), "is also significant from the perspective of the states (and other actors) that have worked to obtain commitments from others, often in the face of strong resistance." These states represent "demandeurs." "Whenever there are incentives for noncompliance with international commitments, demandeurs will seek ways to forestall or respond to violations of others."<sup>347</sup> In the context of building an international regime for FDI, developed countries played the role of demandeurs, seeking hard legal commitments, again as a way to lock-in the kinds of policies toward FDI which they had wanted LDCs to follow all along. As capital-exporters, these countries wanted hard BITs as a way of ensuring that LDCs could never return to the kinds of illiberal policies they had pursued towards FDI throughout much of the post-World War II era. While many of the earliest BITs that were concluded by Germany and Switzerland were comparatively softer than contemporary BITs, lacking any mention of, or advanced consent to, investor-state arbitration, by the 1980s most major capital-exporting countries had developed "model BITs" which contained strong enforcement mechanisms. These model BITs represented "take-it-or-leave-it" offers to all LDCs. It was only after the sea-change in attitudes toward FDI that occurred in the late 1980s resulting in significant liberalization of domestic regulatory regimes governing FDI that LDCs began accepting the offer.

---

<sup>347</sup> Abbott and Snidal 2000, 431.

Again, we can understand the incentives which developed countries had to get LDCs to accept hard legal commitments. After decades of intense conflict with LDCs over the basic purpose and orientation of an international regime for investment, culminating in the turbulent 1970s during which LDCs collectively sought a regime that would regulate the activities of MNCs while imposing few restrictions on their own behavior (as part of the larger illiberal NIEO movement), the revolutionary change in attitudes and policies that began in the late 1980s and continued into the early 1990s was welcomed by developed countries. BITs were seen as a way to lock-in these favorable changes. By demanding hard agreements, the developed countries would make it impossible for countries to retreat back to their policy stances of previous decades. Or, so they thought.

There is now a very real risk that, in the absence of significant reform, many developing countries might eventually turn their back on the international investor rights regime. By generating enormous financial costs for LDCs, the inflexible investor-state arbitration system embedded in BITs has led to growing resentment on the part of LDCs, resentment which translates into increased dissatisfaction with the kind of investor rights regime preferred by developed countries. As a result of this growing antipathy, the legitimacy of the investor rights regime has been called into question. Although many countries may be hesitant to withdraw from the BITs they are party to for fear of the negative signal that this might send to foreign investors, if the financial costs associated with investor-state arbitration continue to mount, many countries may not have any choice but to abandon the system, no matter what kinds of reputational damage this entails. For this reason, I would argue that the decision to demand hard legal commitments on the part of rich countries was ultimately short-sighted, and that a softer approach could have succeeded in building stronger, more sustainable support for investor rights

among LDCs. “Soft law,” explain Abbott and Snidal (2000), “offers many of the advantages of hard law, avoids some of the costs of hard law, and has certain independent advantages of its own.” To the extent that it “facilitates compromise, and thus mutually beneficial cooperation, between actors with different interests and values,” it may represent a superior institutional arrangement.

With respect to the international investor rights regime, the potential benefits of a softer approach are especially apparent when we consider the relative strength and quality of a country’s domestic institutions both as a source of inadvertent noncompliance as well as significant financial costs in the form of arbitral claims. “Soft legalization allows states to adapt their commitments to their particular situation rather than trying to accommodate divergent national circumstances within a single text.”<sup>348</sup> Soft law “should be attractive in proportion to the degree of divergence among the preferences and *capacities* of states.”<sup>349</sup> “Softness,” for instance, “accommodates states with different degrees of readiness for legalization. Those whose institutions, laws, and personnel permit them to carry out hard commitments can enter agreements of that kind; those whose weaknesses in these areas prevent them from implementing hard legal commitments can accept softer forms of agreement.”<sup>350</sup> For those LDCs that already possessed the institutional capacity necessary to provide a reasonable level of property rights protection for foreign investors, developed countries could have demanded hard commitments. However, for those LDCs that clearly lacked such capacity, the rich countries should have sought softer commitments.<sup>351</sup> Of course, the welfare of developing countries was not their primary

---

<sup>348</sup> Abbott and Snidal 2000, 445. Although there is no single multilateral treaty for investor rights, contemporary BITs are remarkably uniform in terms of their substantive and procedural provisions, so much so that, for all intents and purposes, they effectively comprise a multilateral treaty regime.

<sup>349</sup> Abbott and Snidal 2000, 445 (emphasis added).

<sup>350</sup> Ibid.

<sup>351</sup> This assumes that the developing countries in question would have been responsive to offers to accept softer commitments. To the extent that competition to attract FDI is the driving force behind BIT signings, these countries



concern. Instead, their chief concern was to secure and expand the legal rights of their own MNCs internationally.

## **ARE BITS A GOOD IDEA?**

Perhaps the most important question that can be asked about BITs and the international investor rights regime which they embody is this: *Do developing countries truly benefit from such agreements?* This question, whether explicitly acknowledged or left unspoken, is central to the literature on BITs to which I have sought to contribute through this dissertation. In providing an answer to this significant question, we must first answer at least one more question, and depending on the answer we come up with, we might have to address additional questions. The first question we must ask is this: Do the benefits which FDI brings to developing countries outweigh its costs? If our answer to this question is no, then the question of whether or not BITs benefit developing countries becomes moot, requiring little further attention. However, if we believe that the benefits of FDI outweigh its costs, then the next logical question is this: Do BITs increase FDI? If they do, then, by way of transitive property, BITs could be seen as desirable: BITs lead to increased inflows of FDI, and FDI creates net benefits for LDCs; therefore, BITs create net benefits for LDCs. If, on the other hand, BITs do not lead to increased foreign investment, then their desirability would remain uncertain.

The proponents of BITs have assumed that FDI does create net benefits for LDCs and that BITs can help to promote increased FDI. Indeed this is a core underlying principle, or causal belief, of the international investor rights regime advocated by DCs.<sup>352</sup> In their efforts to

---

might have foregone such offers, preferring hard commitments instead, in order to avoid losing out to those countries that had already made hard commitments. Again, the logic of competition is probably difficult to escape.

<sup>352</sup> Consider, one last time, our familiar BIT between India and the United Kingdom, the preamble of which describes the agreement's intended purpose and potential impact in the following manner: "Desiring to create

discover whether BITs have any effect on the distribution of FDI flows among developing countries, most scholars have remained neutral on the question of whether or not FDI itself benefits LDCs and rightly so; the question is largely irrelevant to their objective. Whether or not FDI does in fact benefit host countries, governments in the developing world clearly believe that it does, as indicated by the zeal and fanaticism with which they have sought to attract it. The real question from the perspective of most scholars is whether or not BITs really work. There are good reasons to believe that they do not. The proponents of a purely liberal approach to FDI—an approach which includes BITs—believe that if a country liberalizes its regulatory regime governing FDI and then enters into several BITs, thereby locking in these reforms and enhancing their credibility, it will receive more FDI *which will contribute to economic growth*. But as Chang (2008) suggests, the casual arrows point in the opposite direction. In many, if not most, instances, foreign investment “follows, rather than causes, economic growth.”

The brutal truth is that, however liberal the regulatory regime, foreign firms won't come into a country unless its economy offers an attractive market and high-quality productive resources (labour, infrastructure). This is why so many developing countries have failed to attract significant amounts of FDI, despite giving foreign firms maximum degrees of freedom. Countries have to get growth going before [MNCs] get interested in them. If you are organizing a party, it is not enough to tell people that they can come and do whatever they want. People go to parties where they know there are already interesting things happening. They don't usually come and make things interesting for you, whatever freedom you give them.<sup>353</sup>

Thus, the capacity of BITs, and liberal investment policies more broadly, to stimulate increased FDI remains an article of faith, rather than empirical certainty. What is certain is that these treaties place significant constraints on a country's ability to regulate FDI in ways that might be

---

conditions favourable for fostering greater investment by investors of one State in the territory of the Other State; Recognising that the encouragement and reciprocal protection under international agreement of such investment will be conducive to the stimulation of individual business initiative and will increase prosperity in both States; Have agreed as follows...”

<sup>353</sup> Chang 2008, 99-100.

beneficial to it in the long-run. It is worth addressing the costs of BITs since this is a topic that has received very little attention in the literature.

BITs entail a significant loss of regulatory sovereignty. By entering into such treaties, developing host states give up their right to regulate FDI in ways that might promote their country's long-term economic development.<sup>354</sup> For example, a fundamental norm of the international investor rights regime embodied in BITs is nondiscrimination. Once a government ratifies a BIT, it is obligated to grant foreign firms national treatment—i.e., treatment no less favorable than that which it grants to domestic firms. Therefore, by entering into a BIT, a country surrenders its sovereign right to shield its own national firms from foreign competition in the form of FDI. Any form of protectionism is by definition discriminatory and therefore a violation of the principles, norms, and rules of the international investor rights regime. The question then becomes whether protectionism with respect to FDI is warranted or justifiable. Liberals, of course, offer a resounding no to this question, suggesting that, through its negation of competition, protectionism, whether with respect to trade or investment, leads to an inefficient allocation and employment of resources. It essentially makes protected firms “lazy” or gives them unfair “rents.” But this ignores any distinction between the short run and the long run. “A critical but often ignored impact of FDI,” suggests Chang, is its effects on domestic competitors. “FDI can destroy existing national firms that could have ‘grown up’ into successful operations without this premature exposure to competition, or it can pre-empt the emergence of domestic competitors. In such cases, short-run productive capabilities are enhanced, as the [MNC] subsidiary replacing the (current and future) national firms is usually more productive than the

---

<sup>354</sup> This is not to suggest that BITs do not vary in terms of the depth of commitment which they entail. Some BITs may be relatively shallow (e.g., those concluded by China) whereas others are substantively deep (those concluded by the United States). However, in general BITs tend to entail a significant surrendering of regulatory autonomy with respect to FDI.

latter. But the level of productive capability that the country can attain *in the long run* becomes lower as a result.”<sup>355</sup>

According to Antoine van Agtmael, the former World Bank economist and current investment fund manager who first coined the term “emerging markets,” the 25 companies most likely to be the world's next great multinationals will all come from the developing world.<sup>356</sup> The list includes four companies each from Brazil, Mexico, South Korea, and Taiwan; three from India; two from China; and one each from Argentina, Chile, Malaysia, and South Africa. It is rather doubtful that any of these companies would enjoy such a favorable position today if their home countries had been shackled by the kinds of constraints which the liberal investor rights regime now imposes on so many countries. Consider the experiences of South Korea and Taiwan, so often heralded as liberal success stories. Both countries imposed extensive restrictions and performance requirements on FDI. Until the late 1990s when it adopted a more liberal approach to FDI, the Korean government employed a highly selective, discriminatory approach to foreign investment. It screened out investments which would have contributed very little to its long-term economic development, allowing only those firms that possessed vital technology which Korea did not already possess to invest.<sup>357</sup> Even the United States, today’s leading champion of a stronger, more legalized investor rights regime at the international level, engaged in heavy regulation of FDI during the formative years of its economic development.<sup>358</sup> History, suggests Chang, “is on the side of the regulators. Most of today’s rich countries regulated foreign investment when they were on the receiving end. Sometimes the regulation was draconian—Finland, Japan, Korea and the USA (in certain sectors) are the best examples.

---

<sup>355</sup> Chang 2008, 91.

<sup>356</sup> Cited in Zakaria 2008.

<sup>357</sup> Mardon 1990.

<sup>358</sup> See Chang 2008, 92-4.

There were countries that succeeded by actively courting FDI, such as Singapore and Ireland, but even they did not adopt the *laissez-faire* approach towards [MNCs] that is recommended to the developing countries today.”<sup>359</sup>

Even if some countries benefited from a regulatory approach to FDI in the past, some would suggest that today, as a result of globalization, it is no longer possible to regulate foreign investment. Footloose MNCs, it is argued, are now capable of punishing countries that try to regulate FDI by voting with their feet.<sup>360</sup> Yet, “if firms have become so mobile as to make national regulation powerless,” asks Chang, “why are the...rich countries so keen on making developing countries sign...all those international agreements that restrict their ability to regulate foreign investment? Following the market logic so loved by the neo-liberal orthodoxy, why not just leave countries to choose whatever approach they want and then let foreign investors punish or reward them by choosing to invest only in those countries friendly towards foreign investors? The very fact that rich countries want to impose all these restrictions on developing countries by means of international agreements reveals that regulation of FDI is not yet futile after all.”<sup>361</sup> BITs are as much a locking mechanism for rich countries as they are for reform-oriented governments in developing countries. They are a way for developed states to raise the costs associated with any possible retreat on the part of developing countries back to the statist policies which dominated these countries’ practice during much of the postwar era.

Lastly, in addition to robbing developing countries of their ability to regulate FDI in ways that might be beneficial to their long-term development, BITs may also entail significant opportunity costs insofar as they undermine efforts to strengthen private property rights within LDCs. Instead of negotiating investor rights treaties with rich countries, LDC governments

---

<sup>359</sup> Chang 2008, 96.

<sup>360</sup> See, e.g., Ohmae 1990, 1996. For a contrary view, see Hirst 1997.

<sup>361</sup> Chang 2008, 98.

should be investing their often scarce political capital into a sustained campaign to improve their countries' indigenous institutions, which, as Rodrik has pointed out, would benefit both domestic and foreign investors. "In the area of legal reform," he asks, "should governments focus their energies on 'importing' legal codes and standards or on improving existing domestic legal institutions? In Turkey, a weak coalition government spent several months during 1999 gathering political support for a bill providing foreign investors the protection of international arbitration. But wouldn't a better long-run strategy have involved reforming the existing legal regime for the benefit of foreign and domestic investors alike?"<sup>362</sup> The findings of this dissertation support just such a strategy.

Given the finding that countries with weak legal systems are more likely to become involved in a significantly greater number of arbitral disputes with foreign investors, the governments of these countries should work to strengthen their domestic legal systems, while reducing their exposure to arbitral claims, either by renegotiating their existing BITs or letting those agreements expire. Instead of surrendering their sovereignty over FDI, governments in the developing world should be working to strengthen the rule of law and fighting corruption. To the extent that they are successful in these efforts, they will not only eliminate some of the sources of their credibility problem with foreign investors, they will also make their countries more democratic. What is needed is a more conservative, long-term approach to attracting FDI. Instead of looking for a quick solution or a magic bullet, the governments of these countries should have focused their efforts on improving the quality of domestic institutions.

---

<sup>362</sup> Rodrik 2001, 57. de Soto (2000) essentially makes the same point. Tobin (2007) has shown that foreign investors are significantly less likely to lobby host governments for greater property rights protection when there is a BIT in place. To the extent that improvements in the institutional infrastructure for protecting and enforcing property rights are influenced by the demands of interest groups, including not only domestic investors, but foreign investors as well, Tobin argues that BITs actually decrease the incentive governments have to strengthen their indigenous institutions.

Strengthening domestic institutions has a dual benefit. Not only does it make a country more attractive to foreign investors, it also stimulates domestic investment by giving indigenous entrepreneurs greater confidence that their own property rights will be protected and therefore a greater incentive to invest which promotes economic growth. BITs do nothing to enhance the security of domestic economic actors' property rights. For this reason, although institution building takes time, the payoffs are likely to be greater.

In terms of a long-term strategy for attracting FDI, I would also argue that LDCs should focus on building up their reputations as hospitable and reliable hosts. Governments should strive to maintain good relationships with those foreign firms that have set up shop in their country. This does not mean that a country has to sacrifice all of its sovereignty over foreign investment, but once a government has made a commitment to foreign firms, it should strive to honor these commitments, as should the governments that follow it. Governments should not try to create a false reputation over night by concluding BITs. Again, although such a strategy may take time, the payoffs will eventually materialize. Other foreign investors are likely to reward a country that maintains good relationships with foreign firms by investing themselves.<sup>363</sup>

---

<sup>363</sup> This is essentially the moral of Tomz's (2008) account of the relationship between the reputation of countries and the interest rate premiums which these countries can expect to pay on their sovereign debt.

## REFERENCES

- Abbot, Frederick M. 2000. "NAFTA and the Legalization of World Politics: A Case Study." *International Organization* 54 (3): 519-47.
- Abbott, Kenneth W., and Duncan Snidal. 2000. "Hard and Soft Law in International Governance." *International Organization* 54 (3): 421-56.
- Abbott, Kenneth W., Robert O. Keohane, Andrew Moravcsik, Anne-Marie Slaughter, and Duncan Snidal. 2000. "The Concept of Legalization." *International Organization* 54 (3): 401-19.
- Abdelal, Rawi. 2007. *Capital Rules: The Construction of Global Finance*. Cambridge, Mass.: Harvard University Press.
- Aisbett, Emma. 2007. "Bilateral Investment Treaties and Foreign Direct Investment: Correlation versus Causation." Working Paper 1032, Berkeley, Calif.: CUDARE, Department of Agricultural & Resource Economics, University of California.
- Alchian, Armen A. 2002. "Property Rights." In *The Concise Encyclopedia of Economics*, edited by David R. Henderson. Indianapolis, Ind.: Liberty Fund, Inc.
- Allee, Todd, and Clint Peinhardt. 2008. "Not the Least BIT Rational: An Empirical Test of the 'Rational Design' of Investment Treaties." Paper presented at the 1<sup>st</sup> Conference on the Political Economy of International Organizations, Monte Verità, Switzerland, February 3-8, 2008.
- Allee, Todd, and Clint Peinhardt. 2009. "Delegating Differences: Bilateral Investment Treaties and Bargaining Over Dispute Resolution Provisions." *International Studies Quarterly*, forthcoming.
- Alvarez, Michael E., José Antonio Cheibub, Fernando Limongi, and Adam Przeworski. 1996. "Classifying Political Regimes." *Studies in Comparative Institutional Development* 31 (2): 3-36.
- Anselin, Luc. 1988. *Spatial Econometrics: Methods and Models*. Boston, Mass.: Kluwer Academic Publishers.
- Baker, James C. 1999. *Foreign Direct Investment in Less Developed Countries: The Role of ICSID and MIGA*. Westport, Conn.: Quorum Books.



- Barton, John H., Judith L. Goldstein, Timothy E. Josling, and Richard H. Steinberg. 2006. *The Evolution of the Trade Regime: Politics, Law, and Economics of the GATT and the WTO*. Princeton, NJ: Princeton University Press.
- Beck, Nathaniel, and Jonathan N. Katz. 1995. "What to Do (and Not to Do) with Time-Series Cross-Section Data." *American Political Science Review* 89 (3): 634-47.
- Beck, Nathaniel, and Jonathan N. Katz. 2001. "Throwing the Baby Out with the Bath Water: A Comment on Green, Kim, and Yoon." *International Organization* 55 (2): 487-95.
- Beck, Nathaniel, Jonathan N. Katz & Richard Tucker. 1998. "Taking Time Seriously: Time-Series-Cross-Section Analysis with a Binary Dependent Variable." *American Journal of Political Science* 42 (4): 1260-88.
- Beck, Nathaniel, Kristian Skrede Gleditsch, and Kyle Beardsley. 2006. "Space Is More than Geography: Using Spatial Econometrics in the Study of Political Economy." *International Studies Quarterly* 50 (1): 27-44.
- Bergara, Mario E., Witold J. Henisz, and Pablo T. Spiller. 1998. "Political Institutions and Electric Utility Investment: A Cross-Nation Analysis." *California Management Review* 40 (2): 18-35.
- Biglaiser, Glen, and Karl DeRouen, Jr. 2006. "Economic Reforms and Inflows of Foreign Direct Investment in Latin America." *Latin American Research Review* 41 (1): 51-75.
- Bown, Chad P. 2004. "Developing Countries as Plaintiffs and Defendants in GATT/WTO Trade Disputes." *The World Economy* 27 (1): 59-80.
- Box-Steffensmeier, Janet M., and Bradford S. Jones. 1997. "Time Is of the Essence: Event History Models in Political Science." *American Journal of Political Science* 41 (4): 1414-61.
- Box-Steffensmeier, Janet M., Dan Reiter, and Christopher Zorn. 2003. "Nonproportional Hazards and Event History Analysis in International Relations." *Journal of Conflict Resolution* 47 (1): 33-53.
- Brewer, Thomas L., and Stephen Young. 1998. *The Multilateral Investment System and Multinational Enterprises*. Oxford: Oxford University Press.
- Brewer, Thomas L., and Stephen Young. 1999. "WTO Disputes and Developing Countries." *Journal of World Trade* 33 (5): 169-82.
- Bueno de Mesquita, Bruce. 2009. "Recipe for Failure." *Foreign Policy* 175: 76-81.

- Busch, Marc L., and Eric Reinhardt. 2002. "Testing International Trade Law: Empirical Studies of GATT/WTO Dispute Settlement." In Daniel L. M. Kennedy and James D. Southwick, eds., *The Political Economy of International Trade Law: Essays in Honor of Robert E. Hudec*. New York: Cambridge University Press, 457-481.
- Busch, Marc L., and Eric Reinhardt. 2003. "Developing Countries and GATT/WTO Dispute Settlement." *Journal of World Trade* 37 (4): 719-35.
- Büthe, Tim, and Helen V. Milner. 2005. "The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI Through Policy Commitment via Trade Agreements and Investment Treatment?" Paper presented at The Political Economy of Multinational Corporations and Foreign Direct Investment Conference, Washington University, June, St. Louis, MO.
- Chang, Ha-Joon. 2008. *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism*. New York: Bloomsbury Press.
- Chayes, Abram, and Antonia Handler Chayes. 1993. "On Compliance." *International Organization* 47 (2): 175-205.
- Chayes, Abram, and Antonia Handler Chayes. 1995. *The New Sovereignty: Compliance with International Regulatory Agreements*. Cambridge, Mass: Harvard University Press.
- Clague, Christopher, Philip Keefer, Steve Knack, and Mancur Olson. 1996. "Property and Contract Rights in Autocracies and Democracies." *Journal of Economic Growth* 1: 243-76.
- Clague, Christopher, Philip Keefer, Steve Knack, and Mancur Olson. 1999. "Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance." *Journal of Economic Growth* 4: 185-211.
- Cohen, Benjamin J. 2008. *International Political Economy: An Intellectual History*. Princeton, N.J.: Princeton University Press.
- Cohn, Theodore H. 2005. *Global Political Economy: Theory and Practice*, 3<sup>rd</sup> ed. New York, N.Y.: Pearson-Longman.
- Dai, Xinyuan. 2002. "Information Systems in Treaty Regimes." *World Politics* 54: 405-36.
- de Soto, Hernando. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.
- Denoon, David B. H. 1998. "Cycles in Indian Economic Liberalization, 1966-1996." *Comparative Politics* 31 (1): 43-60.

- Diebold, William, Jr. 1952. "The End of the I.T.O." *Essays in International Finance* (16). Princeton, NJ: Princeton Department of Economics and Social Institutions, Princeton University.
- Dixon, William J. 1994. "Democracy and the Peaceful Settlement of International Conflict." *American Political Science Review* 88 (1): 14-32.
- Dolzer, Rudolph, and Margrete Stevens. 1995. *Bilateral Investment Treaties*. Boston, Mass.: Martinus Nijhoff Publishers.
- Downs, George, David M. Rocke, and Peter N. Barsoom. 1996. "Is the Good News about Compliance Good News about Cooperation?" *International Organization* 50 (3): 379-406.
- Dymond, William A. 1999. "The MAI: A Sad and Melancholy Tale" In *Canada Among Nations, 1999: A Big League Player?*, edited by Fen Osler Hampson, Michael Hart, and Martin Rudner. Oxford: Oxford University Press.
- Egger, Peter, and Michael Pfaffermayr. 2004. "The Impact of Bilateral Investment Treaties on Foreign Direct Investment." *Journal of Comparative Economics* 32 (4): 788-804.
- Elkins, Zachary, Andrew T. Guzman, and Beth A. Simmons. 2006. "Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000." *International Organization* 60 (4): 811-46.
- Encarnation, Dennis J. 1989. *Dislodging Multinationals: India's Strategy in Comparative Perspective*. Ithaca, N.Y.: Cornell University Press.
- Fernández, Raquel, and Jonathan Portes. 1998. "Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements." *The World Bank Economic Review* 12 (2): 197-220.
- Finnemore, Martha. 1996. *National Interests in International Society*. Ithaca, N.Y.: Cornell University Press.
- Finnemore, Martha. 2003. *The Purpose of Intervention: Changing Beliefs about the Use of Force*. Ithaca, N.Y.: Cornell University Press.
- Fisher, Roger. 1981. *Improving Compliance with International Law*. Charlottesville, VA.: University of Virginia Press.
- Frieden, Jeffrey A. 1994. "International Investment and Colonial Control: A New Interpretation." *International Organization* 48 (4): 559-93.
- Fry, Earl H. 1983. *The Politics of International Investment*. New York: McGraw-Hill Book Company.

- Gakhar, Kamlesh. 2006. *Foreign Direct Investment in India: 1947 to 2007: Policies, Trends and Outlook*. New Delhi: New Century Publications.
- Gilpin, Robert. 1975. *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (New York: Basic Books).
- Gilpin, Robert. 2001. *Global Political Economy: Understanding the International Economic Order*. Princeton, NJ: Princeton University Press.
- Ginsburg, Tom. 2005. "International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance." *International Review of Law and Economics* 25: 107-123.
- Goldsmith, Arthur A. 1995. "Democracy, Property Rights, and Economic Growth." *Journal of Development Studies* 32 (2): 157-174.
- Goldstein, Judith, Miles Kahler, Robert O. Keohane, and Anne-Marie Slaughter. 2000. *Legalization and World Politics* (Cambridge: MIT Press).
- Graham, Edward M. 1996. *Global Corporations and National Governments*. Washington, D.C.: Institute for International Economics.
- Graham, Edward M. 2000. *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises*. Washington, D.C.: Institute for International Economics.
- Graham, Edward M., and Paul R. Krugman. 1995. *Foreign Direct Investment in the United States*. Washington, D.C.: Institute for International Economics.
- Green, Donald P., Soo Yeon Kim, and David H. Yoon. 2001. "Dirty Pool." *International Organization* 55 (2): 441-68.
- Guzman, Andrew T. 1998. "Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties." *Virginia Journal of International Law* 38: 639-88.
- Guzman, Andrew T., and Beth A. Simmons. 2002. "To Settle or Empanel? An Empirical Analysis of Litigation and Settlement at the WTO." *Journal of Legal Studies* 31 (1): 205-35.
- Haftel, Yoram Z. 2007. "The Effect of U.S. Investment Treaties on FDI Inflows to Developing Countries: Signaling or Credible Commitment?" Paper presented at the 65<sup>th</sup> Annual Meeting of the Midwest Political Science Association, April, Chicago, IL.
- Haggard, Stephan, and Beth A. Simmons. 1987. "Theories of International Regimes." *International Organization* 41 (3): 491-517.

- Hallward-Driemeier, Mary. 2003. "Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit...and They Could Bite." World Bank Policy Research Working Paper 3121, Washington, D.C.: World Bank.
- Hart, Jeffrey A. 1983. *The New International Economic Order: Cooperation and Conflict in North-South Economic Relations, 1974-1977*. New York, N.Y.: St. Martin's Press.
- Hart, Michael. 1996. "A Multilateral Agreement on Foreign Direct Investment: Why Now?" In *Investment Rules for the Global Economy: Enhancing Access to Markets*, edited by Pieter Sauvé and Daniel Schwanen. Toronto: C.D. Howe Institute.
- Hassenclever, Andreas, Peter Mayer, and Volker Rittberger. 1997. *Theories of International Regimes*. Cambridge: Cambridge University Press.
- Henisz, Witold J. 2000. "The Institutional Environment for Multinational Investment." *Journal of Law, Economic, and Organization* 16 (2): 334-64.
- Henkin, Louis. 1979. *How Nations Behave: Law and Foreign Policy*. New York, N.Y.: Council on Foreign Relations.
- Hirst, Paul. 1997. "The Global Economy: Myths and Realities." *International Affairs* 73 (3): 409-425.
- Holmes, Peter, Jim Rollo, and Alasdair R. Young. 2003. "Emerging Trends in WTO Dispute Settlement: Back to the GATT?" World Bank Policy Research Working Paper 3133.
- Horn, Henrik, Petros C. Mavroidis, and Håkan Nordström. 1999. "Is the Use of the WTO Dispute Settlement System Biased?" CEPR Discussion Paper 2340.
- Jensen, Nathan M. 2003. "Democratic Governance and Multinational Corporations: Political Regimes and Inflows of Foreign Direct Investment." *International Organization* 57(3): 587-616.
- Jensen, Nathan M. 2006. *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment*. Princeton, NJ: Princeton University Press.
- Jodice, David A. 1980. "Sources of Change in Third World Regimes for Foreign Direct Investment, 1968-1976." *International Organization* 34 (2): 177-206.
- Jones, Ray C. 2002. "NAFTA Chapter 11 Investor-to-State Dispute Resolution: A Shield to Be Embraced or a Sword to Be Feared." *Brigham Young University Law Review* 527-59.
- Julius, DeAnne. 1990. *Foreign Direct Investment: The Neglected Twin of Trade*. Washington, DC: Group of Thirty.

- Kaufmann, Daniel, Aart Kraay, and Massimo Mastruzzi. 2008. "Governance Matters VII: Aggregate and Individual Governance Indicators, 1996-2007." World Bank Policy Research Working Paper No. 4654.
- Keele, Luke, and Jason Yackee. 2008. "Foreign Direct Investment Policy in the Developing World: Does Partisanship Matter?" Paper presented at the 66<sup>th</sup> Annual Meeting of the Midwest Political Science Association, April, Chicago, IL.
- Keohane, Robert O. 1984. *After Hegemony: Cooperation and Discord in the World Political Economy*. Princeton, N.J.: Princeton University Press.
- Keohane, Robert O., Andrew Moravcsik, and Anne-Marie Slaughter. 2000. "Legalized Dispute Resolution: Interstate and Transnational." *International Organization* 54 (3): 457-88.
- Kerner, Andrew. 2009. "Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties." *International Studies Quarterly* 53 (1): 73-102.
- King, Gary. 2001. 2001. "Proper Nouns and Methodological Propriety: Pooling Dyads in International Relations Data." *International Organization* 55 (1): 497-407.
- Knack, Stephen, and Philip Keefer. 1995. "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures." *Economics and Politics* 7 (3): 207-27.
- Kobrin, Stephen J. 1984. "Expropriation as an Attempt to Control Foreign Firms in LDCs: Trends from 1960 to 1979." *International Studies Quarterly* 28: 329-48.
- Kobrin, Stephen J. 1987. "Testing the Bargaining Hypothesis in the Manufacturing Sector in Developing Countries." *International Organization* 41 (4): 609-38.
- Kobrin, Stephen J. 1998. "The MAI and the Clash of Globalizations" *Foreign Policy* 112: 97-109.
- Kobrin, Stephen J. 2005. "The Determinants of Liberalization of FDI Policy in Developing Countries: A Cross-Section Analysis, 1992-2001." *Transnational Corporations* 14 (1): 67-104.
- Krasner, Stephen. 1982. "Structural Causes and Regime Consequences: Regimes as Intervening Variables." *International Organization* 36 (2): 185-205.
- Krasner, Stephen D., ed. 1983. *International Regimes*. Ithaca, N.Y.: Cornell University Press.
- Krasner, Stephen D. 1985. *Structural Conflict: The Third World Against Global Liberalism*. Berkeley, Calif.: University of California Press.

- Kydland, F., and E. Prescott. 1977. "Rules Rather than Discretion: The Inconsistency of Optimal Plans." *Journal of Political Economy* 85: 473-91.
- Leblang, David A. 1996. "Property Rights, Democracy and Economic Growth." *Political Research Quarterly* 41 (1): 5-26.
- Li, Quan. 2006. "Democracy, Autocracy, and Tax Incentives to Foreign Direct Investors: A Cross-National Analysis." *Journal of Politics* 68 (1): 62-74.
- Li, Quan. 2009. "Democracy, Autocracy, and Expropriation of Foreign Direct Investment." *Comparative Political Studies*, forthcoming.
- Li, Quan, and Adam Resnick. 2003. "Reversal of Fortunes: Democratic Institutions and Foreign Direct Investment Inflows to Developing Countries." *International Organization* 57(1): 175-211.
- Lipson, Charles. 1985. *Standing Guard: Protecting Foreign Capital in the Nineteenth and Twentieth Centuries*. Berkeley, Calif.: University of California Press.
- Lipson, Charles. 1991. "Why Are Some International Agreements Informal?" *International Organization* 45 (4): 495-538.
- Long, J. Scott. 1997. *Regression Models for Categorical and Limited Dependent Variables*. Thousand Oaks, CA.: Sage.
- Maoz, Zeev, and Bruce Russett. 1993. "Normative and Structural Causes of Democratic Peace, 1946-1986." *American Political Science Review* 87 (3): 624-38.
- Mardon, Russell. 1990. "The State and the Effective Control of Foreign Capital: The Case of South Korea" *World Politics* 43 (1): 111-38.
- Marshall, Monty G. 2002. "Measuring the Societal Impact of War." In *From Reaction to Conflict Prevention: Opportunities for the UN System*, edited by Fen Osler Hampson and David M. Malone. Boulder, CO: Lynne Rienner Publisher.
- Milner, Helen V. 1991. "The Assumption of Anarchy in International Relations Theory: A Critique." *Review of International Studies* 17: 67-85.
- Minor, Michael S. 1994. "The Demise of Expropriation as an Instrument of LDC Policy." *Journal of International Business Studies* 25 (1): 177-88.
- Moravcsik, Andrew. 1997. "Taking Preferences Seriously: A Liberal Theory of International Politics." *International Organization* 51 (4): 513-553.
- Moravcsik, Andrew. 2000. "The Origins of Human Rights Regimes: Democratic Delegation in Postwar Europe." *International Organization* 54 (2): 217-252.

- Neumayer, Eric, and Laura Spess. 2005. "Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?" *World Development* 33 (10): 1567-1585.
- North, Douglas C. 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.
- Oatley, Thomas. 2006. *International Political Economy: Interests and Institutions in the Global Economy*, 2<sup>nd</sup> edition. New York: Pearson-Longman.
- Ohmae, Kenichi. 1990. *The Borderless World: Power and Strategy in the Interlinked Economy*. New York: HarperCollins Publishers.
- Ohmae, Kenichi. 1996. *The End of the Nation-State: The Rise of Regional Economies*. New York: Free Press.
- Olson, Mancur. 1993. "Dictatorship, Democracy, and Development." *American Political Science Review* 87 (3): 567-76.
- Ostry, Sylvia. 1997a. *A New Regime for Foreign Direct Investment*. Washington, D.C.: Group of Thirty.
- Ostry, Sylvia. 1997b. *The Post-Cold War Trading System: Who's on First?* Chicago: The University of Chicago Press.
- Park, Young Duk, and Georg C. Umbricht. 2001. "WTO Dispute Settlement 1995-2000: A Statistical Analysis." *Journal of International Economic Law* 4 (1): 213-30.
- Pearce, Scott. 2002. "Fueling War: The Impact of Canadian Oil Investment on the Conflict in Colombia." Centre for Research on Latin American and the Caribbean, Working Paper Series. <<http://www.yorku.ca/erlac/documents/Pearce.pdf>>
- Peinhardt, Clint, and Todd Allee. 2007. "The Multiple Effects of Bilateral Investment Treaties on U.S. Foreign Direct Investment." Paper presented at the 103<sup>rd</sup> Annual Meeting of the American Political Science Association, September, Chicago, IL.
- PRS Group. 2004. *A Business Guide to Political Risk for International Decisions*.
- Przeworski, Adam, Michael E. Alvarez, José Antonio Cheibub, and Fernando Limongi. 1996. "What Makes Democracies Endure?" *Journal of Democracy* 7 (1): 39-55.
- Przeworski, Adam, Michael E. Alvarez, José Antonio Cheibub, and Fernando Limongi. 2000. *Democracy and Development: Political Institutions and Well-Being in the World, 1950-2000*. Cambridge: Cambridge University Press.



- Raby, Jean. 1990. "The Investment Provisions of the Canada-United States Free Trade Agreement: A Canadian Perspective." *The American Journal of International Law* 84 (2): 394-443.
- Reinhardt, Eric. 2001. "Adjudication without Enforcement in GATT Disputes." *Journal of Conflict Resolution* 45 (2): 174-95.
- Rittberger, Volker, ed. 1993. *Regime Theory and International Relations*. Oxford: Clarendon Press.
- Rodrik, Dani. 1989. "Promises, Promises: Credible Policy Reform via Signaling." *The Economic Journal* 99: 756-772.
- Rodrik, Dani. 2001. "Trading in Illusions." *Foreign Policy* 123: 54-62.
- Rodrik, Dani, Arvind Subramanian, and Francesco Trebbi. 2002. "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development." NBER Working Paper No. 9305.
- Ruggie, John Gerard. 1975. "International Responses to Technology: Concepts and Trends." *International Organization* 29 (3): 557-584.
- Salacuse, Jeswald W. 1990. "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries." *International Lawyer* 24 (3): 655-675.
- Salacuse, Jeswald W., and Nicholas P. Sullivan. 2005. "Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain." *Harvard International Law Journal* 46 (1): 67-130.
- Sauve, Pieere, and Daniel Schwanen, eds. 1996. *Investment Rules for the Global Economy: Enhancing Access to Markets*. Toronto: C.D. Howe Institute.
- Seid, Sherif H. 2002. *Global Regulation of Foreign Direct Investment*. Burlington, Vt.: Ashgate.
- Shihata, Ibrahim F. 1988. *MIGA and Foreign Investment: Origins, Operations, Policies and Basic Documents of the Multilateral Investment Guarantee Agency*. Dordrecht: Martinus Nijhoff.
- Simmons, Beth A. 1998. "Compliance with International Agreements." *Annual Review of Political Science* 1:
- Simmons, Beth A. 2000. "International Law and State Behavior: Commitment and Compliance in International Monetary Affairs." *American Political Science Review* 94 (4): 819-35.

- Simmons, Beth A. 2002. "Capacity, Commitment, and Compliance: International Institutions and Territorial Disputes." *Journal of Conflict Resolution* 46 (6): 829-56.
- Simmons, Beth A. Forthcoming. International Human Rights: Law, Politics, and Accountability. Unpublished manuscript, Harvard University. Cambridge, Mass.
- Simmons, Beth A., and Daniel J. Hopkins. 2005. "The Constraining Power of International Treaties: Theory and Methods." *American Political Science Review* 99 (4): 623-31.
- Smythe, Elizabeth. 1998. "Your Place or Mine? States, International Organizations and the Negotiation of Investment Rules." *Transnational Corporations* 7 (3): 85-119.
- Souva, Mark, Dale L. Smith and Shaun Rowan. 2008. "Promoting Trade: The Importance of Market Protecting Institutions." *Journal of Politics* 70 (2): 383-92.
- Swenson, Deborah L. 2005. "Why Do Developing Countries Sign BITs?" *U.C. Davis Journal of International Law and Policy* 12 (1): 131-155.
- Tobin, Jennifer. 2007. "Separate and Unequal: Bilateral Investment Treaties and Property Rights in Developing Countries." Working Paper, Global Economic Governance Programme, University of Oxford.
- Tobin, Jennifer, and Susan Rose-Ackerman. 2005. "Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties." Yale Law & Economics Research Paper No. 293. New Haven, Conn.: Yale University.
- Tobin, Jennifer, and Susan Rose-Ackerman. 2006. "When BITs Have Some Bite: The Political-Economic Environment for Bilateral Investment Treaties." Unpublished manuscript.
- Tobin, Jennifer, and Marc L. Busch. 2008. "A BIT is Better Than a Lot: Bilateral Investment Treaties and Preferential Trade Agreements." Unpublished manuscript.
- Tomz, Michael. 2007. *Reputation and International Cooperation: Sovereign Debt across Three Centuries*. Princeton, N.J.: Princeton University Press.
- UNCTAD. 1996. *International Investment Instruments: A Compendium, Volume I: Multilateral Instruments*. Geneva: United Nations.
- UNCTAD. 2004a. *World Investment Report: The Shift Toward Services*. Geneva: United Nations.
- UNCTAD. 2004b. "South-South Investment Flows: A Potential for Developing Country Governments to Tap for Supply Capacity Building." Background paper. New York: Office of the Chairman of the Group of 77.
- UNCTAD. 2007. *Handbook of Statistics*. New York: United Nations.

- UNCTAD. 2007. "Recent Developments in International Investment Agreements, 2006—June 2007." *IIA Monitor* 3. New York: United Nations.
- Vandevelde, Kenneth J. 1998. "The Political Economy of a Bilateral Investment Treaty." *American Journal of International Law* 92 (4): 621-41.
- Vernon, Raymond. 1971. *Sovereignty at Bay*. New York: Basic Books.
- von Stein, Jana. 2005. "Do Treaties Constrain or Screen? Selection Bias and Treaty Compliance." *American Political Science Review* 99 (4): 611-22.
- von Stein, Jana. 2008. "The International Law and Politics of Climate Change: Ratification of the United Nations Framework Convention and the Kyoto Protocol." *Journal of Conflict Resolution* 51(2): 243-68.
- Wells, Louis T., and Rafiq Ahmed. 2007. *Making Foreign Investment Safe: Property Rights and National Sovereignty*. Oxford: Oxford University Press.
- Wendt, Alexander. 1992. "Anarchy Is What States Make of It: The Social Construction of Power Politics." *International Organization* 46 (3): 391-425.
- Wendt, Alexander. 1999. *Social Theory of International Politics*. Cambridge: Cambridge University Press.
- Wilson, Sven E., and Daniel M. Butler. 2007. "A Lot More to Do: The Sensitivity of Time-Series Cross-Section Analyses to Simple Alternative Specifications." *Political Analysis* 15 (2): 101-23.
- World Bank. 2007. *Global Development Finance 2007*. Washington, D.C.: World Bank.
- Yackee, Jason Webb. 2007a. *Sacrificing Sovereignty: Bilateral Investment Treaties, International Arbitration, and the Quest for Capital*. Ph.D. diss., University of North Carolina, Chapel Hill.
- Yackee, Jason Webb. 2007b. "Do BITs Really Work?" University of Wisconsin Legal Studies Research Paper No. 1054.
- Yackee, Jason Webb. 2008a. "Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?" *Law & Society Review* 42 (4): 805-31.
- Yackee, Jason Webb. 2008b. "Conceptual Difficulties in the Empirical Study of Bilateral Investment Treaties." *Brooklyn Journal of International Law* 33 (2): 405-62.
- Young, Oran R. 1979. *Compliance and Public Authority: A Theory with International Applications*. Baltimore, Md: Johns Hopkins University Press.

- Young, Oran R. 1980. "International Regimes: Problems of Concept Formation" *World Politics* 32 (3): 331-56.
- Young, Oran R. 1982. "Regime Dynamics: The Rise and Fall of International Regimes" *International Organization* 36 (2): 277-97.
- Young, Oran R. 1986. "International Regimes: Toward a New Theory of Institutions" *World Politics* 39 (1): 104-22.
- Young, Oran R. 1999. *Governance in World Affairs*. Ithaca, NY: Cornell University Press.
- Zakaria, Fareed. 2008. *The Post-American World*. New York: W. W. Norton & Company.
- Zorn, Christopher J. W. 1998. An Analytic and Empirical Examination of Zero-Inflated and Hurdle Poisson Specifications. *Sociological Methods and Research* 26: 368-400.
- Zorn, Christopher J. T. 2001. "Generalized Estimating Equation Models for Correlated Data: A Review with Applications." *American Journal of Political Science* 45 (2): 470-90.

## APPENDIX A

## LIST OF COUNTRIES INCLUDED IN ANALYSES

The following is a list of countries included in the statistical analyses presented in chapters 4 and 5, specifically the models shown in Tables 4.4, 4.5, and 5.5.

- |                                   |                        |                      |
|-----------------------------------|------------------------|----------------------|
| 1. Albania                        | 33. Dominican Republic | 67. Libya            |
| 2. Algeria                        | 34. Ecuador**          | 68. Lithuania        |
| 3. Angola                         | 35. Egypt              | 69. Macedonia*       |
| 4. Argentina                      | 36. El Salvador        | 70. Madagascar       |
| 5. Azerbaijan                     | 37. Equatorial Guinea* | 71. Malawi           |
| 6. Bahrain                        | 38. Eritrea*           | 72. Malaysia         |
| 7. Bangladesh                     | 39. Estonia            | 73. Mali             |
| 8. Belarus                        | 40. Ethiopia           | 74. Mauritania*      |
| 9. Benin*                         | 41. Fiji*              | 75. Mauritius*       |
| 10. Bhutan*                       | 42. Gabon              | 76. Mexico           |
| 11. Bolivia                       | 43. Gambia, The        | 77. Moldova          |
| 12. Botswana                      | 44. Georgia*           | 78. Mongolia         |
| 13. Brazil                        | 45. Ghana              | 79. Morocco          |
| 14. Bulgaria                      | 46. Guatemala          | 80. Mozambique       |
| 15. Burkina Faso                  | 47. Guinea             | 81. Namibia****      |
| 16. Burundi*                      | 48. Guinea-Bissau      | 82. Nepal*           |
| 17. Cambodia*                     | 49. Guyana             | 83. Nicaragua        |
| 18. Cameroon                      | 50. Haiti              | 84. Niger            |
| 19. Central African<br>Republic*  | 51. Honduras           | 85. Nigeria          |
| 20. Chad*                         | 52. Hungary            | 86. Oman             |
| 21. Chile                         | 53. India              | 87. Pakistan         |
| 22. China                         | 54. Indonesia          | 88. Panama****       |
| 23. Colombia                      | 55. Iran               | 89. Papua New Guinea |
| 24. Comoros*                      | 56. Jamaica            | 90. Paraguay         |
| 25. Congo                         | 57. Jordan             | 91. Peru             |
| 26. Congo, Democratic<br>Republic | 58. Kazakhstan         | 92. Philippines      |
| 27. Costa Rica                    | 59. Kenya              | 93. Poland           |
| 28. Cote d'Ivoire                 | 60. Kuwait             | 94. Romania          |
| 29. Croatia                       | 61. Kyrgyzstan*        | 95. Russia           |
| 30. Cyprus                        | 62. Laos*              | 96. Rwanda*          |
| 31. Czech Republic                | 63. Latvia             | 97. Saudi Arabia     |
| 32. Djibouti*                     | 64. Lebanon            | 98. Senegal          |
|                                   | 65. Lesotho*           | 99. Sierra Leone     |
|                                   | 66. Liberia            |                      |

100.	Singapore	109.	Swaziland*	118.	Ukraine
101.	Slovak Republic	110.	Syria**	119.	United Arab Emirates
102.	Slovenia	111.	Tanzania	120.	Uruguay
103.	Solomon Islands*	112.	Thailand	121.	Venezuela
104.	Somalia***	113.	Togo	122.	Vietnam
105.	South Africa	114.	Turkey	123.	Yemen
106.	South Korea	115.	Trinidad & Tobago	124.	Zambia
107.	Sri Lanka	116.	Tunisia	125.	Zimbabwe
108.	Sudan	117.	Uganda		

\* Model 10 from Table 4.5 and models 1, 4-5 from Table 5.5 only.

\*\* Models 1-11 from Tables 4.4 and 4.5 only.

\*\*\* Models 1-9, 11 from Tables 4.4 and 4.5

\*\*\*\* Models 1-9, 11 from Tables 4.4 and 4.5 and models 2-5 from Tables 5.5 only.

## APPENDIX B

### THE DETERMINANTS OF INVESTOR-STATE ARBITRAL DISPUTES: ALTERNATIVE ESTIMATORS

Tables B.1-B.3 present the results of my econometric analysis of investor-state arbitral disputes from chapter 5 using several alternative statistical estimators, including the standard negative binomial regression model (NBRM), the random effects negative binomial estimator, and the conditional fixed effects negative binomial estimator. A discussion of the results using each of these alternative estimators follows. I also discuss the zero-inflated negative binomial (ZINB) estimator, problems I encountered using this estimator, and reasons for why it is an inappropriate estimator in this instance.

Table B.1 presents the results of my analysis of arbitral disputes using the standard NBRM with robust standard errors clustered on country. The results are very similar to those of the population-averaged model reported in chapter 5. Four of my five measures of institutional capacity are statistically significant at the 1% level, while only the *Corruption* variable fails to achieve statistical significance. The coefficients and incidence rate ratios (IRRs) for all five capacity measures are approximately the same as those derived from the population-averaged estimator. *Left Executive* is also now statistically significant at the 10% level in four of the five models.

Table B.2 presents the results of my analysis using a random effects estimator. Again, the results are largely similar to those of the population-averaged model with a few exceptions. The *Law and Order* variable is no longer statistically significant. However, in that same model, *Constraints* is now significant at the 5% level and in the hypothesized direction. *CIM*, *Rule of*

Table B.1 Negative Binomial Regression Model of Investor-State Arbitral Disputes

Explanatory Variables	Model 6	Model 7	Model 8	Model 9	Model 10
<b>INSTITUTIONAL CAPACITY</b>					
<i>CIM</i>	0.05*** (0.05)				
<i>Law &amp; Order (ICRG)</i>		0.75*** (0.11)			
<i>Corruption (ICRG)</i>			0.89 (0.12)		
<i>Rule of Law (WBI)</i>				0.29*** (0.10)	
<i>Control of Corruption (WBI)</i>					0.30*** (0.10)
<b>EXPOSURE</b>					
<i>BITs</i>	1.09*** (0.05)	1.08*** (0.03)	1.06 (0.04)	1.09*** (0.03)	1.07** (0.03)
<i>PTAs</i>	1.15 (0.15)	1.14 (0.11)	1.16 (0.13)	1.19*** (0.09)	1.19** (0.09)
<i>FDI Stock</i>	1.11 (0.13)	1.09 (0.14)	1.09 (0.15)	1.44*** (0.19)	1.43*** (0.19)
<b>EXPROPRIATION RISK</b>					
<i>Tenure (WBDPI)</i>	0.99 (0.01)	0.99 (0.02)	0.99 (0.01)	1.00 (0.03)	1.00 (0.03)
<i>Growth</i>	1.00 (0.01)	1.02** (0.01)	1.02* (0.01)	1.00 (0.01)	1.00 (0.01)
<i>Inflation</i>	1.00 (0.00)	1.00 (0.00)	1.00* (0.00)	0.98* (0.00)	0.98** (0.00)
<i>Internal Conflict (MEPV)</i>	0.95 (0.07)	0.82** (0.07)	0.85 (0.08)	0.88 (0.09)	0.89 (0.09)
<i>Constraints (POLCON)</i>	0.76 (0.57)	0.26 (0.21)	0.30 (0.24)	1.59 (1.56)	1.25 (1.21)
<b>ADDITIONAL CONTROLS</b>					
<i>Left Executive</i>	0.88 (0.29)	0.55* (0.18)	0.56* (0.19)	0.59* (0.18)	0.60* (0.17)



<i>Resource Rents</i>	1.00 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)
<i>Size</i>	1.17 (0.18)	1.19 (0.17)	1.19 (0.18)	0.96 (0.16)	0.98 (0.16)
<i>Income</i>	1.00** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)
<i>Income</i> <sup>2</sup>	1.00** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00** (0.00)	1.00** (0.00)
<i>Devaluation</i>	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)	1.00*** (0.00)
<i>ICSID Member</i>	1.52 (0.50)	1.50 (0.50)	1.37 (0.48)	1.01 (0.33)	1.06 (0.34)
Lagged Dependent Variable	1.09 (0.28)	1.47*** (0.24)	1.49*** (0.24)	1.08 (0.16)	1.13 (0.14)
Observations	1,954	1,465	1,465	702	679
Countries	119	100	100	123	123
Periods	1981-2001	1985-2002	1985-2002	1997-2002	1997-2002
Wald $\chi^2$	217.70	250.24	235.32	272.90	241.48
Log-likelihood	-282.29	-269.60	-271.54	-198.62	-198.42

NOTE: estimates are incidence rate ratios; robust standard errors clustered on country shown in parentheses. All models contain polynomial time counters  $t$ ,  $t^2$ , and  $t^3$  (not shown). \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10% (one-tailed tests).

*Law*, and *Control of Corruption* all retain their statistical significance. *Income* and *Devaluation* are no longer significant in a majority of the models.

Table B.3 presents the results of my analysis using a conditional fixed effects estimator. Fixed effects models capture unobserved heterogeneity between units—in this case, countries—by including separate dummy variables for each unit (country), thereby correcting any omitted variable bias.<sup>364</sup> The inclusion of fixed effects represents a relatively conservative approach to

<sup>364</sup> Green, Kim, and Yoon 2001.

Table B.2 Random Effects Negative Binomial Model of Investor-State Arbitral Disputes

Explanatory Variables	Model 11	Model 12	Model 13	Model 14	Model 15
<b>INSTITUTIONAL CAPACITY</b>					
<i>CIM</i>	0.06** (0.07)				
<i>Law &amp; Order</i> (ICRG)		0.78 (0.12)			
<i>Corruption</i> (ICRG)			0.96 (0.14)		
<i>Rule of Law</i> (WBG)				0.33*** (0.11)	
<i>Control of Corruption</i> (WBG)					0.34*** (0.12)
<b>EXPOSURE</b>					
<i>BITs</i>	1.10*** (0.03)	1.09*** (0.03)	1.07** (0.03)	1.10*** (0.03)	1.08*** (0.03)
<i>PTAs</i>	1.19 (0.12)	1.15 (0.10)	1.18* (0.11)	1.17* (0.11)	1.18* (0.10)
<i>FDI Stock</i>	1.12 (0.16)	1.09 (0.17)	1.11 (0.18)	1.38* (0.26)	1.38* (0.26)
<b>EXPROPRIATION RISK</b>					
<i>Tenure</i> (WBDPI)	0.99 (0.01)	0.98 (0.01)	0.98 (0.01)	0.99 (0.02)	0.99 (0.02)
<i>Growth</i>	1.00 (0.01)	1.02* (0.01)	1.02* (0.01)	1.00 (0.01)	1.00 (0.01)
<i>Inflation</i>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	0.99 (0.00)	0.98 (0.00)
<i>Internal Conflict</i> (MEPV)	0.97 (0.08)	0.82* (0.09)	0.86 (0.09)	0.88 (0.11)	0.89 (0.11)
Constraints (POLCON)	0.61 (0.47)	0.21** (0.17)	0.21* (0.17)	1.19 (1.04)	0.97 (0.84)
<b>ADDITIONAL CONTROLS</b>					
<i>Left Executive</i>	0.94 (0.28)	0.58* (0.18)	0.59* (0.18)	0.70 (0.24)	0.68 (0.22)
<i>Resource Rents</i>	1.00 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)	0.99 (0.01)
<i>Size</i>	1.17 (0.19)	1.20 (0.20)	1.20 (0.21)	0.98 (0.19)	0.97 (0.18)

<i>Income</i>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00* (0.00)	1.00** (0.00)
<i>Income</i> <sup>2</sup>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)
<i>Devaluation</i>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)
<i>ICSID Member</i>	1.84 (0.68)	1.92 (0.78)	1.83 (0.75)	1.31 (0.53)	1.32 (0.52)
Lagged Dependent Variable	0.78 (0.21)	1.08 (0.22)	1.04 (0.19)	0.87 (0.18)	0.91 (0.19)
Observations	1,954	1,465	1,465	702	679
Countries	119	100	100	123	123
Periods	1981-2001	1985-2002	1985-2002	1997-2002	1997-2002
Wald $\chi^2$	106.83	114.42	113.69	73.81	71.42
Log-likelihood	-280.87	-267.13	-268.35	-197.19	-197.01

NOTE: estimates are incidence rate ratios; standard errors in parentheses. All models contain polynomial time counters  $t$ ,  $t^2$ , and  $t^3$  (not shown). \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10% (one-tailed tests).

hypothesis testing.<sup>365</sup> Unfortunately, their inclusion results in a dramatic loss of observations.

Depending on the specification, as many as 82 countries are dropped from the sample due to all zero outcomes, which are perfectly predicted by the dummy variables for these countries.

Across all five specifications, more than half of the countries in the sample are dropped because of this problem. Not surprisingly, many of the explanatory variables in my model of arbitral disputes which were statistically significant using other estimators lose their significance when a fixed effects estimator is employed, including my measures of institutional capacity. While *Rule of Law* is just barely statistically significant at the 10% ( $p > 0.097$ ), the remaining four capacity measures fail to achieve statistical significance. Moreover, three of the measures (*CIM*, *Corruption*, and *Control of Corruption*) are now incorrectly signed. *BITs* retains its significance

<sup>365</sup> Wilson and Butler 2007.

Table B.3 Conditional Fixed Effects Model of Investor-State Arbitral Disputes

Explanatory Variables	Model 16	Model 17	Model 18	Model 19	Model 20
<b>INSTITUTIONAL CAPACITY</b>					
<i>CIM</i>	1.49 (4.20)				
<i>Law &amp; Order</i> (ICRG)		0.98 (0.21)			
<i>Corruption</i> (ICRG)			1.21 (0.26)		
<i>Rule of Law</i> (WBG)				0.09* (0.13)	
<i>Control of Corruption</i> (WBG)					1.94 (2.48)
<b>EXPOSURE</b>					
<i>BITs</i>	1.18** (0.10)	1.04 (0.08)	1.02 (0.08)	1.42*** (0.20)	1.38** (0.19)
<i>PTAs</i>	1.82** (0.52)	1.53 (0.47)	1.48 (0.44)	0.76 (0.49)	0.58 (0.33)
<i>FDI Stock</i>	1.09 (0.36)	1.16 (0.37)	1.18 (0.37)	1.05 (0.62)	1.27 (0.78)
<b>EXPROPRIATION RISK</b>					
<i>Tenure</i> (WBDPI)	1.00 (0.02)	0.99 (0.02)	0.99 (0.02)	0.96 (0.03)	0.96 (0.03)
<i>Growth</i>	1.00 (0.01)	1.02 (0.02)	1.02 (0.02)	1.00 (0.02)	1.01 (0.02)
<i>Inflation</i>	0.99 (0.00)	0.99 (0.00)	0.99 (0.00)	0.99 (0.00)	0.99 (0.00)
<i>Internal Conflict</i> (MEPV)	1.14 (0.16)	0.84 (0.15)	0.85 (0.15)	0.86 (0.24)	0.92 (0.26)
Constraints (POLCON)	0.27 (0.35)	0.11* (0.14)	0.11* (0.14)	0.42 (0.78)	0.62 (1.15)
<b>ADDITIONAL CONTROLS</b>					
<i>Left Executive</i>	0.88 (0.44)	0.72 (0.31)	0.75 (0.32)	2.39 (1.53)	2.66 (1.73)
<i>Resources</i>	1.02 (0.02)	0.99 (0.03)	0.99 (0.03)	1.09* (0.05)	1.11** (0.05)
<i>Size</i>	0.66 (0.91)	0.07** (0.08)	0.06*** (0.06)	2.24 (2.93)	3.77 (4.09)

<i>Income</i>	0.99 (0.00)	0.99 (0.00)	0.99 (0.00)	1.00 (0.00)	1.00 (0.00)
<i>Income</i> <sup>2</sup>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	0.99* (0.00)	0.99* (0.00)
<i>Devaluation</i>	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)	1.00 (0.00)
<i>ICSID Member</i>	2.82 (2.29)	5.30 (5.80)	5.76 (6.43)	0.84 (0.85)	0.54 (0.54)
Lagged Dependent Variable	0.43*** (0.12)	0.69** (0.12)	0.70** (0.12)	0.51*** (0.11)	0.57*** (0.12)
Observations	809	678	678	236	234
Countries	48	45	45	40	40
Periods	1981-2001	1985-2002	1985-2002	1997-2002	1997-2002
Wald $\chi^2$	55.11	78.63	252.49	30.00	26.74
Log-likelihood	-156.47	-148.69	-148.33	-86.15	-86.90

NOTE: estimates are incidence rate ratios; standard errors in parentheses. All models contain polynomial time counters  $t$ ,  $t^2$ , and  $t^3$  (not shown). \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10% (one-tailed tests).

in three of the five models, but *FDI Stock* is no longer significant in any of the models. *Market Size* and *Resource Rents* both achieve statistical significance for the first time, but this result is not consistent across different specifications, occurring in only one or two of the five models. The lagged dependent variable is the only explanatory variable that is consistently significant.<sup>366</sup>

Given the fact that a substantial number of countries are dropped from the analysis due to having all zero outcomes, a fixed effects model is probably an inappropriate estimator for testing my hypothesis regarding the relationship between institutional capacity and the number of arbitral disputes a country experiences over time. Such an approach, suggest Beck and Katz (2001), is usually ill-advised for limited dependent variables such as my own. Arbitral disputes between foreign investors and host states are rare events. The inclusion of fixed effects prevents

<sup>366</sup> I also ran all five models using an unconditional fixed effects negative binomial estimator. The results were largely identical to those of the conditional fixed effects estimator.

me from analyzing those countries that never experience an arbitral dispute. Hence, while it is quite possible that the more than 50 percent of countries that never experience an arbitral dispute enjoy significantly greater institutional capacity (i.e., a strong rule of law, an independent judiciary, minimal corruption, etc.) than those countries that do become involved in such disputes, the use of a fixed effects estimator fails to give my measures of institutional quality credit for the absence of arbitral claims against these countries. Countries that do not experience any disputes are completely removed from the analysis. Moreover, the inclusion of fixed effects almost always masks the impact of slowly changing variables such as institutional capacity.<sup>367</sup> Therefore, I do not regard the results reported in Table B.3 as reliable compared to those using other statistical estimators.

Finally, there are a disproportionately large number of zero counts in the data, a condition known as zero-inflation (and another consequence of overdispersion in the data). Looking at a histogram of the dependent variable *Disputes*, it is evident that the data suffer from zero-inflation. The concern, however, is whether zeros are affecting the estimation of the NBRM. If so, the zero-inflated negative binomial estimator (ZINB) would be more appropriate than the standard NBRM. In order to address this issue, I re-estimated models 1-5 using the ZINB estimator. However, I encountered numerous difficulties using this estimator, which lead me to believe that it is inappropriate in this instance. The following discussion explores the logic behind the ZINB, highlights the fundamentally different assumptions which it makes compared to the NBRM, and describes my concerns regarding its utility with respect to my own dependent variable.

The NBRM is itself designed to capture the underprediction of zeros in the Poisson regression model (PRM). It does so by increasing the conditional variance while leaving the

---

<sup>367</sup> For a discussion of the limitations of fixed effects models, see Beck and Katz 2001 and King 2001.

conditional mean unchanged. In contrast, the ZINB changes “the mean structure to explicitly model the production of zero counts. *This is done by assuming that [zeros] can be generated by a different process than positive counts.*”<sup>368</sup> With respect to the dependent variable in this study, zero-inflated models are designed to account for the fact that for each year  $t$ , country  $i$  will experience one of two outcomes—it will either experience zero arbitral disputes with foreign investors, or it will become involved in a positive, non-zero number of disputes. Yet, in any given year, many, if not most, countries will not experience *any* disputes, suggesting the possibility that, in fact, two different data generating processes are at work. In other words, for many states the outcome will *always* be zero, while for other states, a negative binomial process is at work, one in which a zero outcome is one of many different possible outcomes. Hence, it is possible that there are two distinct populations within the data: one group of countries that has an inherently low risk of experiencing *any* arbitral disputes in a given year, and another group that has a significantly higher risk of becoming involved in one or more disputes. Zero-inflated models are specifically designed to model this “dual regime” data generating process.<sup>369</sup> The ZINB model allows a researcher to disentangle two distinct sets of causal processes by distinguishing (1) covariates that determine whether a country is in the near-zero risk distribution as opposed to the higher-risk group (i.e., those factors that determine the likelihood of experiencing *any* disputes versus *zero* disputes), and (2) covariates which explain variation in the *number* of disputes among countries within the higher-risk population. Accordingly, the ZINB model generates two sets of coefficients or models: (1) a logit or “inflation” model in which the

---

<sup>368</sup> Long 1997, 242 (emphasis added).

<sup>369</sup> Zorn 1998.

dependent variable is the occurrence of any disputes, and (2) a standard negative binomial model in which the dependent variable is a count of the number of disputes.<sup>370</sup>

In contrast to the ZINB, the NBRM assumes that each country has a positive probability of experiencing any given number of arbitral disputes in a given year. This probability differs across countries according to their characteristics (e.g., a country's institutional capacity for protecting and enforcing property rights or its exposure to potential arbitral claims as captured by the number of BITs it has entered into with major capital-exporting countries), but *all* countries are at risk of not experiencing any disputes and *all* countries might experience a dispute. However, this assumption might be false under certain circumstances. For instance, a country that had never formally given its consent to submit its disputes with foreign investors to international arbitration (perhaps by refusing to sign any BITs or other investor rights agreements or because its BITs do not contain any clause giving such consent) would obviously not have any arbitral claims brought against it because such claims are not possible. The ZINB model allows for this possibility. However, there is no a priori reason to believe that the NBRM is not capable of accounting for such cases in which a country has no exposure to arbitral claims by foreign investors. Ultimately, theory must guide the choice between the ZINB and NBRM estimators. In the early years included in my dataset, a case could be made for explicitly distinguishing between those countries with no exposure to arbitral claims from those with some degree of exposure. However, in the latter years of the period under investigation in which almost all LDCs have concluded at least one BIT with a developed country, it is difficult to

---

<sup>370</sup> It is important to note that the signs of the variables will have opposite meanings across these two equations because the dependent variables are coded in opposite directions. The negative binomial model is interpreted in normal fashion: a positive coefficient indicates that a variable has a *positive* effect on the *number* of disputes a country experiences in a given year. In contrast, in the inflation model which captures the effects of the variables *on the probability of a zero outcome*, a positive coefficient indicates that a variable has a *negative* effect on the *likelihood* of any disputes.



justify the presence of a dual data-generating process. For this reason, I believe that the NBRM is the more appropriate estimator.

As has just been described, the ZINB model is actually comprised of two distinct models—a negative binomial model which captures the effects of a set of covariates on the *number* of events (in this case, arbitral disputes) a subject experiences and a logit or “inflation” model which captures the effects of a set of covariates on the probability that a subject experiences a zero outcome. *The explanatory variables included in the inflation model need not be the same as those included in the negative binomial model.* However, in most political science and other social science applications employing the ZINB estimator, standard practice among researchers has been to include the exact same set of covariates in both the logit and negative binomial models. Yet, such an approach is largely atheoretical. Not surprisingly, when I employed this approach, my results made little substantive or statistical sense. While the coefficients and IRRs (not shown) reported for the negative binomial model were largely identical to those using the NBRM, random effects, and population-averaged estimators, the results for the inflation model were substantively confusing and statistically suspect. First, nearly all of the variables in the logit model were statistically significant at the 1% level, raising serious doubts about their statistical validity. Second, many of the variables were incorrectly signed, suggesting substantively contradictory conclusions. For example, the results seemed to suggest that a country’s institutional capacity for protecting and enforcing property rights had a negative impact on the number of arbitral disputes it experienced in a given year, while at the same time increasing the likelihood that it experienced a dispute. While it is possible to imagine some situations in which an explanatory variable might have cross-cutting effects on the outcome of interest, these results would seem to be nonsensical. The only explanatory variable

whose results were substantively consistent was BITs, a measure of a country's degree of formal exposure to arbitral claims. The results for this variable suggested that the number of BITs a country had concluded with high-income OECD countries both increased the number of arbitral disputes it experienced as well as its likelihood of experiencing at least one dispute in a given year, as indicated by a positive coefficient in the negative binomial model and a negative coefficient in the logit model.

Given these results, I re-estimated my models employing a more refined and theoretically-informed model specification. Arguably, there is only one variable in my model of investor-state arbitral disputes which would determine whether a country experienced zero disputes in a given year—namely, its degree of exposure to arbitral claims as indicated by the number of advanced consents to international arbitration which it had granted in the form of BITs, PTAs, investment contracts, or national statutes. As suggested above, a country that had not given any consents would never experience an arbitral dispute. Therefore, the only variable that should be included in the inflation component of a ZINB model is a variable capturing zero exposure to arbitral claims. Toward this end, I created a dummy variable indicating whether a country had entered into any BITs. This variable was coded 1 if a country had entered into at least one BIT, 0 otherwise. This was the only variable that I included in the inflation model. The results for this specification (not shown) were substantively more consistent with my expectations, but it remains to be seen whether such an approach gives us any more explanatory leverage than simply employing the NBRM estimator and treating the zero outcome as one among many different possible outcomes.

Beyond the kinds of theoretical considerations that I have just highlighted, I encountered several practical problems using the ZINB estimator. In many instances, my models failed to

converge. In other instances, Stata failed to report robust standard errors for some variables, while also failing to report Vuong and Wald statistics used to assess goodness-of-fit. These added difficulties confirmed my suspicions regarding the inappropriateness of the ZINB estimator.