THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS

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6. BILATERAL INVESTMENT TREATIES AND FOREIGN DIRECT INVESTMENT: A POLITICAL ANALYSIS*

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INTRODUCTION

Bilateral investment treaties (BITs), which promise foreign investors nondiscriminatory treatment and give them specific additional rights, have become popular. After a slow start, with the first BIT signed between Germany and Pakistan in November 1959 and 72 signed by the end of the 1960s, the number of BITs signed grew steadily but slowly in the 1970s and 1980s before it took off in the 1990s, with 1,857 BITs signed between the 187 members of the UN by December 31, 1999 (UNCTAD 2000, p. 1).[1] Clearly, some governments have thought them worthwhile. Yet, empirical studies of the impact of BITs on foreign direct investment (FDI) have had mixed results. Some studies have found that BITs increase FDI, but empirical analyses of bilateral investment flows, in particular, have tended to find that BITs fail to boost inward FDI into the developing countries that sign them.[2] We advance a theoretical and

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1. 17,391 bilateral treaties would have been hypothetically possible between the then-187 member states of the UN, so more than 10% of all possible BITs had been realized by 2000 (UNCTAD 2000, p. iii); By the end of 2006, 2,573 BITs had been signed between the now 192 member states of the UN (UNCTAD 2007), possibly part of a more general endorsement of neoliberal ideas by developing countries (Yackee 2005; though cf. Elkins, Guzman and Simmons 2006).

2. Many scholars have considered bilateral FDI the most appropriate measure of FDI to examine the effect of BITs on FDI, since each BIT is signed between two countries, only. We will return to this issue below. Most BITs have been signed between one developing country and one advanced capitalist country (usually a member state of the Organization for Economic Cooperation and Development (OECD)), though developing countries have increasingly signed BITs with each other; attempts to negotiate a multilateral investment agreement have repeatedly failed (see e.g., Guzman 1998; Elkins, Guzman and Simmons 2006).

epistemological argument to explain the mixed results of previous studies and to advance the understanding of BITs and their effect on FDI. Statistical as well as qualitative empirical analyses provide support for our argument.

We argue, first, that understanding the effect of BITs on FDI requires a political analysis of BITs. BITs are legal instruments that establish specific rights and obligations; they are part of the remarkable "legalization" of international politics in recent decades (Goldstein et al. 2001). Most strikingly, most recent BITs contain arbitration clauses that allow private parties from either signatory to initiate binding arbitration proceedings against the government of the other, without any need for either government's approval.[3] But while BITs are legal instruments, they exist to address a *political* problem. We focus on this political dimension of BITs to advance the understanding of the effect of BITs on FDI.

In the early years after post–World War II decolonization, outright expropriation was seen as the greatest threat to foreign direct investors. Starting in the 1970s, however, the changing nature of FDI led host country governments to largely refrain from expropriation. Rather, host governments started to use a wide variety of measures—including fees, regulatory requirements for financing or purchasing, and other interventions in the market—to increase *ex post* their share of the benefits from FDI. When negotiating with a potential foreign investor over the terms of the investment, governments of course have every incentive to promise that they will not take any such measures. Once the investment is made, however, governments have strong incentives to renege on such promises, especially in developing countries, where the rule of law often is only weakly established and domestic courts can often not be relied upon to enforce whatever contract the foreign investor might have with the host state. If the only remedy of foreign investors is to withhold future investments, then even the costs that investors collectively may in the long run impose upon the host country are unlikely to outweigh the benefits that political leaders with short time horizons can reap in the short run from reneging on their promises. BITs address the long-standing concern about expropriation by providing assurances against arbitrary expropriation and by committing the signatories to swift, substantial compensation if expropriation were to occur. We suggest, however, that BITs should be understood as attempts to reduce the likelihood of a much broader range of interventions by committing the FDI host country to economically liberal policies and by increasing the speed and costliness of punishments for breaking such commitments.

3. Giving private parties standing in a dispute with a foreign state is a fundamental deviation from long-standing traditions in public international law—though it may be consistent with a more general shift in international businesses' preferences for private dispute resolution fora (see Mattli 2001).

The logic of this theoretical argument, developed in greater detail in Section B, also has epistemological implications. It suggests that BITs should not only boost FDI between the signatory states but more broadly increase inward FDI into the developing country signatory. We therefore argue, second, for monadic analyses of inward FDI rather than dyadic analyses of bilateral FDI, because dyadic analyses may be ill-suited to estimate the effect of BITs on FDI.

After we discuss in Section A the often narrow, legalistic conceptualization of BITs in previous studies, as well as previous dyadic and monadic empirical findings, we present our own theoretical argument in Section B. We then turn to a statistical analysis of inward FDI flows into 122 developing countries with a population of more than 1 million from 1970 to 2000—a much more comprehensive sample than in most previous analyses (Section C). Finding strong correlational support for our argument in the quantitative analyses, we turn in Section D to a qualitative analysis of the hypothesized causal mechanisms. Since the evidence here is mostly anecdotal, our findings in the qualitative section are more tentative, but they suggest cumulatively quite strongly that the positive correlation that we find between BITs and subsequent FDI is indeed driven by the hypothesized causal mechanisms. In the conclusion, we explore some broader implications and note avenues for future research.

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