

**Contingent Credibility: The Reputational Effects of
Investment Treaty Disputes on Foreign Direct Investment**

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Abstract:

During the past few decades many developing countries have begun to sign bilateral investment treaties (BITs) in an attempt to attract greater levels of foreign direct investment (FDI). By signing BITs, investment-seeking governments are thought to more credibly commit to protecting whatever FDI they receive, which in turn should lead to increased confidence among investors and ultimately greater FDI inflows. We argue that this ability of BITs to increase FDI is contingent upon the subsequent behavior of the governments who sign them. BITs should only increase FDI if governments cultivate and maintain a good reputation in the eyes of global investors; that is, if they actually follow through on their BIT commitments. BITs often allow any expropriations or other negative actions to be contested through transparent arbitration venues like the International Centre for the Settlement of Investment Disputes (ICSID), an arbitral institution that is part of the World Bank. Being taken before ICSID, then, generates negative reputations for states who are viewed as “cheaters,” which could result in a sizeable loss of inward FDI. We test the contingent, reputational effects of BITs using cross-sectional, time-series analyses drawing on a panel that includes approximately 140 low and middle-income countries during a period spanning 1982-2005. We find that BITs can increase FDI into countries that sign them, but only if those countries are not subsequently challenged before ICSID. On the other hand, governments suffer notable losses of FDI when they are taken before ICSID, and suffer even greater losses when they lose an ICSID dispute. In other words, we find that whether BITs increase FDI depends upon whether a government develops a reputation for actually upholding its BIT commitments.

Introduction

As bilateral investment treaties (BITs) grow in number and prominence, an ongoing question is whether these treaties are effective. That is, do governments who sign these treaties, which explicitly identify increased foreign investment as their primary goal (Dolzer and Stevens 1995), actually experience increases in inward flows of foreign direct investment? Research to date on this important question returns decidedly mixed findings. Some empirical studies find no or weak effects of BITs on foreign direct investment (FDI), and instead conclude that other macro-level determinants are stronger predictors of foreign investment (Hallward-Driemeier 2003, Tobin and Rose-Ackerman 2005, UNCTAD 1998). Other studies identify significant positive effects for BITs on FDI (Egger and Pfaffermayr 2004, Neumayer and Spess 2005, Salacuse and Sullivan 2005), although these effects often apply only to certain environments.

Divergent results on the question of whether BITs increase FDI likely can be traced to differences across studies in terms of research design, model specification, and theorizing. One explanation lies with the choice of unit of analysis, since some studies examine dyadic effects of BITs while other studies focus on broader, country-level effects.¹ A related difference among studies is whether they examine the effects of U.S. BITs only (Salacuse and Sullivan 2005), a broader cross-national sample (Egger and Pfaffermayer 2004, Egger and Merlo 2007, Hallward-Driemeier 2003, Neumayer and Spess 2005), or perhaps both (Tobin and Rose-Ackerman 2005). Furthermore, the specified timing at which BITs should affect FDI also differs, since some studies focus on signed BITs, others focus on ratified BITs, and still others compare both signing and ratification (Egger and Pfaffermayr 2004, Haftel 2007). Finally, the studies rely on very different baseline models of FDI, a feature endemic to the FDI literature more generally.

¹ It is worth noting that different studies which employ the same unit of analysis sometimes return divergent findings (e.g., Salacuse and Sullivan 2005 as compared to Hallward-Driemeier 2003) and single studies which examine both levels of analysis often generate different conclusions across levels (Tobin and Rose-Ackerman 2005).

Therefore, it is difficult to draw strong substantive conclusions due to the incompatibilities and inconsistencies among existing studies.

Despite these differences, previous scholarship on BIT effects typically casts the debate in terms of whether the treaties are helpful or irrelevant; that is, whether they actually increase the level of investment or instead have no discernible effect. In this paper, we allow for BITs to have both positive and negative effects on FDI (also see Tobin and Rose-Ackerman 2005). Because most BITs contain provisions for international dispute settlement (Allee and Peinhardt 2008), we broaden the effects of BITs to include the potential negative effects of treaty-related disputes on investment flows. Our central argument is that any disputes which arise from BITs could damage the reputation of the “defendant” government, thereby reducing its levels of inward investment. Empirically, then, we examine whether governments who are challenged before an international arbitration panel experience a loss of inward FDI that serves to offset the general benefits of investment treaties.

We argue that governments who sign BITs should experience increased FDI inflows overall, but that such benefits will be at risk if the government is challenged before an international arbitration body. Being taken before an arbitration body signals that a country has failed to live up to the commitments enshrined in the BIT. The mere fact of appearing before an arbitration venue can make investors hesitant to direct future investment into that country, particularly if the dispute is not kept confidential, which is likely to be the case if the venue is the International Center for the Settlement of Investment Disputes (ICSID), a prominent and popular arbitral institution affiliated with the World Bank. It is certainly plausible that losing a panel ruling before a venue such as ICSID can reduce future levels of FDI. In this case, although investment arbitration clauses in BITs might enhance the *ex ante* credibility of a BIT signatory’s

commitment to respect foreign investment, that credibility is contingent on continued good behavior. Any future disputes that emerge from these clauses serve to identify governments who are violating treaty commitments. In this manner, investment arbitration bodies generate reputational costs for those states who are revealed as “cheaters” to the global community.

Our empirical tests reveal robust, supportive findings for this negative relationship between investment disputes and future FDI inflows. Governments whose policies are challenged before an international arbitration body consistently receive less future FDI merely by being the respondent in an investment dispute. If the government ultimately loses the dispute, it suffers a further loss in inward FDI. Overall, the empirical evidence reveals that BITs, through their facilitation of public arbitration of investment disputes, can harm governments who fail to comply with the provisions of the treaties. Our research efforts make a novel theoretical and empirical contribution to what Franck (2007c, 340) labels the “provocative and unexplored question of the role that dispute resolution mechanisms – particularly investment treaty arbitration – play in foreign investment.” This research also illuminates the reputation-generating effects of contemporary international institutions and suggests that seemingly credible commitments can be counterproductive if governments fail to honor the terms of that commitment and are publicly identified for non-compliance.

Compliance, Reputation, and International Institutions

Governments negotiate treaties as means to deal with a range of problems they face in international relations (Koremenos, Lipson, and Snidal 2001). For instance, treaties have been concluded across diverse issue areas in an attempt to generate greater cross-border trade, reduce trans-boundary pollution, or enhance regional security. Yet whether the mutual gains encoded in treaties are realized depends heavily on whether governments who sign preferential trade

agreements, environmental treaties, or arms control agreements actually live up to the commitments stipulated in the treaties. The same is true for attempts to increase FDI through the signing of international investment agreements. Increases in FDI only will be realized if governments actually abide by the terms of the BITs they sign.

The issue of treaty compliance therefore has emerged as an important topic for scholars of international relations. Those in the “managerial” school maintain that compliance is typically high (Chayes and Chayes 1993) whereas dissenters are more skeptical about overall levels of compliance (Downs, Rocke, and Barsoom 1996). Those in the latter camp also emphasize treaty design and the interplay between treaty signing and anticipated treaty compliance.² For purposes here, the most germane discussion concerns the mechanisms by which compliance can be achieved. As noted above, Downs, Rocke, and Barsoom (1996) claim that stronger enforcement provisions, such as those often found in BITs, are needed to promote compliance with meaningful international agreements. Dai (2005) instead emphasizes the role of domestic actors in encouraging compliance with environmental accords. Finally, Simmons (2000) claims that governments comply with their International Monetary Fund (IMF) Article VIII commitments due to their desire to establish a reputation for compliance. All three of these compliance-inducing mechanisms – enforcement bodies, domestic actors, and concerns with reputation – come together in the case of investment treaties, albeit in a manner slightly different than posited by these studies.

Simmons’s (2000) focus on reputation raises the issue of why governments would care about their reputation for compliance with agreements. The answer, put simply, is that reputations matter – and can influence future preferences and outcomes in similar strategic

² See Hopkins and Simmons (2005) and Von Stein (2005) for a related debate about the interplay between treaty participation and subsequent treaty compliance.

settings (Downs and Jones 2002). In Simmons's account, a reputation for compliance with Article VIII commitments – that is, the maintenance of current account liberalization – provides an important signal of credibility to market actors who can influence the state's economic well being. Reputations also have been shown to be important across other economic and non-economic realms. Tomz (2007) demonstrates that the reputation of sovereign borrowers is a major determinant of their access to future capital and the risk premium at which they borrow in the future. Reputation also has been identified as an important determinant of international security outcomes. For instance, scholars from across methodological traditions demonstrate how a state's reputation for resolve can enhance the credibility of a deterrent threat (Huth 1997, Mercer 1996, Sartori 2005). Similarly, Walter (2006) applies a reputational argument for deterrence to decisions of governments in civil conflicts. Across a variety of contexts, then, one would expect that a relevant reputation generated from past events might affect outcomes in similar settings in the future.

In short, many scholars of international politics believe that reputation influences behavior within a number of issue areas, including, perhaps, decisions concerning the allocation of FDI. But this focus on reputational effects begs an important question: how are reputations generated? In contemporary international relations it is often difficult to observe the actions of all relevant actors all of the time. This is particularly true on economic issues such as trade, investment, and lending, where the relevant parties include non-state actors such firms, industries, and banks. In complex global environments, international organizations can provide important information about state behavior (Keohane 1984). One such behavior about which they might provide information is compliance with international agreements (Mitchell and Hensel 2007). Thus, international institutions emerge as a potentially important source of

information on compliance, and, therefore, of a state's reputation for adhering to its commitments. This is particularly true for international institutions whose role it is to arbitrate or adjudicate disputes, since their specific purpose is to clarify facts regarding state compliance with treaty-based legal commitments.

Historically, third-party institutions have played an important role in providing reputation-generating information about actors for purposes of enforcing contracts. The best example is the *Lex Mercatoria* or the "Law Merchant" of medieval Europe, an important legal regime comprised of a system of legal codes, traders, agents, and judges (e.g., Grief 1989, 1993; Milgrom, et.al. 1990). The *Lex Mercatoria* was characterized by swift yet fair proceedings to resolve contractual disputes among long-distance traders. Its most important feature, however, was the written recording of information about the participant's past behavior and past compliance, which generated reputations for traders in a decentralized system characterized by long-distance exchange and indirect transactions. This ability of the law merchant to generate reputational effects has been identified by many as a primary cog in the system of medieval exchange (Grief 1989, Milgrom et.al. 1990, Stone Sweet 2006). It provided crucial information to traders to help them determine with whom they would like to do business, much like the institutions that govern economic exchange at present. Stone Sweet, in fact, labels the current international legal system which governs business transactions, and of which investor-state relations and dispute resolution are a part, as a "new *Lex Mercatoria*" (2006: 627).

Reputation and Investment Arbitration

Investment treaties encompass many of the issues described above. FDI is characterized above all by a credible commitment problem, sometimes referred to as the obsolescing bargain

(Vernon 1971). Before any initial investment is made, multinational firms possess considerable leverage in negotiations with potential host states, yet after the initial investment costs are sunk, bargaining power shifts to the host government, which is then capable of seeking self-serving revisions to the original bargain. This dynamic creates a problem for states that hope to attract foreign investment, since the anticipated *ex post* shift in bargaining power leaves potential investors worried about investing in states who cannot credibly commit to uphold the original bargain. For states seeking FDI, then, BITs represents a credible way to commit *ex ante* to respect the initial terms under which inward investment is made. Furthermore, credibility is enhanced by the inclusion of specific language in BITs that allows investors to seek third-party arbitration in the event that any *ex post* grievances should arise.

Legal scholars have singled out these investor-state dispute settlement clauses within BITs as perhaps the single most important aspect of the treaties (Dolzer and Stevens 1985; Franck 2007b; Yackee 2007). One reason the clauses are viewed as important is because they provide investors with direct access to international arbitration venues. Multinational firms who have grievances no longer must work through their own government to pursue their claims, but instead may seek redress against the host government directly through a third-party arbitration body. A second important feature is that many investor-state arbitration clauses in BITs contain additional provisions in which signatories (and their firms) agree in advance to settle future dispute through one or more international arbitration venues (Yackee 2007). This reduces the potential for delay and guarantees that any perceived violation by the host government can be dealt with through a neutral, third-party arbitration body. Indeed, Franck (2007b) claims the investor-state provisions have represented a “sea change” in the historical arrangements governing relations between investors and host states (191).

Among the various options for international arbitration of investor-state disputes, ICSID stands as the single most important venue. ICSID is highly prominent, due to its establishment by an international convention as well as its direct ties to the World Bank, which gives it additional “institutional gravitas” (Franck 2007c, 372). It has a governing council to which member-states send a representative, a secretariat that disseminates information, and a secretary-general who has the ability to determine jurisdiction and to appoint arbitrators, if necessary. A major source of ICSID’s power is that for those who use it, awards carry the same effect as the judgment of a national court. Additionally, because firms have direct access to arbitration through ICSID, it is easy to see why ICSID stands alone as the venue of primary interest for assessing the role of investment arbitration on FDI. The fact that ICSID has been used far more often than all other investment arbitration venues combined testifies most strongly to its prominence. According to data provided in Franck (2007a), investors have turned to ICSID to contest foreign government’s violations of BITs more than seven times as frequently as other institutionalized arbitration bodies (38-39).³

For all of the aforementioned reasons, ICSID is a focal point for the overwhelming number of states who are parties to BITs, as well as the firms within their borders. ICSID is not only the most active venue in which government violations are resolved, but it is the most transparent. It is the only body that publicizes information about the nature, timing and outcomes of its proceedings and awards. When investors attempt to discern a state’s reputation for upholding its BIT commitments, ICSID is the venue to which they will look. Yackee (2007: 22) notes that investors have become keenly aware of ICISD due to the rise in investment litigation and the coverage that ICSID disputes receive in the media. Because of this

³ Tallies of counts from Franck (2007a, 38) indicate that ICSID has been used 156 times in investor-state dispute settlement while other institutional arbitration options have been used only 23 times.

prominence, we argue that behavior revealed through ICSID proceedings should impact future decisions by foreign investors about whether to allocate or withdraw their resources.

Like the *Lex Mercatoria*, ICSID serves as an important and exclusive source of information about compliance with BITs. This is particularly true given the complexity of the global investment landscape. Firms cannot reliably discern the preferences of government toward BITs (in game theoretic terms, their “type”) or their willingness to violate the terms of the treaties (Tomz 2007, 237-238). Similarly, firms who consider where to invest abroad certainly cannot monitor closely – and constantly update – political and economic developments everywhere in the world. Furthermore, it is nearly impossible for informed observers to understand what actions by host government would violate BIT obligations and which actions would not. This is particularly true given that clear-cut expropriations have been largely supplanted by more nebulous actions alleged to constitute “creeping expropriation.”⁴ ICSID therefore serves an important role in identifying those governments that might have violated their treaty commitments and clarifying publicly whether the actions they have taken are legitimate.

Primary Arguments

We identify two reputation-based mechanisms through which ICSID might harm governments who sign BITs: 1) the reputational costs of any *involvement* before an ICSID arbitration tribunal, and 2) the additional reputational costs of *losing* a dispute before ICSID. An analogy with criminal justice is instructive. As is the case when an alleged criminal is “indicted,” an ICSID dispute filed against a government signals some potential yet unverified guilt on the part of the respondent. Yet like the outcome of criminal proceedings, when a

⁴ According to Guzman “...disputes that do not involve a direct taking are more interesting and important today because outright takings are now quite rare” (1998: 644).

“ruling” is handed down or a “plea” agreement is reached, additional and perhaps more definitive information is conveyed about the “guilt” (or “innocence”) of the responding government.

Reputational Effects of ICSID Filings

The first mechanism considers the potential FDI losses associated with being the “respondent” in an ICSID dispute. We expect that when an investor registers a dispute at ICSID, even if the arbitration process is not concluded or no award has been issued, other investors should be more reluctant to invest in the respondent country. The fact that a foreign investor decides to challenge a government’s treatment of FDI before ICSID sends an important negative message to the international investment community. In a complex world of investment across multiple borders in multiple sectors, the registration of a case before ICSID immediately labels the country as one who seemingly “cheats” on its BIT commitments. We believe this initial signal is particularly salient, even though no legal award has been issued against the government and there is no proof given that the government has failed to comply with the obligations enshrined in its BITs. This negative signal associated with being an ICSID respondent should last throughout the duration of a dispute’s tenure under ICSID jurisdiction.

H1: Governments whose actions are challenged via ICSID arbitration will experience reduced FDI flows, ceteris paribus.

Given the challenges of capturing empirically the timing of these effects, we consider multiple operationalizations of this ICSID-respondent argument. Our primary variable measures

the number of ICSID cases pending against a country in any given year. The use of cases that are “pending” provides a good conceptual fit, since it reflects the current level of overall uncertainty surrounding the country’s adherence to BITs. This measure of cases pending also reduces some of the potential measurement error and inference problems associated with attempting to capture the discrete timing of effects from filings. Nevertheless, we also consider additional variables that emphasize the timing of filings and consider varying lengths of time during which the negative effects of filings might be felt. Given the relatively low number of ICSID disputes across our sample, we consider a pair of variables to capture different time windows for the contemporaneousness of filings before ICSID: the number of ICSID disputes filed against a country within the previous two years, and the number of ICSID disputes filed against the country within a longer, five-year window. Including the number of pending cases, then, we devise three measures for ICSID arbitration involvement, but only one of these three measures is included in our analyses at any time.

Reputational Effects of ICSID Losses

A second mechanism moves beyond considering the negative impact of appearances before ICSID and emphasizes the outcomes of those appearances. Put differently, whether a government “wins” or “loses” an ICSID dispute also should be important. ICSID arbitration panels have the ability to assess culpability in investment dispute cases and to demonstrate more conclusively that a state has (or has not) violated the terms of a BIT. ICSID awards clarify and can reinforce a state’s negative reputation to the broader community by providing additional information that is highly pertinent to investors. Given the potential complexity of issues at stake, ICSID is in a unique position to provide distinct information about a state’s adherence to

its treaty commitments on investment. In this regard, the outcomes of ICSID awards constitute an additional mechanism that could further harm non-compliant BIT signatories. According to Yackee, "...authoritative, impartial arbitration awards have the tremendous potential to increase the reputation costs of the host state's breach by publicly clarifying both the fact surrounding the dispute and the content of the relevant legal rules, and by applying those facts to the rules" (2007: 17). Therefore, we also consider the unique impact that "losing" an ICSID dispute might have on a country's inward FDI.

H2: Governments who lose disputes via ICSID arbitration will experience reduced FDI flows, ceteris paribus.

We assess this argument by once again considering a range of operationalizations. Our primary measure for a negative ICSID outcome emphasizes the importance of losing an award ruling before an ICSID panel. A definitive ruling against the responding state is a particularly strong and definitive signal that a state has violated its BIT commitments and presents additional risk to investors. Approximately one-third of the disputes before ICSID in our analyses are resolved with this type of definitive ruling against the responding state. Our primary operational measure, then, captures the number of rulings in the past two years that have found treaty violations against the respondent. Because of the relatively small number of such rulings, we also broaden the window for negative rulings to five years to explore the timing of reputational effects. A second approach broadens the scope of possible outcomes to include informal settlements between the investor and responding state. Therefore, we generate a second variable that identifies all of the aforementioned negative rulings and adds the number of disputes in

which an informal settlement was reached by the parties. The logic here is that settlements may reflect a *de facto* admission of guilt by the respondent, and as such, also send a signal that generates reputational costs. Just over one-quarter of ICSID disputes end with a settlement, which, when combined with outright rulings against the respondent, means that nearly 60% of disputes signal guilt on the part of the respondent. We consider the number of negative rulings and settlements within the past two years, and then expand the time window to five years to check for robustness of findings.

A final approach returns to our primary measure for ICSID losses in the past two years, but this time adds an additional control variable for pending ICSID disputes (as described above, for hypothesis 1). This allows us to assess the unique impact of lost ICSID disputes, even after controlling for the fact that pending disputes are likely to negatively impact FDI independently. The insertion of the control for pending disputes therefore generates a difficult test of our second hypothesis. Furthermore, this two-pronged approach facilitates a basic comparison of hypotheses 1 and 2 within the same model. If both ICSID filings and ICSID rulings produce reputational costs, we would expect to see negative and statistically significant relationships between both variables and FDI flows.

Data, Control Variables, and Estimation

To test the hypotheses discussed above, we assemble data on the participants, timing and outcomes of ICSID disputes. We build our ICSID dispute data set by first compiling general data from the ICSID website on the participants and timing of each dispute.⁵ Data on dispute outcomes also are taken from ICSID website, but then are supplemented with additional information drawn from the International Institute for Sustainable Development, Investment

⁵ The ICSID website is found at: www.worldbank.org/icsid

Treaty Claims, American Society for International Law, and The Institute for Transnational Arbitration. We code the outcomes of investor-state disputes through ICSID as they are made public. This scheme includes a multi-fold classification scheme built to reflect both the order and the outcomes of the ICSID process. It includes rulings of no jurisdiction, discontinued proceedings (either by the parties, the court, or due to conciliation), settlements (categorized according to the timing of the settlement), and awards in favor of the claimant (investor) or respondent (host country).

In our empirical tests we also consider the general or “baseline” effect that BITs have on FDI flows. In particular, we wish to separate the particular effects of investment arbitration activity through ICSID, which is of primary interest, from the more general effect of investment treaties broadly. All else equal, we expect BITs to increase inward FDI flows. BITs offer increased legalization of investor rights to foreign investors from the partner state. The primary effect of this increased legalization is to reduce the credible commitment problem for states who hope to attract FDI. By signing BITs, governments demonstrate a greater *ex ante* willingness to respect FDI. In turn, this commitment should increase investor’s confidence that their investment will be protected, thereby making them more likely to increase FDI in the country. Our primary variable for BIT effect is a count of the total number of BITs a country has signed. To assess the general impact of BIT, and to isolate ICSID arbitration effects from broader BIT effects, we include this variable in all of our empirical tests. Our tallies are drawn primarily from the list of BITs reported on the UNCTAD website, and supplemented with treaty data from ICSID. We also include data on several additional treaties we have identified that are not reported on the aforementioned websites.⁶

⁶ Our totals for the annual numbers of BITs signed parallel the totals reported by UNCTAD.

In addition to these primary variables of interest, we also include additional explanatory variables that should affect FDI flows. Our collection of control variables includes those variables with the most accumulated explanatory power across country-level FDI models.⁷ They include a proxy for country size, *Gross Domestic Product* (measured via PPP in current international dollars), since larger economies are expected to attract investment aimed at the domestic market. Level of development also is included and is measured using *GDP per capita* (again using PPP in current international dollars). This serves as a proxy for human capital, but probably also affects market-oriented FDI as well via consumer spending effects. We also include a measure of *economic growth*, measured as the annual change in GDP, which is a robust predictor of FDI, presumably because fast-growing economies are more likely to attract the attention of foreign investors. We use the World Development Indicators' measure of exchange rates levels to create measures of *exchange rate volatility*, as in Li and Resnick (2003). Greater volatility previously has been found to be associated with lower levels of net FDI inflows. All of the above variables are taken from the World Bank's *World Development Indicators*. Additionally, we include as a control the *total world FDI* for any given year, which captures the over time changes of the magnitude of foreign investment. This variable is drawn from the same UNCTAD data set as our dependent variable, described below.

Two variables from the latest available update of the Polity data set are included: the standard *Polity net democracy* score, which is scaled at -10 to 10, as well as *regime durability* (Marshall and Jaggers 2005). Although the effects of democracy on FDI remain disputed (Jensen 2003, Li and Resnick 2003, Jakobsen and de Soysa 2006, and Choi and Samy 2008), we are agnostic on its effect and include it for comparability with previous results of FDI models.

⁷ All of the control variables are lagged by one year to address possible concerns with endogeneity. We also convert the units of the GDP data to facilitate the presentation of findings.

To these we add a measure of *property rights protection*, which is constructed similarly to Jakobsen and de Soysa (2006). This variable aggregates four indicators (investment profile, bureaucratic quality, corruption, and law and order) from the PRS's (2007) researcher's dataset and ranges from 0 to 30, with higher levels indicating greater property rights protection (and lower investor risk).⁸

Our dependent variable is *Net FDI Inflows* (in current millions of US dollars), which is taken from UNCTAD's Foreign Direct Investment database.⁹ We emulate others that use net FDI inflows (not FDI as a percentage of GDP or as a percentage of world investment) as a dependent variable.¹⁰ We feel that including the typical standardizing variables on the left-hand side of the regression equation (e.g., FDI as a percentage of GDP) generates more problems than it solves. In our estimations we also take the log of the GDP variables to reduce skewness.

We perform our analysis on a broad cross-section of countries over the relevant time period, which spans three decades. Given the nature of our analyses, we exclude high income countries from the regressions. These countries do not feel the need to sign investment treaties with each other, and thus their role in the international investment regime is qualitatively different than those of the low and middle income countries. Because international investment arbitration was not used extensively before the 1980s, our temporal domain stretches from 1984-2006, which we believe to be an appropriate time period for analysis.¹¹ Data coverage for the dependent variables and all explanatory variables is good, and thus concerns with listwise deletion of cases is minimal given this extensive coverage.

⁸ Although both Li and Resnick (2003) and Jakobsen and de Soysa (2006) scale the individual components of this index, we leave those components untransformed before summing them to create the measure.

⁹ Available at: <http://www.unctad.org/Templates/Page.asp?intItemID=1923>. This data has slightly better coverage than the comparable indicator from the World Bank.

¹⁰ See Li and Resnick (2003) and Jakobsen and de Soysa (2006).

¹¹ Only ten ICSID cases were decided before 1984, and in three of those the tribunal found that it had no jurisdiction.

We employ a statistical model that is appropriate given our panel of data. Because there may be relevant but omitted explanatory variables that we cannot capture with regressors, such as a government's true desire to attract FDI, we include fixed country effects. By including a dummy variable for each country (minus one) these models allow for the possibility of persisting differences in FDI levels across countries. We also include an AR(1) correction for serial correlation in the dependent variable.

Findings

Results for empirical tests of our two hypotheses are contained in a pair of tables, which we discuss consecutively (see Tables 1 and 2). On the whole the reported findings are quite supportive of both primary hypotheses. Governments who are accused of violating commitments enshrined in BITs, as indicated by the filing of disputes before ICSID, experience statistically significant reductions in foreign investment. Furthermore, governments who eventually lose ICSID disputes also witness substantial losses in inward FDI. These findings are robust and appear to function in a complementary manner. In sum, the evidence suggests that investment arbitration through ICSID is an important channel through which signing BITs could lead to less, and not more, FDI.

The evidence in Table 1 indicates that ICSID filings consistently have a negative effect on FDI, which is consistent with our reputational account as postulated in hypothesis 1. Governments who appear as respondents in investment arbitration disputes receive less FDI across all three model specifications in Table 1. Furthermore, the negative effects of BIT filings persist across the duration of the dispute. One initial finding is that FDI reductions occur as the number of pending disputes increases (see Model 1 in Table 1). This is consistent with the

argument that pending disputes before ICSID generate lingering uncertainty about a government's commitment to respect FDI. These findings suggest that investors react not only negatively but also swiftly to an ICSID filing, without giving respondent governments the benefit of the doubt or allowing them the benefit of the arbitration hearing. Furthermore, the stigma attached to being taken before ICSID seems to linger past the date of initial filing. Governments also experience FDI losses when disputes have been filed in the recent past. The findings from Models 2 and 3 in Table 1 demonstrate that FDI also decreases as the number of ICSID disputes filed in the past two and five years, respectively, increases. Taken together, the findings in Table 1 provide initial yet consistent support for the view that simply being taken before ICSID generates important reputation costs.

The second hypothesis, which emphasizes the costs associated with losing ICSID disputes, also receives robust support. Once again, the findings across model specifications in Table 2 provide consistent support for the proposition that by nature of its rulings, ICSID generates important reputational costs for treaty violators. According to the first two models in Table 2, recent losses in ICSID disputes lead to negative and statistically significant reductions in inward FDI. In other words, by nature of its ability to issue awards and thereby assign guilt, ICSID arbitration panels impose additional costs on BIT participants deemed to have violated treaty commitments. If we broaden the conceptualization of losing to include settlement agreements, the same negative and statically significant findings continue to hold in Model 3. This is an important finding, since it suggests that even the appearance of losing, as signaled by a settlement with the investor, leads to punishment in the form of reduced FDI.

A final notable result is contained in Model 4 of Table 2, in which both pending ICSID disputes as well as recent negative ICSID rulings both lead to reduced FDI. Each of these dual

findings is statistically significant at the 90% level of confidence. We conclude from these parallel relationships that the two reputational mechanisms function independently. At one level, investors punish governments who are taken before ICSID because this suggests non-compliance with investment rules. In addition, they further punish governments who later are more conclusively deemed to have violated their commitments, as determined by an ICSID panel. Another way to interpret this fourth model in Table 2 is that the negative effects of lost ICSID disputes on FDI remain significant even after controlling for lost FDI that occurred while the dispute was pending. Although the effects of pending disputes are difficult to disentangle, this final set of results in Table 2 suggests that our two hypotheses are complements instead of substitutes.

These consistent findings for the reputational costs of ICSID filings and losses also should be placed in the broader context of BITs. Although the negative FDI effects of ICSID activity are both novel and important, our findings reveal that BITs in general seem to have positive effects on FDI. Throughout all of the models we report in Tables 1 and 2, FDI flows increase for governments who sign BITs. Put differently, governments who sign BITs and then abide by their obligations to respect FDI should expect to reap the rewards of the added credibility which the treaties generate. For most governments, then, BIT should be economically desirable. But for those governments who appear before ICSID, the FDI-generating properties of BITs can be offset, at least to some degree, by the fallout from acquiring a reputation for not complying with the treaties. Although the interpretation of our point predictions is not straightforward due to variable transformations, it appears that the FDI loss from an additional filing before ICSID more than eliminates the FDI benefits of signing an additional investment treaty (see Table 1). The effects of a lost ICSID ruling are even more substantively important,

since the predicted reduction in FDI (as evidenced by the coefficients on primary explanatory variables in Table 2) due to an ICSID loss offset the predicted FDI benefits associated with signing between seven and ten additional BITs.

We also emphasize that these findings for the effects of investment treaties and investment treaty disputes not only are substantively important, but also are robust and statistically significant even after we control for a range of additional predictors of FDI. The control variables we include in our models are informed by the existing literature, and perform well in the aggregate as an explanation for FDI flows. Factors such as country size and economic growth attract FDI, whereas currency volatility repels it. Domestic political institutions, broadly conceived, also help to attract FDI. The salience of these control variables, coupled with the inclusion of fixed effects and methods of controlling for time, further increases our confidence in the conclusions we draw. Simply put, we feel strongly that ICSID activity is an important component of the potential effects of investment treaties on FDI, and should be incorporated into the ongoing discussion.

Conclusions and Future Research

Our research illuminates an important new pathway through which BITs should affect FDI – by establishing procedures for the international arbitration of investment disputes, which then generate reputational costs for treaty violators. We explore the record of governments who have been brought before ICSID, the world’s most prominent investor-state arbitration body, and find that governments who participate in ICSID disputes experience substantial losses in FDI. Moreover, these FDI losses are transmitted through two reputation-based channels. First, governments experience reduced FDI upon becoming an ICSID respondent, even if the case is

pending or unresolved. Second, the ultimate loss of an ICSID dispute, or even the perception of a loss, leads to further decreases in FDI. This one-two punch generated by investment arbitration activity recasts the debate over the workings of BITs by demonstrating a new source of costs associated with the treaties.

Our findings should not be normatively troubling, however. Governments sign investment treaties with the expectation that they will be followed. If compliance is an important norm in the international system, and if actors believe in *pacta sunt servanda*, then our results should be welcomed. We demonstrate that investor-state arbitration clauses “have teeth.” Investors successfully have challenged governments by taking them before ICSID and have won awards based on the legal merits of their claims. Consequently, governments who violate treaties then pay in the form of reduced inward investment.

In terms of our contribution to the broader literature on BITs, we do not conclude that the overall effect of BITs is negative, or that most governments who sign BITs should prepare to suffer potential losses of FDI. In fact, our research suggests the opposite. In our analyses BITs consistently have a robust, positive effect of FDI flows, *ceteris paribus*. Furthermore, governments who occasionally are taken before ICSID are unlikely to see the reputational losses from an ICSID dispute outweigh the overall FDI benefits of signing BITs. What we do suggest, however, is that the credibility-enhancing properties of BITs are not universal, but rather are contingent on a government’s continued compliance with the treaties.

This dynamic of “contingent credibility” is an important contribution to research in political economy which highlights credible commitment and the importance of reputation. We demonstrate that *ex ante* commitments to adhere to pledges, even those that impose significant constraints on governments, are not automatically credible. Governments sometimes do violate

their investment treaty commitments, and likely will continue to do so, even in the shadow of a prominent enforcement body such as ICSID. An important question to consider, then, is why disputes go before ICSID. For instance, do governments who find themselves as respondents before ICSID commit “rational” breaches of their obligations, or are their appearances before ICSID unintentional or unexpected? Regardless of the answer, it is clear that ICSID serves an important role in generating reputations for states in a complex environment where the challenges of monitoring and information-gathering are sizeable. We suggest that other international institutions, particularly arbitration and dispute settlement bodies, should have similar reputational effects that will be observable in the future behavior of actors within a similar context (Downs and Jones 2001). Dispute settlement through the World Trade Organization (WTO) represents one application of this logic, in which governments take cues from previous WTO panel decisions and subsequently are more likely to challenge particular trade barriers from those countries who previously have been found “guilty” of violating trade obligations (Allee 2008).

Because our findings are preliminary, we offer several avenues for future enquiry. First, future efforts should continue to address the difficult task of identifying the timing at which the negative effects of investment arbitration will be felt. We consistently found that governments lost FDI across a range of time periods while an ICSID dispute was pending as well as after the resolution of the dispute. An important future goal is to pinpoint the timing of these effects as precisely as possible. Second, it also is likely that FDI will become more volatile in the years during and surrounding an ICSID dispute, while some uncertainty lingers and investors await new revelations regarding the legality of the actions of the respondent state. Thus the effect of investment arbitration on FDI volatility is a promising avenue of enquiry. Third,

another important task is to sort out the relative effects of ICSID filings versus ICSID losses. We find that both actions are important, but we offer only limited evidence of the magnitude and relative salience of each occurrence. Another endeavor would be to distinguish even more carefully among the various outcomes of ICSID proceedings. The pursuit of each of these efforts requires further emphasis on the substantive FDI effects of ICSID disputes, an issue that we have not emphasized here.

Although these are only initial findings, our confidence in the reported relationships is high. This is because our country-level analyses represent a “hard test” of our claims regarding the reputational effects of international institutions. We conclude that a country’s overall reputation for respecting FDI is witnessed by actors across borders, and that this reputation applies broadly and exerts influence at the macro level. Yet more nuanced FDI relationships also should be evident. For instance, one might also think about whether reputations are specific to certain industries (for example, does FDI decline only in industries related to the dispute?), or whether reputational effects might be particularly strong between certain pairs of actors. Although ICSID is of primary interest due to its prominence and heavy use, it is possible that other investment arbitration venues could generate more narrow reputations. All of these relationships are difficult to disentangle empirically, yet their pursuit would add to the richness of findings regarding the importance of reputation and credible commitment in the realm of foreign investment.

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Table 1: The Reputational Effects of ICSID Filings on FDI Inflows

	<u>Model 1</u>	<u>Model 2</u>	<u>Model 3</u>
Primary Variables			
Pending ICSID Disputes	-.027 ** (.014)		
ICSID Disputes Filed Against (past 2 years)		-.027 * (.017)	
ICSID Disputes Filed Against (past 5 years)			-.025 * (.012)
Bilateral Investment Treaties	.021 *** (.004)	.021 *** (.004)	.021 *** (.004)
Control Variables			
GDP (log)	1.25 *** (.434)	1.26 *** (.443)	1.26 *** (.434)
GDP Growth Rate	.011 ** (.006)	.011 ** (.006)	.011 ** (.006)
GDP per capita (log)	.074 (.566)	.063 (.565)	.058 (.568)
Exchange Rate Volatility	-.0035 *** (.0008)	-.0035 *** (.0008)	-.0035 *** (.0008)
Global FDI Flows	.370 *** (1.36)	.365 *** (.135)	.367 *** (.135)
Democracy	.024 +++ (.010)	.024 +++ (.010)	.023 +++ (.010)
Regime Durability	-.006 (.006)	-.006 (.006)	-.006 (.006)
Protection of Property Rights	.051 *** (.015)	.050 *** (.015)	.050 *** (.015)

Panel-corrected standard errors with AR(1) correction in parentheses *p<.10, **p<.05, ***p<.01 (one-tailed tests)
 Fixed-Effects estimation, country dummies not reported ++p<.10, +++p<.05, ++++p<.01 (two-tailed tests)

Number of Observations	1709	1709	1709
Number of Groups	101	101	101
R-squared	.647	.647	.647

Table 2: The Reputational Effects of ICSID Losses on FDI Inflows

	<u>Model 1</u>	<u>Model 2</u>	<u>Model 3</u>	<u>Model 4</u>
Primary Variables				
ICSID Rulings Lost (past 2 years)	-.211 ** (.114)			-.190 * (.197)
ICSID Rulings Lost (past 5 years)		-.194 * (.098)		
ICSID Disputes Lost or Settled (past 2 years)			-.136 * (.091)	
Pending ICSID Disputes				-.021 * (.014)
Bilateral Investment Treaties	.021 *** (.004)	.021 *** (.004)	.021 *** (.004)	.021 *** (.004)
Control Variables				
GDP (log)	1.26 *** (.430)	1.28*** (.441)	1.27 *** (.433)	1.27 *** (.431)
GDP Growth Rate	.011 ** (.006)	.011 ** (.006)	.011 ** (.006)	.011 ** (.006)
GDP per capita (log)	.071 (.563)	.058 (.575)	.074 (.564)	.057 (.564)
Exchange Rate Volatility	-.0035 *** (.0008)	-.0036 *** (.0009)	-.0035 *** (.0008)	-.0035 *** (.0008)
Global FDI Flows	.357 *** (.131)	.354 *** (.134)	.359 *** (.133)	.363 *** (.132)
Democracy	.024 +++ (.010)	.024 +++ (.010)	.024 +++ (.010)	.024 +++ (.010)
Regime Durability	-.006 (.006)	-.006 (.006)	-.006 (.006)	-.006 (.006)
Protection of Property Rights	.051 *** (.015)	.051 *** (.015)	.051 *** (.015)	.050 *** (.015)

Panel-corrected standard errors with AR(1) correction in parentheses *p<.10, **p<.05, ***p<.01 (one-tailed tests)
 Fixed-Effects estimation, country dummies not reported ++p<.10, +++p<.05, ++++p<.01 (two-tailed tests)

Number of Observations	1709	1709	1709	1709
Number of Groups	101	101	101	101
R-squared	.646	.646	.645	.647