An Investigation of the Internal Dynamics of Bilateral Investment Treaties: Every BIT Counts

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Abstract

To date, over 2,500 bilateral investment treaties (BITs) have been signed. The widespread use of BITs raises two questions that are addressed in this dissertation: (1) Do BITs increase foreign direct investment (FDI) to developing countries? And (2) what has driven the proliferation of BITs? This research advances the literature assessing BITs and FDI flows by developing BIT strength measures that evaluate various protections and guarantees provided by the treaties. It hypothesizes that stronger BITs, BITs that provide foreign investors more protections and guarantees, attract more investment flows to developing state treaty partners. The results of a time series model from 1985-2000 support the hypothesis. In regards to the second question, previous research argues that the proliferation of BITs is the product of competition for capital among developing states. This study hypothesizes that multinational corporations (MNCs) are driving the spread of BITs. The results from a time series logistic regression support the MNC hypothesis.
Dedication

“I can do all this through Him who gives me strength”
-Philippians 4:13 (NIV)
# Table of Contents

## CHAPTER 1: INTRODUCTION

- INTRODUCTION .............................................................................................................. 1
- OVERVIEW OF THE STUDY ...................................................................................... 3
  - Historical Background .................................................................................................. 3
  - Theory .......................................................................................................................... 6
  - Literature Review ......................................................................................................... 7
  - BIT Measurement Instrument .................................................................................... 8
  - Do BITs Increase FDI flows to Developing States? ......................................................... 9
  - What has Driven the Proliferation of BITs? ................................................................. 9
- CONCLUSION ................................................................................................................ 10

## CHAPTER 2: HISTORICAL BACKGROUND

- INTRODUCTION .............................................................................................................. 12
- DEFINING FDI AND MNCs ........................................................................................ 13
- FOREIGN INVESTMENT, EARLY MNCs, AND PROPERTY RIGHTS IN THE MEDIEVAL ERA ........ 14
  - Early Multinationals in the Medieval Era ..................................................................... 15
  - The Politics of Protection in the Late Medieval Era ...................................................... 17
- FOREIGN INVESTMENT, EARLY MNCs, AND PROPERTY RIGHTS IN THE AGE OF EXPLORATION 18
  - Early Multinationals in the Age of Exploration: The English East India Company ........ 21
  - The Politics of Investment Protection in the Age of Exploration ................................... 24
- FDI, MNCs, AND PROPERTY RIGHTS IN THE 19TH AND EARLY 20TH CENTURIES .......... 24
  - Multinationals in the 19th and Early 20th Centuries: British Infrastructure in Latin America 28
  - The Politics of Investment Protection in the 19th and Early 20th Centuries .................... 30
- FDI, MNCs, AND PROPERTY RIGHTS IN THE INTERWAR ERA .................................. 38
  - Multinationals in the Interwar Era: The United Fruit Company .................................... 40
  - The Politics of Protection in the Interwar Period ......................................................... 43
- FDI, MNCs, AND PROPERTY RIGHTS IN THE POST WWII ERA ................................. 45
- FDI & MNCs Post WWII-1980 ...................................................................................... 48
- FDI & MNCs 1980-2000 ............................................................................................... 50
  - Recent FDI Flows ........................................................................................................ 53
  - The Modern MNC ....................................................................................................... 54
# The Politics of Investment Protection in the Post WWII Era

## SUMMARY

- International Investment Law
- Characteristics of MNC and FDI
- The Politics of Investment
- Enforcement of International Investment Law

## CONCLUSION

## CHAPTER 3: THEORY

### INTRODUCTION

### REGIME THEORY

- Power-Based Theories: Realism and Hegemonic Stability Theory
- Interest-Based Theory: Neoliberalism
- Cognitive Based Theories
- Summary of Approaches to Regime Theory
- Regime Theory and BITs
- Criticisms of Regime Theory

### STRANGE’S STRUCTURAL POWER

- Production
- Security
- Finance
- Knowledge
- US Hegemony and Liberal Agenda
- Consequences of Structural Change: The Rise of Multinationals and the Decline of States
- Criticizing Strange: A Solid ‘Structure’ but Flimsy Finishing Work

### THE POLICY DIFFUSION THEORETICAL FRAMEWORK

### CONCLUSION: DEVELOPING AN APPROPRIATE LENS THROUGH WHICH TO VIEW BITS

## CHAPTER 4: LITERATURE REVIEW

### INTRODUCTION

### EXPLAINING THE BIT PARADOX: WHAT HAS DRIVEN THE PROLIFERATION OF BITs
<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimation Technique</td>
</tr>
<tr>
<td>RESULTS</td>
</tr>
<tr>
<td>Statistically Insignificant Explanatory Independent Variables</td>
</tr>
<tr>
<td>Statistically Significant Explanatory Independent Variables</td>
</tr>
<tr>
<td>DISCUSSION</td>
</tr>
<tr>
<td>CHAPTER 8: CONCLUSION</td>
</tr>
<tr>
<td>INTRODUCTION</td>
</tr>
<tr>
<td>MNCs and BITs</td>
</tr>
<tr>
<td>Do BITs Increase FDI Flows to LDCs?</td>
</tr>
<tr>
<td>What Has Driven The Proliferation of BITs?</td>
</tr>
<tr>
<td>Future Research</td>
</tr>
<tr>
<td>WORKS CITED</td>
</tr>
<tr>
<td>APPENDIX 1: THE CONTENT ANALYSIS OF BITs</td>
</tr>
<tr>
<td>APPENDIX 2: ORIGINAL CODE SHEET</td>
</tr>
<tr>
<td>APPENDIX 3: CODE SHEET GUIDE</td>
</tr>
<tr>
<td>APPENDIX 4: GUTTMAN CODE SHEET</td>
</tr>
<tr>
<td>APPENDIX 5: GAMMA MATRIX</td>
</tr>
<tr>
<td>APPENDIX 6: EXCEPTIONS</td>
</tr>
<tr>
<td>APPENDIX 7: TRANSFERS</td>
</tr>
<tr>
<td>APPENDIX 8: TREATMENT</td>
</tr>
<tr>
<td>APPENDIX 9: BROAD TREATMENT</td>
</tr>
<tr>
<td>APPENDIX 10: BEAUTY IN THE EYE OF THE BEHOLDER: HOST STATE FEATURES MNCs FIND ATTRACTIVE</td>
</tr>
<tr>
<td>APPENDIX 11: MODEL 1B.2 (CONSENT)</td>
</tr>
<tr>
<td>APPENDIX 12: MODEL 2 WITH LAGS</td>
</tr>
<tr>
<td>APPENDIX 13: VARIABLE LIST</td>
</tr>
</tbody>
</table>
List of Tables

Table 4.1. Results from studies on BITs and FDI flows.......................................................... 118

Table 5.1. Exceptions.................................................................................................................. 155
Table 5.2. Transfers .................................................................................................................... 156
Table 5.3. Treatment ................................................................................................................... 157
Table 5.4. Broad Treatment ....................................................................................................... 158

Table 6.1. Summary Statistics .................................................................................................. 171
Table 6.2 Model 1 Variations. .................................................................................................... 173
Table 6.3. Time-Series Regression Results for Bilateral FDI Flows (Model 1). ...................... 174
Table 6.5. Transfers .................................................................................................................. 180
Table 6.6. Broad Treatment. ..................................................................................................... 181

Table 7.1. Logistic Regression Results for Model 2. ................................................................. 196
CHAPTER 1: INTRODUCTION

INTRODUCTION

Financial crisis gripped Argentina in 2002. The crisis forced Argentina to unpeg its currency from the United States dollar, precipitating a 40 percent fall in the Argentine peso’s value (Hornbeck 2002). Foreign owned firms operating in Argentina suffered steep losses from the devaluation. On such company was CMS Energy, an American natural-gas company that invested in Argentina in the 1990s in the midst of Argentina’s public utilities privatization spree (Peterson 2009). Prior to the investment, Argentina and CMS Energy signed an operating agreement stating that utility prices will be “assessed in US dollars, adjusted for inflation in the United States and converted to pesos at the market exchange rate” (The Economist 2012a). Argentina reneged on its commitments during the crisis. It froze utility rates and then assessed utilities in the newly devalued currency (The Economist 2012a). Argentina’s breach of contract benefitted local customers, but caused CMS Energy to lose millions in revenue. CMS Energy argued in the Argentine legal system for compensation from the government due to the government’s violation of the operating agreement, but to no avail. The local courts claimed the government could unilaterally disavow the contract due to the financial crisis. However, CMS Energy had another option to pursue compensation. Its investment was covered by a bilateral investment treaty (BIT).

BITs stipulate the terms and conditions by which foreign investment from one country must be treated in another (Elkins et al. 2006). Most BITs are signed between a
developed, capital exporting country and a less developed, capital importing country.\textsuperscript{1} Germany and Pakistan signed the first BIT in 1959. Countries signed eighty-three BITs in the 1960s, 176 in the 1970s, 377 in the 1990s, and almost 700 from 2000-2005 (UNCTAD 2007). Currently, countries have established over 2,500 BITs, making BITs the most prominent feature of the current international regime governing the treatment of foreign owned property (UNCTAD 2007).\textsuperscript{2} And most pertinent to the CMS Energy’s situation in Argentina, the United States and Argentina established a BIT in 1994.

The United States-Argentina BIT contains an umbrella clause. Umbrella clauses elevate contracts established by a foreign investor and a host state to the status of international law (Salacuse and Sullivan 2005). Consequently, Argentina’s violation of its operating agreement with EMS Energy was not merely a violation of local Argentine law. It constituted a violation of international treaty law. Because of the BIT, CMS Energy was able to take its case against Argentina to the International Centre for the Settlement of Investment Disputes (ICSID), the arbitration body stipulated in the BIT. The ICSID ruled in favor of CMS Energy and required Argentina to pay CMS Energy $133.2 million in compensation for CMS Energy’s losses that occurred due to Argentina’s actions during the financial crisis (ICSID.worldbank.org).

The widespread use of BITs raises two questions that are addressed in this study: 

(1) Do BITs increase FDI to developing countries? And (2) what has driven the

\textsuperscript{1} Recently, BITs are being signed between less developed countries. However, these BITs are primarily conducted for symbolic reasons as little capital flows between developing country pairs (Sornarajah 2010). No BITs have been signed between countries that are among the top 18 capital exporters.

\textsuperscript{2} Regimes are “sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations” (Krasner 1983, 27). The international regime governing the treatment of foreign owned property refers to all of the principles, norms, rules and decision-making procedures in that particular area.
proliferation of BITs? Developed states sign BITs to protect the foreign investments of their multinational corporation (MNCs; Guzman 1998). Developing states sign BITs to attract multinationals to their countries (Guzman 1998). As illustrated by the above example, developed states and their multinationals have benefited from BITs (Salacuse and Sullivan 2005). However, the benefits received by developing host states are still unclear. Developing states are merely granting multinationals extra legal protections and receiving nothing in return if signing a BIT does not spur additional foreign investment into the developing country. This research advances the literature assessing BITs and foreign direct investment (FDI) flows by developing BIT strength measures that evaluate various protections and guarantees, like the umbrella clause mentioned above, present in the treaty. Previous research on the subject has ignored the content of BITs, instead choosing to view BITs as homogenous entities.

MNCs benefit from the extensive investor protections and guarantees provided to them in BITs. Yet multinationals are not included in the dominant explanation of the wide-spread use of BITs, which explains BIT proliferation as a process driven by developing states (Elkins et al. 2006). The current study lays the theoretical foundation from which a MNC led BIT proliferation hypothesis is constructed and empirically tested.

OVERVIEW OF THE STUDY

**Historical Background**

Chapter two details the evolution of the regime governing the protection of foreign owned property. Prior to BITs, developed state foreign investment in developing
countries was not protected through treaty law, but through customary international law and general legal principles of international law. In fact, no multilateral treaty on the treatment of foreign owned property has ever been established. The pre-BIT legal standard was called the international minimum standard for the protection of foreign owned property, or the minimum standard for short.

The minimum standard contained two key principles, full compensation for expropriation and the right to diplomatic interposition. Outright expropriation was the most significant threat to foreign owned property in the developing world in the pre BIT era. Most investments in less developed countries (LDCs) were in the natural resource sector. Host states could expropriate (nationalize) a foreign owned mine or plantation and fully utilize the property (Frieden 1991). The minimum standard did not prevent expropriation. The ability of a state to expropriate property in its territory was firmly established in general principles of international law (Sornarajah 2010; Slomanson 1995). The minimum standard required the host state to provide full compensation to the injured foreign national for any expropriated property (Steiner and Vagts 1968; Borchard 1915).

The minimum standard also allowed injured foreign investors to pursue diplomatic interposition, notably in cases when a host state did not pay full compensation to a foreign investor for expropriated property. Diplomatic interposition refers to the process by which the foreign investor’s home state intervenes on the investor’s behalf and elevates a domestic dispute between a foreign investor and host state to a diplomatic row between the two states (Borchard 1915; Eagleton 1928; Dunn 1932; Eagleton 1970). When these disputes could not be brought to an amicable solution, more drastic measures were taken, including military enforcement in some cases. During its hegemonic reign of
the late 19\textsuperscript{th} and early 20\textsuperscript{th} centuries, the United Kingdom enforced the minimum standard (Lipson 1985). Other European powers enforced the minimum standard with their colonial possessions, and the United States followed suit in Latin America in the interwar era (Lipson 1985).

The minimum standard was replaced by BITs in the post WWII era. Two factors stand out in the decline of the minimum standard and the rise of BITs. First, western powers no longer dominated the international system (Lipson 1985). The rise of the USSR inhibited the west’s ability to pursue diplomatic interposition and strong-arm developing states into compliance with the minimum standard. The second factor concerns the changing nature of foreign investment. After WWII, developed state MNCs began to invest in services and production. Foreign investments in these areas could not be effectively expropriated by a host state (Frieden 1991). For the investment to be lucrative, it had to be connected to the multinational and its supply chains and technical knowledge. Developing states began to realize that they needed foreign multinationals to pursue economic development and began to actively court multinationals in the 1980s (Stopford and Strange 1991). But once the foreign companies invested, the developing host states implemented various restrictive business practices, such as higher taxes, local content requirements for production inputs, and restrictions on monetary transfers, on the companies to reap a larger share of the benefits from the investment and promote domestic economic stability.

Thus, the new issue facing developed state MNCs investing in the developing world was no longer the outright expropriation of foreign owned property, but creeping expropriations via increasingly restrictive business practices. BITs proliferated in this
period because they contain provisions specifically addressing various restrictive business practices, and other issues concerning how host states must treat foreign owned companies.

Theory

Chapter three explains the study’s theoretical approach. Regime theory is the dominant theoretical approach in the discipline of international relations, but it is an inappropriate lens through which to view BITs. In brief, regime theory predicts that a multilateral regime governing the treatment of foreign investments will be established because such a regime is in the interests of states. However, no such multilateral regime has been achieved. Regime theory cannot explain the proliferation of BITs because it is a state-centered approach that ignores the interests and influence of MNCs.

BITs are in the interests of multinationals, and multinationals are influential actors in the international system (Strange 1988a). Political and technological changes in the post WWII international political economy have elevated multinationals to major actor status. Multinational corporations control the knowledge and capital that states need to pursue economic advancement, giving them leverage over states (Strange 1988a). Consequently, MNCs should be included in a theoretical explanation of BITs.

Multinationals are included in the theoretical explanation of BITs through policy diffusion theory, a framework specifically designed to explain the spread of liberalizing polices throughout the international system. In short, BITs have proliferated because they are in the interests of powerful MNCs. These influential international actors lobby their home state to pursue BITs with developing countries in which they want to invest in
order to garner the investment protections and guarantees embedded in the treaties. Multinationals also use their control over the means to economic development to leverage the developing states in which they want to invest to sign BITs with their home state.

**Literature Review**

Chapter four gives a full assessment of the literature on BITs, the highlights of which are discussed below. Elkins et al. (2006) is the leading study explaining the proliferation of BITs. It argues that BITs are the result of competition among developing states for FDI. In short, LDCs will seek BITs with developed states when a state with which it competes for FDI begins its own BIT program (Elkins et al. 2006). Thus, the study assumes that the proliferation of BITs is entirely driven by LDCs and that developed states and MNCs are insignificant parts of the process. This is the glaring flaw in Elkins et al. (2006). MNCs are influential global actors that need to be included in the explanation of BITs.

Studies discerning the effect of BITs on FDI flows to developing states have employed varying research designs, and have reached varying conclusions, both between and within methodological approaches. Monadic designs use the developing state as the unit of analysis and assess the effect of BITs on FDI to the developing country by how many BITs it has signed. The logic behind monadic designs is that developing states signal a stronger commitment to pro-business policies to foreign multinationals by signing more BITs. Therefore, more BITs will produce more foreign investment flows to the developing state from multinational corporations covered and uncovered by BITs. The signaling logic behind monadic designs is flawed. Modern multinationals are
concerned about various restrictive business practices that host states can implement. Multinationals not covered by a BIT will not receive its protection and guarantees; therefore, BITs will not attract FDI from MNCs not covered by the treaty.

Dyadic designs use developed state-developing state pairs as the unit of analysis and assess the effect of BITs on FDI to the developing country by the presence of a BIT in the dyadic pair. The logic behind dyadic designs is that developing states sign BITs to tie their hands, preventing them from implementing restrictive business practices on foreign investors specifically covered by a treaty. Thus, dyadic designs consider BITs credible commitments to the various pro-business policies stipulated in the treaty. However, only one dyadic study has attempted to account for the actual composition of BITs, Yackee (2008), and that study only accounts for one area of variation. BITs contain dozens of provisions restricting host state regulation of multinationals across a variety of issue areas. Studies on the effect of BITs on FDI flows need to account for the internal dynamics of BITs.

**BIT Measurement Instrument**

Chapter five develops a measure of the internal dynamics of BITs. Variation across thirty-seven areas of BITs is assessed using content analysis. The data is from 748 BITs ratified from 1980 to 2009. Underlying trends in the data are assessed using a gamma matrix, which shows four distinct strength dimensions, treaty exceptions, transfer issues, treatment issues, and broad treatment standards. Scale scores were developed for each dimension using Guttman scaling. *Exceptions* measures various areas to which a BIT does not apply. *Transfers* measures the protections provided to foreign
multinationals to transfer money into and out of the host state. *Treatment* measures the guarantees and protections regarding a multinationals ability to conduct business in the manner of their choosing. *Broad Treatment* assesses the existence of three broad treatment standards in the treaty, fair and equitable treatment, national treatment, and most favored nation treatment.

**Do BITs Increase FDI flows to Developing States?**

Chapter six hypothesizes that (1) the presence of a BIT in a dyadic pair increases FDI flows to the developing state in the dyad and that (2) BITs with stronger treaty protections, as measured by the strength variables established in chapter five, will increase FDI to the developing state in a dyadic pair. A time-series analysis of FDI flows within dyadic pairs of states from 1985 to 2000 tests the hypotheses. The results are positive and significant in both cases. The presence of a BIT increases FDI flows to the developing host state in each dyad and stronger BITs increase FDI flows more.

**What has Driven the Proliferation of BITs?**

Chapter seven investigates the proliferation of BITs. The leading explanation for the proliferation of BITs argues that BITs are the product of developing state competition for FDI (Elkins et al. 2006). In short, developing states sign BITs to become more attractive investment destinations than the states with which they compete for FDI (Elkins et al. 2006). This argument is questionable because it excludes multinationals from the process. Multinationals could be driving the proliferation of BITs by influencing their home and host states to sign a BIT. This chapter hypothesizes that the
more attractive a developing country is as an investment location, the greater likelihood that a dyad consisting of a developed state and a developing state will contain a BIT. The hypothesis is tested via a time-series logit model covering dyadic pairs of countries from 1985 to 2000. The results support the hypothesis. BITs are signed where developed state multinationals want to invest.

CONCLUSION

Earlier studies contribute substantially to the discipline’s understanding of BITs, but they do not represent a systematic assessment of the treaties. Yackee (2008) is the first study to account for internal dynamics of BITs; however, his strength measure is based on one aspect, the presence of a provision guaranteeing a foreign investor’s right to dispute settlement. General assessments of BITs such as Dolzer and Steven (1995) and UNCTAD (2007) provide anecdotal assessments of trends in BIT provisions. Those studies in particular were indispensable in the development of this study’s coding system. However, they did not produce systematically collected, testable data. This study is the first to systematically analyze BITs. It does so across thirty-seven different protections and guarantees and it provides a new, testable BIT dataset to the field.

This research further contributes to the study of BITs by providing the literature’s first comprehensive measures of foreign investor protections and guarantees provided in treaties. The four strength measures described above constitute four distinct dimensions of BIT strength. The four dimensions are comprised of a total of nineteen different protections and guarantees present in the treaties. BIT strength scores are used as independent variables predicting FDI flows to developing states. The results indicate that
stronger BITs do increase FDI flows from developed states to developing states. These results hold important practical implications. LDCs are limiting their economic policy autonomy by signing BITs and they are limiting their autonomy more by signing stronger BITs, but they are receiving proportionally higher levels of FDI in return.

This study makes theoretical contributions in two areas. First, the findings bolster the institutionalist (i.e. North 1990; Keohane 1984) argument that institutional design matters by showing that the design of BITs, that is, the strength of protections they provide foreign investors, affects FDI flows induced by the treaties. Second, this research reinforces Strange’s (1988a) contention that MNCs are influential, global actors by demonstrating that multinationals are the driving force behind BITs. In short, MNCs wield structural power and are able to influence their home state, and the state in which they want to invest, to sign a BIT. Regime theory and other theoretical approaches excluding MNCs as major actors cannot adequately explain the proliferation of BITs.
CHAPTER 2: HISTORICAL BACKGROUND

INTRODUCTION

Bilateral investment treaties (BITs) are the most prominent feature of the current international regime governing a host state’s treatment of foreign investors. Yet BITs are a relatively recent phenomenon. The treatment of foreign investors by a host state has always been a contentious issue, with foreign investors wanting certain guaranteed protections and host states desiring to treat foreign investors by the standard of their choosing. This issue is particularly contentious between developed states and developing states. Developed states are usually capital exporters and developing states are usually capital importers. Thus, developed states have sought strong investor protections while developing states have argued against them. However, the actual protections allotted to developed state firms investing in a developing state have varied over time. This chapter traces the evolution of the regime from the earliest stages of globalization in the late medieval period to modern times and discerns the effects of various political and economic developments on the investment regime’s composition and function.

The history of international investment and investment protection is divided into five eras covered in separate sections: (1) the late medieval era, (2) the age of exploration, (3) the early capitalist era (19th century – early 20th century), (4) the interwar era, and (5) the post WWII era. Each section covers (1) the basic macroeconomic features of the era and a description of the era’s typical multinational corporations and their foreign investments, (2) an in-depth examination of the foreign investment activities of a prominent multinational corporation from the era and examples of the political challenges it faced, and (3) an explanation of how foreign investments were protected.
during the period. The final section explains the regime’s changes throughout the periods analyzed.

DEFINING FDI AND MNCs

Foreign direct investment (FDI) can be defined as “the process whereby residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country)” (Moosa 2002, 1). Thus, in contemporary times, the most important component of FDI is the control of assets in a host country by a foreign firm. ³ In general, a foreign firm is considered to be in control of a company in a host state if the firm owns at least 10 percent of the voting stock of the company (Cohen 2007; Krugman and Obstfeld 2005; Moosa 2002). ⁴ Foreign ownership of at least 10 percent is thought to be enough to achieve effective control over the company (Krugman and Obstfeld 2005). ⁵ Investment where foreign ownership does not reach the 10 percent threshold is referred to as portfolio investment. ⁶

FDI and MNC are interrelated concepts. A MNC can be defined as a firm “that owns outright, controls, or has direct managerial influence in income-generating, value

³ FDI can occur without any transfer of resources. This can happen when an investment by a foreign firm is completely financed by borrowing from host country financial markets (Moosa 2002)
⁴ This 10% benchmark is used by the US Commerce Department to classify FDI in the United States.
⁵ As of 2001, 55 countries used the 10% ownership threshold as their basic criterion in defining FDI (FDI Statistics 2003).
⁶ According to Cohen (2007) portfolio investment is “when an individual or financial institution (a mutual fund in most cases) buys a relatively small number of shares in a company located in another country because of the expectation that those shares will appreciate in value and can be sold at a profit sometime in the future” (37).
added facilities in at least two countries” (Cohen 2007, 39). Put simply, “firms become multinational […] when they undertake FDI” (Moosa 2002, 7). Toyota, IBM, Shell, GM, and McDonald’s are all prominent examples of MNCs. For instance, Toyota, a MNC based out of Japan, owns and operates ten vehicle manufacturing and assembly plants in the US and as of 2005 had US investments worth almost $14 billion (Cohen 2007, 131).

FOREIGN INVESTMENT, EARLY MNCs, AND PROPERTY RIGHTS IN THE MEDIEVAL ERA

The early medieval European economy was based on the manorial system (Cameron 1997). This system organized society into three groups: clergy, peasants, and lords. Lords controlled land and provided protection and order for peasants, who worked as laborers and farmers for the lords. Economic interactions were centered around self-sustaining villages; little trade or commerce took place.

Scarcity characterized life in this period—limited agricultural techniques and technologies meant that food supplies were tenuous (Cameron 1997). In Europe, upwards of 80 percent of the population was devoted to agriculture in order to feed the wider community (Appleby 2010). Lords regulated the growing, selling, and exporting of grain crops with the goal of maintaining food supplies and, therefore, political and social stability (Appleby 2010). For instance, lords often prevented the export of grains and restricted the amount of grains that could be used for mead (Appleby 2010). Peasants were reluctant to attempt new agricultural techniques and technologies since a

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7 The word ‘multinational’ will be used in place of MNC. Trans National Corporation, Trans National Enterprise, and Multinational Enterprise all refer to the same concept.

8 The clergy worked for the church, which also controlled land.
failed crop could mean starvation for an entire village (Appleby 2010). Consequently, the threat of scarcity and the desire of the landed elites to maintain political stability retarded the development of new farming techniques, technologies and enterprise (Appleby 2010). Agricultural innovations eventually took place in the late medieval era (Appleby 2010; Cameron 1997). Advances in crop rotation, fertilization, and tools dramatically increased agricultural productivity; as a result, a smaller percentage of the population was needed for food production (Appleby 2010; Cameron 1997). Urban life returned to Europe and spawned what historians have termed the ‘commercial revolution’ (Cameron 1997).

The commercial revolution, characterized by commerce and urban life, began in the late 13th century and eroded the manorial system based on self-sustained villages (Cameron 1997). The earliest forerunners to the modern multinational corporation emerged in this context in the form of family-owned trading and financial companies, the largest and most powerful of which were centered in Italian cities.

**Early Multinationals in the Medieval Era**

The large family-owned companies that existed in the 13th and 14th centuries have been dubbed ‘medieval super-companies’ (Hunt 1994). These companies contributed to economic integration in Europe. Prior to the development of super-companies, trade was primarily conducted by individual merchants and limited to luxury goods destined for the courts of wealthy nobles (Cameron 1997). The super-companies became large-scale

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9 Medieval super-companies are defined as “private profit-seeking organization[s] operating several lines of business in very large volume in multiple, widespread locations through a network of permanent branches” (Hunt 1994, 38-39).
commodity traders, international merchants, international bankers, and manufacturers—all of whom were supported by a network of branch offices located in multiple European cities (Hunt 1994).

The Peruzzi Company is a prominent example of a medieval super-company.¹⁰ By 1300, the Company, headquartered in Florence, controlled branches in Naples, Barletta, the Papal Court of Rome, Pisa, Venice, Paris, Cyprus, and Tunis (Hunt 1994). Like the other medieval super-companies, the Peruzzi’s became wealthy by trading commodities, particularly grain. The Peruzzi negotiated with governments for the procurement of large quantities of surplus grain which it would transport and sell advantageously to buyers in need (Hunt 1994).

The Peruzzi Company was successful because of its ability to use capital effectively (Hunt 1994). Initially the Company accumulated capital by selling grain produced from its private land holdings in Italy. Later the Peruzzi acquired capital by selling company stock. The Company used its substantial capital to conduct trade on a scale not possible by individual merchants, resulting in efficiency and profits. And just as importantly, the Peruzzi Company applied its large capital accumulations to finance—the primary way it developed the political connections necessary to conduct international commerce in the medieval era (Hunt 1994).

¹⁰The Bardi and the Acciaiuoli were the two other firms of late medieval era that qualified as ‘super-companies’ (Hunt 1994).
The Politics of Protection in the Late Medieval Era

The medieval super-companies secured economic access to various territories by providing sovereigns with loans. As mentioned above, the medieval era was characterized by a fragmented international economy. Sovereigns erected numerous trade barriers to maintain social stability and the allegiance of important political forces. However, sovereigns also lacked efficient revenue garnering institutions and often found themselves in need of money, a need that was routinely met with loans from the capital-rich super-companies (Hunt 1994).\(^\text{11}\) The super-companies did not make money from these transactions because usury fees were prohibited by the Church; instead, the loans were given by the companies in exchange for economic access to the sovereign’s territory:

[Finance] was vital to the companies because it made possible the political favors that were very much a part of the nature of the business. [...] financial power was essential to enable the companies to negotiate with the governments for a favorable environment for their enterprises. Without that financial power, the great trading operations would have been impossible (Hunt 1994, 65).

For example, the Peruzzi Company received special access to England’s wool industry in exchange for loans given to various kings. Unfortunately, the Peruzzi and the other super-companies who provided loans for England collapsed when King Edward III was unable to service the loans in the 1340s (Hunt 1994).

In sum, even though little international economic activity took place in the late medieval period, the predecessors to the modern MNC, the European medieval super-companies, engaged in international political and economic activity. Notably, the cross-

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\(^{11}\) The loans were often used by kings to fund military operations or to make their required donations (cins) to the papacy (Hunt 1994).
border economic activity conducted by firms such as the Peruzzi would not have been possible without their political efforts. The companies influenced heads of states to secure and protect market access in foreign lands. The political interactions of trading companies and states are even more pronounced in the age of exploration.

**FOREIGN INVESTMENT, EARLY MNCs, AND PROPERTY RIGHTS IN THE AGE OF EXPLORATION**

The age of exploration started in the 15\(^{th}\) century and its adventurers had a common goal: discover nautical passages to the Far East in order to exploit the lucrative spice trade that had until then been dominated by Italian and Muslim traders via land routes (Cameron 1997). Aided by improvements in ship design and navigation, the Portuguese started making their way around Africa in the 15\(^{th}\) century, establishing fortified trading posts along the way, and by 1488 Bartholomew Diaz had rounded the Cape of Good Hope at Africa’s southern tip (Cameron 1997). Christopher Columbus explored the new world in 1492 and Magellan’s ship circumnavigated the world in 1519 (Cameron 1997).

Fifteenth Century exploration turned to colonial conquest in the 16\(^{th}\) century, a phenomenon reinforced by the popularity of mercantilist economic views, which assumed that wealth was gained through maintaining an export surplus in trade relations. Under mercantilism colonies were required to sell their products, usually crops and raw materials, at below market prices to their colonial overlords. Some colonial powers only allowed their subjects to purchase goods from the motherland, thus “ensuring that the
homeland could sell to its subjects at above world market prices” (Frieden 2006, 2). Spain and Portugal dominated early colonial conquest (Appleby 2010; Ogborn 2008; Cameron 1997). Other European powers, such as the English and the Dutch, did not seek colonial expansion for almost another century. But when they did, unlike the colonial trailblazers, private enterprise played a prominent role.

The European colonies that were established in the centuries following the initial exploration offered different roles for private enterprise. Portuguese and Spanish monarchs kept tight control over colonial economies while private, state-chartered trading companies were powerful forces in the Dutch and English empires. Private, state-chartered trading companies of this era were private firms to whom special rights and privileges were given by the state. These proto-MNCs bear little resemblance to modern MNCs. Governments gave state-sponsored entities monopoly trading rights to colonial possessions and at the height of their influence were even responsible for the administration of colonies, as was the case during the mid-19th century for the English East India Company in Southern India and the Dutch East India Company in Indonesia (Cohen 2007; Chaudhuri 1978). Domestic political circumstances influenced the role of private enterprise in Portuguese and Spanish colonies on the one hand and Dutch and English colonies on the other hand.

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12 For instance, sister colonies in the Spanish empire were not even permitted to trade with one another (McCarthy 2006). However, enforcement of this trade relationship was tenuous as merchants from competing countries would often service the territories of other colonial powers, as was the case with English merchants in Spanish-controlled areas of the new world in the 16th Century (McCarthy 2006).

13 Each country’s sphere of influence was codified in the Treaty of Tordesillas in 1494: Spain dominated most of the new world and Portugal controlled the orient and a slice of coastal South America, what is now a part of Brazil (Ogborn 2008).
Two Iberian social structures left-over from the medieval era impeded the proliferation of private trading companies in Spain and Portugal: (1) Spanish and Portuguese nobilities looked down upon merchants, whom they considered to belong to lower classes, and (2) the absolute monarchies of 16th century Portugal and Spain (Appleby 2010). With their nobles agnostic on the subject, the Iberian monarchies were able to use their powerful positions to implement crown monopolies on colonial trade (McCarthy 2006). The goal of these monopolies stemmed from the mercantilist economic view that dominated the period—monarchs saw colonial trade as a way to garner revenues, primarily in bullion, that were used to enrich the crown and finance war-making and other state activities (Frieden 2006; McCarthy 2006; Gabel and Bruner 2003).

The political circumstances of Dutch and English colonial expansion were different from those of the Spanish and Portuguese. Private Dutch trading companies managed most intra-European trade in the 15th century and the Dutch government was much weaker than the absolute monarchs of the Iberian Peninsula (Cameron 1997). Consequently, the companies had clout in Dutch politics and after a few successful eastern voyages, the Dutch Republic granted several private trading companies a charter to form the Dutch East India Company, which came with monopoly trading rights to that region (Cameron 1997).

Private enterprise also played an important role in English politics. Queen Elizabeth came to the throne in 1558, but her hold on power was tenuous and her decisions regarding private enterprise must be viewed in this light: “Elizabeth’s primary concern was not with building an overseas empire, but with securing her position as
queen and ensuring the security of her realm within the power struggles of western Europe” (Ogborn 2008, 19). Elizabeth did not have the resources to wage wars against looming European threats, such as the Spanish, or to pursue trade and colonial opportunities. Therefore, she worked outside the confines of the state to accomplish both goals.14

Queen Elizabeth pursued trade and colonization through private means as a way of achieving short-term profits for the crown, since she lacked the resources to independently engage in these activities (Ogborn 2008). She granted royal charters with monopolistic privileges to dozens of joint-stock companies in the latter half of the 16th century culminating with perhaps the most prominent of English trading companies, the English East India Company, in 1600 (Ogborn 2008; Cameron 1997). However, monopolistic privileges did not insulate the Company from political challenges, of which it faced many, both at home and abroad.

**Early Multinationals in the Age of Exploration: The English East India Company**

The English East India Company first acquired territory in India in 1639 when political authorities of the Hindu Vianayar Empire granted the company trading rights over the small village of Channapatnam on the southeast coast (Ogborn 2008).15 The English built Fort St. George close to the village and traded bullion for Indian cotton,

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14 Elizabeth used private merchants for war-making activities. The Queen only controlled around 25 ships, which were primarily used to defend the English coast (Ogborn 2008). She licensed privateers, “private vessels authorized by the crown to fight and capture enemy shipping for a share of the value of those ships and their cargoes,” to wage a sea war with Spain in the late 16th century (Ogborn 2008, 23).

15 Specifically, the Raja of Chandragiri granted the Company trade access to India (Ogborn 2008).
silks, and spices (Ogborn 2008).\(^{16}\) St. George was just one of several European forts along the Indian coast as the Portuguese, Dutch, and French had already established coastal trading posts in the region. Initially, the presence of European traders meant little to the native political elites which “judged the Europeans to be an insignificant presence, just one more set of merchants with whom it might be useful to deal but who were not a major force in shaping their worlds” (Ogborn 2008, 79).

Access to the Indian market came amid a shifting political backdrop. In the 1650s the Hindu Vijanayar Empire fell to the Muslim kingdom of Golconda (Ogborn 2008). The Golconda authorities forced new conditions on the Company such as increased taxes and regulations and even blockaded Fort St. George and the surrounding town to force capitulation to the new measures (Ogborn 2008).

The balance of power between the English East India Company and native political authorities began to change in the latter years of the 17\(^{th}\) century and by the mid-18\(^{th}\) century the Company had completed its transition from merchants to masters (Ogborn 2008). The Mughal Empire wrestled power from the Golconda in 1680, but the new empire’s control of the region was fragile and the political footprint of the Company expanded as the Mughal’s political control waned (Ogborn 2008).\(^ {17}\) The English East India Company increased its economic access to the region through military actions and political negotiations and by 1765 it was effectively the ruler of twenty million people (Ogborn 2008). However, fighting for control in India was only half of the Company’s battles.

\(^{16}\) Fort St. George spawned a town around it that became known as Madras (Ogborn 2008).

\(^{17}\) The Company’s settlement in Calcutta grew to perhaps a hundred thousand residents by the mid-1700s and it began to challenge the power of the fragmented local rulers (Ogborn 2008).
Back in England, the Company continually fought for its privileged position. The Company’s initial charter in 1600 only allowed it to receive capital for one voyage at a time; it was only allowed to seek capital on a permanent basis, that is, to become a joint stock company, when a new charter was granted to it by parliament in 1657 (McCarthy 2006). The Company’s charter renewal process was uncertain, irregular, and a privilege it had to fight for in parliament against multiple political factions.\textsuperscript{18} Independent merchants were one group that opposed the Company’s privileged position in India (McCarther 2006; Alborn 1998). The merchants wanted unrestricted access to Indian trade, which the Company denied.

The second group opposing the Company consisted of Whig politicians, who argued against the Company’s role as the primary political authority in India (Alborn 1998). Interestingly, the parliamentary debate at the time did not question whether or not the British should control India—a consensus existed regarding the benefits that India could receive from British administration (Alborn 1998). Rather, the debate centered on whether India’s administration should be via a parliament-appointed minister or through the Company (Alborn 1998). Prominent Whigs such as Adam Smith sided for state control, arguing that a company could not successfully be both a merchant and a government, while the Company sought to maintain its political influence in India (Alborn 1998). The actual policy oscillated over time with the Company in control of India from 1766-1773, then eighty-four years of a combination of authority, and ending in 1857 with control by a parliament-appointed minister (Alborn 1998).

\textsuperscript{18} The English East India Company was finally given a stable charter in 1773 (McCarthy 2006).
The Politics of Investment Protection in the Age of Exploration

A well-defined body of international law governing investment protection outside of Europe did not exist in the 16th and 17th centuries. Access to products such as silks and spices was the motivation of European activity in East Asia. Asians generally traded freely with the Europeans and viewed their Western counterparts as useful economic partners. The plantations and mines, such as those controlled by the Spanish in Latin America and later those in India, were established under colonial rule. These resources were protected primarily by military force.

In sum, European states sought economic opportunities through colonial expansion. The state charted trading companies of the period reaped the benefits. The companies were intimately involved in the politics of the colonies in which they invested, and as was the case for the English East India Company in particular, the companies were also important political forces in their home states.

FDI, MNCs, AND PROPERTY RIGHTS IN THE 19TH AND EARLY 20TH CENTURIES

The modern MNC began to take shape in the 19th century and coincided with the development of the first ever truly global economy. Three main factors set the stage for these advances: (1) the guidance of British hegemony, in particular their support for free trade and establishment of the gold standard and property rights for foreign investors, (2) the technological advances related to the industrial revolution, and (3) changes in corporate governance and firm organization. Foreign investments proliferated in light of these political, economic, and technological changes, and investments were made without
special monopoly rights from home states for the first time at the beginning of the 19th century.

British industrialists, encouraged by their productivity advantages from new machine technology, supported moves to open Britain to free trade. Under free trade, production inputs were less expensive and provided British goods access to foreign markets when reciprocated, which most European countries and former colonies did (Frieden 2006). Mercantilism faded in the 1860s as France and Britain signed a free trade agreement and most of Europe followed suit, although to a lesser extent (Frieden 2006).

The British also maintained the gold standard, which greatly reduced risks associated with foreign exchange and consequently foreign investments. Under this system countries agreed to make their currencies convertible into gold at pre-established, fixed rates (Frieden 2006). Businessmen and firms could invest across borders without worrying about major fluctuations in prices, and profits could be repatriated in equivalent amounts of gold-backed money (Frieden 2006). Germany, Scandinavia, the Netherlands, Belgium, France, Switzerland and the United States were all on the gold standard by 1879 and capital moved relatively freely among these countries (Frieden 2006). Most importantly, for MNCs looking to invest in less developed countries (LDCs) with weak property rights regimes, British hegemony contributed to the development and enforcement of international standards for the treatment of foreign-owned property, which led to increased MNC activity in LDCs (Lipson 1985).

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19 As a result, world trade grew around 3.5 percent per year from 1820 to the end of the century. The movement of labor was relatively unimpeded by political barriers during this era. Over 60 million people emigrated from Europe to the Americas and millions emigrated from China to Southeast Asia and the United States.
The industrial revolution contributed to the establishment of a global economy by increasing both demand for energy and raw materials in industrialized and industrializing states and the need for additional markets for manufactured goods. Technological innovations later in the century in the areas of transportation (steamships and railroads) and communications (telegraphs) made the movement of goods and people more efficient. These factors prompted MNCs to invest abroad by making investments feasible and potentially profitable.

The characteristics of MNCs changed throughout the 19th century. Early firms were small, specialized in one specific unit of production or distribution, and managers of these firms were also owners. Changes in corporate governance in European countries allowed for ownership by tradable shares. This resulted in the separation of ownership from management, which limited liability and facilitated the raising of capital (Jones 2005a; Chandler 1990 and 1977). Corporate legal developments, along with technological innovations in manufacturing techniques, transportation, and communication, allowed corporations to become very large and to gain efficiency by performing many value-added steps within the firm (Chandler 1990 and 1977).

FDI increased dramatically in developed states starting around 1870. The United States and most of Europe, aside from Britain, began to increase tariff levels during this period in response to the dramatic drop in world commodity prices instigated by cheap imports and entrenched through ridged exchange rates tied to a limited supply of gold.21

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20 Most trade was intra-west. LDCs did not have the resources to purchase manufactured products on a large scale (Cameron 1997).

21 According to Frieden (2006): “From 1873 until 1896 prices dropped by 22 percent in the United Kingdom, 32 percent in the United States, more elsewhere” (8). However, new gold discoveries in the late 1880s decreased the value of gold and consequently increased the value of commodities: “since gold was
Firms responded by servicing developed economies directly through FDI rather than facing the decreased competitiveness their exports would suffer from higher tariffs, a process facilitated by an almost universal acceptance of the gold standard and few currency controls (Cohen 2007; Frieden 2006; Jones 2005). A prominent example of an early MNC that thrived in the era of rising tariffs is Singer Sewing Machines.22

FDI to developing countries also increased substantially in this period. FDI in developing countries was geared toward natural resources, infrastructure, and banking services (Gabel and Bruner 2003). An example of British infrastructure investment in Latin America is provided in the next section.

The total stock of world FDI on the eve of WWI is uncertain.23 Records did not distinguish between portfolio investment and FDI (Dunning 1983).24 According to various estimates, Great Britain led the world in outward FDI accounting for about 45 percent of the total stock (UNCTAD 2003; Dunning 1983). The United States and Germany each accounted for about 14 percent, France for 11 percent, the Netherlands for 5 percent and the rest of the world for the remaining 11 percent (UNCTAD 2003; Dunning 1983). The leading recipients of FDI by region were Latin America and Asia.

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22 Singer’s Scottish factory, opened in 1867, is considered to be the first sustained manufacturing investment by a MNC from the United States (Davies 1976). By the turn of the century, Singer had opened factories in Canada, Austria, Germany, and Russia (Davies 1976). Singer’s strategy of manufacturing in target markets allowed it to avoid tariffs and by 1914 Singer accounted for 90 percent of all sewing machines sold world-wide (Davies 1976).

23 Dunning (1983) estimates the total stock of FDI in 1913 at about 14.5 billion.

24 The majority of foreign investments in the early to mid-1800s were primarily portfolio investments in foreign government bonds and large infrastructure projects in the US, South America, Europe, and Russia (Gabel & Bruner 200; Corley 1998). Manufacturing, usually intra-west investment, and resource-seeking FDI, which included investments in the global south, became a major component of the latter in the 19th Century.
while the United States and Canada were the largest individual host countries (Jones 2005; Dunning 1983). Around half of all FDI by 1913 was in the natural resource sector (Jones 2005). FDI in services accounted for another third, primarily in financing, insuring and transporting commodities, and foodstuffs (Jones 2005a). FDI in manufacturing comprised the remaining one-sixth and primarily occurred in the industrialized economies of North America and Europe (Jones 2005a). In total, FDI from the world’s 3000 MNCs accounted for around 9 percent of world economic output at the onset of WWI (Gabel and Bruner 2003).

**Multinationals in the 19th and Early 20th Centuries: British Infrastructure in Latin America**

The British dominated foreign investment in the late 19th and early 20th centuries. By 1914, over 40 percent of global foreign investment originated in Great Britain (Wilkins 1998). Corley (1998) estimates that the British controlled $18 to $20 billion dollars of foreign investment by WWI, of which $8.2 billion came from FDI.25

Infrastructure projects were a major area of pre-WWI British FDI. Railway investments alone accounted for around 46 percent of British FDI in Latin America, primarily in Argentina (Lewis 1977). Proponents of an ‘economic imperialism’

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25 Free-standing companies contributed the lion’s share of British FDI in this period (Corley 1998). Free-standing companies are “firm[s] set up in one country for the purpose of doing business outside that country” (Wilkins 1998, 3). In other words, free-standing companies were developed specifically to service an overseas market; they were not extensions of a pre-existing domestic operation in the firm’s home state (Wilkins 1998). Some of the most influential free-standing British companies were banks (Wilkins 1998). On the eve of WWI 28 British free-standing banks controlled 1,286 foreign branches and the nine largest banks had assets ranging from 19 million to nearly 40 million (Jones 1998, 344-345). The free-standing banks had branches throughout the developing world including Australasia, southern Africa, and Latin America and financed a substantial portion of trade to those regions, making them politically important entities (Jones 1998).
perspective suggest that foreign companies dominated local politics in this period (Weaver 2000). A more detailed examination of the historical record, however, shows a more nuanced and balanced relationship between, for example, the Argentinian government and British railway companies.

British railway companies began investing in Argentina in the mid-19th century and the investment was advantageous for both parties (Lewis 1977). The Argentinian government wanted to modernize its economy by establishing a rail system; however, it did not have the expertise, capital, or technology to accomplish this goal (Platt 1977; Lewis 1977). British companies provided these resources for the Argentinians.

The British rail companies initially received generous investment terms from the Argentinian authorities. The government signed concession agreements with the railways to entice investment. Prominent among the deal-sweeteners was that agreements usually guaranteed the companies a return of at least 7 percent on capital investments; that is, the government agreed to supply the balance in instances when returns dipped below the 7 percent mark (Lewis 1977).

The companies established political connections in order to ensure the favorable treatment they were initially promised. The British companies realized that political winds could rapidly change and the Argentinian government could be pressured by domestic groups to renege on their previous commitments. The railways retained many prominent Argentinian lawyers and forged alliances with political elites to counter these pressures. For instance, David Robertson, the director of the Buenos Ayres Great Southern Railway Company, became close friends with Norberto de la Riestra, the
Minister of Finance, and Anglo-Argentine Railways retained legal officers that also held high political offices (Lewis 1977).

Despite the political hedging of the British rail companies, the concession agreements were altered by the government when the Argentinian economy faltered and popular opinion turned against the foreign companies: “despite an appearance of strength, and the vital position occupied by the foreign companies in the Argentine economy, there was little that the railways could do when Argentine opinion favoured a specific course, no matter how inimical to the interests of the foreign-owned railways” (Lewis 1977, 405). The state ended the guarantee system in the 1890s, gave preference to state-owned lines, and made remittances difficult for foreign firms (Lewis 1977).

However, while the Argentinian government did unilaterally alter concession agreements, it did not make use of a state’s ultimate weapon against foreign-owned companies—expropriation. And when a host state did expropriate foreign-owned property, the injured alien received full compensation from the host state—a principle of international investment law that was firmly established in this period.

**The Politics of Investment Protection in the 19th and Early 20th Centuries**

The origins of modern international investment law can be traced back to the late 19th and early 20th centuries when Europeans sought international legal standards to protect their foreign investments (Van Harten 2008, Jones 2005a). International investment law has long recognized a host state’s sovereign right to expropriate private property, even property belonging to a foreign national, and to control the entry of FDI into its territory (Sornarajah 2010; Slomanson 1995; Dolzer and Stevens 1995).
However, the international community never reached a multilateral agreement outlining the terms and conditions by which foreign investors from one state should be treated in another state. Developed states sought strong protections for their foreign investments. Developing states argued for the freedom to treat foreign nationals under the policy apparatus of their choosing and against a concrete international standard applicable to all states. The legal standard championed by developed states became known as the international minimum standard for the treatment of foreign investment, or the ‘minimum standard’ for short.

The minimum standard required host states to provide foreign investors a certain standard of treatment and protections once the foreign investor was permitted into the host state’s territory. The minimum standard emerged from customary international law and general legal principles. 26 Vattel, an 18th century legal philosopher, provided the intellectual foundation for two key principles of the West’s view of international investment law and the minimum standard: (1) full compensation for injuries to foreign investors and (2) diplomatic interposition is justified if a foreign investor is wrongfully injured and then denied justice. 27

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26 Article 38 of the Statute of the Permanent Court of International Justice establishes treaties, customary international law, and general principles as the three primary sources of international law. Customary international law is defined as “a continuous practice of States in their international relations, accepted by many nations” (Slomanson 1995, 12). General principles are common legal standards regarding the internal jurisprudence of states (Slomanson 1995).

27 The philosophical underpinnings of the Western view of the minimum standard of treatment were established by Vattel in the 18th century (Borchard 1915; Dunn 1932). Vattel argued the following: “‘an individual who was wronged in a strange land and who had there been unable to obtain reparation for this injury from the local sovereign might, with the permission of his own prince, initiate forceful measures to obtain that justice which has been refused him’” (Lillich 1983, 2). Not only did Vattel argue that states must provide foreign investors with access to justice, Vattel also claimed the investor’s home state had a right to intervene in the host state in order to protect the rights of the investor, a process called diplomatic interposition. Vattel justified this claim by arguing that a host state is indirectly harming a home state if the former allows the citizens of the latter to be mistreated (Dunn 1932). Vattel also claimed that the home state should require the host state to make full reparation to an injured foreign investor (Dunn 1932).
The politics of protection: full compensation for expropriation.

Expropriation, also referred to as nationalization or confiscation, is the taking of private property by the state. Wide agreement exists concerning a host state’s right to expropriate foreign-owned property, a right that stems from state sovereignty, and most agreed that the taking had to be for a public purpose; however, the correct level of compensation to be given to foreign investors by host states for the expropriation has been a contended issue (Sornarajah 2010; Slomanson 1995; Dolzer and Stevens 1995). Western, capital-exporting states argued that the minimum standard of treatment includes the notion of full compensation for expropriation: “there appeared to be a consensus among the principal nations of the world—those whose nationals were trading with and investing in the less developed countries or European colonies—that the taking of an alien’s property required a state to pay prompt and adequate compensation” (Steiner and Vagts 1968, 314).

Various tribunals of the period backed the West’s view concerning compensation levels for expropriated foreign-owned property. In a study of sixty international claims tribunals between 1840 and 1940 covering issues related to injuries to aliens and host state responsibility, the majority of cases related to expropriation issues, Norton (1991) found no cases where a tribunal decided that the appropriate amount of compensation

Specifically, Vattel stated that in situations where a host state allowed or caused a foreign investor to be injured, the investor’s home state “should avenge his wrongs, punish the aggressor, and if possible, oblige him to make full reparation; since otherwise the citizen would not obtain the great end of civil association, which is, safety” (Borchard 1915, 351).
was less than the full value of the expropriated property and many actually affirmed the requirement of full compensation.

**The politics of protection: diplomatic interposition.** The minimum standard of treatment required by host states remained a vague concept throughout the 19th century and into the 20th century (Borchard 1915; Vandeveld 2009). Western scholars during this period focused less on identifying specific mistreatments of foreign investors and more on the broad standards that must be met for a home state to evoke diplomatic interposition, the process by which an injured foreign investor’s home state intervenes on the investor’s behalf. Indeed, Eagleton (1970) stated, “this international standard is, in effect, a sort of international due process of law” (557).28 The most prominent reasons for diplomatic interposition in this period were the absence of due diligence and the denial of justice by the host state (Eagleton 1970; Dunn 1932; Eagleton 1928; Borchard 1915).29

The minimum standard required host states to maintain a “certain degree of diligence in preventing injuries to aliens” (Eagleton 1970, 538). In other words, the host state was required to maintain the basic conditions necessary for successful economic interaction to take place. Western scholars also argued that the minimum standard required host states to provide foreign investors access to justice; that is, host states had to “provide for the injured alien a means of obtaining ‘justice’ in the local courts” when

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28 Borchard (1915), however, provided a few examples: the minimum standard “prevents the territorial courts from declining to take jurisdiction of litigation between aliens, or the confiscation of the property of an alien who by war has become an alien enemy, or the forbidding of the alien’s right of succession to property” (39).

29 The Permanent court of International Justice ruled that diplomatic interposition was “‘an elementary principle of international law’” in the *Mavrommatis Palestine Concessions Case* (Lillich 1983, 5).
the alien claimed that it had been injured by a citizen of the host state or through some action of the host state itself (Dunn 1932, 146). To be specific, a denial of justice occurred when a host state failed to take the necessary steps to repair an injury to an alien, not necessarily in cases where an injury occurred. In some cases, home states claimed a violation of the international minimum standard when they believed the courts of the host state came to an unjust decision (Eagleton 1928). If an injured alien had pursued all avenues available through the local judicial system and still contended that justice had been denied, diplomatic interposition could be evoked (Dunn 1932; Eagleton 1928; Borchard 1915).

In instances where a foreign investor was denied justice during this period, the home state government could legally intervene and pursue a variety of methods to achieve reparation for the injured investor; however, the degree of interposition was in part determined by the relationship between the two states. (Borchard 1915). The minimum standard justified less amicable methods in instances where a developed, Western state was evoking diplomatic protection against a ‘backwards’, non-Western state. Borchard (1915) claimed “the weaker the control of the police, or the local safeguards for the protection of foreigners and the proper administration of justice, the greater and more rigorous becomes the diplomatic protection exerted by foreign governments”; consequently, “the majority of Latin American countries are held by various countries of Europe to a higher degree of responsibility for injuries inflicted upon aliens than are countries like the United States and Canada” (406).

Diplomatic interpositions between Western and non-Western states usually began with informal or formal diplomatic negotiations (Borchard 1915). If a settlement could
not be reached the states could move to mediation or arbitration (Borchard 1915). In cases where the host states refused mediation or arbitration less amicable methods could then be used by the home state such as retorsion, display of force, use of armed forces, reprisals, and even war (Borchard 1915).

A prominent example of a ‘less amicable’ diplomatic interposition occurred in 1902-1903 in Venezuela. President Cipriano Castro of Venezuela refused to pay debts owed to Europeans of various nationalities. In response, British, German, and Italian warships, the home states of the injured aliens, blockaded and shelled several Venezuelan ports (Hood 1983). Castro eventually allowed the claims of the injured aliens to be submitted to arbitration (Hood 1983). Other notable military interventions conducted under the principle of diplomatic interposition were those conducted by France in Mexico in 1838 and again in 1861 and the United States in Santo Domingo in 1904 and in Haiti in 1915 (Dunn 1932). The British alone intervened militarily in Latin America twenty-six times between 1820 and 1914 to protect the property and investments of British nationals (Platt 1968).

The view from LDCs: The Calvo Doctrine. Not all legal experts subscribed to the West’s version of the minimum standard. Argentine jurist and diplomat Carlos Calvo (1822-1906) penned what came to be known as the Calvo Doctrine in 1868 (Holden and

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30 According to Borchard (1915), “the principal difference between mediation and arbitration […] consists in the fact that the former is an advisory function and recommends, whereas the latter is a judicial function and decides” (442).

31 Retorsions are ‘retaliations in kind’ such as withholding duties (Borchard 1915)

32 A display of force during this period was often achieved through bringing a warship to the port of the home country (Borchard 1915)

33 Reprisals included seizing the property of host state government (Borchard 1915)
Calvo’s two main points ran counter to the West’s version of the minimum standard: 1) host states have no obligation to provide a higher standard of treatment to foreigners than they do to their own nationals and 2) home states have no right to diplomatic interposition on behalf of their citizens investing abroad (Dolzer & Schreuer 2008; Holden & Zolov 2000; Asante 1988; Dunn 1932).

Calvo argued that because all states are sovereign and equal, and because states are allotted economic freedom in international law, foreign investors were obligated the same treatment as native citizens, but nothing beyond equal treatment (Asante 1988; Dunn 1932). Thus, the Calvo Doctrine argued for the equality of treatment between aliens and natives, as opposed to special treatment for foreign investors. Foreign investors had no right to evoke diplomatic interposition because they were seen as having the same standing as native citizens. The grievances of foreign investors could only be voiced in the domestic courts of the host state, the same as any native citizen and, given this view on diplomatic interposition, the Calvo Doctrine strongly rejected the use of military force by a home state over the treatment of foreign investors.

Calvo Doctrine adherents also challenged the minimum standard over the levels of compensation required for the expropriation of foreign owned property on the same grounds: because only equal treatment is required by international law, the expropriated property of foreign investors is entitled to the level of compensation given to native citizens of the host state (Metzger 1964). However, developed states never accepted the
Calvo Doctrine as part of international law—the developing states promoting the doctrine did not have the military capabilities to enforce it.34

**Enforcement of the minimum standard.** Ultimately, the actual standard of treatment required by host states to provide foreign investors in the pre-BIT era was not decided by either international tribunals or debates among legal scholars. Instead, the potency of the minimum standard was due to British hegemony and to American dominance in the Western Hemisphere after 1900 (Lipson 1985).35 Great Britain and the United States possessed the military capabilities to enforce the West’s version of the minimum standard. Aiding the enforcement of investment protections in developing states was the nature of the investments themselves: most FDI in developing states was in oligopolistic natural resource industries that had the ability to effectively sanction developing states that violated international investment law (Jones 2005a; Lipson 1985).

The international minimum standard for the protection of foreign investments was broad and effective in the late 19th and early 20th centuries. Host states were

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34 Calvo adherents in less developed states attempted to implement this doctrine through the use of the ‘Calvo Clause’ and embraced the Drago Doctrine as an explicit statement against foreign intervention (Holden & Zolov 2000). The Calvo Clause was a binding legal commitment inserted into contracts with private foreign investors stipulating that investors give up their right to diplomatic interposition, limiting their options to domestic legal remedies in cases of injury (Holden & Zolov 2000; Friedman 1964). The Drago Doctrine was established by the foreign minister of Argentina, Luis M. Drago (1859-1921), in a letter to President Theodore Roosevelt stating Argentina’s position regarding the decision by the British, Germans, and Italians to bombard a Venezuelan port mentioned above (Holden & Zolov 2000). Drago argued: “The acknowledgement of the debt, the payment of it in its entirety, can and must be made by the nation without diminution of its inherent rights as a sovereign entity, but the summary and immediate collection at a given moment, by means of force, would occasion nothing less than the ruin of the weakest nations, and the absorption of their government, together with all the functions inherent in them, by the mighty of the earth” (Holden & Zolov 2000, 89) In essence, the Drago Doctrine renounced the use of force to collect debts owed by a less developed state to a foreign national (Friedman 1964).

35 President Theodore Roosevelt’s 1904 corollary to the Monroe Doctrine prohibited military intervention by European states for debt collection in Latin America (Holden & Zolov 2000). In 1933 President Franklin Delano Roosevelt’s Good Neighbor Policy renounced US intervention in Latin America (Holden & Zolov 2000).
responsible for providing all foreign investors access to justice, ‘due diligence’ to provide an environment for productive economic intercourse, and full compensation in cases of expropriation; and in cases where this standard was not met, the home state of the investor was justified by international law to pursue diplomatic interposition, which included military intervention in cases involving less developed host states. Even legal expropriations, those accompanied by full compensation for the expropriated property to the foreign investor, were rare: “before WWI, there simply were no large-scale takings of foreign property” (Lipson 1985, 19).

In sum, during the 19th and early 20th centuries developed, capital exporting states were able to secure a strong minimum standard of treatment for their investors, especially for investors in developing states. Also notable during this period was the ability of developed state multinationals to bargain with and manipulate the policy decisions of developing countries to their advantage, as was the case with British rail investments in Argentina.

FDI, MNCs, AND PROPERTY RIGHTS IN THE INTERWAR ERA

WWI brought major changes to the world economy that shaped FDI and the location of MNC activity.36 Germany, once a major creditor country, limped out of WWI a major debtor, while the United States emerged as the world’s largest creditor (Jones 2005a). The xenophobic dictatorships that emerged in Japan and post-war Germany and Italy placed restrictions on foreign-owned companies (Jones 2005a). The Russian

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36 A global backlash against economic integration occurred in the interwar period, the origins of which date back to the waning years of the 19th century. Countries such as the US and Australia began to limit immigration in the late 1800s and most countries began to increase tariffs during this period; in fact, by the onset of WWI only Britain, the Netherlands, and Denmark remained free-trading countries (Jones 2005a).
Revolution in 1917 led to the expropriation of all foreign investments in that country. Remarkably, trade and investment levels would bounce-back almost to their pre-war levels by the end of the 1920s; however, the Great Depression would bring about longer lasting structural changes to the world economy.

The Great Depression led to classic ‘beggar thy neighbor’ policies “in a futile effort to protect jobs at home and export unemployment” (Cohen 2007, 46). The Smoot-Hawley Act of 1930 substantially increased tariff levels in the United States, which were already on the uptick. Other countries responded in kind and world trade plummeted. The Great Depression also led to the collapse of the international financial system. Large amounts of portfolio lending from the United States was repatriated from Europe leading to a major financial crisis in Germany and other Central European states in 1931 (Frieden 2006; Jones 2005a). Shortly after, both the British and the Americans abandoned the gold standard, which had shackled government responses to the financial crisis by preventing monetary stimulation.

The collapse of the international financial system brought about regional currency blocs, each with its own extensive exchange controls which impacted the location of foreign investments (Kenwood and Lougheed 1992). The dollar area included the United States and Latin America, the Sterling bloc included the British Empire and some North European countries, the German bloc included most of central Europe, the Yen bloc included parts of Asia, and the Gold bloc included France and other Western European

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37 President Herbert Hoover signed the act in the face of academic opposition. 1,028 American economists signed a petition opposing the act (Frieden 2006).

38 Printing money while on the gold standard would lead to further investor sell-offs and a self-fulfilling financial panic (Frieden 2006). The Federal Reserve actually raised interest rates from 1.5 percent to 3.5 percent in 1931 to discourage investors from fleeing the dollar, doing so had the perverse effect of further tightening monetary policy during the depression (Frieden 2006).
states. While overall foreign investment was substantially lower during the Great Depression, resource-seeking foreign investment did proliferate during this period, but it was limited to intra-bloc investment. For instance, resource seeking foreign investment by MNCs based in the United States went primarily to Latin America (Kenwood & Lougheed 1992). Intra-west foreign investments dried-up substantially as countries moved to industrial development programs that included high tariff levels and the exclusion or severe restriction of foreign companies (Frieden 2006).

**Multinationals in the Interwar Era: The United Fruit Company**

A prominent, and controversial, example of an intra-bloc investor in the interwar period is the United Fruit Company. This American multinational developed an economic empire around a single fruit—the banana. In the late 1880s most Americans had never seen a banana (Bucheli 2005). But by the 1930s bananas were cheap, available year round at grocery stores across the country, and were a standard breakfast and lunch item for many Americans (Bucheli 2005; May and Plaza 1958). The United Fruit Company made the mass consumption of bananas possible through its integrated system of production and distribution (Bucheli 2005; May and Plaza 1958).

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39 By 1914 United Fruit owned or leased over 850,000 acres of land in Jamaica, Cuba, Costa Rica, Columbia, and Nicaragua for growing bananas, oranges, coconuts, rubber trees, sugarcane, cacao, and cattle (Jones 2005a). United Fruit was a vertically integrated operation at the time; it owned the plantations and shipped the fruit by company-owned railroads and vessels (Jones 2005a). The size of United Fruit allowed it to negotiate favorable agreements with host governments, including a 1900 agreement with Costa Rica to increase banana consumption in exchange for a ten year export tax exemption (Jones 2005a).

40 In the 1890s bananas were a luxury fruit provided by high-end hotels and restaurants (Bucheli 2005).

41 Standard Fruit also contributed to this phenomenon but to a lesser extent than United Fruit (Bucheli 2005).
Fruit’s activities in Columbia illustrate the general political and economic challenges faced by it and other multinationals of the period.

The Company’s initial Columbian investments were in the 1890s when it purchased land in that country’s Magdalena region (Bucheli 2005). Like its investments in other Latin American countries, the company did not just own plantations in Columbia. United Fruit developed a highly integrated and efficient vertical production system, a necessity given the highly perishable nature of bananas (Bucheli 2005; May and Plaza 1958). It built railroads, developed its own shipping fleet, established a subsidiary (the Fruit Dispatch Company) to distribute bananas in the US, and even created the Tropical Radio and Telegraph Company to provide reliable communication between ships and plantations (Bucheli 2005). The company’s economic and social footprint in Latin America grew rapidly in the initial decades of the 20th century. Political entanglements were a natural part of this process.

As was the case in other Latin American countries, Columbia’s conservative ruling party welcomed the initial investment from United Fruit (Bucheli 2005; May and Plaza 1958). The conservatives emerged victorious from Columbia’s civil war dubbed, ‘War of the Thousand Days,’ which spanned from 1899-1902 (Bucheli 2005). Rafael Reyes was the country’s president. His administration pursued business friendly strategies to attract multinationals and develop export industries (Bucheli 2005). Under the conservative leadership, Columbia granted United Fruit and other fruit companies
generous concession agreements to induce investment, including a controversial twenty year tax exemption (Bucheli 2005).\footnote{It should be noted that the Company voluntarily began paying taxes to Latin American countries in 1914, even if a tax exemption was in effect (May and Plaza 1958). The US established an income tax in 1914, but “the income of U.S. companies from operations abroad was made subject to income tax here with a credit for income taxes paid abroad” (May and Plaza 1958, 20). Consequently, when Latin American countries started their own income tax programs, United Fruit volunteered to pay taxes in various host states, which it could write-off domestically, to gain local political favor (May and Plaza 1985).}

The pro-business policies of the conservative government engendered political problems for the Company. Local officials in Magdalena lamented their inability to tax United Fruit, and labor leaders bemoaned the conservative government’s laissez-faire stance on the rights of workers in the banana industry (Bucheli 2005). However, the political scales hit their tipping point in 1928 when the government ordered a harsh crack-down on banana-worker protests in Magdalena in which multiple workers were killed (Bucheli 2005). The Liberal party used the ‘Magdalena Massacre’ to take control of government in that year’s election (Bucheli 2005).

The Liberal party made policy changes concerning the privileged treatment of multinationals, but the changes were hardly extreme. It initiated a three cent export tax on bananas, but actually extended United Fruit’s rail concession that was set to expire, thanks in part to a one million dollar loan that the Company provided the government (Bucheli 2005). The pro-business policies of the past began to erode further when Alfonso Lopez Pumarejo was elected president in 1934.\footnote{For instance, some minor changes in property rights laws were made under Pumarejo (Bucheli 2005).}

The Company began to question its future in Columbia and when a disease started spreading through Columbian banana plantations the Company initially refused to participate in a government plan to stop the disease, questioning the utility of further
investments under Columbia’s new foreign business environment (Bucheli 2005). However, the American ambassador mediated the dispute and both sides came to an agreement (Bucheli 2005). Notably, the liberal Columbian government never took any steps in this period that questioned the property rights of United Fruit.

**The Politics of Protection in the Interwar Period**

The composition of the minimum standard of treatment remained an intensely debated issue between developed and developing states in the interwar era. The appropriate level of compensation for expropriation, in particular, remained a hotly contested topic.

Perhaps the most famous dialogue on the issue of compensation for expropriation occurred between Mexico and the United States in 1938. The Mexican Constitution of 1917 was designed with land reform in mind and explicitly stated that the state itself owned the land within its territory, implying that compensation is not needed for the expropriation of property (Lipson 1985). This laid the foundation for years of expropriations of foreign owned agriculture and oil properties, to which the United States objected when conducted without full compensation to its injured nationals (Lipson 1985). Secretary of State Cordell Hull exchanged a series of letters with Mexican authorities explaining the position of the United States concerning state responsibilities for the expropriation of foreign-owned property. Hull argued that a general principal of international law existed which required states to make full compensation for expropriation in the following excerpt from a letter to the Mexicans:
The Government of the United States merely adverts to a self-evident fact when it notes that the applicable precedents and recognized authorities on international law support its declaration that, under every rule of law and equity, no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefore. In addition, clauses appearing in the constitutions of almost all nations today, and in particular in the constitutions of the American republics, embody the principle of just compensation. These, in themselves, are declaratory of the like principle in the law of nations… (Emphasis Added) (Quoted in Slomanson 1995, 19).

The phrase ‘prompt, adequate, and effective’ is now known as the Hull formula for compensation. In addition, Hull also rejected Mexico’s claim that expropriation without compensation was justified if carried out equally to foreigners and domestic citizens alike (Borchard 1940). Mexican officials disagreed with Hull on both accounts.

When responding to Secretary Hull’s call for ‘prompt, adequate, and effective’ compensation for the expropriation of US owned property in Mexico, Mexico’s foreign affairs minister claimed, “‘there does not exist in international law any principle universally accepted by countries, nor by the writers of treaties on this subject, that would render obligatory the giving adequate compensation for expropriations of a general and impersonal character’” (Slomanson 1995, 19). The minister went on to write, “‘the expropriation of individual interests nevertheless does not call for immediate compensation and, in many cases, not even subsequent compensation; because such acts are inspired by legitimate causes and the aspirations of social justice’” (Slomanson 1995, 19-20). The Mexicans contended that the expropriation of US owned property was legal because it was applied equally to Mexican citizens and full compensation was not required because the expropriation was done for a just purpose and compensation levels were applied equally to Mexican citizens and foreign nationals.
**Enforcement in the interwar period.** A slightly weakened investment regime existed in the interwar period. Expropriations took place on a wide scale in the Soviet Union as that country moved toward a command economy, and to a lesser extent in Mexico, Turkey, Bolivia, and Eastern Europe (Lipson 1985). While host states paid compensation to injured foreign investors for their expropriated property, thus giving a degree of legitimacy to the minimum standard, it was often less than the full market value of the property (Lipson 1985). Great Britain was weakened by WWI and could not enforce investment law in Eastern Europe or the Mediterranean, and the United States lacked the political will to enforce investment protection outside of the Western Hemisphere (Lipson 1985). However, most foreign investments were completely secure in the interwar era (Lipson 1985).

In sum, even with the Great Depression and the economic isolationism that accompanied it, foreign investments were still secure in the interwar era. Multinationals still maintained their political influence, too. Companies like United Fruit used their economic and political leverage, both at home and abroad, to maintain the generous policies they enjoyed in the developing world. Their privileged positions would not last, however, as most mining and agricultural FDI in the developing world was expropriated in the 1960s and 1970s.

**FDI, MNCs, AND PROPERTY RIGHTS IN THE POST WWII ERA**

A new wave of globalization, starting in the 1950s, swept away the economic isolationism of the interwar period and can be attributed to three broad factors: (1)
national commitments to economic integration, (2) new intergovernmental organizations, and (3) changes in technology. Western leaders realized that disengagement from the world economy and attempts at the ‘beggar thy neighbor polices’ that characterized the interwar era had damaged economies and actually entrenched the global depression of the 1930s. Leaders were thus predisposed to entering into multilateral commitments that would facilitate economic integration.

The United States, the emerging global hegemon, and the United Kingdom, the declining power, spearheaded efforts to design and implement multilateral economic institutions (Milner 1997). The two states reached agreements on international monetary relations and development strategies via the Bretton Woods institutions, and trade via the International Trade Organization (ITO). However, domestic politics in the United States affected the ability of the United States Senate to ratify each treaty.

Business and banking interests in the United States supported the Bretton Woods institutions. The United States government included key players in banking and business in the design and negotiation of the Bretton Woods agreement (Eckes 1975). Support from these key groups in combination with a United States Senate led by pro-economic integration democrats led to the Senate’s ratification of the Bretton Woods treaty in 1945 (Milner 1997).

Business interest groups in the United States did not support the ITO. United States business interests were excluded from the Havana conference where the ITO negotiations took place (Diebold 1952). The lack of interest group pressure allowed United States negotiators to acquiesce to European and developing state demands to allow countries to discriminate in trade and investment for development purposes
(Diebold 1952). Consequently, United States business groups which wanted access and protections for their foreign economic activities did not support the ITO and the treaty was not ratified by the Senate (Milner 1997). A lack of interest group support and a United States Senate led by isolationist Republicans sealed the fate of the ITO (Milner 1997).

The intergovernmental organizations that were created were designed to overcome some of the hurdles associated with economic openness: the General Agreement on Tariffs and Trade (GATT), which was originally was meant to be a temporary institution in place of the failed ITO, was created to reduce barriers to trade; the International Monetary Fund (IMF) was established to address issues associated with the international movement of financial capital; and the International Bank for Reconstruction and Development (IBRD), also called the World Bank, was created to rebuild war-torn Europe, but later evolved into a development organization which currently provides low interest and no interest lows for development projects in LDCs (Frieden 2006).

Technological advancements in the areas of transportation and communication lowered barriers to trade and cross-border investment, facilitating economic integration. The development of large freight ships and containerization allowed products to be moved efficiently over long distances, and advances in communications, such as the fax machine and later the internet, allowed business to be conducted over large distances and for managers in home states to have an increased degree of control of subsidiaries in foreign countries. MNCs and FDI proliferated in light of these developments.
FDI & MNCs Post WWII-1980

Worldwide FDI was limited in the years following WWII, especially in the developing world. The emergence of the communist bloc ended MNC activity in an entire group of countries in Eastern Europe and the 1949 Communist Revolution in China, previously a major destination for FDI, led to the complete exclusion of foreign investment from that country (Jones 2005a). LDCs, many of which were former colonies, were wary of Western involvement and implemented state-led development programs which often included restrictions on FDI (Cohen 2007; Jones 2005a). Import-substitution strategy was a key component to the state-led development programs (Todaro 1989). Policy makers in developing states sought to develop from within, with minimal interference from western companies. Some FDI was allowed in LDCs, but with increasing restrictions, such as foreign ownership being limited to minority shares and limiting FDI to areas that did not compete with local firms (Frieden 2006).

The growing popularity of Marxist ideologies supported import substitution strategies in LDCs and the weakening of Western property rights enforcement capabilities led to increased expropriations in the developing world, dramatically reducing FDI levels in those countries (Lipson 1985). During the 1970s, “virtually all

44 The political meddling of prominent MNCs in developing countries did not contribute positively to their reputation, either. For example, in 1970 US based International Telephone and Telegraph Company tried to prevent the election of socialist Salvador Allende in Chile, and after failing, contributed to plots designed to overthrow the socialist president (Frieden 2006).
45 According to Todaro (1989), “the typical [import substitution] strategy is first to erect tariff barriers or quotas on the importation of certain commodities, then to try to set up a local industry to produce these goods—items such as radios, bicycles, or household electrical appliances” (435).
46 The emergence of the Soviet Union and the prominence of Marxist ideologies such as Dependency Theory and World Systems Theory provided alternative perspectives for LDCs. Dependency Theory, which became popular in Latin America in the Post WWII era, rejects the idea championed by the United States that freer trade and investment can produce gains for less developed and developed countries alike. Instead, the Theory posits that international economic interaction creates a condition of dependency where developed states invest in LDCs to receive cheap natural resources and LDCs become dependent on foreign
[MNC] ownership of mining, petroleum, and plantation assets was wiped out” in developing countries (Jones 2005a, 89). For instance, at least 18 developing countries nationalized oil-producing operations (Jones 2005a).

Circumstances were different among developed states in which FDI levels began to pick-up in the late 1950s. This growth in FDI was the result of general government support for a more open economic system, monetary stability established through the IMF, and persistent, although reduced, barriers to trade (Frieden 2006).47 The US emerged from WWII as the dominant economic power and its multinationals were active in this period, accounting for 85 percent of all new FDI outflows from after the war until the mid-1960s (Jones 2005a). The vast majority of US FDI went to either Canada or to war-torn Western Europe as part of the United States’ effort to rebuild its allies and balance against the emerging Soviet threat (Jones 2005a). In 1958 most Western European countries adopted nonresident currency convertibility to facilitate economic interactions within that group of states. United States FDI in Europe increased immediately because United States MNCs could move funds into and out of most countries in Western Europe (Wilkins 1974).48 Furthermore, the implementation of the

47 The IMF agreement was different from the classic gold standard in three major ways: (1) the “system was based on a U.S. Dollar worth one thirty-fifth of an ounce of gold and on other currencies linked to the U.S. dollar at fixed exchange rates” (Frieden 2006, 290). Under the classic gold standard all currencies were pegged to gold at varying rates. (2) It allowed countries, except the US whose currency was pegged to the price of gold, to make adjustments to the value of their currencies. Virtually all developed countries devalued relative to the US dollar. Currency devaluations or revaluations were not permitted under the classic gold standard. (3) Short-term portfolio lending was restricted. The designers of the monetary regime, such as J. M. Keynes, wanted to avoid instability caused from financial speculation, such as the financial speculation that occurred at the end of the gold standard in the late 1920s.

48 Prior to 1958 only the US dollar was freely convertible.
European Economic Community with a high common external tariff and internal free trade motivated many US manufacturing firms to invest in Europe (Cohen 2007).

In 1980 the world stock of FDI was over $500 billion; by contrast, the world stock of FDI was only $60 billion in 1960. Still, the total world stock of FDI accounted for only 4.8 percent of world output, about half the level reached in 1914 and FDI was more geographically restricted than in the previous era: “by 1980 almost two-thirds of world FDI was located in Western Europe and North America. Latin America and Asia had declined very sharply in their relative importance as host economies” (Jones 2005a, 33). And while FDI levels as a percentage of global output may have been smaller in 1980 than it was in at the onset of WWI, the sheer number of companies operating across borders had risen to over 10,000 in 1980, up from 3,000 in 1914 (Gabel and Bruner 2003).

FDI & MNCs 1980-2000

The stock of world FDI continued to grow and change through the 1980s and 1990s. The United States trade deficit grew throughout the 1970s. The deficit was primarily caused by skyrocketing oil prices in the 1970s, which put billions of dollars in the hands of Arab oil barrens (Strange 1986). Beginning in the mid-to-late 1970s, the US

49 FDI activity also increased as countries further dismantled capital controls after the collapse of the Bretton Woods system in the early 1970s (Jones 2005a).
50 The period from WWII-1980 was dominated by what has been called ‘classic MNCs’: “large integrated corporations” that “conducted virtually all value added activities within themselves” (Jones 2005a, 101). The British firm Unilever is a prime example. Not only did Unilever manufacture many different brands and products, ranging from detergents and margarine to toothpaste and shampoos, it also controlled all aspects of the production and distribution of the products (Roach 2005). Unilever owned factories, packaging operations, transportation services, and even retail shops that serviced other areas of the corporation (Roach 2005; Jones 2005a).
became a major host state for FDI as foreigners sought a place to invest their dollars (Strange 1986). In fact, the US hosted over 40 percent of worldwide FDI in the 1980s and by 1990 US FDI inflows were equivalent to outflows.\footnote{MNCs in this period of ‘alliance capitalism’ transformed from ‘classic MNCs’ to corporations that focused on a core set of products, engaged in strategic alliances with other firms and outsourced stages of the manufacturing process (Jones 2005a).}

MNCs from Western Europe began to invest in the US as their competitiveness increased and to avoid increasing barriers to trade (Jones 2005a). Japanese MNCs began to invest abroad in low wage countries as their domestic labor costs increased and in the US and Western Europe to avoid protectionist tendencies. By 1990 US domination of FDI outflows had ended: “the US share of total outward FDI stock fell from 50 percent in 1967 to 26 percent in 1990” (Jones 2005a, 98).

A shift in LDC policies toward foreign investment started around 1980. Many LDCs altered state-led development plans and instituted free market reforms including the easing of capital controls. LDCs began to see MNCs and FDI as tools for growth and even began to offer investment incentives to attract foreign firms. China started market-oriented reforms in 1979 and began to attract FDI once again. Mexico and Brazil were the primary host states in Latin America as they sought to attract manufacturing industries (Jones 2005a). An average of almost $60 billion a year in FDI went to LDCs from 1990-1994 (Patterson et al 2004).

The 1990s saw huge growth in both the number of MNCs and total FDI as more countries instituted free-market reforms, such as capital deregulation and the privatization of utilities, especially in the former communist countries and other developing countries (Cohen 2007). In 1994, 39,463 total parent MNCs existed; this number increased to
63,312 by 2000 (Gabel and Bruner 2003). The total stock of worldwide FDI grew by 20 percent a year in the first half of the 90s and an amazing 40 percent a year in the second half of the decade and reached $5.976 trillion in 2000 (Roach 2005; Gabel and Bruner 2003).

Mergers and acquisitions were the driving force behind the dramatic growth in FDI in the 1990s. By 1999, 80 percent of all FDI was from mergers and acquisitions and most of this was due to ‘megadeals,’ mergers and acquisitions involving over 1 billion dollars: “there were 175 megadeals in 2000, which accounted for 76 [percent] of the total value of [cross border mergers and acquisitions] for that year (Gabel and Bruner 2003, 32). The vast majority of mergers and acquisitions, in terms of monetary value, took place within the developed world; the total value of mergers and acquisitions in the developing world were small by comparison (Gabel and Bruner 2003). Deutsche Bank, a German company, is a prominent example. Deutsche Bank purchased Morgan Grenfell, a UK based merchant bank, in 1989, Spain’s Banco de Madrid in 1993, Credit Lyonais of Belgium in 1998, and Banker’s Trust, the US’s eighth largest bank, in 1999 (Rugman 2005, 109). The Banker’s Trust deal alone was worth $9.2 billion (Rugman 2005).

Furthermore, financial crises in Latin America and East Asia led to ‘fire-sale’ prices and FDI poured in to affected countries (Krugman 2000).

Mergers come in multiple forms: statutory mergers, subsidiary mergers, and consolidations. A statutory merger is when one company assumes the assets and liabilities of another corporation that goes out of existence (Gaughan 1996). A subsidiary merger, also called an acquisition, is when the target company of the merger becomes part of the parent company, that is, a subsidiary, by the purchase of all or a majority of the former companies voting stock (Gabel and Bruner 2003; Gaughan 1996). The two companies remain legally separate in a subsidiary merger, but under one management (Gabel & Bruner 2003). Examples of a subsidiary merger are Unilver’s acquisition of Ben & Jerry’s Ice Cream (Jones 2005c) and General Motors acquisition of Electronic Data Systems (Gaughan 1996). A consolidation is a type of merger where two companies form a completely new company (Gaughan 1996). For instance, in 2000 Bell Atlantic and GTE merged to form one telecommunications company, Verizon (Gabel and Bruner 2003).
Recent FDI Flows

A slowdown in global economic growth and the coinciding correction in world equity markets led to a steep drop in FDI at the onset of the 21st Century (Patterson et al. 2004). Cross-border mergers and acquisitions alone fell from $1.1 trillion in 2000 to $600 billion in 2001 (Patterson et al. 2004). The total stock of worldwide FDI was $729.2 billion in 2001, down from 1489.8 billion in 2000, $513.8 billion (70.5 percent) of which went to developed countries and the remaining $215.4 billion going to LDCs (29.5 percent) (Patterson et al. 2004).

World FDI flows did not reach 2000 levels until 2007 when FDI topped out at $1.833 trillion (UNCTAD 2008). This recent spurt in FDI was largely driven by megadeals in cross border mergers and acquisitions which reached a record $1.637 trillion in 2007 (UNCTAD 2008). In addition, a substantial amount of profits generated from foreign affiliates was reinvested in host countries, accounting for 30 percent of total FDI flows for 2007.

Twenty-seven percent of 2007 FDI, about $500 billion, went to LDCs (UNCTAD 2008). $53 billion went to Africa with Nigeria, Egypt, South Africa and Morocco receiving the largest shares (UNCTAD 2008). Cross-border mergers and acquisitions and investment in extraction industries and extraction industry services comprised the bulk of African inbound FDI; mergers and acquisition FDI in Africa’s banking industries also made a significant contribution (UNCTAD 2008). About half of all FDI to developing economies, $249 billion, went to South, East, South-East Asia and Oceania, with China and Hong Kong receiving the lion’s share (UNCTAD 2008). $126 billion went Latin America and the Caribbean; Brazil and Chile were top recipients in this region
Brazil in particular was a destination for natural-resource based manufacturing as investors tried to take advantage of rising commodity prices (UNCTAD 2008). Notably, most Latin American and Caribbean FDI inflows took the form of Greenfield investments (UNCTAD 2008).

Seventy-three percent of 2007 FDI, about $1.248 trillion, went to developed countries (UNCTAD 2008). The European Union as a whole received almost two-thirds of all developed country FDI while the United States was the single largest recipient country (UNCTAD 2008). The developed world accounted for $1.692 trillion of all outgoing FDI, 92 percent of the world’s total, while the developing world accounted for $253 billion, $150 billion from South, East, South-East Asia and Oceania and $44 billion from West Asia (UNCTAD 2008).

The Modern MNC

Modern MNCs operate in multiple countries by definition and are often cited as a major contributing factor to globalization. However, scholars have debated the ‘globalness’ of modern MNCs. Rugman (2005) argues that MNCs are primarily a developed country phenomenon, while others argue MNCs, and therefore FDI, are global actors, prevalent and influential in countries around the world (i.e. Cohen 2007; Gabel and Bruner 2003). According to Rugman (2005), relatively few MNCs can be considered global when assessed by where their sales occur (Rugman 2005). Three-hundred and twenty of the world’s 500 largest MNCs make at least 50 percent of their profits in their own home-based region of either NAFTA, the Europe Union, or Asia (Rugman 2005). In fact, only nine of the world’s top 500 firms are considered ‘global’ by Rugman’s (2005)
standard; that is, they have “sales of 20 [percent] or more in each of the three regions of [NAFTA, the European Union, and Asia], but less than 50 [percent] in any one region (4). An example of such a global firm is Flextronics, an electronics-manufacturing service provider with a multi-region imprint: of its $13.4 billion in revenues in 2002, 24.4 percent came from Asia, 30.1 percent came from North America, and 45.5 came from Europe, (Rugman 2005).

Conversely, Rugman’s (2005) assessment of MNCs according to the location of their final sales may not be the best indicator of a firm’s ‘global-ness.’ The geographic distribution of a firm’s production facilities and national diversity of its employees could be used as another standard. Nestle, for instance, is a Swiss based packaged-food company that could be considered global by such a rubric, but not by Rugman’s: 50 percent of its managers are not Swiss, it employs 224,000 employees in 70 countries and operates 470 factories worldwide (Gabel and Bruner 2003).

The United Nations Conference on Trade and Development (UNCTAD) has established a transnationalization index to better assess a MNC’s integration into the global economy (UNCTAD 2007b). The index is composed of three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment. The results of a UNCTAD (2007b) study show that the top 100 non-financial MNCs from the developed world and the top 50 non-financial MNCs from the developing world have generally trended toward increased global integration from 1993 to 2003. Indeed, MNCs appear to be a driving force behind global economic integration.

Multinationals have changed their developing country activities in the post-WWII era, post-1980 in particular. Prior to WWII, MNCs primarily invested in developing
countries in the natural resource and infrastructure sectors. Modern multinationals have additional motives for investing in the developing world. They also invest in LDCs for efficiency-seeking and market access purposes. Efficiency-seeking FDI is conducted to reduce the cost of production. This category of FDI often takes place in low wage, developing countries. Efficiency-seeking MNCs invest in a low cost country, produce products inexpensively, and then export products to other, often more affluent, markets (Cohen 2007). As developing countries become wealthier, MNCs are increasingly seeking access to their markets through FDI (Cohen 2007). With market-seeking FDI, MNCs locate production facilities in targeted markets and sell their products to locals directly, as opposed to servicing markets through exports. Unilever’s activities in India provide an example of market-seeking FDI.

**Example of a modern MNC.** Unilever’s international activities illustrate how multinationals conducted business, and the political problems they faced, in the post-WWII world. Unilever was created in 1929 by the merger of Lever Brothers, a British soap manufacturer, and Margarine Unie, a Dutch margarine manufacturer (Jones 2005b). By 2003 it had investments in 83 host countries and controlled 316 foreign affiliates (UNCTAD 2007b). Its general strategy was to acquire companies, retain their names and key brands, and expand sales in local markets (Jones 2005b). This strategy made Unilever a diverse corporation, both geographically and by product.

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54 Firms often pursue market-seeking FDI to circumvent import barriers. High trade barriers, either tariffs or non-tariff barriers, make servicing a market through trade unprofitable. MNCs can avoid trade barriers by investing directly in a target market.
Unilever initially favored a strategy of diversification (Jones 2005b). Fast economic growth in the 1960s prompted Unilever to expand into new products. Unilever executives believed that their knowledge in soaps and margarines were transferable to other items (Jones 2005b). While some acquisitions proved profitable, the diversification strategy in combination with global economic setbacks in the 70s hurt the Company’s overall profits in this period (Jones 2005b). In fact, Unilever’s sales and profits in 1983 were the same as those in 1971, when assessed in constant prices (Jones 2005b).

In 1984 Unilever decided to pursue core areas that were the expertise of the firm (Jones 2005b). The core business strategy focused on foods, detergents, personal products, and specialty chemicals; brands that fell into other categories were sold (Jones 2005b). From 1983 to 1987 the Company acquired around 70 additional companies in core areas and sold nearly just as many non-core firms (Jones 2005b). The strategy worked. Company yields went from about 4 percent in the early eighties to nearly 13 percent in 1989 (Jones 2005b).

Nearly one-fifth of Unilever’s sales and profits came from the developing world by the end of the 1980s (Jones 2005b). Unilever increased its overseas investments after WWII and began manufacturing soap products in former British colonies in Africa and Asia in the 40s and 50s and opened a factory in Turkey in 1950 (Jones 2005b). The goal of the investments was to reach growing markets whose consumers were rapidly gaining purchasing power. By 1990 Unilever’s most significant developing country investments were in Brazil, India, South Africa, and Turkey; these countries represented 14 percent, 12 percent, 9 percent, and 5 percent, respectively, of the Company’s sales in the
developing world (Jones 2005b). However, the path to success in developing markets
came amid numerous political hurdles.

An ideological shift, beginning in the 1960s, in many developing countries led to
restrictive business environments for Unilever and even to the expropriation of some of
its investments. The array of business restrictions placed on Unilever investments
included price controls, import restrictions, production requirements, local equity
requirements, and restrictions on dividends, remittances, expatriate employment, and
salaries (Jones 2005b).

Unilever’s general response to restrictive business practices was to work closely
with the host government to promote change; it rarely responded with divestment (Jones
2005b). One advantage that the company had when bargaining with state officials was its
significance as an employer in the host state, since it manufactured most of its products
locally for local consumption. Unprofitable endeavors, such as plantations, were often
retained by the Company because they employed many local workers, thus providing
bargaining leverage against government officials and promoting political goodwill among
local populations. And at times, Unilever worked closely with British or Dutch
embassies when bargaining with host state officials. Unilever’s experience in India
during the fifties and sixties provides an illustrative example of the restrictive business
practices it faced and how it responded.

Unilever began producing soap in a Bombay factory for local consumption when
India was still a part of the British Empire in 1924 (Jones 2005b). The business
environment changed dramatically upon Indian independence in 1947. The new

55 In 1964, Unilever’s investments in Burma were expropriated and its Indonesian Company was put under
government (Jones 2005b).
government pursued a strategy of self-sufficiency and sought to minimize the influence of foreign trade and multinationals (Jones 2005b).

In 1956 the Indian government required Unilever to form a new company, Hindustan Lever, and sell 10 percent of equity to the Indian public, a requirement that was raised to 14 percent in 1965 (Jones 2005b). The Company attempted to gain local political favor by appointing an Indian national, P. L. Tandon, to be Hindustan Lever’s chairman in 1961 (Jones 2005b). While this move helped gain national favor, more government business restrictions came in the sixties.

The Indian government applied imports restrictions, price controls, and foreign exchange controls throughout the sixties which impeded the Company’s efficiency and, ultimately, its bottom line. Import restrictions increased input costs for Vanaspati Ghee, the Company’s hydrogenated vegetable oil product, making it nearly unprofitable since the government also applied price controls on the final product (Jones 2005b). Government controls on foreign exchange prevented the Company from importing alkalis, a necessary component to produce synthetic detergents; consequently, the Company had to forgo that potential market (Jones 2005b). Still, even with the business restrictions, by the end of the 1960s Hindustan Lever represented one of the five largest private sector firms in India, making the majority of its sales in soap, a sector that was not subject to price controls, and it employed over 7,000 people in its six Indian factories (Jones 2005b).
The Politics of Investment Protection in the Post WWII Era

Investment protections increased following WWII. Some infrastructure expropriations occurred in this period, but full compensation was usually granted (Lipson 1985). The minimum standard was enforced by the US government and US multinationals.56 For instance, Guatemala’s left-leaning presidents Juan Arevalo and Jacobo Arbenz attempted to lessen their country’s dependence on United Fruit in the late 1940s, ultimately leading to Guatemala’s expropriation of 200,000 acres of United Fruit property. United Fruit responded by decreasing banana exports by 80 percent and US airlines stopped promoting tourism to Guatemala. Both moves were blows to the Guatemalan economy (Lipson 1985). The US state department worked to isolate Guatemala diplomatically and the CIA helped Colonel Castillo Armas with the ouster of Arbenz (Lipson 1985).

In the late 1960s the strength of the regime protecting FDI began to wane. The number of expropriations by developing states increased throughout the early 1970s, peaking in 1975 (Kobrin 1984). For instance, only 34 US owned firms were expropriated from 1946-1966 while 136 US owned firms were expropriated from 1967-1973 (Hawkins et al. 1975). The world changed to a bi-polar structure with the rise in power of Soviet military capabilities and increased competition among MNCs prevented military enforcement and coherent economic sanctions, respectively (Lipson 1985). For example, the entire petroleum market was dominated by a group of large, Western oil companies known as the “Seven Sisters” cartel in the 1950s (Terzian 1985). This cartel

56 US multinationals accounted for over 60 percent of all outward foreign direct investment flows (Lipson 1985).
was comprised of Exxon, Chevron, Mobil, Shell, Texaco, Gulf, and British Petroleum. In 1951, Mossadegh, the Iranian Premier, nationalized the Anglo-Iranian Oil Company, a British investment. The Seven Sisters effectively worked together to boycott Iranian oil (Terzian 1985; Lipson 1985). Iran could not extract, refine, transport, or sell oil during the boycott because of the cartel’s dominance and the willingness of the firms to cooperate, which was a result of the industry’s small number of powerful firms (Lipson 1985). However, the landscape had changed by the 1970s. Oil producing power was no longer consolidated in the hands of the Seven Sisters and Soviet military power increased the stakes of a potential military intervention (Lipson 1985). OPEC states were able to expropriate oil resources and force the renegotiation of concession agreements (Lipson 1985). Western oil companies were forced to acquiesce because of their weakened bargaining positions (Lipson 1985).

Developing states reiterated their view regarding the minimum standard via the United Nations. A large group of LDCs known as the G-77, a response to the wealthy country group known as the G-7, passed a series of resolutions through the General Assembly (GA) of the United Nations. The non-binding resolutions rejected the Western view of the minimum standard and promoted the same core principles originally espoused a century earlier by Calvo. GA Resolution 1803 titled “The Declaration of Permanent Sovereignty over Natural Resources” was passed in 1962. The Resolution stated:

Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both

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57 British and American covert forces eventually ousted Mossadegh under ‘operation Ajax.’ (Yergin 1992).
domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules enforced in the State taking such measure in the exercise of its sovereignty and in accordance with international law (quoted in Brownlie 1995, 238).

The United States actually voted in favor of the resolution, but quickly claimed that ‘appropriate compensation’ meant the same as ‘prompt, adequate, and effective’ (Comeaux and Kinsella 1997).

The G-77 responded with GA Resolution 3041 in 1972, GA Resolution 3171 in 1973, and GA Resolution 3201 in 1974 titled, “The Charter of Economic Rights and Duties of States”, all of which explicitly stated that the definition of compensation was up to the host state (Comeaux and Kinsella 1997; Brownlie 1995; Lipson 1985). “The Charter of Economic Rights and Duties of States” also promoted the exclusive use of domestic court system of the host state for the settlement of investment disputes (Lipson 1985).

The current international legal regime governing foreign investment was developed amid these changing political and economic circumstances. Developed countries and their multinationals could no longer protect their foreign investments through power advantages and developing and developed states still could not agree on an international investment protection standard making a multilateral approach politically impossible. Consequently, countries were left to pursue a patchwork regime to protect foreign investment.

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58 The G-77 also passed GA Resolution 3201 in 1974 titled, “The Declaration on the Establishment of a new International Economic Order”. This resolution reiterated a state’s right to expropriate property (Comeaux and Kinsella 1997).
The makeshift regime is centered on bilateral investment treaties (BITs), but also encompasses the International Center for the Settlement of Investment Disputes (ICSID), the Multilateral Investment Guarantee Agency (MIGA), and, established later, the GATT’s Trade Related Investment Measures agreement (TRIMs). The initial components of the regime were insignificant upon their creation—state membership to the ICSID and MIGA were scant and their facilities under-utilized and few BITs were established. However, they became primary features of the international investment regime once LDCs loosened capital restrictions, began courting FDI, and needed international institutions to facilitate the process.

**Bilateral investment treaties.** BITs establish the terms and conditions by which investments from one state will be treated in another (Elkins et al. 2006). The first BIT was entered into between Germany and Pakistan in 1959. Eighty-three treaties were signed in the 1960s, 176 in the 1970s, 377 in the 1980s, 440 in the 1990s, and by 2005 the total number of BITs had grown to nearly 2,500 (UNCTAD 2007a).

BIT preambles outline the reasons why states join the treaties. The vast majority of preambles contain the following concepts: (1) the purpose of the treaty is to create conditions favorable to foreign investment and (2) the view that foreign investments are beneficial to economic progress in the host state (UNCTAD 2007a). The 1995 BIT between Mongolia and Singapore illustrates these features:

Desiring to create favourable conditions for greater economic co-operation between them and in particular for investments by nationals and companies of one State in the territory of the other State based on the principles of equality and mutual benefit; Recognizing, that the encouragement and reciprocal protection of such investments will be
conducive to stimulating business initiative and increasing prosperity in both States (Mongolia and Singapore BIT, printed in UNCTAD 2007a).

In sum, BITs are signed between states to promote foreign investment because foreign investment is recognized as beneficial by both states.

The majority of BITs are signed between one developed state and one developing state. In 1995 only 161 BITs had been signed between developing states and a number of these were signed for symbolic purposes since the vast majority of foreign investment flows to developing states originated in developed states at and before this time (Dolzer and Schreuer 2008). However, in recent years investments within the developing world have increased and the number of BITs between these countries climbed to 644 in 2005 (UNCTAD 2007a).

BITs are designed to facilitate investments from developed countries to developing countries. Developing states usually have weaker property rights regimes than developed states. A multinational corporation may be wary of investing in a developing country because of the ‘obsolescing bargain’, the potential for a developing host state to renege on non-legally binding commitments to a foreign company once costs have been sunk. BITs commit host states to the commitments made in the pages of the treaty because they hold the binding power of international law.

The International Center for the Settlement of Investment Disputes. The ICSID is an autonomous agency of the IBRD and is headquartered in Washington D.C. The treaty establishing the ICSID came into force on October 14, 1966 and was initially ratified by 22 countries (icsid.worldbank.org 2012). Treaty membership reached 91 by
1989 and currently 148 states have signed and ratified the treaty (icsid.worldbank.org 2012).

The primary purpose of the agency is to “[provide] a multilateral avenue for the settlement of investment disputes between states and nationals of other states” (Bondzi-Simpson 1990, 184). Thus, the parties to ICSID disputes are states and foreign nationals that have invested in that state.\textsuperscript{59} Dispute settlement is done through arbitration tribunals containing arbitrators approved by both parties in a dispute (Bondzi-Simpson 1990).\textsuperscript{60} The tribunal’s ruling is binding on both parties.

The ICSID’s caseload was light initially, but has ballooned in recent years. Member states only registered nine cases with the ICSID in the seventies (icsid.worldbank.org 2012). The total number of registered cases reached 26 by 1989 and 67 by the end of the nineties (icsid.worldbank.org 2012). However, as of April 2012, the ICSID had decided over 230 cases (icsid.worldbank.org 2012). The light caseload of the convention’s early years can be attributed to lower treaty membership, lower levels of investments flows between developed and developing states, and, in particular, the ICSID’s limited jurisdiction. The agency will only hear disputes between parties that consent to its processes (Connerty 2006; Bondzi-Simpson 1990). Consequently, host states could, and did, use the agency’s limited jurisdiction to prevent disputes from ever reaching the ICSID’s dispute settlement procedures.

\textsuperscript{59} Originally, both parties had to be covered by treaty membership to make use of its dispute provisions, but this changed when the Additional Facility Rules were instituted in 1978 making the Center’s services available to host states and firms whose home state have not ratified the treaty (Connerty 2006).

\textsuperscript{60} In instances when the parties cannot agree on the composition of the tribunal, the Chairman of the Arbitration Tribunal shall appoint arbitrators (Bondzi-Simpson 1990).
The heightened case load of the convention’s latter years is due to higher treaty membership, increased investment flows between developed and developing states, and, notably, provisions in BITs. As noted above, BIT membership has swelled in recent decades. Many BITs contain provisions that give advanced consent to ICSID arbitration, limiting each party’s ability to prevent a dispute from moving forward in the ICSID’s dispute process. By 2006, over 900 BITs contained provisions guaranteeing advanced consent to arbitration through the ICSID (Connerty 2006).

The legal standard applied to disputes may vary from case to case. The valid rules of law applied to disputes are, foremost, the rules agreed to by the parties (Bondzi-Simpson 1990). If the parties are covered by a BIT, the rules established therein will be the metric for deciding the dispute. However, if no treaty has been signed between the host state and the home state of the foreign national, or if an investment treaty is in place but the treaty does not contain provisions applying to the dispute at hand, then the host state’s laws governing the disputed issue will be applied (Bondzi-Simpson 1990).

Applicable rules of international law are the third source of standards applied in arbitration (Bondzi-Simpson 1990). Consequently, the legal standard that must be applied by a host state to a foreign national will vary according to the presence or absence of a BIT, the contents of the BIT, if present, and the domestic laws of the host state; therefore, cases decided through an ICSID tribunal have not led to the creation of a generalizable standard governing a host state’s treatment of foreign investment (Sornarajah 2010). 61

61 To make matters more confusing, cases with similar facts and issues have been decided differently by different tribunals. For instance, two cases involving the same company, Societe Generale de Surveillance v. Pakistan and Societe Generale de Surveillance v. Philippines decided differently on the application of
The Multilateral Investment Guarantee Agency. MIGA was established as an autonomous agency of the IBRD on April 12, 1998 by 29 member countries. Its core objective, according to Article 2 of the agency’s founding convention, “shall be to encourage the flow of investments for productive purpose among member countries, and in particular to developing member countries” (miga.org 2012). MIGA pursues this objective, in part, by issuing guarantees against non-commercial risk to investors (Bondzi-Simpson 1990, 171). In 2008, MIGA insured $2.1 billion worth of foreign investment in developing countries throughout the world and boasted 176 member countries (miga.org 2012).

MIGA issues guarantees against the various non-commercial risks. Investors from one MIGA member state investing in another MIGA member state, usually a developing country, are eligible for the guarantee. The agency will pay 90 percent, in most cases, to an investment which is afflicted by a non-commercial risk covered in the treaty (miga.org 2012). Costs to investors usually range from .3 percent to 1.5 percent of the amount of guarantee per annum (Bondzi-Simpson 1990). The typical term of the coverage is 15 years, although some guarantees, usually in industries that take extended time to reap profits such as mining, may last up to 20 years (miga.org 2012).

62 These are: currency transfer restrictions; expropriation; war, revolution, and civil disturbance; and breaches of contract that result in a denial of justice (miga.org 2012).

63 MIGA’s first guarantee was made in 1990 to Freeport McMoran Copper Co., a US multinational, insuring a portion of its $500 million dollar copper mining project in Indonesia (miga.org 2012). The MIGA guarantee covered the firm for up to $50 million in loses that might arise from a breach of contract by the host state and war risks for 14 years after the initial investment (miga.org 2012).
MIGA does not, however, guarantee compensation for all non-commercial risks. The agency’s liability is limited when dealing with measures concerning expropriation or restrictive business practices. In particular, MIGA guarantees do not cover “non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories” (Bondzi-Simpson 1990, 173). Therefore, various restrictive business practices, or even expropriation, may be implemented by a host state on a foreign firm covered by MIGA, making a foreign investment unprofitable, but the firm may still be ineligible for MIGA compensation if the restrictions are applied indiscriminately.

**Trade Related Investment Measures.** The term Trade Related Investment Measures is used to represent the group of policy options that a country can employ to regulate foreign investment that could, either intentionally or unintentionally, affect trade flows between countries (McCulloch 1993). Generally speaking, LDCs have instituted various TRIMs to combat the ability of multinationals investing in their country from

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64 TRIMs can be organized into four categories:

1. Commodity-based input TRIMs refer to investment measures that “pertain specifically to intermediate inputs, discouraging investors from sourcing least-cost inputs in favour of locally produced substitutes” (Greenaway 1992, 148). This classification of TRIMs includes local-content requirements, trade-balancing requirements, laws of similars, limitations on imports, and foreign-exchange restrictions (Greenaway 1992).

2. Factor-based input TRIMs are measures put in place to protect certain factors of production within the host country. Factor-based input TRIMs include local-content requirements, local-equity requirements, expatriate quotas, local hiring targets, national participation in management, research and development requirements, restrictions on foreign ownership, technology transfer, and earnings remittance limits (Greenaway 1992).

3. Commodity-based output TRIMs are measures put in place to ensure “that a certain proportion of final output be exported” (Greenaway 1992, 149). This category of TRIMs includes export-performance requirements, trade-balancing requirements, export-controls, market reserve policy, product mandating, licensing (Greenaway 1992).

4. Factor-based output TRIMs only have two basic categories, technology transfer and earnings remittance limits. Not only do TRIMs vary by type, they also vary in usage across countries and across industry lines (Greenaway 1992).
pursuing strategies that might inhibit the country’s ability to reap economic benefits from the foreign investment.\textsuperscript{65} For instance, multinationals may implement transfer pricing and price fixing strategies to avoid local taxes.\textsuperscript{66}

According to the US Benchmark Survey conducted in 1977 which covered 3,540 US parent companies and 24,666 foreign affiliates, “14 percent of US affiliates were subject to one or more TRIMs” (Greenaway 1992, 151).\textsuperscript{67} The US Benchmark Survey also found that LDCs used TRIMs more frequently than developed countries, with Latin American countries, India, and Nigeria being the primary LDC culprits.

The US International Trade Commission Survey of 1982 gathered information on TRIMs usage in specific industries. The survey showed that the three industries most often subject to TRIMs were motor vehicles, chemicals, and industries associated with high-technology goods. For instance, “40 percent of chemical producers with FDI were reportedly subject to TRIMs...80 percent of motor-vehicle producers were subject to TRIMs... [and] 37 percent of high-tech firms (in computing and accounting machines) were subject to TRIMs” (Greenaway 1992, 152). This survey also showed that the majority of TRIMs in these industries occurred in LDCs. An Organization of Economic Cooperation and Development (OECD) study on TRIMs conducted in 1987 also showed...

\textsuperscript{65} Balasubramanyam (1991) claims that certain TRIMs can not only limit the economic distortions produced by MNCs, but also can help LDCs develop. Balasubramanyam (1991) says that local content requirements can conserve foreign exchange and help to develop local input industries.

\textsuperscript{66} Transfer pricing occurs “when the parent [MNC] and its plants sell goods between themselves (internally) at non-market clearing prices” (Morrissey and Rai 1995, 706). MNCs can use this technique to shift profits from one branch of the MNC to another in order to avoid paying taxes to a particular host country. Transfer pricing can also have an effect on a country’s balance of payments by artificially reducing the value of exports from the MNC (Morrissey and Rai 1995). Price fixing occurs when “the volumes and values of imports and exports desired by the [MNC] are not those desired by the host (and, more importantly, may not be equal to those that would occur in a free market)” (Morrissey and Rai 1995, 706).

\textsuperscript{67} A second US Benchmark Survey was conducted in 1982 and found virtually identical results. Again, 14 percent of US affiliates were subjected to at least one TRIM (Greenaway 1992).
that LDCs continued to be the primary users of TRIMs (Moran 1991). The OECD study also revealed that the most frequently used TRIMs in 1987 were local content requirements and minimum export requirements (Moran 1991).

During the Uruguay round of multilateral trade negotiations, developed countries, led by the United States, pushed for comprehensive rules governing investment; however, seeing TRIMs as development tools and their sovereign right, LDCs were reluctant to proceed with such an agreement (Low and Subramanian 1996). In order to keep LDCs from leaving the bargaining table on other issues of more importance to the developed states such as Trade Related Intellectual Property Rights (TRIPs), the agreement on TRIMs produced from the Uruguay round was narrow in focus and by-and-large unambitious (Low and Subramanian 1996). The agreement reached, however limited, is called the Agreement on Trade-Related Investment Measures.

Overall, the agreement explicitly links regulations already covered in GATT 1994 Articles III and XI to TRIMs by providing an illustrative list of illegal TRIMs that fall under the various sections of Articles III and XI. In addition, the TRIMs agreement provides a timeline for eliminating illegal TRIMs that varies by a country’s development level and establishes a committee to oversee the TRIMs elimination process.

GATT Article III relates to policies concerning national treatment (Low and Subramanian 1996). GATT Article III (i) prohibits states from employing local content requirements. This involves any practice which requires “the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production” (TRIMs Agreement). Local
content requirements are TRIMs that force investors to employ domestically produced inputs into their production process instead of importing potentially less expensive inputs. GATT Article III (ii) prohibits states from employing restrictions aimed at trade-balancing. Trade-balancing TRIMs include any restrictions that require “purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports” (TRIMs Agreement).

GATT Article XI covers quantitative restrictions (Low and Subramanian 1996). Article XI (iii), like Article III (ii), deals with trade-balancing restrictions. Article XI (i) applied to TRIMs prohibits policies which restrict “the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports” (TRIMs Agreement). Article XI (ii) addresses foreign-exchange-balancing measures which restrict “the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise” (TRIMs Agreement). Article XI (iii) addresses domestic sales requirements meant to restrict “the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production” (TRIMs Agreement). In sum, the Agreement of Trade-Related Investment Measures covers TRIMs that include local content requirements, trade-balancing requirements, foreign-exchange-balancing requirements, and domestic-sales requirements.

According to the agreement, developed countries must eliminate all illegal TRIMs within two years of the initiation of the agreement (TRIMs Agreements).
Developing countries have five years to phase out illegal TRIMs and LDCs have seven years (TRIMs Agreement). The TRIMs agreement also requires all states, regardless of development level, to report all of their illegal TRIMs to the WTO within ninety days of the institution of the agreement.

The Agreement on Trade Related Investment Measures has achieved very little success. According to Low (1997), as of 1997 “only some 19 countries have notified TRIMs subject to phase-out commitments since WTO entered into force” (522). In addition, notably missing from the list of illegal TRIMs are restrictions on export performance requirements, which require investors to export a portion of their production and are one of the most frequently employed TRIMs (McDonald 1998; Das 1998). Overall, the TRIMs agreement has added little to the overall regime for the protection of foreign owned property.

No multilateral investment protection treaty. The international community of states has never established a multilateral treaty outlining a comprehensive code of law on the treatment of foreign investment, yet several attempts have been made. The Havana Charter for the establishment of the International Trade Organization contained a section on foreign investment standards, but it stalled in the United States Senate in the 1940s (Sornarahaj 2010; Salacuse and Sullivan 2005; Milner 1997). The OECD produced the Draft Convention of the Protection of Foreign Property in 1967. Developing states did not agree on the terms provided in the treaty and it was only used

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68 However, an export performance requirement may “fall under Article III if it is … linked to local purchases or production, or under Article XI if it is … couched in terms of a prohibition on imports or exports” (McDonald 1998, 184).
as a model treaty for developed states (Sornarahaj 2010; Salacuse and Sullivan 2005; Dolzer and Stevens 1995). The OECD tried again in the early 1990s to establish a multilateral treaty, but developing states once again object to the treaty’s terms, claiming it was biased in favor of developed state multinationals (Sornarahaj 2010; Salacuse and Sullivan 2005).

**SUMMARY**

Three categories of variables have influenced the international regime for the protection of foreign property, particularly the property rights of foreign nationals in developing states: (1) the characteristics of MNCs and FDI, (2) home state-MNC and host state-MNC politics, and (3) the enforcement abilities of the Western states whose multinationals invest in LDCs. This section provides an overview of the evolution of the international investment protection regime and explains how variables in the three categories above have influenced its change.

**International Investment Law**

The legal regime protecting foreign investments has changed dramatically since its inception in the late 19th century. No multilateral treaty dictating a host state’s treatment of foreign nationals has ever been reached. In the late 19th and up to the mid-20th centuries the minimum standard of treatment was established by customary international law and the general legal principles of civilized states and its primary features included full compensation for the expropriation of foreign owned property and
diplomatic interposition in cases where a host government denied justice to a foreign national.

Tribunals in the first half of the 20th century unanimously supported the concept of full compensation for expropriation as part of a minimum standard of treatment that host states must provide foreign nationals, and diplomatic interposition was warranted when justice was denied to a foreign investor by a host state during this period; and when the host state was a LDC, less amicable methods of diplomatic interposition, such as military intervention, were acceptable. These aspects of international investment law came amid protest by proponents of the Calvo Doctrine, who argued that host states should only be required to provide foreign nationals the same standards of treatment they provide native investors, whether the issue was either access to justice and diplomatic intervention or the appropriate level of compensation for expropriation.

A major change to international investment law took place in the post-WWII era as treaty law began to supplant customary law and general legalized principles as the sources dictating the standard of treatment that host states must provide foreign nationals. BITs were initiated in the late 1950s and they addressed specific guarantees of treatment that each state must provide investors from the other state. However, because the specific treatments provided to foreign investors is predicated by the presence or absence of a treaty, and possibly the content of the treaty, the modern international investment law is a patchwork regime.

Multilateral treaties in the post-war era also contributed to the patchwork investment law regime. The ICSID was established as a forum for dispute settlement for host states and foreign investors. MIGA was created to insure investments made in
LDCs and the TRIMs agreement established through the GATT sought to limit investment restrictions that could affect trade flows.

Unlike the pre-WWII era, in which customary international law and general legal principles established standards applicable to all countries, the actual standard of treatment required by host states to provide foreign nationals in the patchwork regime is predicated by the treaties signed by the investor’s home and host states. For instance, a foreign investor covered by a BIT will generally be guaranteed more investment protections than a foreign investor not covered by a BIT; and even if all home and host states are party to the ICSID agreement, the investment covered by a BIT will get better terms in a ICSID dispute since the ICSID takes into account commitments made in BITs. In cases where no BIT is present, the ICSID tribunal will adjudicate a dispute according to the domestic laws of the host state, which generally provide a lower standard of treatment than BITs.

**Characteristics of MNC and FDI**

Not surprisingly, the characteristics of MNCs and their direct investment in the developing world have changed dramatically since the onset of globalization in the 1500s. The state chartered trading companies of the 16th and 17th centuries enjoyed monopoly trading privileges in specific regions or countries and some even administered their home state’s colonial possessions, such as the English East India Company. The modern MNC began to take shape in the 19th century as changes in corporate governance rules in European states permitted multinationals to be owned by tradable shares and advances in transportation and communication technologies allowed
corporations to conduct business over long distances. The FDI in the developing world during this period generally originated in the West and was directed toward natural resources (plantations and mines), infrastructure (railways and utilities), and banking services. FDI in developing countries in the interwar era maintained these basic characteristic, although the source of FDI was limited by currency blocks.

Post-WWII thru-1980 was the era of ‘classic MNCs’—corporations became very large, vertically integrated, and took part in many different economic sectors. The majority of FDI took place within the developed world as LDCs restricted access to foreign corporations and expropriated almost all foreign assets in mining, petroleum, and plantations, and many LDCs expropriated foreign-owned utilities.

Major changes to MNCs and FDI took place in the 1980s and 1990s. Large MNCs, such as Unilever, began to narrow their focus to a core set of products and, more importantly, LDCs started to see FDI as a potential facilitator to economic development and began to seek FDI, particularly in the area of manufacturing. Total worldwide FDI dramatically increased in the 1990s, primarily due to large mergers and acquisitions that took place primarily within the West. While over 70 percent of total FDI occurred within the developed world as of 2007, the total stock of FDI in LDCs reached $500 billion at that time, up from $165 billion in 1980.

The changing nature of FDI in developing states precipitated the need for a modification in investment protection. Most of the FDI in LDCs over the period covered was in natural resources or infrastructure investments meant to get primary products to the market (Jones 2005a). These types of investments produce site-specific rents that can be appropriated by the host state; consequently, they are prone to expropriation (Frieden
1994). Thus, the major concern for foreign investors was whether or not they would receive full compensation for the expropriation of their property in a developing country or even the ability of their home government to diplomatically intervene to prevent an expropriation from happening. Investment law pre-WWII addressed both of these issues.

The characteristics of investments in LDCs changed dramatically in the latter half of the 20th century. Multinationals began to invest in low-cost manufacturing in LDCs. This type of FDI does not produce site-specific rents; therefore, little would be achieved from a host state expropriating the investment. Indeed, developing state expropriations of foreign investments declined throughout the 1980s (Minor 1994). In a study of developing state expropriations from 1980-1992 Minor (1994) found no cases of expropriations in the late 1980s and early 1990s. The major issue facing investors from developed states was no longer expropriation. Instead, the major issues facing modern investments in LDCs are the restrictive business practices employed by a host state, which are intended to allow the host state to reap a larger share of the benefits of the foreign investment, at the possible expense of the investment’s profitability. BITs are designed to alleviate this problem. BITs contain measures restricting the ability of host states to implement various restrictive business practices, a boon to the MNCs of the developing world.

The Politics of Investment

Regardless of the period, multinationals faced political challenges both at home and abroad that affected the profitability and security of their investments. Developing countries have long recognized the need for FDI, albeit intermittently. For instance,
British railway investments in the mid-19th century were sought by the Argentinian government to catapult the country into the ‘railroad age,’ and United Fruit investments were welcomed by the Columbian government in the late 19th century to aid the development of Columbia’s export. British railways and United Fruit were both initially granted generous concession agreements to induce investment. The treatment of these investments deteriorated rapidly when political power in each country shifted away from pro-business parties to left-leaning ones.

An ideological shift on a larger scale happened after WWII. Many developing countries expropriated foreign-owned properties as part of their state-led development programs. However, in the 1980s many developing states began to court FDI once again. Part of the courting process involved signing BITs with developed states as a way of signaling a commitment to the rule of law and free-market oriented policies.69

Enforcement of International Investment Law

Two external factors affected the enforcement of the minimum standard prior to the institution of BITs: the capacity to intervene militarily and the capacity to produce severe economic sanctions by multinationals investing abroad (Lipson 1985). Both of these aspects were weakened throughout the century, most notably after WWII.70

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69 Multinationals have historically also faced political challenges in their home state. For instance, the English East India Company faced continued stern opposition from domestic interests in the British parliament who wanted the Company’s monopoly privileges revoked. And currently, Wal-Mart, an American company, is being investigated for violating the US’s Foreign Corrupt Practices Act because of its alleged illegal payments to Mexican officials to expedite business permits (The Economist 2012b).

70 Lipson (1985) also mentions control over relevant international organizations as a means of enforcing property rights, but this area mainly deals with portfolio investment (enforced by the International Monetary Fund), not foreign direct investment.
The capacity to intervene militarily and to produce punitive economic sanctions is greatest when military and economic power is centralized, i.e. in situations of hegemony (Lipson 1985). Military interventions may face third party resistance in a bi-polar or multi-polar system, and economic sanctions, such as restricting market access or denying future investment, are less effective when alternative markets and investment sources exist.

Britain and the United States were the principal enforcers of the minimum standard in the pre-BIT era. Further, other European states enforced the minimum standard in their colonial possessions (Lipson 1985). British military interventions in developing countries were primarily conducted to enforce property rights for their own nationals (Platt 1968). However, British interventions also effectively strengthened property rights for investors from other developed states (Lipson 1985). The United States began taking responsibility for protecting foreign investments in Latin America in the early 20th century (Lipson 1985). The US wanted to promote and open global economy and enforce the minimum standard but also wanted to lessen European influence in Latin America; consequently, the US unilaterally enforced investment protections in Latin America for US and non-US foreign nationals alike so that European influence in Latin American politics would be diminished while the open international economy would be maintained (Lipson 1985).

A few dominant MNCs and cartels in the pre-BIT era effectively sanctioned states that violated the minimum standard (Lipson 1985). The oligopolistic structure of MNCs that invested in the developing world ensured that individual firms would not pursue their own individual goals over collective corporate interests, and allowed firms to
apply effective private sanctions on developing states that violated international investment law (Lipson 1985).

The ability of the West to enforce its view of the minimum standard for the treatment of foreign owned property diminished shortly after WWII with the ascendance of the Soviet Union to super-power status and the proliferation of corporations looking to invest in the developing world. Western, capital exporting states had to seek BITs as a way of protecting the foreign investments of their multinationals since they no longer had the capabilities to enforce their own version of international investment law through customary law or general principles.

CONCLUSION

BITs are the centerpiece of the current patchwork international regime governing international investments. Three factors worked in concert to elevate BITs to this status in the post-WWII era, replacing the Western view of the minimum standard which was entrenched in customary international law and general legal principles. First, the minimum standard only addressed outright expropriation and not the primary concerns of multinationals investing in developed states—restrictive business practices. Second, an ideological change in the developing world made outright expropriation rare and LDCs began seeking FDI. Third, the West could no longer enforce its views of customary international law and general principles through its power advantages. BITs address each issue: BITs constrain various restrictive business practices; BITs promote FDI in LDCs; and BITs are enforced through treaty law.
CHAPTER 3: THEORY

INTRODUCTION

Theories are lenses through which social scientists view, simplify, and study the world. Political theories focus on different factors in attempt to make sense of complex social interactions. Regime theory is the primary theoretical approach in the discipline of international relations for the study of regimes. However, it does not provide an appropriate lens for the study bilateral investment treaties (BITs), because regime theory cannot explain the popularity of BITs and the absence of a multilateral regime governing the treatment of foreign owned investment.

Regime theory cannot explain the proliferation of BITs because it does not include multinational corporations (MNCs) as major players in regime creation and development. The historical analysis of protections provided to foreign investment was laden with anecdotal evidence indicating key roles played by multinationals in the evolution of the patchwork regime. Nevertheless, anecdotal evidence is not sufficient to validate the inclusion of MNCs in the study of BITs—a theoretical justification is required.

Susan Strange’s explanation of structural power provides a theoretical argument for the inclusion of MNCs in the study of BITs. In short, Strange argues political and technological changes in the post WWII era transformed MNCs into major actors, because they acquired sway over the means to wealth creation and advanced from subservient pawns of states to independent, influential actors capable of bargaining with, and even dominating, states. These insights from Strange are applied to the study of
BITs through policy diffusion theory, which is a framework specifically designed to analyze the spread of liberalizing policies throughout the international economic system.

REGIME THEORY

Regimes are variables that intervene between basic determinants of state actions (power, interests, and values) and actual state actions (Krasner 1983). The most widely accepted definition of this concept was established by Krasner (1983), which defines regimes as “sets of explicit or implicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations” (27).

Regime theory explains the creation of regimes, how, why, and when regimes change, and the mechanisms through which regimes influence the behavior of various actors (Karns and Mingst 2010; Hasenclever et al. 1997). However, regime theory is a disparate field. The major schools of thought in international relations (power based theories, interest based theories, and knowledge based theories) provide markedly different approaches to regimes (Hansenclever et al. 1997).

Power-Based Theories: Realism and Hegemonic Stability Theory

Realism and hegemonic stability theory are power-based approaches because they recognize the distribution of power among states in the international system as the central variable for understanding how regimes are created, how they affect state action, and how they change. While power-based approaches do recognize the ability of regimes to influence state actions, they contend that regimes only influence states because of states’
underlying power relationships (Jervis 1999; Krasner 1993a; Grieco 1990). However, the mechanisms by which, and the conditions under which, regimes emerge vary by the seminal power-based studies covered here. Kindleberger (1973; 1981), Gilpin (1981), and Krasner (1993a) view regimes and any associated cooperation as the product of a powerful state while Grieco (1990) provides a modern realist interpretation and conceptualizes regimes as tools that can help states achieve cooperation under a set of conditions that is limited by concerns states have over relative gains.

**Hegemonic stability theory.** Hegemonic stability theory explains the creation of liberal economic regimes in the 19th century, led by Great Britain, and in the post WWII era, led by the United States. A hegemon is a state that controls a preponderance of military and economic power in the international system. Hegemonic stability theorists argue that only hegemons can create and maintain regimes, that is, regimes cannot be created or survive without the backing of a hegemon (Gilpin 1981; Kindleberger 1973). Two basic approaches explain how a hegemon influences the behavior of states: benevolent and coercive (Snidal 1985b). Kindleberger (1973) presents the benevolent hegemon approach. According to Kindleberger (1973), a willing hegemon can establish an open economic system by unilaterally paying the costs of public goods that would otherwise go under produced, the most important of which is stability. The benevolent hegemon, Kindleberger (1973) argues, allows other states to be free-riders and benefit from stability without paying any costs. Kindleberger (1973) claims that the open economic system will end when there is no longer a hegemon in place that is willing to pay the costs to maintain the system.
Gilpin (1981) presents the coercive hegemon approach. Gilpin (1981) argues that a hegemon will organize the international economic system in a way that is distributionally biased in its favor and co-opt other states into participating in the system. According to Gilpin (1981), the costs of enforcing an economic system are high and can lead to the hegemon’s decline. The regime will change, Gilpin (1981) argues, when another state is able to overcome the hegemon through war and re-write the rules of the system in its favor.

Critics of the hegemonic stability approaches raise several issues. First, in a criticism of the hegemonic approach in general, Mckeown (1983) notes that regimes, particularly in the area of trade, can be created and maintained without the presence of a hegemon. Second, criticizing Kindleberger (1973), Conybeare (1984) notes that an open economic system, free trade in particular, is not a public goods problem and instead should be viewed as a problem of “predatory income transfers” (8). Consequently, an open economic system is not something that can be unilaterally provided by one powerful state. The distribution of benefits from a potential regime is a factor that may prevent its creation.

**Modern realism, relative gains and the limited effectiveness of regimes.**

Realists assume that states are rational, unitary actors and emphasize the importance of power because of their view of the international system as anarchic (Morgenthau 1978). Realists recognize that in anarchy there is no overarching authority present to prevent one state from harming another; thus, states are forced to pursue power in order to prolong their survival. Consequently, states will not willingly cooperate in situations where
cooperation will lead to an unequal distribution of gains: “even the prospect of large absolute gains for both parties does not elicit their cooperation so long as each fears how the other will use its increased capabilities” (Waltz 1979, 106).

Grieco’s (1990) power-based explanation of regimes is centered on the importance of relative gains. Grieco (1990) assumes that states are primarily concerned with defending their power positions relative to other states in the system, not simply maximizing their utility as is assumed by neoliberals. Consequently, Grieco (1990) argues, regimes must do more than just ensure that cheating does not take place for states to cooperate. They must also ameliorate concerns over relative gains. Grieco (1990) notes that regimes accomplish this task by arranging side-payments and by providing differential treatment for weaker states. However, Grieco (1990) does admit that relative gains matter more in some areas than others. Issues in the economic realm or with interactions between long-time allies do not raise the same concerns over relative gains as do areas closely related to security or interactions between foes. Therefore, Grieco (1990) argues that regimes will be most likely to occur in the former areas.

Krasner’s power-oriented approach. Krasner (1993a) uses game theory, the ‘Battle of the Sexes’ situation in particular, to produce a power-based view of how regimes are shaped and impact cooperation among states. Krasner (1993a) argues that the payoff scenario provided in Battle of the Sexes offers a more apt analogy than ‘Prisoner’s Dilemma,’ the scenario preferred by neoliberals such as Keohane (1984), for analyzing the potential for cooperation among states in the anarchic international system because multiple pareto optimal outcomes exist in Battle of the Sexes, while only one
exists in the Prisoner’s Dilemma. On the one hand, the primary obstacle to cooperation in Prisoner’s Dilemma is the potential for states to cheat on their commitments. Neoliberals claim that cooperation can happen when institutions are established that discourage cheating (shadow of the future, reduced transactions costs, etc.). On the other hand, in the Battle of the Sexes scenario, potential cooperation is impeded by concerns about how gains should be distributed and is ultimately decided by the power relationship of the states involved.

Krasner argues that a regime is established when the more powerful actor can use its resource advantages to alter the weaker actor’s preference ordering, so that the pareto-efficient equilibrium favored by the powerful actor becomes the outcome favored by the weaker actor as well (Krasner 1993a). Thus, Krasner (1993a) claims, regimes influence state behavior by helping them avoid pareto inefficient outcomes. The pareto-efficient equilibrium favored by the powerful state cannot be reached or maintained without a regime. However, even if a regime is established, Krasner (1993a) argues, the regime will lack resilience, since it is predicated on the power relationship of the states involved—the regime will deteriorate once the underlying power-relationship from which it was created is altered.

**Interest-Based Theory: Neoliberalism**

Neoliberalism is considered an interest-based theory because it emphasizes the ability of regimes to help states realize their common interests in order to achieve cooperation (Hansenclever et al. 1997). Neoliberal institutionalists maintain the same basic simplifying assumptions as realism, primarily that states are rational, unitary actors.
However, the neoliberal assumption that states are rational egoists, that they are only concerned with maximizing their own gains, differs markedly from the realist emphasis on relative gains and produces a more optimistic view of the chances of cooperation among states than is provided by power based approaches (Keohane 1984; Grieco 1990).

**Neoliberal Institutionalism and how regimes facilitate cooperation.** Keohane (1984) explains how regimes facilitate cooperation among self-interested, rational states with a common interest in situations where cooperation cannot be achieved without coordinated action, that is, in situations of interdependence (Keohane 1984; Keohane & Nye 1977). He accomplishes this task by first showing that cooperation is in the best interests of states and then by showing how regimes can facilitate cooperation.71

Keohane (1984) builds from Axelrod’s (1984) use of the Prisoner’s Dilemma situation to demonstrate how cooperation can be rational for states.72 The dominant strategy for a one-time Prisoner’s Dilemma game is defection; however, if multiple games are played by the same actors, using the tit-for-tat strategy, the most rational choice for actors to pursue is mutual cooperation (Keohane 1984; Axelrod 1984).73 Keohane (1984) explains that regimes can create a ‘shadow of the future:’ a situation

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71 Keohane (1984) uses a rational choice approach to demonstrate that cooperation can be in the best interests of states even when states are assumed to be rational egoists and unitary actors. Keohane (1984) claims: “Rational-choice analysis is used in this book not to reinforce the conventional wisdom that cooperation must be rare in world politics, but to show that it can be pursued even by purely rational, narrowly self-interested governments, unmoved by idealistic concern for the common good or by ideological commitment to a certain pattern of international relations. That is, rational egoist can have incentives to form international regimes” (78).

72 The prisoner’s dilemma game is used because it represents a situation where “there is no solution that is in the best interests of all the participants,” making cooperation among rational states difficult to achieve (Jervis 1978, 171).

73 Axelrod (1984) provides results from a computer tournament where competitors who used the tit-for-tat strategy were the most successful.
where states are aware of possible gains from future interactions, which increases the potential costs of defection. This new information provided through the regime facilitates cooperation between rational states because each state will not want to forgo large amounts of future gains via cooperation for the relatively small amount of gains that it would achieve through cheating.

Keohane (1984) uses the Coase theorem to show how regimes can facilitate cooperation among states. The Coase theorem suggests that cooperation among states requires three specific conditions that are not naturally occurring in international politics, clear legal liability, low transaction costs, and high information levels. Keohane (1984) argues that regimes can create these conditions and thus promote cooperation. Furthermore, Keohane (1984) claims that regimes can create issue linkages and a shadow of the future, thus increasing costs associated with potential cheating. Martin (1992), Mitchell (1994), and Simmons (2000) provide examples of how regimes can facilitate cooperation among states.

**Neoliberal Institutionalism and regime formation.** Neoliberal criticisms of Keohane’s (1984) approach arise over his sole use of the Prisoner’s Dilemma situation to

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74 Martin (1992) examines the European Economic Community’s (EEC) sanctions placed on Argentina during Argentina’s dispute with Great Britain over the Falkland Islands. Britain wanted its EEC partners to place economic sanctions on Argentina for its military actions on the Falkland Islands, a territory claimed by the British. Most European countries were reluctant, seeing no incentive to sanction Argentina. In short, Britain was able to convince members of the EEC to place economic sanctions on Argentina through issue linkages, particularly, by linking British budget concessions within the EEC to the Argentine sanctions (Martin 1992).

75 Mitchell (1994) demonstrates that the design of a regime can impact its effectiveness when studying two sub-regimes meant to prohibit oil tankers from illegally polluting the ocean: “policymakers can improve compliance by regulating those sectors more vulnerable to pressures for compliance and by facilitating the efforts of those government and nonstate actors more likely to implement and enforce such regulations” (457).

76 Simmons (2000) argues that developing countries commit themselves to article VIII of the International Monetary Fund to make a credible commitment to liberal economic policies.
describe all strategic situations that arise among states. Situations-structuralists assert that different types of strategic situations exist in international politics and each situation represents different challenges for cooperation and regime development (Martin 1993; Stein 1990; Snidal 1985; Stein 1983). In other words, the factors influencing regime formation and the mechanisms by which regimes must influence state behavior to achieve cooperation vary by situation. Situations-structuralists organize various strategic situations into four categories: assurance situations, coordination situations, collaboration situations, and suasion situations (Martin 1993; Stein 1990).

All players have the same preferred outcome in assurance games; consequently, regimes have few roles to play in those situations. Regimes, neoliberals contend, can affect cooperation in the other situations.

Coordination problems contain two pareto efficient outcomes, one favored by each player (Martin 1993; Stein 1990). The players bargain over which of the two outcomes will prevail. However, the players do not have an incentive to defect once an agreement is reached, since each player prefers the established regime to no regime at all. Therefore, little attention is paid to monitoring behavior incoordination problems (Martin 1993; Stein 1990; Stein 1983).

Regimes designed to solve coordination problems form out of the common desire of states to avoid the outcome that would be the result of an absence of cooperation.

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77 Situation-structuralists are considered a sub-group of neoliberalism since they still recognize the ability of regimes to facilitate cooperation and consider states to be rational egoists.

78 Battle of the Sexes is an example of a coordination game. Battle of the sexes, which is illustrated by a couple wanting to engage in different activities on a date (say, going to a football game vs. going to the opera), “is a coordination game with two Pareto-efficient Nash equilibria [...] but, unlike in pure coordination games, the players have conflicting preferences regarding the two Pareto optima” (Hasenclever et al. 1997, 105).
Coordination regimes influence state behavior by establishing clear expectations for each state and not through enforcement mechanisms (Martin 1993; Stein 1990).

Collaboration games are situations where equilibrium outcomes are suboptimal and cooperation requires mutual policy adjustment away from each player’s dominant strategy (Martin 1993; Keohane 1984; Stein 1983). Two factors will promote cooperation in collaboration games. First, states will want extensive information on the behavior of other actors because undetected defection is costly for the cooperating state and will impede attempts at retaliation (Martin 1993; Keohane 1984; Stein 1983). Second, states will want mechanisms to increase the shadow of the future. The dominant strategy for a one-time collaboration game is defection; however, if multiple games are played by the same actors using the tit-for-tat strategy, the most rational choice for actors to pursue is mutual cooperation (Martin 1993; Stein 1990; Keohane 1984; Axelrod 1984).

Regimes designed to solve collaboration problems form so states can achieve a common interest that is unattainable without cooperation. Collaboration regimes influence the behavior of states by providing information, monitoring behavior, and increasing the costs of defection.

Suasion situations contain equilibrium outcomes that leave one actor dissatisfied and often take place in situations of power asymmetry (Martin 1993). The more powerful state in suasion games has the dominant strategy to cooperate and, knowing this, the weaker state can achieve its dominant strategy through defection. Consequently,

\[ \text{79 The Prisoner’s Dilemma is an example of a collaboration game.} \]
the dominant state can choose to either defect or to persuade the weaker state to cooperate through tactical linkages: either threats or side-payments (Martin 1993).

Regimes form in suasion situations when a dominant state can coerce a weaker state into following the regime. Suasion regimes influence behavior by establishing expectations for weaker states and the tactical linkages through which the weaker state could be punished by the stronger state if it defects (Martin 1993).

Neoliberalism and regime change. Neoliberals contend that regimes will change when the underlying interests that facilitated the creation of the regime are altered (Keohane 1984). However, neoliberals do not offer specifics on the creation or alteration of state interests, since state interests in Neoliberalism are exogenously given, that is, state interests are the product of structural factors such as the distribution of power in the international system. States are assumed to be unitary, rational actors and are assumed to pursue their interests accordingly. The focus of interest based approaches is to explain how regimes can facilitate cooperation when mutual interest in cooperation exists, not in determining the source of state interest. Consequently, the interest based approach to neoliberalism has little to offer in explaining regime change.

Cognitive Based Theories
Knowledge-based theories of international regimes provide an explanation for the development and change of state interests. Knowledge-based theories criticize the static, ‘black box’ approach to interest formation employed by power-based and interest-based theories. Instead, knowledge-based approaches argue that the interests of states are
“shaped by the normative and causal beliefs that decision makers hold and that, consequently, changes in belief systems can trigger changes in policy” (Hasenclever et al. 1997). Hasenclever et al. (1997) use the label ‘weak cognitivists’ to identify theorists who contend that a state’s perception of what constitutes utility depends upon knowledge yet still maintain the assumption that states are rational utility maximizers.\textsuperscript{80}

Weak cognitivists argue that knowledge structures and dynamics should be included in theoretical models because “the knowledge actors carry in their heads and project in their international encounters significantly shapes their behavior and expectations” (E. Haas 1990, 7). Goldstein and Keohane (1993a) argue that changes in principle beliefs, ideas parsing the just from the unjust, and causal beliefs, guides for decision makers on how to achieve certain goals, can create changes in preferences and consequently the behavior of actors.

Epistemic communities play a prominent role in knowledge formation, knowledge change and thus policy preferences. Epistemic communities are “network[s] of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area” (P. Haas 1992a, 27). Policy-makers often lack an understanding of complicated, highly technical policy areas and lean on epistemic communities such as scientists for policy advice. Epistemic communities provide “channels through which new ideas circulate from societies to governments as well as from country to country (P. Hass 1992a, 27). For instance, western states were largely in agreement regarding broad economic policy

\textsuperscript{80} Strong cognitivists reject the rational choice approach altogether and instead pursue a sociological view where states are viewed as members of the international society of states and obtain their interests from their membership in that society (Bull 2002; Wendt 1999).
preferences after WWII due to the dominance of Keynesianism amongst western economists (Ikenberry 1993).

Weak cognitivists argue that states may engage in learning, which may change their policy preferences and actions (P. Haas 1993; E. Haas 1990; Nye 1987). Nye (1987) distinguishes between complex and simple learning:

Simple learning uses new information merely to adapt the means, without altering any deeper goals in the ends—means chain. The actor simply uses a different instrument to attain the same goal. Complex learning, by contrast, involves recognition of conflicts among means and goals in causally complicated situations, and leads to new priorities and trade-offs (380).

For example, Nye (1987) argues that cooperation between the United States and the USSR on strategic arms control issues was only possible after both states “changed their initial beliefs about the usability of atomic weapons and the mechanics of nuclear deterrence” (147).

In sum, weak cognitivists pose a major challenge to the rational utility maximizing approaches (realism and neoliberalism) by demonstrating that “states sometimes redefine their interests and alter their preferences without a shift in the distribution of power and wealth” (Hasenclever et al. 1997, 146).

**Summary of Approaches to Regime Theory**

As has been demonstrated above, regime theory is not monolithic. The majority of criticisms of regime theory come in the form of cross-fire from the application of the contending theoretical perspectives in international relations: power-based (realism); interest-based (neoliberalism); and knowledge-based (cognitivism).
The foundation of regime theory is Keohane’s (1984) brand of neoliberal institutionalism and it has stirred much debate. The primary realist criticism of neoliberalism has to do with the relative gains-absolute gains dichotomy. Realists argue that the neoliberal view of gains in absolute terms down-plays the strategic concerns faced by states in the anarchic system and produces an overly optimistic view of the ability of states to cooperate through regimes (Mearsheimer 1995; Waltz 1979). Furthermore, realists such as Krasner (1993) criticize Keohane’s use of the prisoner’s dilemma analogy arguing that it does not take into account the distribution of gains among states and, thus, overemphasizes the potential for states to cooperate. Neoliberals, particularly the structuralists-funtionalists (Martin 1993; Stein 1990), attempt to ameliorate some criticisms by recognizing variations in strategic situations.

Knowledge-based approaches, particularly the weak cognitivists, criticize neoliberal and realist approaches because of their structural approach to the interest formation of states (P. Haas 1993; Goldstein & Keohane 1993a; E. Haas 1990; Nye 1987). Weak cognitivists argue that state interests are influenced by such factors as epistemic communities and learning by the elite decision-makers of states.

**Regime Theory and BITs**

Regime theory does not explain why BITs have become the dominant mode of investment protection. The various conceptions of regime theory all predict the presence of a multilateral regime governing investment protection. The power oriented approaches to regime theory predict that a regime will be present when a powerful state benefits from the regime (Krasner 1993a) and is capable of providing the enforcement (Gilpin 1981)
and side payments (Grieco 1990) for the establishment and maintenance of the regime. Using the realist conception of rational, unitary states, powerful western states should want a strong multilateral regime for the protection of the property rights of their companies that invest abroad. A strong multilateral regime seems to be in the interests of powerful states like the United States, because it is home to thousands of multinational corporations.

The interest-based approach (Neoliberalism) to regimes cannot explain the absence of a multilateral regime to protect foreign investment. Neoliberalism is even more optimistic about the chances of international cooperation than realism, since it does not contend that states are concerned over relative gains. For the neoliberals, a regime should occur when states have an interest in cooperating because regimes facilitate cooperation (Keohane 1984). As mentioned above, powerful states would benefit from a regime protecting their investors and weaker states would benefit from having an international regime that makes foreign investors more likely to invest in the weaker, developing states.

The knowledge-based (cognitivist) approach to regimes does not explain the lack of a multilateral regime for the protection of foreign owned property. The cognitivists contend that policy makers’ perceptions of the international system affect their understanding of the system and the policies that they should pursue (Hansenclever et al. 1997). From the 1980s on, epistemic communities, especially Economists, have supported the notion that FDI is conducive to the economic development of states. Developing states are even actively courting MNCs (UNCTAD 2007). The cognitivists cannot explain why the regime for the protection of FDI is fragmented into BITs, when a
multilateral regime would fit into their cognitive frameworks. Regime theory cannot explain the proliferation of BITs because of flaws in its general approach, particularly because it ignores the influences of MNCs.

**Criticisms of Regime Theory**

A prominent criticism of regime theory as a general approach to international relations comes from Strange (1982). Strange recognizes five shortcomings in regime theory: (1) it is a fad that will pass soon, (2) it is imprecise, (3) it has a value bias towards western-backed institutions, (4) it is too static, and (5) it is too state-centered. While Strange’s notion of regime theory as a passing fad was inaccurate, her other points still carry weight.

The imprecision of regime theory stems from its practitioners emphasis on discovering broad theoretical truths about the behavior of states. The use of highly generalizable economic approaches such as game theory, which Strange later referred to as “vague and wooly words,” prevents analysts from examining political relationships that could provide more fruitful explanations of regime dynamics (Strange 1997, xii). Young (1989) concurs and argues that game theory assumptions that states are unitary and rational, usual assumptions for applying game theory to state behavior, abstract away most of the primary considerations of real-world negotiators such as domestic political constraints and a lack of knowledge of the potential payoffs from various strategies.\(^{81}\)

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\(^{81}\) Instead of using game theory, Young’s (1983) analysis organizes regimes into three categories: negotiated regimes (conscious efforts to solve a problem), spontaneous regimes (not consciously formed), and imposed regimes (those imposed by dominant powers).
Strange criticizes regime theory as value biased towards western-backed institutions. Strange considers Keohane & Nye’s (1977) term ‘interdependence’ a “euphemism for asymmetric dependence” and claims that what regime theorists call cooperation and regime development was merely the US exercising its structural power to shape the international system in a way that favored it and, in particular, its MNCs (Strange 1996, xiii).

Strange’s critiques of regime theory as ‘too static’ and ‘too state-centered’ are related to her contribution to the understanding of structural power, which is explained in some detail below. In short, structural changes, which are not accounted for in regime theory, in the areas of security, production, finance, and knowledge have altered the core goals of states from entities that compete for more territory in order to acquire more power to entities that compete for the means to create wealth, which is wielded by MNCs, making them major actors in international relations and necessitating their inclusion in explanations of regimes.

**STRANGE’S STRUCTURAL POWER**

Strange’s primary goal was to explain major changes to the global political and economic system in the second half of the 20th century (Story 2000). To do this, she departs from political science’s traditional concentration on states and international organizations as the major components in the international system and instead adjusts her focus to include markets and corporate organizations, and in doing so, develops a new conception of power in international politics and economics.
Strange recognizes two forms of power that can be exercised by states, relational power and structural power. Relational power is defined by Strange (1994) as the “power of A to get B to do something they would not otherwise do” and is in-step with traditional realist notions of the term (24). Strange’s (1988a) major contribution to the discipline comes from her conception of structural power:

The power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises and (not least) their scientists and other professional people, have to operate; structural power, in short, confers the power to decide how things shall be done, the power to shape frameworks within which states relate to each other, relate to people, or relate to corporate enterprises (24-25).

Structural power refers to the ability of an actor to change not just the rules of the game, but the game itself. A state wielding structural power can shape the choices of other actors without exerting any pressure (Story 2000). In the post-WWII era, advances in technology coupled with the liberalizing effect of US hegemony brought about changes to the four primary components of structural power: production, security, finance, and knowledge (Strange 1988a).

**Production**

The production structure is “the sum of all arrangements determining what is produced, by whom, by what method and on what terms” (Strange 1988a, 62). Two major changes to the global production structure occurred in the last two-hundred years.
First, capitalism became the world’s dominant mode of production. Second, more and more production serves world, as opposed to national, markets.

Technological advances in transportation and information have further globalized the capitalist production structure. Containerization and supertankers allow most products to be efficiently shipped around the world. Corporations can effectively manage complex global supply chains as a result of advances in computers and communication capabilities. Consequently, goods destined for one market can be produced and assembled across the globe.

**Security**

The security structure is “the framework of power created by the provision of security by some human beings for others;” consequently, the providers of security have power over those to whom they provide security (Strange 1994, 45). Strange (1994) uses a broad definition of security that not only includes the traditional notions of security such as the protection from war and violence, but also protection from other unpleasant circumstances, such as bankruptcy, unemployment, and starvation, all factors that contribute to a country’s political stability. The globalization of the capitalist production structure has emphasized the importance of the latter and deemphasized the importance of the former by enhancing “the benefits of peaceful competition for world market shares while raising the costs of competition for command over territory” (Strange 1994, 62).

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Strange (1994) defines capitalism as “a system in which markets for goods and services allow the forces of demand to influence what is produced, so that innovation in products and processes and the application of capital to the means by which they are produced are both rewarded” (64).
Thus, in the post-WWII globalized world, economic relationships influence the ability of states to provide security to their citizens.

**Finance**

The financial structure is “the sum of all the arrangements governing the availability of credit plus all the factors determining the terms on which currencies are exchanged for one another” (Strange 1994, 90). The United States dominates both aspects of the financial structure (Strange 1994). The United States used its powerful position post-WWII to create an open financial system with, eventually, the dollar as the reserve currency. Financial institutions of the United States possess significant sway over which states are granted credit and to which states credit is denied. This is a significant source of power, since credit is necessary for investment and economic development. Technological innovations in the realm of finance combined with the liberalization of the financial system have led to an, at times, volatile financial system where large sums of money can be transferred rapidly into or out of an economy resulting in panics and, sometimes, financial crises (Strange 1998; Strange 1986).

**Knowledge**

The knowledge structure refers to “what is believed (and the moral conclusions and principles derived from those beliefs); what is known and perceived as understood; and the channels by which beliefs, ideas and knowledge are communicated—including

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83 This gives the United States the ability to run large trade and budget deficits, since states desire to keep large amounts of dollars in their coffers to avoid financial crises.
some people and excluding others” (Strange 1994, 119). Strange (1994) notes that the four structures do overlap. This is the case with the knowledge structure, in particular. Knowledge disparities in the area of production create power asymmetries. Firms with technological advantages will have more success in the global marketplace than firms without such technologies. The home states of firms with knowledge advantages seek to entrench those advantages through global institutions, such as the rules established through the World Trade Organization for governing intellectual property rights, which are skewed in favor of developed states already possessing advanced technologies.

**US Hegemony and Liberal Agenda**

Strange’s explanation of the increasing internationalization of economies in the post-WWII period does not rest on structural changes alone. Agency also plays an important role in her explanation of globalization (Keohane 2000). In particular, she argues that the United States used its hegemonic position to liberalize the international economy and that the liberal agenda was pursued in the short term interests of US corporations and financial institutions, and not because of ideology (Strange 1998; Strange 1986). In short, political decisions and non-decisions by the United States, and European powers to a lesser extent, resulted in Strange’s characterization of the international financial system as *Casino Capitalism* (Strange 1986) and *Mad Money* (Strange 1998), where large sums of money rapidly, and sometimes capriciously, flowed in and out of state economies.\(^{84}\)

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\(^{84}\) The Europeans refused to share the Cold War’s financial burden with the United States, preferring instead to focus on welfare state spending (Strange 1986). The resulting large budget deficits in the United
Strange argues that the United States still maintains (as of her final writings in the late 1990s) its hegemonic position (Strange 1998). She claims that most of the powerful MNCs in the global economy are from the United States; consequently, the United States has maintained its structural power in the areas of production, finance, and knowledge. Thus, the United States maintains a non-territorial, corporate empire, where through its MNCs the United States controls the distribution of the structural elements mentioned above (Strange 1989; Strange 1988b).

Consequences of Structural Change: The Rise of Multinationals and the Decline of States

A primary consequence of the structural changes in global politics is that economic and political dimensions of markets have replaced war and peace as the principal concern of states (Strange 1996; Strange 1988b). Wars were fought and alliances were made to protect and expand territorial positions, because territory was the means to power. Now, Strange argues, states compete for market shares, because markets are the means to wealth: “states are concerned primarily to ensure that business conditions within their own jurisdiction are sufficiently attractive to foster wealth-creating activities and to attract inward investment by multinational corporations” (Story 2000, 25).

States forced it to unilaterally withdrawal from the Bretton Woods monetary system in the early seventies (Strange 1986). Even without the discipline imposed from a gold-backed monetary system and large quantities of US dollars residing outside of the US because of its budget and trade deficits, the United States chose to promote free-market principles in the international financial system (Strange 1986). Coupled with technological innovations in currency exchange and financial instruments, large volumes of US dollars moving rapidly and unregulated in and out of countries created an international financial system that resembled a casino, where large gains from financial brokers are inequitably juxtaposed against potentially sudden and dramatic losses by ordinary citizens as a result of financial crises.
The structural changes that led to the primacy of the market have also elevated the status of MNCs to major actors in the global political economy (Stopford and Strange 1991). Multinationals are now the gatekeepers to finance and production technology; in short, they control significant power over wealth creating activities, powers that formally rested in the hands of states (Stopford and Strange 1991). MNCs are at liberty to invest, or divest, in or from the countries of their choosing, giving them leverage. If a country wants investments from a multinational, and with it wealth creating capital and technology, then the country must be willing to accommodate the multinational with a bouquet of business friendly policies (Strange 1996; Stopford and Strange 1991). Often, Strange argues, these policy frameworks inhibit the capacity of states to pursue regulations and distributional measures that would lead to economic development and higher living standards for average citizens (Strange 1998; Strange 1996, Strange 1986). In other words, the ascension of multinationals coincides with the Retreat of the State (Strange 1996). States, once in control of their economic destiny, are now forced to bargain with MNCs for the means to economic development (Stopford and Strange 1991).

Criticizing Strange: A Solid ‘Structure’ but Flimsy Finishing Work
Strange’s contributions to the wider discipline of international relations in the area of structural power are substantial. Her use of structures, security, finance, production, and knowledge, provide the causal mechanisms through which states and MNCs gain leverage over countries in the post-WWII international system. However, Strange’s (1996) ‘retreat of the state’ thesis, an extension of her structural argument, and her claim
of continuing US hegemonic dominance via its multinationals and privileged financial position are overstated (1988b).

**Strange overstates the power of MNCs.** Blanket statements claiming MNC-state relationships to be heavily leveraged in favor of multinationals are brash. All states face the same structural pressures, yet state economic policies towards MNCs are varied. Some states have retained the ability to shape their policy environments while others seem dominated by powerful multinationals. For example, Singapore has developed institutions that integrate MNCs into the economic policy process, but only in an advisory role: “interviewed business representatives all confirmed that the government mainly consults with them for fine tuning advice and ultimately endorsement of their policy strategies” (Dent 2003, 260). Alternatively, Chevron, an oil company, has been accused of dominating the politics of Angola and extracting an inequitable share of the gains from the country’s oil resources (Onishi 2006).

The difference in the two examples is the strength of the states (Fukuyama 2004), or put another way, their institutional capacity (North 1990). State strength refers to “the ability of states to plan and execute policies and to enforce laws cleanly and transparently” (Fukuyama 2004, 7). Rueschemeyer and Evans (1985) note that “an effective bureaucratic machinery is the key to the state’s capacity to intervene” in economic development policies (51).

Strong states can pursue the distributional economic policies demanded by various domestic constituencies that are adversely affected by openness to global economic forces. These constituencies constituted an ‘embedded liberalism,’ as
described by Ruggie (1982), and are a political force, especially in developed countries. Indeed, Rodrik (1996) found that stronger states (measured as government spending) are actually associated with greater economic openness.

Overall, states have not been forced to yield control of wealth creating structures to multinationals and market forces. In opposition to this aspect of Strange’s thesis, Underhill (2000) writes, “We have changing forms of state emphasizing different functions over others, not an emasculation as such” (132). The state’s relationship to the market has been altered, resulting in a broad range of new policy choices and mechanisms through which states still hold sway over markets and market actors (Underhill 2000; Cable 1995). The economic success of a state is in large part determined by its policy choices. It follows then that developing states are not destined to poverty because of the economic structures designed by Western industrialized countries and enforced via their structural power, as argued by Strange (1996). Thus, Strange over-exaggerates the power of firms relative to states and the continued hegemony of the US is therefore in doubt.

Strange overstates US hegemony. Strange (1988b) predicated US hegemony on the supremacy of its multinationals. As stated above, the state-MNC relationship is not as one-sided as Strange contends; consequently, Strange’s (1988b) conception of the US as a corporate empire is built on a false premise. Furthermore, many MNCs have risen from other western industrialized states and emerging markets. As of 2000, fewer than 10,000 of the world’s 63,312 multinationals had their home base in the US and (Gabel and Bruner 2003) and only one-quarter of the world’s top 100 MNCs were US
multinationals in 2004, a significant portion, but substantially smaller than when Strange wrote about the continued dominance of US multinationals in the 80s (UNCTAD 2007). Thus, the dominance of US multinationals has declined.

The United States is not an all-powerful leviathan, blindly and wildly seeking its short-term interests in the realm of finance, either, as described by Strange (1998; 1986). The US will act in its own best interest like all states, but not exclusively. Preservation of the financial system is also a goal, and preservation requires cooperation (Cohen 2000). Washington has at various times led multilateral efforts, at no small cost, to maintain the system, like when the United States provided financial assistance to Mexico in 1994-1995 and to various East Asian states in 1997-1998. This is evidence of its conviction to concede short term losses for the broader good of maintaining the system (Cohen 2000). US leadership has in effect increased cooperation in global monetary issues, since it is nearly impossible for states to seek significantly conflicting macroeconomic policy (Webb 1995). Cohen (2000) concludes: “in practice American hegemony has been, at worst, only intermittently coercive and certainly has not lacked for periods of benevolent generosity as well. To insist otherwise is also to border on caricature” (110).

THE POLICY DIFFUSION THEORETICAL FRAMEWORK

Policy diffusion provides the framework through which the structural elements gleaned from Strange’s work can be applied to the study of BITs. This framework has

\[^{85}\text{The UNCTAD (2007) assessed MNCs by three dimensions to conclude a list of the world’s 100 largest MNCs: assets, sales, and employment.}\]

\[^{86}\text{Furthermore, states still have considerable influence over macroeconomic policy. States still control fiscal policy and may even have more control of monetary policy now than during the classical gold standard of fixed exchange rates during the early 20^{th} century (Gilpin 2001).}\]
been used to explain the timing and geographic reach of various liberal innovations (e.g., Meseguer and Gilardi 2009; Simmons et al. 2006; Lee and Strang 2006). Previous explanations view state economic policies as the result of internal domestic factors (Frieden 1991; Rogowski 1989). However, the clustering of various liberal policy trends over time and space led policy diffusion scholars to suggest that the spread of liberal policies stems from factors external to the state (Simmons and Elkins 2004).

Policy diffusion happens when “the decision to liberalize (or restrict) by some government influences the choice made by others” (Simmons and Elkins 2004, 171-172). Thus, policy diffusion assumes interdependent decision making among states, which occurs “when government policy decisions in a given country are systematically conditioned by prior policy choices made in other countries” (Simmons et al. 2006, 787). The null hypothesis in policy diffusion is independent decision making, or the idea that a state’s decision to adopt liberal policies is solely the result internal politics (Meseguer and Gilardi 2009; Simmons et al. 2006). 87

Policy diffusion suggests four causal frameworks through which liberal policies may spread: coercion, competition, learning, and emulation (Simmons et al. 2006). 88 The insights gained from Strange’s work on structural power and the international influence of multinationals are applied through the coercion framework to produce testable hypotheses for analyzing the spread and utility of BITs.

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87 For example, the determinants of a state’s monetary and exchange-rate policy have been argued to stem from domestic political pressures (Clark 2002), domestic veto player (Keefer and Stasavage 2002), federalism (Hallerberg 2002), coalition governments (Bernhard and Leblang 2002), and domestic policy transparency (Broz 2002).

88 The process of policy diffusion is assumed to be an uncoordinated process; consequently, it is not amenable to game theory analysis, particularly game theory assumptions that actors have complete information and are rational (Elkins and Simmons 2005).
A Coercive Theory of Policy Diffusion

Coercion-based explanations of policy diffusion focus on power asymmetries that permit strong actors to impose their policy preferences on weaker states (Simmons et al. 2006). Powerful actors can influence the policy preferences of weaker states through multiple channels (Simmons et al. 2006). Hard coercion includes direct action by powerful actors to influence the incentives of weaker states to liberalize. Soft coercion includes policy decisions of powerful actors that, either intentionally or unintentionally, change decision making dynamics of weaker states. Very soft coercion includes the ideational channels through which powerful actors can influence the way issues are framed and how states view particular policies. Coercive theory analyses can demonstrate that coercion plays a significant role in liberal policy diffusion through three mechanisms: 1) identifying the coercive actor(s), 2) demonstrating that the coercive actor(s) favors the policy in question, and 3) showing the channel(s) through which the coercive actor(s) influences policy change across borders (Simmons el al. 2006).

MNCs as coercive actors. This coercive explanation of the diffusion of BITs recognizes three primary actors: the home developed state, the host developing state, and

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89 For instance, states may use or threaten to use physical force.
90 For example, strong, developed states implemented the Basel Accord in capital market regulation and weaker, developing states were expected to follow suit (Simmons 2001).
91 An example of very soft power is the US’s ideational dominance in multilateral organizations such as the IMF and the World Bank. These organizations trumpeted the ‘Washington Consensus’ as an ideal policy framework for development, possibly influencing the policy preferences of developing states.
92 Coercion theory makes three assumptions (Simmons et al. 2006). First, the theory assumes that strong states have an intentional motive to influence the policies of weak states. Second, the coercive approach assumes that weaker states would prefer not to change their policy. Third, the coercive framework assumes that vertical power relationships are primary to horizontal relationships for the proliferation of liberal policies.
MNCs of the developed state. In short, MNCs influence both states involved in the treaty because they view BITs as in their interests. MNCs lobby their home state to pursue BITs with the developing state in which they want to invest. MNCs use their structural power to convince developing states to pursue BITs with the MNC’s home state. The diffusion of BITs is a result of pressure from MNCs. International coercion enters the equation through the MNC, which threatens to not invest in the developing country if no treaty is signed. Thus, the MNC’s structural power, its ability to deny investment to a potential host state, is exercised through soft coercion, as defined above. These propositions are expanded below.

**BITs are in the interest of MNCs.** Multinational corporations (MNCs) looking to invest abroad may be wary of investing in a less developed country (LDC) for fear of over-regulation, under-developed legal institutions, and even the outright expropriation of an investment. BITs establish the terms and conditions by which foreign investment must be treated in a LDC (Elkins et al. 2006). Commitments made to investors by LDCs not covered by a BIT are not subject to international law and may be altered at the convenience of the host state. Because BITs grant the terms and conditions contained in the agreement the status of treaty law, BITs provide investors increased confidence that their investments in LDCs can be profitable; consequently, BITs are in the interests of MNCs.

MNCs garner more benefits from BITs, conducted bilaterally, than MNCs would receive from a multilateral regime (Guzman 1998). Developing states would increase their bargaining positions versus developed states by working together in the multilateral
arena. The terms and conditions of a multilateral treaty governing investment protections would not be as generous to MNCs as those conducted bilaterally. Thus, BITs are in the interests of MNCs, more so than a multilateral treaty.

**MNCs influence their home state to sign BITs.** The proposition that a state’s foreign economic policy is influenced by domestic groups is on solid theoretical footing. Domestic groups use the votes of their members, campaign donations, threat of capital flight, labor strikes, and other methods to influence the decisions of foreign economic policy makers (Jacobs and Page 2005; Gourevitch 1996; Frieden 1991; Rogowski 1989). When groups are competing over a particular policy, the most politically powerful group will be successful, leaving some uncertainty regarding the final policy that will be pursued by a particular state because political influence is wielded through a variety of weapons, the effectiveness of which will vary by the political institutions of states (Milner 1997; Destler 1992). However, MNCs will successfully lobby their home state to pursue BITs with LDCs because of weak domestic political opposition.

A substantial literature provides empirical evidence connecting business interests and United States foreign economic policy. Grossman and Helpman (1994), Hansen and Prusa (1997), and Gawande and Bandyopadhyay (2000) all conclude that various firms and industries can purchase import protection from congresspersons with political contributions. Additional studies show that industries located in the district of a Ways and Means committee member are particularly influential on trade policy (Drope and Hansen 2004; Hansen and Prusa 1997). Jacobs and Page (2005) test the impact of business corporations, unions, epistemic communities, and public opinion on the foreign
policy preferences of United States policy makers and find “the strongest and most consistent results [...] are the coefficients for business, which suggest that internationally oriented business corporations are strongly influential in US foreign policy” (114).

Furthermore, Winters (1996) argues that political pressure from internationally oriented businesses will continue to increase as global capital becomes more mobile and global competition increases. Internationally oriented businesses will increasingly pressure the government to pursue foreign economic policies that will allow firms to be competitive internationally (Winters 1996). However, while there is ample evidence to demonstrate the effect interest groups have on foreign economic policy, predicting the type of policy, more or less liberal, for which domestic interests will lobby is a more contentious issue.

Rogowski (1989) and Frieden (1991) provide explanations for how exogenous economic influences can affect political cleavages and policy preferences within a country. Rogowski (1989) assumes complete factor mobility and theorizes that increasing exposure to the international economy will cause predictable domestic cleavages to form, depending on the state’s factor endowments. Owners of the abundant factor will prefer more openness and owners of the scarce factor will prefer less openness. Frieden (1991) criticizes Rogowski’s (1989) assumption of complete factor mobility and instead assumes that some factors are not mobile, at least in the short term. Frieden (1991) predicts that the owners of international firms and financial services, owners of mobile capital, will demand open policies while domestic oriented firms and owners of immobile capital, will want protection.93 Regardless of how the alignment of

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93 According to Frieden (1991), “the interests of two groups—the owners and managers of financial assets and the multinational corporations—are opposed to those of the specific factors, so that financial and
interest groups plays out, a state’s actual stance towards a liberalizing policy is normally
the result of competing interests, which leaves a great deal of uncertainty regarding the
actual policy that will be pursued by the state. However, MNCs seeking BITs will not
run into such domestic political opposition.

MNCs should lobby the policy makers of their home state to sign BITs with
potential host states with little opposition from other domestic groups. While Frieden
(1991) would expect opposition from domestic oriented firms, firms that would have to
compete with multinationals from other states, the international investment dynamic
works differently. BITs are signed between a capital exporting state, the home state of
the MNC, and a capital importing developing country where the MNC wants to invest.
Very little foreign direct investment flows back to the home developed state;
consequently, domestic opposition to the BIT from business groups in the developed
country is unlikely to exist. However, developed state governments are not guaranteed to
follow the interests of internationally oriented businesses that would benefit from BITs.
Some opposition to BITs is present. For instance, anti-globalization groups lobby against
BITs in the United States and Norway and some United States academics have urged
their government to include provisions in BITs that would allow developing host states
more policy flexibility (Whitsitt 2009; Vis-Dunbar 2009a; Vis-Dunbar 2009b). Still,
MNCs should be able to convince policy makers in their home state to pursue BITs with
LDCs in which they want to invest. Multinationals have much to gain through the
signing of a BIT and are likely to contribute large campaign contributions to elected
officials to sway their opinion in the multinational’s favor. BIT opponents lobby against

multinational interests in the developed countries are expected to diverge from the interests of specific
nationally based industrial sectors” (440)
BITs for moral reasons and are not likely to have as much of a financial influence on politicians as multinationals.

**MNCs use their structural power to lobby host states to sign BITs.** Putnam (1988) provides the traditional way of approaching negotiations between states—states develop negotiating strategies based on the interests of domestic groups. This approach is outdated. Domestic groups are not the only actors influencing the interests of states, especially developing states that need the technology, capital, and knowledge of MNCs for economic development. This is particularly true in regards to the spread of BITs, where MNCs from one state can influence the decision-making process of a LDC via their structural power.

Putnam (1988) develops a conceptual framework for understanding how domestic political interests interact with diplomacy and introduces the concept of two-level negotiation games. Level one negotiations are between state diplomats who bargain for the interests of their constituents. Level two negotiations are among the constituents who decide whether to support the agreement reached in level one. Putnam (1988) explains that each state has a ‘win-set’ developed in level two negotiations. Win-sets are “the set of all possible level one agreements that would [...] gain the necessary majority among the constituents—when simply voted up or down” (Putnam 1988, 437). Cooperation is possible when win-sets overlap. Putnam (1988) argues that a smaller win-set actually gives a state more bargaining leverage, even though it decreases the chance of achieving cooperation.
Putnam (1988) contends that a state’s win-set is the function of its domestic politics. This is no longer the case because the boundaries defining a state’s domestic constituency have been blurred. The structural changes in the world economy outlined by Stopford and Strange (1991) and Strange (1988a) have elevated multinationals to global actors. MNCs have the ability to lobby and affect the win-sets of not only their home state, but their potential or actual host state’s win-set as well. However, while the MNC should not expect much political resistance in its home developed state, resistance may abound in the host developing state where groups competing against the MNC may organize to keep it out of the LDC, or, at minimum, to water-down various provisions present in the BIT. Developing countries possessing elements of structural power relative to the MNCs of the potential home state in a BIT should be in position to bargain for treaty terms that allow the host state to maintain greater autonomy in regards to their treatment of the home state’s MNCs. Therefore, MNCs will not be able to dictate the terms of the BIT to LDCs, at least not in all cases.

In sum, MNCs want the protections and guarantees afforded by BITs so they pressure the developing state in which they want to invest to sign a BIT with the MNC’s home state. Developing states would prefer to not be bound by an investment treaty. LDC leaders would rather maintain policy autonomy so they could divvy benefits to constituencies in exchange for political support (Krasner 1985). However, because they seek foreign investment for economic development, they are forced to acquiesce to the desires of MNCs and become BIT partners with the home state of the MNC whose investment they seek.
CONCLUSION: DEVELOPING AN APPROPRIATE LENS THROUGH WHICH TO VIEW BITS

Regime theory is not the proper perspective for viewing BITs, because regime theory cannot explain the presence of BITs and the absence of a multilateral regime governing the protection of foreign investments. The variations of regime theory reviewed above do not include potentially important actors in the proliferation of BITs—multinational corporations. Neoliberals and realists assume that states are unitary actors and that their preferences are determined by exogenous factors. Neoliberals allow for influences from non-governmental actors such as MNCs, but it is still a state-centric approach. Weak cognitivists do attempt to include alternative sources of preference formation, but still focus primarily on the state as a unitary actor. Multinationals need to be included in the study of BITs. As detailed in the historical background chapter, MNC interactions with host states and their home state have affected the content and function of the patchwork investment protection regime. Susan Strange’s work on structural power provides a theoretical justification for the inclusion of MNCs in the study of BITs.

Strange explains how structural changes in the international political economy have elevated the role of MNCs to major actor status. Multinationals control the finance and technology that states need to pursue economic growth, placing them in a strong, but not dominant, bargaining position relative to states. An accurate explanation of the evolution of the patchwork foreign investment regime must include MNCs, because MNCs control structural power.

Strange’s structural power is applied to the study of BITs through policy diffusion theory, a framework which identifies the actors and paths through which liberalizing
economic policies are spread through the international economic system. In brief, MNCs seek BITs because BITs are in their interests. BITs, negotiated bilaterally, provide MNCs with greater investment protections than they would receive through either the absence of a treaty or through a multilateral treaty. Multinationals of developed states lobby their home state to seek a BIT with a developing state in which they want to invest and they use their structural power to influence the developing state to join a BIT with their home state.
CHAPTER 4: LITERATURE REVIEW

INTRODUCTION

Foreign direct investment (FDI) is an integral component of the development plans of many less developed countries (LDCs; Balasubramanyam 2003; Stopford and Strange 1991). FDI provides LDCs with elements associated with economic development, such as technology transfers, job skills, and, of course, much needed capital. However, multinational corporations (MNCs) looking to invest abroad may be wary of investing in a LDC for fear of over-regulation, under-developed legal institutions, and even the outright expropriation of an investment. In hopes of easing the concerns of investors to attract more FDI, LDCs have signed numerous bilateral investment treaties (BITs) with developed, capital-exporting states that are home to MNCs. BITs establish the terms and conditions by which foreign investment will be treated in a LDC (Elkins et al. 2006). To date, over 2,500 BITs have been signed (unctad.org).

The political economy literature on BITs has addressed two questions: (1) What has driven the proliferation of BITs? and (2) Do BITs increase FDI flows to LDCs? Only a few studies have attempted to explain the former question, Guzman (1998), Elkins et al. (2006) and Swenson (2009). These scholars attempt to solve the following paradox that regime theory is unable to answer: why do LDCs sign BITs yet reject multilateral attempts to codify investment protections? Two explanations are examined and critiqued: (1) BITs are the result of competition among developing states to attract FDI, and (2) BITs are the result of lobbying efforts by multinationals that have already invested in a LDC. The latter question has received more attention, but has yielded
ambiguous results, as illustrated in table 1. Empirical studies are organized into two
general approaches, monadic, which have developing states as the unit of analysis, and
dyadic, which have pairs of states, one developed and one developing, as the unit of
analysis.

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<th>Table 4. 1 Results from studies on BITs and FDI flows.</th>
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*Nuanced studies suggest that BITs do promote FDI to LDCs, but only to a limited subset of states.

EXPLAINING THE BIT PARADOX: WHAT HAS DRIVEN THE PROLIFERATION OF BITs?

The BIT paradox is the apparent contradiction between the resistance of
developing countries to accept the western view of customary international law for the
protection of foreign owned property and the increasing propensity of the same states to
sign BITs, which often provide greater protections for foreign investors than customary international law (Sornarajah 2010; Guzman 1998). The leading explanation to this paradox is the competitive theory of BIT proliferation which argues that competition for FDI among developing countries prompted them to sign BITs (Elkins et al 2006; Guzman 1998).

Guzman (1998) and Elkins et al. (2006) contend that the proliferation of BITs is propelled by competition among capital-seeking, typically developing, host states to attract FDI from the developed world. Developing states want to attract FDI as part of their development strategies, but face limitations due to what has been dubbed, ‘the obsolescing bargain’ (Guzman 1998; Vernon 1977; Vernon 1971).94 The obsolescing bargain is the inability of developing states with weak legal institutions to credibly commit to policies promised to MNCs. Developing states may promise MNCs a litany of favorable polices to entice investment in their country; however, the developing state has an incentive to renege on its commitments and attempt to extract an additional share of rents once the MNC has sunk costs into the foreign investment. Guzman (1998) and Elkins et al. (2006) argue that developing states have turned to BITs to overcome the obsolescing bargain, become more attractive investment locations than their peers, and consequently attract a larger share of the total stock of FDI.

94 Vernon (1971) and Vernon (1977) use the phrase ‘obsolescing bargain,’ while Guzman (1998) and Elkins et al. (2006) use the phrase ‘dynamic inconsistency problem’; however, both phrases refer to the same phenomena.
The Obsolescing Bargain

The obsolescing bargaining model predicts that a MNC’s bargaining power will decline over time relative to the bargaining power of the host state in which it has invested (Vernon 1977; Vernon 1971). MNC’s initially possess bargaining leverage over potential host states. A MNC’s access to technology, managerial expertise, and export potential, among other factors, are attractive qualities for developing states which view these attributes as essential features to their development strategies (Stopford and Strange 1991). And while the potential host state does have qualities desired by the multinational, such as low labor costs, mineral resources, etc., the MNC’s capital is mobile giving it the ability to choose in which state it will invest. Thus, the bargaining advantage is in the multinational’s favor prior to the investment. The investment is viewed as a positive sum game by both parties, but the MNC in able to broker a deal in which the initial terms are tilted in its favor. The MNC may use its bargaining leverage to negotiate low tax rates, freedom from capital controls or many other potential benefits that will tilt the distribution of gains from the interaction in the multinational’s favor. However, once the investment has been ‘sunk’ the bargaining advantage begins to favor the host state.

According to the obsolescing bargaining model, the host state gains the bargaining advantage once the investment has been made in the host state. The host state captures the bargaining advantage for several reasons. First, an MNC would suffer high losses by choosing to change its investment to another state once costs have been ‘sunk’ in the investment; thus, the multinational no longer has one of its primary sources of bargaining advantage. Second, initial areas of bargaining advantage may erode over
time. Technology is a prime example. The technological preeminence of the multinational may fade over time as technological innovations become diffused; consequently, an MNC’s bargaining advantage will fade along with the decline of its technological advantage. The host state will use its leverage to alter the terms of the original agreement by increasing taxes, changing various regulations, or altering any other policy that will shift the distribution of gains from the investment in the host state’s favor.

Empirical tests of the obsolescing bargain have yielded mixed results in some regards, but support the hypothesis overall. Initially, case studies were conducted in the extractive sector and found evidence supporting the obsolescing bargain hypothesis (Moran 1975). Host countries began to demand higher taxes, joint marketing, greater processing, increases in nationals employed in managerial positions, and shared ownership after initial contracts were signed and investments were sunk (Moran 1985). For instance, a study of mining investments in Zaire and Zambia shows how initial concessions for a wholly-owned investment with minimal tax rates obsolesced into a 51 percent host-owned joint venture and tax rates up to 87 percent (Shafer 1985).

Case studies in the manufacturing sector have also supported the obsolescing bargain hypothesis. Host countries used their increased bargaining leverage to implement performance requirements on multinationals, which may include increased domestic content and manufacturing requirements and increasing exports (Moran 1985). For instance, between 1957 and 1980, local content requirements for MNCs in the auto industry increased from around 30 percent to 60 percent in Mexico, 95 percent in
Argentina and 100 percent in Brazil (Bennett and Sharpe 1985; Muller and Moore 1978; OAS 1974).

Two quantitative analyses have tested the obsolescing bargain hypothesis in the manufacturing sector. Kobrin (1987) hypothesizes that manufacturing multinationals, especially those in high technology industries, will not experience the obsolescing bargain since these industries continually adopt new technologies and managerial practices. The host state never gains a bargaining advantage on the manufacturing multinational since the multinational’s innovations are always ahead of those of the host state. This hypothesis is tested using a cross-national study of 563 US manufacturing subsidiaries in forty-nine developing countries. The results support the hypothesis. However, as pointed out by Vachani (1995), Kobrin’s research design is static; it only looks at one year. Vachani (1995) tests the same hypothesis using data from 61 subsidiaries in India over 15 years and finds support for the obsolescing bargain hypothesis, that is, subsidiaries in the manufacturing sector were subjected to higher regulatory, tax, and performance requirement burdens over time.

Explaining the BIT Paradox

Developing countries have turned to BITs to overcome the obsolescing bargain and attract more FDI, argues Guzman (1998). Investment incentives in BITs hold the status of international law and cannot be violated without considerable reputational loss for the host state. Hypothetically, membership in a BIT makes a developing state a more attractive location for FDI. Guzman (1998) argues that developing states are forced to sign BITs in order to stay competitive as a destination for FDI; thus, Guzman (1998)
contends competition for FDI among developing states is driving the proliferation of BITs. Guzman’s (1998) notion is empirically tested through the competition-based aspect of the policy diffusion framework by Elkins et al. (2006).

**A competitive explanation of BIT formation.** Competition-based explanations of the spread of liberal policies emphasize the importance of certain policies to attract investors and buyers in international markets (Elkins et al. 2006). The competition framework is particularly helpful when explaining “the policy moves through which governments compete with each other for internationally mobile capital and export-market share” (Elkins et al. 2006, 792). The conventional wisdom is that states prefer higher levels of market control in the absence of competition (Elkins et al. 2006). In particular, the leadership in weakly institutionalized developing states may prefer to maintain less liberal policies giving them the ability to distribute economic rents to important political groups in exchange for political support (Weinthal and Luong 2006; Krasner 1985). However, once a competing state begins to liberalize, the equilibrium characterized by high levels of market control may be destabilized as states begin to compete for footloose economic resources (Elkins et al. 2006; Strange 1991).

The competitive framework contains four assumptions (Elkins et al. 2006). First, states are assumed to believe that the policy in question can affect the attractiveness of the state as a location to conduct international business. Second, states are assumed to believe that the policy will affect investment locations in the short-to-medium term. The idea is that the longer it takes for a policy to impact economic activities, the less likely states will be to pursue a policy. Third, states are assumed to have high levels of
information about the policy choices of competitors and the impact of those policies.

Fourth, the competitive theory assumes that horizontal relationships among states with certain economic features are more important than vertical relationships and potential influences of power.

Elkins et al. (2006) empirically test the competitive theory of BIT formation. Like Guzman (1998), the authors argue, “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 that we hypothesize as provoking many BIT signings” (Elkins et al. 2006, 825). Elkins et al. (2006) hypothesize that a capital-seeking state will be more likely to sign a BIT when a state with which they compete for FDI signs a BIT.

This hypothesis is tested using an event history framework to estimate the duration of time before two potential treaty partners sign a BIT, the dependent variable. The explanatory independent variables, those used to measure levels of competition between potential host states, assess levels of export market competition and export product competition between host states. Each explanatory variable is used in a separate model. Elkins et al. (2006) found each measure to be statistically significant in the predicted direction thus supporting their hypothesis that competition among capital-seeking host states motivates them to sign BITs.

**Critique.** The theoretical framework employed by Elkins et al. (2006) is built on shaky ground because of one dubious assumption—the assumption that the less developed state in each treaty dyad is the state that initiates the treaty. The authors
attempt to justify this assumption by showing that low-income countries tend to sign BITs in clusters: “it appears that potential hosts are more likely to sign in clusters—suggesting that while the major capital exporters stand ready with model treaties in hand, the decision whether and when to sign is left to a large extent to the host” (Elkins et al 2006, 822). However, those clusters could be the result of another set of mechanisms: the MNCs of capital exporting developed states may be pressuring governments to conduct BITs. The MNCs of developed states might pressure governments, both their home state and state in which they want to invest, to pursue BITs. This process explains the clustering effect observed by Elkins et al. (2006)—the MNCs from various developed states view a particular developing host state as an attractive investment location and lobby both governments to become BIT partners.

An Alternative Explanation of BIT Proliferation. Swenson (2009) hypothesizes that the proliferation of BITs is driven by foreign investors, arguing that foreign investors, once in a host state, can leverage the threat to leave to get the host state to sign a BIT with the investor’s home state. Swenson’s (2009) dependent variable is the number of new BITs signed by developing countries over two periods, 1990-1994 and 1995-1999. Her explanatory independent variable is the total stock of FDI in the developing country at the beginning of each period. Swenson’s (2009) results are positive and significant and lead her to conclude that, “concern that foreign firms might relocate if the current host government failed to sign its own BIT motivated BIT signing” (447).
Swenson’s (2009) study can be criticized on multiple fronts: (1) it ignores the dynamic inconsistency problem; (2) it asks a dyadic question in a monadic research design; (3) it does not differentiate between BITs signed with a developed state and BITs signed with a developing state and (4) it assumes that BITs are retroactive. First, the literature on the dynamic inconsistency problem suggests that foreign firms have more leverage over host states before they invest, not after, as proposed by Swenson (2009). A more likely avenue for firms to influence BIT signings is through lobbying their home state government to sign a BIT with a host state where they want to invest. Second, Swenson (2009) makes the dubious assumption that a host state’s FDI stocks originate from the same developed country with which it eventually signs a BIT, yet her research design does not account for either the home state source of the FDI stocks or the home state with which the LDC signs a BIT. A dyadic research design is needed to test those assumptions. Third, developing states sign BITs with developed states to garner FDI. Developing states sign BITs with other developing states for symbolic reasons, since little FDI flows between pairs of LDCs (Vandevelde 2009; Sornarahaj 2010). Swanson (2009) does not include this important distinction. Fourth, most BITs are not retroactive, that is, they do not cover investments that have already been made. Thus, MNCs currently invested in a host state will have little reason to pursue a BIT.

DO BITs ATTRACT FDI TO LDCs?

Both developed, capital-exporting states and capital-importing LDCs expect to receive benefits from being a BIT signatory. Salacuse and Sullivan (2005) refer to these expected benefits as the ‘grand bargain’: protection is promised to the investments made
by the MNCs of the developed state in return for future investments in the LDC. Thus, BITs are expected to overcome the obsolescing bargain.

However, the actual benefits received by developing states from signing BITs remains a hotly debated topic. This research involves serious equity concerns. LDCs essentially forgo a degree of economic sovereignty by limiting their ability to regulate and extract rents from MNCs when they sign a BIT: “BITs may facilitate a division of profits that is less favorable than might occur under other regimes less highly controlled by the developed countries” (Tobin and Rose-Ackerman 2003, 8). Depending on the content of the BIT in question, BITs may limit an LDC’s ability to, among other concerns, respond to balance of payment problems and regulate the environment. In addition, BITs may place domestic industries at a competitive disadvantage by providing foreign investment with preferential treatment and may have a crowding-out effect on domestic investment. If LDCs do not garner increased investment flows from BIT membership, all of the benefits from the treaty will go to the MNCs of developed states at the expense of the LDCs. In this scenario the MNCs of developed states would continue to make investments they would in the absence of a BIT, only they would be getting a better deal in the process.

**Developed states and the grand bargain.** Developed states sign BITs to protect investments in LDCs (Tobin and Rose-Ackerman 2003; Salacuse and Sullivan 2005). Structural changes in the international economy emanating from technological advances in communication and transportation and economic liberalization in trade and finance have prompted the MNCs of developed states to invest abroad in order to seek additional
markets and resources, and achieve greater efficiency (Stopford and Strange 1991). However, a string of expropriations in the late 1960s and 1970s precipitated by a decline in US hegemony demonstrated the vulnerability of investments in LDCs. The willingness of developed states to engage in BITs “rests in the desire of companies of industrialized states to invest safely and securely in developing countries” and to create an international legal framework to govern the treatment of international investments (Salacuse and Sullivan 2005, 75). While international law does recognize the economic sovereignty of all states (Slomanson 1990), by signing a BIT, the capital importing LDC commits itself under international law to provide the various protections to foreign investment that are included in the treaty; and most importantly, BITs entitle investors to dispute settlement provisions when they feel a component of the treaty has been violated by the host state.

Virtually all BITs contain a section covering the settlement of investment disputes, the vast majority of which call for disputes to be settled through the International Centre for Settlement of Investment Disputes (ICSID) (Dolzer and Stevens 1995). Almost 200 total dispute cases between an MNC and a host state were taken to arbitration from 1995-2005 (UNCTAD 2007). Because BITs are a treaty between two sovereign states, not just an agreement between a host state and a MNC, LDCs would face steep reputational costs by ignoring a BIT commitment and not conforming to the dispute settlement process outlined in the BIT. Doing so would be a violation of the fundamental principle of international law—the expectation that treaties are to be observed. In short, BITs appear to have succeeded in developing a legal apparatus that
works to protect the investments of MNCs by subjecting the host state to international arbitration according to each individual treaty.

**Developing states and the grand bargain.** LDCs sign BITs to encourage foreign investment (Tobin and Rose-Ackerman 2003; Neumayer and Spess 2005; Salacuse and Sullivan 2005; Elkins et al. 2006). Investment from an MNC can be beneficial for an LDC’s economic development. For instance, investments can provide capital, technology transfers, and increase the job skills of the local population. Indeed, Salacuse and Sullivan (2005) note, “developing countries sign BITs to promote foreign investment, thereby increasing the amount of capital and associated technology that flows to their territories” (76). Neumayer and Spess (2005) go so far as to claim, “undoubtedly, BITs are so popular because policy makers in developing countries believe that signing them will increase FDI” (1567).

While scholars agree on the assumption that BITs are signed by developing countries to overcome the obsolescing bargain and attract FDI, the mechanism through which BITs attract investment to developing states is a point of contention. Some scholars claim a ‘signaling’ logic is at work while others vie for a ‘tying hands’ approach. The underlying logic has important ramifications for the empirical model used in the study of the effect of BITs on FDI flows to developing states.

**BITs as a form of Signaling (The Monadic Approach)**

The signaling logic is rooted in realist theory. Realists contend that international treaties are merely formal commitments to policies that states would make in the absence
of the treaty (Downs et al. 1996). The signing of a BIT is a host state’s public commitment to business friendly policies, a signal aimed at quelling investor concerns over the dynamic inconsistency problem (Kerner 2009; Sallacuse and Sullivan 2005). According to signaling logic, BITs should affect the investment decisions of foreign investors from states covered by the treaty as well as foreign investors from states not covered by the treaty (Kerner 2009; Sallacuse and Sullivan 2005). Foreign investors view BITs as a credible commitment to business friendly policies because of the developing country’s high ex ante costs associated with entering into the agreement (Kerner 2009; Buthe and Milner 2009). For instance, South Korean President Kim Dae-Jung faced intense political pressure for making a BIT with the United States a key component of his economic policy (Kim 2006). The Korean film industry, which lost protection from competition with the US film industry, adamantly opposed the treaty (Kim 2006).

Through signaling, an LDC will attract FDI from multiple home states through the signing of a single BIT. Quantitative studies designed to capture the signaling logic are monadic, focusing solely on the capital importing state. The dependent variable in these studies is, in slightly varying forms, the total amount of FDI received by the host state, regardless of country of origin. The primary independent variable is, usually, the total number of BITs signed by the host developing state. Signaling studies hypothesize that the more BITs an LDC signs, the more FDI it will receive from capital exporting, developed states. However, studies with the same basic research design have come to opposing conclusions.
**Early monadic studies.** Early monadic studies are limited by at least one of the following: temporal parameters (years covered by the analysis), their scope (the number of states included in a study), or the structure of their data (cross-sectional data, in particular). All of the early studies, with one exception (Grosse and Trevino 2005), find a statistically insignificant relationship between the total number of BITs signed by a developing host state and its FDI inflows.

UNCTAD (1998) used a limited approach. It assessed 133 host countries in 1995 via multiple regression. After their insignificant findings, the authors of this initial quantitative study concluded that BITs play a minor role, at best, in determining the location of FDI. This study is criticized for not controlling for country specific factors, a result of using cross-sectional data (Buthe and Milner 2009).

Salacuse and Sullivan (2005) employ the same basic research design as UNCTAD (1998), except they expand the temporal parameters to three years, 1998, 1999, and 2000 (using three separate cross-sections), decrease the states analyzed to 100, and account for BITs signed with the United States (separately from those signed by other OECD and non-OECD countries). The authors found a statistically insignificant relationship between the total number of BITs developing countries signed with OECD states (excluding the US) and FDI inflows to the developing country. Likewise, the relationship between total BITs signed with other LDCs and FDI inflows to each developing state was statistically insignificant. However, Salacuse and Sullivan (2005) did find that the presence of a BIT with the United States increased overall FDI inflows to the host state at statistically significant levels. They suggest that this finding was a result of the stronger investment protections included in United States BITs. However,
Buthe and Milner (2009) criticize this study for its excluded variable bias, a result of its cross sectional data. It also suffers from high levels of multicollinearity between the three BIT variables (BITs with the US, BITs with OECD, BITs with non-OECD), making it difficult to come to concrete conclusions (Salacuse and Sullivan 2005).

Grosse and Trevino (2005) focus on thirteen Central and Eastern European former communist countries from 1990 to 1999. The authors avoid missing variable bias by using panel data in their random effects, greater least squares model. The authors find a positive and statistically significant relationship between the total number of BITs signed by their observed countries and FDI inflows to those countries. This study can be criticized because of its limited scope, only thirteen countries, and limited temporal parameter.

Gallagher and Birch (2006) also use panel data in their regional study. They study FDI inflows to twenty-four Latin American countries from 1980 to 2003 using a time-series, fixed-effect model and find that the total number of BITs signed by each Latin American country does not have a statistically significant effect on its total FDI inflows.

**Monadic studies.** Tobin and Rose-Ackerman (2005), Neumayer and Spess (2005), Yackee (2009), and Tobin and Rose-Ackerman (2011) are monadic studies that investigate the interaction between BITs and the institutional quality of the host developing state. All four studies test to see if a developing states’ institutional quality influences the ability of BITs to stimulate FDI inflows. Tobin and Rose-Ackerman (2005 and 2011) and Yackee (2009) conclude that BITs work best, that is, they attract the most FDI, when signed by developing states with low levels of political risk (high institutional
Neumayer and Spess (2005) find the opposite: They find that BITs are more productive when signed by developing states with high levels of political risk (low institutional quality).

Tobin and Rose-Ackerman (2005) study the effect of cumulative BIT signings on FDI flows to 63 low and middle income countries from 1980 to 2000 using a time-series model with fixed effects. Their dependent variable is assessed as five year averages of aggregate FDI inflows. Tobin and Rose-Ackerman (2005) include a country risk variable, taken from the International Country Risk Guide, to account for the level of political risk associated with each country. The authors find that BITs only increase FDI flows to countries with low levels of political risk; thus, they conclude BITs complement high institutional quality (Tobin and Rose-Ackerman 2005). Neumayer and Spess (2005) criticize two major aspects of Tobin and Rose-Ackerman (2005) that they remedy in their study. First, the latter does not weight BITs, meaning a BIT signed with the United States is given the same weight as a BIT signed with a much smaller economy, such as Canada. Second, Tobin and Rose-Ackerman (2005) include a relatively small number of countries in their study.

Neumayer and Spess (2005) study the effect of cumulative BITs signings on FDI flows to 120 low and middle income countries from 1970 to 2001. One explanatory independent variable in Neumayer and Spess (2005) is “the cumulative number of BITs a developing country has signed with OECD countries, weighted by the share of outward FDI flow the OECD country accounts for relative to total world outward FDI flow” (Neumayer and Spess 2005, 1573). By taking into account the total outward FDI of a particular OECD country, Neumayer and Spess (2005) avoid equating the potential
impact of a BIT signed with an OECD state with large FDI outflows with the impact of a BIT signed with an OECD state with smaller FDI outflows. Neumayer and Spess (2005) also create an interaction term for BITs and institutional quality, measured using the International Country Risk Guide. The dependent variable is FDI inflows as a percent of all FDI inflows to developing countries. The authors find (1) that cumulative BITs increase FDI flows to developing states, and (2) BITs increase FDI flows to countries with higher levels of political risk more so than countries with lower levels of risk, meaning that BITs are a substitute for poor institutions.

Yackee (2009) replicates Neumayer and Spess’ (2005) study, but makes several change to the latter’s research design. For instance, Yackee (2009) extends the time period to 2003, includes other commercial agreements such as NAFTA, and only investigates FDI flows from the top eighteen capital exporting countries, instead of all OECD member states like Neumayer and Spess (2005). Yackee’s (2009) results conflict with those of Neumayer and Spess (2005). He finds that BITs are actually more effective as political risk decreases, meaning that BITs are complements to countries with higher institutional quality, not a substitute for poor institutions.

Tobin & Rose-Ackerman (2011) present another crack at the institutional aspects of the BIT-FDI puzzle. The authors increase the scope and range of their study to include 97 low and middle income host countries from 1984 to 2007, notably, still a lower number of countries than used by Neumayer and Spess (2005). Tobin and Rose-Ackerman (2011) exclude small island countries, as they did in their 2005 study, to avoid violating unit homogeneity assumptions. Their depdendent variable is the log of real FDI inflows to the host state in a given year. They once again use the total number of BITs
signed by the capital importing country with OECD partners as the independent variable, arguing that BITs do not need to be weighted. BITs signal a commitment to business friendly policies to foreign investors whether the BIT is with the United States or Canada. Tobin and Rose-Ackerman (2011) include an additional hypothesis: “as more and more countries enter into more and more BITs, the relative benefit to a particular country of signing one more BIT can be expected to fall as countries compete for FDI” (8). The authors conclude, in step with the findings from their 2005 study, that the marginal FDI gains from joining a BIT are higher for developing countries with better institutional environments. Tobin and Rose-Ackerman (2011) also find that the effect of BITs on FDI flows has decreased as the total world-wide number of BITs has increased.

The final monadic study covered here is by Buthe and Milner (2009), which largely mirrors Neumayer and Spess’ (2005) study. Similar to Neumayer and Spess (2005), Buthe and Milner (2009) find a positive and statistically significant relationship between the total number of BITs signed by a developing state and the total FDI it receives, which is assessed as a percentage of the host state’s GDP. The unit of analysis in Buthe and Milner’s (2009) study is non-OECD countries with populations greater than 1 million, totaling 129. Countries are analyzed from 1970 to 2000 using a time-series, fixed-effects model.

**Criticism of monadic studies.** The signaling logic used by monadic studies to justify the claim that BITs can attract FDI from MNCs not covered by the agreement is not applicable to today’s globalized world. Structural changes in the international economy have made liberal economic policies a necessary component of the economic
development strategies of LDCs (Stopford and Strange 1991; Strange 1988a). The expropriation of foreign owned property is no longer viewed by LDCs as a necessary policy for economic development (Stopford and Strange 1991; Minor 1994). Developing states want the benefits that stem from multinationals operating within their borders and are willing to enter into BITs to get them (OECD 2003). Through the signing of BITs, LDCs may signal to MNCs from multiple states that they will not expropriate foreign investments, but that is not enough to lure multinationals.

Other areas of LDC economic policy are more important to the investment decisions of multinationals. These areas pose a direct impact on the ability of an MNC’s host state operations to be profitable. For instance, transfer issues are the most frequent source of investment disputes between developing states and multinationals (Vandavelde 2009; Sornarajah 2004). Some BITs guarantee the right of MNCs from a particular state to remit profits unconditionally. This benefit is not available to MNCs from other states. There is no legal avenue for a multinational from another state to achieve this benefit, or any other benefit provided in a BIT under which the multinational is not covered. If a multinational from a state not covered by the treaty is not permitted to remit profits, no law, international or domestic, is broken and it is unlikely a host state will lose or gain potential investments when it exercises its legal and legitimate policies.

**BITs as Tying Hands (The Dyadic Approach)**

The tying hands logic is ingrained in institutionalist (neoliberal) theory. Institutionalists argue that international agreements can be designed to alter state incentives, and therefore state behavior (e.g., Abbott and Snidal 2000; Simmons 2000;
Keohane 1984). According to this logic, BITs change the behavior of host states by raising the *ex post* costs of violating commitments to MNCs made in the treaties (Kerner 2009). BITs limit the policies that host states can apply to MNCs covered by the treaty, thus tying the hands of host states.

A host state would suffer high reputation costs for violating a BIT commitment. Because of its highly public status as a treaty commitment, and a commitment enshrined in international law, the violation of a BIT would generate bad publicity for the host state, which would discourage foreign investors from investing in the state in the future. Violating the terms of a BIT could also cause a diplomatic row with the investor’s home state, possibly spilling into other areas of diplomacy. In fact, host state BIT violations may lead to a reduction in its credit rating, making IMF and World Bank loans and government bonds more costly (Garcia-Bolivar and Schmid 2004).

However, the tying hands logic can only be applied to MNCs covered by the treaty (Kerner 2009). Anecdotal evidence demonstrates how host states can treat MNCs covered by BITs differently than MNCs not covered by BITs. For example, during South Africa’s post-apartheid property reallocation, foreign mining companies covered by a BIT were allotted more favorable treatment than those not covered by a BIT, particularly in the area of compensation paid for expropriation (Peterson 2004).

Through tying hands, a developing state will attract higher levels of FDI from the host state in the agreement. Quantitative studies designed to capture the tying hands logic are dyadic, focusing on state pairs. The dependent variable in these studies is the FDI levels flowing from the home, developed state in the agreement to the host developing state. The explanatory independent variable is, usually, the presence of a BIT
in a particular dyad of states. Tying hands studies hypothesize that the presence of a BIT in a dyadic pair of states will increase FDI flows from the home state to the host state. Most dyadic studies have not verified the tying hands hypothesis.

**Dyadic studies.** UNCTAD (1998) contains a dyadic study of FDI flows from fourteen developed capital exporting countries into 72 capital importing developing countries from 1971 to 1994 using panel data in a time-series analysis. The results indicated a positive relationship between the presence of a BIT in a dyad and FDI flows, but not at statistically robust levels. The study is criticized because of data collection methods and limited control variables (Salacuse and Sullivan 2005). Bilateral FDI data for the 1970s is scarce, requiring the authors to use a variety of sources, each with different data collection methods, to piece-meal the dataset together. UNCTAD (1998) employed a limited set of control variables.

Hallward-Driemeier (2003) investigates the impact of BITs on bilateral investment flows between 20 OECD states and 31 LDCs from 1980-2000 using a time-series model with fixed-effects. The unit of analysis is each OECD state-LCD dyadic pair. Hallward-Driemeier (2003) employs a barrage of various model specifications and control variables and finds in the vast majority of her models that BITs do not have a statistically significant effect on FDI flows within dyadic pairs of states.

Sallacuse & Sullivan (2005) and Gallagher & Birch (2006) both analyze dyads consisting of the United States and a developing country. These studies have conflicting results, likely because of their limited and disparate research designs. Salacuse and Sullivan’s (2005) research contains a dyadic model featuring 31 developing countries
paired with the United States. The authors analyze FDI flows from the United States to a
developing country from 1991 to 2000 and found a positive and highly significant
relationship between the presence of a BIT with the United States and United States’ FDI
flows to the developing countries. Salacuse and Sullivan (2005) use signed, but not
necessarily ratified BITs in their study. Haftel (2008) replicates Salacuse and Sullivan’s
(2005) study but only includes signed and ratified BITs. Haftel’s (2008) results are
study contains a dyadic model consisting of 24 Latin American countries, on the one
hand, and the United States, on the other. Net FDI inflows to the Latin American country
from the United States are analyzed from 1980 to 2003. The results from this dyadic
analysis were not statistically significant.

The final dyadic study covered here is from Kerner (2009). Kerner’s (2009) study
is unique because it tests both the signaling hypothesis and the tying hands hypothesis in
the same model. The unit of analysis is direct dyads (pairs of countries and one
observation per ordered pair). Dyads include one of the original OECD members plus
Japan, Australia, and New Zealand, on the one hand, and 127 developing countries on the
other hand. The period covered is 1982 to 2001. The dependent variable is the natural
log of FDI flows. Two explanatory independent variables are used: the presence of a BIT
in a dyad, and a rolling average of BITs ratified by LDC outside the dyad in years t-1 and
t +1. The former independent variable tests the tying hands hypothesis and the latter
independent variable tests the signaling hypothesis. Kerner (2009) uses a two stage least
squares regression and two instrumental variables to control for endogeneity. Kerner (2009) concludes that BITs have a positive and robust effect on FDI to developing countries and BITs affect FDI through both channels, directly through the tying of hands logic and indirectly through the signaling logic.

**Critique: why not account for variation in BITs?** A possible advantage of dyadic research designs is that they allow researchers to potentially account for differences among BITs. However, none of the aforementioned dyadic studies account for variation in BIT content. In other words, the studies are assuming that any variation that exists across BITs does not have any impact on the amount of FDI the treaty is expected to garner for LDCs. The studies provide various justifications for their homogenous operationalization of BITs. Hallward-Driemeier (2003) provides the following explanation for her homogenous approach to BITs in a footnote:

This paper does treat all BITs equally, when in fact there are some differences between them. The general point that BITs strengthen property rights holds across all of them. It is possible that there would be more of an effect if one looked only at those treaties with the strongest investor protections. Given this would require reading and devising an index measure of several hundred BITs, it is beyond the scope of this paper (14).

Essentially, Hallward-Driemeier (2003) appears to shy away from creating a measure for BITs because of the sheer amount of time that such a process would take.

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95 The first instrumental variable is “the percentage of a host state’s neighbors that have ratified a BIT with the home state in question as an instrument for the existence of a ratified BIT” (Kerner 2009, 87). The second instrumental variable is a “3-year moving average of new BITs that a host state’s neighbors have ratified as an instrument for the 3-year moving average of the number of BITs that a host country has ratified with countries outside the dyad” (Kerner 2009, 87).

96 Kerner (2009) claims that these findings are hidden unless endogeneity is controlled for.
Elkins et al. (2006) justify their assumption of BIT homogeneity by claiming, “most analysts would agree that governments in countries home to large multinational corporations (MNCs) had nearly converged on a single treaty model” (817). Unfortunately, the authors fail to provide a citation indicating to which analysts they are referring. The authors do, however, justify their approach to BITs by claiming that because of the market power superiority of the developed capital-exporting state in the agreement, as well as LDC competition for FDI, LDCs have no bargaining power to alter provisions of BITs and must accept the provisions offered by the developed state if they want to enter into a BIT with a developed, capital-exporting state (Elkins et al. 2006). However, not all scholars agree with this point of view. For instance, Sornarajah (2010) claims the content of each BIT varies according to the bargaining position of each party to the treaty and provides the following observation:

Though the outer shell of bilateral investment treaties looks similar […] a deeper examination would indicate that the contents of the treaties vary so widely that each must be considered a carefully balanced accommodation reached after negotiation between the parties (206).

The fact that most BITs cover the same issue areas does not necessarily guarantee those areas will be treated the same in every BIT. BITs vary because of the bargaining positions of the two states involved in the treaty (Sornarajah 2010). Small changes in language or the inclusion or exclusion of a certain provision could result in large differences in the amount of FDI a BIT can attract. Indeed, Hallward-Driemeier (2003) admits, “while it should be recognized that a BIT could be an important commitment device, the nature of the commitment can vary enormously depending on the terms of the BIT” (3).
The lone study on BIT variation, Yackee (2008). Yackee (2008) examines whether strong BITs can induce more FDI to developing states than weak BITs. Strong BITs guarantee a foreign investor’s right to unilaterally initiate binding arbitration against a host state over a wide range of issues (Yackee 2008). Weak BITs do not provide foreign investors such protections (Yackee 2008). Yackee (2008) utilizes a dyadic, time-series cross sectional research design with clustered standard errors. He assesses FDI flows from the top eighteen capital exporting states to all other countries from 1945-2002. Yackee (2008) concludes that strong BITs do not garner more inward FDI to developing states than weak BITs. In fact, he finds that neither category of BIT has a statistically significant effect on FDI flows from the capital exporting state to the capital importing state.

While Yackee’s (2008) analysis is a step in the right direction, in regards to his inclusion of BIT variation, the analysis is hardly conclusive. Yackee (2008) only includes one area of BIT variation when, in reality, BITs vary across dozens of provisions, the inclusion or exclusion of which could influence the investments decisions of multinationals. Yackee’s (2008) decision to only include an investor’s right to raise disputes in his formulation of strong BITs is arbitrary. A more sophisticated analysis of BIT strength is needed before the BIT strength hypothesis can be properly tested.

CONCLUSION

In conclusion, the literature on BITs contains logical holes. The most prominent explanation of BIT proliferation is the competition hypothesis, which states that the
spread of BITs is the result of developing state competition for FDI (Elkins et al. 2006; Guzman 1998). Developing states sign BITs with developed, capital exporting countries to become more attractive investment destinations than other developing states with which they compete for foreign capital (Elkins et al. 2006; Guzman 1998). However, the competition hypothesis leaves unaccounted two major actors: multinationals and home states. Swenson (2009) suggests that MNCs play the key role in the spread of BITs by lobbying their host developed state to sign a BIT with their home state. Unfortunately, her monadic research design does not capture this dynamic empirically and, furthermore, her logic ignores influences from the obsolescing bargain, which argues that multinationals lose their bargaining leverage with a host state once their investment has been sunk. She also does not account for any influence from the home state. The present study improves upon the aforementioned studies by employing a theoretical framework that allows for potential influences from MNCs and their home states to discern the driving force behind the proliferation of BITs.

Studies trying to discern the effect of BITs on FDI flows to developing countries can be improved by accounting for the internal dynamics of the treaties. Monadic research designs cannot capture influences from BIT variation. Furthermore, the signaling logic undergirding this approach is outdated. Quelling the threat of expropriation through signaling is no longer enough to receive investment from multinationals. Specific, guaranteed protections in a wide variety of policy areas could influence multinationals, however. Yackee (2008), in a dyadic research design, attempts to account for specific guarantees in BITs, but does not go far enough. He only accounts for one area of variation in BITs, the foreign investor’s right to initiate arbitration. The
present study improves upon previous studies by using a dyadic research design and accounting for multiple areas of BIT variation to gauge the effect of BITs on FDI flows to developing states.
CHAPTER 5: MEASURING BIT STRENGTH

INTRODUCTION

Bilateral investment treaties (BITs) establish various guarantees of treatment that a host state must provide foreign investors covered by the treaty. Less developed countries (LDCs) sign BITs to make their economies more attractive investment locations. Developed states sign BITs to garner legal protections for their multinational corporations (MNCs).

Political scientists, economists, and legal scholars have attempted to discern the effect of BITs on foreign direct investment (FDI) flows to developing states, but with mixed results. The puzzle remains: do BITs increase FDI flows to the less developed states? Or, do BITs merely grant developed state multinationals additional economic and legal benefits?

Empirical studies on this topic share one key methodological misstep—every study, with one exception, has treated BITs as homogenous, unchanging influences on FDI flows. Only Yackee (2008) has attempted to account for variation among the treaties, and Yackee’s work only controls for one aspect of treaty variation.

This chapter details the development of measurement instruments to gauge the strength of investment protections that a treaty provides foreign investors. Variation across thirty-seven different aspects of BITs is assessed using content analysis. Strength measures are then developed using Guttman scaling procedures. In the end, this research establishes four distinct measures of treaty strength.
MEASUREMENT OF BITs

This study analyzes 748 BITs. The spatial parameter is restricted to ratified BITs between a developed, top eighteen, capital exporting state, on the one hand, and all other states, on the other hand. The temporal parameter spans from 1980 to 2009. Information on BITs, when they were ratified and full texts of the agreements, was gathered from the UNCTAD website.

Only ratified treaties are analyzed in this study. The goal of this research is to analyze the effect of treaty strength on FDI flows. Treaties that were signed but never implemented (ratified) do not affect the strength of protections that a host state must provide foreign investors. Therefore unratiﬁed treaties are not valid to this study. As of 2005, almost 2,500 total BITs have been signed (UNCTAD 2007); however, not all of these treaties are analyzed here. This research is particularly interested in assessing the impact of BIT provisions on FDI flows from developed, capital exporting states to less developed states. Therefore, BITs signed between two non-top 18 capital exporting states are not included. About 650 BITs fall into this category (UNCTAD 2007). Furthermore, very little FDI flows between developing states (UNCTAD 2007). Developing countries sign BITs primarily for symbolic reasons (UNCTAD 2007; Sornarahaj 2010). No BITs between two top-18 capital exporting states have been signed, so logically, none were coded.

1980 was chosen as the start date for this study for two reasons. First, BITs began to proliferate in the early 1980s. Second, bilateral FDI data became more available.

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97 Almost all BITs are available online through the UNCTAD website; but, as noted in Yackee (2008), the UNCTAD website is not complete. Some treaties are not listed on the UNCTAD website. However, the UNCTAD’s list of BITs is the source widely used in studies of BITs (Elkins et al. 2006, etc.). Other ratified treaties were listed on the UNCTAD website, but the full text of the treaty was not available. These treaties were not coded.
around 1980, an important factor for the next stage of the analysis that attempts to
determine the effect of treaty strength on FDI flows between a developed and a
developing state. All treaties appearing on the UNCTAD website in 2009 that met the
above qualifications were coded using content analysis.

Content analysis “is a research technique for making replicable and valid
inferences from texts (or other meaningful matter) to the contexts of their use”
(Krippendorff 2004, 18). This study applies Krippendorff’s (2004) content analysis
methods to BITs. All BITs were coded twice to ensure inter-coder reliability. Each of
the thirty-seven strength measures exceeded Krippendorff’s (2004) suggested 80 percent
accuracy threshold, meaning both coders scored the variable the same way at least 80
percent of the time.

Three studies outlining provisions present in BITs, UNCTAD (2007), Sornarajah
(2010), and Dolzer and Stevens (1995), informed the initial thirty-seven areas of
variation. Appendix 1 provides a complete explanation of each area of variation.
Appendix 2 provides the original code sheet. Appendix 3 contains the guide to the
original code sheet. It gives explanations and examples of each category for every
variable.

The Creation of a Measurement Instrument

The content analysis produced much data. 748 treaties analyzed across thirty-
seven areas of treaty variation yielded over 27,000 data points. Instead of looking at
every aspect of variation individually, procedures were implemented to find underlying
factors (or dimensions), that is, variables that move together and can be combined to
produce one measure of an underlying concept that exists in the data. Factor analysis is the conventional method for identifying underlying dimensions in data. This study did not use factor analysis because the structure of the data is not amenable to that type of analysis. Factor analysis cannot be used with dichotomous data, which is present in the dataset constructed and utilized here (Bartholomew et al. 2008).

Underlying trends in the data were identified through the use of a gamma matrix (Yule’s-Q with dichotomous data). This technique is used to identify underlying dimensions in dichotomous data. Every variable was dichotomized in order to be used in the gamma matrix (Appendix 4). Gamma coefficients were calculated for each pair of dichotomized variables. Variable pairs with gamma coefficients of .80 or higher qualify as clustering together (MacRae 1970; see Appendix 5 for the complete gamma matrix).

The analysis identified four strength dimensions, or underlying constructs in the data (see Appendices 6-9): Exceptions, Transfers, Treatment, and Broad Treatment. The information in parentheses (i.e. v32a) refers to the variable’s location in the dichotomous code sheet (Appendix 4). A more detailed explanation of each variable and its composition is available in Appendix 1.

Exceptions. Each variable in this dimension concerns some form of exception to the treaty. The host state is not required to provide foreign investors guarantees and protections mentioned in the treaty to areas covered by the exceptions. Weaker treaties will have more exceptions. Stronger treaties will have fewer exceptions. This dimension consists of exceptions in the following areas:

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98 A polychoric version of factor analysis, which is used for dichotomous data, was attempted, but could not be computed because many variables did not contain enough variation.

99 Variables that did not cluster were not used beyond this point in the analysis, which is standard procedure (MacRae 1970).
• *Taxes* (v32a). BITs that contain a provision specifically stating that the treaty does not apply to matters of taxation are coded ‘0.’ BITs that do not contain a tax exception are coded ‘1.’

• *Essential security* (v33a). BITs that contain a provision allowing host states exceptions to the treaty in times where security and public order are threatened are coded ‘0.’ BITs that do not contain a security and public order exception are coded ‘1.’

• *Health and natural resources* (v34a). BITs excluding the treaty from pertaining to public health and natural resource issues are coded ‘0.’ Those that do not contain a public health and natural resource provision are coded ‘1.’

• *Financial services* (v35a). BITs containing a financial services exception allow the host state to renege on transfer provisions in the treaty during times of financial crises and are coded ‘0.’ Treaties not containing a financial services exception are coded ‘1.’

• *Environment* (v36a). BITs containing an environment exception allow the host state to violate BIT commitments in order to protect the environment. BITs with the environment exception are coded ‘0.’ BITs without the environment exception are coded ‘1.’

• *Industry* (v37a). BITs with an industry exception exclude the BIT from applying to a specific industry. BITs with the industry exception are coded ‘0.’ BITs without the industry exception are coded ‘1.’
Transfers. Each variable in this dimension concerns a transfer issue. Transfer provisions govern the ability of MNCs to move money into and out of a host state. Stronger treaties provide more transfer guarantees and protections. Weaker treaties provide fewer transfer guarantees and protections. This dimension consists of the following transfer provisions:

- **Transfers in & out (v15b).** This variable is coded ‘1’ when a transfer provision is present in the treaty and covers either inbound or outbound transfers. The variable is coded ‘0’ when a transfer provision is not present in a treaty.

- **Transfers in & out(2) (v15c).** This variable is coded ‘1’ when the treaty guarantees both inbound and outbound transfers and the variable coded ‘0’ when both inbound and outbound transfers are not guaranteed by the treaty.

- **Transfers & domestic law (v16a).** Some treaties contain provisions subjecting transfer rules to the domestic law of the host state. Treaties with a domestic law provision are coded ‘0’ and treaties without a domestic law provision are coded ‘1.’

- **Exchange rate (v20a).** Treaties that contain a provision stipulating the calculation of the exchange rate for transfers are coded ‘1,’ those without are coded ‘0.’

- **Exchange rate(2) (v20b).** Treaties containing a provision with exchange rate stipulations and the exchange rate is not determined by the host state are coded ‘1,’ all other treaties are coded ‘0.’
Treatment. Each variable in this dimension concerns how a host state is required to treat foreign investors. Stronger treaties provide more treatment protections and guarantees and weaker treaties provide fewer treatment protections and guarantees. This dimension consists of MNC treatment in the following areas:

- Performance requirements (v13b). Performance requirements are “conditions imposed by host countries on investors in connection with the establishment and operation of investments or in exchange for the granting of a particular advantage” (UNCTAD 2007, 64). Treaties without restrictions on performance requirements are coded ‘0’ and treaties with restrictions on performance requirements are coded ‘1.’

- Management positions (v14a). Host states have the right to regulate the entry of foreign nationals into their territory (UNCTAD 2007). Host state may require a multinational to hire locals in management positions. BITs that contain a provision guaranteeing foreign investor’s the ability to employ the management personal of their choosing are coded ‘1,’ those that do not are coded ‘0.’

- Management positions(2)(v14b). BITs guaranteeing the foreign investor to hire the managers of their choosing and, at the same time, do not contain any domestic law restrictions are coded ‘1,’ all other BITs are coded ‘0.’

Broad treatment. Each variable in this dimension concerns broad treatment standards that a host state is required to provide foreign investors. Stronger treaties provide more comprehensive broad treatment standards. Weaker treaties provide fewer,
less comprehensive broad treatment standards. This dimension consists of the following broad treatment provisions:

- **Fair and equitable (v7a).** Fair and equitable treatment provisions provide “a basic standard, detached from the host country’s domestic law against which the behavior of the host country vis-à-vis foreign investment can be assessed” (UNCTAD 2007, 28). BITs containing the fair and equitable standard are coded ‘1.’ BITs without the fair and equitable standard are coded ‘0.’

- **Fair and equitable(2)(v7c).** BITs containing the fair and equitable provision and, at the same time, not containing any domestic law restrictions are coded ‘1,’ all other BITs are coded ‘0.’

- **National treatment (v8b).** National treatment provisions require host states to afford foreign investors, at minimum, the same rights and standards of treatment that it provides its domestic firms. BITs that provide national treatment to a foreign investor and, at the same time, do not contain any domestic law restrictions are coded ‘1,’ all other BITs are coded ‘0.’

- **Most favored nation (v9a).** Most favored nation provisions require host states to give a foreign investor covered by the BIT, at minimum, the same standard of treatment that it allots foreign investors from third party states. BITs with the most favored nation provision present are coded ‘1.’ BITs without the most favored nation provision are coded ‘0.’
• *Most favored nation*(2) (v9b). BITs that provide national treatment to a foreign investor and, at the same time, do not contain either domestic law restrictions or international law restrictions are coded ‘1,’ all other BITs are coded ‘0.’

**The Guttman Scaling Procedure**

This analysis employs Guttman scaling (also called scalogram analysis or cumulative scaling) to assess underlying dimensions of treaty strength that span multiple aspects of the treaties. Guttman scales order both items (treaty variables in this case) and subjects (treaties in this case; McIver and Carmines 1981). The ideal Guttman scale “can accurately predict the subject’s response to each of the dichotomous items that make up the scale,” if the subject’s final scale score is known (McIver and Carmines 1981, 41). Guttman scale items are arranged “so that an endorsement of one implies endorsement of all previous items” (Garson 1976, 172). Assume a Guttman scale with a maximum score of five for instance. In the ideal scale, a score of three will indicate that the first three dichotomous aspects of the scale were present and the final two were absent. This ability of Guttman scales to order items is an advantage that is not present in a simple additive index of scale items. The Guttman scaling procedure was applied to the four strength measures.

Each strength measure was organized graphically so that the most common component of the scale was listed first, and the least common component of the scale was listed last. Take the strength cluster *treatment* for example. The most common component, the component occurring most often in treaties, is *management positions.*
The least frequent aspect of treatment is performance requirements. The middle component of treatment is management positions. A treaty that receives a Treatment score of 1 is expected to only have management positions present. A treaty that receives a treatment score of 2 is expected to have management positions and management positions(2) present.

This underlying cumulative assumption of Guttman scaling is advantageous because it allows a specific interpretation, for instance, of what a treatment score of 2 represents. If the scores were merely summed or averaged, a score of 2 for a variable with three components could have a variety of interpretations. A score of 2 could mean the first two components are present, the last two components are present, or the first and last components are present.

Tests of reproducibility and scalability were applied to the strength measures in order to justify the underlying cumulative assumption of Guttman scaling. All four measures passed the reproducibility and scalability tests (see Appendices 6-9).

**BIT Strength Measure Results**

The gamma matrix identified four underlying dimensions of BITs, which were combined into measures using Guttman scaling. These measures and the interpretation of possible scores are provided in tables 1 through 4. Higher strength scores are expected to garner more inward FDI for the host state.

Exceptions measures various economic or regulatory areas to which the treaty does not apply. A higher exceptions score indicates that fewer exceptions are present in
the treaty. A lower *Exceptions* score indicates that more exceptions are present in the treaty. *Exceptions* ranges from 0-6. The average *exceptions* score is 5.06.

**Table 5.1 Exceptions**

<table>
<thead>
<tr>
<th>Exceptions</th>
<th>Description</th>
<th>Frequency</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>financial services</td>
<td>Prudential measures for financial services exception not present</td>
<td>686</td>
<td>1</td>
</tr>
<tr>
<td>environment</td>
<td>Protection for the environment exception not present</td>
<td>681</td>
<td>2</td>
</tr>
<tr>
<td>health &amp; natural resources</td>
<td>Protection of health and natural resources exception not present</td>
<td>674</td>
<td>3</td>
</tr>
<tr>
<td>industry</td>
<td>Exclusion of certain industries not present</td>
<td>643</td>
<td>4</td>
</tr>
<tr>
<td>essential security</td>
<td>Essential security and public order exception not present</td>
<td>611</td>
<td>5</td>
</tr>
<tr>
<td>taxes</td>
<td>Tax policy exception not present</td>
<td>493</td>
<td>6</td>
</tr>
</tbody>
</table>

*Transfers* measures the protections allotted to foreign multinationals to transfer money in and out of the host state. A higher *Transfers* score indicates that the treaty
provides more freedom for foreign investors to move money in and out of the host state.

A lower Transfers score indicates that the treaty provides fewer guarantees for a multinational to move money in and out of the host state. Transfers ranges from 0-5.

The average Transfers score is 3.28

<table>
<thead>
<tr>
<th>Transfers</th>
<th>Description</th>
<th>Frequency</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>transfers &amp; domestic law</td>
<td>Transfer issues are addressed by the treaty, not restricted by domestic law</td>
<td>747</td>
<td>1</td>
</tr>
<tr>
<td>exchange rate</td>
<td>Provision on the exchange rate used is present</td>
<td>589</td>
<td>2</td>
</tr>
<tr>
<td>exchange rate(2)</td>
<td>Transfer provision present and exchange rate not decided by host</td>
<td>553</td>
<td>3</td>
</tr>
<tr>
<td>transfers in &amp; out</td>
<td>Provision covering either inbound or outbound transfers present</td>
<td>315</td>
<td>4</td>
</tr>
<tr>
<td>transfers in &amp; out(2)</td>
<td>Provision present covering inbound and outbound transfers</td>
<td>249</td>
<td>5</td>
</tr>
</tbody>
</table>
*Treatment* measures the guarantees provided in the treaty to multinationals regarding their ability to conduct business in the manner they see fit in respects to the managers they higher and other various aspects of their business strategy (i.e. performance requirements). A higher *Treatment* score indicates that the treaty provides foreign investors more freedom to conduct their business in the manner they see fit. A lower *Treatment* score indicates that the treaty provides fewer of those guarantees.

*Treatment* ranges from 0-3. The average *Treatment* score is .33.

### Table 5. 3 Treatment

<table>
<thead>
<tr>
<th>Treatment</th>
<th>Description</th>
<th>Frequency</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>management positions</td>
<td>Provision present guaranteeing management positions</td>
<td>108</td>
<td>1</td>
</tr>
<tr>
<td>management positions(2)</td>
<td>Provision present guaranteeing management positions and without restrictions</td>
<td>74</td>
<td>2</td>
</tr>
<tr>
<td>performance requirements</td>
<td>Restrictions present on performance requirements in pre and post establishment phases</td>
<td>63</td>
<td>3</td>
</tr>
</tbody>
</table>
*Broad Treatment* measures the presence of three broad treatment standards in the treaty, fair and equitable treatment, national treatment, and most favored nation treatment. A higher *Broad Treatment* score indicates that the treaty provides greater broad treatment standards for foreign investors and a lower *Broad Treatment* score indicates that the treaty provides foreign investors with fewer broad treatment standards. *Broad Treatment* ranges from 0-5. The average *Broad Treatment* score is 2.31.

<table>
<thead>
<tr>
<th>Broad Treatment</th>
<th>Description</th>
<th>Frequency</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>fair &amp; equitable</td>
<td>Fair and equitable provision is present in the treaty</td>
<td>741</td>
<td>1</td>
</tr>
<tr>
<td>most favored nation</td>
<td>Most favored nation provision is present in the treaty</td>
<td>741</td>
<td>2</td>
</tr>
<tr>
<td>fair &amp; equitable(2)</td>
<td>Fair and equitable provision present and connected to international law</td>
<td>204</td>
<td>3</td>
</tr>
<tr>
<td>national treatment</td>
<td>National treatment provision present without restrictions/exceptions</td>
<td>26</td>
<td>4</td>
</tr>
<tr>
<td>most favored nation(2)</td>
<td>Most favored nation provision present without restrictions/exceptions</td>
<td>18</td>
<td>5</td>
</tr>
</tbody>
</table>
SUMMARY

Previous research on the effect BITs have on FDI flows to LDCs largely treats BITs as homogenous entities, possibly contributing to the ambiguity of the literature’s results. Yackee (2008) accounts for some variation in BITs. For Yackee (2008), strong BITs are those that guarantee foreign investors the right to bring grievances with a host state to an international tribunal and weak BITs are those that do not provide foreign investors such a privilege. Thus, Yackee (2008) distinguishes strong BITs from weak BITs by the presence or absence of one treaty provision.

This research content analyzes thirty-seven areas of BIT variation, uses a gamma matrix to identify underlying treaty dimensions, and Guttman scaling procedures to produce treaty strength scores. Four areas of treaty strength are identified: (1) exceptions, measuring exceptions that weaken various treaty protections, (2) transfers, measuring the guarantees and protections allotted to MNCs in the area of monetary transfers, (3) treatment, measuring the guarantees and protections provided to MNCs from various restrictive business practices, and (4) broad treatment, measuring the presence of broad treatment standards in the treaty. The next chapter tests the effects of the four treaty strength measures on FDI flows from developed states to developing states.
CHAPTER 6: BIT STRENGTH AND FDI FLOWS

INTRODUCTION

Two basic approaches for studying the effect of bilateral investment treaties (BITs) on foreign direct investment flows (FDI) to less developed countries (LDCs) were identified in the literature review chapter: (1) monadic, studies that use the host developing state as the unit of analysis, and (2) dyadic, studies that use home developed state-host developing state pairs as the unit of analysis. Monadic studies were deemed second-best because they use a ‘signaling logic’ that is no longer relevant for influencing the investment decisions of multinational corporations (MNCs) and monadic studies cannot capture variation in BITs.

Empirical studies with dyadic research designs assume that the presence of a BIT in a dyad will increase FDI flows to the dyad’s developing state. However, the results of dyadic studies are mixed, with Kerner (2009) supporting the hypothesis, UNCTAD (1998), Gallagher and Birch (2006), and Yackee (2008) rejecting the hypothesis, and Salacuse and Sullivan (2005) and Haftel (2008) supporting the hypothesis, but only for BITs with the United States.

This chapter improves upon the previous studies in two ways. First, the traditional dyadic hypothesis is applied to a reduced range of observations; only dyads that eventually sign a treaty are included. This configuration is advantageous because it focuses on the before and after effect of BITs. Other dyads containing potentially unobserved influences are removed. The results of the reduced model are positive and statistically significant.
Second, previous dyadic studies have assumed that all BITs provide the same incentives for multinationals to invest in a developing state, regardless of the actual investment protections and guarantees present in the treaties. An alternative hypothesis tests whether strong BITs, BITs that provide more investor protections and guarantees, stimulate more FDI to developing states. The four strength measures developed in the previous chapter are used to test the BIT strength hypothesis. The results indicate that BITs with stronger provisions governing financial transfers and BITs with stronger broad treatment standards garner more FDI to the LDC in a treaty. Thus, in regards to FDI flows to LDCs, BITs matter, and stronger BITs matter more.

THEORY AND HYPOTHESES

As described in detail in the theory chapter, the coercive approach to policy diffusion is the theoretical framework employed in this analysis. While the framework is designed to assess the spread of BITs, its logic can be used to develop hypotheses regarding the efficacy of BITs as well. In brief, MNCs are assumed to be the primary coercive actors, an assumption justified through Strange’s (1988a) work on structural power. MNCs lobby their home government to pursue a BIT with the LDC in which they seek to invest. Multinationals also lobby the host government in which they seek to invest to sign a BIT.

MNCs seek BITs, in general, because BITs limit the constraining policies that a host government can place upon a foreign investor covered by the treaty. In other words, BITs tie the hands of host state governments. BITs overcome the dangers associated with

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100 Yackee (2008) accounts for treaty strength, but only according to one area of BITs.
the obsolescing bargain, the situation where the host state promises a multinational a generous policy apparatus but then reneges on its commitments once the firm has invested in the host state. BITs commit the host state to the policy provisions present in the treaty.

In sum, BITs will increase FDI flows to developing states through two, parallel avenues: (1) developed states sign BITs with the developing states in which their multinationals want to invest and (2) BITs provide multinationals the investment protections and guarantees they need to ensure that their investments can be profitable.

\[ H1_0: \text{The presence of a BIT in a dyad will not affect bilateral FDI flows to the host state.} \]

\[ H1: \text{The presence of a BIT in a dyad will increase bilateral FDI flows to the host state.} \]

However, not all BITs are the same. The investment protections and guarantees present in a BIT vary. BITs with a wider range of investment protections and guarantees could increase the number of home state MNCs that view an investment in a developing state as a potentially profitable venture. Thus, greater investment protections, that is, stronger BITs, should increase FDI flows to a developing state.

\[ H2_0: \text{BIT strength will have no effect on bilateral FDI flows to the host state in a dyad.} \]

\[ H2: \text{Stronger BITs will increase bilateral FDI flows to the host state in a dyad.} \]
METHODS

Spatial and Temporal Parameters

The unit of analysis in this study is dyadic pairs of countries. Each dyad consists of one of the top seventeen capital exporting countries (the home state) on the one hand, and all other countries (the host states) on the other. Each dyad is examined from 1985-2000, the period over which the necessary data overlap.

Potential dyads consisting of two top capital exporting countries are not included in the analysis because no BITs have been conducted among these countries (UNCTAD 2007). While BITs have been established in potential dyads of countries not among the top seventeen capital exporters, these dyads are not included for several reasons. The first reason concerns data availability. Bilateral FDI data is not publicly available for dyadic pairs of non-OECD countries and very little data are publicly available between non-top seventeen capital exporting OECD members and non-OECD members. The second reason concerns the nature of BITs that are conducted between countries that do not export much capital. Many BITs between developing countries are conducted for symbolic reasons as very little FDI crosses between the borders of poorer country pairs.

The top capital exporting countries used in this analysis are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States. These seventeen countries have been the source of most FDI during the period covered, 1985-2000 (Yackee 2008). Singapore is not included as a top capital exporting country because the data source for bilateral FDI flows, the OECD, does not provide data on Singapore’s bilateral FDI flows.
Dependent variable. The dependent variable in model 1 is bilateral FDI flows \((bifdi)\), the data for which was obtained from the OECD website.\(^{102}\) \(bifdi\) consists of outward FDI flows from the top seventeen capital exporting country in each dyad (the home state) to the non-top seventeen capital exporting country in the dyad (the host state), and is in millions of 2010 US dollars.

Most of the previous research on the effect of BITs on FDI flows has used total inward FDI as the dependent variable. The explanatory independent variable in these studies is the total number of BITs signed by a capital importing country; consequently, the use of total inward FDI as the dependent variable is appropriate since the studies are not interested in specific dyadic relationships. However, specific dyadic relationships are of interest in this study. Using the bilateral FDI flows allows this analysis to investigate the impact of treaty dynamics, that is, the various components of the treaty, in dyadic pairs, a feat not possible with total inward FDI as the dependent variable. The effect of specific aspects of investment protection provided in a treaty can only be tested when FDI flows are assed according to the dyadic pairs of countries to which a specific BIT applies.

Explanatory independent variables. Six explanatory independent variables are analyzed across various specifications of model 1. \(BIT_{\text{present}}\) is the explanatory independent variable in model 1a and denotes when a BIT is present in a dyad during a particular year. \(BIT_{\text{present}}\) is coded 0 in the absence of a BIT and 1 when a BIT is

present.\footnote{The analysis only includes BITs that were ratified from 1985-2000 and available on the UNCTAD website.} Only signed and ratified BITs can be used to test hypotheses concerning the internal dynamics of BITs. Treaties that were signed but never implemented will not provide any protections to investors, regardless of their content. Hypothesis 1 will be supported if $BIT_{\text{present}}$ has a positive and statistically significant impact on $bifdi$.

The strength of investment protections provided by each treaty is assessed by four Guttman scaled variables. These variables are used in model 1b. Lower scale scores indicate lower levels of investment protections for MNCs investing in a host state when a BIT is present in the dyad. Higher scale scores denote higher levels of investment protections for MNCs investing abroad when the dyad is covered by a BIT. $Exceptions$ measures the strength of exceptions present in a treaty and ranges from 0-6. $Transfers$ assesses the strength of transfer protections and is scaled from 0-5. The variable $treatment$ gauges the strength of treatment protections and ranges from 0-3. The variable $broad\ treatment$ evaluates the strength of broad treatment standards present in treaties and can vary from 0-5.\footnote{See the previous chapter for more information on the construction and content of each strength variable.} Hypothesis 2 will be supported if any of the BIT strength measures have a positive and statistically significant effect on $bifdi$.

The sixth explanatory independent variable is $sumBIT$, and is utilized in model 1c. This variable is the sum of the four strength scores and can range from 0-19, with a score of 19 indicating that the treaty reached maximum strength of investment protection scores on each of the Guttman scaled variables. Hypothesis 2 will be supported if $sumBIT$ has a positive and statistically significant effect on $bifdi$. 
Control independent variables. Various qualities of a host state may make it a more attractive investment location.\(^{105}\) These varying characteristics need to be accounted for in the models in order to avoid omitted variable bias. The usual host state characteristics are controlled for in this study: host GDP per capita, host legal tradition, host level of democracy, perceived corruption of the host state, the privatization record of the host state, previous levels of FDI into the host state, GDP growth in the host state, and the presence of extractive industries in the host state.\(^{106}\)

Host GDP per capita, *gdp cap*, is a proxy for the host state’s level of economic development. States with higher levels of economic development are, in particular, an attractive location for market seeking FDI. Additionally, efficiency-seeking FDI may be drawn to states with high-skilled workers, whom are associated with economic development. Numerous studies have demonstrated a positive relationship between a host state’s GDP per capita and the level of FDI it receives (e.g., Henisz 2000; Pistoresi 2000; Billington 1999). Consequently, host states with a higher GDP per capita are expected to be associated with higher levels of inward FDI. Data for this variable are from the World Bank and is in thousands of 2000 US dollars.

Host legal tradition, *legal tradition*, controls for the type of legal system employed by the host state, with common law systems coded 1 and civil law systems coded 0. Some authors conclude that common law systems usually provide better property rights protections than civil law systems; consequently, host states with a common law system are expected to garner greater FDI flows than host states with a civil law system (La Porta et al. 1998). Data for this variable are from the World Bank.

\(^{105}\) A literature review of FDI influences is provided in Appendix 10.
\(^{106}\) All of these control variables were provided in the Elkins et al (2006) dataset.
The host state’s level of democracy, *democracy*, is assessed on a -10 to 10 scale with higher numbers indicating higher levels democracy. The host state’s level of democracy is expected to be positively associated with FDI inflows to the host state (Jensen 2003). State characteristics associated with a democratic political system, stable laws, an accessible and independent legal system, and institutions that limit the power of the state, are expected to reduce uncertainty for investors and spur investment. Data for this variable are from the Polity IV dataset.\textsuperscript{107}

*Corruption* is a measure of investor perceptions of corruption levels in the host state. The variable ranges from 0 to 6 with higher scores indicating higher levels of host state corruption as perceived by foreign investors. Some evidence suggests that MNCs may be deterred by corrupt political systems (Perry 2000; Wei 2000). Corruption may be a deterrent to investors because corrupt systems can decrease the predictability of the political environment. Increased levels of corruption in a host state are expected to deter FDI. Data for this variable are from the Political Risk Services Group.\textsuperscript{108}

The privatization record of the host state, *privatization*, is measured as the total value of assets privatized by the host state in a given year. The data are calculated using 1985 US dollars and are given as a percentage of the host state’s GDP. This measure is a proxy for the overall investment climate in the host state, with higher privatization levels sending a pro-market signal to potential investors. Increases in privatization are expected to increase investment flows to the host state (Cohen 2007; Globerman and Shapiro 2002). Data for this variable are from Brune, Garrett, and Kogut (2004).

\textsuperscript{107} The Polity IV dataset is available at http://www.cidcm.umd.edu/inscr/polity/.
\textsuperscript{108} For more information, see the Political Risk Services Group website, http://www.prsgroup.com/.
FDI lag1, is the percent of host net FDI inflows as a percentage of the host state’s GDP, lagged one year. The data are calculated using 2000 US dollars. Agglomeration affects, the process of current FDI stocks attracting additional FDI, have been shown to positively impact FDI flows (Mody and Kinoshita 2007; Mudambi 1995; Wheeler and Mody 1992). In short, higher levels of FDI flows in one year are expected to produce higher levels of FDI flows the next year. Data for this variable are from the World Bank.

Change gdp lag2 measures the change in GDP in the host state and is lagged two years. The variable is calculated using 2000 US dollars. FDI, especially involving market seeking MNCs, have been demonstrated to be positively associated with increased levels of economic growth (Billinton 1999; Culem 1988; Schneider and Frey 1985). MNCs tend to see profitable opportunities in growing economies because individuals in growing economies usually have increasing amounts of consumption power. Market seeking MNCs, in particular, want to invest in production operations in the growing economy and sell their products to these newly affluent consumers. Thus, GDP growth in the host state is expected to be positively associated with FDI inflows to the host state. Numerous studies support this expectation (e.g., Henisz 2000; Pistoressi 2000; Billington 1999). Data for this variable are from the World Bank.

Extraction proxies the level of dependence that a host state economy has on extractive industries. Host developing states with large extractive industries (i.e. oil and mining industries) often receive high levels of FDI. MNCs invest in host states with large amounts of valuable mineral resources regardless of other host state characteristics (Jensen 2003). If not controlled for, the presence of extractive industries may make a host appear to be a more attractive investment location than is actually the case.
Extraction assesses the percent of the host state’s exports that are from fuel, ores, and metals in a given year.\textsuperscript{109} The measure is expected to be positively associated with bilateral FDI flows. Multinationals, especially oil and mining companies, are expected to invest in a state with high extraction scores to gain access to its natural resource wealth. The variable is assessed in 2000 US dollars. Data for this variable are from the World Bank.

Additionally, certain connections between dyadic pairs of states could influence bilateral FDI flows. These influences need to be controlled for in order to avoid omitted variable bias. The following dyad control variables are used here: the presence of an alliance in the dyad, the trade relationship between the two states in the dyad, and whether or not the countries in a dyad share a common language.\textsuperscript{110}

Alliance controls for the presence of a strategic (military) partnership between the two states in a dyad and is coded 1 if an alliance is present and 0 if an alliance is not present. The presence of an alliance in the dyad is expected to increase FDI flows to the host state. This expectation stems from the assumption that strategic ties will increase economic ties (Elkins et al. 2006). Data are from the Correlates of War Project.\textsuperscript{111}

Log trade/gdp accounts for the trade relationship between the two states in a dyad and is measured as the total value of the trade between the two states in terms of the host state’s GDP. This variable is assessed in 2000 US dollars. Efficiency seeking FDI, in particular, has been shown to be attracted to host states that are more open to trade (Dees 1998; Singh and Jun 1995; Lecraw 1991). MNCs looking to use a host state as an export

\textsuperscript{109} The information for this variable was taken from the World Banks’s World Development Indicators.
\textsuperscript{110} All of these control variables are from the Elkins et al. (2006) dataset.
\textsuperscript{111} Data are available at http://www.cow2.la.psu.edu/.
platform will be attracted to open trade policies, which provide multinationals access to cheap inputs. Therefore, a higher Log trade/gdp score is expected to produce more FDI from the home state to the host state (Dees 1998; Singh and Jun 1995; Lecraw 1991). The logarithm of this variable is used to reduce large ranging quantities of trade to GDP ratios to a smaller scope, making data from countries that trade a lot and countries that trade a little, relative to the size of their economies, easier to compare. The data for this variable are from the World Bank.

*Common language* is scored 1 if the states in a dyad share a common language and 0 if the states in a dyad do not share a common language. This variable is a proxy for potential cultural ties that might exist between states in a dyad. Cultural barriers can impede transnational business. Cultural familiarity can smooth business interactions. Furthermore, developed state-developing state dyads with a common language often share a colonial past and have had economic interactions for decades, if not hundreds of years. Thus, the presence of a common language is expected to increase FDI flows to the host state. Data for this variable are from various sources.112

The final two control variables used in the analysis are the total amount of FDI outflows by the host state and the presence of the Cold War. *Rich FDI* measures the total net FDI outflows from the home state in a dyad in a particular year and is provided as a percent of the home state’s GDP. An increase in this variable is expected to produce an increase in FDI inflows to the host state in the dyadic relationship, because the home state exports larger amounts of FDI in absolute terms. Data for this variable are from the World Bank and are in 2000 US dollars.

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112 The data are from Countries of the World and their leaders yearbook 2000, Europa World Year Book 1999, and Central Intelligence Agency, CIA World Factbook.
Cold war accounts for the presence of the Cold War. Dyads from 1985 to 1992 are coded 1, denoting the presence of the Cold War, and dyads from 1993 to 2000 are coded 0, denoting the absence of the Cold War. Higher FDI flows are expected to take place in the absence of the Cold War, in dyads containing former Soviet bloc states in particular. Former Soviet bloc states were closed to FDI during the Cold War and were opened to FDI after the Cold War’s conclusion.

Table 6.1 Summary Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs.</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
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<td>-2417</td>
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<td>0</td>
<td>1</td>
</tr>
<tr>
<td>exceptions</td>
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<td>0</td>
<td>6</td>
</tr>
<tr>
<td>transfers</td>
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<td>1.48</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>treatment</td>
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<td>0.80</td>
<td>0</td>
<td>3</td>
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<tr>
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<td>0.70</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>sumBIT</td>
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<td>10.96</td>
<td>2.01</td>
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<td>16</td>
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<td>4.20</td>
<td>0.09</td>
<td>30.19</td>
</tr>
<tr>
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<td>0.48</td>
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<td>1</td>
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<td>7.11</td>
<td>-10</td>
<td>10</td>
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<tr>
<td>corruption</td>
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<td>1.09</td>
<td>0</td>
<td>6</td>
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<td>1.12</td>
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<td>14.80</td>
</tr>
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<td>145.13</td>
</tr>
<tr>
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<td>85.90</td>
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<tr>
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<td>0.29</td>
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<td>1</td>
</tr>
<tr>
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<td>0.03</td>
<td>0.18</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>log trade/gdp</td>
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<td>-14.86</td>
<td>1.12</td>
</tr>
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<td>0.26</td>
<td>0</td>
<td>1</td>
</tr>
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<td>-14.65</td>
</tr>
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<td>44318</td>
<td>0.47</td>
<td>0.50</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Estimation technique. This analysis uses panel data, a specific type of time-series data which surveys the same cross-sectional units over time (Gujarati and Porter
This type of data is not suitable for ordinary least squares (OLS) analysis. OLS can lead to biased results when assessing panel data since panel data usually violate a major OLS assumption—that estimations are unbiased. Panel data usually contain heteroskedasticity and temporally and spatially correlated errors (Hoechle 2007; Beck and Katz 1995).

A Breusch-Pagan test was applied to each model configuration to test for the presence of heteroscedasticity, which was found to be present in all configurations of model 1. While Wooldridge tests for serial correlation indicated that serial correlation was not present, the data are likely to be spatially correlated due to its panel structure. Another characteristic of the data that needs to be considered when choosing an estimation technique is the relatively short time-period the data cover compared to the number of observations, a characteristic that can cause time-series estimates to have biased results (Hoechle 2007). Consequently, a time series cross-sectional model with Driscoll-Kraay estimators is used in all model 1 configurations because it accounts for all of the above concerns: it can be used when heteroskedasticity and spatially correlated errors are present and it provides robust estimates even when observations are numerous relative to time (Hoechle 2007; Driscoll and Kraay 1998). \(^{113}\)

\(^{113}\) According to Hoechle (2007), the Driscoll-Kraay estimator can be used in unbalanced panels, which this dataset has, and the Driscoll-Kraay “standard errors are heteroskedasticity consistent and robust to general forms of cross-sectional (spatial) and temporal dependence when the time dimension becomes large” (286).
Table 6. Model 1 Variations.

<table>
<thead>
<tr>
<th>Model</th>
<th>Dependent Variable</th>
<th>Explanatory Independent Variable(s)</th>
<th>Dyadic Pairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>bifdi</td>
<td>BITpresent</td>
<td>all dyadic pairs from 1985-2000</td>
</tr>
<tr>
<td>1a.2</td>
<td>bifdi</td>
<td>BITpresent</td>
<td>dyads eventually signing BITs from 1985-2000</td>
</tr>
<tr>
<td>1b</td>
<td>bifdi</td>
<td>exceptions, transfers, treatment, broad treatment</td>
<td>dyads with BITs from 1985-2000</td>
</tr>
<tr>
<td>1c</td>
<td>bifdi</td>
<td>SumBIT</td>
<td>dyads with BITs from 1985-2000</td>
</tr>
</tbody>
</table>

All variations of model 1 use bilateral FDI flows (bifdi) as the dependent variable.

Model 1a employs BITpresent as the explanatory independent variable and is designed to assess the effect of the presence of a BIT on FDI flows to LDCs. Model 1a.2 is a variation of the first model that only includes dyads that eventually signed a BIT. This reduction in scope allows the model to specifically test the effect of a BIT in a dyad.

Model 1b uses the four BIT strength measures as the explanatory independent variables and tests the BIT strength hypothesis. Model 1c’s explanatory independent variable is sumBIT and tests the cumulative impact of all BIT strength measures on FDI flows.

Models 1b and 1c only assess dyadic pairs containing BITs. The control variables are consistent across the various configurations of model 1.
**Table 6.3. Time-Series Regression Results for Bilateral FDI Flows (Model 1).**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1a</th>
<th>Model 1a.2</th>
<th>Model 1b</th>
<th>Model 1c</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
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<td>11.21</td>
<td>276.44</td>
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<td></td>
<td>(39.81)</td>
<td>(66.76)</td>
<td>(1.52)</td>
<td>(37.54)</td>
</tr>
<tr>
<td>BITpresent</td>
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<td>54.30***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(19)</td>
<td>(10.06)</td>
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<td></td>
</tr>
<tr>
<td>exceptions</td>
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<tr>
<td></td>
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<td></td>
<td>(5.51)</td>
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</tr>
<tr>
<td>transfers</td>
<td></td>
<td></td>
<td>24.74**</td>
<td></td>
</tr>
<tr>
<td></td>
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<td></td>
</tr>
<tr>
<td>broad treatment</td>
<td></td>
<td></td>
<td>12.03**</td>
<td></td>
</tr>
<tr>
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<td></td>
<td></td>
<td>(5.46)</td>
<td></td>
</tr>
<tr>
<td>sumBIT</td>
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<td>16.18**</td>
</tr>
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</tr>
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<td></td>
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<td>(6.91)</td>
<td>(2.75)</td>
<td>(3.10)</td>
</tr>
<tr>
<td>legal tradition</td>
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<td>(18.61)</td>
<td>(25.70)</td>
<td>(28.66)</td>
<td>(27.34)</td>
</tr>
<tr>
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<td>229.53*</td>
<td>231.86*</td>
</tr>
<tr>
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<td>(113.66)</td>
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<td>-2.21*</td>
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<td>(1.13)</td>
<td>(1.09)</td>
<td>(1.20)</td>
<td>(1.25)</td>
</tr>
<tr>
<td>corruption</td>
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<td>-10.74</td>
<td>-10.76</td>
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<td>(6.25)</td>
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<td>(3.36)</td>
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<td>(2.15)</td>
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<tr>
<td>fdi lag1</td>
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<td>10.26**</td>
<td>5.95**</td>
<td>6.17**</td>
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<tr>
<td></td>
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<td>(2.72)</td>
<td>(2.08)</td>
<td>(2.18)</td>
</tr>
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<td></td>
<td>(1.29)</td>
<td>(2.11)</td>
<td>(1.47)</td>
<td>(1.53)</td>
</tr>
<tr>
<td>log trade/gdp</td>
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<td>48.77**</td>
<td>75.14***</td>
<td>75.43***</td>
</tr>
<tr>
<td></td>
<td>(14.45)</td>
<td>(13.84)</td>
<td>(11.20)</td>
<td>(10.94)</td>
</tr>
</tbody>
</table>
Table 6.3. Time-Series Regression Results for Bilateral FDI Flows (Model 1) (continued).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1a</th>
<th>Model 1a.2</th>
<th>Model 1b</th>
<th>Model 1c</th>
</tr>
</thead>
<tbody>
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<td>change gdp lag2</td>
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<td>4.18**</td>
<td>6.14***</td>
<td>6.13***</td>
</tr>
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<td>(1.13)</td>
<td>(0.59)</td>
<td>(0.60)</td>
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<td>-37.34**</td>
<td>-10.72</td>
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<td>0.0914</td>
<td>0.1831</td>
<td>0.1815</td>
</tr>
</tbody>
</table>

Notes: Standard errors are in parentheses.
*** Significant at 1%; **significant at 5%; *significant at 10%.

RESULTS

Assessing the Control Variables.

The results indicate that fdi lag1, log trade/gdp, and change gdp lag2 are statistically significant in their expected directions across all three models. Total host state inward FDI, the trade relationship between two states in a dyad, and the growth of the host state’s economy are positively associated with increased bilateral FDI flows in dyadic pairs.
Extraction is highly significant, but not in the expected direction. The percent of a host state’s exports that are from fuel, ores, and metals in a given year is negatively associated with bilateral FDI inflows. Resource curse theory offers an explanation. Natural resource wealth impedes the development of political institutions in LDCs (Robinson et al. 2006; Ross 1999). Authoritarian leaders can maintain power by distributing wealth from the country’s natural resources. Authoritarians do not have to develop government services and other political institutions to maintain their legitimacy. The underdevelopment of political institutions probably deters investors and causes the highly significant, negative coefficient for extraction.

The privatization of assets in the host state, privatization, is positive and statistically significant, but only in model 1a. The presence of the Cold War, cold war, is negative and statistically significant, but only in model 1a. An alliance between the two states in a dyad, alliance, is positive and statistically significant in model 1a and weakly significant, at the .10 percent level, in models 1b and 1c. The host state’s level of democracy, democracy, is negative and weakly significant in models 1b and 1c. And finally, the home state’s total outward FDI, rich fdi, is positive and weakly significant in model 1c.

Model 1a

There are 7914 observations in model 1a. This is down significantly from the over 40,000 observations that are present in the dataset from 1985 to 2000. The primary culprit behind the lost observations is the dependent variable, bifdi, which is absent in about 80 percent cases. The R-squared coefficient in this model is .0991, indicating that
the model explains a relatively small amount of variation in the dependent variable. The low R-squared is likely the result of the panel design.

The coefficient for \textit{BIT}\textit{present} is negative and statistically significant, but only at the .10 percent confidence level. A one unit increase in \textit{BIT}\textit{present}, which is a change from 0 to 1 since this variable is dichotomous, results in a decrease of just over 34 million dollars of bilateral FDI, all else equal. In other words, the presence of a BIT actually decreases the amount of bilateral FDI that the capital importing host state receives from the capital exporting home state. Hypothesis 1 is not supported by the results of this model.

This result is surprising, but only somewhat so. The results of previous research have been mixed, with some studies finding a positive relationship between BITs and FDI, and other studies finding no relationship between the two variables. However, while the results are statistically significant, if weakly so, and substantively significant, a 34 million dollar increase in bilateral FDI is no small sum. The surprising results may be a consequence of a certain aspect of the model and therefore should be interpreted with caution.

Model 1a contains a methodological problem: BITs signed before 1985 are not accounted for in the analysis and neither are regional agreements, such as NAFTA, that may contain BIT-like investment provisions. Consequently, some dyads where BITs, or at least investment protections, are actually present are not accounted for in the model. Perhaps, the model’s unexpected results are the product of its inclusion of three different types of cases: dyads that eventually ratified a BIT, dyads that already have BIT-like
provisions (NAFTA etc.), and dyads that have no reason to ever enter into such an agreement.

Model 1a.2 provides another way to investigate the relationship between the presence of a BIT and bilateral FDI flows by only including dyads where a BIT was eventually signed during the time period covered. This specification allows the model to compare the amount of bilateral FDI flows that occurred in dyad before and after the establishment of a BIT—a much clearer test of the effect of a BIT on FDI flows.

There are 2322 observations in model 1a.2, down significantly from model 1a. The decrease in observations from model 1a is due to the model only including cases where a BIT was eventually signed. The R-squared in this model is virtually unchanged from the first version of the model.

\(BIT_{\text{present}}\) changes dramatically from the first configuration of model 1a to this configuration of the model. The presence of a BIT yields a 54 million dollar increase in bilateral FDI, all else equal, and is significant at the .001 level. This coefficient is substantively significant: a 54 million dollar increase in yearly bilateral FDI in a dyad is sizable. In other words, when looking only at dyads where a BIT was eventually signed, the presence of a BIT increases the amount of FDI from a capital exporting home state to a capital importing host state. Hypothesis 1 is supported by the results of this model.

**Model 1b**

Model 1b contains 1360 observations. The decrease in observations relative to model 1a is primarily due to the structure and limited scope of this model. Model 1b is designed to test the impact of the strength of BIT protections on bilateral FDI flows in
dyadic pairs. To achieve this, this model only looks at dyads that contain a BIT, doing so causes the significant decrease in observations. In short, model 1a assesses the effect of the presence or absence of a BIT on the dependent variable while model 1b assesses the effect of the strength of a BIT on the dependent variable.

The R-squared score of .1831 in model 1b is noteworthy since it is over twice the R-squared score in model 1a. This indicates that about double of the amount of variation in the dependent variable is explained in model 1b than in model 1a. Perhaps, including the impact of the strength levels of BITs provides a much better predictor of bilateral FDI flows. However, the vastly different R-squared scores could be the result of the decreased number of observations in model 1b compared to model 1a.

The effects of the strength variables are mixed. Exceptions, and treatment have a positive effect of bifdi, but their impact is not statistically significant. However, transfers and broad treatment are positive, statistically significant, and produce substantively significant effects on the dependent variable. Therefore, the results from model 1b supports hypothesis 2. The content of BITs matters. Treaties containing greater protections on for transfer and broad treatment issues lead to more investment for host states in the dyads covered.

The results show that a one-unit increase in transfers causes a 24.74 million dollar increase in bilateral FDI, all else equal. In other words, with each one-unit increase in the transfers score, the capital importing host state in each dyad is predicted to garner an additional 24.74 million dollars in FDI from the capital exporting host state in the dyad.

Specific inferences can be made about transfers because it is a Guttman scaled variable. The presence of each additional component of transfers yields an additional
24.74 million dollar increase in FDI from the home state in a dyadic pair to the host state in a dyadic pair. As described in table 6.3, a transfers score of 5 indicates the presence of all five aspects of transfers and is expected to yield, all else equal, a 123.7 million dollar increase in FDI from the home state in a dyadic pair to the host state in a dyadic pair. These results are substantively significant. A 24.74 million dollar increase in FDI for each component of transfers is sizable.

Table 6.4. Transfers

<table>
<thead>
<tr>
<th>Transfers</th>
<th>Description</th>
<th>Projected FDI Increase (millions of US dollars)</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>transfers &amp; domestic law</td>
<td>Transfer issues are addressed by the treaty, not restricted by domestic law</td>
<td>24.74</td>
<td>1</td>
</tr>
<tr>
<td>exchange rate</td>
<td>Provision on the exchange rate used is present</td>
<td>48.49</td>
<td>2</td>
</tr>
<tr>
<td>exchange rate(2)</td>
<td>Transfer provision present and exchange rate not decided by host</td>
<td>72.22</td>
<td>3</td>
</tr>
<tr>
<td>transfers in &amp; out</td>
<td>Provision covering either inbound or outbound transfers present</td>
<td>98.96</td>
<td>4</td>
</tr>
<tr>
<td>transfers in &amp; out(2)</td>
<td>Provision present covering inbound and outbound transfers</td>
<td>123.70</td>
<td>5</td>
</tr>
</tbody>
</table>

The results also indicate that a one-unit increase in broad treatment causes a 12 million dollar increasing in bilateral FDI, all else equal. Put another way, with each one-unit increase in the broad treatment score, the capital importing host state in each dyad is expected to receive an additional 12 million dollars in FDI from the capital exporting host state in the dyad.

Specific inferences can be made about broad treatment because it is a Guttman scaled variable. The presence of each additional component of broad treatment yields an
additional 12 million dollar increase in FDI from the home state in a dyadic pair to the host state in a dyadic pair. As described in table 6.4, a *broad treatment* score of 5 indicates the presence of all five aspects of *broad treatment* and is expected to yield, all else equal, a 60 million dollars dollar increase in FDI from the home state in a dyadic pair to the host state in a dyadic pair. While the increases in FDI produced by *broad treatment* are only half of those produced by *transfers*, these results are still substantively significant. The effect of a treaty with a high *broad treatment* score is substantively different from a treaty with a low *broad treatment* score.

Table 6.5. Broad Treatment.

<table>
<thead>
<tr>
<th>Broad Treatment</th>
<th>Description</th>
<th>Projected FDI Increase (millions of US dollars)</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>fair &amp; equitable</em></td>
<td>Fair and equitable provision is present in the treaty</td>
<td>12</td>
<td>1</td>
</tr>
<tr>
<td><em>most favored nation</em></td>
<td>Most favored nation provision is present in the treaty</td>
<td>24</td>
<td>2</td>
</tr>
<tr>
<td><em>fair &amp; equitable(2)</em></td>
<td>Fair and equitable provision present and connected to international law</td>
<td>36</td>
<td>3</td>
</tr>
<tr>
<td><em>national treatment</em></td>
<td>National treatment provision present without restrictions/exceptions</td>
<td>48</td>
<td>4</td>
</tr>
<tr>
<td><em>most favored nation(2)</em></td>
<td>Most favored nation provision present without restrictions/exceptions</td>
<td>60</td>
<td>5</td>
</tr>
</tbody>
</table>

A second configuration of the model 1b (model 1b.2) uses the same variables as model 1b and adds one additional measure of strength, *consent*. This variable was designed by Yackee (2008) and assesses consent to arbitration provided in a BIT. BITs
that provide investors comprehensive pre-consent to arbitration are coded 1 and all other BITs are coded 0. Yackee (2008) hypothesizes that BITs that guarantee investors access to arbitration in instances of a dispute will produce increased levels of FDI. However, consent does not have a statistically significant effect on bifdi. These results are consistent with Yackee (2008). This finding is not surprising. Consent to arbitration is only one small aspect of multifaceted BITs and in and of itself does not have the ability to sway investor decisions one way or another. The results of this model are available in Appendix 11.

**Model 1c**

Model 1c tests the cumulative effect of the four strength scores on bifdi. This model has the same number of observations as model 1b and a similar R-squared score, .1815. The sumBIT variable is positive, statistically significant, and substantively significant. A one unit increase in sumBIT causes a 16.18 million dollar increase in bifdi, all else equal. In other words, with each one-unit increase in the sumBIT score, the capital importing host state in each dyad is expected to garner an additional 16.18 million dollars in FDI from the capital exporting host state in the dyad. As explained above, sumBIT is coded from 0-19; consequently the impact of a treaty with a high sumBIT score will be substantively different from a treaty with a low sumBIT score. However, model 1c is a simple additive index of the various BIT strength measures, making its results difficult to interpret. For example, two different treaties with a sumBIT score of ten may contain different combinations of provisions.
Overall, the results from model 1c lend additional support the hypothesis 2: the internal dynamics of BITs influence FDI flows. Stronger treaties, that is, treaties that provide more protections for investors as measured by sumBIT, produce greater amounts of FDI flows in the dyadic pairs covered.

**DISCUSSION**

A broad test of the traditional dyadic hypothesis, that the presence of a BIT in a dyad increases FDI flows to the dyad’s developing state, was rejected. However, when the scope of the model was reduced from all dyadic pairs to dyadic pairs that eventually signed a BIT, the hypothesis was supported—BITs had a statistically significant effect on FDI flows to LDCs. Reducing the observations to dyads that eventually signed a BIT provides a better test of hypothesis 1 than the full set of observations, because this specification is a clear test of the before and after effect of a BIT on FDI flows to the LDC in a dyadic pair of states.

The number of observations were paired down further in the models testing the BIT strength hypothesis, that BITs providing stronger investment protections and guarantees will garner increased FDI for the developing state in a dyad. Only dyads containing a BIT were analyzed in these models, the results of which were positive and statistically significant. In other words, when assessing BITs, strong BITs garner more FDI for developing states than weak BITs.

This research adds to the theoretical explanation of the mechanisms through which BITs increase FDI flows to LDCs. Previous explanations were split between a signaling logic, used in monadic studies, and a ‘tying hands’ logic, used in dyadic studies.
The primary explanatory variable in monadic research designs using the signaling logic simply count the total number of BITs that a developing country has signed, suggesting that by signing more BITs a LDC signals a business friendly environment to foreign investors, which convinces the investors to invest in the developing state.

The findings in support of the BIT strength hypothesis reinforce the necessity of a dyadic research design for the study of BITs by showing that treaty design matters. MNCs are more likely to invest in a LDC when certain BIT provisions are present, namely additional protections and guarantees in the areas of financial transfers and broad treatment standards. These effects can only be captured through a dyadic research design. Overall, these results support the larger institutionalist literature by demonstrating that the treaty design matters when considering the ability of a treaty to alter state decisions (e.g., Abbott and Snidal 2000; Simmons 2000; Keohane 1984).
CHAPTER 7: WHAT EXPLAINS THE PROLIFERATION OF BITs?

INTRODUCTION

Bilateral investment treaties (BITs) stipulate the terms and conditions under which investors from one state (the home state) must be treated in another state (the host state; Elkins et al. 2006). The first BIT was established between Germany and Pakistan in 1959. Currently, over 2,500 BITs have been signed, the vast majority of which between a capital exporting developed state, on the one hand, and a capital importing developing state, on the other hand. Elkins et al. (2006) is the most prominent study explaining the proliferation of these treaties.

Elkins et al. (2006) argue that BIT proliferation is a result of competition for capital among developing states. Thus, the authors assume that other actors in the international political economy, such as multinational corporations (MNCs) and the developed states from which they hail, do not play a role in the spread of BITs. Given the role played by multinationals in the evolution of international investment standards provided in the historical analysis chapter, and the structural power multinationals possess as described in the theory chapter, this assumption seems dubious (Stopford and Strange 1991; Strange 1988a).

A new hypothesis, developed from the coercive approach to policy diffusion, is examined in a time-series, logit model covering dyadic pairs of countries from 1985-2000. The results support the coercive hypothesis—BITs are signed with developing countries in which multinationals want to invest.
THEORY AND HYPOTHESES

Policy diffusion is a theoretical framework used to identify the mechanisms through which liberal policies spread throughout the world. Two variations of the policy diffusion framework are employed to study the proliferation of BITs: the competitive framework and the coercive framework. The competitive framework posits the following hypothesis:

\[ H_{10}: \text{A developing state will not be influenced to enter into a BIT when a state with which it competes for capital enters into a BIT.} \]

\[ H_1: \text{A developing state will be more likely to enter into a BIT when a state with which it competes for capital enters into a BIT.} \]

Elkins et al. (2006) and Guzman (1998) explain the competitive hypothesis of BIT proliferation. While developing states want the investment of MNCs, they would prefer to maintain as much policy autonomy as possible. BITs restrict the policy options of capital importing states. But at the same time, BIT policy restrictions make LDCs more attractive investment locations for MNCs. According to the competitive hypothesis, LDCs will join BITs with developed, capital exporting countries when countries with which they compete for capital expand their BIT programs. Thus, according to this hypothesis, the proliferation of BITs is driven by competition among developing states. Developed states are assumed to be willing and ready to sign BITs with any developing country (Elkins et al. 2006).
In the coercive hypothesis developed here, MNCs are assumed to be the primary actors driving the proliferation of BITs. MNCs work through two avenues to pursue BITs: (1) by lobbying their home state and (2) by bargaining with the developing host state. Multinationals effectively lobby their home state to pursue a BIT with the developing state in which they want to invest. Weak political opposition exists in the home state because little FDI flows from the developing host state to the developed home state. Domestic interest groups that normally oppose liberalizing policies will not face foreign competition because of the one-way flow of FDI; therefore, they will have little reason to oppose the BIT.

Multinationals will also effectively bargain with the host state in which they want to invest to sign a BIT. MNCs wield structural power (Stopford and Strange 1991; Strange 1988a). They control access to technology and capital, components that LDCs realize they need in order to develop economically. The LDC will sign a BIT in order to receive FDI from the developed state’s multinationals. Without the additional investment protections and guarantees provided in a BIT, the MNC will not invest in the host state. By signing a BIT, the LDC limits the policy options that it can implement on a foreign multinational, increasing the likelihood that the investment can be profitable for the MNC. The coercive framework posits the following hypothesis:

\[ H_{20}: \text{The LDC's level of attraction as an investment location has no effect on the likelihood that a dyad will contain a BIT.} \]

\[ H_{2}: \text{The more attractive a LDC is as an investment location, the greater the likelihood the dyad will contain a BIT.} \]
MNCs want to invest in developing states with certain characteristics. For instance, a large, fast growing market appeals to market-seeking multinationals and liberal trade policies are alluring to MNCs seeking to use LDCs as export platforms. Multinationals generally prefer to invest in states with business friendly policies and low levels of corruption. These various developing state characteristics are appealing to multinationals, but they are not enough to ensure that an investment is profitable. BITs tie the hands of developing states in a whole host of policy areas. Multinationals want these additional protections and guarantees before they invest in a developing state.

An alternative hypothesis taken from Swenson (2009) is also evaluated. Swenson (2009) argues that multinationals lobby the host states in which they have already invested to sign a BIT with their home state. Multinationals seek BITs because they want more protection for investments that have already been sunk. Thus, the proliferation of BITs is driven by MNCs, but only to states where they have already invested, not states in which they want to invest in the future as described in the coercive hypothesis. The host lobbying hypothesis is as follows:

\[ H_{30}: \text{An increase in bilateral FDI flows in a dyad will not affect the chances that a BIT is present in the dyad.}\]

\[ H_{3}: \text{An increase in bilateral FDI flows in a dyad will increase the chances that a BIT is present in the dyad.}\]
METHODS

Spatial and Temporal Parameters

Model 2 shares many characteristics with model 1, including its unit of analysis, which is dyadic pairs of countries consisting of one of the top seventeen capital exporting countries and one country that is not among the top capital exporters, and its temporal parameter, which is 1985-2000.

Dependent Variable

The dependent variable in model 2 is the presence or absence of a BIT \((BIT_{present})\). This is the same measure that was used as the explanatory independent variable in model 1a. \(BIT_{present}\) is coded 1 when a BIT is active in a dyad, meaning that it has been signed, ratified, and is in effect, and coded 0 when a BIT is not active in a dyad, meaning that a dyadic pair of countries has never entered into a BIT or never ratified a BIT that was signed.

Independent Variables

\(Bifdi\) measures bilateral FDI flows from the top-seventeen capital exporting home state in a dyad to the capital importing host state in the dyad. The host lobbying hypothesis will be supported if \(bifdi\) has a positive and statistically significant effect on \(BIT_{present}\). According to hypothesis 3, multinational corporations will lobby their government to sign and ratify a BIT with the country in which they are investing to gain the increased amounts of investment protections provided by the treaty.
**GDP cap** is the host state’s per capita GDP, a proxy for the host state’s level of wealth and economic development. Efficiency seeking FDI and market seeking FDI are drawn to wealthier developing states, the former for higher-skilled workers and the latter for consumers with higher levels of purchasing power to whom MNCs can sell their products or services (Cohen 2007). Hypothesis 2 will be supported if *gdp cap* has a positive and statically significant effect on *BITpresent*. According to the coercive hypothesis, MNCs will want to invest in a wealthy host state and will lobby the home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

**Democracy** assesses the host state’s level of democracy. High levels of democracy are usually associated with a higher quality of governance. Thus, *democracy* is used here as a proxy for the host state’s quality of governance. Hypothesis 2 will be supported if *democracy* has a positive and statistically significant effect on *BITpresent*. According the coercive hypothesis, MNCs will want to invest in a more democratic country and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

**Privatization** measures the host state’s privatization record. Higher levels of privatization are a signal to potential investors that the host state is moving towards liberal, pro-market policies, which can provide investors predictability. Hypothesis 2 will be supported if *privatization* has a positive and statistically significant effect on *BITpresent*. According the coercive hypothesis, MNCs will want to invest in a country with a higher *privatization* score and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.
*Change gdp lag2* measures the host state’s economic growth rate. Higher levels of economic growth in a host state is a signal to investors that the host’s economy is teeming with profitable opportunities. Hypothesis 2 will be supported if *change gdp lag2* has a positive and statistically significant effect on *BITpresent*. According the coercive hypothesis, MNCs will want to invest in a fast growing economy and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

*Corruption* considers the host state’s corruption levels, with higher scores indicating more corruption. Higher levels of corruption in a host state are generally viewed as an unattractive characteristic for potential investors (Wei 2000). States with lower levels of corruption often have better institutions, which often provide more predictable policy environments for MNCs. Corrupt states often have unstable political systems that could produce unstable policy environments for MNCs. Hypothesis 2 will be supported if *corruption* has a negative and statistically significant effect on *BITpresent*. According the coercive hypothesis, MNCs will want to invest in a country with low levels of corruption and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

*Rich fdi* evaluates the total amount of outward FDI from the capital exporting state in the dyad in a given year. The variable accounts for differences in host states regarding the amount of FDI their MNCs send abroad annually. Hypothesis 2 will be supported if *rich fdi* has a positive and statistically significant effect on *BITpresent*. If more multinationals are investing larger sums, represented in a higher *rich fdi* score, more multinationals should be exerting greater effort to get their home state to engage in
a more aggressive BIT program so that their investments will receive the additional protections provided by a BIT.

Log trade/gdp is the log of the total value of trade between the two states in a dyad in terms of the host state’s GDP. Efficiency seeking MNCs may be drawn to states with which its home state trades. A high log trade/gdp indicates an open trade relationship in the dyad. MNCs can use the developing state as a production platform and sell products back to its home state without being encumbered by various trade barriers. Hypothesis 2 will be supported if log trade/gdp has a positive and statistically significant effect on BITpresent. According the coercive hypothesis, MNCs will want to invest in a country with a high log trade/gdp score and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

Legal tradition identifies the host state’s legal tradition, either common law or civil law. Common law systems are coded 1 and civil law systems are coded 0. Research suggests that common law systems usually provide better property right protections than civil law systems (Globerman and Shapiro 2003; La Porta et al. 1998). This is because civil law systems are usually more formal, more corrupt, have lengthier judicial proceedings and offer an overall inferior access to justice compared to common law systems, which are usually associated with less market regulation and an overall higher quality of justice (Globerman and Shapiro 2003; La Porta et al. 1998). Hypothesis 2 will be supported if Legal tradition has a positive and significant effect on BITpresent. According the coercive hypothesis, MNCs will want to invest in a country with a
common law system and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

*Law and order* gauges the impartiality and strength of the host state’s legal system as perceived by foreign investors and ranges from 0 to 6. Higher perceived levels of judicial impartiality and ruling enforcement receive higher scores. Data for this variable are from the Political Risk Services Group. Hypothesis 2 will be supported if *law and order* has a positive and significant effect on *BITpresent*. According the coercive hypothesis, MNCs will want to invest in countries with better legal systems and will lobby home and host governments to sign a BIT in order to secure the additional benefits that BITs provide investors.

Elkins et al (2006) found evidence suggesting that BITs have proliferated due to competition for FDI among developing countries. In short, they argue that one developing state will be more likely to sign a BIT when one of its economic competitors enters into a BIT. Elkin’s et al’s (2006) main explanatory variable, *competitionBIT*, “measures the degree to which host governments compete in the same foreign markets; that is, whether they have the same export trade relationships” (830). The authors then compute a weighted assessment of BITs signed by the economic competitors of a capital importing state. *CompetitionBIT*, as computed by Elkins et al. (2006), is used in this

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114 Elkins et al (2006) also test two other economic competition variables: BITs among export product competitors and BITs among infrastructure competitors. BITs among export product competitors, *competitionBIT*, “records the degree to which nations export the same basket of goods” (Elkins et al 2006, 830). BITs among infrastructure competitors, *jedinbit*, “captures the degree to which countries have similar educational and infrastructural resources” (Elkins et al. 2006, 830). The three economic competition variables are strongly correlated (Elkins et al. 2006).

115 Elkins et al (2006) establish the *competitionBIT* in the following way: they “compute a spatial lag by anchoring the distances (measured as correlations) at zero by adding 1 to each score and then using these distances to calculate a weighted sum of BITs in force in all other host countries in the previous year” (831).
model. Hypothesis 1, the competitive hypothesis, will be supported if \textit{competitionBIT} has a positive and statistically significant effect on \textit{BITpresent}. BIT data are from the UNCTAD website and the data for the market competition aspect of the variable are from the IMF’s Direction of Trade Statistics.

Model 2 uses variables that control for various home state characteristics, host state characteristics, and dyad characteristics that may influence the likelihood of a BIT existing in a dyad, but do not speak directly to one hypotheses established above. Several control variables that were used in model 1 are employed again here: \textit{alliance}, \textit{cold war}, \textit{extraction}, \textit{common language}, and \textit{fdi lag1}. One control variable not used in model 1 but used in model 2 is \textit{BITcount}, which controls for the number of BITs signed globally by year.

\textbf{Estimation Technique}

Model 2 uses a time-series logistic regression with clustered standard errors. A logit model is used because the dependent variable, \textit{BITpresent}, is dichotomous (non-metric).\textsuperscript{116} The logit technique predicts the log odds of a BIT being present in a dyad using the values of the independent variables (Hair et al. 2006). The clustered standard errors allow the model to identify a particular group to which an observation belongs. It is used here because of the panel nature of the data, which is subject to spatial correlation. Clustered errors identify observations by dyad and thus control for similarities within dyadic pairs observed over time (Williams 2000; Froot 1989).

\textsuperscript{116} An xtprobit model with fixed effects was not used because due to a lack of variation in the dependent variable.
RESULTS

The model contains 7,914 observations across 993 dyadic pairs (or clusters). The pseudo R-squared coefficient is .1499, suggesting a modest ‘goodness of fit’ for the model. Of the control variables not directly testing a hypothesis (alliance, cold war, extraction, common language, and fdi lag1, and BITcount) only BITcount is statistically significant at the .05 level. BITcount has a positive effect on BITpresent. A one unit increase in BITcount increases the probability of a BIT being ratified in a dyadic pair by about 5 percent. Thus, not surprisingly, the odds of a dyadic pair of countries ratifying a BIT increases as more BITs are signed globally. A one unit increase in extraction decreases the probability of a BIT being ratified in a dyad by 55 percent, but it is only weakly significant, significant at the .10 level.
Table 7.1. Logistic Regression Results for Model 2.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient (Robust Standard Error)</th>
<th>Odds Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-2.82 (0.47)</td>
<td>0.06</td>
</tr>
<tr>
<td>bifdi</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>gdp cap</td>
<td>-0.14*** (0.03)</td>
<td>0.87</td>
</tr>
<tr>
<td>legal tradition</td>
<td>-0.17 (0.23)</td>
<td>0.85</td>
</tr>
<tr>
<td>alliance</td>
<td>-0.02 (0.29)</td>
<td>0.98</td>
</tr>
<tr>
<td>democracy</td>
<td>0.04** (0.02)</td>
<td>1.04</td>
</tr>
<tr>
<td>corruption</td>
<td>0.10 (0.09)</td>
<td>1.11</td>
</tr>
<tr>
<td>privatization</td>
<td>0.16*** (0.03)</td>
<td>1.17</td>
</tr>
<tr>
<td>fdi lag1</td>
<td>0.03 (0.03)</td>
<td>1.02</td>
</tr>
<tr>
<td>rich fdi</td>
<td>0.06** (0.02)</td>
<td>1.06</td>
</tr>
<tr>
<td>log trade/gdp</td>
<td>0.04 (0.04)</td>
<td>1.04</td>
</tr>
<tr>
<td>change gdp lag2</td>
<td>0.01 (0.01)</td>
<td>1.01</td>
</tr>
<tr>
<td>extraction</td>
<td>-0.80* (0.41)</td>
<td>0.45</td>
</tr>
<tr>
<td>cold war</td>
<td>-0.21 (0.15)</td>
<td>0.81</td>
</tr>
</tbody>
</table>
### Table 7.1. Logistic Regression Results (continued).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient (Robust Standard Error)</th>
<th>Odds Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>common language</td>
<td>0.08 (0.38)</td>
<td>0.93</td>
</tr>
<tr>
<td>competitionBIT</td>
<td>0.04** (0.01)</td>
<td>1.04</td>
</tr>
<tr>
<td>BITcount</td>
<td>0.05** (0.02)</td>
<td>1.05</td>
</tr>
<tr>
<td>law and order</td>
<td>0.21** (0.07)</td>
<td>1.24</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statistics</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Observations</td>
<td>7914</td>
</tr>
<tr>
<td>Number of dyads</td>
<td>993</td>
</tr>
<tr>
<td>Pseudo R-squared</td>
<td>0.15</td>
</tr>
<tr>
<td>Log pseudolikelihood</td>
<td>-3102.70</td>
</tr>
</tbody>
</table>

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

**Statistically Insignificant Explanatory Independent Variables**

_Bifdi, legal tradition, corruption, and change gdp lag2 did not have a statistically significant effect on BITpresent_. The bilateral FDI from the capital exporting home state in a dyad to the capital importing host state in a dyad, _bifdi_, did not affect the presence of a BIT in the dyadic pair. One and three year lags of _bifdi_ also had an insignificant effect
on $BIT_{present}$ (see Appendix 12). Consequently, hypothesis 3, the lobbying hypothesis is not supported. A probable explanation for this result is that since BITs are not retroactive, they generally do not cover foreign investments that were conducted prior to the implementation of the treaty. Furthermore, multinationals that have already invested in a developing country do not have bargaining leverage over the host state. This logic is well defined in the obsolescing bargaining literature (e.g., Moran 1985; Vernon 1977). Alternatively, BITs tend to not be conducted in dyadic pairs with higher levels of FDI flows because BITs are instruments used to increase the general attractiveness of a potential host state. Host state’s receiving high levels of bilateral FDI from a home state do not need to sign a BIT since they are already an attractive location for investors from the home state.

The type of legal system in a host state, legal tradition, did not influence the presence of a BIT. This result does not lend support to hypothesis 2, the coercive hypothesis, which predicted the variable to be positive and significant. The presence of a common law legal system, the type of system associated with increased FDI flows in several studies (Globerman and Shapiro 2003; La Porta et al. 1998), does not influence the likelihood that a developed state and a developing state will enter into a BIT. However, this result is not condemning to the coercive hypothesis. Legal tradition is an inexact proxy for the quality of a host state’s legal system. The literature on host state legal systems suggests that, in general, common law systems provide better property rights protections than civil law systems. A more direct measure of the quality of a host states legal system is provided by law and order, which is significant in the direction predicted by the coercive hypothesis.
Corruption levels as perceived by foreign investors, *corruption*, had a statistically insignificant effect on *BIT_{present}*. Hypothesis 2 predicted that *corruption* would have a negative effect on *BIT_{present}*. The coercive hypothesis is not supported. Developing states with higher corruption levels are not more or less likely to ratify a BIT with a developed state.

*Change $gdp_{lag2}$*, the change in the host state’s GDP lagged two years, did not have a statistically significant effect on *BIT_{present}*. This variable was tried with a one year lag and a three year lag, but no matter the configuration of *change $gdp_{lag2}$*, the result remained statistically insignificant (see Appendix 12). Hypothesis 3 predicted that BITs would be signed with host states with fast growing economies. The results do not support this aspect of hypothesis 3.

### Statistically Significant Explanatory Independent Variables

*GDP cap* has a negative and highly significant, at the .01 level, effect on *BIT_{present}*. As provided in the odds-ratio statistic, a one unit increase in *gdp cap* (the equivalent of 1,000 dollars per person) reduces the probability of a BIT being signed in a dyadic pair by about 13 percent, all else equal. In other words, the more advanced a host country’s economy becomes, the less likely it will sign a BIT with a capital exporting home country.\(^{117}\) This result does not support hypothesis 2, which predicted a positive relationship between *gdp cap* and *BIT_{present}*.  

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\(^{117}\) A quadratic for of *gdp cap* was also tested. The quadratic of *gdp cap* was employed to see if, initially, an increase in a country’s economic development increased the chances of a BIT being signed in a dyad but the odds of a dyad signing a BIT decreased after a certain level of economic development is reached. However, the results were not significant and, therefore, the quadratic form of *gdp cap* is not included in the model.
The host state’s level of democracy, *democracy*, has a positive and statistically significant effect on *BITpresent*. A one unit increase in *democracy* increases the probability of a BIT being signed by a dyadic pair by about 4 percent, all else equal. This result is substantively significant, since *democracy* ranges from -10 to 10. The positive significance of *democracy* supports hypothesis 2. Higher levels of democracy in a host state, a proxy for overall government quality, lead to higher probabilities of a BIT in a dyadic pair.

The host state’s privatization record, *privatization*, has a positive and statistically significant effect on *BITpresent*. A one unit increase in *privatization* (which is measured in millions of dollars) increases the probability of a BIT being signed by a dyadic pair by about 16 percent, all else equal. This result is substantively significant, since *privatization* ranges from 0 to 14.8. The positive significance of *privatization* supports hypothesis 2. Higher levels of privatization in a host state, a proxy for changes to pro-liberal economic policies, result in higher probabilities of a BIT in a dyadic pair. This supports the supposition that MNCs seek to have their home state enter a BIT with a host state in which they want to invest.

The home state’s annual outward FDI, *rich fdi*, has a positive and statistically significant effect on *BITpresent*. A one unit increase in *rich fdi* (which is measured in billions) increases the probability of a BIT being signed by a dyadic pair by about 6 percent, all else equal. This result is substantively significant, since *rich fdi* ranges from -6.11 to 14.65. The positive significance of *rich fdi* supports hypothesis 2. Higher levels of outward FDI from a home state, a proxy for levels of activity of a home state’s MNCs, lead to higher probabilities of a BIT in a dyadic pair. This supports the argument that
MNCs are lobbying their home governments to conduct more extensive BIT programs with potential host states.

The quality of the host state’s legal system, *law and order*, has a positive and statistically significant effect on *BITpresent*. A one unit increase in *law and order* increases the probability of a BIT being signed by a dyadic pair by about 21 percent, all else equal. This result is substantively significant, since *law and order* ranges from 0 to 6. The positive significance of *law and order* supports hypothesis 2. The higher the quality of a host state’s legal system, the higher the chance a dyadic pair will implement a BIT.

Treaties signed by economic competitors of the host state, *competitionBIT*, has a positive and statistically significant effect on *BITpresent*. A one unit increase in *competitionBIT* increases the probability of a BIT being signed by a dyadic pair by about 4 percent, all else equal. This result is substantively significant, since *competitionBIT* ranges from 0 to about 36. The positive significance of *competitionBIT* supports hypothesis 1. The signing of a BIT by a host state’s economic competitor results in higher probabilities of a BIT in a dyadic pair. This supports the argument that developing states initiate BIT programs when their economic competitors sign BITs.

**DISCUSSION**

The lobbying hypothesis predicts that MNCs will lobby their host state governments to sign BITs with their home state. Moreover, it states that MNCs invested in a foreign developing state will leverage their ability to leave the state and invest elsewhere if the host government does not enter a BIT with the MNCs’ home state.
(Swenson 2009). However, the empirical evidence provided here does not support the lobbying hypothesis. Bilateral FDI flows to the host developing state from the host developed state in the dyadic pairs analyzed have no effect on the likelihood that a BIT is present in a dyad. The insignificant results are probably the product of two logical holes in the hypothesis. First, the hypothesis ignores the insights gained from the literature on the obsolescing bargain. MNC already invested in a host state have lost their initial bargaining leverage (Moran 1985; Vernon 1977). Before they invest, their leverage against LDCs is high because they have the ability to invest in a variety of states. However, once they have invested, they will incur high costs from divesting and re-investing in another country. Host states know this. Consequently, MNCs lose bargaining power once their investments have been sunk in the host state. Second, BITs are not retroactive. They do not cover investments made prior to the establishment of the treaty. Thus, MNCs already invested in a LDC do not have an incentive to pursue a BIT between the MNC’s home state and its host state.

The coercive hypothesis predicts that MNCs will seek to have their home state sign BITs with host states in which they want to invest. The hypothesis is considered ‘coercive’ because of the leverage that MNCs have over developing host states prior to an investment. Host state characteristics generally associated with higher levels of investment flows are predicted to be positively associated with the presence of a BIT in a dyad. The results were mixed, lending tentative support for the hypothesis. The LDC’s wealth, legal system, corruption levels, and economic growth rate did not increase the likelihood of a BIT being present in a dyad. However, the host state’s quality of governance, the presence of liberal economic policies in the host state, and the quality of
the host state’s legal system were positive and statistically significant. LDCs with these positive qualities, positive in the eyes of multinationals, that is, were more likely to be associated with a BIT. Thus, there is support for the notion that the proliferation of BITs is driven by the investment preferences of multinationals.

The competitive hypothesis predicts that a LDC will sign a BIT when a country with which it competes for foreign investment signs a BIT. According to the hypothesis, LDCs want multinationals to invest in their state, not their neighbor’s. BITs make LDCs more attractive investment locations for multinationals (Elkins et al. 2006). Consequently, a LDC is forced to seek BITs when one of its neighbors it competes with for FDI does so first. The results of the empirical analysis support competitive hypothesis. An increase in the number of BITs signed by a LDC’s economic competitor is positively related to the presence of a BIT in a dyad. Thus, the notion that the proliferation of BITs is a result of competition among developing states for foreign investment is supported.

Results in support of both the competitive and coercive hypotheses are not necessarily conflicting. Different BITs may be signed for different reasons. The competitive hypothesis suggests that one LDC joins a BIT once a competing state enters a BIT. However, the hypothesis does not explain why the first BIT was signed. The initial BIT signed by one developing state in a group of economically competing states could be the result of the coercive logic, driven by multinationals, while subsequent BITs could be the result of the competitive logic, driven by competing developing states.
CHAPTER 8: CONCLUSION

INTRODUCTION

This study on bilateral investment treaties (BITs) addresses two questions: (1) Do BITs increase foreign direct investment (FDI) flows to less developed countries (LDCs)? And (2) what has driven the proliferation of BITs? The results indicate that, yes, BITs do increase FDI flows to LDCs and the proliferation of BITs is, in part, driven by the preferences of multinational corporations (MNCs). This study provides new data and practical information for economic policy, and makes an important contribution to international relations theory.

Through the process of answering the above questions, this analysis provides two major contributions to the study of BITs: (1) the study develops a dataset consisting of 748 treaties assessed by thirty-seven different areas of variation and covering thirty years, 1980-2009. Previous studies on BITs provided anecdotal evidence indicating general trends in BIT provisions (UNCTAD 2007; Dolzer and Stevens 1995). This research represents the literature’s first systematic assessment of BITs. (2) This study develops measurement instruments that assess the strength of treaty protections that each treaty provides the MNCs it covers. Only one study has attempted to determine BIT strength and it only accounted for one area of treaty variation (Yackee 2008). This analysis uses thirty-seven areas of BIT variation to develop four distinct dimensions measuring treaty strength.

The testing of the effect of BIT strength on FDI flows led to the conclusion that, not only do BITs matter, but BITs that provide additional treaty protections to foreign investors garner more foreign investments for developing states than BITs that provide
fewer investor protections. This finding has important practical implications.

Developing states are limiting their economic sovereignty by agreeing to the BIT’s terms and conditions. They sign BITs and voluntarily limit their economic sovereignty to attract more developed state FDI. This study concludes that BITs are worth the policy restrictions to which they commit host developing states because stronger policy restrictions produce more FDI inflows for LDCs.

The major theoretical contribution of this study is the support it lends to viewing multinationals as influential actors in the international political economy. Regime theory, in all of its variations (realist, neoliberal, and constructivist), is state centric. It does not consider MNCs major actors in the international system. This study builds upon Strange (1988a) and argues that multinationals are major actors. MNCs are capable of influencing home and host states. Empirically, this research shows that BITs are signed with LDCs in which MNCs want to invest, leading to the conclusion that the proliferation of BITs is driven by MNCs.

**MNCs and BITs**

The historical background chapter showed that the protections allotted to foreign investors in developing states mirrored their needs, leading to the proliferation of BITs. Prior to WWII, the minimum standard for the protection of foreign owned property largely prevented host developing states from expropriating foreign-owned property (Lipson 1985). Most foreign investments in the developing world in this period were in either natural resources or infrastructure (Frieden 1994). Both types of investments could potentially be expropriated and fully utilized by a host state (Frieden 1994). Thus,
outright expropriation was the major threat to foreign owned property in the developing world in this period. However, hegemonic powers successfully enforced the minimum standard. There were few cases of expropriation prior to WWII, and in cases of expropriation, the minimum standard was upheld as full compensation was paid to an injured foreign investor (Lipson 1985).

Circumstances changed after WWII. Virtually all foreign owned natural resource investments in the developed world were expropriated in the 1960s and 1970s as LDCs embraced Marxist ideologies and import substitution development strategies (Lipson 1985; Kobrin 1984). The United States could not stop the expropriations. It was no longer able to enforce the minimum standard because of the rise of the USSR. However, the nature of MNC investments in LDCs changed in the 1980s. LDCs began courting MNCs as they started seeing FDI as an integral part of their economic development strategies after the failure of import substitution efforts.

MNCs began investing in LDCs for manufacturing and market access, both sectors that cannot be successfully utilized by a host state via expropriation (Frieden 1994). Thus, the outright expropriation of an investment in a LDC was no longer the primary threat to MNCs. Instead, restrictive business practices became the primary threat to the profitability of an investment in a developing state. Restrictive business practices encompass all of the various efforts by host states to shape the operations of MNCs so that the host state reaps a larger share of the gains from the investment.

BITs proliferated in light of these changes. BITs include various protections and guarantees for foreign investors covered by the treaty. They inhibit the host state from implementing a wide variety of restrictive business practices. And in situations where an
MNC feels it has been treated unfairly by a host state, BITs allow the MNCs to take their host state to the international arbitration body stipulated in the treaty. In other words, BITs fit the needs of developed state multinationals investing in developing states. Even though BITs are tailored to the needs of MNCs, two questions remain in the literature on BITs. Do BITs increase FDI flows to LDCs? And what has driven the proliferation of BITs?

Do BITs Increase FDI Flows to LDCs?

BITs stipulate the terms and conditions by which states must treat foreign investors (Elkins et al. 2006). LDCs sign BITs to attract FDI; but by signing a BIT, LDC governments willingly limit their ability to pursue economic polices they believe may benefit their country. For instance, Uruguay recently passed legislation to combat its smoking problem. However, Philip Morris International, an American tobacco company, filed a claim against Uruguay in the International Centre for Settlement of Investment Disputes (ICSID; The Economist 2013). Phillip Morris International claims that the restriction on smoking violates the United States – Uruguay BIT. While this particular ICSID case has not been decided, it brings up an important issue. LDCs grant multinationals many legal protections and guarantees through the signing of a BIT. If BITs do not increase FDI flows to the developing state partner of the treaty, then the only actors benefiting from a BIT are MNCs who would invest in the LDC with or without the extra legal protections afforded to them by the treaties. The question is pertinent: Do BITs increase FDI flows to LDCs?
Previous studies addressing this question assume that BITs are homogenous, that all treaties provide the same basic guarantees and protections to foreign investors or that the differences that are present are inconsequential. This research tests the BIT homogeneity assumption. The primary contribution of this study is the development of a measurement instrument that assesses the strength of treaty protections provided in BITs. The strength measures are applied to 748 treaties from 1980-2009. Chapter six hypothesizes that BITs increase FDI flows to the LDC member of a treaty, and that stronger BITs, BITs that provide foreign investors more protections and guarantees, produce greater FDI flows to the LDC member of a treaty. The findings indicate that, indeed, BITs increase FDI flows to developing states and stronger BITs have an even greater effect on FDI flows to developing states.

The results of this study indicate that BITs with stronger *broad treatment* provisions and stronger *transfers* provisions stimulate more FDI to the developing state partner of the treaty. *Broad treatment* consists of three components, fair and equitable treatment, most favored nation status, and national treatment. Fair and equitable treatment entails the “principles of reasonableness, consistency (in effect, the security of legitimate expectations), non-discrimination, transparency, and due process” that host states must provide foreign investors covered by the treaty (Vandevelde 2010). The fair and equitable treatment standard thus “[offers] a malleable basis for [a dispute settlement] award in favor of” the foreign investor (Vandevelde 2010, 203). The most favored nation provision requires the host state to provide an investor covered by the treaty with at least the same favorable treatment that it provides investors from a third country (Vandevelde

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118 Yackee (2008) accounts for one area of variation in BITs, the presence or absence of the host state’s pre-consent to dispute settlement.
2010). Thus, it enables “the nationals of the parties to profit from favourable treatment that may be given to nationals of third states by either contracting state” (Sornarajah 2004, 236). National treatment provisions require that foreign investors receive the same standard of treatment as corporations from the host state (Sornarajah 2004).

Likely, foreign investors invest more when they are covered by a higher broad treatment score because of the nature of the provisions comprising the score. Each component of broad treatment is what the name of the measure implies—broad. The components can be applied to a wide variety of issues, giving multinationals investment protections in a wide span of areas. For instance, a component of the treatment measure (which did not have a statistically significant effect on bilateral FDI flows to developed states) is a guarantee that a multinational can employ the managers of its choosing (e.g., the host state cannot require the MNC to employ a host state native as manager). While this provision may or may not be important to a potential foreign investor, it is only one specific issue. The components of the broad treatment standard may cover managers and a wide variety of other issues important to a foreign firm, depending on the standards applied to host state firms (via national treatment) and multinationals from other states (via most favored nation treatment). In sum, the provisions comprising the broad treatment measure provide foreign investors a flexible basis from which a variety of protections and guarantees can be obtained. This broad, flexible basis for protections and guarantees attracts more FDI to LDCs.

Transfers consists of provisions that allow foreign investors the ability to move funds in and out of a host state. The results from chapter six indicate that stronger transfer provisions produce more FDI for the developing host state in a dyad. These
results are not surprising. According to UNCTAD (2007), “the transfer provisions included in most BITs are particularly important for foreign investors, as they see the timely transfer of profits, capital and other payments as a key condition for the proper operation of their investments” (56). Furthermore, it is safe to assume that the primary reason a multinational invests abroad is to achieve profits. The foreign investment is useless if profits cannot be transferred fairly (i.e. a market exchange rate, not a rate arbitrarily chosen by the host state for its benefit) back to the multinational’s home state, or wherever the multinational would like to reinvest the funds. In sum, transfer provisions seek to ensure that a multinational can profit from its foreign investment; consequently, BITs with stronger transfers scores attract more FDI to LDCs.

**Theoretical implications: treaty design matters.** At the domestic level, North (1990) argues that an institution’s design affects its function. He claims that efficient economic institutions, such as strong property rights, contribute to a state’s economic development (North 1990). At the international level, Neoliberal institutionalists contend that states can design institutions to overcome impediments to cooperation (Keohane 1984). For instance, Mitchell (1994) demonstrates the importance of institutional design in his study of two international institutions meant to stop oil tankers from illegally polluting the ocean. The more successful institution was designed in a way so that it was enforceable and easier to implement.

This study shows that the design of BITs matters, reinforcing conclusions reached by North (1990), Keohane (1984), Mitchell (1994), and other institutionalists. Two BIT areas are particularly important in regards to a treaty’s ability to induce FDI flows, broad
treatment standards and transfer issues. BITs with more broad treatment standards and BITs with more protections and guarantees on transfer issues garner more FDI for the developing state member of the treaty. Broad treatment standards provide general standards of treatment, including fair and equitable treatment, most favored nation treatment, and national treatment, that host states must allot foreign investors covered by the BIT. Transfer provisions allow foreign investors to more freely move money into and out of the host state.

**Policy implications.** BIT policy prescriptions need to stem from the primary goal of the treaties—BITs are established to increase FDI flows between states in the agreement. LDCs want FDI from developed states and developed state multinationals want specific investment protections before they invest in the developing world. However, opponents of BITs in the United States lobby Congress to change the United States model BIT to grant developing states a greater ability to regulate investments from the United States (Vis-Dunbar 2009; Whitsitt 2009). In other words, BIT opponents want the United States to pursue weaker BITs, BITs that provide fewer protections and guarantees to United States corporations. This is a mistake if the goal of BITs is to increase FDI from the United States to developing countries. In particular, the United States should not decrease broad treatment standards or transfer provisions present in its model BITs. This research indicates that weakening treaty protections will decrease FDI flows from developed states to developing states.
**What Has Driven The Proliferation of BITs?**

This research addresses the second question concerning the proliferation of BITs by hypothesizing that the more attractive a LDC is as an investment location, the greater the likelihood a developed state and a developing state will be BIT partners. This hypothesis is based on the notion that MNCs are driving the spread of BITs. MNCs use their political influence over home and host states to convince the countries to sign a BIT, giving MNCs investment protections and guarantees in the states in which they want to invest. The hypothesis is called the coercive hypothesis because it is based on the potential ability of multinationals to coerce states into signing a BIT. Chapter seven juxtaposes the coercive hypothesis against the prevailing explanation of BIT proliferation, the competition hypothesis. The competition hypothesis states that the spread of BITs is driven by developing state competition for foreign capital (Elkins et al. 2006). The results lend support to both hypotheses. Developing states sign BITs when their economic competitors sign them. Developed states sign BITs with developing states that are attractive investment locations for developed state multinationals.

**Theoretical implications: MNCs matter.** Strange (1988a) provides the theoretical foundation for the inclusion of MNCs as major actors in international political economy. Strange argues that technological and political changes post WWII have elevated multinationals to major actor status. MNCs control the technology, production processes, and finance that LDCs need to develop, giving MNCs what Strange (1988a) refers to as structural power. This study supports Strange’s research by providing evidence that MNCs precipitated the spread of BITs.
The results of this study bring into question the neglect of MNCs by regime theory. Regime theory cannot logically produce an accurate explanation for the spread of BITs because it does not include multinationals in its explanation. Regime theory predicts that a multilateral regime will be established governing protections and guarantees for foreign investors. Both developed capital exporting countries and developing capital importing would benefit from such an agreement. However, no such regime has been established. The absence of a multilateral regime can only be explained with the inclusion of MNCs as major actors. In short, multinationals benefit more from a patchwork bilateral system of investment treaties than they would from a multilateral system. In the multilateral setting, developing states could negotiate together, strengthen their position and dilute the protections a multilateral treaty would allot foreign investors (Guzman 1998). On a bilateral basis, multinationals can leverage their structural power to garner the investment protections they want in developing states in which they want to invest.

Furthermore, the notion that MNCs affect international relations between states through their influence in both their home and potential host states is a new concept. Previous theoretical work on international cooperation that includes influences from business interests assumes that companies only influence their home state (Milner 1997; Putnam 1988). In the vein of Strange’s (1988a) work on structural power, this research argues that MNCs are global actors capable of influencing multiple states in order to develop an institutional framework congruent with their interests.
**Future Research**

Qualitative research should be included in future studies on BITs. This study focused on broad variables like GDP growth and rule of law to predict where MNCs want to invest. The political inner-workings of the foreign investment process have been largely ignored. Future research should provide in-depth descriptions of the political interactions between host state government officials, home state government officials and representatives of MNCs.

Future research should also test to see what factors influence the strength of protections and guarantees provided in BITs. For instance, do powerful states negotiate stronger BITs for their MNCs? Do protections provided in BITs stem from other factors, such as home state domestic politics? Or, do developed states that also import capital from emerging market states seek weaker protections in their BITs, so they do not have to provide foreign investors a high standard of protections and guarantees? To answer these questions, the entire population of BITs, not just BITs established between developed states and developing states, needs to be assessed by the BIT strength measures developed here.
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APPENDIX 1: THE CONTENT ANALYSIS OF BITs

Variation across thirty-seven different aspects of BITs was assessed using the coding scheme outlined below. UNCTAD (2007), Sornarajah (2010), and Dolzer and Stevens (1995) inform the areas of variation. Variables are organized into nine categories:

- scope
- temporal application
- general standards of treatment
- compensation for damages
- treatment
- transfer issues
- expropriation
- dispute settlement
- treaty exceptions

**Scope**

Scope refers to the range of investment covered by the treaty. Two variables are in this section: definition of investment and admission standard. In general, treaties covering more areas of investment are expected to generate increased levels of FDI.

**Variable 1: definition of investment.** The definition of investment is an important aspect of BITs because it defines the types of investment that are covered by the treaty. A broad definition of investment will cover more types of investment and can
be expected to produce increased FDI flows. Broad definitions of investment will be seen by investors as a credible policy commitment because, simply put, the protections of the BIT will apply to them. Even if a BIT contains many policy commitments aimed at creating a favorable policy environment for investors, the policy commitments mean nothing to investors not covered by the treaty.\textsuperscript{119} The definition of investment included in treaties was initially coded as follows: (1) no definition of investment present, (2) inclusive definition with domestic law restrictions, (3) exclusive definition, and (4) inclusive definition.

The inclusive definition category includes BITs that provide the broadest definition of investment. The 2004 US model BIT provides an example of an inclusive definition of investment: “‘investment’ means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk” (2004 US Model BIT).

The exclusive definitions category includes the next broadest group of definitions. Exclusive definitions of investment contain a closed-list of types of investment that are covered by the treaty. This category is expected to achieve less FDI that the inclusive definition because it only covers an explicitly limited set of investments. However, they do provide investors with predictability because these categories are explicitly mentioned in the treaty, something that the final category lacks.

The final category of investment, definition with domestic limitations, provides a broad definition of investment but then follows it with a phrase such as ‘subject to

\textsuperscript{119} Furthermore, broad definitions of investment can also be expected to be interpreted by a potential investor as a host state’s commitment to liberal economic policies (Vandevelde 2010).
domestic laws and regulations’ that essentially limits the definition to the various
domestic laws and regulations of the host state. Because the ‘domestic laws and
regulations’ of a LDC can be amended unilaterally and because they are not listed in the
treaty, this category of investment definition does not provide investors with as much
predictability as the previous two categories and is expected to produce the least FDI.

**Variable 2: admission standard.** Admission refers to the conditions and
procedures under which investment will be allowed in the host state. Logically, BITs that
guarantee admission to a wider scope of investments can be expected to attract more FDI.
The admission standards of BITs are divided into two categories: (1) BITs that do not
contain a right of establishment model and (2) BITs that contain a right of establishment
model.120

BITs that follow the right of establishment model provide investors with the least
amount of admission restrictions. This model requires the host state to provide national
treatment, most-favored-nation treatment, and sometimes the more favorable of the two,
as is the case with most US BITs (Dolzer & Stevens 1995; Salacuse and Sullivan 2005).
National treatment requires the host states to provide the investing MNC with the same
establishment standards applied to national firms. Most-favored-nation treatment
requires the host state to give the MNC of the BIT partner state the ‘same best deal’ on
admission standards it provides MNCs from other states. Essentially, the right of

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120 Another model used in BITs is the admission clause model. The inclusion of the admission clause
model in a BIT allows host states to retain their legal right to employ the discriminatory policies of their
choosing when admitting foreign investment. BITs using the admission clause model are coded as BITs
that do not contain a right of establishment model.
establishment model limits the sovereign right of states to discriminate on the entry of foreign investors to their country.

All other admission standards are included in a second category, BITs that do not contain a right of establishment model. BITs in this category allow the host state to retain its sovereignty over admission, that is, the host state can still choose which investments from the home state to admit and deny entry.

**Temporal Application**

Almost all BITs specify the timeframe which the agreement will cover. Timeframes supply investors with predictability regarding the duration of the legal regime provided by the BIT. BITs covering a longer period of time could be more appealing to investors than treaties which cover only, for instance, five years. Investors may also prefer BITs which provide extended protection after the expiration of the treaty. In both cases extended timeframes could provide investors with increased predictability. For example, investors may be reluctant to invest in an LDC if the BIT could expire before the goals of the investor can be realized. Investors may worry that after the investment has been made and costs have been sunk, the host state could refuse to extend the protections of the BIT beyond the initial period specified in the agreement and could legally enact policies detrimental to the profitability of the investment which were previously prohibited by the BIT. Particularly, investors involved in large, complex investment projects that take a long time to implement may prefer BITs which cover a longer period. Variables 3-6 gauge variation in the temporal application of BITs.

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121 The most common timeframe is ten years but some BITs only cover five years while others may span up to thirty (Dolzer and Stevens 1995).
Variable 3: treaty duration. Three basic approaches to temporal application are seen in BITs and treaties are be categorized accordingly. BITs are coded as either (1) not including a provision on treaty duration, (2) including a specified period that the treaty covers or (3) treaties that are to remain in force indefinitely, or until one party chooses to withdraw.\textsuperscript{122}

Variable 4: treaty duration (number of years). Variable 4 is the number of years the treaty is to be in effect.

Variable 5: impact of the treaty after expiration. BITs vary by how investments are treated once the treaty has expired. BITs are put into one of three possible categories: (1) BITs that do not contain a provision concerning the protection of investments after expiration of the treaty or BITs that explicitly state that investments will not be protected after the expiration of the treaty, (2) BITs that provide continued investment protection for a specified number of years, and (3) BITs stating the treaty will continue to remain in force indefinitely, with each party retaining the right to terminate the BIT with written notice, if neither contracting party terminates the BIT at the end of the initial fixed term.

\textsuperscript{122} Some BITs do not provide an explicit timeframe but instead state that the treaty is to remain in force indefinitely or until one of the parties notifies the other of its intentions to withdraw from the treaty. It is unclear how treaties with this provision could impact investment decisions. On the one hand, the treaty could remain in place for an extended period increasing the coverage of the treaty. On the other hand, the treaty could be ended at the whim of one of the states party to the agreement, thus reducing predictability.
Variable 6: impact of the treaty after expiration (number of years). Variable 6 is the number of years the treaty continues to cover investments, those made during the life of the treaty, after the expiration of the BIT.

General Standards of Treatment

Sections on ‘treatment’ in BITs define the legal regime that is applied to MNCs after they have been admitted into the host state (Dolzer & Stevens 1995). General standards of treatment are just that—general. They lack specificity and do not establish a clear legal regime. Consequently, variation in this area of BITs does not just occur in the presence or absence of a specific general standard. Variation also occurs in the qualifying phrases that accompany the standard, meant to either strengthen or weaken the standard’s impact, depending on the provision. Four common general standards of treatment and their variations are explored here. The categories for each general standard grant increasing levels of protection to investors.

Variable 7: fair and equitable. The phrase ‘fair and equitable treatment’ exists in most BITs. ‘Fair and equitable treatment’ is meant to provide “a basic standard, detached from the host country’s domestic law, against which the behavior of the host country vis-a-vis foreign investment can be assessed” (UNCTAD 2007, 28). However, no general agreement exists in international law regarding the legal implications of the phrase (Dolzer & Stevens 1995). Because of this lack of agreement, some BITs have included additional phrases meant to either weaken or strengthen the impact of the ‘fair

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123 UNCTAD (2007) provides seven different categories for the various uses of ‘fair and equitable treatment’ in BITs.
and equitable treatment’ provision. Some BITs weaken the provision by making it subject to the national laws and regulations of the host state. Other BITs have sought to strengthen the provision by connecting the phrase to treatment standards embodied in international law. However, a clear consensus on treatment standards in international law has not been achieved. Therefore, some BITs have included specific definitions of international legal standards concerning what the phrase ‘fair and equitable treatment’ actually entails.

Variable 7 codes four areas of variation in regards to ‘fair and equitable treatment’: (1) BITs which do not contain a ‘fair and equitable treatment’ clause, (2) ‘fair and equitable treatment’ clause is present, but is accompanied by a limiting phrase related to domestic law restrictions, (3) ‘fair and equitable treatment’ clause is present, (4) ‘fair and equitable treatment’ clause is present and is connected to an international legal standard, (5) ‘fair and equitable treatment’ clause is present, is connected to an international legal standard, and specific definitions are provided.

**Variable 8: national treatment (post establishment).** National treatment provisions require the host state to provide MNCs covered by the BIT with at least the same rights and standards of treatment that it provides its domestic firms.\(^\text{124}\) Ideally, for foreign investors, a national treatment provision will prevent a host state from applying potentially harmful measures to foreigners that it does not apply to domestic firms, that is, measures that specifically discriminate against foreign enterprise covered by the BIT.

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\(^{124}\) Unless specifically stated otherwise, national treatment and most-favored-nation treatment only apply to investments in the post-establishment phase of investment, that is, the investments have already been admitted to the country according to the rules provided in the admission section of the BIT.
However, different variations in national treatment provisions may provide different levels of protection to foreign investors. National treatment provisions are categorized as follows to account for this variation: (1) national treatment provision is not present, (2) the national treatment provision is present, but is accompanied by a phrase(s) limiting its impact (domestic law restrictions and/or exceptions to national treatment), and (3) national treatment provision is present without any restrictions or exceptions.

Variable 9: most favored nation (post establishment). Most-favored-nation treatment requires a host state to provide at least equal treatment to the investments covered under the BIT as it does to investments from other states. In other words, this provision requires host states to give foreign enterprise covered by the BIT the ‘same best deal’ that it gives all foreign enterprise. The same basic qualifying statements seen in national treatment provisions accompany most favored nation phrases; therefore, most favored nation provisions are therefore coded similarly: (1) most favored nation provision is not present, (2) the most favored nation provision is present, but is accompanied by a phrase(s) limiting its impact (domestic law restrictions and/or exceptions to national treatment), and (3) most favored nation provision is present without any restrictions or exceptions.

Variable 10: umbrella clause. Umbrella clauses make contracts established by a foreign investor and a host state subject to international law (Salacuse & Sullivan 2005). A contract between an investor and a host state would only be subject to host state laws
under normal circumstances. Host states will not be able to unilaterally alter a contract with a MNC without violating the treaty if this provision is included in the BIT. BITs are coded as either (1) not containing an umbrella clause provision or (2) containing an umbrella clause provision.

**Compensation for Damages**

BITs may include provisions which guarantee compensation for investor property damaged during events outside of the host state’s control. Potentially, investors might be more likely to invest in a state if damages from war, civil disturbances, and natural disasters are compensated for by the host state. These provisions are covered in variables 11 and 12.

**Variable 11: damages from war and civil disturbances.** Most BITs established from 1996-2006 include a provision on protection for investors covering losses sustained during wars and civil disturbances (UNCTAD 2007). Variable 11 accounts for four different approaches to this issue: (1) no protection from war and civil disturbances, (2) protection from war only, (3) protection from civil disturbances only, (4) protection from both war and civil disturbances.

**Variable 12: compensation for natural disasters.** Some BITs go beyond compensation for losses sustained from a war or civil disturbance and include a requirement for compensation for losses sustained from a natural disaster. Variable 12 categorizes BITs as either containing such a provision or not.
Treatment

This section addresses requirements sometimes applied to investors as a requisite to conduct business in a host state. The variables covered are performance requirements and management positions.

**Variable 13: performance requirements.** Performance requirements are “conditions imposed by host countries on investors in connection with the establishment and operation of investments or in exchange for the granting of a particular advantage” (UNCTAD 2007, 64). Various performance requirements are instituted by host states to shape the economic impact of the investment. For instance, performance requirements are often intended to increase local employment, increase demand for local inputs, and to increase exports (UNCTAD 2007).

Most performance requirements are prohibited by the WTO’s Trade Related Investment Measures (TRIMs) agreement. The TRIMs agreement requires host states to provide national treatment to investors in regards to performance requirements. Although applying performance requirements after the admission of an investment would violate the TRIMs agreement, “there would normally be no violation of a BIT if such a requirement were applied on a non-discriminatory basis, or imposed—even on a discriminatory basis—as a condition for the admission of the investment” (UNCTAD 2007, 65). Therefore, performance requirements can be implemented without violating the TRIMs agreement if the performance requirements are either a condition for entry into the host state or the performance requirements are applied to both domestic and
foreign owned firms. Because of this gap left by the TRIMs agreement an increasing number of BITs, especially since 1995, have included various restrictions on performance requirements (UNCTAD 2007).

Generally speaking, restricting the use of performance requirements could generate more foreign investment for LDCs. BITs which stipulate more restrictions could be expected to generate more investment. Performance requirements may force MNCs to conduct business in an inefficient manner. If an investor knows in advance that performance requirements will not be applied to a potential investment, the investor will have greater certainty that the investment will be profitable.

BITs will be organized into one of four categories concerning their restrictions on performance requirements: (1) no restrictions on performance requirements, (2) BITs that provide the same protections as those mentioned in the TRIMs agreement, (3) provides for restrictions against performance requirements, but only after admission into the host state, (4) provides restrictions on performance requirements in both the pre and post admission phases will make up the fourth category.

**Variable 14: management positions.** MNCs may wish to employ nationals from their home state in top managerial positions of foreign offices. However, a MNC’s ability to choose managers of their choice to run foreign operations is not guaranteed: international law allows host states to regulate the entry of foreign nationals into their territory (UNCTAD 2007). Furthermore, some LDCs have enacted legislation requiring certain managerial positions to be filled with nationals of the host state. LDCs use this policy to advance development goals by providing managerial experience to their
nationals and by facilitating the transfer of technology to the host state. BITs address this issue in a variety of ways.

BITs that provide the freedom to employ managers of their choice are expected to be viewed more favorably by MNCs since proper management could impact the profitability of the foreign venture. Some other BITs state that MNCs are free to hire management personnel regardless of nationality but include phrases allowing for domestic law restrictions. These BITs are expected to garner less FDI than BITs in the first category since the latter decreases investor predictability. BITs that do not provide any statement on managerial positions provide the least amount of predictability for investors and are expected to produce the least amount of FDI.

Four categories are discerned here regarding this issue: (1) no provision guaranteeing management positions, (2) provision guaranteeing management positions present, but with domestic law restrictions, (3) provision guaranteeing management for management positions present, and (4) provision guaranteeing management and board of director positions present.

Transfer Issues

One specific area of treatment addressed by virtually all BITs is the regulation of monetary transfers. BIT provisions on monetary transfers are of the utmost importance for both host states and investors. In fact, the majority of recent investment disputes stem from monetary transfer issues (UNCTAD 2007). On the one hand, a MNC cannot fully reap the benefits of a successful investment unless profits from the investment are allowed to be repatriated to the MNC’s home state. On the other hand, a host state’s
concerns with potential balance-of-payment problems and the availability of foreign exchange make the state reluctant to grant investors unlimited transfer rights. Six aspects of monetary transfers are covered here.

**Variable 15: inbound/outbound transfers.** BITs vary according to the scope of transfers which they cover. Some BITs only cover outbound transfers while others cover both inbound and outbound transfers. BITs which cover both inbound and outbound transfers are expected to produce more FDI than BITs which cover only inbound transfers because the inclusion of the inbound transfer right supports the right of investors to establish a presence in the host state (UNCTAD 2007). Variable 15 contains four categories: (1) no provision covering transfer issues, (2) covers outbound transfers only, (3) covers inbound transfers only, (4) specifically covers both inbound and outbound transfers.

**Variable 16: subject or not subject to domestic law restrictions.** Some BITs subject transfer provisions to the domestic laws of the host state while other BITs do not. A statement subjecting transfer rules to the domestic laws of the host state “reduces the level of investment protection considerably” because it could produce uncertainty for investors who are unfamiliar with the host state’s applicable laws and regulations (UNCTAD 2007, 59). Furthermore, host state laws can be changed at the whim of the state, adding additional uncertainty for investors. Therefore, BITs which do not include a statement subjecting transfer issue to domestic law are expected to produce more FDI than BITs including such a statement. Variable 16 contains three categories: (1) transfers
not addressed by the treaty, (2) transfers are subject to domestic law restrictions, (3) transfers are addressed, but there is no mention of domestic law restrictions.

**Variable 17: restrictions on type of currency.** BITs may either limit currencies used in transfers or guarantee a MNC’s ability to make transfers in the currency of their choice. BITs guaranteeing transfers in the currency of the investor’s choice grants flexibility and predictability in this area and should be preferred by investors. Variable 17 is coded as: (1) no provision on currency used for transfers, (2) provision present, but includes restrictions on currency choice, (3) provision present, and guarantees investor’s choice of currency.

**Variable 18: monetary policy exception.** BITs may contain measures intended to provide latitude for host states to apply appropriate policies in times of monetary crises, including the ability to place restrictions on the monetary transfers of foreign investors. Monetary policy exceptions may decrease policy predictability for investors and, consequently, these exceptions could decrease FDI flows to states. Variable 18 is coded as either (1) containing a monetary policy exception or (2) not containing a monetary policy exception.

**Variable 19: personal remuneration.** BITs vary in how they approach personal remuneration, the ability of individual foreign employees to repatriate their foreign wages. Investors may be less likely to invest in countries where their employees’ ability
to repatriate wages is not guaranteed. Variable 19 provides three categories for personal remuneration: (1) personal remuneration not addressed, (2) personal remuneration is addressed and restrictions are allowed, (3) personal remuneration is addressed and restrictions are not allowed.

**Variable 20: exchange rate used for transfers.** BITs may stipulate how the exchange rate for monetary transfers is determined. Some BITs state that the exchange rate should be the rate of exchange at the date of the transfer but do not specify if this is the official exchange rate of the state or the market exchange rate (UNCTAD 2007). Other BITs provide specific determinants of the exchange rate to be used such as the market exchange rate, the exchange rate provided by a specific international bank, or the exchange rate provided by the IMF. Some BITs even provide specific formulas for the calculation of the exchange rate for transfers.

The goal of variable 20 is to categorize broad levels of predictability that the exchange rate provisions in a particular BIT, or lack thereof, provide investors; categorizing all possible areas of variation for this variable would be difficult for coders and would provide ambiguous evidence for gauging overall BIT strength. Therefore, this variable has three simple categories: (1) no provision on exchange rate used for transfers, (2) provision is present, but the exchange rate is determined by an institution of the host state, (3) provision is present and the exchange rate is determined by an institution other than the host state. The categories are organized into ascending levels of predictability. The first category does not grant investors any predictability because the BIT does not contain a provision on exchange rates. The second category provides more predictability
than the first, but exchange rates are still left up to the arbitrary whims of some host state institution. The third category provides the most predictability by establishing how the exchange rate is to be determined and guaranteeing that it is not by the host state.

**Expropriation**

The economic sovereignty allotted to states under international law allows them to pursue domestic economic policies which are thought to benefit their economy—including the expropriation of private property, both domestic and foreign-owned. BITs seek to reduce the uncertainty caused by the possibility of expropriation by stating specific conditions under which expropriation will be considered lawful.

According to a 2007 UNCTAD report, BITs show a remarkable convergence in their coverage of what constitutes a lawful expropriation. Generally, BITs allow for the expropriation of an investment if four conditions are met: the expropriation must be for a public purpose, the expropriation must be conducted in a non-discriminatory manner, the expropriation must be conducted under due process of law subject to judicial review, and the expropriation must be followed by compensation (UNCTAD 2007; Salacuse & Sullivan 2005). The standard of compensation, however, will vary. Variables 21-25 empirically test this expected convergence regarding outright expropriation, variable 26 accounts for variation in compensation standards and variable 27 accounts for variation in how accrued interest is treated in cases of delayed payment for expropriation.

While BITs appear to be homogenous concerning their treatment of outright expropriation, variation does occur regarding how BITs address issues related to indirect expropriations—regulatory actions taken by the host state which “substantially impair the

In sum, BITs may contain substantial variation on expropriation issues. BITs which provide more specifics on how compensation is calculated and distributed and guarantee greater limitations on the host states right to expropriate should produce greater predictability for investors and encourage investment to potential host states.

**Variables 21: expropriation clauses.** BITs may contain an expropriation clause stating that neither contracting party will expropriate the investments of nationals of another contracting party unless specific conditions are met. BITs are expected to contain such a provision since the original purpose of the treaties was to prevent the arbitrary expropriation of foreign-owned property. BITs are coded as either containing or not containing an expropriation clause.

**Variable 22: necessary conditions (public purpose).** BITs generally state that expropriations can only be conducted for a public purpose. This aspect of BITs is meant to prevent host state governments from expropriating foreign investments for private gain or other capricious reasons not designed for a public purpose. BITs are coded as either containing or not containing this necessary condition for expropriation.

**Variable 23: Necessary Conditions (Non-Discriminatory Manner).** Most BITs state an expropriation must be conducted in a non-discriminatory manner. This means an expropriation cannot be targeted at a specific foreign-owned investment. BITs
are coded as either containing or not containing this necessary condition for expropriation.

**Variable 24: necessary conditions (subject to judicial review).** Most BITs include a reference to due process that must be allotted to MNCs for an expropriation to be considered lawful. BITs are coded as either containing or not containing this necessary condition for expropriation.

**Variable 25: necessary conditions (compensation standard).** Most BITs include a compensation standard—a broad guideline for determining the amount of compensation a foreign investor should receive for an expropriated property. BITs are coded as either containing or not containing this necessary condition for expropriation.

**Variable 26: type of compensation standard.** Most BITs stipulate that compensation be afforded for expropriated investments; however, the amount of compensation to be afforded varies by BIT and is subject to debate. Indeed, the amount of compensation which should be granted for expropriations has been one of the most debated issues between developed states and LDCs (Sornarajah 2004). Most BITs use the Hull formula of ‘prompt, adequate, and effective’ compensation. Other BITs use various phrases such as ‘just’, ‘full’, ‘reasonable’, or ‘fair and equitable’ to determine the amount of compensation foreign investors should receive upon the expropriation of their investment. Potentially, vague standards such as ‘reasonable’ or ‘just’ may engender less confidence to investors than, say, the Hull formula which has been the subject of
extensive jurisprudence. The following categories will be used for variable 26: (1) no compensation standard present, (2) reasonable, (3) just, (4) full, (5) fair and equitable, (6) prompt, adequate, and effective, (7) some other compensation standard.

**Variable 27: accrued interest.** Some BITs state that compensation is to include interest over the period from the date of the expropriation to the date of compensation (Dolzer & Stevens 1995). Additionally, some BITs include a provision determining the interest rate and some BITs specifically state when interest begins accruing (Dolzer & Stevens 1995). BITs that provide more specifics regarding the calculation of interest rates are expected to garner more investment than BITs with fewer specifics. Five categories will account for different ways that BITs approach interest owed for delayed compensation: (1) no provision on accrued interest present, (2) provision present requiring payment of accrued interest, (3) provision present, determination of interest rate included, (4) provision present, addresses when calculation of interest begins, (5) provision present, addresses when calculation of interest begins and determination of interest rate.

**Variable 28: indirect expropriation.** BITs are also including provisions on indirect expropriations, also called regulatory takings and creeping expropriations. Indirect expropriations are regulatory actions taken by the host state which “substantially impair the value of an investment” (UNTCAD 2007, 45). For instance, a host state could refuse a license or export rights to a MNC rendering the investment unprofitable. Three categories of BITs can be distinguished regarding indirect expropriations: (1) BITs that
do not address indirect expropriations, (2) BITs that do not specifically address indirect takings but include similar phrases, and (3) those that specifically address indirect expropriations.

BITs which explicitly consider indirect takings as an illegal expropriation and entitle investors subjected to such actions to compensation should increase investment flows to the host state more than BITs that do not contain such a provision. Excessive regulations or the denial of necessary licenses could render an investment worthless. By including provisions requiring indirect takings to receive compensation, host states may be signaling to investors their intention to maintain a business friendly atmosphere for the investment.

**Dispute Settlement Issues**

BITs generally provide a dispute settlement mechanism for disputes that arise between a foreign investor and a host state. Investor-state dispute settlement provisions allot investors a direct avenue to defend their rights and to help ensure host states uphold their BIT commitments.

**Variable 29: dispute settlement rules.** BITs vary in their approach to determining the rules by which investor-state disputes will be settled. The vast majority of BITs call for disputes to be settled through rules established by the ICSID (Dolzer & Stevens 1995). A substantial number of BITs call for arbitration to be conducted under United Nations Commission of International Trade Law (UNCITRAL) rules or by the Court of Arbitration of the International Chamber of Commerce. Some BITs allow for
one party, either the investor or the host state, to unilaterally determine which framework is employed in a dispute (Dolzer & Stevens 1995).

To date, no studies have been conducted to determine which dispute settlement forum is more beneficial to investors. Therefore, Variable 29 will assess treatment of dispute settlement rules by the level of discretion allotted to investors to determine the forum where the dispute settlement process takes place. The variable is coded as follows: (1) no provision on the determination of dispute settlement forum, (2) the host state unilaterally determines the dispute settlement forum, (3) contains a provision on the determination of dispute settlement forum, but the forum is not determined unilaterally by either the host state or the investor, (4) the investor unilaterally determines the dispute settlement forum.

BITs that allow investors to unilaterally choose the dispute settlement forum should provide more predictability than BITs that grant the choice to the host state and BITs that do not address the issue. BITs that address the issue but do not grant unilateral authority to one party, a specific forum is included in the BIT or both parties are required to agree to a forum, will not provide investors the flexibility of being able to unilaterally choose a forum, but should grant greater predictability than a BITs that give the choice of forum solely to the host state.

**Variable 30: pre-consent for dispute settlement.** BITs vary according to the level of guaranteed access to international arbitration they provide investors. A credible policy commitment may only be established when BITs specifically commit a host state, in advance, to international arbitration for investor initiated disputes. Otherwise,
investor would have no legal recourse if the host state violated a provision of the BIT. BITs that specifically guarantee investor access to international arbitration are expected to increase investment flows to the host state.

Yackee (2007) provides the four categories of pre-consent to arbitration that are used here: (1) no pre-consent is included, (2) promissory pre-consent, that is, the host state promises to consent to investor initiated arbitration in the future, but offers no immediate legal commitments, (3) limited pre-consent, that is, the investor’s ability to bring a dispute to international arbitration is limited to disputes arising to specific parts of the treaty, (4) comprehensive pre-consent, that is, the investor is guaranteed access to an international tribunal for any dispute it has with the host state.

**Variable 31: subrogation of insurance claims.** Most BITs contain provisions dealing with subrogation. Many developed, capital exporting states provide insurance programs for their nationals that wish to invest abroad. Some states even require that investment be covered by a BIT in order to be eligible for the investment insurance (Dolzer & Stevens 1995). Subrogation provisions provide “the legal basis upon which the insurer can recoup payments it has made in respect of claims under the insurance policy” (Dolzer & Stevens 1995, 156). It is doubtful that provisions dealing with subrogation would impact investment flows. BITs are coded as follows in regards to subrogation: (1) no provision present allowing subrogation, (2) provision allowing subrogation is present.
Treaty Exceptions

BITs may contain exceptions that could impact the effectiveness of the previously mentioned provisions. Variables 32-37 account for exceptions in the areas of taxes, essential security and public order, protection of health and natural resources, prudential measures for financial services, protection of the environment, and exceptions of certain industries. Each variable is dichotomous: the exception is either coded as present or not present.

Variable 32: taxation. Some BITs will specifically state that the treaty does not apply to matters of taxation.

Variable 33: essential security and public order. Some BITs will specifically allow host states to violate the agreement when a state’s security may be at risk, such as during a war and instances of domestic upheaval.

Variable 34: Protection of Health and Natural Resources. BITs with this provision allot host states more flexibility in regards to how they regulate the impact of foreign investors on public health and natural resources.

Variable 35: prudential measures for financial services. BITs with this provision allow host states to violate certain BIT provisions in times of monetary instability. For instance, a host state may suspend an investor’s remittance guarantees during a financial crisis.
**Variable 36: protection of the environment.** BITs with this provision allow host states to violate certain BIT provisions in order to protect the environment. For instance, a host state may institute pollution restrictions on a foreign company and not violate a provision preventing indirect expropriation.

**Variable 37: exclusion of certain industries.** BITs with this provision specifically exclude certain industries from BIT coverage.

**Provisions excluded from the Analysis**

Not every area of BIT variation was included in this analysis. Areas were excluded because either their impact on investment flows was unclear or the area was too difficult for coders to code accurately, and sometimes both. The following provisions were not coded in this analysis: Applicability to investments made prior to the conclusion of the treaty, covered persons and entities, territorial application, definition of investor, how treaty can be renewed, state-state dispute issues, the timing of a monetary transfer, timing of compensation, and form of compensation.
## APPENDIX 2: ORIGINAL CODE SHEET

### TREATY SCOPE AND DURATION

#### V1. Definition of Investment
- No definition of investment: 0
- Inclusive definition with domestic law restrictions: 1
- Exclusive definition: 2
- Inclusive definition: 3

#### V2. Admission: Right of Establishment Model
- Right of establishment model not present: 0
- Right of establishment model present: 1

#### V3. Treaty Duration
- Not provided: 0
- Treaty duration provided for specified period: 1
- Treaty is to remain in force indefinitely: 2

#### V4. Treaty Duration: Number of Years
Write-in number of years treaty will be in effect (write n/a if not provided): #

#### V5. Impact of the Treaty After Expiration
- No continued treaty coverage for investments: 0
- Continued treaty coverage for investment is provided for specified period: 1
- Investments covered indefinitely: 2

#### V6. Impact of the Treaty After Expiration: Number of Years
Write-in number of years treaty continues after expiration (write 0 if not provided): #
## TREATMENT ISSUES

### V7. Treatment: Fair and Equitable
- Provision not present: 0
- Provision present with domestic law restrictions: 1
- Provision present: 2
- Provision present, connected to international law standard: 3
- Provision present, connected to international law standard, definitions provided: 4

### V8. Treatment: National Treatment (post establishment)
- Provision not present: 0
- Provision present with domestic law restrictions and/or exceptions: 1
- Provision present without restrictions or exceptions: 2

### V9. Treatment: Most Favored Nation Treatment (post establishment)
- Provision not present: 0
- Provision present with either domestic law restrictions, international restrictions, or exceptions: 1
- Provision present without restrictions or exceptions: 2

### V10. Treatment: Umbrella Clause
- Provision not present: 0
- Provision present: 1

### V11. Treatment: Damages from War and Civil Disturbances
- No protection from war and civil disturbances: 0
- Protection from war only: 1
- Protection from civil disturbances only: 2
- Protection from war and civil disturbances: 3

### V12. Treatment: Compensation for Natural Disasters
- Provision not present: 0
- Provision present: 1

### V13. Treatment: Performance Requirements
- No restrictions on performance requirements: 0
- Same restrictions as the TRIMs agreement: 1
- Restrictions in post-establishment phase: 2
- Restrictions in both pre and post establishment phase: 3

### V14. Treatment: Management Positions
- No provision guaranteeing management positions: 0
- Provision present with domestic law restrictions: 1
- Provision present (for management and/or key personnel): 2
- Provision present (for management and/or key personnel and board of directors): 3
TRANSFER ISSUES

V15. Transfers: Inbound/Outbound
No provision covering transfer issues 0
Covers outbound transfers only 1
Covers inbound transfers only 2
Specifically covers both inbound and outbound transfers 3

V16. Transfers: Subject or not Subject to Domestic Law Restrictions
Transfers not addressed by the treaty 0
Transfers subject to domestic law restrictions 1
Transfers addressed, but not subject to domestic law restrictions 2

V17. Transfers: Restrictions on Type of Currency
No provision on currency used for transfers 0
Provision present, includes restrictions 1
Provision present, no restrictions on type of currency used in transfer (freely convertible currency) 2

V18. Transfers: Monetary Policy Exception
Monetary policy exception present 0
Monetary policy exception not present 1

V19. Transfers: Personal Remuneration
No provision on personal remuneration 0
Provision present, restrictions on personal remuneration allowed 1
Provision present, restrictions on personal remuneration not allowed 2

V20. Transfers: Exchange rate used
No provision on exchange rate used for transfers 0
Provision present, decided by host state 1
Provision present, not decided by host state 2
EXPROPRIATION ISSUES

### V21. Expropriation Clause
- No expropriation clause is present: 0
- Expropriation Clause is present: 1

### V22. Expropriation: Necessary Conditions (public purpose)
- Provision not present: 0
- Provision present: 1

### V23. Expropriation: Necessary Conditions (non-discriminatory manner)
- Provision not present: 0
- Provision present: 1

### V24. Expropriation: Necessary Conditions (subject to judicial review)
- Provision not present: 0
- Provision present: 1

### V25. Expropriation: Necessary Conditions (compensation standard)
- Provision not present: 0
- Provision present: 1

### V26. Expropriation: Type of Compensation Standard
- No compensation standard present: 0
- Reasonable: 1
- Just: 2
- Full: 3
- Fair and equitable: 4
- Prompt, adequate, and effective: 5
- Other: write-in: #

### V27. Expropriation: Accrued Interest
- No provision present: 0
- Interest paid for delayed compensation: 1
- Interest paid for delayed compensation, determination of interest rate included: 2
- Interest paid for delayed compensation, addresses when calculation of interest rate begins: 3
- Interest paid for delayed compensation, determination of interest rate include, and addresses when calculation of interest begins: 4

### V28. Indirect Expropriation
- Does not address indirect expropriations: 0
- Not specifically addressed, but similar phrases (tantamount or equivalent to expropriation): 1
- Specifically addresses indirect expropriations: 2
DISPUTE SETTLEMENT ISSUES

V29. Settlements of Disputes: Disputes Settlement Rules
No provision on dispute settlement rules 0
Host state determines forum for dispute settlement 1
Neither host state or investor individually determine forum for dispute settlement 2
Investor determines forum for dispute settlement 3

V30. Settlement of Disputes: Pre-Consent for Dispute Settlement
No pre-consent 0
Promissory pre-consent 1
Limited pre-consent 2
Comprehensive pre-consent 3

V31. Settlement of Disputes: Subrogation of Insurance Claims
Provision not present 0
Provision allowing subrogation present 1
TREATY EXCEPTIONS

V32. Exceptions: Taxation
Tax policy is exempted or limited 0
Tax policy is not exempted or limited 1

V33. Exceptions: Essential Security and Public Order
Provision present 0
Provision not present 1

V34. Exceptions: Protection of Health and Natural Resources
Provision allowing exception present 0
Provision not present 1

V35. Exceptions: Prudential Measures for Financial Services
Provision allowing exception present 0
Provision not present 1

V36. Exceptions: Protection of the Environment
Provision allowing exception present 0
Provision not present 1

V37. Exceptions: Exclusion of certain industries
Provision present 0
Provision not present 1
APPENDIX 3: CODE SHEET GUIDE

TREATY SCOPE AND DURATION

I. **V1. Definitions of Investment**
   a. No definition of Investment: (0)

   b. Inclusive definition with domestic law restrictions: (1)
      i. This category is comprised of inclusive definitions that are accompanied by a
         limiting phrase such as ‘subject to domestic laws and regulations’
      ii. Examples:
          1. 2003 BIT between Azerbaijan and Finland: “The term ‘Investment’
             means every kind of asset established or acquired by an investor of one
             Contracting Party in the territory of the other Contracting Party in
             accordance with the laws and regulations of the latter Contracting
             Party including, in particular, though not exclusively:”
          2. 1999 BIT between Chile and New Zealand (1999): “‘Investment’
             means any kind of asset or rights related to it provided that the
             investment has been made in accordance with the laws and
             regulations of the Contracting Party receiving it, including, though not
             exclusively…”

   c. Exclusive definition: (2)
      i. These included definitions that are limited to a close-list of investments
         provided by the treaty.
      ii. Example:
          1. 2004 Canadian Model BIT: “Investment means:”… (and then a series
             specific types of investment are listed)

   d. Inclusive definition: (3)
      i. This includes asset-based (‘every kind of asset’ or ‘any kind of asset’)
         definitions and tautological definitions of investment (‘every kind of
         investment’). Both attempt to define investment in broad terms. This category
         may provide examples.
      ii. Examples:
          1. 2004 US model BIT: “‘Investment’ means every asset that an investor
             owns or controls, directly or indirectly, that has the characteristics of an
             investment, including such characteristics as the commitment of capital
             or other resources, the expectation of gain or profit, or the assumption
             of risk”.
          2. 2001 BIT between Ghana and Guinea: “‘investment’ means every kind
             of asset and in particular, though not exclusively, includes:”
      iii. BITs in this category may include exceptions. However, if this section contains
           exceptions, section XXXIV (Exceptions: exclusion of certain industries) should
           be coded ‘1’.
II. V2. Admission

a. Right of establishment model not present: (0)
   i. No admission procedure is provided or
   ii. The right of establishment is determined by the domestic laws of the host state
       (sometimes referred to as the ‘admission clause model’).
   iii. This clause allows the host state to retain the right to discriminate against all
        incoming FDI. Treaties using the admission clause model may specifically state
        that the admission of an investment must be approved by “a competent
        authority” in the host state
   iv. No admission standard present is coded the same because both will have a
        similar impact in international law (provide fewer rights than the ‘right of
        establishment model’)
   v. Examples:
      1. 2000 BIT between Ethiopia and the Russian Federation: Investors
         “shall be admitted in accordance with their laws and regulations”
      2. 2002 BIT between Bahrain and Thailand: “the benefits of this
         agreement shall apply to the investment by the investors of one
         Contracting Party in the territory of the other Contracting Party which is
         specifically approved in writing by the competent authority in
         accordance with the laws and regulations of the latter Contracting
         Party”

b. Right of establishment model: (1)
   i. The right of establishment is granted to investors.
   ii. This model requires the host state to provide either national treatment or most-
       favored-nation treatment, and sometimes the more favorable of the two (most
       US BITs contain such a provision), in the pre-establishment phase.
   iii. Mostly US and Canadian BITs use this model, although in the last 10-15 years
       other states (Japan) have begun to use it as well.
   iv. BITs in this category may include exceptions. However, if this section contains
       exceptions, section XXXIV (Exceptions: exclusion of certain industries) should
       be coded ‘1’.
   v. Examples:
      1. 1997 BIT between US and Azerbaijan: “With respect to the
         establishment, acquisition, expansion, management, conduct, operation
         and sale or other disposition of covered investments, each Party shall
         accord treatment no less favorable than that it accords, in like
         situations, to investments in its territory of its own nationals or
         companies (hereinafter “national treatment”) or to investments in its
         territory of nationals or companies of a third country (hereinafter
         “most favored nation treatment”), whichever is most favorable
         (hereinafter “national and most favored nation treatment”). Each Party
shall ensure that its state enterprises, in the provision of their goods or services, accord national and most favored nation treatment to covered investments”.

2. 1998 BIT between Canada and Costa Rica: “Each Contracting Party shall permit establishment of a new business enterprise or acquisition of an existing business enterprise or a share of such enterprise by investors or prospective investors of the other Contracting Party on a basis no less favorable than that which, in like circumstances, it permits such acquisition or establishment by: investors or prospective investors of any third State; its own investors or prospective investors.

III. V3. Treaty Duration
   a. Not provided: (0)
   b. Treaty duration is provided for specified period: (1)
   c. Treaty is to remain in force indefinitely (until one party chooses to withdraw): (2)

IV. V4. Treaty Duration: Number of Years
   a. Write-in number of years treaty is in effect

V. V5. Impact of the Treaty after Expiration
   a. No continued protection for investments after treaty expires: (0)
      i. No provision present mentioning extended protection after treaty expiration or
      ii. Provision explicitly stating no continued protection for investments after treaty expiration.
   b. Continued treaty coverage for investment is provided for specified period: (1)
   c. Investments covered indefinitely: (2)

VI. V6. Impact of the Treaty After Expiration: Number of Years
   a. Write-in number of years treaty continues after expiration (write 0 if not provided)
TREATMENT ISSUES

I. V7. Treatment: Fair and Equitable

a. Provision not present: (0)

b. Provision present with domestic law restrictions: (1)
   i. May or may not be connected to international law standard
   ii. May or may not provide definitions
   iii. This category limits the impact of the provision by making it subject to national
        laws and regulations
   iv. Example:
       1. 1997 BIT between the Caribbean Common Market and Cuba: “Each Party shall ensure fair and equitable treatment of Investments of Investors of the other Party under and subject to national laws and regulations”

c. Provision present: (2)
   i. Example:
      1. 2001 BIT between Cambodia and Cuba: “Investment of investors of either Contracting Party shall at all times be accorded fair and equitable treatment and shall enjoy adequate protection and security in the territory of the other Contracting Party”

d. Provision present, connected to international law standard: (3)
   i. Links fair and equitable treatment to principles of international law
   ii. Example:
      1. 2002 BIT between France and Uganda: “Either Contracting Party shall extend fair and equitable treatment in accordance with the principles of international law to investments made by nationals and companies of the other Contracting Party on its territory or in its maritime area, and shall ensure that the exercise of the right thus recognized shall not be hindered by law or in practice. In particular, though not exclusively, shall be considered as dejure or de facto impediments to fair and equitable treatment any restrictions to free movement, purchase and sale of goods and services, as well as any other measures that have a similar effect”

e. Provision present, connected to international law standard, definitions provided: (4)
   i. This provision provides strong protection by “establishing the obligation of the contracting parties to accord covered investments treatment in accordance with customary international law” (UNCTAD 2007, 32)
   ii. Provides a more specific standard of treatment by defining ‘fair and equitable treatment’ and defining customary international law, probably in the annex of the treaty.
   iii. Example:
      1. 2005 BIT between United States and Uruguay: “Each Party Shall accord to covered investment treatment in accordance with customary international law, including fair and equitable treatment and full protection and security […] a) fair and equitable treatment includes
the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world; and b) “full protection and security” requires each Party to provide the level of police protection required under customary international law”

2. Annex A: “The Parties confirm their shared understanding that “customary international law” generally and as specifically referenced in Article 5 and Annex B results form a general and consistent practice of States that they follow from a sense of legal obligation. With regard to Article 5, the customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens”

II. V8. Treatment: National Treatment (post establishment)

a. Provision not present: (0)

b. Provision present with domestic law restrictions or exceptions: (1)
   i. Domestic law restriction Example:
      1. 1999 BIT between India and Indonesia: “Each Contracting Party shall, subject to its laws and regulations, accord to investment of investors of the other Contracting Party treatment no less favorable than that which is accorded to investments of its investors”

   ii. Provision present with exceptions Example:
      1. 1998 BIT between Germany and Mexico: “The provisions in Article 3 [National Treatment and MFN Treatment] are not biding for a Contracting State to extend to the natural persons and companies resident in the other Contracting State’s territory: the tax benefits, exemptions and reductions which according to tax laws are applicable only to natural persons and residents in the Contracting State’s”

c. Provision present without either domestic law restrictions or exceptions: (2)
   i. Example:
      1. 2000 BIT between Mauritius and Zimbabwe: “Each Contracting Party shall accord to the investments of investors of the other Contracting Party made in its territory a treatment which is no less favourable than that accorded to investments of its own investors or of investors of any third country if the latter is more favourable”

   ii. NOTE: exceptions to this section may be listed later in the treaty
III. V9. Treatment: Most Favored Nation Treatment (post establishment)
   a. Provision not present: (0)
      i. The BIT contains no provision such as “treatment not less favourable than that
         which it accords to […] investment and returns of investors of any third State
         whichever is the more favourable”
   b. Provision present with either domestic law restrictions, international restrictions, or
      exceptions: (1)
      i. Domestic law restriction Example:
         1. 2000 BIT between Malaysia and Saudi Arabia: “In accordance with
            its laws and regulations, each Contracting Party shall in its territory
            accord investments and returns of investors of the other Contracting
            Party treatment not less favourable than that which it accords to
            investments and returns of its own investors, or to investments and
            returns of investors of any third State whichever is the more
            favourable”
      ii. international restrictions (regional and tax treaties) Example:
         1. 1999 BIT between Bahrain and China: “The treatment and protection
            as mentioned in Paragraphs 1 and 2 of this Article shall not include any
            preferential treatment accorded by the other Contracting Party to
            investments of investors of a third Party based on customs unions, free
            trade zones, economic unions, or agreements relating to avoidance of
            double taxation or for facilitating frontier trade”
         2. If the treaty contains a provision making the agreement subject to host
            state laws and regulation, the treaty belongs in category ‘b’.
   c. Provision present without restrictions either domestic law restrictions or international
      restrictions: (2)
      i. NOTE: exceptions to this section may be listed later in the treaty

IV. V10. Treatment: Umbrella Clause
   a. Provision not present: (0)
   b. Provision present: (1)
      i. Requirement to respect obligations made by host state to investor
      ii. Example:
            Contracting Party shall observe any other obligation it may have
            entered into with regard to investments in its territory by investors of
            the other Contracting Party”
         2. 1991 BIT between Italy and Jordan: “Each Contracting Party shall
            create and maintain in its territory a legal framework apt to guarantee
            to investors the continuity of legal treatment, including the compliance, in
            good faith of all undertakings assumed with regards to each specific
            investor”
V. **V11. Treatment: Damages from War and Civil Disturbances**
   a. No protection from war and civil disturbances (no provision present): (0)
   
   b. Protection from war only: (1)
   
   c. Protection from civil disturbances only: (2)
   
   d. Protection from war and civil disturbances: (3)
      i. Often, BITs in this category will contain the phrase, ‘full protection and security
      ii. Example:
         1. 1998 BIT between Bangladesh and Japan: “Investors of either Contracting Party who suffer within the territory of the other Contracting Party damage in relation to their investments, returns or business activities in connection with the investment, owing to the outbreak of hostilities or a state of national emergency such as revolution, revolt, insurrection or riot, shall be accorded treatment no less favorable than that accorded to investors of such Contracting Party or to investors of any third country, as regards to any measure to be taken by the other Contracting Party including restitution, compensation, or other valuable consideration”

VI. **V12. Treatment: Compensation for Natural Disasters**
   a. Provision not present: (0)
   
   b. Provision present: (1)
      i. See 1998 BIT between Mexico and the Netherlands for an example
      ii. Most likely will be in the section with ‘damages from war and civil disturbances’

VII. **V13. Treatment: Performance Requirements**
   a. No restrictions on performance requirements: (0)
   
   b. Same restrictions as the TRIMs agreement: (1)
      i. Example:
         1. 1998 BIT between Canada and Costa Rica: “Neither Contracting Party may impose, in connection with the subsequent regulation of that investment, any of the requirements set forth in the World Trade Organization Agreement on Trade-Related Investment Measures contain in the Final Act Embodying the Results of the Uruguay round of Multilateral Trade Negotiations”
   
   c. Restrictions in post-establishment phase: (2)
      i. In this category there is no phrase restricting performance requirements “as a condition for investment”.
      ii. Example:
         1. 2003 BIT between Azerbaijan and Finland (2003): “Each Contracting Party shall not impose mandatory measures on investments by investors of the other Contracting Party concerning purchase of
materials, means of production, operation, transport, marketing of its products or similar orders having unreasonable or discriminatory effects”

d. Restrictions in both pre and post establishment phase: (3)
i. Example:
   1. 1999 BIT between US and Bahrain: “Neither Party shall mandate or enforce, as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment, any requirement (including but not limited to, any commitment or undertaking in connection with the receipt of a governmental permission or authorization)”
   2. 2002 BIT between Japan and the Republic of Korea: “Neither Contracting Party shall impose or enforce, as a condition for investment activities in its Area of an investor of the other Contracting party, any of the following requirements:”

VIII. V14. Treatment: Management Positions

a. No provision guaranteeing management positions: (0)

b. Provision present with domestic law restrictions: (1)
i. Example:
   1. 2001 BIT between Australia and Egypt (2001): “1. Each Party shall, subject to its laws applicable form time to time relating to the entry and sojourn of non-citizens, permit natural persons who are investors of the other Party and personnel employed by companies of that other Party to enter and remain in its territory for the purpose of engaging in activities connected with investments. 2. Each Party Shall, subject to its laws applicable form time to time, permit investors of the other Party who have made investments in the territory of the First Party to employ within its territory key technical and managerial personnel of their choice regardless of citizenship”

c. Provision present (for management and/or key personnel): (2)
i. Note: NOT subject to domestic legislation
ii. Note: ok if there is a requirement on board of directors
iii. Example:
   1. 1998 BIT between Lithuania and the US: “Companies which are legally constituted under the applicable laws or regulations of one Party, and which are investments, shall be permitted to engage to top managerial personnel of their choice, regardless of nationality”

d. Provision present (for management and/or key personnel and board of directors): (3)
i. Example:
   1. 2003 BIT between Japan and Viet Nam: “Neither Contracting Party shall impose or enforce, as a condition for investment activities in its Area of an investor of the other Contracting Party, and of the following
requirements: […] (f) to appoint, as executives, managers or members of boards of directors, individuals of any particular nationality;”
TRANSFER ISSUES

I. V15. Transfers: Inbound/Outbound
   a. No provision covering transfer issues: (0)
   
b. Covers outbound transfers only: (1)
      i. Example:
         1. 1996 BIT between Belgium-Luxembourg and Hong Know (China):
            “Each Contracting Party shall in respect of investments guarantee to
            investors of the other Contracting Party the unrestricted right to transfer
            their investments and returns abroad”
      ii. BITs with vague language (does not specify inbound and/or outbound) will be
           included in this category
      iii. Example:
           1. 2002 BIT between Ghana and India: “Each Contracting Party shall
              permit all funds of an investor of the other Contracting Party related to
              an investment in its territory to be freely transferred, without
              unreasonable delay and on a non-discriminatory basis”
           2. 2000 BIT between Malaysia and Saudi Arabia: “Each Contracting
              Party shall guarantee to investors of the other Contracting Party, after
              all taxes and obligations have been met, the free transfer of payments in
              any freely usable currency in connection with investments and
              investment returns they hold in the territory of the other Contracting
              Party”
   c. Covers inbound transfers only: (2)
      i. No example available.
   d. Specifically covers both inbound and outbound transfers: (3)
      i. Example:
         1. 2003 BIT between Japan and Viet Nam: “Each Contracting Party shall
            ensure that all payments relating to investments in its Area of an
            investor of the other Contracting Party may be freely transferred into
            and out of its Area without delay.”

II. V16. Transfers: Subject or not subject to domestic laws
   a. Transfers not covered by the treaty: (0)
   
b. Transfers Subject to domestic law restrictions: (1)
      i. Example:
         1. 2003 BIT between China and Djibouti: “Each contracting Party shall,
            subject to its laws and regulations, guarantee to the investors of the
            other contracting Party the transfer of their investment and return held
            in its territory, including”
   c. Transfers addressed, but not subject to domestic law restrictions: (2)
III. V17. Transfers: Restrictions on type of currency
a. No provision on currency used for transfers: (0)
b. Provision present, includes Restrictions: (1)
   i. Example:
      1. BIT between Brunei Darussalam and China: “Transfers of currency
         shall be made without delay in the convertible currency in which the
         capital was originally invested or in any other convertible currency
         agreed by the relevant investors of one Contracting Party and the
         other Contracting Party”
   c. Provision present, no restrictions on currency used in transfers (freely convertible currency): (2)
      i. Example:
         1. No stipulation requiring both parties to agree on a currency
         2. 2000 BIT between Greece and Mexico: “Each Contracting Party shall
            guarantee the right that payments relating to an investment may be
            transferred. The transfers shall be effected without delay, in a freely
            convertible currency, at the market rate of exchange applicable on the
            date of transfer”

IV. V18. Transfer: Monetary Policy
a. Monetary policy exception present: (0)
   i. These usually come in the form of exception. For instance, BITs may stipulate
      that to ensure successful monetary policy, transfer payments may be restricted.
   ii. Example:
      1. 1997 BIT between Austria and Chile: “Capital can only be transferred
         one year after it has entered the territory of the contracting Party”
      2. 2002 BIT between Greece and Mexico: “In case of a serious balance of
         payment difficulties or the threat thereof, each Contracting Party may
         temporarily restrict transfers”
   b. Monetary policy exception not present: (1)
      i. Exception for cases of bankruptcy and criminal offenses do NOT constitute
         monetary policy exceptions

V. V19. Transfers: Personal Remuneration:
   a. No provision on personal remuneration: (0)
   b. Provision present, restrictions on personal remuneration allowed: (1)
   c. Provision present, restrictions on personal remuneration not allowed: (2)
VI.  V20. Transfers: Exchange Rate Used

a. No provision on exchange rate used for transfers: (0)

b. Provision present, decided by the host state: (1)
   i. This category will mention how exchange rate is to be determined, but it will not
      be by the market or an international bank.
   ii. May be determined by a state bank of the host state

c. Provision present, not decided by host state: (2)
   i. Exchange rate can be decided in numerous ways (IMF, market exchange rate, an
      international bank), just not by the host state itself or a state-owned bank.
   ii. Example:
      1. 2002 BIT between Austria and the Philippines: “(2) The payments
         referred to in this Article shall be effected at the market rate of
         exchange prevailing on the day of the transfer. (3) The rates of
         exchange shall be determined according to the quotations on the stock
         exchanges or in the absence of such quotations according to the spot
         transactions conducted through the respective banking system in the
         territory of the respective Contracting Party”
EXPROPRIATION ISSUES

I. V21. Expropriation clause
   a. No expropriation Clause is present: (0)
   b. Expropriation clause is present: (1)
      i. Either ‘expropriation’ or ‘nationalization’ can be used
      ii. Example:
          1. 1998 BIT between Chile and Tunisia: “Neither Contracting Party Shall nationalize, expropriate or subject the investments of an investor of the other contracting Party to any measures having an equivalent effect (hereinafter referred to as “expropriation”) unless the following conditions are complied with”

II. V22. Expropriation: Necessary Conditions (public purpose)
    a. Provision not present: (0)
    b. Provision present: (1)
       i. Example: (applicable for V21-24)
          1. 2001 BIT between Belarus and Croatia: “A contracting party shall not, in its territory, expropriate or nationalize directly or indirectly an investment of an investor of another Contracting Party or take any measure or measures having equivalent effect (hereinafter referred to as “expropriation” except: a) for a purpose which is in the public interest, b) on a non-discriminatory basis, c) in accordance with due process of law, and d) accompanied by payment of prompt, adequate and effective compensation”

III. V23. Expropriation: Necessary Conditions (non-discriminatory manner)
     a. Provision not present: (0)
     b. Provision present: (1)

IV. V24. Expropriation: Necessary Conditions (subject to judicial review)
     a. Provision not present: (0)
     b. Provision present: (1)
        i. Other due process of law examples:
           1. 1995 BIT between Canada and Trinidad and Tobago: “to prompt review, by a judicial or other independent authority of that Party”
           2. 2002 BIT between Russian Federation and Thailand: “in accordance with the procedure established by the laws of the Contracting Party”
           3. The idea here is that neither of them gives the host Government total discretion in determining whether an expropriation may be undertaken or in choosing the applicable procedures” (UNCTAD 2007, 48)

     a. Provision not present: (0)
     b. Provision present: (1)
VI. V26. Expropriation: Type of Compensation Standard
   a. No compensation standard present: (0)
   b. Reasonable: (1)
   c. Just: (2)
   d. Full: (3)
   e. Fair and equitable: (4)
   f. Prompt, adequate, and effective: (5)
   g. Other
      i. Write-in phrase used for compensation standard

VII. V 27. Expropriation: Accrued Interest
   a. No provision present: (0)
   b. Interest paid for delayed compensation: (1)
   c. Interest paid for delayed compensation, determination of interest rate included: (2)
      i. Example:
         1. 1998 BIT between Jordan and Morocco: “and in the event that payment of compensation is delayed the investor shall receive interest at the prevailing market rate in business transactions at the date of compensation payment”
   d. Interest paid for delayed compensation, addresses when calculation of interest rate begins: (3)
   e. Interest paid for delayed compensation, determination of interest rate included, and addresses when the calculation of interest begins: (4)
      i. Example:
         1. 2000 BIT between Costa Rica and the Republic of Korea: “Compensation shall be based on the fair market value of the expropriated investments immediately before expropriation was taken or before impending expropriation became public knowledge, whichever is the earlier. It shall include interest based on the applicable commercial rate from the date of dispossession of the expropriated property until the date of payment and shall be made without undue delay, be effectively realizable and be freely transferable”
         2. May use the phrase “normal commercial rate” to determine interest rate (see BIT between US and Ivory Coast)
VIII. V28. Indirect Expropriation

a. Does not address indirect expropriations in any way: (0)

b. Not specifically addressed, but similar phrases (tantamount or equivalent to expropriation): (1)
   i. Note: treaties in this category will NOT include the phrase ‘direct or indirect’
   ii. This category may include this phrase: “any measures having an equivalent effect” of expropriation, dispossession, or nationalization
   iii. This category may include this phrase: ‘any measure tantamount to’ expropriation, dispossession, or nationalization
   iv. Some treaties may use the word ‘deprivation’
   v. Example:
      1. 1998 BIT between the United Kingdom and Hong Kong: “Investors of either Contracting Party shall not be deprived of their investments nor be subjected to measures having effect equivalent to such deprivation in the area of the other Contracting Party”

c. Specifically Addresses indirect expropriations: (2)
   i. Example:
      1. 2001 BIT between Kuwait and Lithuania: “Investments of either Contracting State or any of its investors shall not be nationalized, expropriated or subjected to direct or indirect measures having effect equivalent to nationalization or expropriation (hereinafter collectively referred to as “expropriation”) by the other Contracting State”
DISPUTE SETTLEMENT ISSUES

I. V29. Settlement of Disputes: Dispute Settlement Rules (for investor-state disputes)

a. No provision on dispute settlement rules: (0)

b. Host state determines forum for dispute settlement: (1)

c. Neither host state or investor individually determine forum for dispute settlement: (2)

d. Investor determines forum for dispute settlement: (3)

II. V30. Settlement of Disputes: Pre-consent for Dispute Settlement (for investor-state disputes)

a. No pre-consent: (0)

b. Promissory pre-consent: (1)
   i. BITs in this category promise to consent, but do not actually provide consent in advance
   ii. The key word in the example is *shall*
   iii. Example:
       1. 1982 BIT between Japan and Sri Lanka
          a. “Each Contracting Party *shall*, at the request of the [investor],
             consent to submit any legal dispute … to…arbitration”
             (quoted in Yackee 2007, 24).

c. Limited pre-consent: (2)
   i. BITs restrict dispute settlement access to a limited set of provisions within the treaty
   ii. BITs in this category “offer the state’s consent to arbitrate only certain kinds of disputes—typically disputes over the amount of compensation due in cases of expropriation, and sometimes also including disputes over the freedom to transfer investments and proceeds out of the state” (Yackee 2007, 23)
   iii. Example:
       1. 2000 BIT between Mauritius and Swaziland: “*If a dispute involving the amount of compensation resulting from expropriation, nationalization, or other measures having effect equivalent to nationalization or expropriation*, mentioned in Article 6 cannot be settled within six months after resort to negotiation as specified in paragraph (1) of this Article by the investor concerned, it may be submitted to an international arbitral tribunal established by both parties”

d. Comprehensive pre-consent: (3)
   i. BITs in this category “allow investors to unilaterally initiate arbitration in the event of an ‘investment dispute’” (Yackee 2007, 22).
   ii. Example:
       1. 1991 BIT between Switzerland and Ghana: “Each Contracting Party hereby consents to the submission of an investment dispute to international arbitration”
III. V31. Settlement of Disputes: Subrogation of Insurance Claims
   a. Provision not present: (0)
   b. Provision allowing subrogation present: (1)
      i. Example:
         1. 2000 BIT between Brunei Darussalam and the Republic of Korea: “During
             arbitration proceedings or the enforcement of an award, the Contracting
             Party involved in the dispute shall not raise the objection that the
             investor of the other Contracting Party has received compensation under
             an insurance contract in respect of all or part of its loss”
         2. 2001 BIT between Benin and Ghana: “If one Contracting Party or its
designated agency makes a payment under an indemnity given in respect of an
investment in the territory of the other Contracting Party, the latter Contracting
Party shall recognize the assignment to the former Contracting Party or its
designated agency by law or any legal transaction of all the rights and claims of
the party indemnified and that former Contracting Party or its designated agency
is entitled to exercise such rights and enforce such claims by virtue of its
subrogation, to the same extent as the party indemnified”
TREATY EXCEPTIONS

I. V32. Exceptions: Taxation
   a. Tax policy is exempted or limited: (0)
      i. Exempted Example:
         1. 1999 BIT between Argentina and New Zealand: “The provisions of this Agreement shall not apply to matters of taxation in the territory of either contracting Party. Such matters shall be governed by the domestic laws of each Contracting Party and the terms of any agreement relating to taxation concluded between the Contracting Parties”
      ii. Limited Example:
         1. 2003 BIT between Japan and Viet Nam: “Nothing in this Agreement shall apply to taxation measures except as expressly provided for in paragraphs 2, 3 and 4 of this Article. 2. Articles 1, 3, 7, 9, 22 and 23, shall apply to taxation measures”
      iii. If tax policy is limited, restricted, or subject to domestic legislation, code the treat as ‘0’.
      iv. NOTE: exemptions for MFN and National Treatment status related to taxes are covered in those respective portions of the treaty. If a treaty only exempts taxes as related to MFN National Treatment status or a tax treaty with a third party, code that treaty as ‘1’. For an example see the 1994 BIT between the US and Argentina.
   b. Tax policy is NOT exempted or limited: (1)

II. V33. Exceptions: Essential Security and public order
   a. Provision allowing exceptions present: (0)
      i. Example:
         1. 1998 BIT between US and Mozambique: “This Treaty shall not preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests”
         2. 2003 BIT between Finland and Kyrgyzstan: “Nothing in this Agreement shall be construed as preventing a Contracting Party for taking any action necessary for the protection of its essential security interests in time of war or armed conflict, or other emergency in international relations. 2. Provided that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination by a Contracting Party, or a disguised investment restriction, nothing in this Agreement shall be construed as preventing the Contracting Parties from taking any measure necessary for the maintenance of public order”
   b. Provision NOT present: (1)
III. \textbf{V34. Exceptions: Protection of Health and natural resources}
\begin{itemize}
\item a. Provision allowing exceptions present: (0)
  \begin{itemize}
  \item i. 1998 BIT between Mauritius and Switzerland: “Nothing in this Agreement Shall be construed to prevent a Contracting Party from taking any action necessary […] for reasons of public health or the prevention of diseases in animals and plants”
  \item ii. 1999 BIT between Argentina and New Zealand: “The provisions of this Agreements shall in no way limit the right of either Contracting Party to take any measures (including destruction of plants and animals, confiscation of property or the imposition of restrictions on stock movement) \textit{necessary for the protection of natural and physical resources or human health}”
  \end{itemize}
\item b. Provision is NOT present: (1)
\end{itemize}

IV. \textbf{V35. Exceptions: Prudential measures for financial services}
\begin{itemize}
\item a. Provision allowing exceptions present: (0)
  \begin{itemize}
  \item i. Example:
    \begin{enumerate}
    \item 2004 Canadian model BIT: “Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons”
    \end{enumerate}
  \end{itemize}
\item b. Provision is NOT present: (1)
\end{itemize}

V. \textbf{V36. Exceptions: Protection of the Environment}
\begin{itemize}
\item a. Provision allowing exception for protection of the environment present: (0)
\item b. Provision NOT present: (1)
\end{itemize}

VI. \textbf{V37. Exceptions: Exclusion of Specific Industries}
\begin{itemize}
\item a. Provision present: (0)
\item b. Provision not present: (1)
\end{itemize}
APPENDIX 4: GUTTMAN CODE SHEET

TREATY SCOPE AND DURATION\textsuperscript{125}

V1. Definition of Investment

(v1aDefInvest)
No definition of investment or definition with domestic law restrictions 0
Definition present without domestic law restrictions 1

(v1bDefInvest)
No definition of investment, definition with domestic law restrictions, or exclusive definition 0
Inclusive definition 1

V2. Admission: Right of Establishment Model

(v2aAdmission)
Right of establishment model not present 0
Right of establishment model present 1

V3. Treaty Duration

(v3aDuration)
Not provided 0
Treaty duration provided 1

(v3bDuration)
Not provided or provided specified period 0
Treaty is to remain in force indefinitely 1

\textsuperscript{125} Variables 4 (treaty duration), 5 (impact of the treaty after expiration), and 6 (impact of the treaty after expiration: number of years) were not dichotomized for the gamma matrix and Guttman scaling. They were excluded because they either lacked variation or a logical way to dichotomize the data was not possible.
TREATMENT ISSUES

V7. Treatment: Fair and Equitable

(v7a)
Provision not present
Provision present

(v7b)
Provision not present or provision present with domestic law restrictions
Provision present

(v7c)
Provision not present or provision present with domestic law restrictions
Provision present and connected to international law standard

V8. Treatment: National Treatment (post establishment)

(v8a)
Provision not present
Provision present

(v8b)
Provision not present or present with domestic law restrictions and/or exceptions
Provision present

V9. Treatment: Most Favored Nation Treatment (post establishment)

(v9a)
Provision not present
Provision present

(V9a)
Provision not present or provision present with either domestic/intl law restrictions or exceptions
Provision present

V10. Treatment: Umbrella Clause

(v10a)
Provision not present
Provision present

V11. Treatment: Damages from War and Civil Disturbances

(v11a)
No protection from war and civil disturbances
Protection from war and civil disturbances
V12. Treatment: Compensation for Natural Disasters

(v12a)
- Provision not present: 0
- Provision present: 1

V13. Treatment: Performance Requirements

(v13a)
- No restrictions on performance requirements or same as TRIMs: 0
- Restrictions on performance requirements: 1

(v13b)
- No restrictions on performance requirements, same as TRIMs, restrictions in post-establishment phase only: 0
- Restrictions on performance requirements in both pre and post-establishment phases: 1

V14. Treatment: Management Positions

(v14a)
- No provision guaranteeing management positions: 0
- Provision guaranteeing management positions: 1

(v14b)
- No provision guaranteeing management positions, contains domestic law restrictions: 0
- Provision guaranteeing management positions: 1
TRANSFER ISSUES

V15. Transfers: Inbound/Outbound

(v15a)
No provision 0
Provision present 1

(v15b)
No provision covering transfer issues or covers outbound transfers only 0
Provision covering inbound transfers or provision covering inbound and outbound transfers 1

(v15c)
No provision covering transfer issues or, provision covers either inbound or outbound transfers (but not both), 0
Provision covers both inbound and outbound transfers 1

V16. Transfers: Subject or not Subject to Domestic Law Restrictions

(v16a)
Transfers not addressed by the treaty 0
Transfers addressed by the treaty 1

(v16b)
Transfers not addressed by the treaty or transfers addressed but subject to domestic law restrictions 0
Transfers addressed and not subject to domestic law restrictions 1

V17. Transfers: Restrictions on Type of Currency

(v17a)
No provision on currency used for transfers 0
Provision present 1

(v17b)
No provision on currency used for transfers or provision present and includes restrictions 0
Provision present, No restrictions on type of currency used in transfer (freely convertible currency) 1

V18. Transfers: Monetary Policy Exception

(v18a)
Monetary policy exception present 0
Monetary policy exception not present 1
V19. Transfers: Personal Remuneration

(v19a)
No provision present on personal remuneration 0
Provision present on personal remuneration 1

(v19b)
No provision present on personal remuneration, or present and restrictions allowed 0
Provision present on personal remuneration and restrictions not allowed 1

V20. Transfers: Exchange rate used

(v20a)
No provision present on exchange rate used for transfers 0
Provision present 1

(v20b)
No provision present on exchange rate used for transfers, or provision present and decided by host state 0
Provision present and exchange rate used for transfers not decided by host state 1
EXPROPRIATION ISSUES

V22. Expropriation: Necessary Conditions (public purpose)

(v22a)
Provision not present 0
Provision present 1

V23. Expropriation: Necessary Conditions (non-discriminatory manner)

(v23a)
Provision not present 0
Provision present 1

V24. Expropriation: Necessary Conditions (subject to judicial review)

(v24a)
Provision not present 0
Provision present 1


(v25a)
Provision not present 0
Provision present 1

V27. Expropriation: Accrued Interest

(v27a)
No provision present or provision present but determination of interest rate not specified 0
Provision present and determination of interest rate is specified 1

(v27b)
No provision present or provision present but determination of interest rate not specified,
determination of interest rate included, but does not include when interest starts to accrue 0
Provision present, determination of interest rate included, and includes when interest starts to accrue 1

V28. Indirect Expropriation

(v28a)
No provision present 0
Provision present (may specifically say indirect or may use similar phrases) 1

126 Variables 21 and 26 were not dichotomized for the gamma matrix and Guttman scaling. Variable 21 (expropriation clause) did not contain variation. Variable 26 (type of compensation standard) is purely categorical.
**DISPUTE SETTLEMENT ISSUES**

**V29. Settlements of Disputes: Disputes Settlement Rules**

**(v29a)**  
No provision or host state determines forum for dispute settlement 0  
Provision present and forum chosen other than solely by the host state 1

**(v29b)**  
No provision or host state determines forum for dispute settlement, or neither host state or investor determine forum for dispute settlement 0  
Provision present and investor determines forum for dispute settlement 1

**V30. Settlement of Disputes: Pre-Consent for Dispute Settlement**

**(v30a)**  
No pre-consent 0  
Pre-consent present 1

**(v30b)**  
No pre-consent present, or promissory pre-consent, or limited pre-consent present 0  
Comprehensive pre-consent present 1

**V31. Settlement of Disputes: Subrogation of Insurance Claims**

**(v31a)**  
Provision not present 0  
Provision allowing subrogation present 1
TREATY EXCEPTIONS

V32. Exceptions: Taxation

(v32a)
Tax policy is exempted or limited 0
Tax policy is not exempted or limited 1

V33. Exceptions: Essential Security and Public Order

(v33a)
Provision present 0
Provision not present 1

V34. Exceptions: Protection of Health and Natural Resources

(v34a)
Provision allowing exception present 0
Provision not present 1

V35. Exceptions: Prudential Measures for Financial Services

(v35a)
Provision allowing exception present 0
Provision not present 1

V36. Exceptions: Protection of the Environment

(v36a)
Provision allowing exception present 0
Provision not present 1

V37. Exceptions: Exclusion of certain industries

(v37a)
Provision present 0
Provision not present 1
## APPENDIX 5: GAMMA MATRIX

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APPENDIX 6: EXCEPTIONS

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Guttman Scaling Coefficients:

The coefficient of reproducibility is a measure of the errors in the Guttman scales in terms of total responses: “error is assigned to every observed response which fails to correspond to the ideal scale pattern predicted by the total scale score” (McIver and Carmines 1981, 48). Reproducibility coefficients are calculated as 1 - (# errors) / (total responses). Reproducibility coefficient scores of .90 or higher are appropriate for Guttman scaling (1944).

The coefficient of scalability checks the skewness of the marginal errors. Marginal errors are the sum of all non-modal frequencies. Scalability coefficients are calculated as 1 – (scale errors) / (marginal errors). According to Ostergard (2003), “a coefficient of scalability of .60 or higher is used as a rule of thumb as an indication of scalability” (162).

Coefficient of Reproducibility for Exceptions: .97
Coefficient of Scalability for Exceptions: .62
### APPENDIX 7: TRANSFERS

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#### Guttman Scaling Coefficients:

- Coefficient of Reproducibility: .99
- Coefficient of Scalability: .96
APPENDIX 8: TREATMENT

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Guttman Scaling Coefficients:

Coefficient of Reproducibility: .99
Coefficient of Scalability: .77
APPENDIX 9: BROAD TREATMENT

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Guttman Scaling Coefficients:

Coefficient of Reproducibility: .99
Coefficient of Scalability: .99
APPENDIX 10: BEAUTY IN THE EYE OF THE BEHOLDER: HOST STATE FEATURES MNCs FIND ATTRACTIVE

INTRODUCTION

Do certain policies and characteristics make a potential host state an attractive investment location for MNCs? If so, which policies and characteristics matter most? Or, is beauty in the eye of the beholder; that is, do different firms look for different features in a host state? This chapter reviews the literature on determinants of investment location and attempts to parse-out features that influence the location decisions of MNCs.

The first section examines theoretical approaches to MNCs and FDI. The second section explains the variation that characterizes MNCs and how this variation may influence location decisions. The third section reviews the literature on MNC investment location and addresses variables in the following categories: taxes and incentives, agglomeration economies and investment trends, institutions and business climate, host state trade policy, economic integration, classic fundamentals, and exchange rates. Lastly, the fourth section concludes the chapter by assessing the impact of each category on MNC location decisions.

THEORIES OF THE MNC

Theories of MNCs attempt to answer two basic questions: (1) Why does FDI happen? (say, instead of trade) and (2) How can MNCs be successful in foreign environments? The Hymer-Kindleberger Tradition, the Product Cycle Model, and the Eclectic Paradigm have been the dominant theoretical frameworks to answer these two questions and are explored next.
Hymer-Kindleberger Tradition

Steven Hymer’s ground-breaking dissertation titled *The International Operation of National Firms*, finished in 1960 but not published until 1976, was the first major attempt to explain why MNCs could be successful in foreign countries (Cohen 2007; Jones 2005a; Buckley 1985; Agarwal 1980). Hymer dismissed factors emphasized by traditional economic theory, which focused on factor endowments and viewed FDI as a function of international differences in rates of return on investment, and instead drew from organization theory to formulate his thesis. Hymer recognized the inherent disadvantages of foreign firms—domestic firms have greater knowledge of local tastes, legal and political system, business environment, and market conditions—and to be competitive Hymer contented that foreign firms must have some sort of compensating advantage, an advantage they have over local firms, that could exist in the absence of a perfect market (Cohen 2007; Jones 2005a; Buckley 1985). Market imperfections also contributed to a firm’s decision to invest directly instead of exporting or licensing. Hymer explained that MNCs would be more likely to invest directly in a country instead of license technology to a firm in a foreign market in order to maintain monopolistic advantages in technology and MNCs would prefer direct investment over exporting in order to avoid costly tariffs (Buckley 1985).

Kindleberger (1969) added to Hymer’s thesis by exploring areas where foreign firms could possess an advantage. Kindleberger (1969) found that foreign firms could have an ownership advantage in areas such as product differentiation, marketing skills,
access to patented knowledge/technology, better access to finance, management skills, and advantages from economies of scale.

The Hymer-Kindleberger approach, while innovative at its conception, is no longer viewed as an accurate lens through which to understand MNCs. Many MNCs have developed the skills necessary to operate in a foreign market, making the cost of ‘foreignness’ less dramatic (Buckley 1985). High entry costs associated with foreign investments are now isolated to states with a weak MNC presence (Buckley 1985).

The Product Cycle Model

The Product Cycle Model was developed by Raymond Vernon. Vernon (1966) theorized that products and production techniques move through a three-stage process which ends in the need for MNCs to invest in low-cost countries. In the new product stage, a product is developed and sold in the same high income country. During this stage skilled labor is used at a relatively high cost and efficient production techniques have not been fully developed. However, the resulting high retail prices are relatively unimportant as the innovating firm has a monopoly on the product. Vernon’s (1966) second stage is product maturation. In this stage other firms begin to produce the same product. This competition forces the innovator to cut costs and improve the product. Costs are initially cut by expanding the scale of production to match increased demand and improving manufacturing techniques. Toward the end of this stage firms begin to invest abroad in order to secure access to additional markets, usually in other high-income countries. In the final stage, product standardization, the product and production
techniques have become standardized. Now, firms will invest in low cost countries to improve efficiency and export the product to target markets.

Scholars now conclude that the product cycle theory is obsolete (Cohen 2007; Hoos 2000; Buckley 1985). While the theory adequately explained the behavior of US manufacturing FDI from the 1950s to the 1970s, it does not explain more recent phenomena such as mergers and acquisitions and market-seeking FDI in low-cost countries (Cohen 2007).

Eclectic Paradigm

The eclectic paradigm was developed by John H. Dunning and incorporates aspects from organizational advantages, location advantages, and internalization advantages, thus the approach is often called the O. L. I. paradigm (Dunning 1988). Dunning argues that a firm must have advantages in all three aspects before it will engage in FDI. First, the firm must have some sort of ownership advantage. These types of advantages are derived from the Hymer-Kindleberger tradition mentioned above. Essentially, the firm must have some tangible or intangible asset or skill that allows it to compete with domestic firms that have a natural advantage in their home market. Second, firms must gain an advantage from internalizing these ownership advantages instead of relying on normal market exchange. For instance, when investing in LDCs where patent laws are non-existent or weakly enforced, firms may find investing directly in a country more productive than selling a license to have the product produced by a domestic firm, which could sell the technology or process in question to competitors or begin making the product on its own. Third, the firm must see location advantages in
investing abroad rather than serving the foreign market through exports. Examples of location specific advantages are: “the spatial distribution of natural and related resources endowments and markets;” “international transport and communication costs;” “investment incentives and disincentives;” “artificial barriers to trade in goods and services;” and “cross-country ideological, language, cultural, business, political differences” (Jones 2005a, 12).

**Real World Motivations for FDI**

Cohen (2007) provides what he calls ‘real world motivations’ for why firms invest abroad. The first real world motivation is diminishing opportunities to expand in the firm’s home market. A firm’s home market may become saturated and the firm must then seek additional markets in order to expand and placate shareholders’ desires for higher returns. The second real world motivation involves finesse marketing strategies like Toyota’s decision to move some of its production to the United States so that US consumers will view Toyota vehicles as ‘American Made’. Finesse marketing strategies also include risk diversification and attempts to establish a first presence in a market in order to gain brand name recognition. The third real world motivation for FDI relates to service industries which may follow another industry in order to continue to provide their service. The forth motivation relates to monetary issues and investing to take advantage of countries with low currencies. Cohen’s (2007) final real world motivation for FDI involves the possibility that corporate executives may open a foreign subsidiary based on faulty assumptions or a current management trend.
THE MANY FACES OF FDI

Substantial variation exists within the total stock of FDI (Cohen 2007; Jones 2005a). Recognizing this variation is imperative for understanding the location decisions of MNCs. In short, MNCs are attracted to various country characteristics depending on the objective and method of the foreign investment.

Variation by Objectives

The foreign investments of MNCs are divided into four categories based on the objective of the investment: resource-seeking FDI, market-seeking FDI, Efficiency-seeking FDI, and strategic asset-seeking FDI (Cohen 2007). Resource-seeking FDI is primarily influenced by geology and climate but other factors matter as well, such as infrastructure quality, tax and regulatory policy, and the rule of law (Cohen 2007). Most resource-seeking FDI comes in the form of north-south investments where MNCs from developed states extract non-renewable resources (petroleum and minerals) and renewable resource (agricultural and forestry) from LDCs and export them to the north.

Market-seeking FDI places production facilities in a targeted market as opposed to servicing the market through exports. Various factors can motivate a firm to invest for market-seeking purposes, the most prominent of which is to avoid import barriers. High tariffs and non-tariff barriers can make exporting to a particular market unprofitable. Firms can essentially ‘jump’ costly tariffs by opening a foreign subsidiary in a target market. MNCs may also open a foreign subsidiary for market seeking purposes when the MNC’s home currency is expected to appreciate relative to the potential host state’s currency making exports to that state less competitive (Cohen 2007). The MNC could
avoid this disadvantage by servicing the market directly through a foreign subsidiary. Other reasons MNCs choose market-seeking FDI over exporting include the ability for foreign subsidiaries to tailor products to the tastes of the local market, to reduce transportation costs, and to be viewed more favorably by consumers in the target market by providing local jobs and economic stimulus. Market-seeking FDI tends to target large, affluent, and growing markets (Cohen 2007).

The goal of efficiency-seeking FDI is to reduce the cost of production. This category of FDI often takes place is low wage countries. Efficiency-seeking MNCs invest in a low cost country and then export products to other markets. Strategic asset-seeking FDI is conducted to acquire a portion or all of the assets of a foreign firm to increase the competitiveness of the purchasing firm through either increased synergy or less completion. (Cohen 2007).

**Variation by Global Production Strategy**

Two basic production strategies are recognized in the literature, vertical production and horizontal production. Vertical production is associated with “dividing the manufacturing process into segments in which various parts of a finished product are made by two or more subsidiaries in two or more countries anywhere in the world” (Cohen 2007, 72). A vertical production strategy is often associated with efficiency-seeking FDI (Shatz and Venables 2000). A horizontal production strategy is often associated with market seeking FDI. This strategy usually involves building a duplicate plant in a host country where most of, or the entire product in the case of manufacturing FDI, is produced in this location and sold to the local market (Shatz and Venables 2000).
FDI data is often in aggregate form and does not distinguish between horizontal and vertical FDI. This is problematic because each type of FDI is attracted by different factors: horizontal FDI “is a substitute for trade and occurs when trade costs (on final assembled products) are relatively high; [vertical FDI] is a complement to trade costs, occurring when trade costs are low” (Navaretti and Venables 2004, 96).

**Variation by the Method of Establishing a Foreign Subsidiary**

Foreign subsidiaries can be established by either greenfield investment, mergers and acquisitions, or privatizations. Greenfield investments create a brand-new company in the host state. Mergers and acquisitions are investments where a MNC gains control of a host state firm through either the purchase of voting stock in the firm (acquisition) or through a merger (Cohen 2007).

The method of finance and ownership structure also varies by investment. Investments can be either financed in the home state, the host state, or a combination of the two. Investments may also involve a strategic alliance or joint venture. A strategic alliance involves a partnership between a foreign and host state firm to share costs in areas such as research and development and management techniques. Some host states require investors to form a joint venture, a situation where ownership is shared by multiple parties, with either a sector of government or a host state firm.

**WHERE MNCs INVEST AND WHY**

Potential host states vary according to their size, wealth, institutional quality, and foreign investment policies. Numerous studies have attempted to determine which of
these factors influence the location decisions of MNCs. This vast literature spans five decades and has yielded ambiguous results. Empirical studies on the subject include surveys, case studies of various firms and industries from various states, and various aggregate level econometric approaches. This section explores the effects of a handful of well-studied variables on investment flows and attempts to distinguish general factors that impact location decisions of MNCs.

Taxes and Incentives

States sometimes attempt to become attractive investment locations by providing various fiscal and financial incentives to MNCs. FDI seeking states may use any combination of low corporate tax rates, special corporate tax rates to a specific industry or firm, investment allowances, various tax incentive schemes, and may even provide certain firms, such as financial institutions, with a tax haven. Li (2006) provides a theoretical framework explaining why some states offer greater incentives than others and claims, in sum, that LDCs in particular will use incentives to offset other disadvantages related to poor institutional quality and low policy commitment credibility. Thus, investment incentives can be used by states to lure MNCs to their territory by “stuffing a very tangible fistful of money into the invisible hand of the marketplace” (Cohen 2007, 165). However, the question remains: are these incentives successful in attracting FDI?
The Aggregate Approach: Survey of Investors

Early studies surveyed MNCs to determine the impact of tax policy on investment location decisions. Barlow and Wender (1955) found that only 10 percent of 247 US companies claimed that a favorable foreign state tax policy was a condition for investment. Robinson (1961) and Aharoni (1966) also surveyed US companies and found similar results. One respondent in Aharoni’s (1966) survey replied, “‘tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there’” (quoted in Morisset and Pirnia 2002, 275). The findings of more recent surveys from Young (1994) and Deloitte and Touche (1997) confirm the results of earlier studies and a 2002 World Bank survey of 191 MNCs found that only 29 percent of respondents listed national tax policy as a “very influential factor” determining investment location (MIGA 2002, 19). Thus, according to survey evidence, while tax policy may matter to some extent, it is not the primary factor influencing location decisions of MNCs (Morisset and Pirnia 2002).

The Aggregate Approach: Econometric Analysis

Early econometric studies concluded that tax policies have little effect on the location of FDI because market and political factors tend to dominate investment location decisions (Morisset and Pirnia 2002). Morisset and Pirnia (2002) assessed this portion of the literature:

The general conclusion that emerged from the early econometric studies is that the effect of tax policy on FDI is rather limited, at least compared to other factors such as political stability, the costs and availability of labor and basic infrastructure. The importance of these other factors suggests
that tax policy is a poor instrument to compensate for various negative factors in the investment climate of a country (277).

However, the conclusions drawn from early econometric studies are hardly conclusive. These studies used aggregate data that did not capture important factors such as changes in trade and investment policy and did not distinguish between the average tax rate of the host state and the effective tax rate, the actual percentage reduction on the rate of return on an investment (Morisset and Pirnia 2002). More recent studies attempt to account for these and other nuances.

**Firm and state characteristics.** Most of the initial studies in the literature examined the impact of taxes and incentives on the average MNC. Later studies began to distinguish between investment objectives and production strategies and other firm and state characteristics which could influence the effects tax policy and investment incentives could have on a MNC’s location decision.\(^{127}\) More recent studies have distinguished between firm characteristics such as firm maturity and finance strategy, firm size, host state wealth, and home state tax policy. Hartman (1984 and 1985) distinguishes between FDI financed by retained earnings and transfers of funds. The author hypothesizes that mature firms, firms that invest through the profits of their foreign subsidiary, will only be influenced by host state tax policies when they choose to invest while immature subsidiaries, those who continue to rely on parent company investment, are impacted by both home state and host state tax policies. Hartman (1984 and 1985) indeed finds that mature subsidiaries respond to host state

\(^{127}\) For instance, a study from Guisinger and Associates (1985) found that the location decisions of export-oriented firms are more sensitive to tax rates than firms seeking market access.
changes in tax policies as hypothesized when testing aggregate time-series data of foreign subsidiaries in the U.S. Hartman’s (1984 and 1985) hypothesis is supported by Boskin and Gale (1987) and Young (1988), both of which make minor alterations to Hartman’s models and provide longer sample periods. In the same vein, Rolfe et al. (1993) suggests that startup companies prefer tax policies and incentives that reduce their initial costs, such as equipment and material exemptions, while expanding firms prefer tax reductions on profit.

The impact of tax policies may also be influenced by the size of a firm and the wealth of the host state. Coyne (1994) demonstrates that large firms will be less influenced by tax incentives than smaller firms because the resources of large firms allow them to employ tax avoidance strategies. Mutti (2003) uses data from three different US benchmark census years (1982, 1989, 1994) to show that tax policy has different effects on the amount of FDI it attracts based on the wealth of the host state. The author concludes that MNCs producing for export in a low income country will be very responsive to changes in host state tax policies, much more so that MNCs producing for export in high income states. Similarly, Mutti (2003) finds that MNCs producing for the host state’s market will show unit elasticity to tax levels in low income states and will be inelastic in high income states.

**Home state double taxation strategies.** MNCs may be subject to double taxation, a situation where a MNC is taxed in both the home and host country. To avoid double taxation and the financial burden this would place on MNCs, most countries adopt either a credit system (such as the US, Japan, Greece, Ireland, Spain, and the UK), or an
exemption system (most other EU countries) for their MNCs (De Mooij and Ederveen 2003). Countries using the credit system (also referred to as worldwide system) allow taxes paid to the host country to be counted against taxes owed in the MNCs home state (De Mooij and Ederveen 2003). Countries using the exemption system (also referred to as the territorial system) do not tax income that has been taxed by a host country (De Mooij and Ederveen 2003).

Slemrod (1990) makes modifications to Hartman’s (1985) model, such as controlling for the tax system of host states and the investment method of MNCs. Using disaggregated country-level panel data, Slemrod (1990) finds that investments made through retained earnings are not responsive to host state tax levels as suggested by Hartman (1984 and 1985). Further evidence of the impact of home state tax policy on FDI is provided by Hines (1995). Hines (1995) studies FDI in US states and finds that MNCs from exemption countries experience a larger decrease in FDI when met with higher tax rates than MNCs from tax credit states.

Scholes and Wolfson (1990) hypothesize that an increase in host state tax rates can actually increase FDI to that country. In particular, MNCs from home states with a credit tax system will not be impacted by higher host state taxes since they receive tax credit in their home state for taxes paid abroad. In addition, host state corporations may actually be put at a disadvantage since they must pay the full effect of the high tax rates (Scholes and Wolfson 1990). Swenson (1994) finds support for this hypothesis when examining how changes in US tax policy in 1986 impacted FDI flows by MNCs from tax credit and tax exempt home states.
Blonigen (2005) assesses the literature and concludes that MNCs from tax credit states are relatively unaffected by host state tax policy. However, Altshuler and Newlon (1993) claim that differences in home state tax policy (exemption vs. credit) have no real impact on the competitiveness of MNCs because of their ability to manage income repatriations to avoid taxes, as the authors show in their examination of US MNCs.

De Mooij and Ederveen (2003) conduct a meta-analysis of 25 empirical studies on the impact of tax rates on FDI. The authors find “a median tax rate elasticity of foreign capital of -3.3”, that is, a 1 percent increase in taxes causes a 3.3 percent decrease in FDI (De Mooij and Ederveen 2003, 690).

**Tax treaties.** Tax treaties, often based off of the OECD Model Tax Convention, are intended to alleviate double taxation and to reduce tax avoidance. Egger et al. (2006) construct a bilateral panel dataset covering tax treaties from 1985-2000 to test the impact of the treaties on investment flows. The authors conclude that the presence of a tax treaty reduces investment flows between countries and that “depending of the adopted estimator, the impact of tax treaties lies between -15% and 20% in most cases and takes a value of -31% at most” (Egger et al. 2006, 904).
Agglomeration Economies and Investment Trends

Studies on the impact of agglomeration economies test to see if a host state’s current stock of investment can actually draw additional investment to the state. Theoretically, investments currently in a country may create self-perpetuating locational advantages for “industrial sectors relying heavily on intermediate inputs from suppliers in close proximity or those able to gain through labor or informational spillovers between firms” (Mody and Kinoshita 2007, 77). According to the agglomeration hypothesis, host states may benefit from an initial strategy of providing various investment incentives because once foreign corporations are established in a host state other investments will follow because of agglomeration benefits. These benefits are expected to continue after the initial investment incentives are ended. A competing hypothesis, called the ergodic hypothesis by Wheeler and Mody (1991), suggests that classic areas of comparative advantage determine location decisions (wages, market size, transportation costs, etc.) and foreign investments will leave the country when initial investment incentives end.

Wheeler and Mody (1991) use three measures to assess agglomeration benefits in a host state: infrastructure quality, degree of industrialization, and level of FDI. The authors test the agglomeration hypothesis on US manufacturing firms investing abroad. Their results indicate that agglomeration benefits do impact investment decisions, but only after the host state reaches a certain level of development. Mudambi (1995) tests the same hypothesis and found that “the stock of foreign capital is very significant in determining the current level of investment” when investigating FDI flows to 44 developing countries in 1985 and 1990 (253).
**Investment trends.** Mody and Kinoshita (2007) use survey data of Japanese firms regarding how likely they are to invest in China, Thailand, Malaysia, Indonesia, Vietnam, the Philippines, and India. The survey also asked the firms if they have already invested in the country and if their competitors have invested in the country. The authors found that “in the early phases of investing in a new country when few firms have experience in the country, the actions of competitors are likely to dominate, leading to an apparent herd behavior,” but in later phases individual firm experience is more important (Mody and Kinoshita 2007, 88-89). The authors note that the effects of learning by experience or from the experience of competing firms are difficult to disaggregate from the effects of agglomeration economies.

**Institutions and Business Climate**

Institutions create order and reduce uncertainty in economic interactions (North 1990). In particular, ensuring property rights has been hypothesized as a central element in reducing uncertainty and creating conditions conducive for economic activity (North 1990). Institutional quality has been hypothesized as an important factor in the location decisions of MNCs because a state with stable laws, an accessible and independent legal system, and limited power can reduce uncertainty for investors and thus spur investment. Studies testing institutional hypotheses have investigated legal systems and corruption levels, political regimes, and the overall business climate of host states. The results are mixed not only due, once again, to the heterogeneity of MNCs, but also because of the difficulty of measuring institutional quality (Blonigen 2005).
**Legal System and Corruption.** Perry (2000) surveyed MNCs that invested in Sri Lanka and found that, overall, the quality of the legal system there did not play a significant role in the location decision of the firms. Perry (2000) did, however, find some interesting results based on the certain characteristics of MNCs. First, larger firms were more likely to investigate the quality of the legal system than smaller firms, most likely due to the greater resources of the former. Second, MNCs from Western states tended to be concerned with Sri Lanka’s legal system while Asian firms, with the exception of Japan, were not. Finally, market seeking firms were 68 percent more likely to be concerned with the quality of the legal system than their export seeking counterparts. Thus, Perry (2000) concludes that the location decision of firms with different characteristics and goals will be impacted differently by institutional quality. However, this study suffers from selection bias and its finding should be interpreted with this in mind. By only surveying firms that chose to invest in Sri Lanka, Perry (2000) may have been only looking at firms that are generally less concerned with institutional quality.

Wei (2000) uses corruption indices and a proxy for institutional quality and finds support for his hypothesis that corruption levels are inversely related to FDI flows. However, Wheeler and Mody (1999) include corruption measures in their study but do not find a statistically significant relationship between corruption and FDI flows when accounting for agglomeration effects.

**Political regime.** Oneal (1994) investigates the relationship between political regime and FDI flows and find that either no relationship between the two exists or that
authoritarian regimes attract more FDI than democratic regimes. This study contributes to the conventional wisdom that authoritarian regimes can attract more FDI than their democratic counterparts because of their ability to avoid labor issues and provide special deals for MNCs that may be unacceptable in democratic societies. However, Jensen (2003) notes that these studies are flawed because their failure to control for natural resources, an oversight that has caused them to find a spurious relationship between authoritarian states and FDI because natural resources are often correlated with authoritarian states. Jensen’s (2003) study controls for natural resources and then assesses the effects of political regime on FDI using both panel regression and cross-sectional analysis for 114 countries. Even when controlling for economic conditions and policy decisions, the author finds that democratic governments attract as much as 70 percent more FDI than authoritarian states.

**Overall Investment Climate.** A key feature for attracting efficiency seeking FDI is the overall investment climate of the potential host state (Cohen 2007). Investment climate is the loosely defined term used to assess a potential host state’s overall quality of governance, a factor expected to influence the ability of investments to become profitable. Globerman and Shapiro (2002) provide a comprehensive approach for measuring the quality of a state’s investment climate. The authors provide a governance infrastructure index to measure to institutional quality. The index assesses a state’s political stability, rule of law, graft, regulatory burden, political freedom, and government effectiveness. Globerman and Shapiro (2002) conclude that high governance infrastructure scores are associated with higher levels of investment. However, the
authors do note that “while governance improvements can attract FDI, they do so at a diminishing rate” (Globerman and Shapiro 2002, 1915). While the study covers a wide scope of countries, up to 144 in some model specifications, the temporal aspect is limited to 1995-1997, thus limiting the robustness of the conclusions.

**Special economic zones.** LDCs in particular may be perceived as having less attractive investment climates, however measured. One strategy commonly employed by LDCs to improve their investment climates in the eyes of investors is to create special economic zones (SEZ). SEZs are specific areas within a state with different economic regulations than the rest of the state’s territory. These zones are designed to reduce bureaucratic and legal obstacles for incoming FDI and therefore improve the investment climate of the state and spur investment, particularly for export industries. Research on SEZs supports the hypothesis that they increase incoming FDI. Ranis and Schive (1985) find that the use of SEZ was instrumental in Taiwan’s transition to export-oriented industrialization. Woodward and Rolfe (1993) study the distribution of FDI among Caribbean states and find that the acreage designated for SEZs is a positive and statistically significant factor for attracting FDI in those states. Fung et al. (2002) found that Chinese provinces designated as SEZs attracted more FDI than other Chinese provinces.

**Host State Trade Policy**

The traditionally hypothesized relationship between host state trade policy and FDI is straight-forward—higher levels of trade protection cause firms to invest directly in
a host state. Trade barriers reduce the competitiveness of exports; therefore, firms invest
directly to ‘jump tariffs’ and directly access the host state’s market. However, empirical
tests of this hypothesis have yielded mixed results. The mixed results are most likely due
to the different goals of MNCs and different methods of measuring trade openness.
Market seeking MNCs could be prompted to invest directly in a country to avoid tariffs,
but efficiency seeking MNC have no such incentives and high trade barriers could
actually act as a deterrent to them because the trade barriers could increase the costs of
importing production inputs. In addition, quantifying a host state’s openness to trade is
problematic because of the difficulty of measuring non-tariff forms of protection
(Blonigen 2005; Lim 2001).

Dees (1998), Singh and Jun (1995), and Lecraw (1991) find a positive
relationship between trade openness and FDI. Dees (1998) and Singh and Jun (1995)
assess trade openness by using the ratio of exports to imports (or in some models the ratio
of exports to GDP). Lecraw (1991) uses an index of various factors to account for trade openness.

Branard (1997) and Wheeler and Mody (1992) find a negative relationship
between trade openness and FDI, thus supporting the tariff jumping hypothesis. Branard
(1997) uses the average tariff level of potential host states as his measure of trade
openness while Wheeler and Mody (1992) use an index composed of multiple factors
including import and export restrictions, currency convertibility, and profit repatriation
controls. However, when testing only US electronics-related FDI, firms more likely to be
vertically integrated and efficiency seeking, Wheeler and Mody (1992) found a positive
relationship between trade openness and FDI.
Economic Integration

Economic integration occurs regionally through numerous trade agreements and multilaterally through the WTO (previously the GATT). Blomstrom and Kokko (1997) suggest that regional integration will have an inconsistent impact of FDI flows, depending on the goals of the MNC in question. On the one hand, regional trade agreements reduce barriers to trade and should therefore reduce the need for tariff jumping FDI. On the other hand, regional trade agreements often have stipulations reducing investment barriers as well as trade barriers. These reductions should work to increase FDI for efficiency seeking and resource seeking firms.

Buthe and Milner (2008) hypothesize that membership in a multilateral trade agreement can increase FDI to LDCs. The authors suggest that by becoming a member a multilateral trade agreement (WTO or GATT), LDCs are signaling to MNCs a commitment to liberal economic policies. This commitment, the authors argue, can ease the concerns of investors who would otherwise be wary of investing in LDCs with poor investment climates. Thus, membership in a multilateral agreement may be a substitute for poor institutions in LDCs. Buthe and Milner (2008) test their hypothesis by studying investment flows to non-OECD countries from 1970 to 2000 and find that membership in the GATT/WTO regime does have a positive and statistically significance impact on FDI to LDCs.
Classic Fundamentals

The size of the host state market is widely believed to be positively associated with FDI inflows. Large host markets allow for economies of scale and lower fixed costs and are particularly attractive for horizontal (market seeking) FDI. Theoretically, vertical (efficiency seeking) FDI should be largely unaffected by market size. However, because most FDI is structured horizontally, many studies have found market size, usually proxied by GDP or GDP per capita, to be the most robust determinant of FDI.

A long line of studies have found support for the hypothesis that labor costs are inversely associated with FDI. Riedel (1975) found low labor costs to be a significant factor for Taiwan’s FDI inflows. Similar conclusions were found by Donges (1976) and Donges (1980) in studies of Spain and Portugal, respectively, and Agarwal’s (1980) study of German foreign investments in Colombia, Ecuador, El Salvador, and Mexico. Feenstra and Hansen (1997) and Dees (1998) are examples of more recent articles that support the labor hypothesis in their studies of US owned maquiladoras in Mexico and Chinese incoming FDI, respectively. However, several recent studies have hypothesized that raw labor costs are secondary to labor quality in attracting FDI. Mody and Srinivasan (1998) found that labor quality was a more important factor than raw labor costs for attracting Japanese FDI and Fung et al. (2000) conclude that labor quality, measured by educational attainment, is the significant factor attracting US and Japanese FDI to Chinese provinces, not average wage costs. The results of the recent studies suggests that unit labor costs is probably a better measure to determine the attractiveness of a potential host state’s labor force, unfortunately, such data is often not available (Lim 2001).
Exchange Rates

Traditionally, economists argued that fluctuations in exchange rates would not impact foreign investment flows to a country, the logic being that “while an appreciation of a firm’s home country’s currency would lower the cost of assets abroad, the (expected) nominal return goes down as well in the home currency, leaving the rate of return identical” (Blonigen 2005, 385). More recent studies have shown that exchange rates can indeed affect FDI because of imperfect capital markets (Froot and Stein 1991) and transferable firm-specific assets (Blonigen 1997).

Froot and Stein (1991) argue that imperfect capital markets, the situation where the cost of borrowing from external sources of capital is greater than internal sources, create circumstances where exchange rate fluctuations give firms from one country a financing advantage over firms from another. Froot and Stein (1991) explain their point with the following stylized example:

Imagine first that both a U.S. and a Japanese investor are bidding to buy an American office building. The building will produce an expected $100 million of rental revenues next year, and be worthless thereafter. Either investor can go to the same bank and get a mortgage loan on the same terms: the bank will lend at an interest rate of 10 percent, but for only up to 90 percent of the purchase price. The U.S. investor has $7 million in cash available, and the Japanese investor has 1,000 million yen. The exchange rate is 200 yen/dollar. Under this scenario the U.S. investor wins the bidding, because he can make a $7 million down payment and thus pay as high as $70 million for the building. The Japanese investor, on the other hand, has wealth of only $5 million, and so can bid just $50 million. Now suppose that the dollar depreciates to a value of 100 yen. The Japanese investor’s dollar wealth increases to $10 million, and he wins the bidding. Thus, the depreciation of the dollar has increased the relative wealth of the Japanese, and changed the outcome of the auction (1194-1195)
Froot and Stein (1991) find empirical support for their hypothesis through simple regressions using US aggregate FDI data. Klein and Rosengren (1994) provide further empirical support for Froot and Stein’s (1991) hypothesis using US FDI data disaggregated by source country and type of FDI.

Blonigen (1997) argues that the purchase of transferable firm-specific assets by a foreign firm will be affected by currency fluctuations because these assets will become less expensive for the foreign firm but will not decrease in value when transferred abroad. Blonigen (1997) uses the following stylized example to explain his point:

A Japanese firm and a U.S. firm. The markets are completely segmented, so that both firms have production and sales solely in their own country. A U.S. target firm has an innovation (a firm-specific asset) which will make an acquiring firm’s assembly line 10-percent more productive […] For the U.S. acquiring firm, a change in the exchange rate makes no difference in its valuation of the target firm, since its gains will be denominated in dollars, as will be the price it must pay for the target firm. However, the Japanese firm’s gains will be denominated in yen, since its production and sales are in Japan, while if it wins the bid it must pay for the target firm in dollars. Therefore, a depreciation of the dollar relative to the yen will raise the Japanese firm’s reservation bid, while leaving the U.S. firm’s bid unchanged, and presumably make it more likely that the Japanese firm will acquire the asset (448-449).

Blonigen (1997) finds strong support when testing this hypothesis when studying Japanese acquisitions of US high-technology assets when the dollar depreciated relative to the yen.
SUMMARY

The inability of scholars to come to an agreement on locational determinants of FDI is due to three interrelated factors: (1) variation in MNCs; (2) variation in methods; and (3) disaggregated data. First, MNCs investing abroad for different purposes, efficiency seeking (often organized vertically), market seeking (often organized horizontally), natural resource seeking, and strategic asset seeking, look for different qualities in a potential host state. To further complicate matters, the management of MNCs with similar goals may come to completely different conclusions in regards to the potential profitability of investing in a particular host state. Second, the literature review provided above includes surveys, case studies, and large-N econometric studies and each method has its disadvantages. Surveys are dubious because of the reluctance of MNCs to divulge corporate strategies. Case studies can be misleading because a group of firms or a specific industry may have similar investment goals (market seeking, etc.), thus biasing the results and reducing generalizability. Large-N econometric studies are limited due to disaggregated data, the third factor. Most available data is not disaggregated by industry or firm, especially data provided by LDCs. This data limitation prevents studies from accounting for variation in goals of MNCs. Still, even with the limitations of the literature, some general conclusions can be reached.

Tax Policy and financial incentives

This literature review has highlighted multiple factors which could influence the ability of host state financial incentives to effect MNC location decisions: MNC financing method (Rolfe et al. 1993; Young 1988; Boskin and Gale 1987; Hartman 1984
and 1985), home state double taxation strategy (Hines 1996; Slemrod 1990; Acholes and Wolfson 1990), firm size (Coyne 1994), and host state income level and investment objective (Mutti 2003). While the effect of host state tax policy can be impacted by various state and firm characteristics, the meta-analysis provided by De Mooij and Ederveen (2003) appears to be in line with most general assessments of the literature (i.e. Cohen 2007; Jenson 2006; Lim 2001)—incentives can influence investors and in some situations more than others. However, the combination of firm and tax policy diversity, poor data (especially lack of data that distinguishes between types of FDI—market-seeking, efficiency-seeking, etc.), and the ability of some firms to skirt tax responsibilities make useful generalizations regarding tax policy difficult to discern.

**Agglomeration Economies and Investment Trends**

The evidence provided by Mody and Kinshita (2007) Mudambi (1995), and Wheeler & Mody (1991) supports the agglomeration hypothesis that current stocks of FDI attract future investments. However, these results are dependent on the host state’s level of development, that is, more developed states will see greater agglomeration effects.

**Institutions and Business Climate**

North’s hypothesis that institutions create order and reduce uncertainty has been applied to MNC location decisions by multiple studies. The reviewed literature shows that states with less corruption (Wei 2000), democratic institutions (Jensen 2003), and a strong overall business climate (Globerman and Shapiro 2002) succeed in attracting more
investment than states without those features. However, other research suggests that SEZs can substitute for poor institutional quality and attract FDI (Fung et al. 2000; Woodward and Rolfe 1993; Ranis and Schive 1985).

**Host State Trade Policy**

The overall impact of host state trade policy on FDI is mixed and depends on the investment motivations of MNCs (Lim 2001; Wheeler and Mody 1992). Openness to trade increases FDI from efficiency seeking MNCs because low trade barriers will decrease input costs and make the host state a more competitive export platform. In the same way, efficiency seeking FDI will be negatively impacted by steeper barriers to trade. Trade openness will decrease FDI from market-seeking firms because lower trade barriers encourage foreign firms to service the host state market through exports from their home state. Likewise, market-seeking firms may be encouraged to invest in a host state rather than service it through exports when tariff levels are high.

**Economic Integration**

Regional economic agreements lower barriers to trade and are expected to have the same impact as explained above on efficiency seeking and market seeking FDI (Blomstrom and Kokko 1997). However, multilateral trade agreements (GATT/WTO) have a positive effect on FDI for LDCs because multilateral membership signals a commitment to liberal economic policies (Buthe and Milner 2008).
Classical Fundamentals

Market size is generally seen as the most significant factor in predicting FDI location. While efficiency seeking FDI may not be impacted by market size, market seeking FDI is influenced by this factor. Market size is found to be the most robust determinant of FDI because most FDI is market seeking.

Early studies on labor costs suggest that this factor is inversely related to FDI (Dees 1998; Feenstra and Hansen 1997; Donges 1980; Agarwal 1980; Donges 1976; Riedel 1975). However, more recent studies suggest that labor quality plays a larger role in attracting FDI (Fung et al. 2000; Mody et al. 1998). Unit labor cost is probably the best measure when determining the attractiveness of a potential host state, but this information is not widely available (Lim 2001).

Exchange Rates

While conventional wisdom held that FDI flows were unaffected by exchange rates, empirical evidence suggested the opposite. More recent studies have shown how imperfect capital markets (Froot and Stein 1991) and transferable firm-specific assets (Bonigen 1997) can cause FDI flows to be sensitive to exchange rate fluctuations.
### APPENDIX 11: MODEL 1B.2 (CONSENT)

<table>
<thead>
<tr>
<th>Variable</th>
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</tr>
</thead>
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<td>consent</td>
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<td></td>
<td>(12.22)</td>
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<td>exceptions</td>
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<td>transfers</td>
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<td></td>
<td>(10.16)</td>
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<td>treatment</td>
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<td></td>
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<td>broad treatment</td>
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<td>(6.84)</td>
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<tr>
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<tr>
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<td>(47.06)</td>
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</table>

Observations    1360  
Number of dyads  285  
R-squared        0.1834

Notes: Standard errors are in parentheses.  
*** Significant at 1%; ** significant at 5%; * significant at 10%.
## APPENDIX 12: MODEL 2 WITH LAGS

### Model 2: Logistic Regression Results

<table>
<thead>
<tr>
<th>Variable</th>
<th>1-year lags</th>
<th>3-year lags</th>
</tr>
</thead>
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<td>-0.14***</td>
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<tr>
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<td>(0.04)</td>
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<tr>
<td>legal tradition</td>
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<td>0.03**</td>
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<td>(0.10)</td>
</tr>
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<td>privatization</td>
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<td>0.17***</td>
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<td>Variable</td>
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<td>3-year lags</td>
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<td>-------------------</td>
<td>-------------</td>
<td>-------------</td>
</tr>
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<td></td>
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<td>0.05***</td>
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<tr>
<td>Pseudo R-squared</td>
<td>0.14</td>
<td>0.13</td>
</tr>
<tr>
<td>Log pseudolikelihood</td>
<td>-2561.31</td>
<td>-2702.55</td>
</tr>
</tbody>
</table>

Robust standard errors are in parenthesis.

***Significant at 1%; **significant at 5%; *significant at 10%.
APPENDIX 13: VARIABLE LIST

**Dependent Variables**

*Bifdi*
- Bilateral FDI flows from the top seventeen capital exporting country in each dyad (the home state) to the non-top seventeen capital exporting country in the dyad (the host state).
- In millions of 2010 US dollars.
- Data source: OECD website.

*BITpresent*
- Denotes when a BIT is present in a dyad.
- 0 = no BIT. 1= BIT present.
- Data source: UNCTAD website.

**BIT Variables**

*Exceptions*
- Measures the strength of exceptions present in a treaty.
- Range: 0-6.
- Data source: Original to this study

*Transfers*
- Measures the strength of transfer provision present in a treaty.
- Range: 0-5.
- Data source: Original to this study

*Treatment*
- Measures the strength of treatment protections present in a treaty.
- Range: 0-3.
- Data source: Original to this study
**Broad Treatment**
- Measures the strength of broad treatment standards present in the treaty.
- Range: 0-5.
- Data source: Original to this study

**SumBIT**
- The sum of the four treaty strength measures for each treaty.
- Range: 0-19.
- Data source: Original to this study

**CompetitionBIT**
- A weighted assessment of BITs signed by the economic competitors of a capital importing state.
- Data source: Elkins et al. (2006).

**BITcount**
- The number of BITs signed globally by year.
- Data source: Elkins et al. (2006).

**Host State Control Variables**

**GDP cap**
- Host state GDP per capita.
- Thousands of 2000 US of dollars
- Data source: World Bank (in Elkins et al. 2006).

**Legal tradition**
- Host state legal tradition
- 0= civil law. 1= common law.
- Data source: World Bank (in Elkins et al. 2006).

**Democracy**
- Host state’s level of democracy
- Range: -10 to 10 (higher scores indicate higher levels of democracy).
- Data source: Polity IV Dataset (in Elkins et al. 2006).
**Law and Order**
- Quality of the host state’s legal system
- Range: 0 to 6 (higher scores indicate better legal system).
- Data source: Political Risk Service Group (in Elkins et al. 2006).

**Corruption**
- Host state corruption levels.
- Measures investor perceptions of corruption levels in the host state.
- Range: 0 to 6 (higher scores indicate higher levels corruption).
- Data source: Political Risk Services Group (in Elkins et al. 2006).

**Privatization**
- Privatization record of the host state.
- Total value of assets privatized by the host state in a given year as a percentage of the host state’s GDP.
- The data are calculated using 1985 US dollars.

**FDI lag1**
- FDI inflows to the host state.
- Percent of host net FDI inflows as a percentage of the host state’s GDP, lagged one year.
- The data are calculated using 2000 US dollars.
- Data source: World Bank (in Elkins et al. 2006).

**Change gdp lag2**
- Host state GDP growth.
- Measures the change in GDP in the host state, lagged two years.
- Data source: World Bank (in Elkins et al. 2006).

**Extraction**
- The percent of the host state’s exports that are from fuel, ores, and metals in a given year.
- Data source: World Bank (in Elkins et al. 2006).
Dyadic Control Variables

Alliance

- Controls for the presence of a strategic partnership between the two states in a dyad.
- 0 = alliance not present. 1 = alliance present
- Data source: Correlates of War Project (Elkins et al. 2006).

Log trade/gdp

- Trade relationship between the two states in a dyad.
- Measured as the total value of the trade between the two states in terms of the host state’s GDP (log value).
- Data source: World Bank (in Elkins et al. 2006).

Common language

- 0 = states do not share common language. 1 = states share common language

Rich FDI

- Home state FDI outflows.
- Measures the total net FDI outflows from the home state in a dyad and is provided as a percent of the home state’s GDP.
- Data source: World Bank (in Elkins et al. 2006).
Cold war

- Presence of the Cold War.
- Dyads from 1985 to 1992 are coded 1, denoting the presence of the Cold War.
- Dyads from 1993 to 2000 are coded 0, denoting the absence of the Cold War.
- Data source: Elkins et al. (2006).