The Political Economy of the Investment Treaty Regime

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Oxford: Oxford University Press, 2017

About the book:

Investment treaties are some of the most controversial yet least understood instruments of global economic governance. Public interest in international investment arbitration is growing, and some developed and developing countries are beginning to revisit their investment treaty policies. The Political Economy of the Investment Treaty Regime synthesizes and advances the growing literature on this subject by integrating legal, economic, and political perspectives. Based on an analysis of the substantive and procedural rights conferred by investment treaties, it asks four basic questions. What are the costs and benefits of investment treaties for investors, states, and other stakeholders? Why did developed and developing countries sign the treaties? Why should private arbitrators be allowed to review public regulations passed by states? And what is the relationship between the investment treaty regime and the broader regime complex that governs international investment? Through a concise yet comprehensive analysis this book fills in some of the many 'blind spots' of academics from different disciplines, and is the first port of call for lawyers, investors, policymakers, and stakeholders trying to make sense of these critical instruments governing investor–state relations.

Endorsements:

With incisive analysis from the perspectives of economics, law, and political science, the authors deliver a singularly important work of clarity at a critical time for global economic order. With as much a domestic perspective as an international one, the authors illuminate highly politicized questions with a fairness that is refreshing.
Professor David D. Caron, member of The Iran-United States Claims Tribunal

Their book dispassionately synthesizes the available legal, economic, and political literature relevant to understanding the investment treaty regime's oft-proclaimed "legitimacy crisis." It seeks to supply lawyers needing political context and political scientists needing legal knowledge with the unfiltered facts required to assess whether such a "crisis" exists and, if so, what the ways forward might be.
Professor Jose Alvarez, New York University

CHAPTER 6

INVESTMENT TREATIES, FOREIGN INVESTMENT, AND DEVELOPMENT

INTRODUCTION

This chapter examines the aggregate economic effects of investment treaties, focusing on their impact on investment flows and on economic development. The first section reviews studies of investment treaties' investment protection provisions on foreign investment. This subject has received a disproportionate share of attention in empirical work on the investment treaty regime. The second section examines the impact of investment treaties on governance in the countries that are bound by them, which in turn could have macroeconomic effects. Both these sections outline the findings of existing empirical studies, assess the relevance of these findings, and discuss methodological and measurement challenges that make it difficult to draw strong conclusions from the existing literature. The third section examines the impact of investment liberalization provisions of investment treaties on foreign investment and development. As described in previous chapters, liberalization provisions were historically rare in BITs, but are increasingly common in new investment treaties, particularly plurilateral investment treaties and investment chapters of preferential trade agreements. Such provision could have important – and thus far largely unexplored – macroeconomic effects.

THE IMPACT OF INVESTMENT TREATIES ON FOREIGN INVESTMENT

Empirical work on the macroeconomic effects of investment treaties focuses primarily on the question of *whether* entering into an investment treaty increases inward FDI for developing countries. This focus reflects the common view that the purpose of investment treaties is to promote new foreign investment, on the assumption that increased inward investment leads to economic development (van Aaken 2011). The impact of investment treaties on foreign investment is an important question for policy-makers, as developing countries typically signed these treaties in the expectation that it would help them attract foreign investment (see Chapter 8). Nevertheless, three important caveats should be borne in mind when evaluating these studies.

First, both the review of evidence on the economic implications of foreign investment in Chapter 2 and the microeconomic analysis in Chapter 5 suggest that the economic effects of foreign investment vary depending on the reasons for the investment, the industry in question and the economic and institutional conditions of the host state. As such, any rigorous analysis of the macroeconomic effects of investment treaties needs to go beyond the question of *whether* investment treaties affect FDI flows and also consider *how* and *why* investment treaties affect foreign investment. More recent studies have begun to probe some of these questions but the question of *whether* investment treaties affect FDI continues to receive disproportionate attention.

Even if investment treaties increase inward FDI in states that sign them, policy-makers need to consider whether these increases are the result of a net increase in investment ('investment creation') or whether they come at the expense of other investment ('investment diversion'). The pool of capital available for FDI at any given time is not fixed.[1] Investment treaties may *create* new opportunities for direct investment and thereby increase the global direct investment stock – for example, by solving hold-up problems. On the other hand, investment treaties could also *divert* investment between states via three different mechanisms. The first is that, by providing protections for investment in one host state that are not available for investment in other host states, investment treaties could divert foreign investment from one host state to another. That would result in a classic collective action problem, whereby it may be individually rational for developing countries to sign treaties to increase their share of global FDI, but collectively irrational for developing countries as a group to sign investment treaties (Elkins, Guzman, and Simmons 2006).[2] While parallel considerations about diversion and creation of international trade resulting from preferential agreements have been widely discussed since the 1950s (Viner 1950), the issue has received little attention in empirical work on the macroeconomics of investment. Second, since investment treaties give foreign investors rights that domestic investors do not have, they could provide foreign investors with an 'ownership' advantage over their domestic competitors in host states (see Chapter 2). The result could be that investment treaties divert productive investment opportunities away from domestic investors, as discussed in Chapter 5. A third form of investment diversion relates to the home state: investment treaties may encourage companies to route investments that they would have made in any event through a corporate intermediary in a third country in order to take advantage of an investment treaty between the third country and the host country (see Chapter 2).[3] All three scenarios would show up as 'positive' effects of investment treaties on investment in quantitative studies, but not because of actual investment 'creation'.

Finally, recall from Chapter 2 that most investment treaties cover not only FDI but also many forms of portfolio investment, such as minority shareholdings, loans, and financial derivatives. We noted in Chapter 2 that economists are more sanguine about the benefits of portfolio investment than FDI, both due to the greater volatility of portfolio investment flows and because portfolio investment does not normally entail positive spillovers for the host state such as technology transfer or human capital development. A comprehensive macroeconomic assessment of investment treaties would need to consider investment treaties' impact on the investment decisions of bankers and fund managers, as well as on states' ability to regulate portfolio flows.[4] However, at the time of writing neither the impact of investment treaties on portfolio investment flows, nor the impact of investment treaties on governments' ability to regulate those flows, has been subject to significant theoretical and empirical scrutiny.

[1] Capital is invested in many ways aside from direct investment, including the purchase of sovereign bonds, real property and gold, as well as through portfolio investment in debt and minority shareholdings (Feldstein 1995). Changes in the allocation of capital between direct investment and other forms of investment can increase or decrease the value of direct investment globally. The amount of capital available for direct investment can also change as a result of shifts in the allocation of current income between investment and consumption – for example, decisions by firms to retain and reinvest earnings rather than distribute dividends to shareholders, or decisions by consumers to save more.
[2] We return to the competition among developing countries for capital in Chapter 8.

[3] There is evidence of cases in which this has occurred (*Mobil v. Venezuela*, 2010, para. 204). Similarly, Petrobas is reported to have invested abroad via third countries to secure BIT-protections because Brazil has no ratified BITs (Poulsen 2015, p. 7, ftn 28). That said, no study has suggested that this practice is sufficiently common to explain an observed impact of investment treaties on investment flows between treaty partners.
[4] Recall from Chapter 4 that broad free transfer of funds provisions included in many investment treaties – for example, those contained in US BITs – place legal limits on the ability of states to impose capital controls, even when necessary to respond to financial crises (Waibel 2010; Gallagher and Stanley 2013).

Causal mechanisms

An important question in quantitative studies of how investment treaties affect FDI is whether to try to isolate the impact of an investment treaty on FDI between the partner countries or, alternatively, whether to assess the impact of entering into an investment treaty on total inflows of FDI to a country, including inflows from foreign countries that are *not* covered by the treaty. Which approach is appropriate depends on theories of which foreign investors are influenced by the existence of an investment treaty. There are two, potentially complementary, theories in the existing literature of how the investment protections provisions of investment treaties could affect FDI. The first is commitment theory: the theory that the protection investment treaties provide is directly relevant to the investment decisions of investors that are covered by the treaty. As discussed in Chapter 5, this could be, among other reasons, because they help such investors solve hold-up problems or because they provide covered investors with legal rights that are not available to competitors of other nationalities. But the central premise of commitment theory is that only those investors that are covered by the treaty directly benefit from the protection provided by the treaty.

The second is signalling theory: the theory that when a country enters into an investment treaty it sends a signal to investors from all foreign countries, including those not covered by investment treaties, that it has laws and policies in place that protect foreign investment. The theoretical underpinnings of signalling theory have been examined in economics (e.g. Spence 1973). Investment treaties must satisfy two conditions to operate as signals. First, foreign investors must lack information about the investment climate in the country in question. If there were no such information asymmetries, investors could rely on their own (correct and fully-informed) assessment of the investment climate in the host state because the existence of an investment treaty would not communicate any additional information. Second, it must be less costly for states that provide sufficient protection to foreign investment to become and remain parties to investment treaties than it is for states with bad investment climates. If that were not the case, all states would be equally likely to ratify investment treaties and the existence of a treaty would not convey any meaningful information about the quality of the investment climate. Tobin and Rose-Ackerman (2011) contend that investment treaties meet the second condition because the risk of liability in investment treaty claims is greater for states with bad investment climates. On this basis they argue that investment treaties act as signals of a good investment climate.[5]

Quantitative studies of the impact of investment treaties on FDI: A summary

An Appendix to this chapter lists thirty-four published quantitative studies of how investment treaties affect FDI. The majority focus specifically on the impact of *bilateral* investment treaties on FDI in developing or middle-income countries. We are not aware of studies that have tested the investment impact of FCN treaties or the impact of investment treaties among developed countries, such as the ECT or the proposed TTIP.

The studies' results are mixed. A majority find that investment treaties have a positive and statistically significant impact on inward FDI in at least some circumstances. Among these, the

[5] Kerner (2009) proposes a different variation of signalling, according to which civil society actors' opposition to investment treaties means that the act of signing the treaty entails a political cost to a government, and the willingness of a government to incur that costs sends a signal that it will protect foreigin investment. For a critique see Bonnitcha (2014).

scale of the impact varies remarkably, with some reporting strong effects and others finding positive but only small effects. Among the studies reporting a positive effect of BITs on investment flows, some also come to apparently contradictory findings.[6] Finally, a sizeable minority of studies find that there is no statistically significant effect of BIT-adoption on FDI flows. Studies examining signalling effects – i.e. the impact of entering into investment treaties on total inflows of FDI to a country, including inflows from foreign countries that are *not* covered by the treaty – seem more likely to find that investment treaties have a positive impact on inward FDI than those examining commitment effects.

Estimation challenges

The literature faces several challenges. It needs to account for theoretically relevant differences between (i) investment treaties; (ii) host states; and (iii) investors. Moreover, significant challenges arise from endogeneity. In this section we examine each of these four challenges in turn, which will make clear that existing studies are not of equal quality. The quality of future studies in the field should also be assessed by examining the way in which they deal with these challenges.

The first challenge relates to the way in which investment treaties are coded by quantitative researchers. Several early studies treated the existence of a signed investment treaty as the independent variable. In doing so, these studies failed to distinguish between investment treaties that subsequently entered into force and those that were never ratified and thus never entered into force. Yet, in theory, only ratified treaties that become legally effective can act as a credible commitment and/or a costly pro-investor signal. For the most part, more recent studies have addressed this problem (see e.g. Haftel 2010).

Early studies also failed to distinguish between investment treaties that contained provisions allowing for enforcement through investment treaty arbitration and those that did not, a characteristic that is crucial to investment treaties ability to function as commitment or signalling devices. For instance, Yackee (2009) showed that results indicating a strong impact of BITs on FDI (e.g. Neumayer and Spess (2005)) are no longer significant once investment treaties are recoded to distinguish between those that allow for enforcement through investment treaty arbitration. Three more recent studies have examined variation in the impact of investment treaties that provide advance consent to investment treaty arbitration and those that do not. These studies find that investment treaties that provide advance consent to arbitration are no more effective in attracting FDI than those that do not (Peinhardt and Allee 2012b: Berger et al. 2011 and 2013). These finding are the opposite of what both commitment and signalling theories predict, and raise questions about whether more general findings that investment treaties increase FDI are, themselves, reliable.

Some contributions have tried to disaggregate investment treaties even further, for instance by constructing indexes of treaty 'strength' (e.g. Haslam 2007; Dixon and Haslam 2015). If done carefully, such studies could allow researchers to test the importance of legally relevant features of investment treaties. However, studies that rely on a single index of treaty 'strength' come with their own challenges. While it may be possible to rank certain features of a treaty – for example, progressively wider definitions of the range of 'investments' covered by different treaties[7] –

[6] For example, one concludes that only US BITs increase co-signatories' FDI (Salacuse and Sullivan 2005), and another that most BITs increase FDI but US BITs do not increase co-signatories' FDI from the US (Gallagher and Birch 2006).

[7] See Chapter 2 for discussion of the range of 'investments' that investment treaties typically cover.

aggregating these aspects into a single index of treaty 'strength' involves a set of essentially arbitrary decisions about the relative importance of various features of the treaty. Moreover, aggregating different parts of treaties to create a single measure of treaty 'strength' ignores the interaction between different provisions – most importantly through the MFN clause (Poulsen and Yackee2016; see also below). These challenges are further augmented in the context of investment chapters that form part of broader trade agreements, where there may be interaction effects between investment and non-investment provisions.

A second challenge is that investment treaties could have different effects in different host states. If investment treaties attract FDI by solving hold-up problems, they are likely to be most effective in countries that are poorly governed. In contrast, if investment treaties attract FDI through signalling effects, they are likely to be most effective in states that have recently improved their internal governance. As such, a core question is whether investment treaties are more effective in attracting FDI to countries that are poorly governed or to countries whose governance has improved. Findings of studies on this point are mixed. Some find that investment treaties are more effective in attracting FDI to countries with relatively strong domestic institutions (Desbordes and Vicard 2009; Tobin and Rose-Ackerman 2011), whereas others come to the opposite conclusion (Neumayer and Spess 2005). One possible explanation for these different results is the difficulty in capturing intangible domestic political and institutional characteristics within a metric of 'governance quality'. We return to this issue below.

A third challenge is that investment treaties could be more effective in promoting some types of investment than other types of investment. For example, Chapter 5 suggested that investment treaties are likely to be more effective in promoting investment in sectors that involve high sunk costs, such as natural resources and utilities.[8] Whether this hypothesis is correct is an important empirical question for policy-makers, as Chapter 2 showed that foreign investment in different sectors is associated with different patterns of costs and benefits for the host state.

The difficulty in obtaining good data on foreign investment disaggregated by sector makes it difficult to test the impact of investment treaties on investment in different sectors. Thus far, only a few studies have examined the impact of investment treaties on FDI disaggregated by sector. Colen and Guariso (2013) find that investment treaties have a significant positive impact on FDI in the mining sector but not on FDI in any other sector. These findings are consistent with those of Busse, Königer and Nunnenkamp (2010) who find that investment treaties are more effective at attracting FDI to resource-rich countries. Similarly, Danzman (2016) finds the investment treaties have a positive impact on investment in infrastructure projects but no impact on aggregate FDI.[9] Further support for the view that investment treaties are more effective in promoting investment that entails high sunk costs comes from Kerner and Lawrence (2014). Rather than disaggregating FDI by sector, they use annual data supplied by US companies operating across all sectors on the value of their foreign affiliates' assets, which is disaggregated into fixed and liquid capital. Fixed capital includes plants, equipment and concession rights; liquid capital includes cash and inventories. They find that US investment treaties – including free trade agreements with investment chapters – have a positive, but small, impact on investment in fixed capital but no impact on the value of firms'

[8] Another issue that may be relevant is the size of the investor and the investment, given that the costs of investor-state arbitration make it uneconomic for investments below a certain value. See Chapter 3 for discussion of the costs of investor-state arbitration.

[9] Danzman uses the broad World Bank classification of 'infrastructure' investment as including: oil, gas, and mining; electric power and other energy; water sanitation and flood protection; transportation and roads; and information and communication. All these sectors are associated with high ratios of sunk costs to total investment value.

holdings of liquid capital. Disaggregating foreign investments by capital intensity, Colen, Persyn, and Guariso (2016) find similar results for foreign investment in 13 countries in the former Soviet Union and Central and Eastern Europe.

The fourth and, perhaps, greatest challenge is the problem of endogeneity. In particular, studies should account for the fact that many states adopted laws and policies that might have an independent impact on FDI around the same time that they entered into investment treaties (omitted variable bias), and the possibility that growth in FDI between a given pair of countries could be a reason why those states decided to negotiate an investment treaty (reverse causality).[10] For instance, both Neumayer and Spess (2005) and Salacuse and Sullivan (2005) suggest a causal link between investment treaties and FDI, but their results are not robust once endogeneity is taken into account (Aisbett 2009). Omitted variable bias is a particularly serious concern with studies of the signalling effect of investment treaties. As Chapter 8 shows, many developing countries signed investment treaties around the same time that they amended national laws and policies governing FDI. Signalling theory predicts that investment treaties affect inward FDI from all countries, as is likely to be the case with national reforms. Because it is difficult to construct metrics that capture relevant national reforms (see below), the relative importance of the two factors is difficult to disentangle.

The dependent variable

Another issue that has received less attention is the quality and relevance of the measure of foreign investment used as the dependent variable. The vast majority of quantitative studies use data on FDI flows or, less frequently, FDI stocks. There are three main limitations associated with these measures. First, there are problems of overall *data quality* of FDI. Second, there is a mismatch between the *investments* covered by investment treaties and what FDI statistics measure. Third and finally, there is a mismatch between the *investors* covered by investment treaties and what FDI statistics measure.

First, the quality of FDI stock data is poor. In 2007, only about 100 economies reported inward FDI stock data and among those the method of evaluation differed significantly (Fujita 2008, 115). Outward FDI stock data is even more patchy. This lack of stock data is the reason the majority of quantitative studies use data on FDI flows, which is generally more reliable. That said, there are also problems with FDI flow data (Fujita 2008, 107). These problems could also bias results if errors in FDI data were correlated with host country characteristics – for example, if under-estimation of FDI flows correlated with low quality of government institutions and bureaucracy.

The second issue arises because FDI flow is a measure of the cross-border movement of capital. FDI flows comprise loans, equity and reinvested earnings contributed by the investor to a foreign entity in which the investor has a shareholding of 10% or more.[11] FDI flow data does not include the value of investments in a host a country that are owned by foreigners but financed by loans or capital raised in the host country (Beugelsdijk et al. 2010). In contrast, whether an investment falls

[10] One possible explanation for reverse causality could be that investors that have invested in a given host country have an incentive to lobby their home country to enter into an investment treaty. We return to this issue in Chapter 7.

[11] We have already noted that investment treaties cover portfolio investment, which is not counted in FDI statistics. In this section we do not engage in further discussion of this dimension of mismatch between what is covered and what is measured.

within the protection of an investment treaty depends on whether it is foreign-owned, not on whether it is financed by foreign capital.[12] FDI flow data may still be useful as a proxy for changes in the value of foreign-owned investment covered by an investment treaty. However, the mismatch between the two could also be a source of bias – for example, if the quality of local institutions in the host state influences the extent to which foreign investors rely on local financing.

In principle, the use of FDI stock data could partially resolve these problems. FDI stock data is intended to measure the value of foreign-owned assets and, therefore, corresponds more closely with the value of 'investments' covered by an investment treaty. However, FDI stock data is often calculated by aggregating FDI flows over time, rather than through direct measures of the market value of foreign-owned assets (Kerner 2014).[13] FDI stock data calculated in this way suffers from the same basic mismatch between what is measured and what is covered by an investment treaty as FDI flow data.

A third limitation is the mismatch between the *investors* covered by an investment treaty and what FDI statistics measure. Many investment treaties cover both directly and indirectly owned foreign investments. For example, an investment in Ecuador that is owned by a Cayman Islands subsidiary of a US parent company qualifies for protection under the Ecuador-US BIT.[14] In contrast, FDI data measures only the immediate source and destination of investment. The previous example would show up twice in FDI data – once as US investment in the Cayman Island and again as Cayman Islands investment in Ecuador – but would not show up in FDI data on US investment in Ecuador. This is major issue in practice because about 30% of global FDI flows through tax havens and jurisdictions offering special purpose entities that facilitate transit investments (UNCTAD 2016, ch. 5).[15] This mismatch between what is measured and what is covered by investment treaties is an especially serious problem for empirical testing of commitment theory. Using FDI data to test commitment theory depends on the problematic assumption that the immediate source of foreign investment is a satisfactory proxy for whether that investment is covered by an investment treaty.

Partly for these reasons, some quantitative studies have begun to test the impact of investment treaties using different dependent variables as proxies for the value of foreign investment stocks and flows. Egger and Merlo (2012) find that the presence of a German BIT is correlated with an increase in the number of German multinational firms that are active in the partner country and the volume of investment made by such firms. Provided the result is not due to endogeneity, which from the study is unclear, questions arise as to whether this result is generalizable to other countries or may be driven by the close link between German investment treaties and the provision of German investment insurance (see Chapter 7). Jandhyala and Weiner (2014) find that the coverage of an investment treaty significantly increases the price that international companies paid for foreign petroleum assets in market transactions. This finding suggests that investors in that sector

[12] Moreover, from an economic policy perspective, the more important question for a host state is whether foreign investment is foreign-owned not whether it is foreign-financed. This is because positive spillovers associated with foreign investment – such as, technology transfer, skills and improved management (see Chapter 2 for discussion) – arise from foreign ownership or control of an investment, rather than from foreign financing of an investment.

[13] Historical cost-based US outward FDI stock is defined by the Bureau of Economic Analysis as 'net book value of U.S. parents' equity in, and net outstanding loans to, their foreign affiliates. The position may be viewed as the U.S. parents' contributions to the total assets of their foreign affiliates or as the financing provided in the form of equity or debt by *U.S. parents* to their foreign affiliates.' (italics added) (BEA 2004, M-21).

[14] Article 1(a) of the Ecuador-US BIT 1993 states that treaty covers 'every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party'.

[15] For example, in 2014 the Netherlands was the largest recipient of US outward FDI and Luxembourg, Ireland, the British Carribean Islands and Bermuda were all in the top 10.

value the protection provided by investment treaties, and that the presence of an investment treaty is likely to lead to additional investment in that sector. These studies are useful additions to a literature largely relying on highly aggregated FDI flows.

Qualitative studies

In light of the methodological challenges and mixed findings of econometric studies, other scholars have employed different methodologies to examine the relationship between foreign investment and investment treaties. One alternative is directly surveying those responsible for firms' investment decisions to see whether they regard investment treaties as a relevant factor in their decision-making. In the early 1990s, a series of surveys of British, German, Swedish and US investors by the World Bank indicated that, at that time, Western investors were rarely aware of investment treaties: only '[p]rofessional advisors, such as accountants or merchant bankers, would be people to concern themselves with such minutia, only after detailed project planning was already underway.' (MIGA 1991, 92). They considered other parts of the investment regime complex, like DTTs, to be far more important.

Investors are now likely to be more aware of investment treaties due to the rise of investment treaty arbitration over the last two decades (see Chapter 1). However, some more recent surveys are broadly consistent with the World Bank's findings mentioned above. Yackee (2009) surveyed in-house general counsel of seventy-five Fortune 500 companies. The responses 'indicate a low level of familiarity with BITs, a pessimistic view of their ability to protect against adverse host state actions, and a low level of influence over FDI decisions'. Equally, Copenhagen Economics found that European investors in China were rarely familiar with relevant BITs and, even when they were, that the treaties were only relevant for actual investment decisions in a small number of cases (Copenhagen Economics 2012).

Other surveys point to a greater awareness and relevance of investment treaties. 19% of respondents to an *Economist* survey of 602 corporate executives, indicated that the existence of an investment treaty influenced their investment decisions 'to a very great extent' (Shinkman 2007). Although Sachs (2009) raised doubts about the reliability of Shinkman's results, it does suggest that investment treaties play at least some role in influencing the destination and volume of foreign investment in some countries. In a more recent survey, Hogan Lovells and the British Institute of International and Comparative Law (BIICL) (2015) received responses from 301 senior decision-makers at Fortune 2000 companies. The responses suggest a high level of familiarity with investment treaties, and that senior decision-makers regard investment treaties as an important consideration when making decisions about foreign investment. However, other responses to the survey cast doubt on the reliability of these results. For example, in many cases the respondent's company had, in fact, invested in countries in which the respondent said the company would not invest due to the absence of an investment treaty (Hogan Lovells and BIICL 2015). This highlights one major methodological challenge with surveys in general: responses of investors do not necessarily match their behaviour in practice.

A second approach has been to focus on the impact of investment treaties on the availability and pricing of political risk insurance. The political risk insurance industry is important for two related reasons. First, because political risk insurers take on the financial risk of failure of investments, they have a strong self-interest in being fully-informed about the effectiveness of legal arrangements that can mitigate those risks. Second, if the presence of investment treaties affects the pricing of political risk insurance, it would give investors that purchase insurance a financial incentive to invest more in countries covered by investment treaties. In a detailed series of interviews with private and government-sponsored political risk insurers, Poulsen (2010) found that the existence of an investment treaty covering a proposed investment had little impact on the coverage and pricing of political risk insurance. There were exceptions, like the German investment insurance program (see Chapter 7), but the vast majority of private and public providers did not report investment treaties to have a significant impact on their decision-making (cf. also Yackee 2011). It is an open question, whether these results would be different today, now that the potency – but also unpredictability – of investment treaty arbitration has become more apparent to investors and their advisors.

Finally, one study has assessed whether investment promotion agencies use investment treaties when marketing their country to foreign investors (Yackee 2015). If investment treaties operate as signals of an attractive domestic climate, we would expect rational states to publicize actively information about the existence of its investment treaties. Yet, Yackee finds that hardly any states do so. This could be because the agencies fail to act in their own interest – or that of their government – or because the agencies have made an accurate judgment that the treaties are not a significant factor for foreign investors considering whether to invest in the host state.

At the time of writing, academic scholarship has yet to produce detailed case studies focusing on the role of investment treaties in individual investment decisions. Nor has business literature assessed the importance of the treaties for different actors *within* firms. If carefully constructed, such studies could give us greater micro-level insights on how investment treaties influence foreign investment decisions, which in turn can have macro-level impacts. We know of at least a couple of cases where investment treaties are reported to have had a decisive impact on foreign investment decisions,[16] but when and under what circumstances investment treaties influence the destination and volume of individual investments remains an open question.

All in all, there is a large and growing literature seeking to assess the extent to which investment treaties influence foreign investment decisions. Most of this literature uses econometric techniques to measure the impact of investment treaties on FDI flows, which involve significant challenges in terms of data availability and econometric specification, but some recent studies have begun to use other methods and more fine-grained measures of investment. The results are mixed. Taken together, the literature suggests that investment treaties do have some impact on *some* investment decisions in *some* circumstances, but that they are unlikely to have a large effect on the majority of foreign investment decisions. When considering the macroeconomic implications of these conclusions, it is also important to recall the caveats noted at the beginning of this section: any evaluation of the investment treaties' economic impact depends not only on *whether* investment treaties increase aggregate inward foreign investment, but also on *how* and *why* investment treaties affect different types of investment.

[16] As an example, in discussions with his colleagues the Dutch ambassador to Venezuela reported that the investment treaty arbitration provision in the 1993 Netherlands-Venezuela BIT was instrumental for Royal Dutch Shell's participation in large natural gas project (Poulsen 2015, 8 ftn 29). It is unclear from the report whether an investor-state arbitration provision in a contract would have been an adequate substitute for Shell, nor is it clear whether the treaty's arbitration provision was required for Shell to acquire political risk insurance.

MACROECONOMIC EFFECTS THROUGH CHANGES IN GOVERNMENT DECISION-MAKING

We turn now to a second macroeconomic effect of investment treaties that has received significantly less attention in empirical literature: the impact of the treaties on government decision-making. As Chapter 4 explained, several protections that investment treaties provide to foreign investors concern the *process*, as opposed to the outcome, of government decision-making. For example, arbitral tribunals have interpreted FET provisions as requiring host states to provide due process in administrative decision-making. Decision-making processes that affect foreign investors and that are fundamentally biased or that completely ignore relevant evidence are likely to breach FET provisions (Dolzer and Schreuer 2012). In theory, investment treaties should encourage governments to ensure that decision-making processes conform to these procedural standards, as breaching them runs the risk of costly investment treaty arbitrations by foreign investors (Echandi 2011). On this basis, several legal scholars have argued that investment treaties encourage ‘good governance’ and respect for ‘the rule of law’ in countries that sign them (e.g. Dolzer 2006; Schill 2010; Vandevelde 2010). These effects on government decision-making processes could contribute to economic development, both through the direct benefit of ‘better’ government decisions and by encouraging both foreign and domestic investment.[17] If investment treaties promote better property right protections for *all* investors, this should be of particular interest for small and medium sized domestic firms without privileged access and influence over domestic policy-makers (on the joint interest of foreign firms and smaller domestic firms in replacing cronyism with property right protections, see e.g. Markus 2012).

There are three core assumptions underlying the hypothesis that investment treaties improve government decision-making. The first is that the constraints that investment treaties place on host state conduct correspond with underlying concepts of ‘good governance’ and the ‘rule of law’. We do not address this question here, save to note that this assumption is the subject of significant disagreement and that ‘good governance’ and ‘the rule of law’ are, themselves, contested concepts.[18] Instead, we focus on the second assumption, namely that the constraints imposed by investment treaties are internalized in national administrative practices and judicial systems.[19] Legal scholars generally assume that ‘the monetary sanctions [investment treaty tribunals] can impose exert considerable pressure on states to bring their domestic legal orders into conformity with the investment treaty obligations.’ (Schill 2012, 137; see generally Cohen 1990). However, as we will see, this empirical proposition remains largely untested and, to the extent evidence exists, it raises serious doubts about whether this second assumption is correct. A third assumption is that ‘good governance’ and the ‘rule of law’ contribute to economic development. We do not address this assumption here, save to note that it is the least controversial of the three and that it is the subject of its own highly sophisticated empirical literature.[20]

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[17] For example, Dolzer (2006) contends that investment treaties reduce ‘the space for unprincipled and arbitrary actions of the host state and thus contribute to good governance, which is a necessary condition for the achievement of economic progress in the host state.’

[18] For the argument that the provisions of investment treaties align with these concepts see Vandevelde (2010) and Schill (2010). For critiques, see Van Harten (2009) and Calamita (2015). These issues are central to debates among legal academics about how vague substantive provisions of investment treaties should be interpeted and applied. Those debates are discussed in Chapter 4.

[19] We do not examine the impact of investment treaties on national legislators, as there has been no published research on this question.

[20] On the role of governance in economic performance, see e.g. North (1990) and Rodrik, Subramanian and Trebbi (2004); on the rule of law and economic growth, see e.g. Haggard and Tiede (2011).

Impact of investment treaties on administrative and judicial decision-making

One way in which states could seek to ensure that they internalize the constraints of investment treaties in national administrative practices is by establishing processes to share information about investment treaties between different parts of government. There is no direct evidence of any state establishing such mechanisms prior to the early 2000s.[21] The absence of institutional arrangements to ensure compliance with investment treaties is consistent with the fact that few developing country governments expected investment treaties to 'bite' in practice (see Chapter 8). This may have changed as states became more aware of investment treaty arbitration. Chapter 5 noted that some countries have now implemented internal processes of information sharing among agencies that deal with foreign investment in an attempt to ensure compliance (UNCTAD 2010). The spread of such institutions and the ways in which they influence administrative decision-making in practice are two important questions for further research.[22]

Qualitative studies have started to shed more light on the impact of investment treaties in particular countries. Following surveys and interviews with government officials, Coté (2014) concludes that officials with responsibility for health, safety and environment regulation in Canada's national government and officials with responsibility for tobacco control in a selection of developing countries had low levels of awareness of the content of investment treaties and of the risk of claims by foreign investors under such treaties. Her conclusion that Canadian officials were largely unaware of their investment treaty obligations is significant as, at the time her research was conducted, Canada had already been the subject of over a dozen investment treaty arbitrations over a period of a decade. Interviews conducted by Van Harten and Scott (2016) with government officials in the Canadian province of Ontario paint a very different picture.[23] They find that the Ontario trade ministry played an important role in reviewing policy proposals of various environmental agencies for compliance with Canada's obligations under investment treaties. They also find significant, albeit variable, levels of knowledge of investment treaties among government officials.

In a third study, Sattorova, Omiunu and Erkan (2016) examined the impact of investment treaties on administrative decision-making in Nigeria, Turkey and Uzbekistan through a series of interviews with government officials. Although they interviewed only twenty-eight officials across these three countries, their findings suggest a relatively low awareness of investment treaties in each of the three countries, even after their first experience of investment treaty claims. They also suggest that

[21] Of course, the absence of evidence does not prove that such mechanisms did not exist. Nor does the absence of an institution with the express mandate of ensuring compliance with investment treaties rule out the possibility that legal agencies within some states are aware of investment treaties and play a role in vetting policy proposals in light of a range of legal risks, including the legal risk of claims under investment treaties (e.g. Van Harten and Scott 2016). Moreover, even if states do not have institutions or practices in place to ensure compliance with investment treaties across government, this does not rule out the possibility that investment treaties influence government decision-making in specific cases – for example, cases in which foreign investors themselves invoke the existence of an investment treaty when bargaining with government. We discuss this in more detail in Chapters 5 and 9.

[22] Note that another way in which investment treaties may have indirectly influenced the development of national law in some countries is through the World Bank Guidelines for the Treatment of Foreign Direct Investment. These Guidelines were inspired by BIT obligations and, throughout the 1990s, the World Bank encouraged developing country governments to incorporate them into their own legal systems (Shihata 1993; Poulsen 2015, ch. 4). The World Bank and the IFC continue to encourage developing countries to include provisions inspired by BIT obligations in their national investment laws – see e.g. Appendix 6 to the World Bank's Law Reform Handbook (2010), which provides the basis for the IFC's advisory work on investment law reform to developing countries.

[23] We return to possible explanations for the different conclusions of these two studies in the sub-section on methological issues, below.

none of the three countries had established an institutional mechanism to ensure that administrative decision-making was consistent with the provisions of investment treaties.

The divergent findings of these studies suggest that an important question for further research is whether investment treaties have different impacts on domestic governance in different states and on different actors within government within the same state. One concern noted by Sattorova, Omiunu and Erkan (2016) is that:

> the high costs of putting in place dispute prevention and management mechanisms also highlight the fact that the ability of host governments to actively prevent their exposure to international liability by changing domestic governance practices can be severely circumscribed by the very weaknesses in the domestic legal and bureaucratic culture which international investment law allegedly aims to improve.

In addition, it remains an open question whether the extent to which a state internalizes the constraints of investment treaties is related to that state's form of government – i.e. democratic, authoritarian, etc. There is a wider body of scholarship that suggests that compliance with international law varies with regime type (Slaughter 1995; see also Alter 2014, chs. 2 and 9), although this literature largely relates to compliance with obligations of international law that are not backed by an enforcement mechanism akin to investment treaty arbitration.

Apart from the impact of investment treaties on administrative decision-making, a related issue is the impact of investment treaties on domestic courts and legal institutions. As explained in Chapter 4, investment treaties place obligations on states to ensure that foreign investors receive a basic level of procedural fairness in domestic court proceedings. If these treaty obligations encourage states to reform their judicial systems, they could lead to improvements in respect for the rule of law. Testing this hypothesis raises similar empirical questions to hypotheses concerning the impact of investment treaties on administrative decision-making – i.e. to what extent are investment treaty provisions internalized within institutions of the host state? Moreover, there is a further mechanism by which investment treaties could affect domestic judicial institutions. This mechanism rests on the premise that foreign investors have an interest in a functioning court system in the states in which they invest. By giving foreign investors the possibility to resolve disputes with the host state through investment treaty arbitration, investment treaties could *reduce* the incentive of foreign investors to lobby for improvements in judicial quality (Ginsburg 2005; see also Mazumder 2015). If this hypothesis is correct, investment treaties that provide for investment treaty arbitration could have a negative impact on the quality of judicial institutions.

These hypotheses about the potential impact of investment treaties on judicial institutions give us three empirical propositions outlined in Figure 6.1 below. The first two are mutually exclusive, whereas the third may be correct regardless of whether either of the first two are correct.

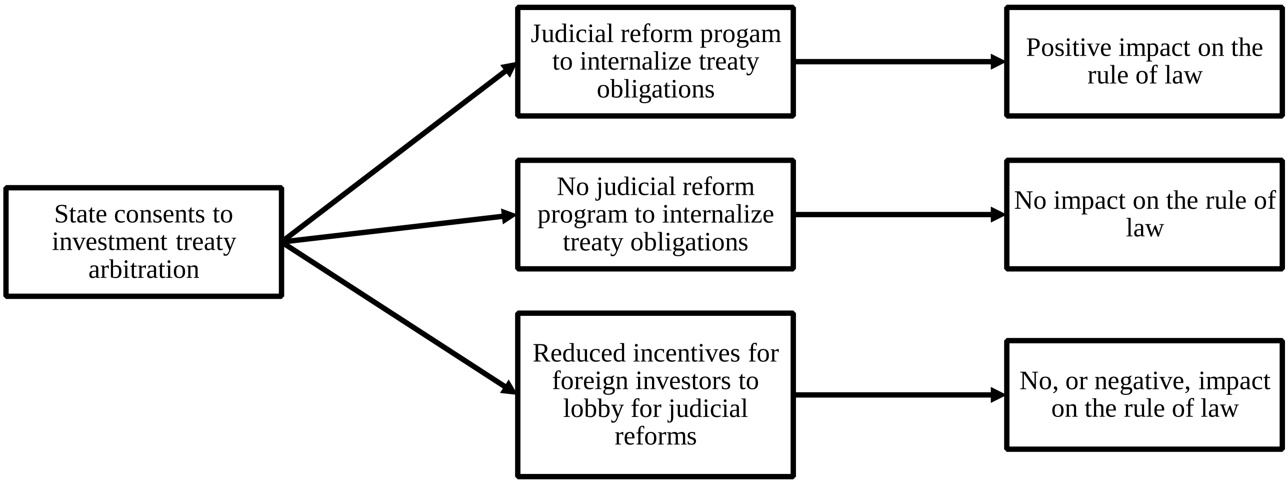

FIGURE 6.1. INVESTMENT TREATIES AND JUDICIAL INSTITUTIONS: THREE OPTIONS

Relatively little empirical research has been done to test these hypotheses. Ginsburg (2005) examines the impact of signing a BIT on changes in the quality of governance in developing countries over subsequent years, as rated by the World Bank's Worldwide Governance Indicators (WGI). He concludes that signing a BIT does not have a positive impact on governance and has a minor negative impact on the 'rule of law' indicator. This is consistent with the hypothesis that investment treaties reduce investors' incentive to advocate for improvements in the legal system of the host state by giving them access to an alternative system to resolve disputes. Aranguri (2010) reports that the number of BITs a country signs leads to improvement in the country's rating on the WGI 'regulatory quality' indicator but none in the 'rule of law' indicator. He interprets these findings as consistent with the hypothesis that investment treaties improve the quality of administrative decision-making but do not improve the quality of judicial institutions.[24] Sasse (2011) examines the impact of the number of BITs a country ratifies on the WGIs. He finds that the number of BITs a country ratifies has a negative association with 'regulatory quality' and 'the rule of law' indicators but that these correlations are not statistically significant. This is an important area for future research.

Methodological challenges

Quantitative studies of the impact of investment treaties on government decision-making face similar methodological challenges to those faced by studies examining the relationship between investment treaties and FDI. Foremost among these is endogeneity. As mentioned, many developing countries adopted investment treaties at the same time that they implemented reforms of their domestic investment regimes (see further discussion in Chapter 8). As such, investment treaties may be correlated with improvements in governance and the rule of law, but not because the former had any causal impact on the latter.

[24] He also finds that adverse arbitral awards under BITs lead to decreases in regulatory quality and the rule of law in developing countries. It is not immediately obvious why this should be the case. Bearing in mind that the World Bank's indicators are based on survey respondents' perceptions of governance, one possible explanation is that adverse awards influence perceptions of governance.

Measuring the quality of ‘governance’ or the ‘rule of law’ also raises difficult issues. Existing quantitative studies generally use the WGIs. However, the WGIs aggregate data from a wide range of variables. For example, the WGI rule of law index includes some sub-components that are relevant for the study of investment treaties, such as expropriation risk and other property right measures, but it also includes others that are not, such as tax evasion, trust in the police and human trafficking. Moreover, the WGIs are based largely on survey responses and, therefore reflect the perceptions of respondents. A large share of respondents to WGI are either business-people or commercial risk-rating agencies and perceptions among these groups – for example, perceptions of problems with ‘burdensome’ taxes or rules – do not necessarily correspond to the ‘quality’ of governance as perceived by other groups (Kurtz and Schrank 2007a).[25] This problem highlights the underlying challenges arising from the contested character of ‘good governance’ and ‘the rule of law’ as concepts.

Qualitative studies face a range of different challenges. Foremost among these is that investment treaties potentially implicate a vast array of host state conduct. As such, it is difficult to draw strong conclusions from interviews with officials within any one agency of government. For example, Coté (2014) and Van Harten and Scott (2016) paint very different pictures of the level of awareness of investment treaties among government officials in Canada. One possible explanation for these divergent findings is simply that different arms of the Canadian government have different levels of knowledge of investment treaties and different institutional practices. A second challenge is that government lawyers with direct knowledge of the impact of investment treaties of government decision-making are often unable to speak about their experiences due to confidentiality constraints (Van Harten and Scott 2016). There are no easy solutions to these challenges.

At the time of writing, there is insufficient evidence either to confirm or to reject claims about the impact of investment treaties on host government decision-making processes. However, the evidence that is available raises serious questions about the assumption that states regularly and reliably internalize the constraints that investment treaties place on administrative and judicial action within their domestic systems. Until more research is available, claims that investment treaties promote ‘good governance’ or ‘the rule of law’ should be treated with caution.

MACROECONOMICS OF INVESTMENT LIBERALIZATION PROVISIONS

As outlined in Chapter 4, a small but growing minority of investment treaties contain provisions governing the admission and establishment of new foreign investment. There are two main types of these ‘pre-establishment’ provisions – namely, MFN and NT provisions. Both prohibit discrimination between investors and investments on the grounds of nationality in the admission and establishment of new investments. Pre-establishment NT is the more powerful obligation, as it gives foreign investors the right to establish new investments in a host state on the same terms as domestic investors. As such, this section focuses on the macroeconomic implications of pre-establishment NT.

Investment liberalization provisions are a central concern for policy-makers and treaty negotiators in practice. For example, both the European Commission and the Office of the US Trade

[25] Citizen surveys are also included in the indicators, but only from Africa and Latin America and even there they play a comparatively small role to that of corporate entities and their responses differ in important ways from that of business people (Kurtz and Schrank 2007b). For a response to these criticisms, see Kaufmann, Kraay, and Mastruzzi (2007).

Representative (USTR) cite investment liberalization as a main negotiating objective for the investment chapter of TTIP (USTR 2014; European Commission 2015d), and disagreements between the US and China about the inclusion of pre-establishment national treatment stymied the negotiation of a prospective US-China BIT from 2008 to 2013 (Weijia 2015). However, to date the theoretical and empirical implications of the investment liberalization provisions of investment treaties have received relatively little academic attention.

The economics of investment liberalization

Chapter 2 examined the underpinnings of arguments in favour of a state voluntarily providing pre-establishment national treatment to foreign investors as a matter of domestic law and policy. To summarise: simplified theoretical models of the international economy, such as the Heckscher-Ohlin model, imply that a non-discriminatory regime for new cross-border investment benefits both capital importing and capital exporting countries. Moreover, evidence of positive spillovers associated with inward FDI provides a further reason not to discriminate against foreign investment. To be sure, these two observations do not imply that host states should not regulate investment. Rather, they suggest that any restrictions or conditions on new investment – for example, prohibition of activities that cause unacceptable environmental impacts or restrictions on mergers that lead to monopolies – should be applied equally to both domestic and foreign investors.

The economic case *against* pre-establishment national treatment rests on arguments similar to those made in support of ‘infant industry’ protection in international trade. In its simplest form, the argument is that new domestic companies require protection from foreign competition in order to grow to the size and level of sophistication required to compete with foreign-owned firms. Although favouring inefficient domestic firms is costly in the short-term, such policies could benefit a state in the long-term if they accelerate productivity growth for domestic firms and allow them to realise economies of scale (Melitz 2005). Such arguments depend on the presence of externalities, asymmetric information, monopoly rents or other market imperfections (e.g. Rodrik 2008; World Bank 2009).

Historically, many countries placed discriminatory restrictions on the entry of new foreign investment. For example, China has encouraged FDI in many manufacturing sectors, while requiring that investment in sectors like consumer electronics be made by way of joint ventures with local partners (for a positive account, see e.g. Rodrik 2006). These policies go some way to explaining why, at the time of going to press, China has not ratified any investment treaty providing for pre-establishment national treatment.

As described in Chapters 1 and 2, countries have progressively lifted restrictions on FDI since the 1990s. Outright prohibitions on FDI are much rarer than they once were. And in many sectors and countries governments discriminate *in favour* of foreign investors, offering special tax breaks or incentives that are not available to domestic investors (Johnson and Toledano 2016). Nevertheless, all countries impose discriminatory conditions on the entry of FDI in at least some sectors (OECD 2015b). Such restrictions are imposed for a variety of reasons. Countries restrict foreign investment in the arms sector for strategic reasons; foreign investment in print and broadcast media is often limited for reasons relating to media independence and plurality; and foreign investment in utilities is often subject to conditions because such industries are expected to provide broad public access to services. Decisions about whether to admit foreign investment and, if so, on what terms continue to raise a range of competing policy considerations.

A large body of scholarship debates the merits of government policies that actively seek to direct a state's economic development compared to laissez-faire policies that emphasise the importance of non-discriminatory treatment of foreign investment (e.g. Pack and Saggi 2006). Rather than reviewing these debates in detail, our purpose here is to assess their relevance for investment liberalization provisions of investment treaties. For even if the economic arguments in favour of unilaterally implementing a policy of pre-establishment national treatment are correct, a central question is whether there is any economic benefit to a host state from entering into *binding commitments* in an investment treaty to grant pre-establishment national treatment.

The Economics of Investment Liberalization Commitments in Investment Treaties

The first section of this chapter highlighted two different causal mechanisms by which the investment protection provisions of investment treaties could affect foreign investors' investment decisions. The first of these is commitment theory. In the case of the post-establishment treatment of foreign investment, the putative need for an internationally binding commitment arises because the investor has sunk capital in the project, which is then at risk from policy reversals by the host state (Guzman 1998). In contrast, foreign investors' capital is not at risk from policy reversals by the host state that change the conditions governing entry of *new* foreign investment. Due to this fundamental point of difference, commitment theory does not provide an economic rationale for a host state to enter into pre-establishment national treatment obligations in investment treaties.[26] A state that wished to adopt a policy of pre-establishment national treatment could achieve the same benefits by unilaterally implementing such a policy through its national law,[27] while still retaining the flexibility to reimpose restrictions on new foreign investment in the future.

The second causal mechanism by which the investment protection provisions of investment treaties could affect foreign investors' investment decisions is signalling theory. Via this logic, the inclusion of pre-establishment national treatment provisions in investment treaties could send a signal to foreign investors that the country in question has laws and policies in place that are conducive to new foreign investment. For a signal to convey any information it must be costly. Binding pre-establishment NT provisions in an investment treaty satisfy this requirement, because such provisions make it costly for the state in question to abandon policies liberalizing the entry of new foreign investment in the future. However, the ability for investment liberalization provisions to have macroeconomic effects in practice via signalling depends on a range of further empirical assumptions – for example, the assumption that prospective foreign investors are able to distinguish between investment treaties that guarantee pre-establishment NT and those that do not. Empirical studies have yet to test these assumptions directly.[28]

[26] Similarly, Chapter 5 shows that the 'hold-up' problem and the problem of 'over-regulation' stem from the sunk costs that a foreign investor incurs when it makes an investment in the host state. In the absence of sunk costs, these problems do not arise.

[27] This is analogous to the situation in simplified theoretical models of international trade, which predict that it is efficient for a country to liberalize unilaterally, unless the country is large enough that its tariffs induce terms-of-trade effects (Krugman, Obstfeld and Melitz 2015).

[28] Several studies have examined the impact of preferential trade agreements on FDI. Many recent preferential trade agreements (PTAs) contain investment chapters and such investment chapters often contain pre-establishment national treatment and MFN provisions. However, studies of the impact of PTAs on FDI do not normally distinguish among PTAs on the grounds of whether they contain such chapters or provisions (e.g. Medvedev 2012).

Some empirical studies do speak to these questions indirectly. In one quantitative study, Lesher and Miroudot (2007) find that preferential trade agreements with 'stronger' investment provisions lead to a greater increases in FDI. In a similar study, Dixon and Haslam (2015) find that only 'strong' investment treaties increase inward FDI for Latin American countries. Both studies use indexes for the 'strength' of a treaty's investment provisions that include an assessment of whether the treaty includes pre-establishment liberalization commitments, among other factors. However, neither study allows the effect of investment liberalization provisions, if any, to be isolated. As noted in the first section of this chapter, there are also significant methodological difficulties associated with indexes of treaty 'strength'.

Berger et al. (2013) seek to isolate the impact of pre-establishment liberalization provisions more directly. They conclude that the inclusion of such provisions in BITs does not have any additional impact on FDI, but that the inclusion of identical provisions in preferential trade agreements does result in significant additional FDI. The authors suggest that this apparently anomalous result could be explained by the limited public attention that BIT negotiations receive, and hypothesise that investors are unaware of the actual legal content of investment treaties. If so, this would be consistent with the view that, insofar as they have any impact, investment treaties' liberalization provisions influence FDI flows through signalling effects. That said, it is worth re-iterating that very little research has been conducted on this question. For studies of the impact of investment treaties' liberalization provisions, disentangling the role of treaty commitments and national level reforms raises particular difficulties. Given the caveats about methodology noted in the first section of this chapter, claims about the impact of liberalization provisions in investment treaties on FDI should be treated with caution.

The political economy of investment liberalization commitments

Insofar as scholars have considered the economics of investment treaties' investment liberalization provisions, they have generally focused on benefits arising from the political economy of investment liberalization (e.g. Vandevelde 2000). Allowing foreign investment in a sector that was previously closed or restricted to foreign investors creates both winners and losers within host countries. The most obvious losers are inefficient domestic firms in the liberalized sector, which find their profit margins squeezed by more efficient foreign competitors. The obvious winners are workers in the liberalized sector in the host state, although consumers and suppliers also potentially benefit (Pandya 2014).[29] Even if the benefits to the winners significantly outweigh the costs to the losers, the political influence of protected domestic firms may make it difficult for host governments to open their economies to foreign investment (Grossman and Helpman 1996). There is a substantial literature in the political economy of trade policy showing how small and well-organised industry lobbies with an interest in protection can influence national trade policy (e.g. Grossman and Helpman 1994; see also Chapter 5).

In theory, the negotiation of binding and reciprocal liberalization commitments in investment treaties could encourage the formation of broader political coalitions in favour of investment liberalization. For example, in the context of investment liberalization negotiations, workers in the host state and firms with an interest in investing abroad could be mobilised in support of the treaty as a counter-balance to firms campaigning for protection at home. This could allow states to bind

[29] These distributive effects of foreign investment are consistent with the predictions of the Heckscher-Ohlin model, which is introduced in Chapter 2.

themselves to a package of binding and reciprocal commitments that would be politically difficult to maintain if implemented solely through national law.

In Chapter 8 we discuss the extent to which developing countries saw investment treaties – for instance those with liberalization provisions – as devices to 'tie in' or promote liberalizing reforms. However, to date, there has been little empirical research into whether investment treaties alter political economy dynamics in a way that allow host states to enact or maintain liberalizing reforms. If investment treaties do have political economy effects, one would expect the inclusion of investment liberalization provisions in investment treaties to lead to the 'opening' of new sectors to foreign investment on a national treatment basis. In contrast, if binding investment liberalization commitments are primarily intended to operate as signals, we would expect such commitments to reflect prior domestic reforms – i.e. for host states to enter into binding commitments only in relation to sectors in which foreign investment is already allowed on a national treatment basis as a matter of domestic law. These are important questions for future research.

Different political economy considerations arise in relation to the practicalities of negotiation of liberalization commitments. All investment treaties that contain pre-establishment NT provisions also contain reservations to those provisions. Developed states generally have greater capacity within government to foresee situations in which pre-establishment NT obligations could conflict with future political priorities. Stiglitz (2008) suggests that they are also more likely to have industry lobbies that understand the implications of treaty negotiations for their interests, although this proposition has not yet been subject to empirical testing. This imbalance in information, expertise and negotiating capacity may go some way to explaining why, in BITs between developed and developing countries, the developed country often has the more extensive list of reservations to pre-establishment national treatment (Cotula 2014).[30]

Manger (2009) argues that political economy dynamics in home states also play a central role in explaining the inclusion of investment liberalization provisions in the investment chapters of PTAs. Drawing on case studies that include EU, Japanese and US PTA negotiations with Chile and Mexico, he argues that home state firms lobbied for the inclusion of investment liberalization provisions with a view to establishing export platforms in the host country to supply the home state market. The inclusion of preferential investment liberalization and tariff reduction provisions in the same PTA was important, as they gave home state firms mutually reinforcing advantages over firms from other developed countries seeking to use the host state as an export platform from which to supply the home state's market. Manger's thesis is provocative in that it suggests that the protectionist objectives of home state at least partly drove the inclusion of investment liberalization provisions in investment treaties. Whether the same is true for the investment liberalization provisions of bilateral and multilateral investment treaties is an important question for further research. Manger's thesis also draws attention to possible interactions between the investment liberalization provisions and non-investment provisions of PTAs – particularly, in relation to their impact on FDI. This, too, is an important question for further research.

[30] We see a similar effect in relation to the negotiation of service liberalization commitments in PTAs between developed and developing countries (VanGrasstek 2011).

CONCLUSION

This chapter has examined the macroeconomics of investment treaties. Most of the empirical literature on investment treaties remains narrowly focused on the question of whether investment treaties promote inward FDI. Much of this work suggests that the investment protection provisions of investment treaties do have some positive effect on FDI, although these findings should be interpreted in light of the significant methodological challenges facing econometric studies. Qualitative studies suggest that investment treaties influence some investors' investment decisions, but that such effects are uncommon.

As we know relatively little about *how* and *why* investment treaties affect different types of investment in different types of host states, strong claims about the macroeconomic effects of investment protection provisions in investment treaties should be treated with caution. Investment treaties may change the legal structure of foreign investments, for instance, rather than their destination and volume. Equally, even if investment treaties increase investment flows to some countries, recall from Chapter 2 that not all foreign investment necessarily promotes economic development. Similarly, recall from Chapter 5 that investment treaties could, in theory, promote 'over-investment' by encouraging investors to proceed with investment projects that have negative externalities (knowing that states may have to pay compensation if they implement future measures to reduce such externalities).

The second and third sections of this chapter examined the impact of investment treaties on the quality of governance in the countries that sign them and the implications of investment liberalization provisions, respectively. Both sections also highlighted gaps in our understanding of the macroeconomic effects of investment treaties. Although some legal scholars make bold claims about the ability of investment treaties to promote 'good governance' or 'the rule of law' in the countries that sign them, such claims have been subject to little empirical scrutiny. Equally, few studies have considered the macroeconomic impact of liberalization provisions and we therefore know little about their impact on investment flows or political economy dynamics within host states. This is particularly important for North-North investment treaties. Assuming that they lead to reciprocal investment liberalization at the domestic level, liberalization provisions are the most plausible way such agreements can promote investment among developed countries.

APPENDIX

TABLE 6.1. QUANTITATIVE STUDIES EXAMINING THE IMPACT OF INVESTMENT TREATIES ON FDI

Author and date	**Causal mechanism**	**Main reported finding of the study**
Aisbett (2009)	Commitment and signalling effects	BITs with OECD countries do not increase FDI to developing countries either through commitment or signalling effects
Banga (2008)	Signalling effects	BITs with developed countries increase FDI to Asian developing countries through signalling effects
Berger, Busse, Nunnenkamp and Roy (2011)	Commitment effects	BITs with full advance consent to investment treaty arbitration have no greater impact on FDI than other BITs, suggesting that BITs do not increase FDI through commitment effects
Berger, Busse, Nunnenkamp and Roy (2013)	Commitment effects	BITs and regional trade agreements with full advance consent to investment treaty arbitration have no greater impact on FDI than other investment treaties, suggesting that investment treaties do not increase FDI through commitment effects
Blanton and Blanton (2012)	Commitment effects	US BITs decrease US outward FDI stock in partner countries
Busse, Königer and Nunnenkamp (2010)	Commitment effects	BITs increase FDI flows to developing countries through commitment effects
Büthe and Milner (2009)	Signalling effects	BITs increase FDI to developing countries through signalling effects
Büthe and Milner (2014)	Signalling effects	Preferential trade agreements with investment protection provisions akin to those found in BITs increase FDI to developing countries through signalling effects
Colen and Guariso (2013)	Signalling effects	BITs increase FDI in the mining sector in Central and Eastern European countries through signalling effects
Colen, Persyn and Guariso (2016)	Signalling effects	BITs increase FDI in sectors with high sunk costs in Central and Eastern European countries through signalling effects
Coupé, Orlova and Skiba (2009)	Commitment effects	BITs with developed countries increase FDI to transition countries
Desbordes and Vicard (2009)	Commitment effects	BITs increase OECD countries' outward FDI stock in partner countries (i.e. commitment effect)
Danzman (2016)	Signalling effects	BITs with developed countries increase FDI inflows to infrastructure investment in developing countries, but do not increase total FDI inflows
Egger and Merlo (2007)	Commitment effects	BITs increase OECD countries' outward FDI stock in partner countries (i.e. commitment effect)
Dixon and Haslam (2015)	Commitment and signalling effects	BITs do not increase FDI through signalling effects; 'strong' investor provisions in ratified BITs among Latin American states increase FDI through commitment effects in the context of, or combined with, trade agreements.
Egger and Pfaffermayr (2004)	Commitment effects	BITs increase OECD countries' outward FDI stock in partner countries (i.e. commitment effect)
Gallagher and Birch (2006)	Commitment and signalling effects	BITs with the US do not increase FDI in Latin American countries from the US, but do increase FDI from other countries through signalling effects
Grosse and Trevino (2009)	Signalling effects	BITs increase FDI to Central and Eastern European countries through signalling effects
Haftel (2010)	Commitment effects	Ratified US BITs increase FDI from the US (i.e. commitment effect)
Hallward-Driemer (2003)	Commitment effects	BITs with OECD countries do not increase FDI to developing countries
Kerner (2009)	Commitment and signalling effects	BITs with OECD countries increase FDI to developing countries through both commitment and signalling effects

Kerner and Lawrence (2014)	Commitment effects	US BITs increase investment in fixed capital by US firms in partner countries.
Lesher and Miroudot (2007)	Commitment effects	BITs do not increase FDI through commitment effects; investment provisions in preferential trade agreements do increase FDI through commitment effects.
Neumayer and Spess (2005)	Signalling effects	BITs increase FDI to developing countries through signalling effects
Peinhardt and Allee (2012a)	Commitment effects	BITs with the US do not generally increase FDI
Peinhardt and Allee (2012b)	Commitment effects	BITs with OECD countries increase FDI from partner countries, but there is no difference between the effect of BITs with and without investment treaty arbitration.
Salacuse and Sullivan (2005)	Signalling effects	US BITs increase FDI to developing countries from all sources (i.e. signalling effect); other OECD BITs have no significant signalling effect
Sokchea (2007)	Signalling effects	BITs with OECD countries increase FDI to Asian countries through signalling effects
Swenson (2005)	Signalling effects	BITs increase FDI to developing countries through signalling effects
Tobin and Rose-Ackerman (2005)	Commitment and signalling effects	BITs with the US do not increase FDI to developing countries from the US; in general, BITs do not increase FDI through signalling effects.
Tobin and Rose-Ackerman (2011)	Signalling effects	BITs with OECD countries increase FDI to developing countries through signalling effects. These effects are greater for host countries with stronger domestic political institutions

The Political Economy of the Investment Treaty Regime, Chapter 6. Oxford: Oxford University Press, 2017.