

MAKING TREATIES MATTER: THE INTERACTIVE EFFECT OF BIT STRENGTH AND
DOMESTIC POLITICAL CONSTRAINTS ON FDI

Sarah Bauerle Danzman

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Approved by:

Layna Mosley

Thomas Oatley

James A. Stimson

ABSTRACT

SARAH BAUERLE DANZMAN: Making Treaties Matter: The Interactive Effect of BIT Strength and Domestic Political Constraints on FDI
(Under the direction of Layna Mosley.)

Under what conditions can governments use international commitments such as Bilateral Investment Treaties (BITs) to attract foreign direct investment (FDI)? Previous research on the effect of BITs on FDI flows have largely ignored the role of domestic political variables in conditioning the effect of international treaties and institutions. The ability of BITs to attract FDI should depend both upon the extent to which treaties help make contracts more complete through pre-consent to investor-state arbitration and the extent to which domestic political constraints reassure firms that governments will honor their international commitments. Using a time series cross sectional dataset of 118 developing countries from 1970 to 2000, I find statistical support for my hypotheses. Treaty strength and domestic political constraints have an interactive effect on FDI inflows to developing countries. BITs with no pre-consent to arbitration have no effect on FDI inflows regardless of domestic political constraints. BITs that do require pre-consent to arbitration, however, have an increasing and statistically significant positive effect on FDI inflows as domestic political constraints increase. These findings reiterate the importance of the interactive effect of international and domestic institutions. The ability of states to benefit from an open international economic system depends in part upon domestic politics. International treaties and institutions can help governments mitigate informational problems that impede growth, but their ability to do so depends upon the strength of domestic institutions to hold government to their commitments.

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Introduction

Under what conditions can governments in developing countries make firms believe it is safe and profitable to directly invest within their domestic economies? Do firms require specific types of domestic institutions in order to mitigate the uncertainty associated with directly investing in foreign domains? Or, can countries with histories of weak political institutions diminish the negative economic effects associated with political uncertainty through international treaties and institutions?

As foreign direct investment (FDI)¹ has become an increasingly important source of development capital in emerging economies, the question of how governments can attract such capital has garnered much interest from scholars of political economy. At the heart of an explanation of the political determinants of FDI is an analysis of how governments can affect firm behavior. Under what conditions will firms want to invest within a developing economy? The literature on firm decision-making as well as early literature on the bargaining dynamics between governments and firms emphasize the importance of mitigating firm uncertainty over future government behavior (Williamson 1985; Bernhard and Leblang 2006; Vaaler, Schrage and Block 2005; Spanakos and Renno 2009; Desbordes 2009). Because firms have more bargaining power before directly investing than they do after sinking costs into a direct investment, multinational enterprises are particularly worried that governments will extract rents from foreign firms through higher taxation, performance requirements, discriminatory regulations that favor domestic firms, and even expropriation (Kobrin 1987; Dunning 1993). This fear is particularly poignant in situations in which multinational firms make high up front and immobile capital investments and when domestic firms lobby governments for protection from foreign entrants. Thus, a central question for scholars of the political determinants of FDI is how governments can reduce investor uncertainty about policies towards foreign firms in the future and how governments can commit to investor friendly policies over time?

Two rather distinct research programs have emerged around either a domestic level of analysis or a focus on the effects of international institutions. Jointly, these literatures ask a broader question about the extent to which firms' beliefs about state behavior are conditioned by institutional commitments. However, individually they tend to either address how domestic political institutions reduce investor uncertainty or how international treaties and institutions affect the investment environment.

For instance, research that emphasizes the domestic level of analysis often focuses on the de-

¹ FDI is defined as a sufficient ownership stake in a business venture to command corporate control, often quantified as 10% ownership or more

gree to which various domestic institutions can help governments make a credible commitment to investor friendly policies. Several authors argue governments can use central bank independence or fixed exchange rates to commit to a monetary policy of low inflation (Keefer and Stasavage 2003; Bearce 2008; Thies and Arce 2009). A decentralized state with weak economic institutions will have a harder time maintaining the fiscal discipline firms prefer (Calvo and Mishkin 2003; Rodden 2006). Others focus on the effects of electoral institutions and partisanship on FDI flows (Pinto and Pinto 2008; Garland and Biglaiser 2009).

At the same time, a growing body of literature focuses on the ability of international treaties and institutions to act as credible commitments to and costly signals of liberal economic policies (Simmons 2000; Simmons and Hopkins 2005; Bütthe and Milner 2009; Goldstein, Rivers and Tomz 2007). For example, Gray (2009) finds membership in the IMF allows Eastern European countries to signal their commitment to a investor friendly political environment. Several studies argue membership in the WTO, the IMF, and regional trade treaties reassure firms either through creating a credible commitment to open economic policies or by signaling a government's resolve for maintaining a liberal investing environment. Bütthe and Milner (2008) argue preferential trade agreements help governments capture more FDI inflows through a similar causal mechanism. In other words, developing countries may be able to use international treaties to compensate for weak domestic institutions.

However, while international level variables help to shape the global investing environment, the effects of international institutions may be highly conditional on domestic institutions. In order for international institutions to help reduce investor uncertainty, they must actually constrain state behavior.² The ability of institutions to establish norms of behavior and means of identifying cheating that help lower uncertainty about states' preferences and policies depend upon the extent to which institutional commitments create costs to cheating and thereby help separate sincere promises of cooperation from insincere ones. So, if international institutions generate information by creating costs to defection, an understanding of under what conditions defection actually would be costly is essential to an understanding of institutional effectiveness. In other words, international treaties and institutions may be complements rather than substitutes for weak domestic political environments since domestic governments ultimately decide whether to adhere to such commitments.

The importance of domestic level factors in conditioning the effect of international institutions is not a novel theoretical contribution. Indeed, the second generation of international institutional scholars have focused much of their attention on the mediating effects of domestic

² Unless, of course, institutions function solely as costly signals. For more on how to interpret treaty compliance see Downs, Rocke and Barsoom (1996) and von Stein (2005).

institutions and other political conditions. Within the literature on FDI, Jensen (2003) argues that federal domestic systems make international commitments more credible. However, much of this literature ignores the fundamental importance of interacting the international with the domestic in favor of a reductionist methodological strategy (Oatley forthcoming).

In this paper, I test the ability of bilateral investment treaties (BITs) to attract foreign direct investment (FDI) as contingent on both the degree to which such treaties generate information through pre-consent to investor-state arbitration and the extent to which domestic political institutions constrain government behavior. I do so because the literature on BITs, in particular, does a poor job of embedding an understanding of the effectiveness of international treaties within a broader context of the complex ways in which international "push" factors and domestic "pull" factors affect the ability of institutions to mitigate the informational problems that prevent cooperative behavior.

My analysis proceeds in five parts. The next section presents background on the emergence of a BIT regime as well as a review of the existing literature on the ability of BITs to attract FDI. The following section presents my theory for how BITs and domestic political constraints should interactively affect firms' decisions to directly invest in potential host countries. The third section operationalizes my variables of interest and explains my design. The fourth section presents and interprets my statistical findings as well as performs some robustness checks and tests for alternative explanations. The final section concludes with implications and suggestions for further research.

Background

In this section, I first discuss the development and proliferation of bilateral investment treaties as an institutional solution to the uncertainty firms face when directly investing in developing countries. I then outline the existing literature on the effectiveness of BITs in attracting FDI and identify central problems of these analyses.

BITs and FDI

FDI presents a political problem to multinationals for two related reasons. First, firms have a bargaining advantage *ex ante* when governments are trying to attract investment, but are much weaker after they have sunk immobile investments into the host market. This time-inconsistency of bargaining strength incentivizes governments to make promises of business-friendly behavior they never intend to keep in order to attract FDI and to then renege on those promises once

firms have sunk their investments.³ Second, foreign investment is made in an incomplete contracting environment (Williamson 1985). When a firm invests domestically, it has clear rights under domestic law that protect the fulfillment of contracts and the right to seek damages to breach of contract in a domestic court system. A foreign investor's rights in a domestic court, however, are more precarious. Foreign firms often have little and varying legal recourse in domestic courts. As such firms are wary when investing internationally that host governments will expropriate firm assets without appropriate compensation. Indeed, decolonization sparked a wave of expropriations without compensation as newly independent states nationalized foreign firms. It is not surprising that BITs originated in the late 1950s and began as an instrument used mostly between European ex-colonizers and the post-colonial south.⁴ Thus the central problem that firms face when they want to invest directly is that they want assurances of protection given the uncertainty of an incomplete contracting environment, but any promises a host government makes *ex ante* is incredible due to the time inconsistency of firms' and government's bargaining strength.

BITs, and treaties with similar provisions,⁵ are an attempt to mitigate the uncertainty of incomplete contracts between firms and governments. These treaties are agreements between states, but they provide specific legal protection for firms. The first BITs closely mimic the 1959 Draft International Convention on Investments Abroad and the OECD 1967 Draft Convention (Yackee 2008, 415). Typical terms include national treatment, a promise to not invoke performance requirements,⁶ the right to repatriate earnings, and the right to fair compensation in the event of expropriation. While these four terms represent the core legal provisions of this class of treaties, BITs are increasingly including specific language about arbitration in the event of investment disputes between firms and host states arising from violations of these four key protective principles.

The extent to which BITs include specific dispute settlement mechanisms has changed over time. Early BITs often did not provide standing arbitration agreements. However, over time most BITs have come to include pre-consent to a dispute settlement mechanism in which firms

³ See Kobrin (1987) for a seminal work on obsolescing bargaining and FDI.

⁴ The first was signed between West Germany and Pakistan in 1959. The majority of early BITs were between European and developing countries. The United States initially refrained from BIT negotiations and pushed instead for a multilateral investment protection regime, and only signed its first BIT (with Panama) in 1982. European countries still lead in the number of treaties in force. No BITs exist between two OECD countries; BIT cosigners are characterized by asymmetrical power. See Elkins, Guzman and Simmons (2006) for an extended history of BIT diffusion.

⁵ The majority of the empirical literature on BITs look only at bilateral investment treaties. However, there are several other classes of treaties that have different names but are functionally equivalent to BITs. Yackee (2008) argues that studies of the effects of these treaties on FDI flows should consider all treaties that include the "core" provisions of BITs (national treatment, no performance requirements, right to repatriate earnings, and right to compensation). My analysis includes these "BIT-like" treaties.

⁶ Performance requirements specify a percentage of local sources a firm must use in production

can request arbitration against states. This evolution is reflective of a general trend toward increased legalization of interstate behavior.⁷ But, this investor-state dispute settlement is also unique in that trade treaties tend to address arbitration between two states. Allowing firm-initiated arbitration makes the decision to file a complaint less of a strategic political decision because firms do not have to convince their home state to advocate for them, but rather can instigate disputes on their own behalf. Increasingly, BITs tend to specify the International Centre for Settlement of Investment Disputes (ICSID) as the facilitator of dispute settlement. This represents a change from either *ad hoc* arbitration or none at all. ICSID was established through a multilateral treaty designed by the International Bank for Reconstruction and Development (the World Bank) and has been in force since 1966. The autonomous institution facilitates arbitration of disputes between investors and states,⁸ with the consent of both parties. Jurisdiction requirements mandate that BITs may only use ICSID to facilitate arbitration when both signatory states are ICSID Contracting State.⁹ Under ICSID arbitration, disputing states face specific rules for how to create arbitration panels as well as rules about the speed of arbitration. ICSID also mandates disclosure of all requests for arbitration and well as detailed outcomes of all proceedings. As of December, 2009, firms have used BIT provided jurisdiction to file 189 disputes through ICSID (ICSID 2010, 10).

Existing Research

The literature on BITs tends to focus on the central puzzle of whether and under what conditions such treaties help developing nations attract FDI. As such, the BIT literature reflects a broader literature on the extent to which and in what ways international institutions affect states more generally. In terms of whether BITs affect FDI flows, many studies find little support for the claim that BITs actually do increase FDI (Hallward-Driemeir 2003; Tobin and Rose-Ackerman 2005; Bubb and Rose-Ackerman 2007; Yackee 2009). If BITs really do not help states attract FDI, it is puzzling why states sign these treaties and in such numbers. However, the lack of finding significant effect of BITs may very well be due to a fundamental misunderstanding about the degree to which such treaties can influence firm decisions. FDI is largely driven by economic and firm-level factors. BITs can only affect flows of FDI at the margins. If a state has no characteristics required to attract FDI, a BIT will not increase investment flows. If a state has unique resources, especially scarce natural resources, that makes it attractive to FDI, not having a BIT will not prevent firms from investing. Rather, BITs can provide states a competitive edge

⁷ For more on this general trend, see the special issue of International Organization (2000 54:3) on Legalization.

⁸ ICSID arbitrates disputes pursuant to many classes of treaties, not just BITs.

⁹ As of February 2010, 144 states have ratified the ICSID treaty

against other states with similar endowments. We should expect that the effect of BITs on FDI will be at the margins rather than the primary causal factor. However, we should not mistake small effects for insignificant effects; as developing countries compete for mobile capital, small increases in FDI can still have important economic consequences.

The literature that focuses on the conditions under which BITs affect FDI flows tends to follow from Guzman (1998), who assumes BITs constrain state behavior by making reneging on treaty promises sufficiently costly. Guzman and others claim states that break treaty commitments face high reputational costs as firms become less likely to invest in countries with histories of disregarding property rights of foreign entities (Allee and Peinhardt 2010). Thus, most of the literature focuses on determining if BITs function by credibly committing states to pro-investment policies or by providing a costly signal of a state's preference for pro-investment laws but rarely suggesting BITs could be both. A credible commitment mechanism would suggest that BITs should increase dyadic FDI flows - firms should only be willing to invest directly if they have specific legal protections guaranteed through a treaty. Empirical evidence for this argument is mixed with some studies finding confirmatory support (Bütthe and Milner 2008; Neumayer and Spess 2005; Kerner 2009, see also Elkins, Guzman & Simmons 2006) while others find no evidence that BITs positively affect dyadic FDI flows (Yackee 2007, 2009). A costly signaling mechanism, however, would suggest BITs should increase aggregate FDI flows since all potential investors can observe a BIT ratification. Again evidence is mixed; some studies find BITs increase overall FDI flows (Kerner 2009) while others find no support for this claim (Hallward-Driemeir 2003; Tobin and Rose-Ackerman 2005; Bubb and Rose-Ackerman 2007).

The focus on credible commitments versus costly signals in this literature often ignores the possibility that BITs can both reassure firms of their specific protections through enforceable commitments as well as have positive externalities as firms in other home countries view BIT ratification as a public signal that a government is investor friendly. Moreover, the ability of such treaties to make firms feel protected depends upon firms' ability to identify non-compliance. BIT language, however, is far from clear; treaty provisions are often left open to differing interpretations and this makes it harder for firms to determine when governments cheat (Yackee 2008, 420). Even if firms can identify and punish cheaters, the domestic political benefits states gain from breaking commitments may outweigh the costs firms are able to impose on them. Thus, central to the ability of BITs to increase firms' confidence in host country contracts is the domestic political environment.

Given the growing emphasis of conditional effects of domestic political variables on international variables in the institutional literature more broadly, it seems odd that the extant literature on BITs tends to ignore this interaction. This is even more surprising given the rich

literature on how domestic level politics such as regimes type (Jensen 2006; Li and Resnick 2003; Evans 1979; Huntington 1968), electoral rules (Garland and Biglaiser 2009), federalism (Jensen 2003), rule of law (Li and Resnick 2003), and culture (Elkins, Guzman and Simmons 2006) affect FDI more generally. In contrast, studies of the effects of various institutions on FDI flows tend to use domestic level variables as controls rather than as a key part of the causal story (Büthe and Milner 2008, 2009; Hallward-Driemeir 2003; Tobin and Rose-Ackerman 2005; Bubb and Rose-Ackerman 2007; Yackee 2008, 2009; Neumayer and Spess 2005). Some spend considerable time addressing selection effects that may condition the extent to which treaty compliance is actually cooperation (Kerner 2009; Büthe and Milner 2008). However, selection effect models only help mitigate problems associated with the endogeneity of signing treaties. These models do not address the question of how domestic factors influence the substantive effects of treaties.

The ability of institutional arrangements such as BITs to affect FDI is mostly likely contingent on domestic politics. If domestic governments have poor reputations for complying with international commitments, a BIT will probably be unable to attract new FDI. Additionally, the domestic political constraints in a country provide firms with information about the probable stability of investor friendly policies and compliance with BIT terms. Thus, research on BIT effectiveness should consider domestic factors that would make investors believe countries will abide by their BITs.

Theoretical Framework

While governments sign BITs with other governments, their real audience is multinational enterprise; FDI-seeking states sign BITs to attract FDI while FDI-exporting states sign BITs to appease constituent firms. This means that states primarily sign BITs not to improve relations with their co-signers, but rather to make their market more legally and economically desirable to international businesses. This holds for both FDI-seeking countries and FDI-exporting countries; FDI-seeking countries want firms to believe directly investing in their economy is secure while FDI-exporting countries want firms headquartered within their borders to gain legal protection for their affiliates and subsidiaries as well as have ample options for investment and growth. Since the audience of BITs are firms, a country's propensity to sign a BIT is more closely linked to economic policy than foreign policy. While rivalrous states will probably not sign BITs with one another,¹⁰ firms will view such treaties between states with normalized relations as reflective of the degree to which each signatory government follows an open economic policy. I also assume that firms pay attention to the ratification of BITs. Firms in particular see BITs as a way to

¹⁰ The United States and Cuba, for example

protect their investment from seizure and costly host-country government regulation such as high taxation, limits on repatriation of earnings, and performance requirements.

Notice that governments do not view BITs as ways to make their host markets more desirable to firms due to ownership or internalization advantages.¹¹ BITs can only make host markets more desirable for locational reasons. That means that BITs provide the legal protection needed to make a country with a given factor/sector profile or consumer market profile more attractive from a legal sense. In other words, BITs cannot make a country that has no prior locational advantage suddenly attractive. Rather, firms first choose the structural features of an investment location they want and then look at a portfolio of countries that fit that structural profile. Countries with ratified BITs within that list are evaluated more favorably than countries that are not party to BITs. Countries with stronger BITs and with BITs signed specifically with the country from which the firm's FDI emanates are evaluated most favorably. This implies that BITs only play a factor when there are multiple countries with similar locational advantages, but variation in the presence and strength of BITs.

In an incomplete contracting environment, firms seek assurances that their investments will be protected and that they will have reasonable means of recourse in the event that contracts are breached. One option governments have to reassure firms is to sign and ratify a BIT. However, the degree to which firms will believe governments will depend upon the degree to which domestic political constraints lock in government commitments as well as the strength of the treaty commitment. I discuss each in turn.

Domestic Political Constraints

Firms care not only about the rules today, but also the rules tomorrow when directly investing. Because direct investment makes capital less mobile, firms care about and are wary of countries' incentives to renege on agreements after firms sink costs into their immobile investments. States develop incentives to renege from two main sources. The first stems from time-inconsistency problems. States have incentives to promise high levels of investor protection to attract firms, but less incentive to actually follow through on such promises when firms sink costs into immobile investments such as manufacturing plants and production chains. The second stems from leadership changes. A country's government often has a difficult time reassuring firms that governmental changes will not bring changes to policies towards investors' legal rights. The ability of treaties to attract investment will depend upon the extent to which domestic political institutions make renegeing on treaty commitments difficult.

¹¹ See Dunning (1993) for an overview of the conditions under which firms choose to directly invest overseas.

While agreeing to a BIT helps FDI-seeking states reassure firms that they will uphold investor protection, the promise to adhere to the terms of a BIT is only as good as a firm's belief that the current government will not renege on the treaty as soon as the firm sinks cost into its investment and the firm's belief that changes in leadership will not induce changes in treaty compliance. Firms calculate the ability of states to renege on their treaty commitments by the degree to which economic policy decision-making is centralized. In other words, firms care about the level of domestic political constraints leaders face when constructing economic policy. The more individuals required to agree to a change in policy, the more firms believe that states will honor their international commitments. Additionally, the greater the space between ideal policy positions of these individuals, the more firms believe states will have a difficult time renegeing on their commitments. This is because when key policy decision-makers hold differing policy preferences it becomes more difficult for the desire of one decision-maker to back out of an agreement to translate into an official policy change. In other words, once states change the status quo by signing and ratifying a treaty, multiple decision-makers with differing policy ideal points locks states in to the new status quo.¹² This makes their commitment to the provisions in the BIT more credible, thus making firms more comfortable directly investing in their market.

Hypothesis 1: The effect of BITs is conditional on the extent of domestic political constraints. BITs will help states attract more FDI as domestic political constraints increase

Treaty Strength

While domestic political constraints help to overcome time inconsistency problems, the strength of BITs help to overcome the investment risk associated with incomplete contracts. By institutionalizing governments' *ex ante* promises, BITs establish agreed upon rights and responsibilities. Furthermore, BITs protect against host government retraction by providing dispute settlement procedures to a varying degree of specificity and centralization. BITs that require states to pre-consent to standing dispute settlement procedures more firmly constrain states because providing clear procedures through which to mediate disputes makes it harder for states to exploit vagueness in treaty wording to conceal cheating. In other words, clarity of procedures makes determining levels of compliance and punishing non-compliance straightforward and objective. When it is easier to determine state non-compliance, the cost of renegeing increases; states must consider not only the immediate benefits from non-compliance but also the reputational

¹² Notice that while domestic political constraints make BITs seem more likely to endure, they do so through a status quo bias. This mechanism also implies that high domestic political constraints make it more difficult for a state to sign and ratify a BIT in the first place.

costs. Firms will be less likely to directly invest in countries with histories of non-compliance with BITs.¹³ Since states actively seek FDI, the cost of non-compliance (reduced FDI flows) may often outweigh the immediate benefits accrued from failing to provide agreed upon investor protections. Firms, therefore, assess the ability of treaty strength to help make contracts more complete as a function of domestic political constraints; the more a firm can trust a government is locked in to its treaty commitments the more it can believe that the strong BIT provisions will protect it.

Hypothesis 2: Strong BITs that require pre-consent to arbitration will attract more FDI and this effect will be more pronounced as domestic political constraints increase.

Operationalization

To test the above hypotheses, I conduct pooled time series analysis of inward foreign direct investment for 118 developing countries. As do many analyses of BITs and FDI, I restrict my sample to developing countries because FDI flows among developed countries are qualitatively different from FDI flows between developed and developing countries. This difference is largely due to the fact that the majority of FDI among developed countries is due to cross-border mergers and acquisitions of large multinationals while FDI flows between developed and developing countries tends to be geared to greenfield investment or smaller acquisitions. Since OECD countries do not sign BITs with one another, and because intra-OECD flows account for at least half of all FDI flows, including developed countries would mask any effect that BITs have on increasing a developing country's ability to attract FDI. Since BITs affect firms' decisions to directly invest by helping to make contracts more complete, it follows that BITs are not needed in developed countries where contract law is more richly developed and has a history of reciprocity across other developed countries.

Additionally, I leave out BITs between developing countries because BITs between developing countries rarely result in FDI flows. The puzzle of why developing countries sign BITs with each other if such treaties do not generate FDI flows is interesting, but a separate research question. I draw my sample from Büthe and Milner's (2008) dataset of 122 non-OECD countries with populations of more than one million between 1970 and 2000.¹⁴ This dataset is an improvement over many others that restrict sample size to a subset of 50 or 60 countries based on data availability, which may lead to biased findings since data availability is non-random. However,

¹³ While I argue that non-compliance creates reputational costs, I do not test this assumption. Future work should focus on specifically testing this microfoundational assumption.

¹⁴ The sample is left censored at 1970 because UNCTAD data on FDI starts this year.

there are many countries for which data on all 31 years of the sample were unavailable, so my panel is unbalanced.

Dependent Variable

My dependent variable, annual net inward FDI flows,¹⁵ is the sum of all FDI that enters a country in a given year minus any repatriated earnings, as a percentage of GDP.¹⁶ By constructing this measure as a percentage of GDP, I effectively control for the size of the economy and therefore the amount of investment opportunity in the country. The decision to scale FDI in terms of GDP is a consistent feature of the literature on determinants of FDI (Blanton and Blanton 2007; Büthe and Milner 2008; Jensen 2006; Neumayer and Spess 2005).¹⁷

It may seem counterintuitive to use monadic data of overall FDI inflows rather than dyadic flows, especially if BITs function through creating specific contractual obligations between cosigners.¹⁸ However, FDI data at the dyadic level are not widely available.¹⁹ I partially control for this problematic aspect of the dependent variable by weighting the importance of BITs by the percentage of FDI outflows for which rich cosigners are responsible. In other words, rather than specifically testing a dyadic dependent variable, I create an explanatory variable that weights signing BITs with countries that export a large portion of global FDI more than signing BITs with countries that account for a small percentage of overall world FDI flows.

Explanatory Variables

To test my two hypotheses, I use four key explanatory variables: *BIT Coverage*, *Strong BIT Coverage*, *Weak BIT Coverage*, and *Domestic Political Constraints* as well as the interaction between each measure of BIT coverage and *Domestic Political Constraints*.

My measure for *BIT Coverage* was created as follows. I used Yackee's dataset of BIT²⁰

¹⁵ By testing flows rather than stock I avoid the estimation problems that arise when regressing an integrated variable.

¹⁶ This figure comes from the World Development Indicators Database.

¹⁷ Some authors choose to use an unscaled measure of FDI Kerner (2009). This modeling choice is theoretically imprecise because it assumes that BITs should be able to increase FDI flows uniformly. Scaling FDI flows acknowledges the economic determinants of FDI flows.

¹⁸ As discussed above, the dyadic versus aggregate effect debate has dominated the literature on the effect of BITs on FDI. It is probably the case that many firms that invest in developing countries have subsidiaries in multiple OECD states. This suggests that the contractual obligations of BITs can allow a firm headquartered in a state that does not have a BIT with the developing state to still have access to arbitration through a subsidiary based in an OECD state that does have a BIT in force with the developing state.

¹⁹ Even where there are dyadic data, researchers widely acknowledge these figures as unreliable.

²⁰ While I refer to these treaties as BITs, this is a bit of a simplification. One of the main contributions of Yackee's database is that it also includes BIT-like treaties. For example, the United States and Japan had several "friendship, commerce, navigation" (FCNs) treaties that included the core provisions of BITs. Additionally free trade agreements (FTAs) often have investment protection commitments. These treaty obligations are included in the data because such treaties are functional equivalents of BITs.

strength as a basis for my measure (Yackee 2009). He codes BITs signed and ratified between 17 developed, FDI-exporting countries and all other countries between 1955-2002. Because I hypothesize that BITs affect FDI flows through strengthening contracts, I only count BITs that have been ratified and therefore incorporated into domestic law. To convert his data set to one measure for each country year I add up all "in force" BITs to which a country is party, weighted by the percentage of world FDI exports²¹ for which that country's BIT partners are responsible in a given year. This variable, *BIT Coverage*, can be thought of as the percentage of global FDI outflows from a developing country's treaty partners. Because FDI exports net out any repatriated earnings, this percentage can be negative but rarely is. *BIT Coverage* cannot exceed 100.

Because my theory suggests that BITs that require a pre-consent to investor-state arbitration are qualitatively different from other BITs, I create a variable *Strong BIT Coverage* that accounts for the percentage of world FDI for which a country's BITs that include arbitration agreements account and a variable *Weak BIT Coverage* that accounts for the percentage of world FDI for which a country's BITs that do not include investor-state arbitration agreements account. To construct these variables, I use Yackee's coding of BIT strength. Yackee assigns a strength score from 1-4 for each BIT, with 1 being the strongest BIT and 4 being the weakest BIT. BITs are coded 1 ("strongest") when they include pre-consent to arbitration. In other words, "strongest" BITs allow investors to unilaterally file arbitration complaints against a host state with a third party tribunal. For each country year, *Strong BIT Coverage* adds up all "strongest" BITs in force in a country and weights them by the percentage of world FDI exports for which the country's strong BIT partners are responsible for that year.²² I create *Weak BIT Coverage* by adding up all other BITs in force for a given country year and weighting them by the percentage of world FDI exports for which the country's weak BIT partners are responsible for that year.

Both of my hypotheses predict that BIT effectiveness is conditional on the degree to which domestic politicians are locked into treaty decisions. I operationalize the concept of *Domestic Political Constraints* by thinking about the degree to which political decision-making is fractionalized. Fractionalization of decision-making, often thought of as the number of veto points there are in a political system, makes it difficult for political leaders to change policy (Tsebelis 2002; Henisz 2000). This leads to a status quo bias, or "lock-in." I directly measure this concept through a widely used measure, Witold Henisz's *Domestic Political Constraints Index* (2002). *Domestic Political Constraints* measures the number of independent branches of government

²¹ I obtain these data from UNCTAD's online dataset.

²² For some observations, states have ratified BITs that require pre-consent to arbitration through ICSID but have not yet joined ICSID. Since these states cannot actually use ICSID for arbitration, I treat these treaties as not in force and therefore excluded from the variable.

that hold veto power over policy change as well as the degree to which branches are aligned.²³ Increased alignment makes policy change easier. *Domestic Political Constraints* takes on a value between 0 and 1, with higher values representing more constrained government.

Hypothesis 1 predicts the extent to which firms believe BITs will protect their investments is conditional on the degree to which domestic political constraints lock states into their treaty commitments. Therefore, I include an interaction term in my equation of the lagged value of *BIT Coverage* and the lagged value of *Domestic Political Constraints*. Hypothesis 2 predicts BITs with pre-consent to investor-state arbitration will attract more FDI than BITs without pre-consent and that this effect will increase as domestic political constraints increase. Therefore, I test this hypothesis by interacting *Strong BIT Coverage* with *Domestic Political Constraints* and by interacting *Weak BIT Coverage* with *Domestic Political Constraints*.

Control Variables

I control for a variety of economic and political explanations generally thought to affect firms decisions to directly invest in a country. First, I control for the size of economy by including the lagged value of a country's *GDP Per Capita* in 1995 dollars.²⁴ I standardize to 1995 dollars to control for currency fluctuations and use a natural log transformation to correct for left skew. Firms may also want to invest in countries that exhibit strong economic growth. To account for this, I include a lagged measure of *GDP Growth*. Firms may be more inclined to directly invest in states with a greater degree of *Trade Openness* measured as imports plus exports divided by GDP. An open trading environment indicates a liberal economic political environment as well as a productive economy.

In terms of political control variables, since firms may not want to invest in countries with high levels of violence or threat of regime change, I control for *Political Instability* using Arthur Bank's dataset of violent and destabilizing political events (Banks 1999). Since *GATT/WTO* membership may signal to investors a country's willingness to liberalize markets, I include a dummy variable for whether a country belonged to the GATT (before 1995) and the WTO (after 1995) (see Bütte and Milner 2008). Much research has focused on the effect of regime type on FDI flows. Some argue firms prefer the stability of authoritarian regimes (Huntington 1968; Evans 1979; Tuman and Emmert 2004) while others argue firms prefer to invest in democracies (Jensen 2006, 2003; Li and Resnick 2003; Henisz 2000). Accordingly, I use *Polity IV* as a control (Marshall and Jaggers 2002).

²³ This measure includes the judiciary and sub-federal institutions and uses a spatial model to account for diminishing marginal returns to veto players.

²⁴ My economic control values all come from the World Development Indicators database.

To account for the dynamic nature of FDI, I include a lagged dependent variable in my model.²⁵ Since I expect BITs, political constraints, macroeconomic conditions, and other political conditions to all affect FDI flows dynamically, I lag all independent variables by one year. Table 1 reports the descriptive statistics of my variables. Notice my dependent variable as well as my key explanatory variables are all skewed left. Because many of these observations are zero values and some are negative values, simply transforming the variables through the natural log is not an option.²⁶ One way to fix for this problem is to add an arbitrary constant to each observation to make all observations positive and then take the natural log. However, transforming variables this way obscures their substantive effect. Less important than the distribution of the variables is the distribution of the residuals. Diagnostic assessment found the errors to be distributed close to normal, which lends support for including the variables in their original form.

Table 1: Descriptive Statistics

	Mean	Std. Dev.	Min	Max
Inward FDI/GDP	1.6256	2.9721	-25.7818	39.8747
POLCON	0.0953	0.1794	0	0.6547
BITs	19.5193	21.5249	-0.2275	91.8244
Strong BITs	8.3728	15.8668	-0.2529	90.3088
Weak BITs	10.9965	14.7093	0	79.9623
GATT/WTO	0.6484	0.4775	0	1
Instability	2.3870	4.6401	0	49
Polity	-0.9957	6.9120	-10	10
Ln(GDP/PC)	6.8680	1.2011	4.4395	10.4744
GDP Growth	3.3817	6.5787	-50.2481	85.9
Ln(Openness)	4.0348	0.5639	1.8438	6.0846

Estimation and Results

Most research on BITs and FDI employ a time series cross sectional fixed effects model. Diagnostic assessment confirms FDI flows exhibit country-specific effects.²⁷ A test for autocorrelation signals my equation is not highly autocorrelated²⁸; this is unsurprising since I include a lagged dependent variable. Accordingly, I use ordinary least squares to estimate a fixed effect

²⁵ The coefficient estimate of a lagged dependent variable is biased and inconsistent, but usually trivially so. See Keele and Kelley (2006). An alternative is to estimate an autoregressive trend using generalized least squares. However, because my panel is unbalanced, this technique is highly inefficient.

²⁶ The natural log of zero is undefined and thereby transforming the variables this way creates missing data.

²⁷ A linear regression absorbing unit effects found that R^2 due to country fixed effects alone for FDI as a percentage of GDP is .35

²⁸ GLS estimates of an Ar(1) coefficient is 0.1360.

model with robust standard errors clustered by country.²⁹

To embed my analysis within a larger critique of reductionism, I first estimate a model that looks only at BITs and then a model that looks only at domestic political constraints. To test my two hypotheses that predict an interactive effect between the international variable of BITs and the domestic variable of political constraints, I estimate several models that all take the same basic structure with varying measures of *BITs*:

$$\begin{aligned}
 FDI_{i,t} = & \alpha_{i,t} + BIT_{i,t} + POLCON_{i,t} + BIT * POLCON_{i,t} \\
 & + GATT/WTO_{i,t} + Instability_{i,t} + PolityIV_{i,t} \\
 & + GDP/PC_{i,t} + GDPGrowth_{i,t} + Openness_{i,t}
 \end{aligned}$$

Table 2 reports the results. Model 1, which includes *BIT Coverage* but not *POLCON*, finds a positive coefficient estimate that is significant to the 0.01 level. Substantively, this model finds that BITs uniformly increase FDI inflows. Model 2, which includes *POLCON* but not *BIT Coverage*, indicates that domestic political constraints have a positive and statistically significant effect on FDI inflows as well.³⁰ These models represent the majority of theory building and empirical study of the political determinants of FDI in the extant literature. Both models find their particular level of analysis, the institutional or the domestic, to explain FDI inflows in a monotonic fashion. More *BIT Coverage* brings more FDI, *ceteris paribus*. Likewise, more *POLCON* brings more FDI, *ceteris paribus*.

However, the theory outlined above indicates a more complex causal story. The ability of interstate treaties such as BITs to attract FDI should vary by the level of domestic political constraints. As Models 3 through 5 indicate, this is precisely the case. As a whole, each of these models that interact a measure of *BIT Coverage* with *POLCON* indicate that the relationship between BITs and FDI and the relationship between political constraints and FDI are not independent. The ability of a government to reassure investors through signing BITs and BIT-like treaties is conditioned on the degree to which domestic political constraints give interstate treaties more meaning.

²⁹ Estimating robust standard errors accounts for heteroskedasticity within panels. Clustering by country accounts for heteroskedasticity across panels.

³⁰ I also ran a model that included both *BIT Coverage* and *POLCON* without an interaction term. Both variables displayed similar coefficient estimates with similar levels of statistical significance. Control variables also remained stable.

Table 2: Determinants of FDI Flows as a Percentage of GDP

	Model 1 BITs	Model 2 POLCON	Model 3 All BITs x POLCON	Model 4 Strong BITs x POLCON	Model 5 Weak BITs x POLCON
Lagged FDI	0.375*** (0.05)	0.378*** (0.05)	0.366*** (0.05)	0.366*** (0.05)	0.378*** (0.05)
POLCON		1.471*** (0.45)	0.524 (0.61)	0.745 (0.54)	1.486*** (0.52)
BITs	0.016*** (0.00)		0.011** (0.01)		
BITs x POLCON			0.022 (0.02)		
Strong BITs				0.013* (0.01)	
Strong BITs x POLCON				0.017 (0.02)	
Weak BITs					0.004 (0.01)
Weak BITs x POLCON					0.000 (0.02)
GATT/WTO	0.713** (0.29)	0.755** (0.30)	0.666** (0.29)	0.678** (0.29)	0.746** (0.30)
Instability	-0.012** (0.01)	-0.007 (0.01)	-0.008 (0.01)	-0.008 (0.01)	-0.008 (0.01)
GDP/PC	-0.044 (0.39)	0.161 (0.39)	-0.058 (0.40)	-0.008 (0.40)	0.137 (0.38)
GDP Growth	0.017** (0.01)	0.014** (0.01)	0.019** (0.01)	0.018** (0.01)	0.019** (0.01)
PolityIV	0.022 (0.29)	0.014 (0.01)	0.014 (0.01)	0.014 (0.01)	0.013 (0.01)
Trade Openness	0.728** (0.29)	0.804*** (0.28)	0.756** (0.29)	0.777*** (0.28)	0.796*** (0.29)
Constant	-2.327 (2.28)	-3.935* (2.24)	-2.323 (2.30)	-2.645 (2.38)	-3.778* (2.19)
Within R^2	0.225	0.221	0.227	0.227	0.222

OLS Fixed Effects with robust (clustered) standard errors in parentheses. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$; two-tailed tests. $N=2,384$, $n=118$; analysis covers 1970-2000 subject to data availability. The dataset, though unbalanced, displays less than 3% missingness.

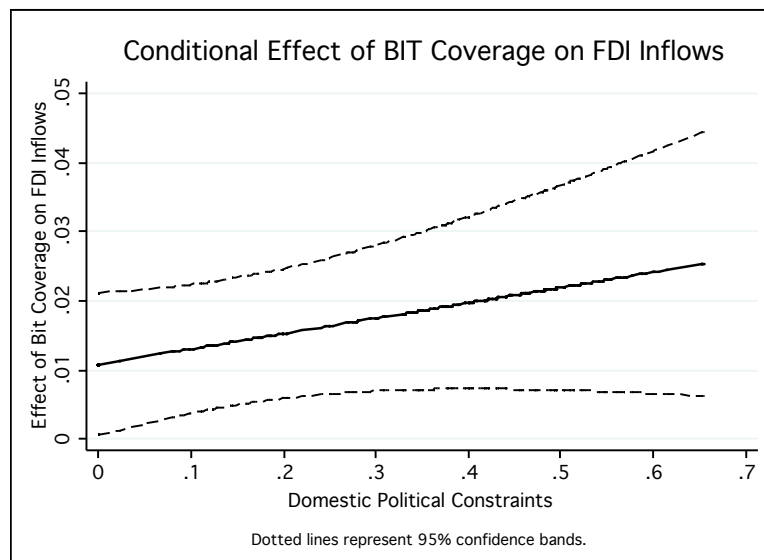
Model 3, *All BITs*, specifically tests *Hypothesis 1*. Recall I expect that the ability for BITs to attract FDI will increase as domestic political constraints increase; firms will trust government commitments more when they know domestic institutions make policy change difficult. Because coefficient estimates and significance levels of interaction terms are difficult to interpret in table form, Figure 1 illustrates the effect of BIT Coverage on inward FDI flows as domestic political constraints increase. Overall, Figure 1 supports *Hypothesis 1*. At extremely low levels of domestic political constraints, BITs do not have a statistically significant effect on FDI. However, as political constraints increase, BITs have a statistically significant effect that increases in magnitude as political constraints increase. Substantively, at the mean level of domestic political constraints,³¹ a one standard deviation increase in a country's BITs Coverage increases FDI

³¹ An example of a country with a mean *POLCON* score is the Russian Federation from 1994 onward.

flows by 0.53% of GDP which amounts to a 17.84% of one standard deviation increase in FDI inflows. When domestic political constraints are one standard deviation above their mean³², a one standard deviation increase in a country's BITs Coverage increases FDI flows by 0.69% of GDP. This amounts to a 23.34% of one standard deviation increase in FDI inflows. And, at the sample maximum level of domestic political constraints, a one standard deviation increase in a country's BITs Coverage increases FDI flows by 1.04% of GDP. This is equivalent to a 34.97% of one standard deviation increase in FDI inflows. At the highest level of BIT Coverage and political constraints,³³ we observe an increase in FDI equivalent to 2.33% of GDP.

Substantively, how should we interpret the importance of these effects? First, most developing countries receive very little FDI as a percentage of their GDP. The sample mean is around 1.6%. Thus, even small changes in FDI flow as a percentage of GDP are of substantive import. Second, as mentioned above, theory on production chain locational decisions leads us to expect that BITs can only capture investment on the margins. BITs can help persuade firms seeking efficiency gains to invest directly, but such treaties will do little to capture resource or market-seeking FDI. While data limitations make it difficult to directly test this expectation, small substantive effects fit with this explanation.

Fig. 1: The Interactive Effects of BITs and Domestic Political Constraints on FDI



Notice, however, the widening of the confidence bands at high levels of political constraints. At high levels of constraints, the lower confidence interval flattens and even slightly recedes.

³² An example of a country with a *POLCON* score one standard deviation above the mean is Honduras in the late 1990s.

³³ Substantively, Chile has the highest observed *POLCON* score in the sample from 1994 onward.

This may indicate that after reaching a certain threshold of political constraints, BITs have a constant effect on FDI. Such an interpretation fits theoretical arguments that high levels of political constraints could substitute for the treaty provisions in BITs (Elkins, Guzman and Simmons 2006). However, my dataset is such that there simply are not very many observations of extremely high levels of *POLCON*.³⁴ The wide confidence band at these upper values may reflect a loss of efficiency rather than a causal story. When I transform all variables to correct for left skew, I find the confidence bands tighten and I no longer see a flattening of the lower confidence interval.³⁵ This finding supports the suggestion that the widening of the confidence interval in Model 3 is due to efficiency issues.

What happens to the effect of BITs on FDI when we take treaty strength into consideration? Models 4 and 5 test *Hypothesis 2* by including *Strong BIT Coverage* and *Weak BIT Coverage*.³⁶ Analyzed jointly, these two models indicate that not only is the effect of BITs on FDI conditional on domestic political constraints, but that BITs must include strong arbitration commitments in order to attract foreign investment.

Model 4 specifically estimates the interactive effect of *Strong BIT Coverage* and *POLCON* on *FDI Inflows*. Again, because it is easier to interpret interactive effects graphically, Figure 2 illustrates the effect of a one percent increase in the amount of world FDI a country's strong BITs (i.e. BITs that include pre-consent to investor-state arbitration) cover on its inward flow of FDI conditioned on its level of domestic political constraints. Overall, the graph supports *Hypothesis 2*. At extremely low levels of domestic political constraints, Strong BITs do not have statistically significant effect on FDI.³⁷ As political constraints increase, the coefficient estimate for Strong BITs' effect on FDI increases and becomes statistically significant at $\alpha = .05$. Substantively, at the mean level of domestic political constraints, a one standard deviation increase in a country's Strong BITs Coverage contributes to an increase of FDI amounting to 0.36% of GDP. When domestic political constraints are one standard deviation above their mean, a one standard deviation increase in a country's Strong BITs Coverage increases FDI inflows by 0.45% of GDP. And, at the sample maximum level of domestic political constraints, a one standard deviation increase in a country's Strong BITs Coverage contributes to a 0.63% of GDP increase in FDI. Since the substantive effects of Strong BIT coverage on FDI inflows appears smaller than the substantive effects of all BITs, it may seem that BIT strength is not important. However, it is important to remember that Strong BITs are a subset of all BITs and therefore the smaller

³⁴ About 87% of all values of *POLCON* are below 0.4.

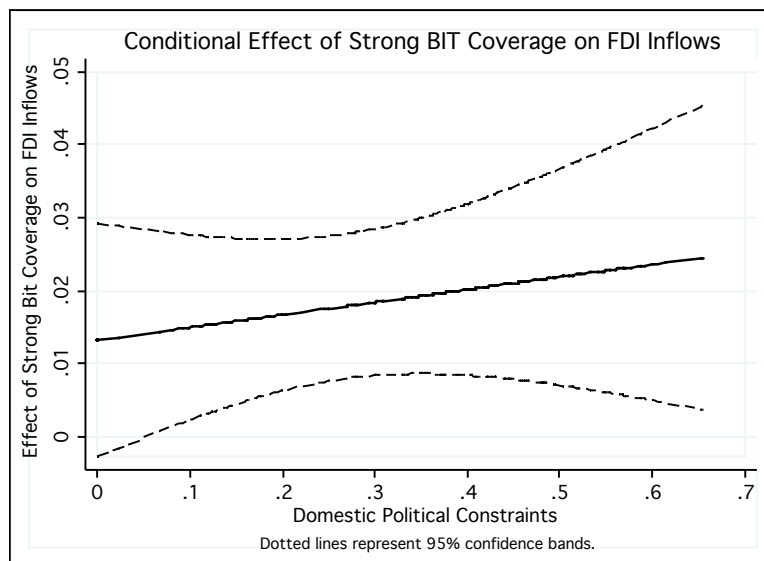
³⁵ Results of this estimation are available upon request.

³⁶ An estimation equation that included both measures of BIT Coverage returned similar results.

³⁷ Of course, this does not mean that Strong BITs have no effect, it is just that we have less confidence in the magnitude of the effect.

substantive effect is reflective of this subsetting.

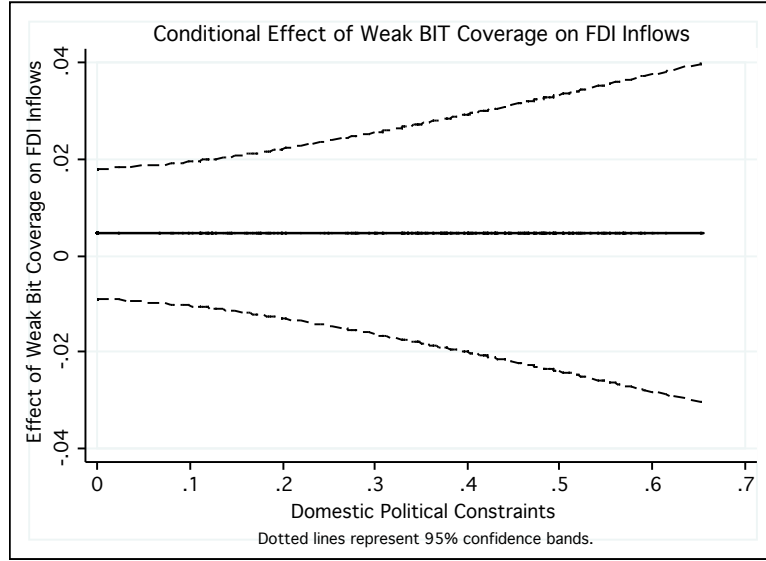
Fig. 2: The Interactive Effects of Strong BITs and Domestic Political Constraints on FDI



Additionally, at extremely high levels of political constraints, while the coefficient estimate for Strong BITs increases, the lower confidence interval recedes. This indicates that the effect of Strong BITs at extremely high values of political constraints is statistically indistinguishable from the effect of Strong BITs at moderate levels of political constraints. As mentioned above in the discussion of the *All BITs* model, this statistical finding could reflect a certain amount of substitutability between domestic political constraints and BITs or could be an artifact of left skewed data that decreases efficiency of coefficient estimates at extremely high values.

My fifth model tests the effect of Weak BITs on FDI, conditioned by domestic political constraints. Again, I present these results graphically in Figure 3. The results are quite clear; the effect of Weak BITs on FDI is never statistically significant regardless of the level of domestic political constraints. Furthermore, the slope of the coefficient estimate is relatively constant. There is no statistical evidence to support a claim that Weak BITs help developing countries attract FDI. This finding corroborates the theoretical expectation that BITs without pre-consent to arbitration are not strong enough to reassure potential investors. A binding dispute settlement process is important to firms who want to reduce uncertainty not just over whether a government will renege on its promise of fair treatment but also over the process through which investors may seek repayment in the event that a government breaks its treaty commitments.

Fig. 3: The Interactive Effects of Weak BITs and Domestic Political Constraints on FDI



Turning to my control variables, except for *GDP/PC*, my coefficient estimates are correctly signed according to the extant literature and remain stable across all five models. What is interesting here is what variables are not statistically significant. Political instability, though inversely related to FDI inflows, is only statistically significant in Model 1, which is the only model that does not include a measure of domestic political constraints.³⁸ GDP per capita never achieves statistical significance and is negatively signed in Models 1 through 3, which seems counterintuitive but is consistent with other studies that weight FDI inflows by GDP and may reflect firms preference to invest in countries with low wages (Büthe and Milner 2008; Rudra 2008). Perhaps most surprising is the lack of statistical significance of *Polity IV* across all five models. A block F-test indicated lack of significance was not due to multicollinearity with other independent variables.³⁹

Robustness Checks and Alternative Explanations

While my theory states that domestic political constraints lock governments into treaty commitments thus creating compliance consistency across governments, the way that *POLCON* is computed makes evaluation of this causal claim a bit challenging. Because *POLCON* incorporates ideal policy distance between veto players, electoral outcomes are incorporated into the

³⁸ Considering Henisz (2002) specifically created this variable due to methodological and theoretical concerns about tautological coding schemes for measures of political risk, this is not surprising.

³⁹ Exclusion of *Polity IV* does not change the substantive findings of my analysis, and if anything makes my key substantive effects stronger and more statistically significant. I choose to include *Polity IV* because the literature on the political determinants of FDI emphasize regime type so strongly. My findings suggest otherwise.

measure. This coding scheme helps to account for situations in which institutional rules create *de jure* constraints that political leaders can easily flout by installing their cronies in these veto seats. However, this means that leadership changes affect the value of *POLCON*. As a robustness check, I substitute the measure *Checks* (Keefer and Stasavage 2003) for *POLCON*. *Checks* simply counts the number of veto players in a political system. While this coding scheme ignores the decreasing returns to scale each new veto player has on constraining executive decisions, it is invariant to electoral results. Using *Checks* in place of *POLCON* did not change my fundamental results. An increase in *BIT Coverage* had an increasing positive effect on FDI at higher values of *Checks*. Furthermore, at extremely low values of *Checks*, the effect of *BIT Coverage* on FDI inflows is not statistically significant, confirming my central finding that BITs are more able to lower firm uncertainty over the investment environment when domestic political institutions make it difficult for governments to change policies.

Additionally, my analysis finds that regime type is not a statistically significant determinant of FDI inflows. This finding is consistent with Büthe and Milner (2008), but runs counter to much of the literature on the political determinants of FDI (Feng 2001; Jensen 2003, 2006; Garland and Biglaiser 2009). The idea that democracy attracts FDI builds off of a broader literature that suggests democracies are better able to join and be constrained by international cooperative institutions (Martin 2000; Ikenberry 2001; Mansfield, Milner and Rosendorff 2002). Li and Resnick (2003), however, argue that electoral democracy should have a mixed effect on international cooperation. While democracies often reveal more credible information through freedom of the press and open political process and tend to have greater property rights protection, they also create incentives for politicians to appease domestic constituents at the expense of international commitments. My results support this claim that democracy itself is a poor predictor of the ability of international treaties and commitments to effectively constrain state behavior. Rather, domestic political constraints help to ensure potential cooperative partners that governments will have more trouble reneging on their commitments.⁴⁰ Alternative models that interacted my three measures of *BITs* with *Polity IV* found BIT effect is not conditional on regime type, providing further support for this claim.

Another alternative explanation could be that respect for the rule of law generally may matter more to firms than domestic political constraints. Perhaps a strong rule of domestic law makes firms believe governments will also honor their international commitments. Accordingly, I substitute *Law and Order* for *POLCON* in my analysis. I find that the effect of BITs actually

⁴⁰ For my sample, *POLCON* and *Polity IV* have a correlation coefficient of 0.5949, indicating the two variables are sufficiently different.

decreases as *Law and Order* increases.⁴¹ Rather than reassuring firms that governments will honor treaty commitments, a strong rule of law may render BITs unnecessary to provide investor protection in the first place.

Conclusion

Previous research on the effect of BITs on FDI flows have ignored the role of domestic political variables in conditioning the effect of international treaties and institutions. This article hypothesized that the ability of a developing country's BITs to attract FDI depends both on the strength of the treaties and on the country's level of domestic political constraints. BITs that require pre-consent to investor-state arbitration help make contracts more complete by providing clear rules and procedures for identifying and punishing cheating. But a strong BIT by itself is not enough to reassure firms that governments will honor their promise of investor protection. Rather, firms will be more certain that governments will comply with BIT provisions and domestic political constraints increase in potential host countries. As political constraints rise, governments are more locked in to their treaty commitments because institutional rules make it more difficult for governments to renege on policy promises even if they would prefer to do so.

My statistical analysis provides strong empirical support for my hypotheses; BITs have a greater positive effect on FDI inflows as domestic political constraints increase. Furthermore, while BITs without pre-consent to investor-state arbitration have no statistically significant effect on FDI flows, BITs that do include pre-consent do display a statistically significant effect on FDI flows that increases as domestic political constraints increase. These findings hold even under a strict estimation technique of fixed effects with a lagged dependent variable.

However, the small substantive effect of BITs on FDI underscores the broader literature on firm decision-making that maintains the decision to directly invest overseas is multifaceted. BITs can help make the legal environment in a developing country more desirable for firms, but firms also care about many other characteristics of a potential host countries' economy. To the extent that ratifying strong BITs requires governments to cede jurisdiction of disputes with foreign firms to an outside body, this article echoes a more general finding that developing countries must often sacrifice autonomy for growth. If BITs only affect FDI inflows on the margins, developing countries may view this tradeoff between autonomy and economic development as particularly grim. Furthermore, as BITs become more common place, it may be the case that governments, especially in states with little natural resource endowments, will face increasing

⁴¹ Results available upon request.

pressure to sign such treaties in order to compete for capital.

The popular alternative explanation that regime type drives firms decisions to invest in potential host countries, however, is not supported by my analysis. Firms care less about how leaders come to power and more about the extent to which institutions constrain leaders once they obtain power. This finding has some important implications to the literature on hybrid regimes and direct democracy movements founded on anti-institutional rhetoric. Democratization processes that do not bolster the autonomy of political institutions from the executive may not be able to use international treaties and institutions to attract development capital. Venezuela and Ecuador are two prominent examples of states that became less attractive to investors as political leaders used direct democracy to undermine domestic political constraints.

More generally, this article reiterates the importance of examining the interaction between domestic and international institutions. The extent to which a state benefits from a global open economic system depends upon both domestic and international factors and in turn upon the ways in which domestic and international factors interact. Domestic political institutions condition the ability of governments to use international commitments to aid development. Liberalized capital markets may help states attract investment, but only to the extent that domestic political conditions reduce uncertainty. As scholars of international relations continue to examine the extent to which international institutions facilitate cooperation, they must consider the domestic level variables that will effect the degree to which international commitments actually constrain government actions. To the extent that BITs represent a mechanism through which governments reassure *multinational firms* rather than other *governments*, future research should develop a more robust theory of how international institutions facilitate cooperation not just across states but among a variety of state and non-state actors.

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