Competing for Capital:

The Diffusion of Bilateral Investment Treaties, 1960-2000

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Abstract

Over the past forty-five years, bilateral investment treaties (BITs) have become the most important international legal mechanism for the encouragement and governance of foreign direct investment. Their proliferation over the past two decades in particular has been phenomenal. These intergovernmental treaties typically grant extensive rights to foreign investors, including protection of contractual rights and the right to international arbitration in the event of an investment dispute. How can we explain the diffusion of BITs? We argue that the spread of BITs is driven by international competition among potential host countries – typically developing countries – for foreign direct investment. We design and test three different measures of economic competition. We also look for indirect evidence of competitive pressures on the host to sign BITs. The evidence suggests that potential hosts are more likely to sign BITs when their competitors have done so. We find some evidence that coercion plays a role, but less support for learning or cultural explanations. Our main finding is that diffusion in this case is associated with competitive economic pressures among developing countries to capture a share of foreign investment. We are agnostic at this point about the benefits of this competition for development.

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The global market for productive capital is more integrated than ever before. The growth of Foreign Direct Investment (FDI) is a clear example. According to World Bank Data, gross foreign direct investment as a percentage of total world production increased seven-fold from 1.2% to 8.9% between 1970 and 2000. Though such investments tend to be highly skewed geographically – developed countries account for over 93 per cent of outflows and 68 percent of inflows[1] - foreign capital has come to play a much more visible role in many more countries world wide.

It is widely recognized that economic globalization requires market-supporting institutions to flourish. But unlike trade and monetary relations, no *multilateral* rules for FDI exist.[2] Direct investments in developing countries are overwhelmingly governed by *bilateral* investment treaties (BITs). BITs are agreements establishing the terms and conditions for private investment by nationals and companies of one country in the jurisdiction of another.[3] Virtually all BITs cover four substantive areas: FDI admission, treatment, expropriation, and the settlement of disputes.[4] These bilateral arrangements have proliferated over the past forty-five years, and especially in the past fifteen, even as political controversies have plagued efforts to establish a multilateral regime for FDI.

Why the profusion of bilateral agreements? The popularity of BITs contrasts sharply with the collective resistance developing countries have shown toward pro-investment principles

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[1] UNCTAD, http://r0.unctad.org/en/subsites/dite/fdistats_files/Annextables/Annextab02.pdf
[2] For a review of the relevant legal literature see Dolzer 1981; Minor 1994; Sornarajah 1994; Vagts 1987.
3 Automated System for Customs Data (AYSCUDA) , http://www.asycuda.org/cuglossa

under customary international law and the failure of the international community to make progress on a multilateral investment agreement.[5] On its face, this seems to suggest that BITs do not simply reflect the ready acceptance of dominant international property rights norms. Our theory and findings support the competitive economic mechanisms described in the introduction to this collection (Simmons, Dobbin, and Garrett, this issue): the diffusion of BITs – and the liberal property rights regime they embody – are propelled in good part by the competition among potential host countries for credible property rights protections that direct investors require.

The article is organized as follows. The first section describes the spread of BITs in some detail. The second section presents a model of competition for investment that could lead to diffusion among competitors. The third section discusses the methods we use to test our propositions (and a range of alternatives), and the fourth section discusses our findings. Our data are consistent with competitive pressures for BIT proliferation: governments are influenced by competitors' policies and by the mobility of FDI in manufactures, which tends to intensify competition among hosts. Moreover, governments with a reputation for corrupt behavior are especially prone to sign BITs, which is what we would expect if BITs are a mechanism for corrupt regimes to tie their hands in the case of an investment dispute. We interpret our findings as evidence of pressure for certain governments to adopt capital-friendly policies in highly competitive global capital markets.

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[4] ICSID Bilateral Investment Treaties, http://www.worldbank.org/icsid/treaties/intro.htm
[5] Guzman 1998.

Securing Investors' Legal Rights

From Custom To Bilateral Investment Treaties

Foreign direct investment has always been subject to contractual and political hazards that raise the expected costs of investing.[6] Before the use of BITs, few mechanisms existed to make state promises about the treatment of foreign investment credible.[7] Customary international law, expressed succinctly in the "Hull Rule," held that "no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefore."[8] Apart from the obvious problem of enforcement, this approach did not allow potential hosts voluntarily to signal their intent to contract in good faith.

Both customary international law and its practice were under attack by developing country hosts by the 1950s. The nationalization of British oil assets by Iran in 1951, the expropriation of Liamco's concessions in Libya in 1955, and the nationalization of the Suez by Egypt a year later served notice of a new militancy on the part of investment hosts. The nationalization of sugar interests by Cuba in the 1960s further undercut assumptions about the security of international investments.[9] Meanwhile, collective resistance to the Hull Rule in the United Nations was on the rise. In 1962 the UN General Assembly adopted the "Resolution on Permanent Sovereignty over Natural Resources" which provided for merely "appropriate"

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[6] Henisz 2000.

[7] For a discussion of the historical protection of foreign investment see Lipson 1985.

[8] See Cordell Hull's note to the Mexican Minister of Foreign Affairs during 1938 dispute over land expropriations, reprinted in Green H. Hackworth, Digest of International Law v. 3, § 228 (1942). The Rule itself predates Cordell Hull's statement, and various statements of it can be found in decisions from the early part of the 20th century. See Concerning the Factory at Chorzow (Ger. v. Pol.), 1926-29 P.C.I.L. (ser. A), Nos. 7, 9, 17, 19; Norwegian Shipowners Claims Arbitration (U.S. v. Nor.) 1 Rep. Int'l Arb. Awards 307 (1922).

[9] Guzman 1998.

compensation in the event of expropriation. Several more United Nations resolutions followed in the 1970s,[10] along with a string of under-compensated expropriations around the world.[11]

Bilateral treaties made their debut in the late 1950s, just as consensus on customary rules began to erode. BITs were innovative in a number of respects.[12] They require an explicit commitment on the part of the potential host government and involve direct negotiations with the government of potential investors. In this way, BITs up the political ante for the host government and raise expectations of performance. The typical BIT offers a wider array of substantive protections than did the customary rule. For example, BITs typically require national treatment and most-favored-nation treatment of foreign investments in the host country,[13] protect contractual rights,[14] guaranty the right to transfer profits in hard currency to the home country,

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[10] These are discussed in Lipson 1985. In 1966 the General Assembly reaffirmed states' rights to nationalize resources without reference to international legal principles. In 1972 the general Assembly passed Resolution 3041 (XXVII), which contained an endorsement of the Trade and Development Board's resolution 88 (XII) of October 19, 1972, regarding permanent sovereignty over natural resources, and claimed that compensation natural resource nationalization cases was to be fixed by the nationalizing state with jurisdiction for such cases falling within the sole jurisdiction of the nationalizing country's courts. The 1973 Resolution on Permanent Sovereignty over Natural Resources (Resolution 3171) stated that in the event of nationalization "each State is entitled to determine the amount of possible compensation and the mode of payment." The Charter of Economic Rights and Duties of States (GA Res. 3281(xxix), UN GAOR, 29th Sess., Supp. No. 31 (1974) 50) which specified the right of each state "To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent" with national courts taking jurisdiction in case of disputes (Art. 2(c)).

[11] See Kobrin 1980.

[12] Other mechanisms have been used to try to protect foreign investment, of course. One possibility since 1988 is to apply for insurance through the World Bank's Multilateral Insurance Guarantee Agency (MIGA). MIGA covers risks associated with transfer restriction, expropriation, breach of contract, and risks relating to war and civil disturbances. See http://www.miga.org/. US businesses can also insure against risks associated with currency inconvertibility, expropriation, and political violence by applying for investment insurance from the Overseas Private Investment Corporation (OPIC), a U.S. government agency. See http://www.opic.gov/Insurance/.

[13] E.g., The 1994 U.S. Prototype Bilateral Investment Treaty, Office of the Chief Counsel for International Commerce, U.S. Department of Commerce; Article 2(1), 2(2)(a). For convenience throughout this article we label the more developed partner in a BIT the "home" country (meaning the home of investors) and the less developed partner the "host." The treaty obligations bind both parties, but in the vast majority of treaties there is a developed country that will be the source of most FDI and a developing country that will be the recipient.

[14] E.g., 1994 U.S. Prototype BIT, Article I(d)(ii).

and prohibit or restrict the use of performance requirements.[15] Finally, and perhaps most importantly, BITs provide for international arbitration of disputes between the investor and the host country,[16] typically through the International Center for Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL).

The Spread of BITs

Despite the aggressive campaign waged by some developing countries against the relevant customary international law, BITs were embraced by many potential host governments.[17] Figure 1 documents the geometric growth of both investment treaties and mean inflows of foreign direct investment as a percentage of GDP from 1960 to 2000. Early BITs typically involved a mid-sized European power and one of the least developed countries, often in Africa. (See Table 1.) The negotiation of BITs proceeded at a moderate pace until the mid-1980s, rarely exceeding 20 new treaties per year. Late in the decade, however, the rate of signings accelerated dramatically, with an average of more than one hundred new treaties a year throughout the 1990s.

[Table 1 and Figure 1 about here]

The United States embraced BITs later than its west European counterparts. Between 1962 and 1972, during which time West Germany entered into 46 BITs and Switzerland entered into 27, the U.S. eschewed such treaties and signed only two Friendship Commerce and

[15] E.g., 1994 U.S. Prototype BIT, Article V(1-2).
[16] E.g., 1994 U.S. Prototype BIT, Article IX.
[17] It is interesting to note, however, that some of the most vociferous opponents of the Hull Rule were in fact late comers to the BITs movement. As of the late 1990s, Mexico for example had signed only two BITs, with Spain and Switzerland. Brazil did not sign a BIT until 1994, and as of the late 1990s none of its 10 bilateral agreements had entered into force. India's pattern is similar to that of Brazil. See http://www.worldbank.org/icsid/treaties/treaties.htm (accessed 10 December 2003).

Navigation Treaties – with Togo and Thailand.[18] One reason for the delayed US participation in bilateral arrangements may have been the hope of retaining a multilateral approach. The United States was one of the most aggressive proponents of the Hull Rule and may have feared that BITs represented a threat to its claim that investment was already protected under customary international law. Moreover, potential hosts may have had incentives to resist the relatively onerous provisions the U.S. government typically tried to secure. One of the prime differences between the terms typically offered by the Europeans and U.S. at this time was the formers' emphasis on investment protection and the latter's additional insistence on liberalization.[19]

It was not until 1981 that the United States changed its view on BITs. There is evidence that some officials in the Reagan administration viewed BITs as an alternative way to protect the principles contained in the embattled Hull Rule. Secretary of State George Schultz argued that BITs were designed "to protect investment not only by treaty but also by *reinforcing traditional international legal principles* and practice regarding foreign direct private investment" [emphasis added].[20] By the mid-1980s, the U.S. pursued investor protection in the same fashion as did the Europeans. George Schultz noted in his communication with the President upon completion of six BITs in 1986[21] that, "[o]ur approach followed similar programs that had been undertaken with considerable success by a number of European countries, including the Federal Republic of

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[18] Vandevelde 1988.

[19] "Multilateral or Bilateral Investment Negotiations: Where Can Developing Countries Make Themselves Heard?" Briefing Paper No.9, http://cuts.org/9-2002.pdf. Some observers note that the insistence on liberalization explains the inability of the US to secure agreements with East and Southeast Asian countries until quite recent years. See Reading 1992.

[20] George P. Schultz, transmission letter to the president recommending transmission of the US-Turkey Bilateral Investment Treaty, 1985. http://ankara.uembassy.gov/IRC/treaty/1985BIT.HTM

[21] Turkey, Morocco, Haiti, Panama, Senegal, and Zaire.

Germany and the United Kingdom since the early 1960s."[22] By the late-1980s, it is safe to say that governments in countries home to large MNCs had nearly converged on a single treaty model. Developing countries could, increasingly, opt to take it or to leave it. As Figure 1 attests, many did the former.

Early on, BITs were primarily agreements between countries of starkly varying developmental levels and political traditions. Figure 2, which plots the mean difference in GDP per capita between BIT partners as well as that between states in all other dyads "at risk" of signing in a given year, demonstrates that the economic differences within these dyads have declined fairly substantially over time, even while the wealth disparities between non-BIT dyads have increased. As is the case with wealth, the "political gap" between new BIT signers has also diminished significantly over the last thirty years. Figure 3 plots the mean difference in the level of democracy (as measured by the Polity scores) of BIT partners in the year of their signing against that of all other dyads at risk of signing. Over time new BIT partners have become more similar, evidence that the institution is spreading among a population of dyads not especially vulnerable to such agreements.

[Figure 2 and Figure 3 about here]

By late in the 1990s there were a few twists to the basic theme of wealthy countries picking off potentially lucrative but risky venues one at a time. From about 1999, developing countries began a rather more proactive effort to create bilateral investment treaties among themselves. These activities have been coordinated through UNCTAD, and sometimes with the assistance of a major capital exporting country, such as Germany or France. During a meeting

[22] George P. Schultz, transmission letter to the president recommending transmission of the US-Turkey Bilateral

jointly sponsored by UNCTAD, the Swiss government, and a group of 15 developing countries (G-15), seven developing countries signed eight bilateral treaties among themselves.[23] Individual developing countries soon began to seize the initiative. At the request of Thailand, a mini-lateral conference yielded seven more developing country BITs,[24] and furthered discussions on several more. Bolivia (2000), India (2001) and Croatia (2001) initiated mini-lateral discussions on a similar model. France financed a round of discussions primarily among the Franco-phone countries in 2001 that attracted 20 participants and yielded 42 BITs, many of which involved non-contiguous, poor, highly indebted African countries for which it is difficult to imagine much benefit. (What are the chances that capital from Burkina Faso would flow to Chad, or investors from Benin would soon demand entrée to Mali?) More understandable, from an economic point of view, was the German funded and supported meeting in October 2001 that drew together seven capital-poor countries (five of which were officially "highly indebted poor countries") and four wealthy European countries,[25] yielding both understandable (Belgium-Cambodia) and bizarre (Sudan-Zambia) bilateral treaty combinations.[26] This recent turn toward BITs between developing states is more difficult for our theory to explain. It does seem to suggest that more political or sociological explanations may be increasingly relevant quite

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Investment Treaty, 1985. http://ankara.uembassy.gov/IRC/treaty/1985BIT.HTM

[23] Egypt, India, Indonesia, Jamaica, Malaysia, Sri Lanka and Zimbabwe.

[24] Thailand-Zimbabwe, Thailand-Croatia, Thailand-Iran, Zimbabwe-Croatia, Zimbabwe-Sri Lanka, Croatia-Iran, Thailand Kazakhstan, Zimbabwe-Kazakhstan, Croatia-Kazakhstan. Sweden also participated and concluded a BIT with Thailand.

[25] Participants included Cambodia, Eritrea, Malawi, Mozambique, Sudan, Uganda, and Zambia. Upon the request of these countries, Belgium, France, the Netherlands and Sweden were both invited to participate and responded affirmatively.

[26] Notice that even multilateral meetings of this sort have not yielded multilateral treaties on investment. The states involved have always chosen instead to sign a series of BITs. The question of why multilateral approaches are not adopted is interesting, but we leave it for another day.

recently in some regions. However, these cases are still relatively few and of such recent vintage that they do not affect the broader relationships we report below.

Leaders and followers in BIT agreements.

BITs present potential benefits for both capital exporting and capital importing countries. But which group of countries initiates and drives the signing of such agreements? Our theory, to anticipate the following section, assumes that potential *host* countries have an important role in initiating or nurturing BIT negotiations. Is this a plausible assumption? After all, power-based theories – or "coercive" theories in the language of Simmons, Dobbin, and Garrett (this issue) – suggest that dominant capital exporting countries such as Germany or the United States control the agenda and begin BIT negotiations according to their own schedule and needs. Indeed, the chronology described above suggests that some home countries establish BIT "programs" and sign agreements with a slate of developing countries in concentrated periods of time.

If the dominant powers determine the BIT schedule, then we should see evidence of home country "programs" when we look at BITs, by country, across time. Programs would look like clusters, or peaks, of activity in certain eras in a home country's history. By the same logic, if host countries take a lead role in producing BITs, their histories would also show some evidence of concerted, programmatic activity. Figure 4 and Figure 5 chart the number of BITs signed since 1959 for the 12 most active BIT signatories from both home (Figure 4) and host (Figure 5) countries. It appears that most home countries have BIT activity that lasts at least 20 years; most of these countries, in fact, sign BITs throughout the forty-year period. Spain is an exception, with a short spate of BITs in the 1990's only. Potential hosts, however, demonstrate a

very different pattern: their BIT signings spike up in a more clustered pattern, one indicative of programmatic activity (Figure 5).[27]

[Figure 4 and Figure 5 about here]

Evidence of programmatic activity can be established statistically as well. Comparing the average kurtosis[28] scores for the home and host countries, it is clear that the distribution of BITs over the past forty years is significantly more peaked (less uniform) for the host than it is for home countries (9.11 and 4.48, respectively). The standard deviation of their distributions over time is also lower for host countries than it is for home (7.08 versus 9.39, respectively), suggesting a more clustered pattern of activity for the host. If BITs are driven by home country programs, it is not especially apparent in the data. Rather, it appears that potential hosts are more likely to sign in clusters – suggesting that while the major capital exporters stand ready with model treaties in hand, the decision whether and when to sign is left to the host.

The notion that home countries make take-it-or-leave-it offers to potential hosts and that hosts eventually decide to sign BITs is also consistent with the observed content of BITs. These treaties tend to provide consistent terms, even across different home countries. In particular the core terms of the treaties are always present: BITs invariably provide for mandatory dispute resolution before an international arbitration body, a private right of action for investors, monetary compensation in the event of a violation, national treatment, and most favored nation treatment. This suggests that host countries are "price–takers" with respect to the terms of these treaties, consistent with our assumptions. In essence, each home country has market power over

[27] Appendices 1 and 2, available online [author's website], also organized by capital exporting and importing countries, summarize the BIT history for all 178 countries that have ever signed a BIT.

the terms that will govern investment by its own locals. Host countries, on the other hand, realize that they must compete with other potential hosts, and therefore cannot demand changes to the core provisions of the treaties.

A Competitive Theory of BIT Diffusion

Our theory of BIT diffusion has a simple structure. BITs are viewed by host governments and by investors as devices that raise the expected return on investments. They do this by assisting governments in making credible commitments to treat foreign investors "fairly" – as described in the previous section. BITs give host governments a competitive edge in attracting capital[29] if there are otherwise doubts about their willingness to enforce contracts fairly. Governments with little inherent credibility are more likely to sign BITs than are governments known for their fair treatment of foreign capital. The result is a competitive dynamic among potential hosts to reduce the risks and enhance the profitability of investing.

BITS as a Credible Commitment

Governments may have many motives to sign a BIT, but the most significant is to make a credible commitment to treat foreign investors fairly. BITs allow governments to make credible commitments because they raise the *ex post* costs of noncompliance above those that might be

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[28] Kurtosis is the degree to which a distribution is peaked, or clustered with high kurtosis indicating clustered data, and low kurtosis indicating a more uniform distribution.

[29] There is debate in the literature about the impact of BITs on investment flows. The small number of papers on the subject have generated inconsistent results. The most recent and sophisticated study of which we are aware, however, concludes that BITs do, indeed increase FDI and serve as a substitute for good domestic institutional quality Neumayer and Spess 2004. Other relevant studies include Hallward-Driemeier 2003; Tobin and Rose-Ackerman 2003; UNCTAD 1998.

incurred in the absence of the treaty. They do this by (1) clarifying the commitment, (2) explicitly involving the home country's government, and (3) enhancing enforcement. [30]

BITs raise *ex post* costs of reneging on contracts by reducing the ambiguity of the host government's obligations. BITs are much more precise than customary international law in this area. They also provide a broader legal framework in which to interpret specific contractual obligations. Precision removes potential avenues of plausible deniability, making it clearer to a broader range of audiences (domestic audiences, other foreign investors, other governments), that an obligation has been disregarded. Clear violations imply a much greater reputational cost than do actions not clearly barred by law.[31]

The second way BITs raise *ex post* costs of reneging is by involving the investor's government as a treaty party. BITs are negotiated between sovereign states. State-to-state legal arrangements directly implicate the interests of the home government much more directly than do simple investment contracts between private parties. The home government has an interest in broader principles of good faith treaty observance. Treatment that violates a BIT qualifies as a breach of the fundamental principle of international law: *pacta sunt servanda* (treaties are to be observed). Reneging on a contract governed by a treaty arrangement can damage important foreign policy interests.

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30 We cast our argument in the credible commitments framework, but our competition argument may be compatible with signaling theories as well. Some of the empirical implications would be different than those we describe here, however. If a BIT is a signaling device, we would expect more reliable rather than less reliable property rights protectors to sign them. We might also expect less reliable governments to sign one, rather than multiple treaties, since one should suffice to send the signal. Empirically, we tend to observe multiple signings per host, which leads us to frame the issue as one of credible commitments rather than costly signals that reveal type. Both frameworks could, however, explain a competitive dynamic to sign BITs.

31 See Abbott 2000; Lipson 1991; Guzman 2002.

Finally, BITs raise *ex post* costs by significantly enhancing contract enforcement. These agreements contain mandatory dispute settlement provisions that investors are entitled to use when they feel the host state has violated the relevant BIT. Significantly, investors can begin arbitration proceedings without the approval or support of their home government. Moreover, the host can neither prevent the legal proceeding from going forward, nor can it control the final decision of the international arbitration tribunal. The international tribunal can require a host found to be in violation of its obligations to pay monetary damages. The sovereign host state could of course in principle refuse to pay, but that decision could have even more profound reputational consequences: when a government spurns the decision of a neutral authoritative third party with which it has voluntarily pre-committed to comply, a range of important actors – public and private – are likely to infer that government is an unreliable economic partner. By giving private parties a right to pursue and receive a legal remedy, BITs boost the credibility of the host government's commitment. As a result, we would expect some violations to be deterred by a BITs commitment and expected returns to investments to increase accordingly.

Do these formal dispute settlement mechanisms actually come in to play in the way we have described? Theoretically, we should expect such arbitrations to be rare, since fully informed parties should be able to settle "out of court" and avoid litigation costs. When we do observe arbitration, it is more likely to indicate information asymmetries than the seriousness of the case.[32] Nonetheless, a significant number of cases have in fact gone to arbitration. A recent conservative estimate puts the number at at least 160 cases.[33] Due largely to controversial measures taken by the government in early 2002, Argentina alone has recently been a party to

[32] This point has long been recognized in the law and economics literature. See Bebchuk 1984.

some 30 BIT arbitrations, most of them under ICSID and the rest under UNCITRAL rules.[34] BIT arbitrations have given rise to a number of significant awards, including recent decisions against the governments of the Czech Republic ($350 million), Lebanon ($266 million), and Ecuador ($70 million).[35]

In short, BITs represent a credible commitment because of the range of *ex post* costs – diplomatic costs, sovereignty costs, arbitration costs, and reputational costs – involved in both their observance and their violation. We argue below that some governments have incentives to increase these costs in order to attract foreign direct investment.

Competitive BIT Signings: Logic and Implications

In the previous section we argued that BITs allow governments credibly to commit themselves to protect investors' property rights. The ability to do so lowers risks and increases expected returns to investment. If this is the case, then BITs can be a mechanism – like favorable tax treatment, lower wages, and efficient infrastructure – for making a jurisdiction a more attractive to place in which to invest. Like these mechanisms, committing to a BIT involves costs for the host government. We characterize these as "sovereignty costs." These are the costs any government pays when they negotiate, ratify and comply with an investment treaty. We would include here the political costs of assembling a coalition in support of foreign investors' rights, as well as the costs associated with giving up a broad range of policy instruments relevant to domestic social or developmental purposes (taxation, regulation,

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[33] UNCTAD 2004.. This number omits, of course, disputes that were resolved prior to the arbitration stage.
[34] See http://www.bomchilgroup.org/argmar04.html#16.
[35] For examples of awards, see reports of the International Institute for Sustainable Development, at www.iisd.org/investment. See also *The National Law Journal*, Arbitration Survey, "Global Litigation," 15 September 2003. See also http://blog.lewrockwell.com/lewrw/archives/Friedman-BITs-9-15-03.pdf

performance requirements, property seizure, currency and capital restrictions). Most striking are the sovereignty costs associated with the delegation of adjudicative authority: virtually any legal change or rule that affects foreign investors is potentially subject to review by a foreign tribunal. The decision to sign a BIT always involves an assessment by the host as to whether the expected benefits of attracting an additional increment of foreign capital outweighs these costs. In many cases, the answer is no. In this section, we discuss the conditions under which the expected benefits for a particular government might outweigh these sovereignty costs.

BITs can attract capital from two broad resource pools. First, they can shift resources from consumption or domestic investment, effectively stimulating new international capital investments that would not have been made absent the treaty. Secondly, and more importantly for our theory, BITs can redirect international capital flows from one venue to another. A BIT gives the host signatory a "reputational advantage" over otherwise comparable rivals in the competition for (re)distribution of an existing investment pool.[36] The possibility of investment diversion means that governments may have competitive reasons to implement BITs. It is the ability of a BIT - or at a minimum, its perceived ability – to give one country an advantage over other similarly situated countries in the competition for capital that provokes many BIT signings.[37]

The strategic structure we are describing creates serious collective action problems among potential host countries. Collectively, they might be better off resisting the demands of investors (avoiding the sovereignty costs described above), but individually, it is rational to sign,

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[36] This redistributive effect contrasts with customary international law, under which all potential hosts have the same obligations and enjoy the same benefits.

[37] Guzman 1998 provides a more complete discussion of the potential impact of competition on BITs.

in hopes of stimulating capital inflows. Some regional efforts have been made to coordinate host resistance. In the Caribbean, for example, collective efforts have been made to reduce BIT concessions,[38] though predictably, the "cartel" has been difficult to maintain.[39] The observation of such efforts is consistent with the competitive context we believe accounts for the diffusion of BITs over the past several years.

A competitive theory of BITs has at least three observable implications. First, *BITs should diffuse among host country competitors.* Their power to divert is most keenly felt among countries that, from an investor's point of view are close substitutes. It is precisely these countries that should display the clearest evidence of interdependent decision making. This is a unique prediction of competitive theory. No other diffusion mechanism – whether hegemonic, cognitive, or ideational– makes this specific prediction.

Second, *BITs should diffuse more readily among host governments that lack credibility.* For these countries, a BIT can be expected to make a real difference to investors, other factors held constant. In countries that already have institutions and practices that are favorable to investors, transparent and predictable, a costly BIT adds little value. These states can compete for capital on the basis of their "inherent" credibility. This relationship is in principle consistent with power-based explanations (powerful home governments may be more likely to demand

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[38] CARICOM countries, for example, produced a document entitled "Guidelines for use in the Negotiation of Bilateral Treaties" that states, among other things, that CARICOM countries should not accept any restriction on the use of performance obligations and that they should retain the right to nationalise and to "determine at the time of nationalization the quantum of compensation and the terms of payment." Source: Caribbean Community Secretariat, reproduced in "UNCTAD, International Investment Instruments: A Compendium," v. III.

[39] Jamaica, a member of CARICOM when the guidelines were adopted, signed a string of BITs with important partners in the late 1980s and early 1990s, including the U.K. (1987); Switzerland (1990); the Netherlands (1991); Germany (1992); France (1993); Italy (1993); U.S. (1994); Argentina (1994); and China (1994). These BITs include performance requirements and compensation provisions that are inconsistent with the CARICOM guildelines.

BITs from unreliable hosts than inherently reliable ones), but it is much less consistent with the more sociological accounts supplied in the introduction to this volume. If governments have been "socialized" to accept the dominant paradigm for investor protection, there would be no reason for the more credible host governments to largely exempt themselves.

Third, *BITs should diffuse most readily to countries where the competition for capital is the most intense.* Competition intensifies where the number of plausible hosts for a particular investment project is greatest. For this reason, host competition for investment in extractive goods is far less intense than in light manufactures: while the number of countries in which bauxite mining is profitable is quite limited, almost any jurisdiction can host a Nike plant. If our competition hypothesis is correct, these treaties should be more prevalent where host competition is most fierce: in light manufactures rather than in primary production or extractive industries. This prediction is the *exact opposite* of what one might expect were the demand for BITs propelled in "hegemonic" fashion, by the home country. From a home government's point of view, theories of obsolescing bargaining should predict the need for enforceable investment protections precisely in those industries that involve large upfront difficult-to-relocate investments. Obsolescing bargaining[40] suggests investors are more likely to demand treaties to protect their extractive and primary production investments, at least relative to easier-to-relocate light manufactures.[41]

Fourth, *BITs should spread as the pool of available capital grows.* As the pool of global capital grows, any competitive advantage (such as that conferred by a BIT) should yield a larger

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[40] See Vernon 1971; Vernon 1977.

[41] Kobrin (1987) finds that manufacturing is not characterized by the inherent, structurally-based and secular obsolescence that is found in the natural resource-based industries.

marginal increase in FDI inflows. Thus, the expected return per BIT should increase with the size of the investment pool, which encourages hosts to scramble to improve access to a share of the bigger "pie." While other scholars have suggested that BITs may contribute to a growth in FDI (Neumayer and Spess, 2004), our theory suggests a possible feedback loop: the expectation of greater payoffs may stimulate more treaties. This relationship is not predicted by more sociological explanations, which might expect BITs to proliferate as a function of the density of BITs themselves, rather than the growing volume of investment. Nor is it predicted by learning theories, which would presumably require a demonstration that BITs actually "work" in attracting capital.

A competitive theory of BITs predicts interdependent decision making among competitors, diffusion to those with a credibility gap, diffusion among countries that depend on manufacturing over extractive production, and diffusion as the pool of available capital grows. In the following section, we develop an empirical strategy for testing the plausibility of economic competition among hosts in driving the diffusion of BITs.

Empirical Methods And Data

Analytical Design

We use an event history framework to estimate the duration of time before two countries sign a BIT. Our analysis begins in 1959, the year of the first BIT, and includes those BITs signed up to January 1, 2000, the last year for which we have accurate data. Since the focus of the analysis is a bilateral agreement between governments in a given year, the appropriate unit of analysis is the country dyad-year. In each dyad, we identify the potential "home" and the potential "host" country based on their relative level of development, as measured by GDP per capita. Of course, such designations become less meaningful the closer the members of the dyad

are in their level of development. But treaties among countries of a similar level of development – especially at the higher end – are considerably less likely. In the reported analyses we exclude "developed dyads" from the sample in order to minimize the bias from estimates derived from "irrelevant dyads."[42] Otherwise our sample includes all independent states, as identified by Gleditsch and Ward (1999).[43]

Event history methods offer a convenient way to incorporate time dependence in models of policy or innovation adoption. Our formulation is slightly more complicated than most since the unit of analysis is the country dyad and the model includes variables measured for one or the other member of the dyad as well as for the dyad itself. We estimate the following equation:

$$Y = \alpha X + \beta Z + \delta V_{ab} + \gamma W y_{t-1}$$

where Y is a BIT between countries A and B, X is a vector of conditions that affect country A's calculations, Z is a vector of conditions that affect country B's calculations, V is a matrix of characteristics of the relationship between country A and B, and Wy is a count of BITs among a group of host countries specified by the spatial weight W (spatial lags).[44] We estimate this equation with a Cox proportional hazard model, a useful estimator when one does not have strong assumptions about the effect of time on the baseline hazard.

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[42] We exclude dyads in which both members are classified as "highly developed" by the World Bank in that year.

[43] This inclusive sample ensures that we will encounter missing data, particularly for smaller countries. We experiment with several methods of managing missing data, none of which alter the substantive findings. For the results below, missing values are set to 0 and dummy variables indicating a missing value are included for each variable in the model. Such a method yields underestimates of standard errors (see King, Honoker, Joseph, and Scheve (2001)).

[44] While spatial lags are common solutions to estimating the relational effects that we hypothesize, they do introduce a potential degree of endogeneity. Unless non-diffusion predictors are included in the model, spatial lags can absorb these effects when the domestic variables are correlated within the network. For this reason, some scholars have moved towards simultaneous equation modeling, in order to model the endogeneity. Recent monte-carlo evidence reported in Franzese and Hays (2004) suggests that the costs associated with such models may

Data and Measures

Our dependent variable is the number of years that dyad goes without a treaty, marked by the year of a treaty's signing, rather than the year in which it enters into force. We reason that the signing not only approximates the moment during which a government deliberates over the treaty, but is also the more important event for purposes of sending a pro-investment signal to international markets.[45] Both UNCTAD and the World Bank's ICSID track the date and signatories of BITs. While the two sources basically agree, UNCTAD's list is more recent and more comprehensive.[46] As the equation above indicates, our independent variables take on one of four analytic forms: (1) independent factors associated with the 'home" country; (2) independent factors associated with the "host" country; (3) factors associated with the relationship between host and home countries; and (4) spatial lags of the dependent variable.

Spatial Lags as Diffusion Indicators: Competition, Cultural Emulation, and Learning. Spatial lags of the dependent variable are most useful in testing diffusion theories in our own competitive framework as well as some of the alternative mechanisms discussed in the introductory chapter of this volume (see Anselin 1988). To assess the source and strength of the various influences of policy diffusion we construct a series of spatial lags, modeled largely after those in Simmons and Elkins (2004). Spatial lag models treat spatial dependence in the same way time-series models treat serial correlation. Instead of lagging the value of the dependent variable one unit in time, one "lags" it one unit in space. The spatial lag is a measure of the

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outweigh their benefits in large samples. Our solution is to specify the non-diffusion components as completely as possible. Nonetheless, we recognize that effects from spatial lags may be slightly inflated.

[45] See UNCTAD 1998: "As the great majority of BITs are ratified, it is reasonable to assume that, in the perception of investors, signing a BIT is the crucial action: Once a BIT is signed, or expected to be signed, the market has absorbed it or begins to absorb it."

dependent variable (either its mean or its sum) in the host country's "neighborhood." The neighborhood is mapped by an N by N by T spatial weights matrix conventionally labeled W. Thus, a general formulation of the spatial lag for host country i can be written as

$$Wy_i = \sum_{j=1,\ldots N} W_{ij} \cdot y_j$$

where W is the spatial weights matrix and y_j is the dependent variable for country j (in our case, the number of BITs that j has signed). In matrix form we write the relationship as Wy, where y is an N by T matrix of observations on the dependent variable, with the dependent variable varying by year.[47]

Our theory predicts interdependent decision-making among host countries that compete for the same sources of global capital. Thus we need to determine the "competitive distance" between hosts. We create spatial weights that capture "competitive distance" in three ways. The first measures the degree to which host governments compete in the same foreign markets; that is, whether they have the same export trade relationships.[48] (All data sources and descriptive statistics are provided in the Data Appendix.) This is a useful indicator because trade competitors are also likely to be competitors for FDI and empirical studies show that the two are strongly correlated. We reason that countries that compete for export markets are structurally positioned to compete for the same sources of FDI as well. The second measure records the degree to

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[46] Our comparison of the two datasets found that, for the years they overlapped (1959-1997), UNCTAD included over two hundred treaties not included in the ICSID database.

[47] W, then, is an N x N x T matrix and y is an N x T matrix.

[48] We use the IMF Direction of Trade data to produce an N by N by T matrix of correlations (between countries) across the countries' proportion of exports to each of the 182 partner countries. Two countries that export goods in the same proportions to 182 countries will have a score of 1; while those with entirely opposite relationships will have score of –1. For a similar approach see Finger and Kreinen (1979). Network analysts often use this sort of measure to identify competitors (see Wasserman and Faust 1994).

which nations export the same basket of goods.[49] This measure captures the idea that investors choose between alternative locations for direct investment that they consider close substitutes. An automobile manufacturer, for example will consider investing in countries that produce steel; cocoa producers are not in the pool of comparable potential investment sites. Our third measure captures the degree to which countries have similar educational and infrastructure resources. Assuming that potential foreign direct investors are concerned with a country's human assets as well as its technological and communications infrastructure, we reason that countries with similar educational and infrastructural profiles will compete for the same pool of capital.[50] For all three competition measures, we compute a spatial lag by anchoring the distances at zero (adding 1 to each score) and then calculating the yearly sum of BITs in force weighted by each country's competition matrix.

These competition measures appear to have a fair degree of validity. For example, Figure 6 plots the values for the "distance" in export products between Brazil and select countries across time. If these values are to be believed, Brazil's products correlated quite highly with those of most Latin American countries in the 1960's and 1970's. This correlation decreased in the 1990's, at which time Brazil's export profile began to resemble that of the United States and Canada more than that of its Latin American neighbors. This finding is consistent with the common interpretation of the increasingly diversified Brazilian economy, one whose exports in

[49] We calculate the distance between countries according to their export products, using information from the World Bank's World Development Indicators (WDI) that describe a country's export mix. These indicators tap the value of exports (in 1995 US dollars) in sectors such as food, fuel, agricultural raw materials, ores and metals, and arms. We calculate the correlation between countries for each year across 13 such indicators. The result is a measure, ranging from –1 to 1, of the similarity between countries according to the products they export.

[50] We compare such investment profiles by calculating correlations, by year, between countries across roughly 15 educational and infrastructural variables selected from the WDI. These distances range from –1 to 1.

everything from technology to agriculture now compete directly with the United States and less directly with smaller Latin American nations (Baer 2001).

[Figure 6 about here]

We also use spatial lags in a similar way to measure the influence of an important alternative explanation suggested in the introduction, that of cultural peers. We use three measures of "cultural distance": predominant religion, colonial heritage, and predominant language. Unlike the competition measures, the cultural measures are binary; a country either shares a common language with another, or it does not. The spatial lag amounts to the percentage of BITs in force among those countries with the same cultural identity (religion, language, or colonial heritage). This measure captures an important possibility: that BITs result more from socially constructed emulation of policies of important reference groups than from hard-nosed economic competition. Note that this measure does not capture whether BITs are more likely *between* cultural peers, an effect we test with the relational variables themselves (see below).

Finally, spatial lags are used to capture the effects of policy learning. Our notion of learning, consistent with that articulated in Simmons, Dobbin, and Garrett (this issue), implies that policy makers from host countries are motivated to sign BITs based on the treaties' demonstrated benefits (specifically, increased FDI). Our model does not invest policy makers with Herculean powers of observation or analysis; nor does it treat them as remedial statisticians. We assume simply that policy makers assess the success of countries in attracting investment over recent years given the countries' level of development and their number of treaties in force during this time. We replicate this cognitive process by regressing, each year, the average gross foreign direct investment as a percentage of GDP for the previous five years on the average

number of treaties in force for that country during that period as well as its average GDP per capita. The unstandardized regression coefficient for the BITs variable in each of these yearly equations is our indicator of a policy maker's estimate of the payoff of these treaties in terms of increased investment.[51] Thus, we assume that each year decision makers observe and draw conclusions about the effects of BITs on investment, controlling for a country's level of development.

Because foreign direct investment data is sparse in the 1960's, the effect of the treaties is incalculable with any degree of certainty, both for us and for policy makers at the time. Throughout the 1970's and most of the 1980's the apparent effect of BITs is effectively zero. However, by the early1990's – the period in which well over half of existing BITs were signed – BITs appear to have obvious payoffs. Those countries with BITs in force in those years are very clearly also the recipients of investment. The coefficient in 1990, for example, suggests that each BIT in force is associated with an extra .05 percent of GDP in investment. Thus, a country with 50 BITs (e.g., Chile) has almost 2.5 percent of its GDP (that is, for Chile, more than a $1 billion) in investment more than a country without a BIT. This is the difference between having no foreign direct investment and having the worldwide average for a low or middle-income country, for whom gross foreign direct investment averages around 2.3 percent of GDP. To an observant host country in 1990, BITs would certainly *appear* to have some demonstrable benefits.

[51] In order to compute these results, we use only those data that are immediately available to us (and, more to the point, to policy makers). We reason that our informational constraints should match those of policy makers. As such, we use data reported in the World Bank's World Development Indicators and do not make efforts to impute or otherwise fill in missing data in these equations.

We consider one final interdependent mechanism, coercion. It may be that potential hosts are coerced or at least strongly encouraged to enter into BITs. If so, a likely juncture for the application of such pressure is at the time a country seeks IMF credits. We incorporate a dichotomous measure of whether or not a country has drawn on IMF resources in a given year. Though we do not believe the pursuit of or entry into BITs is explicitly stipulated in formal loan conditions, there may be more subtle pressures on a state in balance of payments difficulties to use these treaties to attract foreign capital.

Home Country Considerations. The proliferation of BITs could be explained by two home-country considerations: the desire to protect existing overseas capital, and the desire for additional investments. These considerations could significantly influence the pool of BITs that are potentially available, independently of any competitive dynamic among potential hosts. In the analysis that follows we control for the total FDI "exposure" of the home country; that is, the degree to which a country's capital is actually invested abroad. For this we use a measure of net foreign direct investment as a proportion of GDP (scored negatively when outflows outweigh inflows and positively when inflows outweigh outflows). On average, we expect high outflows to produce a greater willingness to supply BITs on the part of investors' governments.

We also include (but to not report) country dummies for the identity of home governments with the most active BIT programs (Germany, Switzerland, France, the UK, Italy, and the United States) to absorb any idiosyncratic tendencies to pursue BITs and to capture the effect of large BIT programs.

Host Country Considerations. Our competitive story of the diffusion of BITs suggests that competitive reputation building, through BITs, can set off a sequence of treaty signings among countries that compete with one another. In general, we expect governments with greater

indigenous credibility to be less willing to pay the sovereignty and other political costs associated with concluding BITs. We capture this idea by using an indicator of investors' perceptions of corruption in the host country. The more corrupt a state is perceived to be, the more necessary it becomes to lure investors with an explicit promise to delegate adjudication to an authoritative third party. We complement this measure with one of the nature of the legal system itself. Some research suggests common law systems tend to provide better property rights protections;[52] civil law systems are more likely, these scholars argue, to implement regulatory solutions to perceived social conflict[53] – precisely the kind of approach likely to make external capital flinch. If civil law systems are much less oriented toward credible rules of capital protection, governments in those systems should more frequently reach for an external commitment mechanism, such as a BIT.[54] Finally, we would like to use a measure of the extent to which the host's legal system is perceived by foreign investors as strong and impartial. Unfortunately, the measure that appears to be most appropriate in getting at legal strength and impartiality ("law and order") is confounded by the inclusion of investors' assessment of *popular* observance of the law, which likely has little to do with the judiciary's attitude toward foreign investors. Nonetheless, our argument implies that a reputation for "law and order" should reduce a host's need to sign a BIT.

Another important factor, and one with implications for our competition story, has to do with a country's exposure to competition. If BITs are driven by competition for capital, they should be most prevalent where that competition is most fierce. We have argued that

[52] La Porta, Lopez-De-Silanes, Shleifer and Vishny 1997. La Porta, Lopez-de-Silanes, Shleifer and Vishny 1998.

[53] Botero, Djankov, La Porta, Lopez-de-Silanes and Schleifer 2002.

competition for capital is most cutthroat in manufacturing; by comparison, there are limited sites worldwide that produce copper or other extractive commodities. The fewer the alternative investment sites – the more protected the host from international competition – the less likely a host is to sign a BIT. To capture this idea, we construct a measure of extractive industry dependence by summing the share of each country's exports of both fuel and "ores and metals", as recorded in the WDI. Approaches emphasizing the coercive role of dominant powers would anticipate a positive coefficient for extractive industries, since these are most subject to obsolescing bargaining and hence intensified political risks. Our expectation, however, is that this effect will be swamped by competition among hosts for manufacturing FDI, and we anticipate a negative effect. The outcome on the extractive industry variable thus provides a fairly crisp test of the importance of competition *among hosts* in explaining the diffusion of BITs.

Quite aside from indicators of the need for a credible commitment discussed above, a number of economic conditions make particular hosts especially attractive BIT partners. We control for the economic desirability of the investment site by controlling for market size of the host country (log of the host's GDP),[55] the host's wealth (GDP per capita),[56] and the host's growth (GDP growth rate).[57] We also control for FDI flows in the current and the previous period.[58] Realizing that actual capital flows are themselves endogenous to more basic

[54] We use an indicator of a English Common law tradition used by La Porta et. al.
[55] Kobrin 1976; Wheeler and Mody 1992.
[56] Henisz 2000.
[57] Kobrin 1976; Wheeler and Mody 1992.
[58] The literature on agglomeration economies, stressing the increasing benefits of co-location by economic units, provides a justification for including prior FDI inflows. See Wheeler and Mody 1992.

determinants of those flows, we capture the economic desirability of the potential host by controlling for the quality of its work force (the rate of illiteracy).

Finally we control for other political and policy conditions in the host country. Since investors may see democracies as less capricious, we control for the host's democracy level. It is possible that the pattern of BITs is driven by a few countries' aggressive privatization programs, and so we control for the value of privatized assets in a given year. And finally, we recognize that to sign BITs requires a certain degree of diplomatic capacity. We account for the diplomatic and legal capacity to enter into BITs by controlling for the total number of embassies a country hosts and has established in foreign countries.[59] A host with extensive diplomatic representation is more likely to have the international political and legal capacity to conclude a larger range of treaties.

Characteristics of Country Pairs. In this analytic category we identify the *relational variables* that might be associated with the likelihood of an agreement between the two nations. We focus on three kinds of relationships: business, security, and cultural relationships. Since firms are likely to want to invest in or near their export markets and to otherwise take advantage of vertical downstream linkages, [60] we control for the intensity of business transactions, proxied by the extent of trade between the two countries. Investment agreements may also have a

[59] See Guzman and Simmons 2005.

[60] The literature that has focused on firm and industry level explanations for the location of foreign direct investment emphasize that firms that depend on foreign sales are more likely to invest overseas. For example, some research suggests that firms' decision to deepen their presence in a particular country is influenced by the extent of its prior experience in that jurisdiction (Ball and Tschoegl 1982.) Others have found that firms are more likely to invest where they have strategic advantages, and these are plausible connected with vertical downstream linkages (Kimura 1989.) The measure proposed here assumed these effects may show up in the aggregate trade relationships at the national level.

foreign policy[61] or even a security rationale as well. To address this possibility, we include a measure of the intensity of the alliance relationship for each pair. We also consider the possibility that BITs reflect cultural relationships, although this variable could cut in opposing directions. On the one hand, it may be easier for states with cultural similarities to negotiate successfully. But on the other, if cultural similarities also reduce the perceived risks of investment, a common culture might operate in the opposite direction, reducing the need for a BIT. We test the relationship between cultural characteristics and BITs signing by coding country pairs with shared language, religious and colonial traditions. Note that these variables should not be confused with the cultural spatial lags, which are measures of a host's peer's treaty activity.

Findings

We present results from three specifications of our model (Table 2). The first includes the export partner lag together with the full set of covariates described above. The last two models include one of the remaining two competitive spatial lags (export product similarity and infrastructure/workforce similarity) in a reduced form of the model (excluding statistically insignificant covariates from model 1). Several clear empirical patterns begin to emerge. There is fairly consistent and convincing evidence of the importance of competition for capital among developing countries in explaining the proliferation of BITs over the past four decades. In all cases, higher rates of BIT signing among competitors appear to have significantly increased the rate at which a given country itself enters into a BIT. In two cases out of three, our measure of

[61] Gowa 1994; Pollins 1989.

the policies of competitors was statistically significant. Potential host governments seem more motivated to sign BITs when countries whose exports compete in similar third markets, and countries that can be considered comparably "attractive" to investors in terms of their infrastructure and work force have done so. In the case of similarity of export products, the substantive result was even larger than for the other two measures, but the statistical significance was just shy of standard levels (p=.14). Commercial rivals' policies seem to be a pretty clear influence on a government's attitude toward BITs.

One can see the size of these effects quite clearly in Figure 7a, which plots the survival curve for two different values of the "export partner similarity" variable. In this illustration, a country whose closest competitors have amassed 40 agreements has a markedly increased risk of signing an agreement compared with a country whose competitors have refrained from signing. In the late 1990's the difference between such countries in their probability of signing is almost .20. The results of these three competition variables alone provide preliminary evidence that competition is central to BIT diffusion.

The evidence also suggests that as global FDI has increased, potential hosts have been more willing to sign BITs. One interpretation of this finding is that as the pool of FDI has increased, the competitive stakes for a share have grown. But even more decisive for a competition model, the results clearly show that higher extractive production by the potential host *reduces* the propensity to negotiate a BIT (contrary to expectations based on investors' demands to address obsolescing bargains endemic to primary and extractive production). Figure 7b, which compares the signing rates for a government with an extractive-based economy versus one with an exclusively manufacturing-based economy, suggests that – *ceteris paribus* – signing rates can differ by as much as 20 percentage points depending upon a state's level of extractive

material exports. Both the magnitude and stability of this effect across models suggests that it is a fairly robust finding. Most importantly, this finding speaks most decisively to the *host* rather than the *home* driven diffusion of these agreements.

Host country competition also shows up in the characteristics of hosts associated with signing. We have characterized a BIT as a potential host government's way to improve access to international capital by making a credible commitment to respect property rights. Investment treaties, we have argued, are a way to enhance a reputation as a safe venue for capital investment when domestic institutions themselves can't deliver. But they involve sovereignty costs, which governments are loathe to pay unless they have no reasonable domestic alternative.

The evidence provides some support for this argument. Potential hosts that are perceived by foreign investors as corrupt are much more likely to sign BITs than those who are not; in two specifications this relationship is highly statistically significant, and in the third it is nearly so. Even more convincing is the finding that common law host countries are significantly less likely to enter into BITs than are similarly situated governments of civil law countries.[62] Common law hosts were only about half as likely to commit to a BIT as were their civil law counterparts. This suggests that common law countries have less need for an external source of credibility to be attractive to investors; theirs is built into the legal system itself.[63]

Contrary to expectations, however, we find the perception of law and order in the host positively and consistently predicts a higher probability of signing a BIT. We have already noted

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[62] Most of which are of the French civil law tradition, but including socialist legal traditions and German and Scandinavian civil law countries.

[63] Interestingly, none of the tests we ran indicate similar effects for participatory democracy. Jensen, however, argues that democracies are better able to make credible commitments and that they are therefore better able to attract FDI. Jensen 2003.

that this indicator only partially reflects our argument, as it conflates perceptions of the strength of the court system with perceptions of popular willingness to obey the law. Even so, the strong positive result is surprising. One possibility is that this measure is picking up the relatively favorable orientation of some countries toward legal solutions to conflicts generally.

In addition to the competition variables, our coercion variable (use of IMF credits) is significant in each of the models. This may mean that states seeking assistance from the IMF are encouraged to enter into BITs. Alternatively, it may be that the conditionality of IMF loans overlaps with the obligations of the BIT, reducing the costs of the latter.

Other diffusion processes may account for the spread of BITs over the past four decades, but the evidence is much less convincing than for competition dynamics. The claim that learning is taking place is not supported: the direction of the effect of a demonstrated correlation between BIT signing and FDI inflows is negative. Governments are much more likely to sign BITs based on their competitors' policies than on a (admittedly simple) demonstration that BITs "work." Note, however, that our indicator of learning is rational updating unmediated by the more sociological channeling effects discussed by Simmons, Dobbin, and Garrett (this issue). BITs signed by other hosts in a country's religious network had consistent positive effects on the propensity to enter into a BIT,[64] but those of the language and colonial heritage networks were insignificant.

Many of the variables that would predict home country interest in offering a BIT to a developing country performed quite well and generally as expected. The size of the host economy, relatively low host country wealth, and economic growth all increased the likelihood

[64] This result is consistent with Simmons and Elkins 2004.

of a BIT. Our work also comports with that of previous studies with respect to the attractiveness of low-wage, high quality work forces: large GDP per capita differentials and high literacy rates were good predictors of a BIT. BITs are also more likely to be concluded with developing countries whose current accounts tend toward surplus, indicating that an export orientation is a plus. All of the country dummies (the five most active hosts and the five most active home countries; not reported here) were highly significant, with the partial exceptions of Germany and the United States. Their inclusion reduces the potential concern that BITs diffusion is driven by idiosyncratic policies in a few of the most active countries.

Control variables describing the *relationships* between home and host countries were important predictors of BITs. While the effect of dyadic trade is as hypothesized, the effect is statistically insignificant in two of three models. Political and cultural relationships seem to be more important. In accordance with expectations, BITs are more likely among allies. A common language within the dyad makes it much more likely a pair of countries will negotiate a BIT, but a colonial link *reduces* by about two-thirds the likelihood that a country pair will do so. Perhaps investors in home countries perceive the risk in their country's former colonies to be lower than in other states. After all, colonies' legal institutions are likely to be similar to, if not partially overlap with, legal institutions in the mother country. This fits with our conception of BITs as being created to establish a credible legal framework for investment that is otherwise lacking.

Finally, we consider the potential impact of commonly experienced "shocks" on the propensity to sign BITs. All countries could have been affected by the cold war, and our results indicate a significantly lower propensity to sign BITs during that era. There is also evidence that

the commonly experienced density in these bilateral arrangements has influenced further signing. The number of BITs in force globally seems to affect the propensity to sign.

Conclusion

The use of bilateral investment treaties has grown significantly since the early 1960s. Their growth is especially remarkable given the outright rebellion many hosts have staged against customary law understandings and multilateral codifications of investors' rights that are quite similar to those contained in these proliferating bilateral accords. Why the disjunct? How can we understand the diffusion of these pro-market agreements across time and space?

The diffusion mechanisms spelled out in the introduction to this volume suggest a broad range of empirically verifiable hypotheses about BITs diffusion. Both theoretically and empirically, the competition model seems most apt in this case. These treaties are meant to improve conditions under which global capital relocates, prospers, and repatriates. They are also meant to raise the reputational stakes for governments of capital-poor economies by committing them to respect property and contractual rights of foreign investors and to agree to arbitration – effectively clipping their sovereignty – in the event of any disagreement over subsequent investment contracts. There are clearly possibilities here for mutual gain for hosts and investors, though we are agnostic about the global welfare effects of these treaties, given their potential redistributive consequences. We admit that some of the more recent treaties between very poor countries do not square with our straightforward competitive model; nonetheless, the strongest case can be made for a competitive diffusion dynamic in this case.

Let us begin with the project's null hypothesis: that country characteristics or commonly experienced shocks explain the pattern of BIT diffusion. There was plenty of support in the data for traditional economic explanations. Some of the most important drivers of the spread of BITs

are very likely factors that drive investment decisions more generally. The pattern of BITs shows that home governments want to secure investments in developing markets that are large, vibrant, somewhat open, with competitively priced, high quality labor. On the other hand, BITs are most valuable where political risk is endemic. China, which has concluded a large number of BITs with both rich and poor partners, would be the quintessential BIT partner, according to our model.

We also found strong evidence that dyadic characteristics explain BITs. BITs are much more likely to be negotiated among country pairs of the same culture (as indicated by a shared language and common religion) and among country pairs with strong security commitments. But if cultural linkages explain home-host pairs, cultural emulation is much less in evidence among potential hosts. Only one indicator of cultural emulation among hosts – share of countries within a host's religious network that have signed BITs – had any purchase at all on the diffusion of BITs. These cultural arguments may in the end be a more satisfying account available for the growing category of "strange BITs" between highly indebted, capital poor, non-contiguous country pairs. We know anecdotally that third parties (France, UNCTAD) facilitated many of these agreements, indicating that in many cases external political or cultural forces may be crucial. The strong positive effect of IMF borrowing on the propensity to sign a BIT also reminds us that a certain degree of coercion may be at play in some cases.

We do not doubt that multiple motives exist for the spread of this form of protection for foreign investors. But the competitive story has strong theoretical foundations and is the most consistently supported by the data. First, it was very well supported by three different measures of "competitive space": by export market, export product, and work force/infrastructural quality. When more of a host's closest competitors have signed BITs, that country is much more likely

do so itself. The remarkable consistency across these three highly nuanced measures of competitive space provide strong initial evidence of a tendency to match the policy choices of competitors.

Second, the size and character of markets for foreign direct investment have fed the competitive atmosphere in predictable ways. The sheer size of the available pool of investment has greatly raised countries' stakes in securing a share. More BITs are signed when the global capital pool increases. This finding is of course consistent with home countries' concern to protect their investors as well as hosts' desire to increase their access. But a second finding much more clearly indicates that the impetus for signing is host-country driven. Our theory of competition among hosts predicts more BITs where the market for FDI is most competitive – the manufacturing sector. We found, *in contrast to what theories of obsolescing bargaining would predict*, that dependence on extractive industries *reduced* the probability that a host would make such a commitment.

Finally, a theory of host-driven competition was supported by some of our findings about the qualities associated with those hosts most likely to sign. We expected BITs to be pursued most assiduously by host governments whose domestic institutions render them least able to make credible commitments to protect property rights. We found this to be supported by two very different indicators, one perceptual and the other institutional. Hosts were much more likely to sign if their regime was perceived as corrupt by foreign investors. They were also more likely to sign depending on the nature of their legal institutions. Common law countries – legal systems that some well-documented empirical work has shown to be associated with better legal protection for property rights – are much less likely to sign than are civil law countries. We recognize there are other reasons for common law countries to be reluctant to enter into

international treaty obligations generally, but these results are so strong and so consistent that the differential ability of various legal traditions indigenously to protect property rights is probably at work as well. In this context, our finding on "law and order" is somewhat puzzling. But we are far less convinced that this indicator captures the domestic institutional guarantees of protection and fairness that foreign direct investors seek.

The diffusion of norms that protect investment has been furthered by host governments' desire to attract a share of the global capital pool. We have doubts that this phenomenon can be explained by the appeal of liberal ideas alone, for we have witnessed the proliferation of BITs just as multilateral and customary law approaches have foundered. Most governments would prefer to avoid the explicit commitments contained in these treaties; there continue to be practically none concluded between the wealthiest countries of the world. In some regions, developing countries have tried to coordinate their responses to BITs in hopes of gaining more favorable terms, with notably limited success. In short, we base our conclusions on the importance of competition for capital not just on statistical relationships that show up in the quantitative analysis, but also on the broader context in which our analysis is nested.

BITs are part of a larger process of globalization that has been furthered by the dynamics of competition. This competition is driven by the desire of developing countries to participate in the global capitalist system. But has this uncoordinated strategy of signing away the sovereign right to regulate a growing segment of national economic activity yielded the results developing countries have hoped for? The evidence whether BITs actually succeed in attracting capital is unclear on this point. Our research suggests why this may be the case. Competition for capital has important redistributive consequences. The result of the BIT competition may be only minimally improved access to capital at a high cost to national sovereignty.

Table 1: The First 40 Bilateral Investment Treaties Signed
Universe: States with over 1 Million Inhabitants between 1959 and 1999

Investing Country	Host Country	Year BIT Signed
Germany	Dominican Republic	1959
Germany	Pakistan	1959
Germany	Malaysia	1960
Germany	Greece	1961
Switzerland	Tunisia	1961
Germany	Togo	1961
Germany	Thailand	1961
Germany	Liberia	1961
Germany	Morocco	1961
Switzerland	Niger	1962
Switzerland	Cote d'Ivoire	1962
Switzerland	Guinea	1962
Germany	Cameroon	1962
Switzerland	Congo	1962
Switzerland	Senegal	1962
Germany	Guinea	1962
Germany	Turkey	1962
Germany	Madagascar	1962
Switzerland	Rwanda	1963
Netherlands	Tunisia	1963
Switzerland	Liberia	1963
Switzerland	Cameroon	1963
Germany	Sri Lanka	1963
Germany	Tunisia	1963
Germany	Sudan	1963
Italy	Guinea	1964
Switzerland	Togo	1964
Germany	Senegal	1964
Germany	Niger	1964
Switzerland	Madagascar	1964
Belgium-Lux.	Tunisia	1964
Germany	Korea	1964
Switzerland	Tanzania	1965
Switzerland	Malta	1965
Germany	Sierra Leone	1965
Switzerland	Costa Rica	1965
Germany	Ecuador	1965
Netherlands	Cameroon	1965
Netherlands	Cote d'Ivoire	1965
Sweden	Cote d'Ivoire	1965

Figure 1: Number of Bilateral Investment Signed, relative to Global Foreign Direct Investment as a proportion of Global GDP, by year
Universe: States with over 1 Million Inhabitants between 1959 and 1999

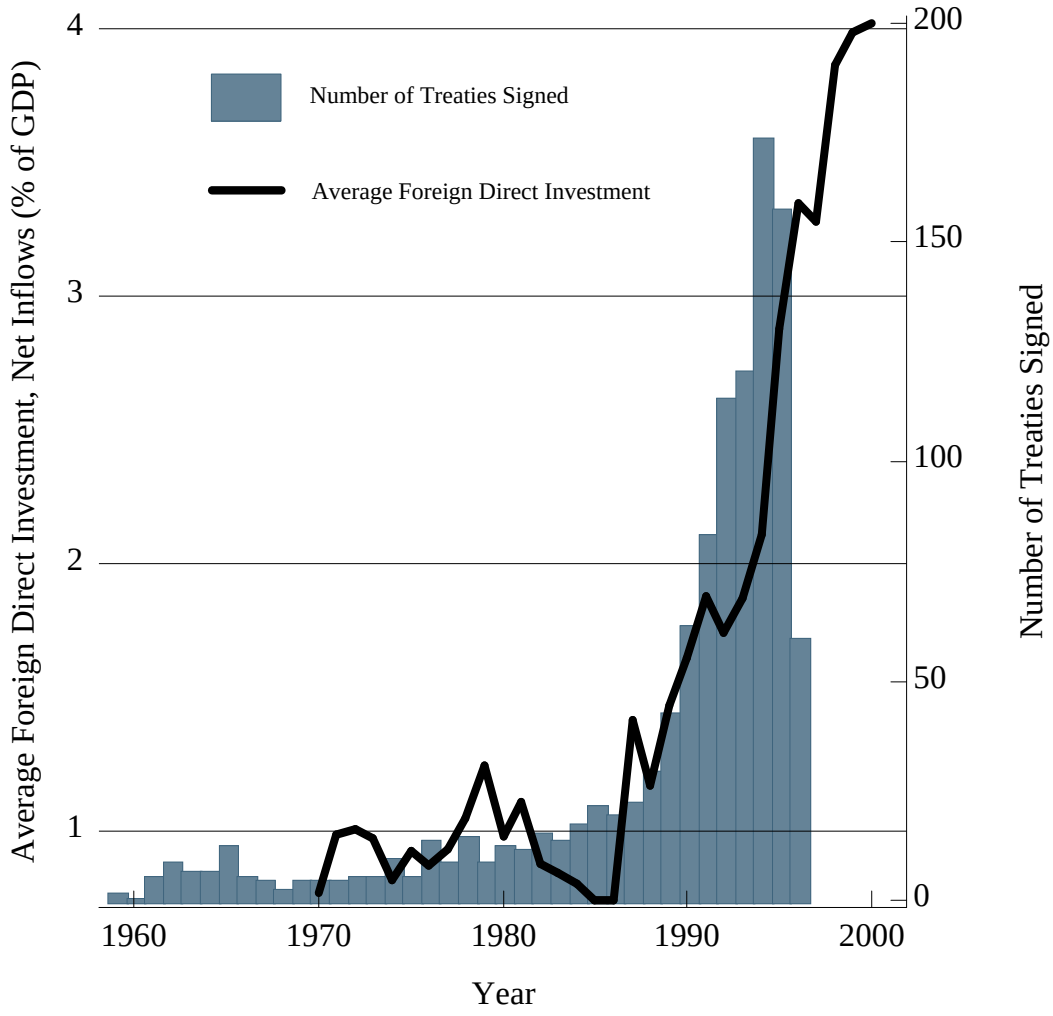
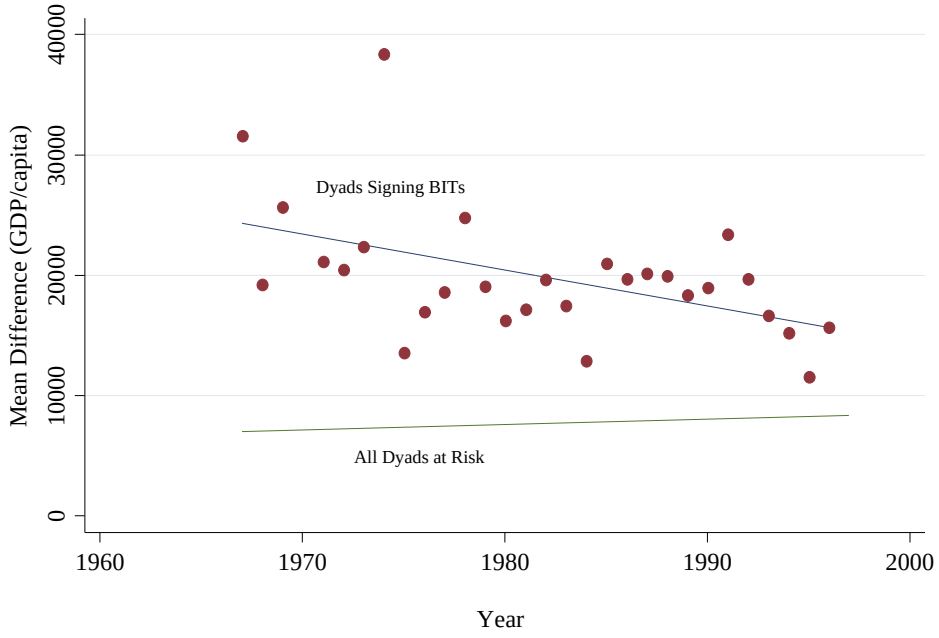
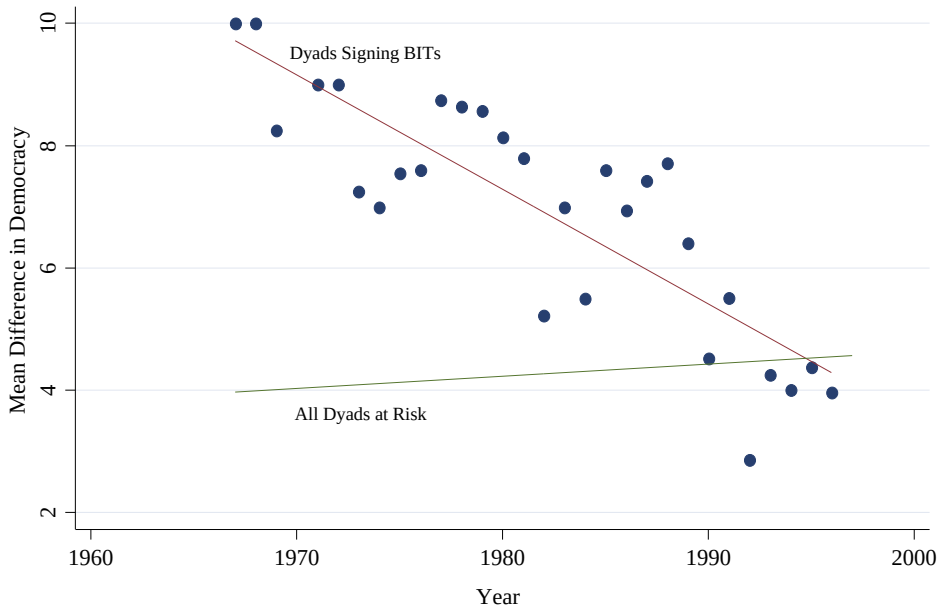


Figure 2: Mean Difference in GDP per Capita between Dyad Members
Universe: States with over 1 Million Inhabitants between 1960 and 1999



* Data points shown are for dyads signing BITs

Figure 3 Mean Difference in Democracy between Dyad Members
Universe: States with over 1 Million Inhabitants between 1960 and 1999



* Data points shown are for dyads signing BITs

Figure 4 Number of BITs signed, by country (1959-1999)
Twelve most active BIT signers of capital exporting countries

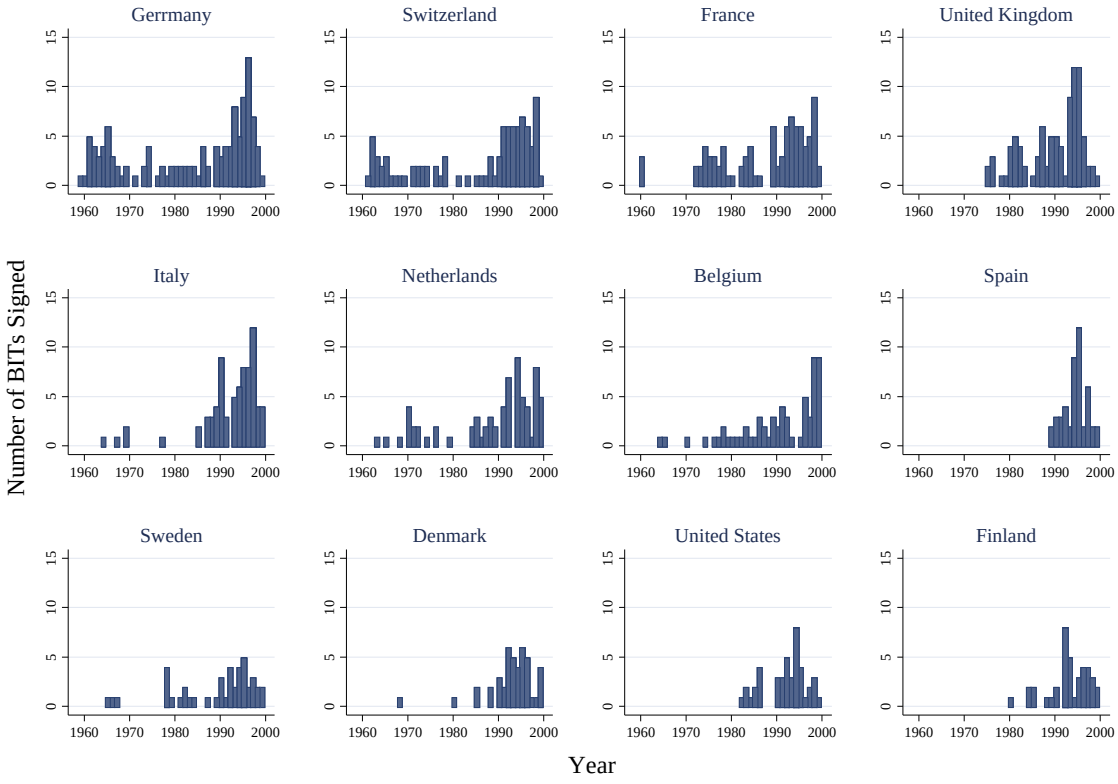


Figure 5 Number of BITs signed, by country (1959-1999)
Twelve most active BIT signers among capital importing countries

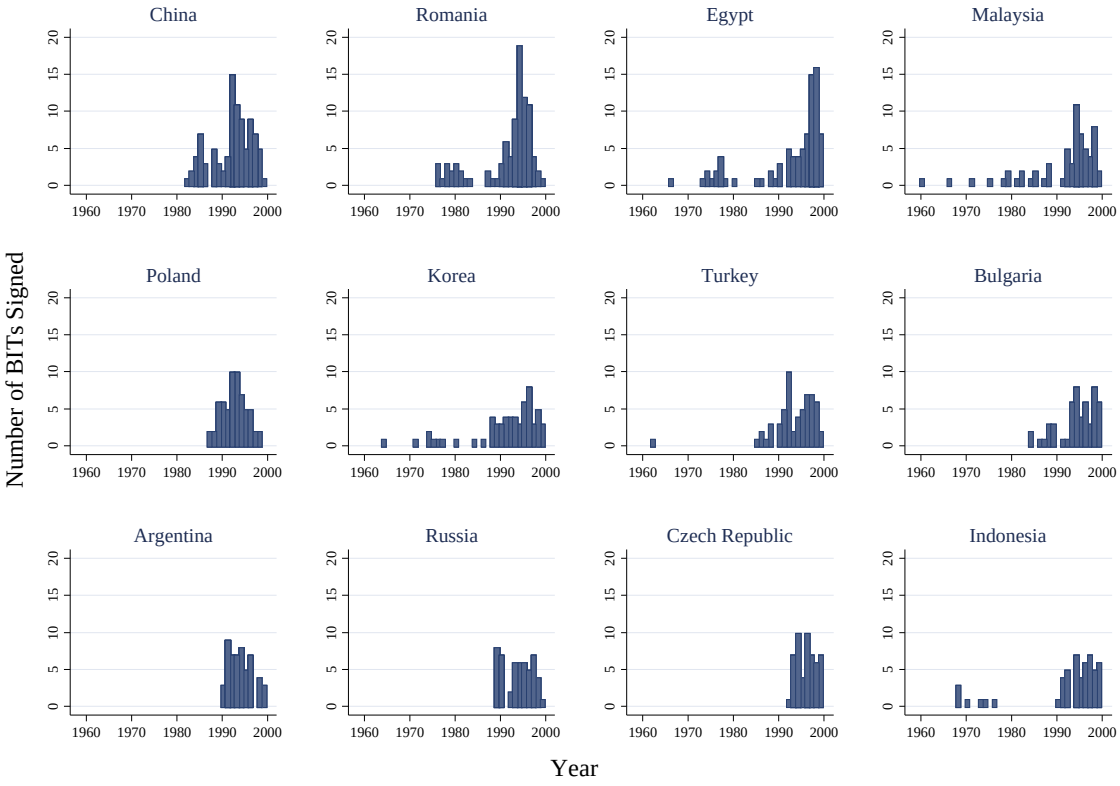


Figure 6: A Measure of Export Market Similarity, the Brazilian case

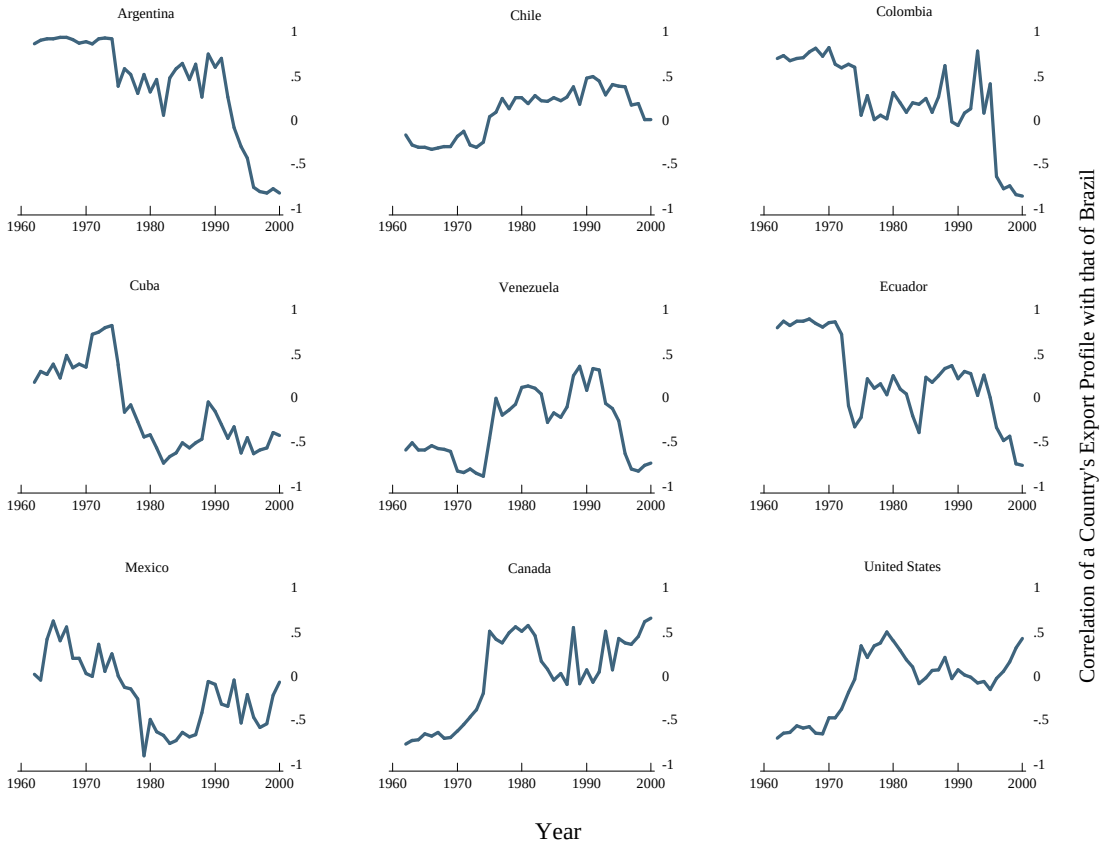


Table 2: A Model of BIT Signings
Cox Proportional Hazard Model

Explanatory Variables	Model 1	Model 2	Model 3
Competitive Theory			
BITs among hosts with…			
similar export partners	1.02***		
	(0.00)		
similar products		1.03	
		(0.02)	
similar infrastructure and education			1.02*
			(0.01)
Host's extractive industries/exports	0.55***	0.57***	0.56***
	(0.07)	(0.07)	(0.07)
Host's Corruption	1.10**	1.06*	1.06
	(0.04)	(0.04)	(0.04)
Average Annual FDI flows (global)	1.33***	1.50***	1.42***
	(0.10)	(0.12)	(0.11)
Alternative Diffusion Explanations			
Cultural Emulation: BITs among hosts with…			
similar religion	1.01	1.02*	1.02*
	(0.01)	(0.01)	(0.01)
similar language	0.99		
	(0.06)		
similar colonial heritage	1.02		
	(0.04)		
Learning from success	0.38**	0.38**	0.43**
	(0.16)	(0.15)	(0.18)
Coercion: Host's use of IMF credits	1.24***	1.18**	1.17**
	(0.10)	(0.09)	(0.09)
Host Control Variables:			
Host's GDP	0.95	0.99	0.98
	(0.03)	(0.03)	(0.03)
Host's GDP/capita	1.01	0.98	0.99
	(0.03)	(0.02)	(0.02)
Host's Growth in GDP	0.99	0.99	0.99
	(0.01)	(0.01)	(0.01)
Host's FDI (% of GDP)	12.99**	6.35	6.90
	(16.44)	(8.22)	(8.81)
Host's FDI (% of GDP, t-1)	0.07*	0.21	0.23
	(0.11)	(0.32)	(0.34)
Host's illiteracy rate	0.99***	0.99***	0.99***
	(0.00)	(0.00)	(0.00)
Host's Capital Account/GDP	1.01***	1.02***	1.02***
	(0.01)	(0.00)	(0.00)
Host's common law tradition	0.59***	0.58***	0.58***
	(0.05)	(0.05)	(0.05)
Host's Law and Order	1.17***	1.19***	1.17***
	(0.04)	(0.04)	(0.04)
Host's Democracy	1.00	1.00	1.00
	(0.01)	(0.01)	(0.01)
Host's Embassy Representation	1.01***	1.01***	1.01***
	(0.00)	(0.00)	(0.00)

Explanatory Variables	Model 1	Model 2	Model 3
Host's Privatization Record	1.07***	1.08***	1.08***
	(0.02)	(0.02)	(0.02)
Home Control Variables			
Home Net FDI	0.37	0.42	0.47
	(0.30)	(0.32)	(0.36)
Dyadic Control Variables:			
Dyadic Trade (% of hosts GDP)	1.19*	1.13	1.13
	(0.11)	(0.11)	(0.11)
Common Colonial Heritage	0.58**	0.55***	0.56***
	(0.13)	(0.12)	(0.12)
Common Language	1.38***	1.45***	1.44***
	(0.17)	(0.17)	(0.17)
Alliance	1.67***	1.43***	1.42***
	(0.20)	(0.16)	(0.16)
Common "Shocks":			
Cold war	0.64***	0.64***	0.70**
	(0.09)	(0.09)	(0.10)
Number of BITs globally, by year	1.24***	1.25***	1.21***
	(0.07)	(0.07)	(0.07)
Observations	206782	217853	209024
Number of country-pairs analyzed	6608	6957	6938
Number of BITs	1131	1232	1229
Log Likelihood	2945.445	3248.815	3250.901

Standard errors in parentheses

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

Figure 7a: Survival Estimates According to the Average Number of BITs of Competitors (measured by Similar Export Partners)
Estimates derived from Model 1, Table 3

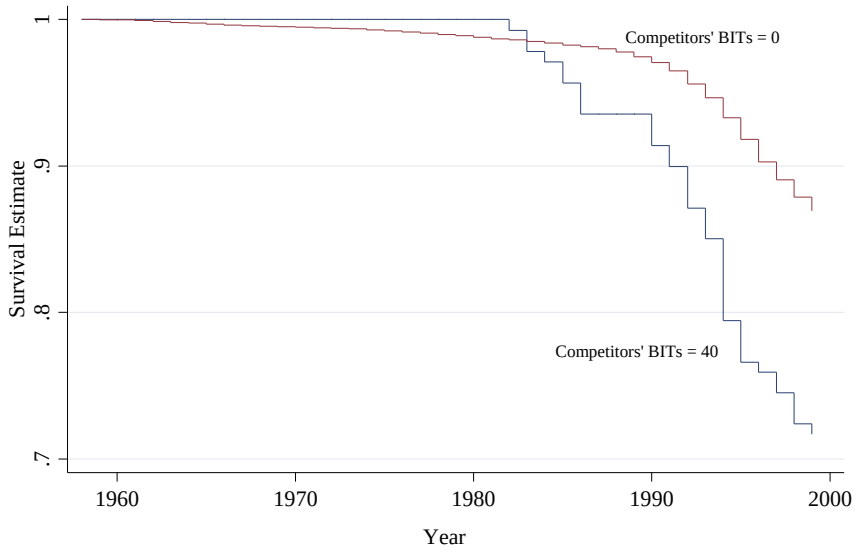
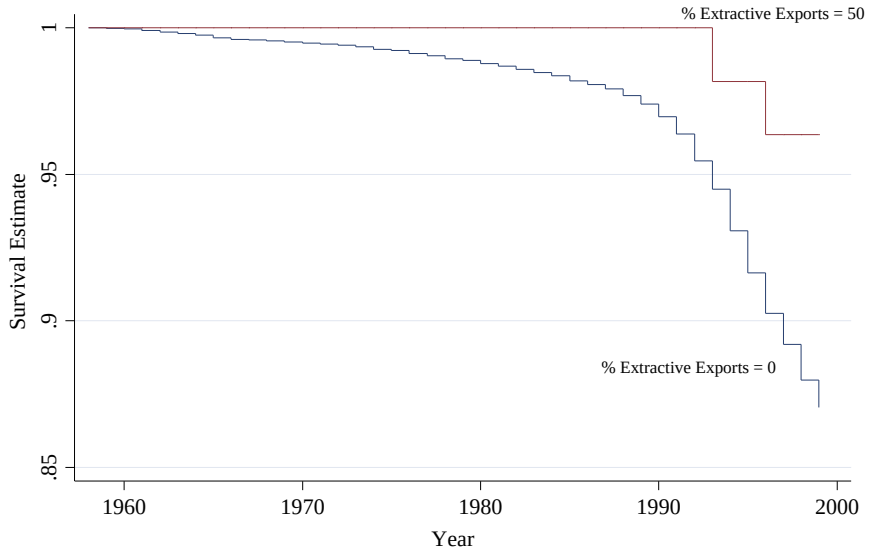


Figure 7b: Estimates According to Percent of Exports in Extractive Industries
Estimates derived from Model 2, Table 5



Data Appendix: Summary Statistics and Sources for Variables Included in the Analysis

	Variable:	Mean	SD	Min	Max	Data Sources
Dependent Variable	Bilateral Investment Treaty (Survival Rate)*	0.97	0.17	0	1	(1)
Explanatory Variables:						
Competition	BITs Among Export Market Competitors	3.28	5.64	0.00	83.82	(1), (2)
	BITs Among Export Product Competitors	2.55	3.21	0.00	10.68	(1), (3)
	BITs Among Infrastructure/Work Force Competitors	4.86	5.91	0.29	19.55	(1), (3)
	Host's extractive industries/exports	0.29	0.34	0.00	1.00	(3)
	Perceptions of Host's Corruption	3.79	1.56	0.00	6.00	(4)
	Host's Legal Heritage (Common Law)	0.28	0.45	0.00	1.00	(5)
	Perceptions of Host's Law and Order	2.96	1.95	0.00	6.00	(4)
	Average Annual Global FDI Flows	2.21	1.02	1.01	4.57	(3)
Other Diffusion Mechanisms	BITs Among Countries with same Religion	2.71	3.49	0.00	32.00	(1), (7), (8), (9)
	BITs Among Countries with same Language	3.12	3.54	0.00	43.25	(1), (6)
	BITs Among Countries with same Colonizer	2.59	3.59	0.00	56.39	(1), (6)
	Learning from Success	-0.17	0.21	-0.66	0.07	(1), (3)
	Coercion: Host's use of IMF Credits	0.76	0.39	0.00	1.00	(3)
Host Country Controls	Host's GDP	0.58	3.09	0.00	86.45	(3)
	Host's GDP/capita	2.22	4.84	0.08	52.71	(3)
	Host's GDP Growth	3.95	5.59	-61.47	85.90	(3)
	Host's FDI (% of GDP)	0.02	0.04	0.00	1.45	(3)
	Host's Illiteracy Rate	0.34	0.25	0.02	0.94	(3)
	Host's Capital Account/GDP	-4.64	8.38	-120.60	59.45	(3)
	Host's Democracy	2.88	3.76	0.00	10.00	(10)
	Host's diplomatic representation (embassies)	42.23	33.05	2.00	158.00	(11)
	Host's privatization program	0.16	0.77	0.00	14.80	(12)
Home Country Controls	Home Net FDI	0.02	0.04	0.00	1.45	(3)
Dyadic Controls	Dyadic Trade (% of Host's GDP)	0.04	0.17	0.00	8.61	(2), (3)
	Common Colonial Heritage	0.05	0.21	0.00	1.00	(6)
	Common Language	0.07	0.26	0.00	1.00	(6)
	Alliance Partners	0.06	0.25	0.00	1.00	(13)
Common "shocks"	Global number of signed BITs	4.04	4.91	0.00	17.22	(1)

*Summary statistics for the dependent variable expressed as average survival rates (rate of not signing a BIT).

Data Sources:

(1) UNCTAD, http:// www.unctad.org/en/docs/poiteiiad2.en.pdf;
(2) International Monetary Fund, *Direction of Trade Statistics*;
(3) World Bank, World Development Indicators; http://devdata.worldbank.org.ezp2.harvard.edu/dataonline/
(4) The PRS Group, http://www.prsgroup.com/
(5) La Porta, Lopez-De-Silanes, Shleifer and Vishny 1997; La Porta, Lopez-de-Silanes, Shleifer and Vishny 1998.
(6) Alvarez, Cheibub, Limongi, and Przeworski, 1996; Political and Economic Database Codebook, http://www.ssc.upenn.edu/~cheibub/data/ACLP_Codebook.PDF; various country websites.
(7) *Countries of the World and Their Leaders Yearbook 2000;*
(8) *The Europa World Year Book 1999;*
(9) Central Intelligence Agency. *CIA World Factbook.* http://www.odci.gov/cia/publications/factbook/;
(10) Polity IV Dataset, http://www.cidcm.umd.edu/inscr/polity/
(11) Tagish Diplomatic Directory: http://www2.tagish.co.uk/Links/embassy1b.nsf/.
(12) Brune, Garrett and Kogut 2004.
(13) Correlates of War Project, http://cow2.la.psu.edu/. Gibler and Sarkees 2004.

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