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BITs and bargains: Strategic aspects of bilateral and multilateral regulation of foreign investment

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Abstract

Bilateral investment treaties (BITs) provide international standards for the protection of foreign investment. Andrew Guzman has argued that BITs represent a prisoner's dilemma for developing countries—they would have been better off operating under customary international law. We formalize and critique Guzman's claim and demonstrate that a prisoner's dilemma is not necessary to explain the developing countries' behavior. Instead, the optimal strategy for newly independent states may have been to reap a windfall gain by a temporary period of expropriation and then to use BITs to commit to respecting property rights to new foreign investments. Finally, we argue that a multilateral agreement on investment (MAI) is now unlikely because the widespread coverage of BITs has narrowed the achievable surplus of an MAI.

JEL classification: F21; F53; F55; K33; O16; O19; O24

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States that receive foreign investment face a standard commitment problem: They want to attract investors because of the potential benefits that flow from capital investment, but once an investment is made, the host state has an incentive to renege on the terms of the investment, imposing high taxes and regulation or even nationalizing the investment. Enforceable contracts are the standard solution to these problems, but under customary international law,

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contracts between private investors and states are of dubious enforceability. Over the past 50 years, bilateral investment treaties (BITs) have emerged to fill this lacuna of international law by providing international standards for the treatment of foreign investments, a *pacta sunt servanda* ("pacts must be respected") for host states vis-à-vis foreign investors, and an international dispute resolution process for enforcing those standards. The history of the international legal regulation of foreign investment suggests that the current patchwork regime of BITs resulted from the strategic decisions of capital importers and exporters.

Andrew Guzman provides the seminal discussion of the impact of BITs in a 1998 paper entitled "Why LDCs Sign Treaties that Hurt Them." He argues that, on the margin, low-income countries find that signing a BIT is better than refusing to sign, but that a regime where BITs cover the world is worse for developing countries than a regime in which BITs do not exist. This is an important claim because the number of BITs has risen rapidly in recent years to about 2500 at the end of 2005. They are major instruments for the governance of cross-border investment. Furthermore, the United Nations Conference on Trade and Development (UNCTAD) has supported the BIT regime, organizing meetings in which developing and transitional countries sign BITs, not only with developed nations but also with each other (United Nations Conference on Trade and Development [UNCTAD], 2000). If this effort might do more harm than good, then it is important to understand how that could be so.

Guzman's basic argument is that a multi-party "prisoner's dilemma" exists under which each developing country has an incentive to sign BITs with developed countries that may supply foreign direct investment (FDI) or other types of investment capital (Guzman, 1998, pp. 666–667). At any point in time, the benefits to a less developed country of signing a BIT with a wealthier country may exceed the value of staying out and losing investment funds to rival countries. However, once all become part of a system that protects outside investors, BITs do not give any less-developed country a competitive advantage over any other, and most of the surplus from foreign investment is transferred to the investors. Thus, developing countries might be better off if the option of signing BITs were not available. Of course, as Guzman recognizes, the BITs regime may be better for developing countries than a no-BIT regime if the overall level of investment flowing to developing countries is sufficiently increased—the net result depends upon the relative magnitudes of the increased total flow of investment versus the lower benefits earned by developing countries per dollar of investment. But Guzman argues that the initial resistance of developing countries to rules of customary international law that protect foreign investment implies that the latter effect dominates, making developing countries worse off. As Guzman notes, his argument is a direct application of work on competitive markets and its extension to the inter-state competition for investment (Guzman, 1998, p. 672). The inter-governmental literature demonstrates both that competition can limit rent seeking by individual governments, but that, at the same time, it favors mobile owners of capital who can pick their locations (Rose-Ackerman & Engel, 2001; Rose-Ackerman & Rodden, 1997). Inter-state competition for investment funds can limit the benefits obtained by governments and their taxpayers.

This paper builds on and critiques Guzman's analysis. We first formalize Guzman's argument using a simple stylized model of BIT signings. Our analysis clarifies the assumptions behind Guzman's paper and also demonstrates weaknesses in his analysis. Given our critique of Guzman's model, we propose an alternative explanation for the initial resistance of