ELSEVIER International Review of Law and Economics 25 (2005) 107–123

International Review of Law and Economics

International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance

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Abstract

This paper concerns the increasing use of international commitment devices by developing countries. These devices include bilateral investment treaties, international arbitration, and multilateral trade commitments. The conventional wisdom is that such devices help to remedy local institutional deficiencies. Using an empirical analysis of bilateral investment treaties, this paper argues that, under some circumstances, international devices may be substitutes for local institutions and lead to reductions in governance quality.
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Keywords: Domestic institution; Foreign investment; Governance; International law

Parties to an international contract have essentially three alternatives to resolve disputes and enforce sanctions against opportunism. They can rely on formal contract law enforced by state courts or other domestic institutions that ultimately rely on state courts. They can rely on a variety of informal institutions, utilizing reputation and shame sanctions to deter breach and enforce agreements. Or they can look to international institutions such as arbitration to enforce promises. This paper is primarily concerned with one increasingly popular form of international alternative to domestic institutional protection, the Bilateral Investment Treaty (BIT).

From a modest beginning in 1959, such treaties (known as BITs) have surged in popularity. BITs are designed to protect foreign investors against expropriation and regulatory

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0144-8188/$ – see front matter © 2004 Elsevier Inc. All rights reserved.
doi:10.1016/j.irle.2004.06.002

uncertainty. They typically will specify standards of treatment for foreign investors from a home country in a host country, and provide for extra-jurisdictional dispute resolution and enforcement, lowering the risk of bias in the local jurisdiction. BITs take advantage of a widely recognized regime of international arbitration, especially a sub-set of it involving a novel right of private investors to bring suit against a sovereign state, a relatively new development in international law.[1]

This paper begins by describing the BITs and their rapid spread as a primary institution to regulate investment, along with a consideration of their economic character. Part II then describes the characteristics of countries that have signed BITs, showing that countries that have signed them are richer, more democractic, and have better governance. Part III then describes several puzzles related to the BITs, concluding that BITs are best understood as a coordination device to resolve a Battle of the Sexes game between investors and host countries over the level of investment protection. Part IV evaluates the effects of BITs on developing country governance and shows that their effect is ambiguous at best. The implication is that sometimes international commitment devices can substitute for, rather than complement, domestic institutions. This result helps reconcile the puzzle of how hundreds of millions of dollars in governance assistance has produced so little improvement in developing countries in the last decade.

Although the focus is on bilateral investment treaties, it is suggestive of a broader set of questions. Much of the work to date on the role of law in economic development has focused on domestic institutions. The focus to date has been almost exclusively on the positive and normative questions associated with identifying domestic institutional configurations that will facilitate economic growth. This research agenda has produced very rich results. This paper argues, however, that more attention should be paid to institutions that lie at the intersection of the domestic and international spheres. These institutions allow investors and governments alike to "exit" the local jurisdiction, with effects on domestic institutional environments.

1. Bilateral investment treaties and the standard of expropriation

A Bilateral Investment Treaty is a treaty concluded between two states designed to regulate investment between them. Most analysts believe the purpose of the BITs is to attract foreign investment by providing security to foreign investors, primarily in developing countries where fear of expropriation might otherwise deter investment. To date, most BITs have been concluded between a developed country and a developing country.[2] While the number of BITs between two developing countries has expanded in the last decade, no BIT

[1] The most well-known institution that provides this arbitration is the World Bank's International Centre for the Settlement of International Disputes, which as of this writing has a docket of 48 cases brought by foreign investors against regulatory and policy changes that allegedly violated agreements. In one case, a tribunal ordered the Czech Republic to pay one company $350 million for depriving it of a stake in a television station. Several similar cases have been successfully resolved under Chapter 11 of the North American Free Trade Agreement (NAFTA).

[2] Zachary Elkins, Andrew Guzman and Beth Simmons, Competing for Capital: The Diffusion of Bilateral Investment Treaties 1960–2000, draft on file with author.

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