The Effects of International Investment Arbitrations on Foreign Direct Investment Flows

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Abstract

Do international investment disputes only ever have a downside for the governments involved, or can they also have an upside? The question is tackled empirically in the context of Foreign Direct Investment (FDI). FDI arguably drives economic growth, but governments of low-income countries may face a temptation to expropriate foreign investors, e.g. to redistribute wealth. As scholars noted, countries that expropriate may suffer damages to their reputation as safe investment locales, especially when investors lodge complaints with international institutions, thereby discouraging future FDI. Current studies assume that any dispute damages the trustworthiness of the host country involved, regardless of the outcome. This study shows how the outcome of a dispute may matter more than its filing and contributes an original causal mechanism to the literature: when countries lose a dispute, their reputation takes a hit, but when they win or settle a dispute their reputation can improve. The article contributes to the empirical literature on foreign direct investment, investment treaties and dispute resolution mechanisms. The empirical contribution is a statistical analysis of how international arbitrations help shaping the reputation of host states as trustworthy investment destinations. The results can inform policy debates on investment agreements, at a time when many are terminated unilaterally, and on the impact of transparency in dispute settlement.

1 Introduction and Research Question

Investment provisions are among the thorniest issues in contemporary global governance. Economic and trade agreements have not been finalized owing to disagreement on investment chapters, such as in the case of the Canada-European Union Comprehensive Economic and Trade Agreement (Pelc 2017). Research in international political economy analyzing the effects of investment treaties has often focused on how international investment arbitrations, made possible by investment treaties with investor-state dispute settlement provisions, has

affected flows of foreign direct investment (FDI). FDI is among the most studied phenomena in international economic relations, being the largest source of capital inflow in the developing world (Singer 2010) and resilient to most crises (Büthe and Milner 2014; Loungani and Razin 2001).

FDI also presents a stark dilemma: while it arguably drives economic growth and technology transfer to host countries, in particular to low-income host countries, at the same time it may tempt governments to expropriate foreign investors to redistribute wealth, whether directly (i.e., by nationalizing assets) or indirectly (e.g., by changing laws or regulations). In 2006, newly elected Bolivian president Evo Morales nationalized the entire natural gas industry and Venezuelan president Hugo Chávez expropriated two oil fields from French and Italian companies. Li (2009) reports over 500 acts of direct expropriation between 1960 and 1990, and since 1996 over 100 claims of direct expropriation have been filed at various international institutions.[1] Indirect expropriation can happen when governments change the regulatory or investment environment in a way that negatively and discriminatorily affects a company or investor, including with new labor or environmental regulations. For example, around 2010 the Venezuelan government refused to issue an environmental permit to a Canadian-based mining company which meant a *de facto* the termination of a contract; as a result of an investment arbitration on the matter, Venezuela was ordered to pay over one billion U.S. dollars in damages to the firm.[2] Indirect expropriation appears to be increasingly more common with respect to direct expropriation (Pelc 2017): for every direct expropriation
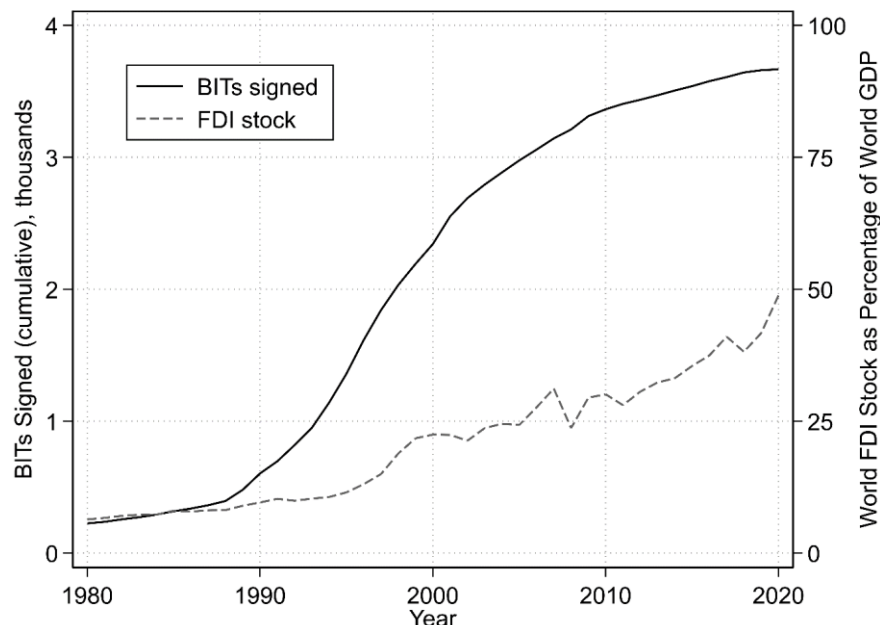
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[1] UNCTAD, Investment Policy Hub.
[2] ICSID Case No. ARB(AF)/11/2.

dispute there have been roughly four indirect expropriation cases.[3]

Figure 1: Total Number of Bilateral Investment Treaties Signed and World FDI Stock as Percentage of World GDP. 1980-2020.

Note to Fig. 1: The solid line shows the total number of bilateral investment treaties signed worldwide until a given year. The dotted line shows worldwide FDI instock as a percentage of world GDP, namely the ratio between FDI stock, as the value of capital and reserves attributable to a non-resident parent enterprise (plus the net indebtedness of foreign affiliates to parent enterprises), and total world GDP. The figure presents the astonishing growth and increased importance of FDI for the world's economy over the past 40 years. FDI stock was about 6.4% of the world GDP in 1987, and it became almost 50% in 2020. Data from UNCTAD: World Investment Report 2021, FDI/MNE Database, Investment Policy Hub.

Political science scholarship investigated the impact of bilateral investment treaties (BITs) that many governments of low-income countries have signed as credible commitments to investors. Starting in the 1960s, governments around the world started signing Bilateral Investment Treaties (BITs) establishing the terms and conditions for private international investment between two countries. The single most important aspect of a BIT consists in its

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[3] The estimate refers to cases for which data is available. UNCTAD, Investment Policy Hub.

investor-state dispute settlement clauses (Franck 2006; Simmons 2014), which endow private investors with the right to directly sue a foreign government for damages. Supporters claim that companies would look more favorably upon a host country if there was a BIT protecting the firm's investment (Allee and Peinhardt 2011; Jensen 2008; Rosendorff and Shin 2012; Tobin and Rose-Ackerman 2011), since before BITs only a state could file a claim against another state (Simmons 2014). The BIT-signing frenzy of the 1990s and 2000s sometimes resulted in over 200 new BITs signed in a single year. There are currently more than 2,500 investment treaties in force worldwide.[4] In the past forty years, the role of FDI in the world economy has been steadily and remarkably increasing, so much so that worldwide FDI stock in 2020 was nearly 8 times the share of world GDP than it represented in 1980 (Figure 1).

The number of publicly known investor-state arbitrations increased markedly in the 2000s, following the surge in BITs signing and the increase in FDI flows.[5] The explosion of investor-states disputes in the past 10-20 years meant that almost twice as many cases were filed in the 10 years between 2010-2019 than in the previous 23 years, from 1987-2009 (Figure 2).[6]

By allowing individual foreign investors to file a claim against a government, BITs created a new institutional mechanism in the investment regime capable of generating new signals concerning the credibility and the reputation of host governments. When host countries expropriate foreign investors without prompt and adequate compensation, they may suffer damages to their reputations as safe investment locales and thereby discourage future

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[4] UNCTAD, Investment Policy Hub.
[5] While investment arbitrations can also be filed under the framework of a Free Trade Agreement (FTA) or a multilateral Treaty with Investment Provisions (TIP) for example, the vast majority of known disputes have been filed by invoking a BIT as a legal instrument.
[6] The first ISDS case ever filed was in 1987.

investment.

Figure 2 – Total Number of Investor-State Disputes (cumulative) and FDI Stock as Percentage of World GDP. 1980-2020
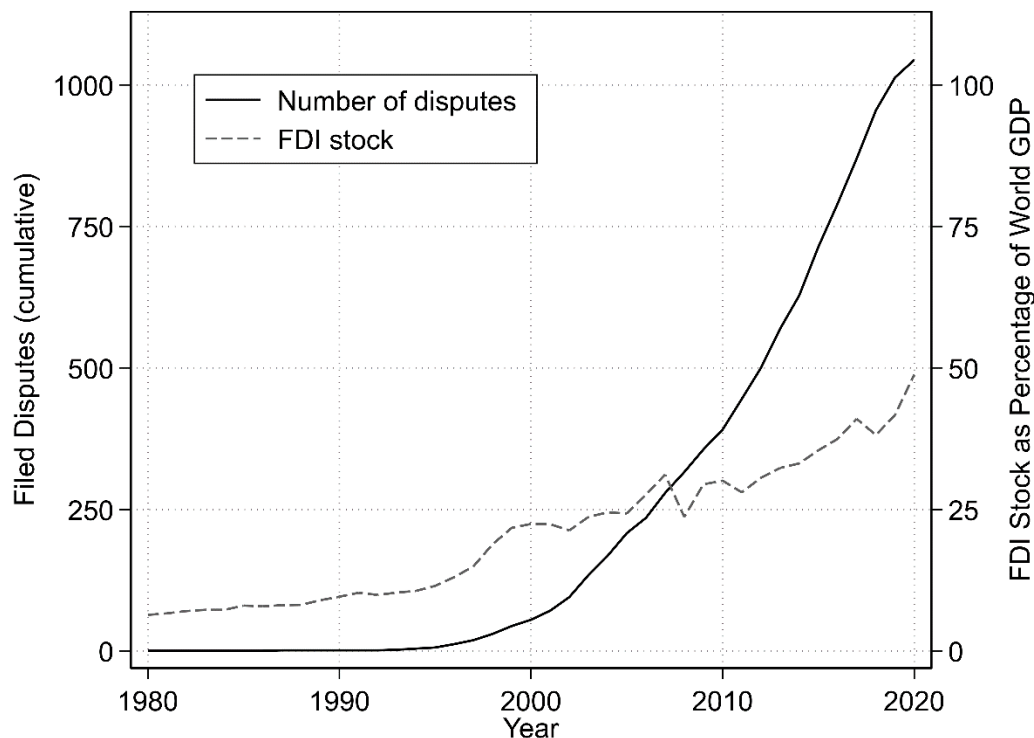
Note to Fig. 2: The solid line shows the total number of investor-state disputes filed until a given year. The dotted line shows FDI instock as a percentage of world GDP, namely the ratio between FDI stock, as the value of capital and reserves attributable to a non-resident parent enterprise (plus the net indebtedness of foreign affiliates to parent enterprises), and total world GDP. The figure highlights the explosion of investor-states disputes in the past 10-20 years. Almost twice as many cases were filed in the 10 years between 2010-2019 than in the previous 23 years, from 1987-2009. The first ISDS case ever filed was in 1987. Data sources from UNCTAD: World Investment Report 2021, FDI/MNE Database, Investment Policy Hub.

Some scholars argue that whenever a government is involved in a dispute its reputation is tarnished (Aisbett, Busse, and Nunnenkamp 2018; Allee and Peinhardt 2011; Wellhausen 2015). However, if that were the case, it should be expected that investors would move their money elsewhere after a country's involvement in a dispute, regardless of the outcome. This is

not what can be observed. On the one hand, Argentina and Venezuela saw their foreign investment inflows dry up quickly after receiving a sleuth of filings beginning in the late 1990s. On the other hand, however, Mexico's and India's FDI inflows increased even after multiple disputes were filed against them by investors. The question is whether the initial act of filing an arbitration, by itself, entirely captures the effects of the arbitration process. If an investment dispute does not always tarnish a country's reputation, can it improve it in some contexts and contribute in explaining why FDI levels increase over the years even in countries heavily involved in investment disputes?

For example, although Mexico is among the countries most targeted by disputes with thirty cases filed against it in 1997-2017, the total FDI in Mexico (FDI stock) as a percentage of total world FDI grew more or less steadily from 1.2% in 1997 to 2% in 2012. This implies that international investors increased their investments in Mexico compared to other countries for over 15 years despite the arbitrations against Mexico.[7] Even more puzzling is the case of India: both the number of cases against India and its total FDI as a proportion of world FDI have been increasing since 2000, with inward FDI in India increasing from .36% to 1.16% of world FDI from 2003 to 2017. India's FDI as the *proportion* of world FDI more than tripled in those 14 years, despite the numerous arbitrations against India's government.[8] This shows that investors as a group can increase their relative investments in countries that are among the most heavily involved in investment disputes. For India, whose FDI increased with respect to

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[7] Mexicos's FDI inward stock was 56 billion USD in 1997; it increased to 459 billion USD in 2012.
[8] World FDI increased significanly from 2003 to 2017, which explains also why India's inward FDI stock skyrocketed from 32 to 377 billion USD in those same years. Data on FDI and data on cases filed is from UNCTAD, Investment Policy Hub.

other countries, ten of the twelve concluded arbitrations (83%) were either settled or discontinued; investors only won one case. In contrast, only four out of the twenty-one (19%) concluded arbitrations against Mexico were either settled or discontinued; investors won nine (43%).[9]

This article deals with how international arbitrations can impact cooperation on investment by looking at the effects of different dispute settlement outcomes on FDI flows. While previous studies have looked mainly at the effect of case filings on FDI, I focus on how the possible case outcomes (settlement, case won by investor, case won by host government) can influence government reputation in the eyes of investors through different causal mechanisms, which in turn affects FDI inflows to the host countries.

The study advances novel theoretical and empirical contributions that complement our understanding of the effects of investment arbitrations. The main theoretical contribution of the article is an original reputational mechanism: I argue that when an arbitration is settled, the reputation of the host government as a safe investment locale can improve, thereby increasing FDI inflows. Previous studies assumed that any investment arbitration carried negative consequences for the governments involved, mostly due to their focus mainly on the arbitration filing and not always also on the arbitration outcome.

The main empirical contribution of the paper is the estimation of the impact of the outcomes of investment arbitrations, in addition to their filings. I find that a settlement of an international arbitration is associated with an increase in the host government's FDI inflow. More generally, the paper finds strong evidence in support of the argument that different arbitration outcomes

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[9] UNCTAD, Investment Policy Hub.

have different effects on the reputation of the host countries involved. These findings resonate with and complement the broader political science literature by providing a better understanding of the incentives available to host governments.

Lastly, this study sheds light on the implications of the lack of transparency and publicity regarding arbitral proceedings (Hafner-Burton, Steinert-Threlkeld, and Victor 2016). Greater transparency may benefit especially low- and middle-income countries, which are overwhelming more likely to be involved as defendants in investment arbitrations: in 2019, 80% of new arbitrations were brought against developing and transitioning economies.[10]

The article proceeds as follows. First, I discuss the literature on investor-state dispute settlement in international relations and related disciplines. Second, I introduce novel theoretical claims regarding the effects of investment arbitrations and offer four testable implications of the argument. Third, I describe the statistical analysis, data and method, and present the findings. Finally, I discuss the policy implications of the findings and avenues for further research.

2   Dispute Settlement and Foreign Direct Investment

There are relatively few works in the literature that deal explicitly and empirically with the relationship between FDI inflow and investment arbitrations (e.g., Aisbett, Busse, and Nunnenkamp 2018; Allee and Peinhardt 2011; Wellhausen 2015). These articles focus mostly on the reputation-damaging consequences of investment arbitrations without considering potential reputation-improving effects. Allee and Peinhardt (2011) find that an ISDS filed

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[10] UNCTAD, International Investment Agreement Issue Note, July 2020.

against a host country leads to less FDI, suggesting that any ISDS activity would be an unequivocal signal to current and potential investors that would damage the trustworthiness of the host country.[11]

An investor may be more responsive toward arbitrations that affect herself or other conational investors directly, compared to arbitrations that concern investors from different countries. Wellhausen (2015) shows that arbitrations tend to matter more within a specific home-host relationship. Namely, bilateral FDI flows within a directed dyad are likely to decrease on average once an investor from the home country files an arbitration against the host government.[12] Similarly, Aisbett, Busse, and Nunnenkamp (2018) claim that a single filing causes a significant reputational damage to the host government, which leads to a significant decrease in FDI to the host country from the home country of the dissatisfied investor.

If the purpose is to understand the total effects of investment arbitrations on FDI flows, then a narrow focus on the act of filing a dispute tells us little about the impact of the outcome of the dispute. Even by looking at all the available data, the mere act of filing does not necessarily allow an observer to make any statistically justifiable or reasonable inference without information beyond the filing. For example, the percentages of cases won by investors (29%), cases won by the host state (36%) and cases settled or discontinued (32%) are similar and statistically indistinguishable from one another (Table 1).[13] A filing does not give investors

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[11] They use country-year data.

[12] The article deals with 'breach of contract', but that is based exclusively on whether an investment arbitration is filed and does not tell observers whether a contract was in fact breached by the host state. Investors may file cases for other reasons, without even the perception of a breach of contract. Pelc 2017. For example, in one instance a case was dismissed by the court because "the Claimant's claim is fraudulent and was brought in bad faith". Award of Cementownia v. Turkey (I), ICSID Case No. ARB(AF)/06/2.

[13] This applies whether reference is made to all cases or only to cases involving BITs.

enough information by itself to determine whether a contract has actually been breached, unless they are willing to discount the work and the output of arbitration tribunals in its entirety, so that every filing is unambiguous evidence of untrustworthy behavior on the part of the state. If it were the case, it is not clear that dispute-settlement institutions would have any independent informational effect at all. If all the information observers care about were in the act of filing, what role can the outcome play? Since international investors can unilaterally file an arbitration against a government, what are the implications for the investor-state dispute settlement regime? This is relevant to both developing and developed countries, as investors come overwhelmingly from capital-rich countries and may file for leverage or to deter government regulation also in developing jurisdictions (Kerner and Pelc 2022; Pelc 2017). In the context of trade, Chaudoin, Kucik, and Pelc (2016) found that disputes brought up at the World Trade Organization can have different effects on trade depending on the outcome. What are the different effects of different investment arbitration outcomes?

3   Theory and Testable Implications

This section presents a theory of how investment arbitrations influence foreign investors' perceptions of the investment environment of a host country. An international investor is based in a home country and directs or re-directs her capital towards a host country.[14] The theory focuses on investors that are not directly involved in an arbitration (as claimants) against a host government, and on how they interpret and act upon information produced by

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[14] There are costs involved in moving capital or investment, which depend on the nature of the investment and its sector. Including these costs does not alter the argument.

arbitration outcomes that are made publicly available.[15]

The decision of where to invest is mainly influenced by economic and political considerations (Beazer and Blake 2018; Jensen 2008). Investors commonly pick destinations where they expect the highest returns on their investment, by assessing market opportunities or international openness to capital of a potential host country. When assessing risk to invested assets in a host country, the types of risks considered by investors typically fall in two categories: structural predictors and government behavior. Structural predictors may include political factors like executive constraints, respect of property rights and risks connected to international security.[16] In contrast, information on the behavior of host governments towards other investors is not as publicly available.

The perceived trustworthiness of a host government goes beyond the constitutional *de iure* powers of the executive or the private property rights and guarantees that are legally available in a jurisdiction, and it also refers to the *de facto* behavior of host governments in their dealings with investors. For example, investors are likely to learn of a new government policy that would transfer more than 80% of the value of an oil field production to the state, because that policy would be public,[17] but investors are less likely to learn that a government is

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[15] The difference between an investor who is also a claimant and an investor that is not a claimant is purely functional. They are part of the same set of foreign investors, but while all claimants are investors, not all investors necessarily are or become claimants, because they may never decide to file a claim or may not be in position to take advantage of any treaty or contract to do so. The overwhelming majority of investors never file investor-state disputes against a host state.

[16] In addition to data from the World Bank or other organizations, there are several specialized business publications that focus on these types of risk. One of the most widely used by the business community is the International Country Risk Guide (ICRG).

[17] As President Morales did in Bolivia in 2006. Hajzler 2012.

allowing a *de facto* occupation of an investor's property without compensation.[18] In other words, it is not easy for investors that are not directly affected by specific government actions to learn of administrative or other roadblocks a government or an administration may put in place that may unduly affect the value of an investment, or that may allegedly amount to a failure to guarantee fair and equitable treatment. Investors are working with poor information on the *de facto* behavior of host countries because from the outside it may be difficult to distinguish unlawful expropriation from legitimate, BIT-consistent behavior.[19]

The information produced by international arbitration tribunals allows boundedly-rational investors to update their prior beliefs about a host country behavior. Put differently, investment arbitrations provide information that would not have been public otherwise. The value of this information is highlighted by the fact that the parties involved in these disputes often go to great lengths to keep the proceedings secret (Hafner-Burton, Steinert-Threlkeld, and Victor 2016).

The outcome of an investment arbitration is an informative part of the arbitration process for investors. ISDS arbitrations can only be started by investors, who can file a claim against a host government at a dispute settlement institution.[20] Most previous research on the topic focuses exclusively on this initial aspect of an arbitration. However, the fact that claims are filed unilaterally by investors may elicit investors to sometimes leverage claims towards host

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[18] For example, as an arbitration decided was the case for a Belgian investor in Burundi. Joseph Houben v. Republic of Burundi, ICSID Case No. ARB/13/7.

[19] A government expropriation may be lawful if followed by prompt, adequate and effective compensation (Hull's rule). Such cases may be consistent with BIT obligations when the expropriation is due to national security or other overriding government interests, provided that a suitable compensation protects the interest of foreign investors.

[20] Provided the home country of the investor has treaty with ISDS provisions, such as a Bilateral Investment Treaty or a Treaty with Investment Provisions (TIPs), for example. There are over 2,500 BITs or TIPs currently in force. UNCTAD, Investment Policy Hub.

countries for strategic reasons (Pelc 2017), thereby making the filing of a dispute a noisy signal for observing investors. A tribunal then adjudicates the case on the evidence presented by the parties and renders an award. The award can be favorable to the investor (the tribunal upholds the claim, fully or in part, and awards compensation to the investor) or it can be favorable to the host government (the tribunal finds the claim with no legal merit, does not award compensation to the investor, or may even decide that the investor is to bear the majority of the tribunal costs). The outcome of an arbitration can be more informative than its filing because it indicates not only that an investor and a host country have an ongoing dispute, but also that the respective responsibilities of the parties according to the tribunal. At any point during the arbitration the parties can discontinue or settle the dispute; the latter outcomes are also informative because they are observationally equivalent to the claimant (investor) discontinuing the proceedings.

Investors' decisions on FDI allocations can only be affected by information related to investor-state disputes if investors know of these disputes. Formal or informal ties among executives of firms of the same nationality are especially common within the business community working abroad, compared to ties among executives that work for firms of different nationalities (Wellhausen 2014). Therefore, firms with the same nationality that invest in the same host country are more likely to know of cases filed by conational companies, so information from an investor-state dispute is more likely to impact FDI flows between the home and host country, compared to FDI flows coming to the host country from different countries that were not directly involved in an arbitration.

Depending on the outcome, an arbitration can convey different information that could influence FDI flows, and such information is more likely to affect primarily FDI flows between the home and host countries involved in the arbitration.

3.1 Arbitration Filing

The informational content conveyed by the filing of an arbitration does not necessarily affect the reputation of a host country because, by itself, it does not indicate whether the host country breached the terms of a contract. Lacking any additional information, a filing may not even suggest that a host country is likely to be in the wrong, as historically more cases have been won by host countries (36.5%) than by investors (29.4%), as Table 1 shows.

Some scholars suggest the filing could be interpreted as a somewhat costly signal due to the arbitration costs. In 2011–2015, legal fees (plus tribunal costs) for each party of an arbitration were around 5-6 million USD on average (Commission 2016). However, arbitration costs can be vastly offset by the award, as almost 70% of publicly available cases that were decided in favor of investors awarded more than 10 million USD to investors, and 25% awarded investors more than 100 million USD.

The signal sent by a filing is further confused by the possibility open to investors to file a case strategically, in order to strengthen their bargaining position for contract negotiations or other reasons (Calvert 2017; Pelc 2017; cf. also Johns, Thrall, and Wellhausen 2020). To mention only one example, a case was dismissed by an international tribunal because, as the court put it, "the Claimant's claim is fraudulent and was brought in bad faith".[21] In other

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[21] Award of *Cementownia v. Turkey (I)*, ICSID Case No. ARB(AF)/06/2. Cementownia was based in Poland.

words, an arbitration filing *by itself* may not particularly informative and may not be expected to have a significant impact on FDI flows.

Table 1: Frequency Distribution of Investor-State Dispute Settlement Cases. 1987– 2019.

ISDS Case Status	%	Count
Won by investor(s)	29.4	198
Won by host state	36.5	246
Settled or discontinued	32.0	216
Tied	2.1	14
Total ISDS Concluded Cases	100	674
Additional Pending Cases	–	349
Total ISDS Cases Filed	–	1,023

As of Dec 31, 2019. Source: UNCTAD Investment Policy Hub.

Complementing Kerner and Pelc (2021) claim that the informational content of ISDS claims is less than it once was because of the proliferation of arbitrations, I argue that the informational content of ISDS filings is noisy because it contains little information about state conduct if considered in isolation from the arbitration outcome. This hypothesis complements the literature and leads to the following testable implication:

> *Hypothesis 1 (ISDS Filing)*: following the filing of an investor-state dispute, the FDI net inflow to the host country from the home country of the claimant will not vary significantly, on average.

3.2 Arbitration Outcomes

Arbitration outcomes can convey different information to investors about the

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trustworthiness of a host country. There are three main possible outcomes, as a dispute can be won by the investor, settled, or won by the host country. These three outcomes are almost equally likely, based on past arbitrations (Table 1). Let us examine them separately.

When a tribunal decides a case in favor of the investor, it signals that the conduct of the host government was not compliant with previous agreements or in breach of contract. Consistently with existing literature, this information can damage the host country reputation in the eyes of potential investors, especially those from the same home country as the claimant, who may decide to invest or reallocate their capital elsewhere. FDI inflows in the host country may decrease as a consequence (Aisbett, Busse, and Nunnenkamp 2018; Allee and Peinhardt 2011; Wellhausen 2015).

> *Hypothesis 2 (Claimant wins)*: following a case won by the claimant, the FDI
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> net inflow to the host country from the home country of the claimant will decrease,
>
> on average.

When a case is settled, I argue that it can signal to investors that the host government is amenable to finding a solution that is agreeable to investors. While previous research tended to interpret a settlement as evidence of wrongdoing by the host government (Allee and Peinhardt 2011; Pelc 2017), I argue that it cannot possibly be clear to investors without prior beliefs or information beyond the court proceedings.[22]

We can distinguish at least two possible settlement scenarios in the abstract, depending on

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[22] Unlike GATT/WTO disputes, settlement details are not usually available. In other words, there is no public information to determine the level of concessions of the defendant in the settlement. Busch and Reinhardt 2000.

the claimant's beliefs in the strength of her case. In the first scenario the claimant believes she can win the arbitration. If the defendant believes it will lose the case, then it can make significant concessions; this would suggest that the host country is willing to repair the relationship with the investor without waiting for a court award. If the defendant believes it can still win the case, it may make fewer (if any) concessions; this would suggest that the claimant's case is weak or frivolous. Then, regardless of what the defendant believes, the investor can discontinue the case unilaterally. [23] An observed settlement or discontinuation of the dispute is evidence of the fact that the investor is satisfied, else she could simply continue with the arbitration. Such a settlement shows that the host country is attempting to foster a favorable investment environment. In the second scenario the claimant believes the claim is empty and will not stand to further scrutiny. Such a case may be settled by the claimant with minimum concessions by the defendant, or even discontinued. This settlement/discontinuation would signal that the host government has done nothing wrong.

Although these different settlement scenarios may not be distinguishable on the basis of the arbitral proceedings, they all point in the same direction: *conditional on the case being filed*, a settlement shows that the host government is fostering a favorable investment environment.[24]

> ***Hypothesis 3 (Case Settled)***: following a settlement the FDI inflow for the host
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> country from the home country of the claimant will increase, on average.

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[23] The observable outcome of a negotiated settlement between the parties or of a discontinuation of a case is the same: the dispute ends before an award is produced by the tribunal.

[24] The claimant has additional information that is not available to other investors at large, but the argument in this paper is focused on the impact of arbitral outcomes on potential investors, not only investors that happen to be claimant in a specific arbitration. There have been only around a thousand claimants so far; the total number of foreign investors is much, much greater.

When a case is won by the host country, it signals that the tribunal found no wrongdoing on the part of the host government that the claimant could prove in court. In this case the trustworthiness of the host government in the eyes of foreign investors should not be tarnished, because the tribunal decision suggests that either the claim was brought forth in bad faith or it did not withstand scrutiny by the tribunal.

> *Hypothesis 4 (**Host country wins**)*: following a case won by the host country, the
> FDI inflow for the host country from the home country of the claimant will not
> decrease, on average.

Table 2: Hypothesized Effects of ISDS Activity on Host FDI Inflow

ISDS Activity	FDI Inflow Change Literature	FDI Inflow Change Theory	Hypotheses
Case Filed against Host	−	=	H1
Investor wins a case	−	−	H2
Case is settled	−	+	H3
Host wins a case	n.a.	$= or +$	H4

Note: the sign indicates the expected effect on host FDI inflow after the corresponding ISDS event. There is no consensus in the literature on the hypothesized effects of a settled case; among the exceptions are Allee and Peinhardt (2011) and Pelc (2017).

To summarize, this study complements the current literature in two ways. First, I argue that arbitration outcomes are more informative than arbitration filings for foreign investors. Second, I argue that some arbitration outcomes can have positive effects on the reputation of a host government. Table 2 summarizes the hypothesized relationship between ISDS activity and FDI flow, which also includes the predictions and findings from the existing literature. As can be seen, Hypothesis 2 is consistent with previous work by Allee and Peinhardt (2011),

Wellhausen (2015), and Aisbett, Busse, and Nunnenkamp (2018) among others. Hypotheses 1 and 3 are complementary to the literature, and Hypothesis 4 is new.

4 Empirical Analysis of Investor-State Disputes

The empirical strategy tests the implications of the theory using multivariate regression on an original dataset built for the purpose. I estimate several specifications with different control variables, as well as several sets of fixed effects for robustness. In the regression analyses, I estimate separate coefficients for ISDS cases filed and for each of the three possible ISDS outcomes (case settled, case in favor of investors, case in favor of host). Data on investment arbitrations and on bilateral FDI flows are mainly from UNCTAD and are widely used in political science and international political economy.

4.1 Data and Method

I use a time-series, cross-sectional dataset where each observation is uniquely identified by a directed dyad (home country to host country) and a year. The overall dataset includes all dyads for which there is at least one available observation of bilateral FDI flow.[25] The observations used for the analyses include 171 host countries, 176 home countries, and 3,975 unique dyads. Due to the limited availability of bilateral FDI data, the analyses focus on the period 2001–2012; this is an important limitation of the data since ISDS may have different effects in different decades (Kerner and Pelc 2021).

I focus on dyads because the reputation of a host government can only travel as far as

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[25] Bilateral FDI flows and bilateral volumes of trade are the sparsest variables in the dataset and the most stringent constraint on the number of cases that enter the analyses.

information. Information is more likely to be shared and trusted among firms from the same country, or in the same sector, or with investments in the same host country, which are more likely to be part of the same networks. Nationality is relevant because multinational executives in emerging economies are likely to know and communicate with each other.[26]

I restrict the analysis to dyads where the capital-importing country is not part of the Organization for Economic Cooperation and Development (OECD), because non-OECD countries are more likely to sign BITs to attract investment.[27]

I use the following specification:

$$\Delta FDI_{ij,t} = \beta_1 ISDS_{ij,t-1} + \beta_2 BIT_{ij,t-1} + \beta_3 X_{ij,t-1} + \beta_4 X_{i,t-1} + \beta_5 X_{j,t-1} + \epsilon_{ij,t}$$

The dependent variable is FDI net inflow (in current US dollars) from UNCTAD.[28] Subscript i refers to a specific home country, the country of the investor, and j refers to a host country; ij hence refers to a specific dyad, and t to a specific year. $\Delta FDI_{ij,t}$ refers to the FDI net inflow of a directed dyad in a given year. FDI net inflow refers to the flow of foreign investment in the host country; for example, negative FDI net inflow for a particular year indicates that the aggregate value of disinvestment by foreign investors was more than the value of capital newly invested in the host economy. FDI net inflows are a measure of change that reflect investors' responsiveness to change and new information about an investment

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[26] See Wellhausen 2014, cf. Elkins, Guzman, and Simmons 2006; Kerner 2009. It is assumed for the moment that investors from the same home country behave similarly and have access to similar information; this assumption is necessary for the data aggregated at the country level that is used in this study. It can be relaxed when the theory is tested on firm-level data.

[27] Several studies support the selection of non-OECD host countries for similar reasons. Aisbett, Busse, and Nunnenkamp 2018; Wellhausen 2015.

[28] UNCTAD, FDI Statistics: https://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI- Statistics-Bilateral.aspx.

environment. The dependent variable is transformed using the Inverse Hyperbolic Sine (IHS), which allows an interpretation of the results similar to a logarithmic transformation, but unlike a logarithmic transformation it has the added advantages of working with negative values (i.e. negative FDI flows) and zero values.[29]

The main predictors of interest are four variables connected with investor-state disputes data in each dyad: yearly counts of cases filed, cases won by investors, cases settled and cases won by the host government. The data was collected mainly from UNCTAD, but other sources have been used where UNCTAD data was incomplete or unavailable.[30] The dataset includes each publicly available ISDS case until 2017; ISDS cases are recorded depending on the directed dyad to which they refer.[31] The ISDS variables are lagged by one year, consistent with the expectation that it takes time to relocate investment after ISDS information becomes public (Allee and Peinhardt 2011).

Two variables control for the existence of Bilateral Investment Treaties (BITs) in the dyad, collected from UNCTAD.[32] A dummy records whether a BIT has been signed in the dyad, to capture the association between bilateral FDI and the existence of BIT in the same dyad; this controls for the effect a BIT might have on bilateral FDI net inflow.[33] When filing a case,

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[29] For an example in the literature, see Aisbett et al. 2018, Appendix. See also: Bellemare and Wichman 2020; Pence 2006.

[30] In addition to UNCTAD Investment Policy Hub (https://investmentpolicyhubold.unctad.org), I also used the World Bank International Centre for the Settlement of Investment Disputes (https://icsid.worldbank.org/en/) and italaw (https://www.italaw.com/).

[31] For example, a case filed by a Canadian investor against the Venezuelan government is only recorded in the directed dyad where Canada is the home country and Venezuela is the host country.

[32] UNCTAD, Investment Policy Hub.

[33] There is no definite consensus in the literature on whether BITs have a positive impact on FDI. Sauvant and Sachs 2009. Some scholars claim BITs are only effective when the domestic institutions of the host country are already trustworthy. Jensen 2008; Jensen et al. 2003; Tobin and Rose-Ackerman 2011. Others find that BITs are most

foreign investors can invoke a BIT or any other treaty with investment provisions that allows

for dispute settlement and international arbitration, such as the Energy Charter Treaty, or a

Free Trade Agreement (FTA). Another variable records the cumulative number of BITs

signed by the host country, including those outside of the dyad, to control for the potential

impact that signed BITs external to the dyad can have on bilateral FDI within the dyad. The

focus on BITs signed rather than BITs in force does not affect the analysis because BITs

signed are very likely to enter in force soon afterward: about 82% of the BITs signed before

2013 entered into force eventually, and they did so on average less than 2.4 years after

signing; more than 40% of the signed BITs entered in force within the following year.

The dataset includes twelve political and economic variables, because economic and

political conditions in both host and home country are widely recognized as key drivers of

firm decisions on FDI allocation based on existing research. Control variables can be related

to the dyad (*ij*), the home country (*i*) or the host country (*j*). Economic variables include Gross

Domestic Product (GDP) per capita (logged) and GDP growth for both host and home,[34] to

capture economic development and economic growth which may influence a firm's decision

to move capital somewhere else. A measure of the volume of *bilateral trade*[35] is included to

capture existing links and networks between home and host firms and economies that might

facilitate investment; trade is a dyadic variable. Host country's *population* is included as a

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effective for states who already lack credibility. Rosendorff and Shin 2012. Some have found that BITs have a positive impact on FDI because they have repercussions if breached, while others are more skeptic. Allee and Peinhardt 2011; Büthe and Milner 2014; Tobin and Rose-Ackerman 2011.

[34] GDP data are from the World Bank.

[35] Bilateral trade data come from the Correlates of War Trade Statistics, when available. Barbieri, Keshk, and Pollins 2009; Katherine and Keshk 2016. Otherwise, data are from the Direction of Trade statistics of the International Monetary Fund.

proxy for the size of the market in the host economy. A measure of *capital account openness*

for the host country is meant to control for the ease with which investment can enter or exit the

country, which can systematically influence investment inflows (Chinn and Ito 2006). An

additional variable aggregating the *total FDI received by host outside of the dyad* in a given

year controls for the variation of total FDI net inflow in a given host country across years.

Political variables include a measure of *political constraints* in the host country (as

constructed by Henisz 2002), because research suggests that democratic countries are more

likely to include ISDS clauses in their BITs, which in turn may favor FDI net inflows

(Simmons 2014). A dummy for host government *leadership turnover*[36] is also included to

control for changes in executive leadership that may influence the investment climate or

previous government commitments. Two variables related to the host country are obtained

using indicators from the *International Country Risk Guide* (ICRG),[37] widely used by the

business community. One ICRG variable is a measure of external threat, an assessment of the

risks deriving from war, cross-border conflict and foreign pressures; the variable ranges from

0 to 12, with a higher score indicating a higher risk. Scholars argue that firms increase their

required return on investment when dyadic diplomatic tensions arise (Desbordes 2010). The

other variable derived from ICRG indicators is about the *investment environment* and it is a

sum of four indicators that together contribute to build the investment environment in a

given country. The variable ranges from 0 to 28, with the following ICRG indicators

contributing thus: investment profile (12 points), corruption (6 points), law and order (6

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[36] Executive leadership data are from the Archigos dataset (version 4.1). Goemans, Gleditsch, and Chiozza 2009.
[37] Data produced by the PRS Group.

points), bureaucratic quality (4 points).[38]

I estimate eight specifications, several of which include fixed effects on year, dyad or host-year (Table 3). Fixed effects control for unobserved heterogeneity, i.e. if in a year world FDI changes abruptly due to exogenous shocks, for example, that could systematically affect dyadic FDI net inflows and thereby bias the estimates. Fixed effects absorb variation and tend to bias estimates toward zero. Put differently, including fixed effects provides a more conservative test of the theory.

Models (1) through (5) and Models (6) through (8) are similar in that new controls are added moving from one model to the next. Model (1) includes only ISDS variables, model (2) also BIT variables. Model (3) includes year and dyad fixed effects, and models (4) and (5) add the set of controls and dyadic trade volume, respectively. Model (6) includes BIT and ISDS variables, with dyad and host-year fixed effects. Models (7) and (8) add two GDP variables related to the home country and also dyadic trade volume, respectively. Models (6) through (8) do not include control variables related to host country or dyad, because the host-year and dyad fixed effects already capture the variation associated with host and dyad variables.[39] The main differences across models are the choice of controls and fixed effects. The two pairs of models (4)-(5) and (7)-(8) differ only in the inclusion or exclusion of the bilateral trade variable, whose availability is limited and affects sample size significantly. In each model, each predictor except *total FDI* is lagged by one period to allow for some delay in investment decision making and implementation, and thereby reduce the risk of reverse

[38] PRS Group, International Country Risk Guide Methodology, 2018.
[39] The variable Total BITs signed is included in models (6) to (8). It has no discernible effect.

causation.

4.2 Results and Discussion

As Table 3 shows, the coefficients for the ISDS variable *cases filed* do not appear to be significantly associated with changes in FDI net inflows in any model, and the size of the coefficient is always negligible.[40] This supports Hypothesis 1.

The coefficients of cases won by investors, although not statistically significant,[41] has a negative sign in the models with fixed effects, which is moderately consistent with Hypothesis 2. The coefficient of cases won by the host country, albeit not statistically significant in any of the models with fixed effects, has a positive sign, which is moderately consistent with Hypothesis 4.

A consistent pattern can be observed by comparing the coefficients for the variable *cases settled* with the other ISDS variables within each model. The coefficients for *case settled* are positive and statistically significant (at the .05 significance level) even in the most conservative models (5) and (8) with fixed effects (Figure 3). This lends strong support to Hypothesis 3.

In substantive terms, these results suggest that for a government of an economy like Tunisia or Ecuador settling a pending case with an investor from economies like those of France or the United Kingdom was associated with an increase of about 8.4 million USD in bilateral FDI net inflow the following year, on average.

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[40] Strictly speaking, the coefficients of the variables of interest cannot be directly compared across models because their samples sizes are different (as reported in Table 4). They should be compared within models instead.
[41] At the .1 significance level.

**Table 3: Investor-State Dispute Outcomes and Bilateral FDI Flow. 2001–2012.**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BIT Signed in the Dyad (1 = Signed)		0.531**	0.202**	0.138	0.144	0.190**	0.145*	0.131
		(0.054)	(0.093)	(0.100)	(0.100)	(0.085)	(0.087)	(0.087)
BITs Signed by Host, Total		0.019**	0.019**	0.019**	0.018**	-0.054	-0.053	-0.068
		(0.001)	(0.005)	(0.005)	(0.006)	(0.044)	(0.044)	(0.046)
Total FDI Received by Host Outside of the Dyad (IHS)				0.048**				
				(0.006)				
Cases Settled (count), Dyad	1.167**	1.101**	0.830**	0.739	1.023**	0.767*	0.777*	1.013**
	(0.277)	(0.270)	(0.422)	(0.461)	(0.422)	(0.405)	(0.405)	(0.369)
Cases To Host (count), Dyad	0.637**	0.464	0.131	0.170	0.193	0.143	0.156	0.154
	(0.296)	(0.291)	(0.407)	(0.395)	(0.397)	(0.408)	(0.406)	(0.402)
Cases To Investor (count), Dyad	0.274	0.153	-0.163	-0.121	-0.059	-0.228	-0.229	-0.206
	(0.332)	(0.324)	(0.679)	(0.735)	(0.742)	(0.646)	(0.647)	(0.644)
Cases Filed (count), Dyad	0.180	0.105	-0.069	0.013	0.018	-0.049	-0.043	-0.021
	(0.112)	(0.110)	(0.165)	(0.164)	(0.166)	(0.163)	(0.163)	(0.162)
Political Constraints, Host				0.290**	0.355**			
				(0.125)	(0.129)			
GDPpc (ln), Host				0.913**	0.959**			
				(0.201)	(0.209)			
GDP Growth, Host				0.008**	0.012**			
				(0.004)	(0.004)			
Population (ln), Host				2.628**	2.916**			
				(0.427)	(0.450)			
Capital Openness, Host				-0.450**	-0.495**			
				(0.132)	(0.139)			
GDPpc (ln), Home				0.793**	0.772**		0.830**	0.857**
				(0.196)	(0.206)		(0.167)	(0.179)
GDP Growth, Home				0.007*	0.008*		0.002	0.003
				(0.004)	(0.004)		(0.004)	(0.004)
External Threat (PRS Group)				-0.044**	-0.062**			
				(0.022)	(0.023)			
Investment Environment (composite of PRS Group data)				0.009	0.013			
				(0.014)	(0.014)			
Host Leadership Turnover, Dummy				-0.002	-0.008			
				(0.036)	(0.038)			
Total Volume of Trade (ln), Dyad					0.027*			0.013
					(0.014)			(0.014)
N	42562	36413	36366	29789	28238	36328	35890	32620
Year Fixed Effects	No	No	Yes	Yes	Yes	No	No	No
Dyad Fixed Effects	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Host-Year Fixed Effects	No	No	No	No	No	Yes	Yes	Yes

* p<.1, ** p<.05. The dependent variable is the Inverse Hyperbolic Sine (IHN) of a host country's bilateral FDI inflow. In each model, each predictor is lagged one period (except *Total FDI* in Model 5). Sample sizes and fixed effects relative to each model are indicated. Robust standard errors are always used when fixed effects are included. Constant not shown.

I now turn to the other variables in the model, which are included to provide a more conservative test of the argument. The coefficients of the BITs variables are not always statistically or substantively significant, but in each case the magnitude of the coefficient

relative to the BIT within the dyad is about an order of magnitude greater than the coefficient of the variable measuring the total number of host BITs. The latter is consistent with the literature: since each bilateral relationship involves at most one BIT, and BITs are different, investors learn information that is more relevant to them from cases disputed under a BIT that applies to their investment. In other words, investors are more likely to react to cases that are more likely to concern them (Wellhausen 2014: 235—241).

Figure 3: Coefficient Plot of Investor-State Dispute Variables
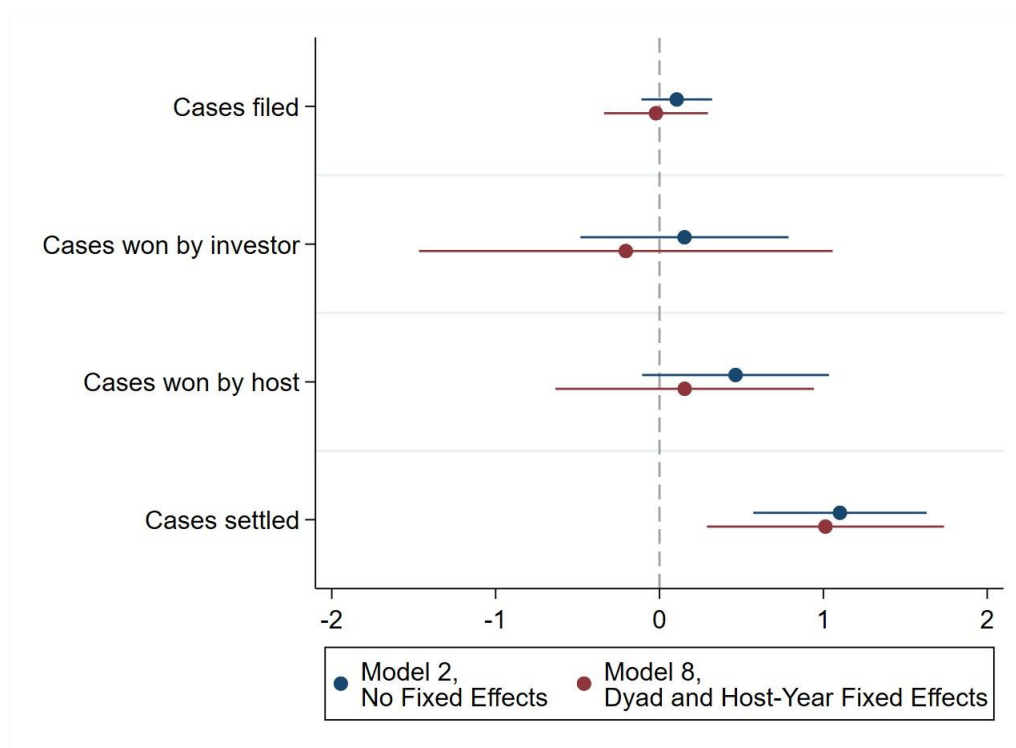
Host country *political constraints* are positively associated with bilateral FDI net inflow, which is expected as they are connected with the protection of property rights. Host *GDP per*

capita and host *GDP growth* are positively associated with bilateral FDI net inflow, and so is host *population*, which can be substantively interpreted as a proxy for the size of the internal market. Population is the single largest coefficient among the variables included.

Total volume of trade in the dyad seems to be positively associated with bilateral FDI, albeit the substantive effects are minimal. The *host external threat* variable seems to be negatively correlated with FDI inflow. It is not possible to reject the null hypothesis that host *investment environment* is not correlated with bilateral FDI, which suggests that the variable does not capture factors beyond other variables included in the model or the varying intercepts (i.e. fixed effects). *Host leadership turnover* does not seem to be significantly correlated with FDI net inflow.

Host *capital account openness* is negatively associated with bilateral FDI, which is consistent with recent scholarship showing that capital-exporting firms support states that impose capital controls (Shadmehr 2019).

The main results are robust to alternative model specifications and additional robustness checks. The coefficient for cases settled remains positive and statistically significant (at the .05 significance level) in virtually all specifications tested, including regressions run with a 2-year, 3-year or 4-year time-window, namely with the ISDS variables aggregated over a multiyear period and lagged (see Appendix). By looking at multiyear lagged time periods, rather than one-year lags, estimations are less likely to incur in spurious correlations. Lastly, the main results are do not significantly change if the dyadic dummy for BIT signed is substituted with the dyadic variable for BIT in force.

5 Final Remarks

This article makes a twofold contribution to the literature on the determinants of foreign investment. It argues that the outcomes of investment arbitrations are an important part of the discussion on the impact of investment arbitrations, in addition to arbitration filings. In particular, it argues that settled arbitration can have a positive effect on the bilateral FDI net inflow of a host country because they can signal a willingness of the host government to engage meaningfully with investors even after the filing of an arbitration (Wellhausen 2019). The study provides an empirical estimation of the impact of settled arbitrations on FDI flows.

The study provides evidence on the impact of investment arbitrations that can inform the current policy debate on investor rights and protections, which is among the most heated issue in international agreement negotiations. Many developing countries have been rescinding their bilateral treaties due to the many arbitrations filed against them, thereby ostensibly rejecting the regime in which only investors can initiate a dispute. Several major developing economies, including India and South Africa, vowed to rescind all their bilateral investment treaties mainly due to concerns about investor-state dispute settlement, and have been questioning the role played by treaties with investment provisions in fostering investment attraction.

The study contributes to the scholarship on the determinants of foreign investment. While the impact of investment arbitrations on FDI was mostly studied from the point of view of the filing, this study adds nuances to our understanding of the impact of investment arbitration outcomes.

Lastly, by improving our understanding of the effects of dispute settlement institutions,

this research offers a contribution to the policy debate about the secrecy of arbitral awards (Hafner-Burton, Steinert-Threlkeld, and Victor 2016). If the publicity of arbitration outcomes can have positive consequences for the host countries, then more governments may have an incentive to make those outcomes publicly available.

The study identifies several promising avenues for further research. While this analysis assumes similar behavior by conational companies, this assumption may be tested with firm-level data. Future research may also look at other observable implications of the theory, especially concerning the intermediate steps of the causal chain, namely how much investors know about arbitrations, or how much of an influence they believe these cases have in their decision-making.

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Appendix

Table 4: Investor-State Dispute Outcomes of the Previous Three Years and Bilateral FDI Flow. 2001–2012.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BIT Signed in the Dyad (1 = Signed)		0.525**	0.204**	0.140	0.147	0.193**	0.148*	0.133
		(0.054)	(0.093)	(0.100)	(0.100)	(0.085)	(0.087)	(0.087)
BITs Signed by Host, Total		0.018**	0.019**	0.019**	0.018**	-0.053	-0.052	-0.067
		(0.001)	(0.005)	(0.005)	(0.006)	(0.044)	(0.044)	(0.046)
Total FDI Received by Host Outside of the Dyad (IHS)				0.048**				
				(0.006)				
Cases Settled in Past 3 years (count), Dyad	1.085**	1.024**	0.775**	0.766**	0.890**	0.658**	0.676**	0.731**
	(0.181)	(0.176)	(0.296)	(0.335)	(0.354)	(0.264)	(0.265)	(0.270)
Cases To Host in Past 3 years (count), Dyad	0.683**	0.575**	0.295	0.308	0.311	0.219	0.233	0.198
	(0.194)	(0.190)	(0.252)	(0.244)	(0.248)	(0.243)	(0.244)	(0.243)
Cases To Investor in Past 3 years (count), Dyad	-0.130	-0.232	-0.502	-0.509	-0.465	-0.570	-0.571	-0.575
	(0.218)	(0.213)	(0.468)	(0.495)	(0.508)	(0.405)	(0.402)	(0.398)
Cases Filed in Past 3 years (count), Dyad	0.229**	0.176**	0.027	0.050	0.061	0.037	0.040	0.049
	(0.064)	(0.063)	(0.094)	(0.093)	(0.095)	(0.090)	(0.090)	(0.090)
Political Constraints, Host				0.294**	0.358**			
				(0.125)	(0.129)			
GDPpc (ln), Host				0.904**	0.948**			
				(0.201)	(0.208)			
GDP Growth, Host				0.008**	0.012**			
				(0.004)	(0.004)			
Population (ln), Host				2.620**	2.907**			
				(0.426)	(0.449)			
Capital Openness, Host				-0.450**	-0.495**			
				(0.132)	(0.139)			
GDPpc (ln), Home				0.803**	0.784**		0.838**	0.865**
				(0.197)	(0.206)		(0.167)	(0.179)
GDP Growth, Home				0.007*	0.008*		0.002	0.003
				(0.004)	(0.004)		(0.004)	(0.004)
External Threat (PRS Group)				-0.045**	-0.063**			
				(0.022)	(0.023)			
Investment Environment (composite of PRS Group data)				0.011	0.015			
				(0.014)	(0.014)			
Host Leadership Turnover, Dummy				-0.000	-0.006			
				(0.036)	(0.038)			
Total Volume of Trade (ln), Dyad					0.027*			0.013
					(0.014)			(0.014)
N	42562	36413	36366	29789	28238	36328	35890	32620
Year Fixed Effects	No	No	Yes	Yes	Yes	No	No	No
Dyad Fixed Effects	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Host-Year Fixed Effects	No	No	No	No	No	Yes	Yes	Yes

* p<.1, ** p<.05. The dependent variable is the Inverse Hyperbolic Sine (IHN) of a host country's bilateral FDI inflow. Each predictor is lagged by one period, except for *Total FDI* in Model 5). Sample sizes and fixed effects are indicated for each model. Robust standard errors are always used when fixed effects are included. Constant not shown.