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*Symposium: The Regime for
International Investment—Foreign
Direct Investment, Bilateral
Investment Treaties, and Trade Agreements*

INTRODUCTION
The Global Economy, FDI, and the
Regime for Investment

By HELEN V. MILNER*

THE world economy has maintained or enhanced its integration in the past decade even in the face of the global financial crisis. A large part of this globalization has been driven by capital flows. This symposium focuses on one element of these capital flows, foreign direct investment (FDI), and on the regime in place to safeguard and promote such investments around the globe.¹ The articles by Allee and Peinhardt and Simmons focus on the nature and evolution of the bilateral investment treaties (BITs) that have been developed to protect such investments and that have proliferated since the 1990s. The final article, by Büthe and Milner, turns its attention to the ways in which international trade agreements affect FDI. The comparison between the investment and trade agreements is instructive, since they seem to have different effects.

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¹ Salacuse 2010. The articles in the symposium are Simmons 2014; Allee and Peinhardt 2014; and Büthe and Milner 2014.

FDI FLOWS AND THE REGIME FOR GLOBAL INVESTMENT

FDI has become one of the most important economic flows in the global economy. It is a critical source of capital for developing countries and remains a significant source of investment in the developed world. FDI has grown in part because countries changed their policies toward it dramatically after the 1980s; governments in developing countries made unilateral policy changes that opened up markets across the globe and increased competition among countries for FDI.²

FDI has grown in terms of both flows and stock over the past few decades, although the financial crisis has weakened this channel. In 1990 global FDI flows were about \$290 billion (constant 2005). In 2000 this figure had increased to \$1.58 trillion in constant dollars. In the following years it dropped slightly and then peaked in 2007 just before the financial crisis.³ By 2011 it had recovered, but it remains slightly below 2000 levels at about \$1.34 trillion (in constant dollars). On average, since 1990 FDI grew by about 7.6 percent per year (or about \$50 billion per year). About half of all FDI now flows to the developing world; developing and transition economies, respectively, accounted for 45 percent and 6 percent, respectively, of global FDI by 2012. For these countries FDI flows have become the largest source of external capital, outweighing portfolio, debt, and aid flows.⁴ Looking at the stock of global FDI, there has been an annual increase of 9.1 percent since 1990 and of about 7.2 percent since 2000. In 2011 global FDI stock reached about \$18 trillion. Roughly two-thirds of this was located in developed countries, but China's share alone has grown to about \$628 billion, and Hong Kong's to about \$1 trillion.⁵

Most FDI is undertaken by multinational corporations (MNCs), although a small but growing fraction has been accounted for by sovereign wealth funds (SWFs). MNCs use FDI to build their global production networks and to service host markets. These corporations exert a significant influence on the world economy and within particular countries. In 2011 foreign affiliates of MNCs employed an estimated sixty-nine million workers, who generated \$28 trillion in sales and \$7 trillion in value added.⁶ FDI is a very important part of the global economy, and MNCs are significant actors on the world stage. Indeed, the relationship

² Pandya 2014.

³ See UNCTAD 2012, xi.

⁴ International Monetary Fund 2013, 170.

⁵ UNCTAD 2013a.

⁶ UNCTAD 2012, xi.

between these transnational investors and states is a primary issue in the global investment regime.

At the international level, great changes have also occurred in the set of norms, rules, and procedures guiding the expectations of actors—that is, in the regime—for global investment. From an unwelcoming environment that treated FDI with suspicion—as evidenced by the proposals made in the New Economic Order by developing countries at the UN in the 1970s—a new regime has developed that protects and promotes foreign investment. Unlike in international trade, however, a multilateral agreement regulating FDI does not exist. As Simmons notes in her article, this difference may reflect the time inconsistency problems in international investments and thus the greater need for credible commitments there.⁷ The closest analog to the World Trade Organization's rules for FDI are the Agreements on Trade-Related Investment Measures (TRIMs) in the Uruguay Round of the WTO signed by all the members in 1995. These agreements prohibit policies that indirectly inhibit foreign investment through their discriminatory treatment of products.⁸ They are generally seen as weak protections for FDI. The OECD in the 1990s attempted to negotiate a multilateral agreement on investment (MAI), but this process has been riven with dissension and delay and remains unfulfilled.⁹ Some developed countries that favor it have tried to move the negotiations to the WTO context, but this has not yet resulted in a multilateral accord, as significant opposition remains among both developed and developing nations.¹⁰

Instead a bilateral regime has emerged to protect and promote FDI. Since the 1960s states have signed increasing numbers of bilateral investment treaties (BITs). In addition, growing numbers of preferential trade agreements (PTAs) have begun to add or include investment clauses, as shown in the Bütthe and Milner article in this symposium.¹¹ None of these agreements, however, is global; rather, all of them are either bilateral or regional in nature. BITs have been the most popular and controversial of these agreements, and they are the focus of two of the articles in this symposium.¹²

Why does FDI need an international regime? In international trade, concerns over the externalities for other states generated by unilateral

⁷ Simmons 2014.

⁸ World Trade Organization 2013.

⁹ Neumayer 1999; Nunnenkamp and Pant 2003.

¹⁰ Åslund 2013.

¹¹ Bütthe and Milner 2014.

¹² Allee and Peinhardt 2014; Simmons 2014.

trade policies in the form of protectionist trade wars, terms of trade shifts, discriminatory behavior, and domestic interest group pressures created a demand for a broad multilateral regime to restrain such behavior and to provide mutual trade barrier reduction.¹³ In trade the key is for the biggest players to make an agreement to restrain their behaviors and then let the smaller players sign on. In the investment area the problems relate more to the underprovision of investment, especially in poor developing countries. In order to receive the benefits of FDI, host countries have to reassure foreign investors that their capital will not be expropriated (directly or indirectly) after they make an investment. Governments face a time-inconsistency problem and investors know this. Without some form of credible commitment *ex ante*, investors may decide not to invest. Investment agreements between capital-rich home and poorer host countries try to guarantee foreign investors the same treatment as domestic firms and to provide for some form of dispute-settlement mechanism (DSM). In doing so, they offer a way for poorer host countries to credibly commit to resist direct or indirect expropriation by making it more costly *ex post*. But unlike in trade, these agreements tend to be between unequal countries: roughly 55 percent of BITs are between a poor host country and a rich home one.

BITs have been seen as a credible commitment mechanism allowing host countries to overcome the time-inconsistency problems that FDI raises.¹⁴ The Allee and Peinhardt article in this symposium raises questions about how important this aspect is from the perspective of the host country.¹⁵ But generally it is believed that BITs seek to provide a stable investment climate. They lock countries in to agreements that offer national or nondiscriminatory treatment to foreign investors, allow firms access to dispute-settlement procedures, and promise third-party arbitration of disputes. Violating these provisions does seem to be costly for countries and hence there is evidence of credible commitment.¹⁶ These strong provisions have provoked a reaction against such treaties. FDI in the developing world has certainly increased since these agreements were signed, but it is not clear that they are a main cause.¹⁷

The proliferation of these agreements has raised a series of questions on both sides of the bargaining table. One issue is whether a multi-

¹³ Bagwell and Staiger 2002; Maggi and Rodriguez-Clare 2007.

¹⁴ Guzman 1998.

¹⁵ Allee and Peinhardt 2014.

¹⁶ Allee and Peinhardt 2011.

¹⁷ Büthe and Milner 2009; Franck 2007; Haftel 2010; Kerner 2009; Neumayer and Spess 2005; Salacuse and Sullivan 2005.

lateral regime would serve everyone's purposes better. Such a regime would standardize the terms of the arrangements that each country has made with others. And it might relieve competitive pressures on poorer states to give better terms to certain capital-exporting countries in search of more investment. But the desirability of such a multilateral agreement would depend heavily on its contents, which countries do not agree upon. Many host countries, for instance, would like to see more obligations for investors written into such agreements so that other public policy goals, like environmental protection or labor rights, are addressed.

In addition, there has been growing displeasure over the loss of sovereignty associated with the dispute-settlement mechanisms in BITs, as the Simmons article in the symposium points out.¹⁸ Countries are increasingly critical of both the ability of firms to sue directly and the delegation of arbitration to outside, third parties. Since 1972, when the first case was filed, at least 550 investment arbitration cases have been launched, most of them since the mid-1990s.¹⁹ From 1990 through 2012, foreign firms publicly sued at least ninety-four host states for unlawful interference with their property.²⁰ While a majority of these cases are Northern home countries and firms against Southern host countries, there have been an increasing number of North-North cases. This has led to complaints against the BITs regime by both developed and developing countries. Australia, for instance, recently stopped signing BITs that contain external, third-party arbitration, while South Africa and India have begun reviews of all their BITs.²¹ The main concern is that the costs of BITs in terms of lost sovereignty may not be worth the benefits of increased investment that they are alleged to bring.

The backlash against BITs has led to a variety of changes. Some developing countries are opting out of the main dispute-settlement forum, ICSID: Bolivia, Ecuador, and Venezuela are the major ones so far.²² Over 160 BITs have been renegotiated since the mid-1990s, with the frequency increasing of late.²³ Furthermore, Poulsen and Aisbett argue that countries have dramatically slowed down their rates of signing and ratifying BITs as they have experienced their first legal claims in the DSM procedures.²⁴ The Simmons article in this symposium also docu-

¹⁸ Simmons 2014.

¹⁹ Schultz and Dupont 2013.

²⁰ Wellhausen 2013.

²¹ UNCTAD 2012, 87; UNCTAD 2013b, 10.

²² Hafner-Burton, Steinert-Threlkeld, and Victor 2013.

²³ Haftel and Thompson 2013.

²⁴ Poulsen and Aisbett 2013.

ments other ways in which the growing disenchantment with BITs is changing the investment regime.²⁵

The proliferation of BITs has led to the surge in investment disputes and the filing of many cases. These cases tend to be ones where firms or rich, capital-exporting countries sue poorer developing ones, although this is less the case most recently. And as Simmons shows, the strictest BITs tend to be signed by the weakest countries in their moments of most difficulty.²⁶ These findings might lead one to believe that the cases should be won overwhelmingly by the firms and rich countries that are suing. Interestingly, however, recent data suggest that the Northern, home countries and firms are not winning the investment arbitration as much as conventional wisdom would suggest.²⁷

At the same time, countries are increasingly signing preferential trade agreements (PTAs) with one another,²⁸ and these agreements increasingly include investment chapters that contain terms similar to those in BITs.²⁹ These agreements are seen as providing an even more credible commitment to protection of investors than are BITs.³⁰ Hence, while BITs are increasingly contentious, PTAs with investment clauses are taking their place and adding the potential for trade sanctions.³¹ And home governments have resorted to trade sanctions to punish BIT noncompliance; for example, the US government suspended trade preferences in the GSP for Argentina in 2012.³² PTAs, however, usually have different types of investment clauses than BITs. In PTAs investment chapters tend to include provisions promising national or nondiscriminatory protection to investors, and they sometimes involve external, third-party arbitration, but they rarely allow firms to file suit without their government's support. Only 10–12 percent of all PTAs include investor-state dispute-settlement procedures, and less than 10 percent of all ICSID cases involve filings under PTA provisions.³³ As Büthe and Milner suggest, PTAs with stronger investment clauses that include third-party arbitration may be more successful at luring foreign investment and less likely to provoke governmental antipathy.³⁴

²⁵ Simmons 2014.

²⁶ Simmons 2014.

²⁷ Hafner-Burton, Steinert-Threlkeld, and Victor 2013; Schultz and Dupont 2013.

²⁸ Mansfield and Milner 2012.

²⁹ Büthe and Milner 2014.

³⁰ Büthe and Milner 2008; Manger 2009.

³¹ Tobin and Busch 2010.

³² White House 2012.

³³ International Center for Settlement of Investment Disputes 2013.

³⁴ Büthe and Milner 2014.

In sum, FDI is an increasingly important element of the global economy. It has become a main source of external capital for developing countries and even for some developed ones like the US. To deal with the problems involved in such long-term capital investment, governments have created a decentralized, bilateral regime. This regime has evolved into an asymmetric one that offers strong protections for investor rights. But this has caused a backlash against BITS, as countries re-evaluate their costs and benefits and as global economic capacity shifts around the world, with economic growth migrating to the developing world. Explaining the nature of these agreements and the evolution of this system are the central themes of this symposium.

THEORETICAL PERSPECTIVES ON FDI AND THE INVESTMENT REGIME

Research on the investment regime has tended to invoke one of three theoretical perspectives evident in the literature in international relations broadly: diffusion, power politics, and the rational design of institutions. Each of these perspectives assumes a more or less rational set of agents, but the utility functions of the agents differ in each case. These perspectives help explain patterns in the international investment regime, including the similarities and some striking differences in a system of global governance built largely on bilateral agreements. They also enrich our understanding of the consequences of this way of governing global finance and alert us to the possible mechanisms that could change the system.

These three theoretical perspectives are the main ones represented in the articles within this symposium.³⁵ Using new data on the terms of BITS, Allee and Peinhardt demonstrate support most strongly for the power perspective. Rich capital-exporting countries and firms are able to get host countries to sign the most constraining agreements when the power imbalances are greatest. Using similar data, Simmons finds that both competitive emulation and power politics play a role in the creation and evolution of the investment regime. She notes, however, that changes are afoot as states react against this asymmetric regime. Bütke and Milner's findings looking at PTAs tend to support the institutionalist perspective on how cooperation problems such as time inconsistency shape bargaining over the terms of these agreements.

The articles advance the research agenda of these perspectives by examining the contents of the agreements at a finer level of detail and

³⁵ Allee and Peinhardt 2014; Simmons 2014; Bütke and Milner 2014.

by bringing new data to bear on them. They suggest that both rational design of institutions and power matter in the negotiation and functioning of international economic agreements. In very asymmetric situations, such as those between highly developed capital-exporting and poor capital-importing countries, agents may rationally design agreements at the most general level, and power considerations may determine more aspects of the agreement. Thus, in the search for profitable investing environments, investors and the capital-exporting countries they come from may well understand the time-inconsistency problems of FDI and the need for locking host countries into very constraining agreements; their greater bargaining power may then enable them to do this. In more mutually interdependent situations, like those involving the reciprocal exchange of market-access provisions in PTAs, strategic bargaining among the agents may result in a rationally designed agreement that is less subject to power considerations.³⁶ The initial asymmetries between countries that are negotiating agreements may shape how important power and rational design considerations are.

An interesting contrast that emerges from these studies is between PTAs and BITs. PTAs seem to have a stronger and more consistently positive effect on FDI than do BITs.³⁷ But BITs may pave the way toward PTAs,³⁸ and PTAs have increasingly come to include investment provisions. The trade agreements may be less asymmetric in general and thus provide a more acceptable forum for solving the time-inconsistency problems inherent in FDI.³⁹ An important avenue for future research lies in probing the differences and linkages between BITs and PTAs. This would require more exploration of and data on the specific contents of these agreements and on their dispute-settlement procedures and cases. In addition, further attention to the changing relationship between international investors and host countries seems important. Globalization may have improved the capacity of mobile capital to exploit profitable opportunities worldwide, but the shifting balance of

³⁶ There is some evidence that countries with more equal capabilities tend to sign PTAs more than very unequal ones because they involve the exchange of reciprocal market access (Mansfield and Milner 2012). Rich developed countries often provide unilateral access to their markets to the poorest and weakest countries through nonreciprocal agreements, such as the Lomé Convention or the Generalized System of Preferences (GSP).

³⁷ Even when examining the different elements of BITs, scholars come to different conclusions over their impact on FDI. For instance, Berger et al. 2013 show that certain types of BITs have a strong positive relationship with FDI; by contrast, Peinhardt and Allee 2012 show very little effect on FDI for either PTAs or BITs.

³⁸ Tobin and Busch 2010.

³⁹ Mansfield and Milner 2012.

economic power toward some of the major developing countries may be altering the dynamics of the investment regime.

The future direction of the investment regime is currently in play, but one path may lead to larger regional groupings of countries in broad trade agreements that include investment provisions, especially if the current multilateral trade negotiations under the WTO fail. The recently announced negotiations over the Transpacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership are examples of such wide-ranging regional agreements. These regional groupings, if successfully negotiated, would cover the areas involving the most dense global production networks of MNCs. If they remain open to other countries to join, they might provide a more balanced regime for investment than the current bilateral regime.

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