Articles

Bilateral Investment Treaties and Domestic Institutional Reform

RICHARD C. CHEN*

The bilateral investment treaties ("BITs") signed between developed and developing countries are supposed to increase the flow of investment from the former to the latter. But the evidence indicates that the existing approach of guaranteeing special protections for foreign investors has only a modest impact on luring their dollars. At the same time they are failing to produce meaningful benefits, these treaty commitments create substantial costs for the host States that make them, exposing them to liability and constraining their regulatory authority. Given this state of imbalance, the time seems ripe for a new approach, but existing proposals for revising BITs are either insufficient or unrealistic, or in some instances even counterproductive.

This Article calls for a fundamental redesign of BITs based on empirically validated premises about how host States actually attract foreign investment. Political science and economic studies show that foreign investors place substantial weight on the quality of domestic institutions. Existing BITs fail to promote investment because they are not an adequate

* Associate Professor of Law, University of Maine School of Law. For helpful comments and discussions, I am grateful to Julian Arato, Kathleen Claussen, Sarah Dadush, Melissa Durkee, Charles Norchi, Ryan Scoville, and Jason Yackee, as well as to participants in the 2015 ASIL-ESIL International Economic Law Joint Research Workshop at the Max Planck Institute, the 2016 Junior International Law Scholars Association Annual Meeting at the University of Pennsylvania Law School, and a faculty workshop at the University of Maine School of Law. Thanks also to William Wahrer for excellent research assistance.

substitute for these institutions, nor are they effective in generating reform. The proposed model would make domestic institutional reform the organizing principle of BIT design, and the Article offers several specific provisions that would help achieve that goal. Such an approach would produce immediate benefits for host States and so should be particularly attractive to developing countries. But the institutional reform model also retains the end goal shared by both sides of increasing foreign investment and so should be more realistically attainable than proposals pitched as benefiting developing States alone.

INTRODUCTION

The stated purpose of most bilateral investment treaties is to foster economic cooperation between the States that sign them, primarily by promoting the flow of capital from developed to developing countries.[1] Yet it is becoming increasingly clear that the features of most BITs are no longer optimized, if they ever were, to achieve that goal. A number of empirical studies have found that BITs do not actually succeed in increasing foreign direct investment ("FDI"), while other studies have found at most a modest impact.[2]

The existing BIT model, which has largely remained static since at least the 1980s, emphasizes investor protection.[3] The model's underlying assumption is that BITs succeed in attracting capital to a developing State by promising foreign investors a special set of substantive rights and procedural options, as a way to compensate for the risks posed by a precarious political regime or immature legal system.[4] The empirical literature finding only modest effects on FDI now casts doubt on that assumption. And at the same time that BITs appear to be failing to produce their expected benefits, they are creating substantial costs for capital-importing States, both in terms of exposing the State to investment treaty liability and constraining its regulatory authority.[5]

This Article calls for a reexamination of the foundational premises of BIT design. To do so, it looks to empirical research outside the BIT context, studying other potential influences on FDI growth. While commitments made in international agreements appear to have minimal effect on foreign investment, the quality of a host State's domestic institutions has been shown to make a more significant difference. Although particular studies differ on which specific institutional factors matter and to what extent, the empirical literature is generally consistent in finding that foreign investors take

---

1. *See* Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L.J. 67, 76 (2005).

2. *See* Tim Büthe & Helen V. Milner, *Bilateral Investment Treaties and Foreign Direct Investment: A Political Analysis*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS 171, 176–78 (Karl P. Sauvant & Lisa E. Sachs eds., 2009) (summarizing studies).

3. *See* Salacuse & Sullivan, *supra* note 1, at 74, 76.

4. *See id.* at 77.

5. *See* AARON COSBEY ET AL., INVESTMENT AND SUSTAINABLE DEVELOPMENT: A GUIDE TO THE USE AND POTENTIAL OF INTERNATIONAL INVESTMENT AGREEMENTS 12–15 (2004), https://www.iisd.org/pdf/2004/investment_invest_and_sd.pdf. Some commentators have further suggested that BITs may affirmatively harm a host State's economy by transferring control over domestic assets to foreign investors. *See* Joshua Boone, *How Developing Countries Can Adapt Current Bilateral Investment Treaties to Provide Benefits to Their Domestic Economies*, 1 GLOBAL BUS. L. REV. 187, 190–92 (2011).

institutional quality into account in making investment decisions.[6] Based on this empirical evidence, I argue that BITs should be redesigned to focus on improving domestic institutions as the optimal way of achieving the ultimate goal of increasing FDI.

As the evidence that BITs are failing to achieve their intended purpose continues to mount, many have offered ideas to improve on the status quo. Most scholars have focused on marginal changes that retain the basic premises of the investor protection model.[7] But as I demonstrate below, these changes would at best reduce the costs of BITs by pushing back against their intrusion on host State sovereignty. They are not designed to promote the benefits of increased FDI that BITs are supposed to yield. More recently, commentators have begun to brainstorm possibilities for a more systemic overhaul. These critics are particularly concerned that, even when developing States succeed in attracting foreign investment, they often fail to extract the benefits they expect from the relationship, such as gains in economic development.[8] Thus, they propose an alternative BIT model repurposed to specifically promote the development of host States.

The difficulty with the more systemic proposals—perhaps why they have yet to gain traction—is that they are framed primarily around the objectives of only one of the interested parties. By contrast, my argument for an institutional reform model makes the case that it is a better bargain for both sides. Although key premises are reevaluated, the end goal remains the same as that for which the investor protection model was purportedly designed, namely promoting FDI. And it is important to remember that increased FDI is in the interests of not just the importing State but also the exporting State, which benefits when its investors find more opportunities in better markets. Thus, the argument for domestic reform is not about development for the host State's sake alone, but about the prospects of a better partnership for everyone involved.

At the same time that the proposed model seeks to benefit both sides, it also addresses a particular need of developing countries.

---

6. *See, e.g.*, Matthias Busse & Carsten Hefeker, *Political Risk, Institutions and Foreign Direct Investment*, 23 EUR. J. POL. ECON. 397, 400–01, 410 (2007); Zdenek Drabek & Warren Payne, *The Impact of Transparency on Foreign Direct Investment*, 17 J. ECON. INTEGRATION 777, 785–87 (2002).

7. *See, e.g.*, Barnali Choudhury, *Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to the Democratic Deficit?*, 41 VAND. J. TRANSNAT'L L. 775, 831 (2008) (proposing ways to recalibrate investment arbitration so that it strikes a better balance between public and private interests).

8. *See* COSBEY ET AL., *supra* note 5, at v–vi.

Whereas the investor protection model left host States to hope that increased FDI would eventually translate, in some undetermined manner, into benefits they could capture, the institutional reform model is specifically designed to produce such benefits. That is because improving domestic institutions for the particular benefit of host States is the means to the shared end of increased FDI. The benefits, in other words, are built-in rather than contingent. Thus, while the institutional reform model may not accomplish everything that advocates for developing countries would desire, its adoption would significantly advance their objectives even while serving the overlapping interests of capital-exporting States.

The Article will proceed in four parts. Part I will provide an overview of existing BITs and evaluate how well they are serving their intended purpose. In particular, after explaining how the investor protection model is supposed to promote FDI, this Part will explore evidence suggesting that it has largely failed to do so. Part II will detail existing reform efforts, including both the incremental proposals that merely tinker with the investor protection framework and the systemic proposals that repurpose BITs as instruments for host State development. Part III will make the case for the shift in focus to improving domestic institutions, replacing investor protection with what I will call an institutional reform model. This Part will detail the general evidence showing that the quality of domestic institutions is a significant determinant of foreign investment decisions and highlight the key variables that have been shown to matter most. This Part will also elaborate on the argument that an institutional reform model has the potential to be a better bargain for all interested stakeholders and thus is more realistically attainable than alternative proposals.

Part IV will then attempt to translate the new model into three specific proposals, drawing on the key variables identified in the prior Part. First, BITs should incorporate conditional aid and technical assistance provisions. In a conditional aid program, the capital-exporting country would provide aid to the capital-importing country, with continued receipt being dependent on the achievement of certain benchmarks. In a technical assistance program, experts would be sent to work with the relevant actors in the host State to build the capacity of domestic institutions. Prior or existing efforts in both of these regards have seen minimal success in fostering institutional reform. I argue that establishing such programs under the auspices of a BIT relationship, where each party has a clearer interest in effective long-term cooperation, has the potential to yield greater returns.

Conditional aid and technical assistance are the most direct ways to address institutional reform, but they would require a significant investment of resources and are far removed from what BITs currently contain. The second and third proposals would more readily fit into the existing structure, but are better described as facilitating, rather than directly contributing to, the desired reform. The second proposal involves a redesign of the standard dispute resolution mechanism to maximize incentives for host States to improve their domestic judiciaries. Rather than providing for arbitration at the election of the foreign investor, the revised approach would permit arbitration only under certain conditions designed to pressure host States that would prefer to resolve disputes in their own courts to pursue reform. The third proposal involves establishing a dispute prevention mechanism that would attempt to address foreign investor complaints before they escalate. Apart from resolving individual complaints, such a mechanism could also serve as a focal point for coordinating broader reform of the institutions that write and administer the host State's laws.

Before proceeding, it is worth briefly acknowledging a different implication of the empirical evidence that will not be my focus here. Given the evidence that BITs, as currently designed, may be producing more costs than benefits, there is a plausible argument that the substantive rights provided under the investor protection model should be scaled back. In other words, if the presence of BIT protections is not attracting FDI, why leave them in place to be used against host States by aggrieved foreign investors? At the very least, an approach that better balances investor protection and host State sovereignty would seem to be warranted, and commentators have proposed ways in which specific substantive protections should be recalibrated accordingly. I discuss these proposals in Section II.A and believe some of them may well be compatible with my own, but I bracket the question of whether and to what extent a recalibration is needed. My proposals below assume that some degree of investment protection would remain in place, but this Article is otherwise agnostic as to the specific scope that protection should entail.

As a final caveat, I should also emphasize that I am focused here on BITs between developed and developing countries, which account for the majority of such treaties.[9] An increasing number of BITs do involve developing States on both sides, and some even involve two developed nations or other pairs in which there is a "good chance of reciprocal investment."[10] Investment provisions

9. *See* Salacuse & Sullivan, *supra* note 1, at 74.

10. Anthea Roberts, *Clash of Paradigms: Actors and Analogies Shaping the Investment Treaty System*, 107 AM. J. INT'L L. 45, 91 (2013).

have also appeared in multilateral free trade agreements, and the trend appears to be going in the direction of more regional treatymaking.[11] Needless to say, the dynamics of all these relationships are very different, and making progress on just one BIT paradigm would constitute a worthwhile endeavor.

I. THE INVESTOR PROTECTION MODEL

This Part begins with an overview of BITs and how the current investor protection model is supposed to promote foreign investment. It then evaluates the success of that model, drawing on the empirical literature measuring the impact of BITs as well as discussing reasons in principle to be pessimistic.

A. The Basic Paradigm

The modern BIT was created in the 1950s, but its content continued to evolve into the late 1980s, when the basic structure that still predominates began to take shape.[12] The 1980s marked a turning point because, as the communist era came to an end, many States that were formerly closed off to foreign investment developed an interest in attracting outside capital.[13] That change resulted in a dramatic increase in the number of BITs, from 309 in place as of 1988 to 2181 by 2002, most of them concluded between developing States on the one side and industrialized nations on the other.[14]

These BITs took the form of what commentators have called a "grand bargain."[15] Developing countries see foreign investment as a way to spur their own growth and development.[16] That is supposed to occur both through the infusion of needed capital and the deployment of technology.[17] Capital-exporting nations, in turn, have an interest in facilitating the entry of their investors into new

11. U.N. Conference on Trade & Dev., *World Investment Report 2012: Towards a New Generation of Investment Policies*, at xx (2012) [hereinafter *World Investment Report 2012*], http://unctad.org/en/PublicationsLibrary/wir2012_embargoed_en.pdf.

12. *See* Salacuse & Sullivan, *supra* note 1, at 73–75.

13. *Id.* at 74.

14. *Id.* at 75.

15. *Id.* at 77.

16. *Id.*

17. *Id.*

markets.[18] One potential obstacle to an otherwise attractive market is the presence of political and legal risks. The concern is that, once an investor begins a venture in and commits resources to a particular host State, that State will change the rules in a way that benefits itself and harms the investor.[19] Recourse under the host State's domestic law, and pursued in the local courts, is likely to be inadequate, particularly in developing countries with immature legal systems.[20] BITs attempt to remove this obstacle by supplying, via international agreement, the investment protection that domestic law fails to adequately guarantee. In short, the grand bargain entails the host State's "promise of protection of capital in return for the prospect of more capital in the future."[21]

What specifically does this promise encompass? The typical BIT contains substantive protections for investors, ranging from prohibitions on expropriations without compensation to guarantees of fair and equitable treatment, of full protection and security, and against arbitrary and discriminatory treatment.[22] It also includes procedural guarantees, most importantly the option of resolving disputes with the host State in a neutral arbitral forum such as the International Centre for Settlement of Investment Disputes ("ICSID").[23] Foreign investors are thereby permitted to bypass the host State's domestic courts to challenge government regulations or other actions before a panel of international arbitrators and obtain relief that is supposed to be enforceable in the courts without further review.[24]

In principle, the provisions described above could operate neutrally, striking a fair balance between the concerns of investors and needs of host States. On their face, the substantive guarantees seem like perfectly sensible assurances of fair treatment, and the procedural option of a neutral arbiter seems like a reasonable safeguard against potential bias in domestic courts. In practice, however, the substantive protections have been interpreted in a way that is perceived as overly generous to investors, and the tribunals charged with enforcing them are seen as biased in favor of

18. *Id.* at 76.

19. *Id.* at 75.

20. *See id.*

21. *Id.* at 77 (emphasis omitted).

22. RUDOLF DOLZER & CHRISTOPH SCHREUER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW 13 (2d ed. 2012).

23. *Id.* at 13, 239.

24. *Id.* at 239.

investors.[25] To illustrate, tribunals have interpreted the fair and equitable treatment to require "the stability of the legal and business framework."[26] Although most tribunals acknowledge that this requirement does not go so far as to freeze in place the preexisting regulatory scheme, they have struggled to draw a principled line, and their emphasis on stability opens the door for nearly any regulatory change to be challenged.[27] Another commonly cited formulation of the fair and equitable treatment standard provides as follows:

> The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.[28]

Commentators have pointed out that this formulation of the standard far exceeds what any country, developing or not, could expect to achieve.[29] Thus, the protections afforded to foreign investors have likely exceeded what those same investors could have expected from their own home States.

The criticisms may be overstated. For example, Susan Franck has shown that investors do not prevail at an unusually high rate; her 2007 study finds that investors won 38.5% of the time.[30] Moreover, the investors who prevailed recovered far less than they initially sought.[31] In any event, tribunal practice continues to evolve, and it may well be headed toward a more balanced approach.

But the fact remains that investment treaty claims that many

25. *See, e.g.*, Muthucumaraswamy Sornarajah, *Developing Countries in the Investment Treaty System: A Law for Need or a Law for Greed?*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP 43, 51–61 (Stephan W. Schill et al. eds., 2015) (criticizing the expansive interpretation of BIT principles to privilege investor protection over host State sovereignty).

26. LG&E Energy Corp. v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, ¶ 125 (Oct. 3, 2006).

27. *See* DOLZER & SCHREUER, *supra* note 22, at 145–49.

28. Técnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award, ¶ 154 (May 29, 2003).

29. *See* Sornarajah, *supra* note 25, at 56–57, 57 n.30.

30. Susan D. Franck, *Empirically Evaluating Claims About Investment Treaty Arbitration*, 86 N.C. L. REV. 1, 48–52 (2007).

31. *Id.* at 57–64.

would deem quite aggressive are at least viable under existing interpretations of BIT provisions. For example, commentators reacted with alarm when Philip Morris brought claims challenging the regulation of cigarette packaging.[32] The prevailing sentiment was that good-faith legislation designed to promote public health should not be subjected to potential investment treaty liability and scrutiny by international arbitrators.[33] But because existing arbitral jurisprudence leaves the door open to such claims, countries report a "chill" on exercises of their regulatory authority as they hesitate to pass legislation that could give rise to similar challenges.[34]

As these costs pile up, the question becomes whether they are offset by the benefits that BITs provide in terms of attracting additional foreign investment. The next Section addresses that question.

B. Evaluation

BITs are supposed to promote economic cooperation by increasing the flow of FDI, typically from a developed to a developing country. There are two primary mechanisms by which they could do so. The first is to increase FDI between the two States that are parties to a specific treaty by providing assurances of fair treatment in the host country to investors from the capital-exporting country. The second is to attract more investment to the developing State from all sources by sending a broader signal to investors worldwide about that State's domestic environment for investment. With both mechanisms, there are empirical studies, as well as reasons in principle, to support a pessimistic outlook.

---

32. *See, e.g.*, Alfred de Zayas, Opinion, *How Can Philip Morris Sue Uruguay over Its Tobacco Laws?*, GUARDIAN (London) (Nov. 16, 2015), https://www.theguardian.com/commentisfree/2015/nov/16/philip-morris-uruguay-tobacco-isds-human-rights (describing an arbitration between Philip Morris and Uruguay and calling for the entire investor-State dispute settlement system to be abolished). Philip Morris's claims against Uruguay were recently dismissed. *See* Philip Morris Brands Sàrl v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Award, ¶ 590 (July 8, 2016).

33. *See* de Zayas, *supra* note 32. In earlier work, I explained in further detail how arbitral jurisprudence created this conflict between foreign investors' rights and the host State's authority to regulate in the public interest, and I proposed tools of interpretation to reduce that conflict. *See generally* Richard C. Chen, *A Contractual Approach to Investor-State Regulatory Disputes*, 40 YALE J. INT'L L. 295 (2015).

34. Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 337, 346 n.46 (2007) (citing "mixed anecdotal evidence" on regulatory chill).

The first causal pathway is the one that BITs were formally designed to use. As explained in the prior Section, the investor protection model was created to provide additional treaty-based protections for investors from the capital-exporting country. Whereas they might previously have been deterred from investing because of perceived instability in the host State's domestic system, the presence of BIT protections would encourage greater investment by mitigating those risks. This mechanism for increasing FDI views BITs as "hands-tying devices" because they create costs for the host State if it fails to live up to its treaty commitments.[35]

Efforts to find evidence of increased FDI specifically between the two parties of a particular BIT are referred to as dyadic analyses, and most of them have found at most a marginal effect.[36] A couple of studies have found evidence that U.S. BITs produced a boost in FDI to the developing country signatory.[37] But another study looking at U.S. FDI flows to a different set of countries during a different time period contradicted this finding.[38]

The second mechanism by which BITs could affect FDI is by sending a signal to investors from all States that the host State "is generally serious about the protection of foreign investment."[39] The signing of BITs suggests, at a minimum, that the State in question *desires* to attract investment and would therefore be disinclined to take measures that would adversely affect its reputation. Moreover, signing BITs also creates a more concrete incentive for host States to reform their domestic institutions, because improper actions may create treaty liability to at least some foreign investors.[40] Thus, even foreign investors not from a country that has entered into a BIT with the host State could take other BIT signings into account on the theory that they would stand to benefit from general improvements to the domestic environment.

Efforts to measure this signaling effect are referred to as monadic analyses, which examine aggregate FDI flows from any

35. Andrew Kerner, *Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties*, 53 INT'L STUD. Q. 73, 76 (2009).

36. *See* Büthe & Milner, *supra* note 2, at 176–78 (summarizing studies).

37. *See id.* at 177–78.

38. *See id.*

39. Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 WORLD DEV. 1567, 1571 (2005).

40. Jennifer L. Tobin & Susan Rose-Ackerman, *When BITs Have Some Bite: The Political-Economic Environment for Bilateral Investment Treaties*, 6 REV. INT'L ORGANIZATIONS 1, 5 (2011).

source into capital-importing countries.[41] The results of these studies are more varied than the dyadic analyses. At least a couple have found BITs to have a significant impact on FDI.[42] Others, however, have found effectively no impact and suggest that prior findings to the contrary failed to account for the endogeneity of BIT adoption.[43] In other words, there may be a correlation between BIT adoption and FDI increases not because the former causes the latter, but because both are caused by another variable, or the latter causes the former.[44]

A recent study by political scientists Jennifer Tobin and Susan Rose-Ackerman attempts to measure the value of signaling more precisely by taking into account the quality of host State institutions. They conclude that BITs are ineffective when they are used as substitutes for an otherwise unfavorable domestic investment environment.[45] However, they find evidence that BITs can have a more substantial impact when they complement an existing set of effective domestic institutions.[46] They explain this counterintuitive result by suggesting that while signing BITs may send a signal about the host country's commitment to attracting foreign investment, "they are not the only information about political risk available to investors."[47] Thus, a country with weak institutions cannot expect

41. Büthe & Milner, *supra* note 2, at 176.

42. *See* Peter Egger & Michael Pfaffermayr, *The Impact of Bilateral Investment Treaties on Foreign Direct Investment*, 32 J. COMP. ECON. 788, 790 (2004); Neumayer & Spess, *supra* note 39, at 1582.

43. *See* Emma Aisbett, *Bilateral Investment Treaties and Foreign Direct Investment: Correlation Versus Causation*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS, *supra* note 2, at 395, 421–24; *see also* Deborah L. Swenson, *Why Do Developing Countries Sign BITs?*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS, *supra* note 2, at 437, 448 (providing evidence that "the signing of BITs was positively correlated with previous investment levels" and suggesting that this may occur as the result of lobbying by foreign investors already located in the host State).

44. *See* Aisbett, *supra* note 43, at 422.

45. Tobin & Rose-Ackerman, *supra* note 40, at 2.

46. *Id.* Others have found similar trends, but noted them more in passing without attempting to develop the theoretical explanation that Tobin and Rose-Ackerman offer. *See* Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract FDI? Only a Bit . . . and They Could Bite*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS, *supra* note 2, at 349, 368; Jason Yackee, *Do BITs Really Work?: Revisiting the Empirical Link Between Investment Treaties and Foreign Direct Investment*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS, *supra* note 2, at 379, 391.

47. Tobin & Rose-Ackerman, *supra* note 40, at 5.

that signing a BIT will dramatically alter investor perceptions, but a country with stronger institutions can use BITs "to lend credibility to [its] otherwise favorable domestic environment."[48]

With both dyadic and monadic analyses, the mixed nature of the findings is likely due, at least in part, to poor data quality.[49] The studies also raise a variety of complex methodological issues, such as how best to isolate the effects of BITs from other simultaneous changes in the domestic environment.[50] Resolving such methodological debates is beyond the scope of this Article.

For present purposes, it is enough to make two modest points about the empirical literature. First, with only a handful of positive studies that might well be outliers, no one would dispute that there is ample room for improvement. Given that BITs impose meaningful costs on host States, one would hope to find more robust and consistent evidence that they are succeeding in promoting FDI. Second, it is notable that, to the extent there has been evidence of impact, it tends to come from monadic rather than dyadic analyses. The implication, most strongly supported by the Tobin and Rose-Ackerman study, is that BITs are succeeding, if at all, based on their signaling of a commitment to reform domestic institutions rather than on promises to protect a particular State's investors.

This latter point is significant because my argument for improving the effectiveness of BITs seeks precisely to build on—and strengthen—their capacity to promote such reform. In Part III below, I show, based on empirical research outside the context of BITs, that the quality of domestic institutions is an important factor in foreign investment decisions. That research, combined with the results of Tobin and Rose-Ackerman's study, supports my argument that BITs should focus on institutional quality as the optimal path toward greater FDI.

In any event, the initial takeaway at this point is that there is some evidence that BITs are already contributing to FDI by signaling a commitment to domestic institutional reform. But at the same time, the signal is a modest one, and there is significant potential to enhance the impact of BITs by increasing the likelihood that signing

48. *Id.* at 6.

49. *See* Büthe & Milner, *supra* note 2, at 178; Jason Webb Yackee, *Do Bilateral Investment Treaties Promote Foreign Direct Investment? Some Hints from Alternative Evidence*, 51 VA. J. INT'L L. 397, 410–11 (2011).

50. Lisa E. Sachs & Karl P. Sauvant, *BITs, DTTs, and FDI Flows: An Overview*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS, *supra* note 2, at xxvii, lv; *see also id.* at lv–lvi (identifying other difficult issues).

them actually produces such reform.

II. EXISTING EFFORTS AND PROPOSALS

The prior Part paints a bleak picture of the international investment law regime. On one side of the equation, the investor protection model creates significant costs for capital-importing States, subjecting them to potential treaty liability and thereby placing constraints on their regulatory authority. On the other side, the model appears to have only a marginal impact on attracting foreign investment. It is no wonder then that developing countries are questioning whether continued participation in BITs makes sense.[51] And to the extent they begin withdrawing from BITs or opting out of the international investment law regime, as some have already done,[52] that is a loss for foreign investors and the capital-exporting States in which they are based. Some commentators take the view that exit is the best outcome for developing countries: the system is so deeply flawed that any attempt to realign it is a lost cause.[53]

At least some participants in the regime, however, have chosen to explore possible ways to reform the system rather than simply exiting it. Commentators have offered a variety of proposals, a few of which have begun to be implemented. This Part explores existing reform efforts and proposals to improve upon the status quo, divided into the incremental and the more systemic. I explain why the incremental proposals are likely insufficient, while the more systemic proposals are likely unrealistic and in some cases even counterproductive.

My focus in this Part is on reform efforts designed to make BITs more effective. There is a separate line of critique that sees international investment law as illegitimate, particularly to the extent that ad hoc panels of unaccountable arbitrators are empowered to review the actions of democratically elected governments.[54]

---

51. I emphasize in other places that increasing FDI is in the interest of capital-exporting States as well, so the failure of BITs to produce that result is a lost opportunity for both sides. But because developing States are subject to more investment treaty claims, they bear the costs disproportionately and thus have more to complain about with the existing system overall.

52. JESWALD W. SALACUSE, THE LAW OF INVESTMENT TREATIES 21–23 (2d ed. 2015).

53. *See* Sornarajah, *supra* note 25, at 61.

54. *See, e.g.*, Stephan W. Schill, *Enhancing International Investment Law's Legitimacy: Conceptual and Methodological Foundations of a New Public Law Approach*,

Commentators taking this view propose, for example, that international investment law be construed to be more deferential to State decisions,[55] or that the arbitration system be replaced with a standing investment court.[56] There may be some overlap as proposals designed to improve legitimacy may well enhance effectiveness at the same time. But the focus of the present discussion is on ideas for improving the latter specifically.

A. Incremental Proposals

Improving the effectiveness of BITs could mean increasing their benefits or reducing their costs. Most incremental reform proposals are focused on the latter. They do not grapple with the apparent failure of BITs to increase FDI flows, but are instead concerned primarily with pushing back against perceived intrusions on host State sovereignty through the aggressive assertion of investor rights.

The basic concern, alluded to earlier, is that as the scope of investor protections has grown, even good-faith exercises of regulatory authority may be challenged under BIT provisions like the fair and equitable treatment standard.[57] The prospect of investment treaty liability threatens State sovereignty because "State parties to investment agreements can no longer legislate at will in the public interest without concern that an arbitral panel will determine that the legislation constitutes interference with an investment."[58] Notably, it is not only developing countries that are feeling this regulatory constraint. As capital has begun to flow in increasing levels from developing to developed countries, and developed countries are signing investment treaties with each other, even States that are predominantly capital-exporting have now been on the receiving end of investment treaty claims.[59]

---

52 VA. J. INT'L L. 57, 66 (2011).

55. *See* William W. Burke-White & Andreas von Staden, *Private Litigation in a Public Law Sphere: The Standard of Review in Investor-State Arbitrations*, 35 YALE J. INT'L L. 283, 304–05 (2010) (proposing that arbitral tribunals apply a margin of appreciation, borrowing the deferential standard used by the European Court of Human Rights in reviewing the actions of Member States of the Council of Europe).

56. *See* GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW 180–84 (2007).

57. Chen, *supra* note 33, at 296.

58. Choudhury, *supra* note 7, at 778.

59. *See* Anthea Roberts, *Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States*, 104 AM. J. INT'L L. 179, 196 (2010).

A variety of proposals have been offered to address the intrusion concern, and some have begun to be adopted. One set of suggestions seeks to revise the substance of BIT protections. That could mean adding preambular language emphasizing that the treaty's terms should generally not limit the State's right to regulate in the public interest[60] or language that specifically narrows the scope of certain protections.[61] Thus, for example, the current 2012 version of the U.S. Model BIT ties the fair and equitable treatment standard to "the customary international law minimum standard of treatment of aliens,"[62] which is thought to be narrower than the standard developed and applied by arbitral tribunals.[63] A related approach would provide for carve-outs identifying specific areas, such as public health regulations, that are exempt from any BIT liability.[64]

Another set of proposals attempts to improve the quality of the arbitration process. For example, Barnali Choudhury argues that if arbitrators are going to make decisions that affect the public interest, there needs to be greater transparency to the public as well as opportunities for public participation through the submission of amicus curiae briefs.[65] Similarly, commentators have suggested that tribunals review legislation or other State conduct with a greater degree of deference[66] or apply a public law approach that would evaluate regulations purportedly intruding on investor rights under a

60. *See World Investment Report 2012*, *supra* note 11, at 144. In this regard, the current U.S. Model BIT states that the parties seek to achieve the treaty's "objectives in a manner consistent with the protection of health, safety, and the environment, and the promotion of internationally recognized labor rights." Treaty Between the Government of the United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment pmbl., U.S. DEPT. OF STATE (2012) [hereinafter 2012 U.S. Model BIT], http://www.state.gov/documents/organization/188371.pdf. This marked a change from earlier BITs whose preambles tended to focus solely on investor protection and investment promotion. *See* Karen Halverson Cross, *Converging Trends in Investment Treaty Practice*, 38 N.C. J. INT'L L. & COM. REG. 151, 190 (2012).

61. *See* Boone, *supra* note 5, at 198–99.

62. 2012 U.S. Model BIT, *supra* note 60, art. 5.

63. *See* DOLZER & SCHREUER, *supra* note 22, at 134. *But see* Patrick Dumberry, *Moving the Goal Post! How Some NAFTA Tribunals Have Challenged the FTC Note of Interpretation on the Fair and Equitable Treatment Standard Under NAFTA Article 1105*, 8 WORLD ARB. & MEDIATION REV. 251, 271–72 (2014) (describing how some tribunals have suggested that the customary international law minimum standard has evolved in the direction of the more robust treaty standard).

64. *See* Chen, *supra* note 33, at 321–22.

65. Choudhury, *supra* note 7, at 809–17.

66. *See* Burke-White & von Staden, *supra* note 55, at 304–05.

proportionality standard.[67] As noted earlier, these proposals are designed in part to improve the legitimacy of the arbitration process by providing for greater public input and by guarding against overly intrusive arbitral review. But they may also have an impact on effectiveness for similar reasons: if tribunals are making better decisions, and as a general matter deferring more to host States, the costs of BITs are likely to decrease.

The bottom line is that incremental reforms have gained traction precisely because they are modest, and because they speak to the interests of developed countries that are feeling the costs of regulatory constraint. It is far from clear that they will actually succeed in achieving the intended goals of limiting costs; much depends on how arbitrators interpret new provisions and whether they are interested in reevaluating old ones.[68] What does seem clear is that these modest proposals will have little impact on the other major concern about BITs, namely that they are failing to substantially boost FDI levels. These reform efforts are not designed to achieve that purpose and contain nothing likely to address that concern. Thus, there is a clear upper limit to how much these efforts would actually accomplish in terms of improving the effectiveness of BITs.[69]

B. Systemic Proposals

While the literature on BITs has generally focused on incremental changes that leave the existing framework of investor

---

67. *See* Benedict Kingsbury & Stephan W. Schill, *Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law*, *in* 50 YEARS OF THE NEW YORK CONVENTION: ICCA INTERNATIONAL ARBITRATION CONFERENCE 5, 51–52 (Albert Jan van den Berg ed., International Council for Commercial Arbitration Congress Ser. No. 14, 2009).

68. Some of the proposals described above would require the adoption of new provisions, but others, such as the proportionality test, are arguably within the power of tribunals to implement through the interpretation of existing treaties. *See id.*

69. Stephan Schill, Christian Tams, and Rainer Hofmann argue that the proposals discussed in this Section could indeed contribute to host State development—in other words, produce benefits and not merely reduce costs. *See* Stephan W. Schill et al., *International Investment Law and Development: Friends or Foes?*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP, *supra* note 25, at 3, 29–32. However, their argument is that the proposed changes would remove obstacles to the host State's own efforts to advance its development. *See id.* at 29 (arguing that the proposed reforms would "grant host States sufficient policy space to pursue their development strategies"). That, of course, is a less ambitious goal than designing BITs to affirmatively contribute to FDI or economic development.

protection in place, at least some commentators have begun to question the viability of that framework. It is particularly troubling to these critics that even when developing countries succeed in attracting FDI, the increased investment does not consistently contribute to the host State's economic growth.[70] The major alternative that has begun to emerge is a new model focused on host State development.[71] Commentators in this vein take the view that BITs were never about investor protection, or even about increasing FDI, in the first place—at least from the standpoint of developing countries.[72] Rather, investor protection and increasing FDI were means to the end of furthering the development of host States.[73] This perspective leads to the conclusion that BITs should be fundamentally repurposed to address development directly, rather than leaving host States to hope that increased FDI (should it in fact arrive) will gradually lead to progress in that regard.

Advocates of what can be called a "development model" propose two categories of changes.[74] One category involves crafting provisions that help to ensure that FDI actually adds value to the host State. This could mean, for example, drafting an admissions clause that permits host States more flexibility to restrict "low-quality FDI" that is unlikely to contribute to economic development.[75] Similarly, a development model could remove the now-standard prohibition on performance requirements. As defined by the United Nations Conference on Trade and Development ("UNCTAD"), performance requirements "are stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their operations in the

70. *See* COSBEY ET AL., *supra* note 5, at v ("[I]t is becoming more and more widely accepted that the proper goal in attracting investment is *quality*, rather than *quantity*. In the end, if investment does not increase well-being on a sustainable basis, it is not worth having, much less actively chasing.").

71. For a comprehensive model developed by the United Nations Conference on Trade and Development, see *World Investment Report 2012*, *supra* note 11, at 132–61.

72. *See* Yannick Radi, *International Investment Law and Development: A History of Two Concepts*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP, *supra* note 25, at 69, 73–75.

73. *Id.*

74. Such advocates would also generally agree with the incremental reforms described in the prior Section—for example, recalibrating investor protections to create the policy space host States need to pursue their development agenda. *See supra* note 69. A third proposal of incorporating technical assistance provisions is one I also advocate and thus return to in Section IV.A below.

75. Genevieve Fox, Note, *A Future for International Investment? Modifying BITs to Drive Economic Development*, 46 GEO. J. INT'L L. 229, 252 (2014). As Fox explains, many BITs provide for a presumptive right of admission. *See id.*

host country."[76] They can involve, among other things, "obligations to hire local labor, use locally created inputs, maintain partial or joint ventures with locals, export some percentage of goods produced, or transfer technology."[77] Although the trend in recent BITs has been toward prohibiting such performance requirements, advocates contend that, if used selectively and appropriately, they can help host States better capture the benefits that FDI is supposed to produce.[78]

A second category of proposed changes is focused on promoting development that is *sustainable*. Sustainable development means pursuing economic growth in a manner that properly takes into account social and environmental concerns.[79] Advocates of a development model suggest that BITs can incorporate these concerns by placing obligations on investors, thereby correcting the asymmetry that exists in current BITs.[80] For example, firms making certain types of investments could be required to perform impact assessments that address likely effects on human rights and the environment.[81] BITs could also require firms to agree to certain corporate social responsibility standards and provide for various accountability mechanisms, including civil or criminal liability in the host or home State.[82]

The development model, if adopted, has the potential to meaningfully alter the effectiveness of BITs. The first category of reforms addresses the benefits side of the equation, while the second

---

76. U.N. CONFERENCE ON TRADE & DEV., FOREIGN DIRECT INVESTMENT AND PERFORMANCE REQUIREMENTS: NEW EVIDENCE FROM SELECTED COUNTRIES, at 2, U.N. Sales No. E.03.II.D.32 (2003), http://unctad.org/en/docs/iteiia20037_en.pdf.

77. Fox, *supra* note 75, at 248 (footnotes omitted).

78. *Id.* at 249–50; *see also* Boone, *supra* note 5, at 196 ("Performance-based requirements are probably the most powerful regulation method that developing countries do not use.").

79. Andrea Saldarriaga & Kendra Magraw, *UNCTAD's Effort to Foster the Relationship Between International Investment Law and Sustainable Development*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP, *supra* note 25, at 125, 130.

80. *See id.* at 136–37.

81. J. ANTHONY VANDUZER ET AL., INTEGRATING SUSTAINABLE DEVELOPMENT INTO INTERNATIONAL INVESTMENT AGREEMENTS: A GUIDE FOR DEVELOPING COUNTRIES 260 (Aug. 2012), https://www.iisd.org/pdf/2012/6th_annual_forum_commonwealth_guide.pdf (prepared for the Commonwealth Secretariat).

82. *See* Markus W. Gehring & Marie-Claire Cordonier Segger, *Overcoming Obstacles with Opportunities: Trade and Investment Agreements for Sustainable Development*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP, *supra* note 25, at 93, 118–20; *see also* VANDUZER ET AL., *supra* note 81, at 364–65 (describing different enforcement mechanisms for investor obligations).

category goes further than the incremental proposals described in the prior Section in seeking to reduce costs. The primary concern is that, unlike the incremental proposals, the development model is one-sided and not pitched at States that predominantly export capital. It may be true that developing countries have always seen investor protection and increasing FDI as means to the end of advancing their development. But it would be a mistake to equate the motivations of one contracting State with the parties' *shared* purpose. In the absence of a stronger case that the development model is in the interests of both sides, the proposed revisions may not be realistic possibilities.

There is an additional concern that aspects of the development model would be counterproductive if adopted. This is particularly true of the first category of reforms. Determining what FDI is likely to contribute to development and imposing conditions to capture more of its value will be a complex process to get right, and there is a risk that such actions will not only deter particular investors but also signal a less favorable environment to the broader business community.[83] The concern applies to a lesser extent to the second category of reforms. Because of the general movement in the international community toward valuing sustainable development,[84] the incorporation of such principles in BITs would likely be perceived as responsible governance rather than as an indication of hostility to FDI. But the concern of deterring investment does not fully disappear because individual firms may be dissuaded and particular BITs that overreach in this area may still end up sending a problematic signal.

Advocates of the development model have advanced the conversation and generated many useful ideas. Their more aggressive proposals may in fact work for host States that are, for example, rich in resources or otherwise seen as attractive markets because they possess greater leverage in the negotiation process. Moreover, it is conceivable that in some instances capital-exporting countries will be sufficiently motivated by altruism or strategic considerations to enter BITs that prioritize sustainable development.[85] But there are strong reasons to doubt that the

83. *See* Fox, *supra* note 75, at 249–50 (acknowledging this concern for performance requirements).

84. As one example, the United Nations General Assembly recently adopted a resolution identifying seventeen sustainable development goals for the international community to pursue. G.A. Res. 70/1 (Oct. 21, 2015).

85. The model may also be appropriate for pairs of developing countries that expect capital to flow equally both ways.

development model will be viable in many or perhaps most instances. As explained in Section III.C below, the model proposed here is intended to be pitched as a better bargain for all involved and thus more realistically attainable, even if it does not offer everything that advocates of the development model would like in an ideal world.

III. THE INSTITUTIONAL REFORM MODEL

Having described and evaluated the shortcomings of existing reform efforts, I turn in this Part to the case for an institutional reform model. The literature on BITs indicates that they are having at best a modest impact on increasing FDI. Meanwhile, empirical studies on the determinants of FDI find that domestic institutional quality is one key factor. Section III.A details that evidence. In light of all the available evidence on what works and what does not, Section III.B argues for a redesign of BITs to focus on improving domestic institutions in order to increase their effectiveness in promoting FDI. Finally, Section III.C explains why the institutional reform model has the potential to be a better bargain for both sides and thus should be more realistically attainable than other systemic proposals that have been offered.

A. The Importance of Domestic Institutions

Political scientists and economists have extensively explored the relationship between domestic political and legal institutions, on the one hand, and foreign direct investment, on the other. Their conclusions vary in the extent of the correlation and in their assessment of which specific institutional factors matter most. But the literature is generally consistent in concluding that a meaningful correlation exists.

To be clear at the outset, no one suggests that the quality of a State's institutions is the driving factor in a firm's decision to invest there. Evidence and common sense suggest that the nature and scope of the business opportunity provide the initial motivation.[86] The

---

86. *See* John Hewko, Special Report, *Foreign Direct Investment in Transitional Economies: Does the Rule of Law Matter?*, E. EUR. CONST. REV., Fall 2002, at 71, 73. Economic factors that make a host country attractive include "a large domestic market, sustainable growth, sufficient economic and infrastructure development and/or high natural resources endowment." Kyeonghi Baek & Xingwan Qian, *An Analysis on Political Risks and the Flow of Foreign Direct Investment in Developing and Industrialized Economies*, ECON., MGMT., & FIN. MARKETS, Dec. 2011, at 60, 64.

absence of political and legal risks is probably never an affirmative reason in itself to invest in a country. And when those risks are present, the investment may nonetheless be deemed justified based on the size of the business opportunity, and the risks simply treated as issues to be managed.[87]

Nonetheless, common sense also suggests that the extent of those risks would affect a firm's calculation on whether and how much to invest in a particular location, assuming it is sufficiently attractive from an economic perspective. Weak institutions can increase costs and create inefficiencies for businesses in general, whether foreign or domestic.[88] Moreover, because their investments often result in sunk costs, foreign firms are "especially vulnerable to any form of uncertainty, including uncertainty stemming from poor government efficiency, policy reversals, graft or weak enforcement of property rights and of the legal system in general."[89] Thus, the quality of a State's institutions would be expected to affect the level of FDI at least at the margins, and the evidence supports such a relationship.

Early investigations of this relationship looked for links between investment and general concepts like political risk or uncertainty. A typical such study uses a regression analysis to examine how one or more specified variables relate to FDI levels in a group of countries. For example, a 1985 study on political and economic determinants of FDI in fifty-four developing countries concluded that the variable of political instability significantly reduced the inflow of FDI.[90] Similarly, a 1996 study found a significant correlation between political risk and FDI inflows, with the impact increasing for countries that received higher levels of FDI.[91] This research, although not conclusive, provides support for the reasonable notion that decreased risk in a country's political and legal system would correlate with higher levels of investment.

In addition to regression analyses, researchers have relied on surveys of firms for evidence of the relevance of political risk. Early surveys on the subject found "that executives report political

87. *See* Hewko, *supra* note 86, at 73–74; *see also* Yackee, *supra* note 49, at 435–36.

88. Agnès Bénassy-Quéré et al., *Institutional Determinants of Foreign Direct Investment*, 30 WORLD ECON. 764, 765 (2007).

89. *Id.*

90. Friedrich Schneider & Bruno S. Frey, *Economic and Political Determinants of Foreign Direct Investment*, 13 WORLD DEV. 161, 166, 173 (1985).

91. Kwang W. Jun & Harinder Singh, *The Determinants of Foreign Direct Investment in Developing Countries*, TRANSNAT'L CORPS., Aug. 1996, at 67, 87. Additional studies are collected in Baek & Qian, *supra* note 86, at 64.

instability to be the most important variable influencing their foreign investment decisions, aside from market potential."[92] More recent studies have similarly identified political risk as the key constraint on investment when the opportunity is otherwise attractive from an economic standpoint. For example, a 2007 survey of 602 executives from multinational corporations around the world identified "political risk and governance issues [as] the most prominent barriers to investment into emerging markets."[93] Moreover, survey responses indicated a perception that political risk was becoming a bigger concern than it had been in the past.[94] A 2009 survey of a similar population likewise ranked political risk first on a list of constraints on foreign investment in emerging markets, ahead of factors such as macroeconomic stability, access to financing, infrastructure capacity, and access to qualified staff.[95]

More recent studies have broken political risk—or its flipside, institutional quality—down into discrete components to better understand their influence on FDI. Some of these components, such as a concern about political violence,[96] will be set aside because however important they may be, they are likely beyond the scope of what an economic treaty could meaningfully address. Others, such as the question of regime type, will be bracketed because the research has pointed to contradictory conclusions.[97] The focus for the

92. Schneider & Frey, *supra* note 90, at 162 (citing YAIR AHARONI, THE FOREIGN INVESTMENT DECISION PROCESS (1966); RAGHBIR S. BASI, DETERMINANTS OF UNITED STATES PRIVATE DIRECT INVESTMENT IN FOREIGN COUNTRIES (1963)).

93. Matthew Shinkman, *The Investors' View: Economic Opportunities Versus Political Risks in 2007–11*, *in* WORLD INVESTMENT PROSPECTS TO 2011: FOREIGN DIRECT INVESTMENT AND THE CHALLENGE OF POLITICAL RISK 84, 84, 87 (Laza Kekic & Karl P. Sauvant eds., 2007), http://graphics.eiu.com/upload/wip_2007_web.pdf.

94. *Id.* at 87–88.

95. WORLD BANK GRP.: MULTILATERAL INV. GUARANTEE AGENCY, WORLD INVESTMENT AND POLITICAL RISK 2009, at 66, 70 (2010), http://ccsi.columbia.edu/files/2013/11/WIPR_2009.pdf. The survey defined political risk as "breach of contract by governments, restrictions on currency transfer and convertibility, expropriation, political violence (war, civil disturbance and terrorism), non-honoring of government guarantees, adverse regulatory changes, and restrictions on FDI outflows in home countries." *Id.* at 28.

96. *See* Baek & Qian, *supra* note 86, at 66 (noting that "[w]ar and political violence—on both the domestic and international level—deter foreign investment").

97. In particular, studies have reached conflicting conclusions on whether having a democratic government correlates with more or less FDI. The competing forces at work are readily identifiable. On the one hand, democratic governance may exacerbate political risk by increasing "policy instability" and allowing domestic interest groups to influence policymaking to the detriment of foreign firms. Nathan Jensen, *Political Risk, Democratic Institutions, and Foreign Direct Investment*, 70 J. POL. 1040, 1042 (2008). On the other hand, democratic governments may be less politically risky because they are more

remainder of this Section will be on the institutional factors that have been identified as relevant to the foreign investment decision-making process and that can serve as a foundation on which to base proposals for a new BIT model. As with the above studies of political risk in general, I rely on both regression analyses and survey evidence in drawing the below conclusions.

First, foreign investors value a transparent and rational policymaking process.[98] Undoubtedly the actual substance of a host State's laws is important, as investors will be drawn to environments that offer favorable tax laws and financial regulations.[99] But there is independent value in a well-functioning process. Rules in general are likely to be more effective when affected parties have a voice in shaping them, and business rules in particular likely benefit from the input of firms, including foreign-owned ones.[100] Moreover, foreign investors worried about sunk costs are particularly sensitive to policy instability and uncertainty.[101] While even rational rulemaking institutions are liable to change course sometimes, they are at least less likely to veer off in arbitrary directions.

Second, foreign investors value an efficient bureaucracy.[102] Apart from the institutions that create laws and regulations, businesses must be concerned about the range of government officials who implement and administer them. Excessive red tape

---

transparent and more sensitive to the reputation harms that would come from mistreatment of foreign investors. *Id.* at 1041. Moreover, some scholars have suggested that some democracies actually have greater policy stability and that allowing input into the policymaking process is on the whole beneficial to foreign firms. *Id.* Given these complex dynamics, it is unsurprising that empirical studies have produced contradictory results. *See id.* at 1043.

98. *See* Baek & Qian, *supra* note 86, at 64–65.

99. *See* Christian Daude & Ernesto Stein, *The Quality of Institutions and Foreign Direct Investment*, 19 ECON. & POL. 317, 322, 327 (2007) (finding that regulatory quality, defined to reflect the "content of policies," has the largest impact on the volume of FDI).

100. Hewko, *supra* note 86, at 76.

101. Baek & Qian, *supra* note 86, at 64 (noting that "policy instability and arbitrary regulation in FDI-related policies create uncertain investment environments and hurt the profitability of foreign investments").

102. Busse & Hefeker, *supra* note 6, at 407 (finding "bureaucratic quality [to be] positively associated with FDI flows"); Daude & Stein, *supra* note 99, at 321–22, 327 (finding that government effectiveness, defined to include "indicators on the quality of bureaucracy, the competence of civil servants, the quality of public service provision, and the credibility of the government's commitment to its policies," has a significant effect on FDI); Drabek & Payne, *supra* note 6, at 788 (citing "[a]dministrative inefficiency [as] probably today the most frequently observed deterrent to FDI").

interferes with the efficient conduct of business.[103] Corruption similarly "produces bottlenecks, heightens uncertainty, and raises costs,"[104] with the added concern of forcing investors to choose between forgoing an opportunity entirely and paying a bribe that could lead to criminal liability.[105] By contrast, an efficient bureaucracy allows firms to reduce costs and minimize distractions as they focus on their actual value-creating business activity.

Third, foreign investors value an independent judiciary capable of enforcing contract and property rights.[106] Scholars have long noted the connection between a strong judiciary and a hospitable environment for investment, emphasizing that even the "best" substantive law will be of little value in the absence of effective court enforcement.[107] Foreign investors, like all commercial actors, depend on the presence of efficient and impartial courts to ensure that their contract and property rights will be protected.[108] Backlogged courts with slow processing times, or judges who are subject to bribery or government influence, interfere with business activity by negating that expectation. Outside the context of commercial

---

103. *See* Hewko, *supra* note 86, at 74 ("Nothing exasperates an investor more than the need to shuffle from ministry to ministry or to negotiate a seemingly endless bureaucratic maze where everyone and no one is in a position to resolve issues or grant approvals."); *see also* SCOTT YUNXIANG GUAN, CHINA'S TELECOMMUNICATIONS REFORMS: FROM MONOPOLY TOWARDS COMPETITION 133–34 (2003) (describing how excessive bureaucratic discretion has created problems for investors in the telecommunications industry in China); Mark Dutz et al., *Turkey's Foreign Direct Investment Challenges: Competition, the Rule of Law, and EU Accession*, *in* TURKEY: ECONOMIC REFORM & ACCESSION TO THE EUROPEAN UNION 261, 275 (Bernard M. Hoekman & Sübidey Togan eds., 2005) (noting how "insufficient respect for the rule of law," including the "uneven application of bureaucratic red tape," can "profoundly damage any country's investment climate").

104. Mohsin Habib & Leon Zurawicki, *Corruption and Foreign Direct Investment*, 33 J. INT'L BUS. STUD. 291, 292 (2002).

105. *See* Drabek & Payne, *supra* note 6, at 785.

106. *See* Glen Biglaiser & Joseph L. Staats, *Do Political Institutions Affect Foreign Direct Investment? A Survey of U.S. Corporations in Latin America*, 63 POL. RES. Q. 508, 517 (2010) (summarizing survey results as "suggest[ing] that CEOs prefer countries that provide investment safety linked to adherence to rule of law, upholding of private property rights, [and] use of a relatively efficient and effective court system"). The same authors conducted a regression analysis of judicial institutions in Latin America and found that "countries in the region with greater judicial strength and rule of law tend to receive higher levels of FDI." Joseph L. Staats & Glen Biglaiser, *Foreign Direct Investment in Latin America: The Importance of Judicial Strength and Rule of Law*, 56 INT'L STUD. Q. 193, 200 (2012) [hereinafter *FDI in Latin America*].

107. *See, e.g.*, KENNETH W. DAM, THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT 93 (2006).

108. *See FDI in Latin America*, *supra* note 106, at 193–94.

disputes, a strong judiciary also provides a valuable check on arbitrary policymaking and other forms of government overreach, thus contributing to good governance more broadly.[109]

In short, foreign investors are attracted to host States with effective lawmaking, administrative, and judicial institutions. The preceding three factors flesh out what that looks like, but the basic point is straightforward and intuitive. The next Section addresses how these factors can lay the foundation for a new BIT model premised on domestic institutional reform.

B. Translation to BITs

Given the evidence that strong institutions that reduce political risk help to attract foreign investment, I argue that BITs should be redesigned to promote domestic institutional reform. Before developing that argument, I pause to address why the investor protection model fails to address these same political risk concerns. Recall that, as described in Section I.A, political risk was the very problem BITs were supposed to help overcome. But the empirical evidence discussed in Section I.B suggested that BITs are not seen as adequate substitutes for weak domestic institutions, and it is worth elaborating on why that may be so.

Consider first the option of arbitration, which was intended to allow foreign investors to bypass a weak or potentially biased domestic judiciary. But it is in fact an incomplete solution. The host State's courts may still be needed to adjudicate non-treaty-based disputes (either with the State itself or with private parties) and to enforce arbitral awards.[110] Thus, the quality of the legal system still matters to foreign investors, as they cannot expect to avoid contact with it entirely. Relatedly, despite the perception that the investor-State arbitration regime is biased in favor of investors, some evidence exists to suggest that investors are routinely disappointed in the outcomes of that process.[111]

---

109. *See id.* at 194.

110. *See* Franck, *supra* note 34, at 369–70 (describing the role of national courts in enforcing arbitral awards and adjudicating domestic law disputes); *cf.* Daniel Berkowitz et al., *Legal Institutions and International Trade Flows*, 26 MICH. J. INT'L L. 163, 167 (2004) (noting, in the context of international trade, that although private parties may attempt to contract for private dispute resolution, they may still need domestic courts to enforce compliance with any arbitral ruling).

111. *See supra* notes 30–31 and accompanying text. Of course, it may be that investors are feeling disappointed because they have been bringing unmeritorious claims or overstating their damages, but there is at least reason to think that access to arbitration is far

Moreover, apart from encounters with the legal system, foreign investors have reason to be concerned about the quality of governance more generally. The ability to enforce legal rights is undoubtedly important, but not every wrong or inefficiency caused by a weak institution produces a cognizable legal claim, under BITs or otherwise. Firms that are concerned about an inefficient bureaucracy or arbitrary policymaking are thus unlikely to be fully reassured by the substantive protections that BITs provide. And so it is not surprising that empirical studies have generally painted a pessimistic picture about the capacity of BITs to increase bilateral FDI flows.

What about the second mechanism by which BITs were supposed to contribute to FDI growth—by sending a broader signal that the host State is committed to improving its environment for investment? The studies on this effect were slightly more promising, and commentators have argued that signing BITs should in fact create incentives for domestic reform.[112] But this impact has not been consistently discernible, and the more nuanced study by Tobin and Rose-Ackerman finds that BITs attract FDI primarily when the host State *already has* effective domestic institutions.[113] Adequate existing institutions are needed because investors have access to other information, and if that information suggests a "weak investment environment," the signal sent by the signing of a BIT is of negligible value.[114]

Accordingly, even those who defend the existing model on the ground that it incentivizes host State reform would likely agree that the model is not optimally designed for that purpose. Any effect that BITs as currently constituted have on domestic institutions is a byproduct of the investor protection provisions rather than a designed feature. Host States may decide against particular reforms or reform

---

from a panacea for harmed foreign investors.

112. *See* Celine Tan, *Reviving the Emperor's Old Clothes: The Good Governance Agenda, Development and International Investment Law*, *in* INTERNATIONAL INVESTMENT LAW AND DEVELOPMENT: BRIDGING THE GAP, *supra* note 25, at 147, 159 ("Host state signatories to [international investment agreements] risk incurring significant costs if they do not reform domestic institutions to give effect to treaty standards of protection, including direct costs of litigation for treaty breaches and any ensuing compensatory damages to the foreign investor as well as indirect costs, such as the . . . effects of reputational loss."); *see also* Benjamin K. Guthrie, Note, *Beyond Investment Protection: An Examination of the Potential Influence of Investment Treaties on Domestic Rule of Law*, 45 N.Y.U. J. INT'L L. & POL. 1151, 1192–97 (2013) (describing more specific mechanisms by which BITs would influence domestic institutions).

113. *See supra* notes 45–48 and accompanying text.

114. Tobin & Rose-Ackerman, *supra* note 40, at 2.

in general because the expense of pursuing it outweighs the costs of noncompliance. Or they might simply try and fail. Foreign investors, in turn, may give some weight to the presence of a BIT in evaluating the risks of investing in a particular State, but the signal is not reliable enough to produce a substantial impact.

The question then becomes whether a redesigned BIT that specifically focuses on the improvement of host State institutions could have a more substantial impact on FDI. Reserving the question of how such improvements are to be achieved for the next Part, I contend that, if BITs can facilitate such changes, increased FDI is likely to follow for two reasons. First, as the host State's environment for investment begins to improve, foreign investors should take notice and adjust their decisions accordingly. Notably, any resulting increase in FDI in this scenario would be more sustainable, because it would be based on concrete progress on the ground rather than on the abstract signaling that the investor protection model offers. Second, once BITs could be shown to facilitate institutional reform on a consistent basis, the previously limited signaling value would become more meaningful. In other words, foreign investors could now more reasonably rely on the signing of BITs to indicate that positive changes in the host State were forthcoming, and so the benefits of increased investment could arrive before the changes themselves.

Two caveats should be acknowledged so as not to exaggerate the potential value of a redesigned BIT. First, as noted above, the absence of political risk is generally not an affirmative reason to invest in a particular State.[115] Thus, there is a limit to how much can be accomplished through institutional reform; investors must still see an economic opportunity for the removal of risk barriers to have an impact. Second, studies suggest that firms do not conduct systematic evaluations of political risk, but rather make assessments in an ad hoc, impressionistic manner.[116] This suggests that even if BITs begin to produce concrete improvements in host State institutions, any corresponding increases in FDI may not happen immediately and will

115. *See supra* notes 86–87 and accompanying text.

116. *See* Hewko, *supra* note 86, at 74 (noting that investors' risk perceptions are "rarely based on a thorough understanding of the political, social, legal, and cultural situation in the country, but, rather, on information obtained from newspaper headlines and television news reports back home, anecdotes from previous trailblazers, [or] perceptions as to what their competitors were thinking and doing"); Yackee, *supra* note 49, at 431 (describing a study finding that "political risk analysis was often weakly institutionalized, with managers often possessing only a 'diffuse, subjective, and impressionistic' perception of political risk" (quoting STEPHEN J. KOBRIN, MANAGING POLITICAL RISK ASSESSMENT: STRATEGIC RESPONSE TO ENVIRONMENTAL CHANGE 113 (1982))).

depend on the gradual evolution of perceptions among the business community. Relatedly, recent survey evidence suggests that investors possess only a "low level of familiarity with BITs" and that they have "a low level of influence over FDI decisions."[117] Given increasing media coverage of BITs as a result of high-profile investor-State disputes, investor awareness may well be on the rise, but to the extent this lack of familiarity persists, it would limit the signaling value that even a redesigned BIT would have.

The above caveats notwithstanding, the point remains that there is significant unharnessed potential in BITs to produce more gains in FDI for developing countries. The institutional reform model may help realize that potential.

C. A Better Bargain

As alluded to earlier, the investor protection model has been referred to as a grand bargain, in which developing countries agree to limit their sovereignty as a way to attract foreign investment from developed countries.[118] But as things currently stand, the evidence suggests that host States are incurring the costs of regulatory constraint without substantial corresponding gains in increased FDI. Moreover, as noted in Section II.B, the foreign investment that developing countries have received has not consistently led to the economic growth that provided the motivation for their participation.

The institutional reform model has the potential to be a better bargain for both sides. First, it should be remembered that it is in the two States' shared interest to increase FDI: developing countries want to attract it, but developed countries are also seeking to cultivate more and better outlets for their investors. Thus, if the empirical evidence indicates that better domestic institutions in the host State are key to promoting FDI, then both States stand to benefit from such improvements. This argument distinguishes my proposal from the ones I criticized in Section II.B as politically unrealistic. Whereas a shift toward emphasizing the development of host States would likely be resisted as a one-sided repurposing, the institutional reform model can be pitched as an opportunity to produce gains for both States.

At the same time, the value of improved domestic institutions to the host State specifically should not be overlooked. An important feature of the proposed model is that it builds in benefits for the host State, rather than leaving them contingent on some trickle-down

117. Yackee, *supra* note 49, at 429.

118. *See supra* notes 15–21 and accompanying text.

effect. In other words, while the ultimate shared goal of increasing FDI remains the same, the proposed model seeks to improve host State institutions as the means toward that end. And such improvements would of course be beneficial in and of themselves, apart from the value they bring in increased FDI.[119] By contrast, the investor protection model assumed that increased FDI would eventually result in benefits to the host State but did nothing to promote that outcome.[120] Thus, while the institutional reform model may not go as far as advocates for developing countries would prefer, it is designed to produce value for them immediately, even as it seeks to more effectively accomplish the shared goal.

A shift to an institutional reform model is not without costs, particularly to capital-exporting States. Some of the proposals discussed in the next Part require an investment in resources by developed countries; others could be perceived as a contraction of the protections afforded to foreign investors. On the flipside, any payoff in terms of increased FDI may take time to materialize. Thus, the value proposition to capital-exporting States may not be as self-evident as it is to host States. That said, given the dissatisfaction among developing countries with the current model, ideas to improve the arrangement from their perspective are sorely needed. The approach I propose is a more plausible compromise than others that have been offered, with at least the potential to be a better bargain for all participants in the long run.

IV. THREE PROPOSALS

This Part begins the conversation about how BITs can be designed to foster improvements to the domestic institutions of developing countries. The first proposal would most directly serve that purpose, but would also be the farthest afield from what BITs currently contain and would require a substantial investment of resources. The second and third proposals would help to facilitate rather than directly produce institutional reform, but could be implemented more readily into the existing structure. The three proposals could work well together or be adopted independently of each other.

119. An important caveat to this point is that reforms designed to please foreign investors or the business community do not necessarily spillover into benefits for the public at large. I plan to return to this question of when and how such benefits can be more broadly distributed in future research.

120. *See supra* notes 70–74.

As noted in the Introduction, I have bracketed the question of how, if at all, the substantive protections generally provided for under the current model should be revised. My analysis of the shortcomings of existing BITs would support an argument for reducing foreign investor protections because the evidence suggests they may be producing greater costs than benefits.[121] Others have made proposals for how that recalibration should be done, including ideas I summarized in Section II.A. My primary critique of those proposals was that they addressed only the costs of BITs and offered nothing to improve their capacity to promote FDI. But the proposals I offer here to enhance the benefits side of the equation may well be compatible with a simultaneous effort to reduce the costs.

A. Conditional Aid and Technical Assistance

The first proposal is that BITs should include commitments by developed States to provide conditional aid and technical assistance to developing countries to promote the institutional reform needed to enhance FDI. Of the proposals offered in this Part, this one most directly addresses the issue of improving host State institutions. It is also the farthest afield from what the current model of BITs encompasses. Rather than focusing solely on reciprocal commitments by each State to the other's investors, these novel provisions would create a deeper partnership between the two States themselves. The provisions would require a significant investment of resources by the developed State in particular, but they would have the potential to trigger meaningful reforms and ultimately yield greater benefits for both sides.

While this Article is the first to make the case for expressly linking BITs and domestic institutional reform, the concept of foreign aid to assist in capacity building has a long history. Foreign aid in general was traditionally focused on stimulating economic development by, among other things, supporting infrastructure improvements, delivering new technologies, and providing for basic needs.[122] Countries acting individually, as well as collectively through international organizations like the World Bank and International Monetary Fund, provide aid based on a combination of altruistic and self-interested motives.[123] Since around the 1980s,

121. *See supra* Section I.B.

122. Steven Radelet, *Foreign Aid*, *in* 2 INTERNATIONAL HANDBOOK OF DEVELOPMENT ECONOMICS 98, 105 (Amitava Krishna Dutt & Jaime Ros eds., 2008).

123. *Id.* at 101–05. Self-interested motives include advancing the foreign policy agenda of the donor state or promoting "the economic interests of certain firms or sectors in the

countries and organizations providing aid began to focus on promoting the rule of law in recipient States.[124] These efforts grew out of a recognition that aid on the whole was failing to contribute to the recipient country's growth and development.[125] The missing ingredient was thought to be the rule of law and institutions that could put the received aid to effective use, and so aid for the specific purpose of institution-building became a priority.[126]

The rule of law continues to serve as a guiding ideal for social progress, and empirical evidence exists to support the belief that its presence in a State is correlated with effective development.[127] But actually translating the high-level ideal into concrete steps that can be taken to achieve it has proved to be elusive.[128] The reasons for this are many. One is a disagreement about what the rule of law actually entails. Rachel Kleinfeld finds that the concept has been "used to imply at least five different goals: making the state abide by law, ensuring equality before the law, supplying law and order, providing efficient and impartial justice, and upholding human rights."[129] Actors working to promote the rule of law refer inconsistently to these different definitions, and some remain "hotly disputed."[130]

There are also problems with foreign aid programs in general that show up in the rule-of-law aid context specifically. First, foreign aid may have the effect of reinforcing the status quo. Ineffective governments that citizens would have sought to replace may survive longer because aid allows them to provide a minimally adequate level

---

donor country." *Id.* at 104.

124. Thomas Carothers, *The Problem of Knowledge*, *in* PROMOTING THE RULE OF LAW ABROAD: IN SEARCH OF KNOWLEDGE 15, 15 (Thomas Carothers ed., 2006).

125. *Id.* at 16–17.

126. *Id.* at 17 ("It has become a new credo in the development field that if developing and postcommunist countries wish to succeed economically they must develop the rule of law.").

127. Tjaša Redek & Andrej Sušjan, *The Impact of Institutions on Economic Growth: The Case of Transition Economies*, 39 J. ECON. ISSUES 995, 998–1002 (2005) (summarizing studies).

128. The parallels to the present Article are hard to miss. The institutions that are important to attracting foreign investment are likewise key to fostering economic growth from a purely domestic standpoint. *See id.* at 999 (describing a study in which "property rights" and "regulatory institutions" were found to have a significant impact on economic growth).

129. Rachel Kleinfeld, *Competing Definitions of the Rule of Law*, *in* PROMOTING THE RULE OF LAW ABROAD: IN SEARCH OF KNOWLEDGE, *supra* note 124, at 31, 34–35.

130. *Id.* at 35.

of services.[131] Political elites who lack the will to seek reform may use aid money for patronage purposes, enabling themselves to retain their positions or status.[132] Aid money also creates more opportunity for corruption, when new public funds are available to be used for various forms of private gain.[133] The lack of progress persists even when aid is made on a conditional basis. That happens both because metrics to measure progress are difficult to identify and because aid providers have a strong bias toward continuing to disburse funds regardless of their effectiveness.[134]

Although these are serious obstacles, there are nonetheless potential solutions and reasons to believe that BITs can provide a proper setting for implementing them. As an initial point, regarding the definitional problem, this Article proposes focusing on the issue of improving institutions rather than seeking to advance particular substantive ends. In other words, the goal is to reform key institutions that are known to be necessary to support the rule of law. Some aid providers use precisely this same approach. In a report on U.S. rule-of-law aid efforts, for example, the Government Accounting Office defined the scope of its subject as follows:

> Throughout this report, we use the phrase "rule of law" to refer to U.S. assistance efforts to support legal, judicial, and law enforcement reform efforts undertaken by foreign governments. This term encompasses assistance to help reform legal systems (criminal, civil, administrative, and commercial laws and regulations) as well as judicial and law enforcement institutions (ministries of justice, courts, and police, including their organizations, procedures, and personnel).[135]

---

131. Radelet, *supra* note 122, at 107–08.

132. *See* Katherine Erbeznik, Note, *Money Can't Buy You Law: The Effects of Foreign Aid on the Rule of Law in Developing Countries*, 18 IND. J. GLOBAL LEGAL STUD. 873, 885–86 (2011).

133. *Id.* at 886.

134. *Id.* at 891. Erbeznik elaborates on the incentives facing aid providers, which answer to the citizens of donor countries. "[T]hese citizens," she explains, "have almost no ability to monitor the effect of aid on rule of law reform . . . . As a result, the success of the aid agencies is measured by the volume of input—money given, in other words—as opposed to output or real reform." *Id.* She adds, "The other problem with aid agencies' incentives is that their continued existence depends on the premise that foreign aid can produce reform. If foreign aid is anathema to reform, the aid agency has no purpose and will not continue to be funded." *Id.* at 892.

135. U.S. GEN. ACCOUNTING OFF., GAO/NSIAD-99-158, FOREIGN ASSISTANCE: RULE

Kleinfeld identifies several problems with this institutional approach, most prominently that it may result in providers attempting to duplicate their country's own institutions and produce formal change without making a meaningful difference on the ground.[136] Although these concerns are valid, they can likely be managed by effective partnering of the sort I recommend below, which is intended to allow recipient States to customize institutions to advance their tailored vision of the rule of law.

Apart from the definitional concern, the two major steps that can be taken to improve the effectiveness of aid are obtaining effective buy-in from the recipient State and requiring accountability. BITs can help carry out these goals by establishing a committee consisting of representatives of both States that is charged with administering funds for defined purposes, establishing metrics for performance, and monitoring progress on those metrics. As I will explain, while these steps could be taken outside the context of a BIT relationship, there is reason to believe they will hold particular promise in this specific setting.

Obtaining buy-in starts with giving the recipient State a voice in shaping reform. This has the benefit of increasing the likelihood that the recipient State will actually do the work of pursuing reform. Such buy-in is critical because otherwise "recipient governments will do just enough to guarantee a continued flow of revenue."[137] Effective reform, by contrast, depends on state actors developing a normative "commitment to reform even when no one is watching."[138] Equally important, giving the recipient State a voice makes it more likely that proposed reforms will be properly tailored to address the State's needs and fit the State's culture. Experience shows that States cannot merely copy the institutions of another and expect them to take hold and produce the rule of law.[139] Giving the recipient State a role in shaping the relevant institutions would go a long way toward establishing the foundation for their ultimate success.

OF LAW FUNDING WORLDWIDE FOR FISCAL YEARS 1993–98, at 1 n.1 (1999), http://www.gao.gov/assets/230/227749.pdf (report to congressional requesters).

136. Kleinfeld, *supra* note 129, at 50–52.

137. Erbeznik, *supra* note 132, at 887.

138. *Id.* Gustav Ranis goes a step further to argue that reform packages should be designed entirely by the prospective recipient, with donors responding more passively like a commercial bank. Gustav Ranis, *Towards the Enhanced Effectiveness of Foreign Aid*, *in* FOREIGN AID FOR DEVELOPMENT: ISSUES, CHALLENGES, AND THE NEW AGENDA 57, 60 (George Mavrotas ed., 2010). While this goes farther than my proposal, the underlying rationale of increasing the recipient country's sense of ownership is the same.

139. *See* Kleinfeld, *supra* note 129, at 51–52.

Once buy-in is achieved, there must also be accountability. That starts with setting appropriate benchmarks, which in itself is not a simple task. Past efforts at making aid conditional have tended to focus on formal change, such as the enacting of laws and regulations or the creation of an institution.[140] Those are, of course, only first steps, as laws must actually be enforced and institutions must actually function properly. But metrics on effectiveness are hard to develop, particularly when progress is likely to be gradual. There is no simple solution to these difficulties, except to emphasize that a long-term commitment to the process at least has a chance of resolving them. Apart from benchmarks and metrics, accountability also requires monitoring and actual enforcement of conditions. As noted earlier, a key reason that conditional aid has previously been less effective than expected is that aid providers have failed to follow through on the enforcement of conditions.[141]

Other commentators have proposed steps along these same lines outside the BIT context,[142] and while they have been attempted on a fairly limited basis, there are examples of success stories.[143] I do not suggest that a BIT relationship is necessary to implement these measures, but rather that they have particular potential in a BIT context. The main reason is that BITs represent—to some extent under the present model, but even more so under the proposed institutional reform approach—a commitment to long-term economic cooperation, thereby creating the conditions for a more effective partnership. The capital-exporting State, seeking to cultivate a foreign market for its investors, will have a more specific, vested interest in seeing aid succeed than a typical aid provider does. Likewise, the longer time horizon under which the contracting States would be working allows for more effective cooperation between them in the slow process of reform, from the development of ideas through the supervision of implementation.

With regard to accountability in particular, there is a further

140. *See* Radelet, *supra* note 122, at 111–12.

141. *See supra* note 134 and accompanying text.

142. *See* Radelet, *supra* note 122, at 113–15; *see also* Carrie Manning & Monica Malbrough, *Bilateral Donors and Aid Conditionality in Post-Conflict Peacebuilding: The Case of Mozambique*, 48 J. MOD. AFR. STUD. 143, 147 (2010) ("In general, conditionality has been found to work best when key actors in recipient countries buy into the goals of conditionality, when the performance can be verified and then rewarded or punished in a timely and predictable manner, and when it is clear where responsibility lies for the implementation of the required measures.").

143. *See* Manning & Malbrough, *supra* note 142, at 164–65 (describing the reasons that conditional aid succeeded in Mozambique's peacebuilding efforts).

reason why performance within the BIT relationship may improve on past failures. Unlike traditional aid agencies, which are predisposed to dispense aid regardless of performance because they have no other function, the joint committee charged with overseeing reform would be involved in all parts of the process and so be better equipped to stay focused on the ultimate objective. For such a committee, with a clear mandate to produce measurable results, aid would clearly be a means to an end rather than a de facto end in itself. Accordingly, it would be more realistic to expect such a committee to resist the temptation to overlook conditions and instead to use its broader set of tools to keep looking for solutions to the seemingly intractable problems.

As may already be implicit in the above discussion, BITs providing for conditional aid should also include provisions on technical assistance. Technical assistance is aimed at "helping develop human, institutional and regulatory capacities in developing countries."[144] Activities may include "drafting constitutions and legislation; advising on institutional reform; establishing new institutional frameworks; . . . advising on judicial reform; offering short training courses on specific legal topics; and providing . . . guidance on legal education generally."[145] It would be a natural extension for the joint committee in charge of dispensing conditional aid to take on the role of coordinating expertise-sharing between the countries.

The obstacles to effective technical assistance largely parallel those to conditional aid. In particular, there is a risk that experts from the developed State will attempt to simply "transplant[]" the rules and systems of their country to the host State without adequate understanding of "the political . . . and social . . . context in which it operates."[146] The solutions likewise track those I propose above. Effective technical assistance requires proper buy-in from the host State: "It is the responsibility of domestic policymakers, supported by their legal experts, to choose the scope and direction of the country's legal reform in conformity with the country's needs and special characteristics."[147]

---

144. *Technical Assistance and Capacity Building*, U.N. CONF. ON TRADE & DEV., http://unctad.org/en/Pages/DITC/TNCD/Technical-Assistance-and-Capacity-Building-.aspx (last visited June 5, 2017).

145. Julio Faundez, *Legal Technical Assistance*, *in* GOOD GOVERNMENT AND LAW: LEGAL AND INSTITUTIONAL REFORM IN DEVELOPING COUNTRIES 1, 1 (Julio Faundez ed., 1997).

146. *Id.* at 5.

147. Ibrahim F.I. Shihata, *Legal Framework for Development: Role of the World Bank*

Technical assistance is primarily offered by multilateral institutions such as the World Bank and UNCTAD.[148] Although provisions on technical assistance have not, to my knowledge, appeared in BITs, they have been proposed by advocates of the development model.[149] These advocates acknowledge that "it will be easiest to negotiate technical assistance commitments that advance home state interests" and propose as an example "supporting improvements in the transparency and efficiency of host state regulation."[150] That, of course, is the idea behind the institutional reform model in general—that it has the potential to advance home State interests by improving the quality of the host State as a site for investment.

In sum, rule-of-law values and institutions are not easily exported, even when the exporting country offers monetary aid and technical expertise. Nonetheless, there are recognized solutions to address the primary obstacles and reasons to believe they hold particular potential to succeed in the context of a BIT relationship.

B. Dispute Resolution

Conditional aid and technical assistance are the most direct ways to foster institutional reform and have the broadest potential reach. I turn now to the first of two proposals aimed at facilitating the reform of specific institutions. One of the consistent findings in the empirical literature described earlier is that the quality of the host State's judiciary is important to foreign investors.[151] There is a concern, however, that the standard dispute resolution provisions contained in existing BITs operate to undermine the domestic courts. And even if that concern has not been conclusively demonstrated, we should nonetheless consider whether the provisions could be revised so that they affirmatively contribute to strengthening the quality of local courts.

---

in Legal Technical Assistance, 23 INT'L BUS. LAW. 360, 366 (1995) (emphasis omitted).

148. *See id.* at 365. UNCTAD specifically works with States "to formulate international investment rules that effectively foster sustainable development and inclusive growth." *International Investment Agreements (IIAs)*, U.N. CONF. ON TRADE & DEV., http://unctad.org/en/pages/DIAE/International%20Investment%20Agreements%20(IIA)/International-Investment-Agreements-(IIAs).aspx (last visited June 5, 2017).

149. *See World Investment Report 2012*, *supra* note 11, at 129; *see also* VANDUZER ET AL., *supra* note 81, at 498–501 (providing a sample provision).

150. VANDUZER ET AL., *supra* note 81, at 496.

151. *See supra* notes 106–09 and accompanying text.

Most BITs contain a standard consent to arbitration.[152] That means that each of the contracting States agrees at the time of the BIT signing to allow the other State's aggrieved investors to elect to pursue claims against them in front of a designated arbitral tribunal.[153] This consent clause serves as a continuing offer that the foreign investor accepts when it chooses to initiate arbitration.[154] Most BITs provide for ICSID as the arbitral body,[155] but other institutions such as the International Chamber of Commerce and London Court of International Arbitration, as well as the option of an ad hoc proceeding, are available.[156] Some BITs impose certain conditions on consent, such as a requirement that local remedies first be exhausted[157] or that a certain period of time pass to give the parties a chance to resolve the dispute amicably.[158] Below, I propose adapting these very ideas and others so that they work together to facilitate institutional reform.

By providing an alternative that allows foreign investors to bypass the local courts, arbitration was supposed to provide a substitute that would have made domestic judicial reform unnecessary. But as explained above, given that arbitration is available only for treaty-based claims and arbitral awards may require judicial enforcement, foreign investors cannot realistically expect to avoid local courts entirely.[159] And the empirical evidence confirms that the anticipated effect is not occurring. In addition to the general evidence cited earlier that BITs fail to serve as substitutes for weak domestic institutions, we have more specific evidence that the arbitration option in particular does not help to attract FDI. Jason Yackee attempts to isolate the effect of arbitration provisions in a comparative study of strong and weak BITs, rather than simply measuring the impact of BITs in the aggregate, as most other studies have done.[160] He defines strong BITs as those that have "effective

---

152. DOLZER & SCHREUER, *supra* note 22, at 258.

153. *Id.* at 257–58.

154. *Id.* at 258.

155. States separately join the ICSID Convention, which does not in itself constitute consent to any particular arbitration, but provides a framework of standard clauses and procedural rules as well as an agreement that ICSID awards are binding and final. *See id.* at 238–39.

156. *Id.* at 238, 241.

157. *Id.* at 264–67.

158. *Id.* at 268–70.

159. *See supra* note 110 and accompanying text.

160. Jason Webb Yackee, *Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?*, 42 LAW &

host state pre-consents to investor-initiated arbitration" and weak BITs as those that do not have such pre-consent.[161] The study finds that strong BITs are not associated with greater foreign investment levels.[162]

At the same time that the option of arbitration is failing to attract FDI, there is some empirical evidence to suggest that its presence may weaken the host State's domestic courts. Tom Ginsburg contends that when BITs provide investors with access to arbitration, the ability to "bypass domestic courts may reduce courts' incentives to improve performance by depriving key actors from a need to invest in institutional improvement."[163] Ginsburg provides preliminary empirical support for his thesis, citing evidence that performance on a rule-of-law metric declines in the years after a BIT is signed.[164] This would suggest that investors, though not adequately assured by the option of arbitration to factor it into their location decisions, nonetheless come to rely on its availability once in a particular host State, to the detriment of the local courts. If correct, the result would be perversely ironic: a provision intended to appeal to foreign investors would be not only failing to do so, but also potentially driving them away by weakening an institution that does actually influence their location decisions.

Ginsburg's evidence is far from conclusive, and there are reasons to question whether the effect he identifies is occurring. For the same reason that foreign investors would not perceive arbitration as an adequate substitute for weak domestic courts when deciding where to invest, it seems unlikely that these investors would lose any interest in the quality of the host State's judiciary merely because arbitration is available. Domestic courts are still needed to enforce arbitration awards and to resolve domestic law disputes. Thus, as Susan Franck explains, "[I]f one presumes that foreign investors are stakeholders who are vital to promoting the rule of law and

---

SOC'Y REV. 805, 806–07 (2008).

161. *Id.* at 814.

162. *Id.* at 827–28.

163. Tom Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, 25 INT'L REV. L. & ECON. 107, 119 (2005).

164. *Id.* at 121. Others have made similar arguments without empirical support. *See, e.g.*, MARK HALLE & LUKE ERIK PETERSON, INVESTMENT PROVISIONS IN FREE TRADE AGREEMENTS AND INVESTMENT TREATIES: OPPORTUNITIES AND THREATS FOR DEVELOPING COUNTRIES 23–24 (Dec. 2005), http://www.undp.org/content/dam/rbap/docs/Research%20&%20Publications/poverty/RBAP-PR-2005-Investment-Provisions.pdf (arguing that "BITs . . . provide foreign investors with the means of detouring around" domestic institutions and thereby reduce "the impetus for [their] broader improvement").

institutional integrity, their influence does not exit the market purely by creating the right to arbitrate treaty claims."[165] Instead, Franck contends, "[P]roperly valuing the potential role of national courts in resolving investment disputes suggests that there is a strong incentive to develop the rule of law in national courts and promote the integrity of the dispute resolution process."[166]

Regardless of whether Ginsburg or Franck is correct as to the effect of existing BITs, the question for present purposes is how BITs can be designed to optimize any influence they have over the domestic judiciary. I propose combining several ideas that are currently in circulation to achieve that effect. One proposed reform to the arbitration provision is to permit recourse to arbitration only when the investor's home State authorizes it. Some States have in fact implemented such a requirement by amending their domestic laws.[167]

Another existing proposal is to reinstate the exhaustion of local remedies requirement that existed under customary international law but was overridden in most BITs. Such a requirement would reduce the bypassing concern identified by Ginsburg while still preserving the option of arbitration as a last resort. Franck notes some additional advantages:

> Presumably, if foreign investors were required to litigate disputes through domestic courts rather than directly taking their claims to international arbitration, this might build the capacity of local courts by the following: (1) providing domestic courts with an opportunity to articulate relevant principles of domestic law; (2) increasing the transparency of the system; and (3) giving notice to future investors of the relevant domestic legal standards and their application.[168]

Advocates for the development model have made a similar proposal, citing similar benefits.[169] A small number of BITs, most of them older, do include an exhaustion requirement.[170] More recently, to address the concern of delay in domestic court proceedings, a few

165. Franck, *supra* note 34, at 370 (footnote omitted).

166. *Id.*

167. Anthea Roberts, *Triangular Treaties: The Extent and Limits of Investment Treaty Rights*, 56 HARV. INT'L L.J. 353, 411 (2015).

168. Franck, *supra* note 34, at 366 n.144.

169. *See* VANDUZER ET AL., *supra* note 81, at 413.

170. DOLZER & SCHREUER, *supra* note 22, at 265.

BITs have refined the exhaustion requirement by providing for the option of arbitration if the case is not resolved within a given timeframe, ranging from six to thirty-six months.[171]

The provisions just described are motivated primarily by the simple goal of reining in the use of arbitration against host States, but with some tweaks they can be adapted and combined together to create stronger incentives for institutional reform. Subject to further empirical evaluation, and with the caveat that the circumstances in particular States may vary, my suggestion combines the above ideas as follows. BITs should reinstate the exhaustion requirement so that foreign investors' first recourse would be to domestic courts. However, foreign investors would have two potential paths to arbitration: if a prescribed time limit for the domestic proceeding is exceeded, or if, after a proper decision in the domestic case has been rendered, the investor's home State consents to the arbitration request.

The rationale behind this proposal is to maximize incentives for host States to improve their legal systems.[172] The proposal here puts pressure on host States to reform their judiciaries from the standpoints of both efficiency and quality. If host States know that arbitrations may be filed after a certain time period, they will have an incentive to improve the efficiency of their courts, since most governments would generally prefer to have investment disputes resolved in their own system.[173] Likewise, if they know that arbitrations following exhaustion can be filed only with the consent of the investor's home State, they will have an incentive to build a more competent and independent judiciary whose decisions the home State will then be more likely to respect.

As noted at the outset, these changes are designed to facilitate, and not directly produce, institutional reform. But they have the potential not only to reduce any negative impact of foreign

---

171. VANDUZER ET AL., *supra* note 81, at 412 & n.c.

172. Franck notes that it is not self-evident that increasing the involvement of foreign investors in the domestic legal system will necessarily lead to positive reforms. Franck, *supra* note 34, at 370 n.163. It would thus be unwise to rely solely on spurring their efforts alone.

173. Although Franck's study on the outcomes of investment arbitration suggests that States are not losing at the high rate that is sometimes postulated, she nonetheless recognizes the common perception that the system is biased in favor of investors. *See* Franck, *supra* note 30, at 48–50. Moreover, even if States do not lose at an unfairly high rate in arbitration, they would presumably prefer to resolve investment disputes in their own courts because those courts possess greater familiarity with the domestic political context and the legitimacy to rule on matters of public concern. *See* Chen, *supra* note 33, at 311–12.

investors bypassing the local judiciaries, but also to affirmatively strengthen the courts' capacity by incentivizing the host State to take action.

C. Dispute Prevention

While a revised approach to dispute resolution could incentivize improvements to the host State's judiciary, better mechanisms for dispute *prevention* could help foster reforms in other government institutions. The proposal is to create a consultation mechanism for foreign investors to raise, at an early stage, concerns about problematic legislation or other government conduct. Such early intervention encourages cooperation between the investor and State and can help not only with resolving a particular issue, but also with enhancing the capacity of the relevant government institutions.

Some States have begun implementing ideas along these lines. For example, in 1999, South Korea created an Office of Foreign Investment Ombudsman, which handles between 300 and 500 complaints per year.[174] The subjects of the complaints include labor, taxation, environment, finance, and intellectual property issues, among others.[175] While the office initially resolved approximately twenty-five percent of disputes, it has progressed to consistently resolve in the range of ninety percent in more recent years.[176] As an indicator of success, the country touted, until recently, the fact that no investor arbitration claim had been filed against it.[177] More broadly, though no causal claims can be made, it is worth noting that Korea has experienced substantial year-over-year growth in FDI, from $13.67 billion in 2011 to $20.91 billion in 2015.[178] The general package of reforms that Korea implemented in the late 1990s, which included the creation of the ombudsman office along with other FDI-

---

174. Françoise Nicolas et al., *Lessons from Investment Policy Reform in Korea* 23, 25 (OECD Working Papers on Int'l Inv. 2013/02, 2013), https://www.oecd.org/investment/investment-policy/WP-2013_2.pdf.

175. *See Resolved Cases—Introduction*, FOREIGN INVESTMENT OMBUDSMAN, http://ombudsman.kotra.or.kr/eng/rsc/case.do (last visited June 5, 2017).

176. Nicolas et al., *supra* note 174, at 24–25.

177. *Id.* at 25. That changed recently when an ICSID arbitration was filed by a U.S.-based investor in 2012. *See $4.68B Lone Star Versus Korea Hearing Begins in Washington DC*, KOREA TIMES (May 15, 2015), http://www.koreatimesus.com/first-hearing-opens-over-lone-star-asset-sell-offs-in-korea.

178. *See* JEFFREY I. KIM, FOREIGN INVESTMENT OMBUDSMAN ANNUAL REPORT 2015, at 8 (2016), http://ombudsman.kotra.or.kr/common.FileDownload.do?file_id=FILE_000000000000346.

friendly measures, has been identified as a useful model for other countries seeking to increase foreign investment.[179]

Brazil has taken the concept of an ombudsman office and added it to the recent investment agreements it has signed. Having mostly sat out when Latin American countries were signing BITs in large numbers in the 1990s, Brazil developed an alternative model known as Agreements on Cooperation and Facilitation of Investments ("ACFIs") and signed six of them in 2015.[180] The ACFIs have been described as curbing the excesses of BITs, primarily by omitting the fair and equitable treatment provision and excluding investor-State arbitration.[181] The key innovation for immediate purposes is the provision requiring each State to set up a focal point, which is modeled after the Korean ombudsman and provides a mechanism for "dialoguing with government authorities to address the suggestions and complaints from the other party's government and investors."[182]

Although Korea's creation of an ombudsman office shows that domestic law can successfully provide for dispute prevention, there are potential advantages to creating such mechanisms as part of a bilateral treaty framework. In particular, focal points created under the auspices of a BIT can benefit from, as well as deepen, the cooperative relationship between the contracting States. Focal points can benefit from this partnership insofar as the States share resources and expertise; this may be particularly important for developing countries that, unlike South Korea, lack the capacity to unilaterally implement the ombudsman concept. At the same time, the regular flow of communication and resource-sharing can only strengthen the partnership and thereby enhance the conditional aid and technical assistance programs described in Section IV.A above. Brazil appears to recognize the value of this cooperative relationship, as the ACFIs have paired focal points with the creation of a Joint Committee consisting of representatives from each government that helps to

179. *See* Nicolas et al., *supra* note 174, at 5–6.

180. Fabio Morosini & Michelle Ratton Sanchez Badin, The New Brazilian Agreements on Cooperation and Facilitation of Investments (ACFIs): Navigating Between Resistance and Conformity with the Global Investment Regime 4 (2016) (unpublished manuscript), http://www.law.nyu.edu/sites/default/files/upload_documents/Morosini%20-%20Global%20Fellows%20Forum.pdf.

181. *See id.* at 22–23, 25.

182. Fabio Morosini & Michelle Ratton Sanchez Badin, *The Brazilian Agreement on Cooperation and Facilitation of Investments (ACFI): A New Formula for International Investment Agreements?*, INVESTMENT TREATY NEWS, Aug. 2015, at 3, 4, https://www.iisd.org/sites/default/files/publications/iisd-itn-august-2015-english.pdf.

facilitate information exchange and problem solving at the State-to-State level.[183]

From the standpoint of fostering institutional reform, I would note first of all that an ombudsman office or focal point is a valuable institution in and of itself. To the extent that foreign investors are concerned about bureaucratic inefficiency, they would value the availability of a one-stop shop where their concerns can be appropriately directed and escalated and regular communication is ensured. The early intervention that an ombudsman can provide helps to minimize harm to the investor, which in turn may forestall litigation or arbitration and, just as importantly, encourage the firm to continue or expand its investment presence.

Apart from its value as an institution that prevents disputes, a foreign investment ombudsman can also be the central clearinghouse for coordinating broader reforms. One study analyzing the Korean office's impact emphasizes that, in addition to addressing individual grievances, it also takes "pre-emptive measures to prevent future grievances by encouraging systemic improvements and legal amendments."[184] Moreover, the office responded to foreign investors' concerns about their ability to participate in the policymaking process with the creation of a new mechanism to receive such input before regulations are formally adopted.[185] Systemic reforms are also facilitated by regular meetings between representatives of government agencies and a Foreign Investment Advisory Council, which consists of representatives of foreign chambers of commerce and CEOs of foreign firms, to discuss "macro-level issues."[186]

In short, the creation of a foreign investment ombudsman or focal point has significant potential not only to prevent specific disputes, but also to foster broader institutional reform. By using specific complaints as the impetus for reform conversations, such an office would nicely complement the conditional aid and technical assistance committee that would approach the same set of issues with more of a bird's-eye view.

---

183. *Id.* at 4.

184. Nicolas et al., *supra* note 174, at 24.

185. *See* KIM, *supra* note 178, at 56.

186. *Id.* at 54–55.

CONCLUSION

The time is ripe for a new approach to BITs. Commentators have identified a host of flaws in the existing model, and more importantly developing countries are beginning to question whether it is still in their interests to participate. While many scholars focus on tinkering with the investor protection approach, these changes would at best help limit the costs of BITs without furthering the goal of increasing FDI. By contrast, advocates for developing countries offer systemic proposals that could significantly increase the effectiveness of BITs, but in their repurposing of the model do not adequately account for the distinct interests of the capital-exporting States.

This Article offers a new model that remains true to the BIT's original, shared purpose, but fundamentally rethinks its underlying premises, rejecting investor protection in favor of a focus on the domestic institutional environment. Drawing on empirical evidence showing that the quality of domestic institutions is an important determinant of foreign investment, the Article contends that BITs should be redesigned to promote the reform of those institutions. Prioritizing such reform benefits developing countries directly in a way that the investor protection model does not, but it also promotes FDI to the benefit of both States and so is more realistically attainable than other systemic proposals. And while the revisions proposed here are not without costs, such an investment in the international investment law regime may be necessary for its long-term viability and ultimate success.