

**Defecting on Development:
Bilateral Investment Treaties and the Subversion
of the Rule of Law in the Developing World**

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One doesn't have to spend much time in a developing country to see how the scarcity of investment capital hobbles social and economic progress. Without sufficient supplies of long term risk capital, entrepreneurs are unable to fund wealth enhancing investments, established industries are unable to expand their plant and equipment, and governments are unable to supply a range of public infrastructure services such as potable water, sewage collection and treatment, and navigable roads and highways. The predictable result is increased poverty, illness and widespread social and political alienation. Against this backdrop, it is not at all surprising that the task of enhancing the supply of both foreign and domestic investment capital figures as a fundamental and durable feature of humane development policy.

Although a number of different modalities have been proposed to respond to capital scarcity, one of the most important (and widely heralded) initiatives has been the use of the bilateral investment treaty (the "BIT").² The BIT is lauded for the discipline it imposes on developing states in their dealings with foreign investors, particularly those from the developed world. Specifically, reliance on the BIT provides foreign investors with credible assurances that host states will not opportunistically renege on their

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² Reisman and Sloane, *infra*; Kathleen Kunzer, "Developing a Model Bilateral Investment Treaty", (1983) 15 L. & Pol'y Int'l Bus 273 (1983) (BIT prototype is a significant contribution to the efficient operation of the world economy"); Adeoye Akinsanya, "International Protection of Direct Foreign Investments in the Third World" (1987) 36 International and Comparative Law Quarterly 58 (BITs offer "most practical and effective means of affording treaty protection to alien investors in the Third World"); Zouhair A. Kronfol, *Protection of Foreign Investments: A Study of International Law* (1972) 35-36 (BITs are perhaps the most effective form of guarantees, emphasizing mutuality and respect for the legitimate interests of the states that are parties to them); Marion Nash, "U.S. Practice: Bilateral Investment Treaties" 87 AJIL 43 (BITs provide important protections to investors and create a more stable and predictable legal environment for investment).

contractual undertakings, will pay compensation in the event of breach, and will remit disputes arising from the contract to resolution through international commercial arbitration. In sharp contrast, domestic investors are not protected by these treaties, and are consigned to relying on domestic law and legal institutions for protection³. Thus, the BIT legal regime constitutes a legal enclave of sorts, where many of the risks of legal and political failure that confront domestic investors generally are substantially lessened or, indeed, eradicated, for foreign investors⁴.

In this paper, I argue that the formation of these legal enclaves has had significant and perverse effects on the welfare of developing countries. My critique focuses on the ways in which these enclaves have systematically subverted the evolution of robust rule of law institutions in the developing world. This subversion is the result of a complex dynamic in which foreign investors rationally refrain from championing good and generalized rule of law reforms in the developing state, preferring instead to protect their interests by relying on the BIT rule of law enclave. It is not simply that the potential voice of foreign investors in favor of good rule of law reforms is lost, but that foreign investors will actively seek to retard the development of certain regulatory initiatives that are the hallmarks of the mature social welfare state. In this manner, the formation of these rule of law enclaves inflicts a double whammy on law reform efforts in developing states, first by dulling the interest of foreign investors in building good domestic rule of law institutions and then by encouraging foreign investors to devise alternative institutional arrangements that are inimical to the development of sound regulatory institutions and policies. This is especially regrettable given that good rule of law institutions are increasingly regarded by many commentators as an essential prerequisite for the realization of economic and freedom goals in the developing world.

³ This disparity in treatment is exacerbated when host countries erect restrictions on the capacity of domestic residents to export capital abroad. Consequently, domestic investors are captive in their own market, and forced to rely on domestic laws and legal institutions to protect their investment.

⁴ Further compounding the asymmetry in legal treatment accorded domestic and foreign investors is the fact that foreign investors can typically avail themselves of political risk insurance offered by their home governments and by international agencies, whereas domestic investors lack access to such insurance protection.

I make this argument in several stages. First, I review the case for institutions in promoting the realization of development goals in the less developed countries. I specifically address the case for law and legal institutions as an engine for development, and argue for the value of a thinly conceived rule of law that focuses on ensuring widespread access to justice and on the performance of courts, administrative tribunals, law enforcement officials, prosecutors, prison officials, and the legal profession. Interestingly, despite the relatively uncontroversial normative character of these reforms, their adoption faces stiff resistance in many developing countries. While cultural, historical and technical barriers provide part of the explanation, I suspect that the critical challenge is that the rule of law, and its supporting institutions, has strong public goods properties, meaning that unless the host state will supply the rule of law, it will be under-demanded and under-supplied in private markets. Further complicating matters is the complex political economy relating to the adoption of rule of law reforms. Even the thinnest conception of the rule of law entails checks and constraints on the exercise of both public and private power, and so, while these reforms are likely welfare enhancing for society as a whole, they are likely to impose concentrated losses on certain entrenched elites. Hence, there is a need for rule of law reformers to think carefully about how these political economy barriers can be surmounted in the course of constructing new or strengthened rule of law arrangements.

On the basis of this foundation, I then turn to the bilateral investment treaty. As discussed above, I argue that the creation of BIT inspired enclaves siphons off foreign investor voice from the enterprise of creating good and generalized rule of law institutions, and causes foreign investors to demand contractual protections that will foreclose the developing state's ability to construct certain regulatory arrangements that are more transparent and responsive, but which nevertheless increase the risk of future private investment losses from legitimate state regulatory intervention. These problems are powerfully evidenced by considering the impact of the BIT legal regime on the character of foreign investment in public infrastructure projects. Enhancing funding for these projects was one of the principal rationales for the adoption of BITs in the first

place, and, given the particular character of public infrastructure projects, they provide a useful place to discern the corrosive impact of BITs on the rule of law.

In the concluding part of the paper, I reflect on whether one of the best ways for the developed world to prod elites in developing states to create good (and generalized) rule of law regimes is to refrain simply from entering into any BITs that confer preferential treatment on foreign investors as against domestic investors. In this manner, the general legal regime supplied by host states would be subject to much more intense scrutiny by foreign investors, and, in so doing, their interests would be rendered much more closely aligned with domestic residents interested in rule of law reform. One way of achieving this result is to support the revival of the much criticized (at least in American legal circles) Calvo Doctrine, which has the national treatment of foreign and domestic investors at its core.

I. Institutions, Development and the Role of the Rule of Law

Institutions and Development

Over the last decade, there has been a growing interest in, and commitment to, the role that institutions play in promoting economic development goals in the less developed countries of the world. This interest is motivated by the glaring and tragic disparities that exist between the developed and developing countries of the world in terms of wealth, health, literacy and freedom outcomes. It is also motivated by the failure of non-institutional theories of development to undergird effective and durable reform strategies across a range of different developing states.

The central claim of institutional theories of development is that the quality of a country's institutions is the central determinant of economic growth. North, for instance, contends that the economic value of institutions derives from the constraints they impose

on human behavior in order to facilitate wealth enhancing economic exchange.⁵ In the absence of effective institutions, high transaction costs of exchange (particularly the costs of devising credible mechanisms to bond future performance in the event of non-simultaneous exchange) would thwart the adoption of value increasing transactions, with the consequence that societal wealth would be correspondingly stunted. Thus, institutions are simply the formal rules, informal constraints and the enforcement characteristics of both that shape behavior⁶.

The claim that the quality of a country's institutional arrangements matters has not been confined only to pursuit of economic growth objectives. Sen, for instance, regards institutions as being implicated in the pursuit of a broad and multi-dimensional development enterprise that has enhancement of freedom at its core.⁷ For Sen, economic wealth creation only has instrumental value insofar as it allows citizens in developing countries to pursue the ends that they value. To the extent that increased economic growth does not lessen income inequality (and, may, in some circumstances, increase it), ill health, illiteracy or citizen equality, then it cannot be equated with increased citizen welfare in the developing world.

However broadly or narrowly the ends of development are defined, there is a growing body of empirical literature that substantiates the linkage between institutions and development goals. The seminal study is by Kaufmann, Kraay, and Zoido-Lobaton⁸. To evaluate the correlation of institutional performance and development goals, the researchers assembled a comprehensive governance database containing over 300 different governance measures. These measures were designed to illuminate the

⁵ Douglas C. North, "The New Institutional Economics and Third World Development" in Harris, J. et al., eds., *The New Institutional Economics and Third World Development* (London: Routledge, 1995), p 17-27 at 18. See also: Mancur Olson, Jr., "Distinguished Lecture on Economics in Government: Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor", (1996) 10 *Journal of Economic Perspectives* 3: "[A]t a high level of aggregation, .. each of the factors of production (can be eliminated) as possible explanations of most of the international differences in per capita income. The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies" (at 19).

⁶ *Ibid* at 23.

⁷ A. Sen, *Development as Freedom*.

⁸ Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Labaton, "Governance Matters" (1999) World Bank Policy Research Working Papers No. 2196, (download at <http://www.worldbank.org/research>).

“traditions and institutions by which authority in a country is exercised”. To render tractable the task of correlating institutional performance with development outcomes, the researchers invoked six different aggregate measurements of institutional performance: voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft. On the basis of a sample of between 155 and 173 countries (depending on the aggregate measure used), they found that institutional performance (or “governance”) “matters a great deal for economic outcomes”⁹. Specifically, a one-standard deviation increase in any one of the six measures was found to cause between a two-and-a-half and four-fold increase (decrease) in per capita incomes, (infant mortality), and a 15 to 25 percent increase in illiteracy.

Although the data linking institutional performance to development objectives (particularly economic growth) is voluminous, these studies are much less definitive in addressing the extent to which good institutional performance is, in fact, dependent on other underlying factors, such as culture, geography, or history. This is a fundamental issue because, for instance, if institutions turn out to be contingent on non-institutional background factors, then the prescription that certain template institutions should be adopted (or strengthened) in a developing state becomes more speculative. Another source of ambiguity within these data concerns the precise institutional matrix associated with robust development. Ideally, policy-makers would want to know which institutions map onto development goals and how. Saying that “institutions matter”, or even, to be more precise, that “common law institutions” matter, is a fairly dim lodestar to support an ambitious institution building exercise in a host country. And finally, even if one knew for certain that specific institutional forms were more desirable than others, and that these institutions were relatively transportable across a number of different country settings, the issue of *how* these institutions can be implanted must be addressed. The fact remains that we do not have a clear understanding of whether there is some optimal sequence by which different institutions should be implanted. Nor do we possess a clear understanding of the various political economy barriers that stand in the way of reform, and how they should be surmounted.

⁹ Ibid at 3.

I address each of these issues in turn.

Institutions and Underlying Cultural/Historical/Geographical Variables

Commencing with Weber, there has long been an understanding that some cultures do better than others when it comes to economic growth.¹⁰ Weber credited ascribed Protestantism with the lion's share of credit in explaining the emergence of capitalism and its supporting institutions. In particular, Protestantism's innate skepticism of hierarchical authority, its encouragement of industry, and its emphasis on individualism were regarded as critical to the successful evolution of capitalist institutions. Subsequent research, however, has demonstrated that Protestant cultures do not have a lock on growth promoting institutions. Greif's work comparing the different trade patterns and underlying institutional arrangements of Maghribi (part of the Muslim world) and Genoese (part of the Latin world) traders underscores the extent to which individualist cultures generally are more conducive to the emergence of pro-growth institutions.¹¹

But it is not only culture that shapes institutions. Acemoglu et al., for example, see institutions as an important determinant of economic growth, but then claim that

¹⁰ Max Weber, *The Protestant Work Ethic and the Spirit of Capitalism*, (Talcott Parsons trans., 1958).

¹¹ Avner Greif, "Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualistic Societies" (1994) 102 *Journal of Political Economy* 912. Need discussion of Tatsuo. Whereas the Maghribi traders were hobbled in their capacity to expand their trading activities owing to their reliance on collectivist social and economic relations, the much more individualist Genoese traders were forced to develop legal, political and second-party economic institutions that promoted trust and certainty of economic relations that turned out to have considerable economic survival value. According to Greif, the relatively inhospitable environment of some collectivist cultures to institutions designed to facilitate impersonal economic relationships is an important cautionary tale for enthusiasts of unbridled reform through massive institutional transplantation. This finding is echoed in a recent draft article by Amer N. Licht, Chanan Goldshmidt and Shalom H. Schwartz, "Culture Rules: The Foundations of the Rule of Law and Other Norms of Governance", June 9, 2002 Draft. The researchers find that institutions with good rule of law properties, heightened accountability, and low corruption appear to be at odds with certain cultures having different underlying views from western cultures on the role of hierarchy and the respect to be accorded individual autonomy. They argue that where a society is prepared to support individual rights, institutions will place a premium on accountability and laws to ensure the predictability of action. In contrast, more collectivist, hierarchical cultures are less concerned with individual rights, and therefore give less sway to the rule of law as a social control mechanism.

congenial geographic conditions are the controlling factors in predicting the success or failure of institutions.¹² This is illustrated by comparing the quality of institutions in colonies where geography and climate have coalesced to create conditions that were congenial to contagious disease and, hence, high mortality rates for European colonists, as opposed to those settings in which the prospect of disease was much more remote. In the former case, colonists rationally under-invested in institution building, and sought only to establish relatively shallow “extractive” institutions that facilitated the rapid and wholesale withdrawal of wealth.¹³ In the latter case, a more attractive environment led colonists to devise more forward looking institutions that entailed more effective constraints on governmental power and the formation of property rights and contract.

There is doubtless a complex interplay between institutions and underlying social, geographic, cultural, and historical conditions. Institutions do not arise in a vacuum, nor would we expect them to be immune from societal influences once they are established. The infinite variety of institutions across the world offers ample evidence of the role of societal context. However, as Davis and Trebilcock caution, the fact that background conditions can exert some *influence* on the character of institutions does not mean that institutions are merely epiphenomenal, that is, that they are the deterministic byproduct of these factors.¹⁴ In a clever empirical study that examined the differing institutional arrangements and corresponding performance of similarly situated countries (at least in terms of culture, geography, and resources), the researchers found significant scope for societal choice in the design of institutions despite similarities in the underlying context for these choices.

So far, the relationship between underlying societal conditions and institutions has been evaluated mainly on the assumption that the crucial causal relationship runs from underlying societal circumstances to institutions, and the critical issue has been the power

¹² Daron Acemoglu, Simon Johnson, James Robinson, and Yngyong Thaicharoen, (2002) “Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth”, Working Paper 9124, National Bureau of Economic Research Working Papers Series (download at <http://www.nber.org/papers/w9124>).

¹³ The differences between extractive and non-extractive institutions is also discussed in xx, Africa’s Stalled Development.

¹⁴ Kevin Davis and Michael J. Trebilcock, Law and Development, Draft Manuscript, Chapter 3, The Limits of Skepticism.

of this relationship. Yet, it is not difficult to imagine that the causal relationship runs in the opposite direction, as well. The adoption of strong institutions will, in turn, support the realization of certain societal goals that will, in turn, shape the underlying circumstances in which institutions operate. In this setting, the relationship between underlying societal circumstances and institutions constitutes a virtuous circle of sorts, where each is mutually reinforcing of the other. The opposite, of course, would be true for weak institutions in which a downward spiral in both institutional performance and underlying societal circumstances occurs.

Which Institutions Matter and the Role for the Rule of Law

If institutions demonstrably matter for development, the next question is to ascertain which institutions matter most. The mere recognition that social rules and norms are important for societal development is barely adequate to the task of fuelling a constructive and concrete reform agenda. According to many commentators, the institutions that matter the most for development are Western institutions of private property protection, freedom of contract, democratic political institutions, entrenched civil rights, and meaningful checks on executive power. Although concessions can be made surrounding the pace and sequencing of these reforms, there is little debate surrounding the desirability of this institutional end-point.

On the other hand, other scholars have argued that the precise character of institutions is less important for good development goals than their underlying properties. In this vein, Rodrik et al assert that “institutional quality trumps all else in determining economic growth”, including trade patterns and underlying geography, but then decline to pinpoint a specific set of institutions as worthy of emulation.¹⁵ In their view, development does not imply a precise menu of institutional arrangements, but only that whichever institutions are created must be careful to maintain sensitivity to the role of

¹⁵ Dani Rodrik, Arvind Subramanian, and Francesco Trebbi, “Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development”, (2002) Working Paper 9305, National Bureau of Economic Research, (download at <http://www.nber.org/papers/w9305>).

incentives, competition, hard-budget constraints, sound money, fiscal sustainability, and property rights, and are consistent with underlying societal context. The task of the policy reformer then is to ensure that local knowledge is harnessed in the design of institutions with desirable underlying properties¹⁶

The available empirical evidence is only somewhat helpful in resolving this debate. Take, for example, the importance of democratic institutions for the realization of economic development goals. It is not difficult to build a strong *a priori* normative case in favor of an inextricable linkage between democratic political institutions and economic growth. Following Smith and Hayek, societal wealth is maximized when economic activity is organized through the market, rather than through collectivist decision-making. Specifically, well functioning markets require scope for individual risk-taking and initiative, exploitation of local knowledge, and certainty in private ordering. Against this benchmark, several core features of democratic political arrangements -- equality of citizens, protection of private property, binding constraints on governmental authority, and freedom of speech and inquiry – would appear to be indispensable for markets. Nevertheless, the linkage has not been borne out empirically.¹⁷

One way of responding to this complexity is to recall Sen's admonition that the purpose of development is not confined to economic wealth creation, so that even if democracy is not found to be indispensable to markets, a strong case for its adoption can be framed in terms of its intrinsic value in enhancing freedom and individual agency. Yet, even if one were to argue for the value of democratic institutions in non-instrumental terms, it is still necessary to discern which of the constituent components of the panoply of institutional arrangements associated with democracy are deemed essential for the pursuit of a humane development agenda. After all, if there are some aspects of democracy that are less important for the attainment of development goals than others,

¹⁶ The focus on context translates into an emphasis on the value of harnessing local knowledge in institutional and policy reform, a theme which is given pride of place in James C.Scott, *Seeing Like a State* (New Haven, Yale University Press: 1998).

¹⁷ A. Przeworski and F. Limongi, "Political Regimes and Economic Growth", (1993) 7 *Journal of Economic Perspectives* 51 (Of 21 findings examined by the authors, 8 found in favor of the linkage between democracy and growth, 8 in favor of the linkage between authoritarianism and growth, and 5 discovered no difference between the impact of either system of government on growth).

sensitive policy-makers would want to be able to identify those institutions are so as to train their efforts on the institutions that possess the greatest potential to improve living standards in the developing world.

It is here that a number of commentators have coalesced around the over-arching importance of the rule of law and its corresponding institutions in promoting development goals. Typically, empirical validation of the importance of rule of law variables derives from survey results, such as those reported above from Kaufmann et al, that seek to characterize the state of a country's rule of law environment, and then to regress these impressionistic characterizations against various performance indicia.¹⁸ Again, however, these studies do not illuminate *which* laws or legal/regulatory institutions are most essential for successful creation of a robust rule of law environment, and a lively debate has ensued regarding what is required for the successful implantation of the rule of law in the developing world.

At one level, the debate over which aspects of the rule of law should receive greatest attention reflects a more fundamental and ancient debate respecting formal versus substantive conceptions of the rule of law. This debate has infiltrated the development arena where two different approaches to rule of law reform have emerged: the substantive and the institutional/procedural schools. The former emphasizes the importance of specific laws in realizing the benefits of rule of law reform. Posner, for instance, argues in favor of the adoption of a rules-based legal system in the developing world that would focus primarily on property rights and contract law.¹⁹ Posner regards property and commercial law as being intrinsically more universalistic and therefore more easily transported across jurisdictions than other bodies of law, namely

¹⁸ The use of rule of law indicia as a basis for law reform efforts has long been controversial. One problem is that the indicia (which often result from expert efforts to classify a country's rule of law institutions) are fairly broad, and often subsume factors that are not directly related to rule of law institutions. See: Kevin Davis, Draft article for the Michigan Law School Conference on Development.

¹⁹ Richard Posner, "Creating a Legal Framework for Economic Development", The World Bank Research Observer, February 1998, pp 1 -11. A similar argument is made by Frederick Schauer, "The Politics and Incentives of Legal Transplantation".

constitutional and family law.²⁰ In a similar vein, De Soto has focused on the wealth-retarding effects of informal property rights in the developing world, and on the need to formalize these rights via formal systems of property rights, property registration, and workable systems of contract.²¹

The claim that the development prospects of a country can be promoted through the adoption of substantive legal rules imported from other, more successful jurisdictions has been criticized on several different grounds. First, there is concern that transplanted laws will be inconsistent with underlying social, cultural or historical conditions, and will therefore lack normative salience. Berkowitz, Pistor and Richard for example, find a relatively low success rate for substantive laws that have been adopted from other states, particularly when these laws are not meaningful to recipients nor tailored to local circumstances.²² Second, as Upham has shown, devotion to the transplantation of foreign substantive laws tends to divert the attention of law reformers toward formalized legal rules, and obscures an appreciation of the ways in which informal rules and sanctions operate to shape behavior.²³ And even where law reformers are attentive to the role of informal norms in a society, it is likely quite difficult to determine where formal laws should substitute for informal norms, where they should be used to complement informal norms, and where they should simply refrain from entering the field of informal norms altogether. These concerns are particularly acute in societies that are organized on kinship and clan lines, and which effect social control through a complex constellation of informal rules and sanctions, and where the adoption of substantive legal rules could

²⁰ Other commentators place greater emphasis on substantive human rights protections, and on ensuring that developing states' behavior conforms to an internationally acceptable standards. Indeed, Farber has advanced a provocative argument that the adoption of human rights protections by developing states has instrumental value in advancing wealth creation objectives. Daniel Farber, "Rights as Signals", (2002) 31 *Journal of Legal Studies* 83. The argument is that constitutional protection of human rights constitutes a credible signal of a government's commitment to a low discount rate and a reduced threat of opportunism against investors. This is because the enforcement of human rights is costly to governments as it entails a loss of social control and a sharing of power with the courts.

²¹ Hernando De Soto, *The Other Path, The Mysteries of Capitalism*.

²² Daniel Berkowitz, Katharina Pistor, Jean-Francois Richard, "The Transplant Effect" (2003) 51 *Am. J. Comp. L.* 163.

²³ Frank Upham, "Mythmaking in the Rule of Law Orthodoxy", (September 2002) Working Papers, Rule of Law Series, Democracy and the Rule of Law Project, Carnegie Endowment for International Peace, No. 30.

easily upset existing and fragile social equilibria.²⁴ Finally, as Pistor argues, the adoption of laws without complementary institutions will undermine the success of rule of law building because of the lack of effective enforcement.²⁵

Given both normative and positive concerns over the prospective value of substantive law reform, it is not surprising that the reformer's gaze has shifted to institutional/procedural reform. By focusing on the development of putatively non-substantive institutional arrangements, the hope is that it might be possible to avoid some of the more contestable features of a substantive rule of law reform program. Tamanaha, for instance, argues in favor of the desirability of a legal order in which government is bound by the laws it enacts, where citizens are treated equally under the law and where citizens have access to a fair and neutral decision-maker.²⁶ Similarly, xx emphasizes the non-controversial aspects of the "pre-liberal" rule of law, which focuses on the control of governmental power, namely that government should follow the rules it enacts and even that government should, in some circumstances, be precluded from legislating in certain areas.

In contrast to the relatively weak empirical support that exists for the substantive strand of rule of law reform (at least in the international setting), there is stronger empirical support, at least as measured against wealth creation goals, for the claim that constraints on governmental power have demonstrable developmental value. Xx find that countries that diffuse political power and that enable the judiciary to review governmental conduct are more prosperous than countries that lack these checks and balances. There is further empirical evidence that countries that possess an independent judiciary are better off than countries that do not. Finally, Mahoney's work on the superior economic performance of common law versus civilian legal systems is also

²⁴For these reasons, substantive legal transplantation is most obviously vulnerable to the charge of Western legal imperialism made by Trubek and Galanter. David M. Trubek and Marc Galanter, "Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States" (1974) *Wisconsin Law Review* 1062.

²⁵ Katharina Pistor, "The Standardization of Law and Its Effect on Developing Economies" (2002) 50 *Am. J. Comp. L.* 97.

²⁶ Brian Tamanaha, "The Lessons of Law and Development Studies" () 89 *American Journal of International Law* 476.

instructive given the significance he attributes to the common law's inherent distrust of unbridled governmental power.

In a recent paper I have written with Michael Trebilcock, we frankly acknowledge the difficulties that inhere in devising a non-controversial and universalistic conception of the rule of law in the development context.²⁷ Each rule of law variant is ultimately vulnerable to the charge that its application in some settings will trench upon deeply held social norms or beliefs, and therefore subject reform advocates to the charge of "legal imperialism". Nevertheless, by invoking a relatively "thin" rule of law as the basis for law reform, we hope to be able to temper as much as possible the criticism of unwarranted and counter-productive intervention in the developing world. In particular, we develop an argument for a rule of law reform project that would concentrate upon ensuring widespread access to justice and non-corrupt, effective and publicly accountable courts, administrative tribunals, law enforcement officials, prosecutors, prison officials, and the legal profession.

The Political Economy of Legal Institutional Reform

Much of the literature on the rule of law in the developing world dwells, appropriately enough, on the institutional endpoints of reform. The underlying assumption appears to be that once socially optimal institutional arrangements can be identified, then the actual implementation exercise is a relatively straightforward, technical enterprise. But the relatively dismal track record of numerous legal reform efforts in the developing world suggests a role for a variety of factors that impede successful implementation. It is, of course, difficult to determine *ex post* why putatively welfare enhancing legal reform fails. It may be that the program for reform was technically deficient, that it was insensitive to underlying cultural or historical conditions, or that there were insufficient resources available to support its adoption. Nevertheless,

²⁷ Ronald Daniels and Michael Trebilcock, "Explaining Resistance to Rule of Law Reforms in Developing Countries".

in many cases, particularly those in which a relatively thin rule of law reform agenda is being pursued, it is hard to avoid the suspicion that something else, namely domestic political-economic impediments, are at play.

That political economic constraints are implicated in the transformation of developing societies from weaker to stronger rule of law regimes is something that ought to have been foreseen. A rule of law reform agenda, even one that is modestly conceived, will have an impact upon the interests of ruling domestic elites.²⁸ For instance, the prescription in favor of the creation of truly independent and effective courts means that governments must refrain from seeking to influence judicial decision-making and must agree to not to exempt themselves from the equal application of the law. In countries where judicial decision-makers are often complicit in shoring up existing elites, and may receive direct benefits themselves from these actions, it is clear that rule of law reform, even if other underlying societal conditions are supportive, is fraught with complex politics. It is for this reason that Carothers argues that “[t]he primary obstacles to such reform are not technical or financial, but political and human. Rule-of-law reform will only succeed if its gets at the fundamental problem of leaders who refuse to be ruled by the law”.

The question then is how should these political interests be managed? In a recent working paper, Kaufmann acknowledges the damaging effect of domestic interest groups on rule of law reform, and contends that without significant re-ordering of domestic political institutions, reform is unlikely to succeed.²⁹ The program that Kaufmann envisages is ambitious and entails the adoption of concrete domestic measures to address the “challenges of political contestability, political financing reform, and transparency in parliaments, the judiciary and the executive”. To secure these goals, Kaufmann endorses the need for “concrete political commitment by the domestic leadership” and for close monitoring, presumably by domestic and external experts, of reform progress.³⁰

²⁸ Thomas Carothers, “The Rule of Law Revival”, (1998) 77 *Foreign Affairs* .

²⁹ Daniel Kaufmann, “Rethinking Governance: *Empirical Lessons Challenge Orthodoxy*”, Discussion Draft, March 11, 2003 (download at <http://www.worldbank.org/wbi/governance>).

³⁰ *Ibid* at 36.

Nevertheless, if rule of law reforms meet stiff political resistance, it is not clear that pushing down the reform effort to the basic institutions of government will be any more manageable.

Another promising avenue for domestic institutional reform emanates from the international arena, and contemplates the imposition of concrete sanctions on recalcitrant states in an effort to prompt desired domestic reforms. Many international human rights scholars, for instance, have argued that the international community ought to deploy economic and, in some cases, military sanctions to protect various minority groups who endure systemic discrimination and violence as a result of state action (or inaction). Yet, as is well known, the creation and imposition of calibrated international sanctions that will actually induce desired domestic reforms across a broad range of different state contexts is a daunting task, and one which has to address a range of different obstacles relating to the normative force of the target state's claim of sovereignty in its internal affairs, the fecklessness of the international community in enforcing sanctions, and the difficulties in defining and enforcing sanctions that are commensurate with the undesirable state of affairs. Further, effective sanctions must be targeted; they must be capable of being trained only on those actors who are implicated in the creation and continuation of the impugned conduct.

Assuming that these barriers can be overcome, a particular virtue of international sanctions is their normative sting, and, specifically, the instrumental role that such condemnation can play in mobilizing external and internal resistance to a rogue regime. This case has been forcefully made by Koh and by Hathaway, who subscribe to an interactive model whereby domestic and international regimes each affect and shape the other.³¹ Externally imposed normative sanctions by the international community can inspire, fortify and galvanize domestic interest groups into taking action aimed at correcting domestic institutional or policy frailties, particularly when sanctions engage

³¹ Harold Hongju Koh, "Why Do Nations Obey International Law" (1997) 106 Yale L.J. 2599; Oona Hathaway, "Do Human Rights Treaties Make a Difference?" (2002) 111 Yale L.J. 1935.

the interest and commitment of civil society actors both at home and abroad.³² The difficulty, however, lies in the significant variance in state responsiveness to these sanctions. Regrettably, the most egregious state violators are often the most resistant to international normative influence.

If externally imposed normative sanctions cannot always be counted on to create a domestic political environment that is amenable to rule of law reform, then another possible way in which the iron grip of vested interest groups can be broken is by adopting domestic policies that are designed to induce a variety of interest groups to emerge and to champion the adoption of good institutions. One example of this approach is furnished by ill-fated privatization programs that were launched in the newly liberalizing states of the former Soviet Republic. Reform proponents had anticipated that the rapid privatization of assets would elicit a demand for good rule of law by the recipients of those assets. In this manner, a political coalition in favor of change would emerge, not fuelled by normative inspiration, but simply by the recipients' collective self-interest in ensuring that the law would protect their interests by supplying good property, contract, and corporate law rules and institutions. Nevertheless, instead of fuelling demand for stronger commercial laws, the acquirers of these assets, many of whom obtained these assets in less than ideal circumstances, were understandably leery of efforts to create laws and legal institutions that would fetter their ability to hold these assets or to strip them with impunity, and thus were firmly dedicated to the perpetuation of the weak laws and legal institutions that were already in existence, and which facilitated their theft.³³

And so, the task of mobilizing domestic interest groups in developing states to champion a welfare enhancing rule of law reform agenda is a challenging one, particularly when, in classic public choice terms, the beneficiaries of these reforms are widely dispersed, will receive only small personal benefits from the adoption of the reforms, and are forced to operate within a closed, perhaps even hostile, political regime.

³² Kathryn Sikkink, "The Complementarity of Domestic and International Legal Opportunity Structures and the Judicialization of the Politics of Human Rights in Latin America", (March 2003, Draft Paper for the Yale Globalization Workshop).

³³ Black and Kraakman and Stiglitz.

In other words, the demand for the rule of law is a public good of sorts, where the benefits of its adoption will be distributed broadly, but the costs of advocacy are borne narrowly. In this setting, it is necessary to identify and recruit other stakeholders who can be counted on to make the case for welfare enhancing rule of law reform when, for a variety of different reasons, domestic interest groups cannot or will not.

II. The Case for the Bilateral Investment Treaty as an Investment Promoting Device in the Developing World

The first BIT was ratified in 1959.³⁴ Since that time, the BIT has become a predominant feature of the economic relationship between developed and developing countries. Today, there are over 2000 BITs in force.³⁵ By and large, most of the BITs have been executed between developed and developing countries³⁶, although there are a few notable exceptions to this pattern.³⁷ The BIT has proved to be an attractive mechanism to protect foreign investors' interests against the risk that host states will exercise their sovereign powers to debase, or, in extreme, expropriate the investments made by foreign investors.³⁸ These problems are particularly acute in situations where the foreign investors are required to make up-front and sunk investments, and the payback period on these investments is long. Once the investor has made this investment, the host government has strong incentives to try to transfer value to itself. These transfers can be done via a number of different methods, ranging from naked (and, increasingly, less frequent) expropriation to the enactment of regulatory rules and sundry obligations that have the effect of eroding investor value.³⁹

³⁴ Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (1995).

³⁵ U.N. Conference on Trade and Development, *World Investment Report 2003*.

³⁶ Andrew Guzman argues that developing countries were forced to adopt and ratify BITs as a result of a classic prisoner's dilemma problem among developing states that arose from the demise of the Hull Doctrine. As soon as a group of first mover states adopted a BIT, other developing states that were anxious to protect their capital inflows were forced to do the same. Guzman notes that in other fora, the developing states were able to coordinate amongst themselves to prevent adoption of onerous compensation obligations in the event of state takings in relation to foreign investment. (1998) 38 *Va. J. Int'l L.* 639.

³⁷ The Free Trade Agreement between Canada and the United States, which was subsequently supplanted by the North American Free Trade Agreement that includes Mexico as well.

³⁸ This is the familiar dynamic inconsistency problem.

³⁹ Michael S. Minor, "The Demise of Expropriation as an Instrument of LDC Policy, 1980-1992, (1994) 25 *J. Int'l Bus. Stud.* 177, 180 (no acts of direct expropriation from 1987 on).

Of course, the problem of opportunistic behavior in contracting relations is not unique to foreign investment contracts, and, to some degree, besets all contracts involving non-simultaneous exchange, and, in particular, government contracts. For example, in the absence of binding constitutional or international treaty obligations, sovereign governments are unable to bind themselves credibly to contractual obligations that limit their scope for subsequent opportunistic conduct.⁴⁰ This is because sovereign governments possess the innate capacity to enact legislation that will prevail over any explicit contractual undertakings they have made, and will insulate them from responsibility for damages caused by breach of the contractual undertakings. In fact, governments routinely undertake actions which can impact adversely the value of investments made by private investors, but which are nonetheless regarded as part and parcel of the legitimate exercise of public power. For instance, various types of environmental, health and safety, labor, and zoning regulations all possess the capacity to inflict losses on investors. In these cases, conventional doctrines of sovereign immunity, coupled with explicit regulatory enactments, are sufficient to insulate governmental decision-makers from financial responsibility to investors who are adversely affected by the intervention.⁴¹

The distinctive problems for foreign investors arise by virtue of their exclusion from the host state's political community.⁴² It is true and, as I will argue below, important that at the time of initial investment, foreign investors are on equal footing to host governments. However, as soon as the investment is made, power shifts to the host government. As Vernon has observed, foreign investors face an "obsolescing bargain" where "almost from the moment that signatures have dried on the [investment] document,

⁴⁰ Pablo Spiller cites.

⁴¹ Generally, most commentators have supported the state's power to regulate in these circumstances without compensation on the basis that the private investors are best able to insulate themselves from these risks and further, on the basis that democratic constraints will place inherent controls on the irresponsible exercise of public power.⁴¹ However, to the extent that certain investor groups are systematically excluded from domestic politics, either because of some status affiliation or because of the non-democratic nature of politics, then the case for investors bearing the full risk of governmental policy becomes less compelling.

⁴² These problems could also arise when certain domestic minority groups, defined by race, religion or ethnicity, suffer state sanctioned discrimination, and therefore lack voice in the domestic political arena. See: Chua, *World on Fire*.

powerful forces go to work that quickly render the agreement obsolete in the eyes of the government”.⁴³ In its most malign form, host governments realize that there is little that the investor can do to protect the value of her investment, and simply engage in opportunistic redistribution of the surplus generated by the investment.

The problem for foreign investors is that when the government’s view of the need to protect the investment changes, they lack direct or indirect political voice in the domestic arena that will temper government conduct. Foreign investors cannot vote in domestic elections (assuming that the host country holds elections in the first place).⁴⁴ Nor, as a class, do foreign investors typically command much affection from the citizens of host countries, particularly when their actions or motives in making the initial investment are impugned by host governments, as is often the case when governments decide to breach. Consequently, the only constraint on government behavior in these circumstances is the reputational sanction that will be visited on the host government in the international arena (particularly in international capital markets) and, predictably, the strength of these sanctions is a function of how the government’s actions are interpreted abroad (namely are they understood to be an opportunistic taking or a legitimate response to some market failure or to an abusive and corrupt set of contractual undertakings) and on how dependent the host government is on further international capital investment.

Of course, rational foreign investors will anticipate these contracting problems, and seek to adopt safeguards that limit the scope for government opportunism.⁴⁵ At the simplest level, foreign investors can decline to invest in the host country or can insist that the host country include a risk premium in the contract price to compensate for the risk of subsequent government debasement. Alternatively, investors can insist on relatively short payback periods, or on a variety of government bonding mechanisms like payments in foreign escrow accounts, all of which reduce the risk of government breach, or, at least, render the foreign investor indifferent to the prospect of such breach. However, all

⁴³ Raymond Vernon, *Sovereignty at Bay*, (New York: Basic Books, 1971) at 47.

⁴⁴ Foreign citizens also often face restrictions on the overt political contributions they can make to domestic political parties.

of these self-help measures entail a cost to the contracting parties. A relatively short payback period, for instance, means that certain socially desirable investments with longer payback periods will not be funded. Alternatively, from the perspective of the host state, a short payback period may limit their capacity to ensure that the private investor fulfills the host state's expectations regarding the operation of long lived assets. Reliance on escrow accounts means that valuable investment capital will be tied up in non-productive uses. Finally, although host states could adopt constitutional safeguards that seek to bond the commitment of governments to their contracts with private investors, foreign investors may be skeptical of the immutability of these constitutional commitments and, further, of the willingness of the host state's judiciary to enforce their terms.

Against this backdrop, the BIT's value in providing enhanced discipline of host government opportunism emanates from its requirement that host states honor the terms of the underlying investment contract, that disputes arising from the investment will be submitted to international commercial arbitration, and that "prompt, adequate, and effective" compensation will be paid by host states in the event of breach.⁴⁶ It is true that the principal sanction for a host state violating the terms of the BIT is primarily reputational in nature, and thus similar to the reputational consequences for other acts of host state opportunism that are not governed by treaty. However, the difference between host state opportunism in the treaty and non-treaty case relates to the much greater clarity of the reputational signal to the international community when state opportunism involves the express violation of a well-established and widely-used treaty convention as determined by an international arbitration panel.⁴⁷ Breach of one BIT puts other nations on notice that their BITs, and related investments as well, are vulnerable to repudiation. And perhaps even more seriously, the decision to breach an economic treaty will cause the international community to re-evaluate the likelihood of treaty breaches in other

⁴⁶ There is, in fact, variance across in the content of these requirements, but generally the requirements I enumerate are valid across a range of different BITs.

⁴⁷ The ways in which international law and treaty obligations shape state behavior has received careful analysis in recent paper by Oona A. Hathaway, "Between Power and Principle" A Political Theory of International Law" (March 2004 Draft). Hathaway develops a political theory for the role for international law that, among other things, considers the role of reputational sanctions in promoting state adherence to international law.

spheres, and to adjust their state to state relations accordingly. Accordingly, host states will not lightly renege on a BIT given their knowledge of the damaging consequences that they will suffer in their interactions with the international community.

Once it is recognized that a host state cannot blithely renounce the obligations contained in a BIT without incurring severe harm, it is easier to appreciate how the principal features of the instrument work to discipline state conduct in its relations with foreign investors. Unlike the pre-BIT uncertainty that used to prevail in the foreign investor protection regime with respect to when a host state would be obliged to pay compensation to foreign investors for its actions and for what amount, the BIT regime is much more determinate and typically requires that any breach of the foreign investment contract be accompanied by “prompt, effective and adequate” compensation from the host state.⁴⁸ Thus, the scope of government liability simply keys off of the terms of the contract negotiated with the foreign investor.

Further buttressing the determinacy of the foreign investors’ contract with the host state is the commitment of the parties to rely on binding international commercial dispute arbitration for dispute resolution. Typically, international commercial arbitration panels consist of three people, two of whom are appointed by each of the parties and the third by agreement of the parties or by agreement of the appointed panelists in the event of a dispute. This increases investment certainty in several ways. First, it protects the foreign investor from the risk that disputes arising under the contract will be resolved in home state courts that are biased against their interests because they are closely tied to the government of the home state. Lack of judicial independence is a common challenge in many developing countries and foreign investors have good cause for doubting their capacity to get a fair hearing in the host state’s courts. Even if judicial independence and

⁴⁸ As Andrew Guzman notes, the BIT emerged as a response to the growing repudiation of the Hull Doctrine in customary international law, which required compensation for foreign investors that was “prompt, effective and adequate”. *Virginia International Law Review*.

objectivity is not an issue, foreign investors will worry about judicial competence and the prospect that courts will make mistakes in their adjudication of the dispute.⁴⁹

Second, international commercial arbitration permits the parties to specify resolution of the dispute against a foreign source of law, thereby limiting the risks of reliance on under-developed, perverse or manipulable law of the host country. Third, international commercial arbitration constitutes a relatively narrow and non-transparent enterprise. Tribunals generally decline to grant broad rights of standing to stakeholders who proclaim some interest in the subject matter of the dispute. Further, their dominant interpretive canons are focused on the parties' expectations as expressed in the terms of the contractual documentation, and they are less interested in the general welfarist implications of the contract in question.

In tandem then, the BIT and recourse to international commercial dispute arbitration constitute a robust legal enclave that allow developing states, particularly those suffering from fragile political and legal institutions and traditions, to avail themselves of the benefits of international investment capital. The BIT is designed to permit foreign investors to contract out of the host country's legal system, and to reduce the risk of subsequent and predictable state-sponsored opportunism. By creating a highly certain, credible foreign investment regime, the host state stands to benefit from a larger supply of low cost capital to fund its projects than would be available to it in the absence of such a treaty.⁵⁰ Additionally, by concluding a BIT, the host government binds not only itself, but future host governments as well, thereby enabling the state to secure access to

⁴⁹ The prospect of mistakes is increased when the parties agree to interpret the contract against a foreign source of law, and the domestic judiciary is lacks familiarity with the intricacies of foreign systems.

⁵⁰ However, in a recent empirical investigation of the impact of BITs on foreign direct investment flows, Hallward-Driemeir finds that BITs did not exert a statistically significant effect on the level of foreign investment experienced by developing countries. She contends that treaties act more as complements rather than substitutes for host state legal regimes. Mary Hallward-Driemeir, "Do Bilateral Investment Treaties Attract FDI? Only a bit .. and they could bite", June 2003. A similar point is made by Been and Beauvais, (BITs do not confer any competitive advantage in the market for FDI). However, if this is correct, it raises vexing issues as to why developing countries conclude BITs that confer no advantages whatsoever. Vandeveld, in contrast, finds that, based on UNCTAD data, BITs are "marginally successful in increasing investment". Kenneth J. Vandeveld, "The Economics of Bilateral Investment Treaties" (2000) 41 Harv. Int'l L.J. 469.

long-term investment capital that may transcend the expected life of the government currently in power.⁵¹ Thus, providing that the state uses this foreign investment capital for socially desirable projects in the host country, the case for the BIT as a welfare enhancing device for the developing world would appear to be watertight.

III. Bilateral Investment Treaties and the Subversion of Rule of Law Reform

Despite the strong case that many enthusiasts have made for the welfare enhancing role of the BIT in the developing world, careful examination of its impact on developing countries reveals a much less convincing claim. In the following discussion, I consider the incentives that the BIT enclave provides to foreign investors and host states in their contracting relations, and explain how these incentives are inimical to socially desirable rule of law reform in developing states.

Foreign Investor Exit from Generalized Domestic Law Reform Initiatives

As I discussed earlier, one of the chief arguments in favor of the BIT is that it seeks to create a stand alone legal enclave in which foreign investors can be largely insulated from the legal and political risks of contracting in the home state and relying on its institutions.⁵² However, a neglected aspect of reliance on these enclaves is the extent to which it dulls any interest or incentive on the part of foreign investors to seek to condition their investments in the host developing state on the creation of good rule of law institutions that would be generally accessible to foreign and domestic investors alike. When BIT protection is available, the character of the host state's commercial law

⁵¹ Andrew Moravcsik, states enter into treaties to bind successor governments.

⁵² The prospects for foreign investors to play a role in extracting rule of law reforms is thoughtfully canvassed by Susan Rose-Ackerman, "Contracting in Politically Risky Environments: International Business and Reform of the State", Draft Working Paper. However, in contrast to the analysis I develop in this paper, Rose-Ackerman is skeptical of the capacity of foreign investors to serve as effective agents for domestic rule of law reform: "Although multinational business will benefit as a group from more clarity and stability in the legal environment and may be allies in the reform effort, the world community cannot rely on their individual profit-maximizing deals to push countries reliably down the path of reform" (at 33).

system and the quality of its judiciary (as measured by its independence, expertise, and integrity) are of less consequence to the prospective investor. Because the BIT-based enclave offers prospective investors the ability to reduce host state legal risk through a combination of comprehensive contracts, designation of foreign law as the basis for dispute resolution, and off-shore international commercial arbitration, foreign investors will rationally refrain from undertaking efforts to investigate or to change the domestic rule of law regime.⁵³ In Hirschmann's terms, the BIT enclave enables foreign investors to exit from domestic legal regime and this, in turn, implies a withdrawal of their voice from the domestic debate over the need for, and character of, good laws and legal institutions.⁵⁴

However, it is not just foreign investors who benefit from a BIT regime. Host state political elites will also obtain benefits from the adoption of BITs. Adoption of the BIT allows host governments to confer targeted rule of law benefits on a relatively small, discrete and mobile group of investors, while preserving their ability to extract personal benefits from the provision of weak generalized rule of law institutions to its captive domestic citizens.⁵⁵ That is, the BIT allows domestic political elites to access foreign capital but without having to abide any restrictions on the exercise of their political power by independent courts that would be required were a more general set of rule of law reforms enacted.

This siphoning off of foreign investor voice from domestic law reform enterprise imposes significant costs on developing states. The nature of these costs can be illustrated by considering an alternative model in which foreign investors would be precluded from disentangling their investments from the inherent underlying risks of the

⁵³ The argument I am making could be strengthened by noting that some investors may not be merely indifferent to the presence of a BIT, but may actively seek out investments in those countries that have a BIT because these contracts offer greater protection against future regulatory risks than investors would typically receive. In other words, investors may sort for BIT countries on the basis of their risk preferences or, more significantly, on the likelihood that they will have some conflict with the host state. Hallward-Driemeier.

⁵⁴ Albert A. Hirschman, *Exit, Voice and Loyalty*.

⁵⁵ For example, predatory domestic elites may use the judicial system to harass and exploit fellow citizens engaged in legitimate economic activity. Further, by promoting a compliant, weak judiciary, domestic elites reduce the likelihood that they will later be forced to account for graft and corruption.

host state's legal system.⁵⁶ In these circumstances, foreign investors can be expected to be strongly interested in the existence of generalized and sound contract, commercial and corporate laws, as well as in the independence, integrity, and expertise of the domestic judiciary. These are goods which are also of considerable value to citizens in the developing world. Indeed, it is not far-fetched to imagine that once a host state constructs a credible commercial law regime, the stage will be set for the development of other desirable rule of law reforms. This is so because a credible commercial law regime requires an expert, independent and non-corrupt judiciary, as well as a set of substantive legal rules that constrain the exercise of public power. In essence, these mechanisms create a precedent for other more generalized reforms that can leverage off of the same institutional framework.

The dynamic through which sound generalized commercial law and supporting legal institutions will emerge is not mysterious. Essentially, if all foreign investments were inextricably tied to the host state's underlying legal regime, prospective foreign investors would rationally incur search costs respecting the underlying risks of a host country's legal regime before making an investment. In some circumstances, on the basis of a selfish cost-benefit analysis, they would rationally decide to invest in political activities aimed at eliciting better laws and legal institutions from the host state, even though pursuit of these laws would yield positive externalities for other investors operating in the developing state. Likewise, host state governments that were desirous of securing the capital of footloose foreign investors would be forced to produce laws and legal institutions that were as good as, or better than, those produced by competitor jurisdictions.⁵⁷ Highly mobile investors would then gravitate to those jurisdictions offering the best investment opportunities, which would in part be a function of the

⁵⁶ Rose-Ackerman and Rossi also argue that host states should not delineate between the treatment of foreign and domestic investors. It should be stressed that the argument for denying foreign investors the ability to contract out of the host state's legal environment does not logically imply denying private commercial parties the right to contract out of a host state's commercial laws via choice of law and forum clauses in commercial agreements. What I am arguing for here is limiting the capacity of foreign investors to enter into agreements with the state that permit the foreign investor to contract out of the host state's general legal and regulatory framework.

⁵⁷ There is ample evidence that foreign investors confer significant benefits on developing countries. See for instance, F. Bergsten, T. Horst and Moran, *American Multinationals* (1978).

quality of the underlying legal product.⁵⁸ In this manner, foreign investors would become willing conscripts in the enterprise of rule of law reform.

There are a number of objections that could be raised with this model. Perhaps the most obvious is that by tying foreign investment to the host state's legal system, the overall level of foreign investment in the developing world will decline, and this will impose significant welfare losses on citizens in the developing world. Specifically, the claim is that if foreign investors are unable to take refuge in BIT based enclaves, they will simply refrain from investing in the developing world altogether. A less dramatic variant on this scenario is that foreign investors will continue to invest in the developing world, but because the cost of investing will increase (by forcing reliance on second best self-help measures), the overall level of investment will decline. Yet it is important to bear in mind that what is at risk is primarily the distribution of investment capital between states that adopt good rule of law institutions and those that do not. Whereas the current BIT based foreign investment regime exerts a leveling effect on foreign investment flows across developing states, a regime based more directly on the quality of a country's general legal institutions can be expected to reward some states handsomely while penalizing others. Importantly, the basis for receiving increased investment flows would be the quality of a country's general legal institutions. The fact that citizens in recalcitrant rule of law states (and, more importantly, their political elites) will not be able to benefit from the projects that would have been funded by foreign investors in a BIT based regime will doubtless impose short term and wrenching social costs. But I suspect that, in the medium to long run, this model will induce the production of better laws and legal institutions that likely are of far greater importance to social welfare than those projects that are predicated on the protections afforded by the BIT.⁵⁹

Other objections may be leveled against the proposed model. It can be argued that the costs to foreign investors of search and analysis of a country's legal regime will

⁵⁸ The term is from Roberta Romano, "Law as Product".

⁵⁹ In this respect, the proposed model constitutes a market-enforced regime of conditionality that may ultimately be of greater importance and efficacy than the haphazard efforts on the part of governments and international financial institutions to condition political, social and economic benefits provided to developing countries on certain types of desired state conduct.

be too complex and expensive, thereby deterring prospective investors. However, there are already a number of private providers of information on country-specific legal risks and consequently the informational burdens on prospective investors are likely not very great.⁶⁰ Others may argue that few foreign investors are likely to invest the resources necessary to lobby host governments to supply good legal institutions or, if they do invest in these activities, that their investments will be socially suboptimal. This, too, is not likely a fatal objection. So long as some marginal investors are minded to engage in activism, and the benefits of their actions result in the creation of generalized rule of law reforms that benefit all (meaning infra-marginal) investors, then the political pressure necessary to counteract the entrenched interests of existing elites is likely to be fairly powerful.⁶¹ Further, it is worth remembering that extant entrenched interests will also face coordination problems in seeking to negate foreign investors' interest in improved rule of law institutions, suggesting that it is not a foregone conclusion that foreign investors will always lose in the hurly burly of the domestic political arena.

Another possible concern relates to the reform agenda that foreign investors are likely to pursue in the domestic arena. Instead of advocating good rule of law reforms that benefit a broad array of citizens, they can be expected to seek out narrow concessions that confer targeted benefits on them alone, and which have the effect of replicating many of the distinctive foreign investor preferences that are embedded in the BIT-based regime. However, from the self-cost benefit perspective of the foreign investor it is not clear that specialized concessions are nearly as attractive to foreign investors as more generalized and durable rule of law reforms, particularly when these concessions do not

⁶⁰ The International Country Risk Guide, Heritage Foundation/Wall Street Journal Index of Economic Freedom. The strengths and weaknesses of these measures are discussed in Davis, "What Does the Rule of Law Variable Measure?" (March 2004 Draft).

⁶¹ In this respect, the obvious analogy is to institutional investors whose financial interests in a company may be small (when viewed from the perspective of their relative shareholding), but nevertheless large enough to induce them to undertake activism on behalf of all shareholders generally. See Bernie Black, John Coffee, and Mark Roe on Institutional Investors. Of course, I am not claiming that these investors will necessarily undertake the socially desirable level of intervention in the domestic economy given the difficulties in overcoming innate collective action problems that would arise were the foreign investors to seek to recover the funds they had invested in political activism on behalf of all of the domestic beneficiaries of their efforts.

enjoy treaty status and, therefore, subsequent home state denial of them does not necessarily impair relations with the investor's home state.

A final objection to this model is that, even if foreign investors are inclined to engage in activism aimed at eliciting better rule of law arrangements in the host country, host state governments are unlikely to be very receptive to their entreaties. This objection then is not so much about the incentive of foreign investors to engage in activism, but its ultimate efficacy. It would be foolhardy to claim that foreign investors will always and in every circumstance be able to obtain rule of law concessions from existing political elites. But, it would be equally foolhardy to predict that foreign investors will never have any effective political voice in the host state political arena.⁶² The reality is that the identity of influential political interests will vary in any society from moment to moment. Depending on the intensity of the commitment of existing political elites in the host state to securing funding for certain projects, foreign investors may find that they enjoy considerable, albeit fleeting, political influence when deciding whether or not to support these projects.⁶³

Thus, a strong case can be made that the adoption of the BIT has facilitated and, indeed, induced foreign investor exit from domestic law reform initiatives. By limiting the scope for foreign investor exit from the host state legal system, by, for instance, intentionally tying these investments to the underlying legal system, foreign investors will be more interested in the quality of host state laws and legal institutions generally. In this way, investor interest in good laws (either expressed through a refusal to invest in the state or, alternatively, to invest only if good laws and legal institutions are supplied) can be aligned with the interests of broadly dispersed, although politically inarticulate, domestic interests.

⁶² Alan Rugman, "Multinational Enterprise Strategy for Developing Countries", Draft Working Paper dated February 23, 2000 argues that multinational enterprises investing abroad are regulation takers, not regulation makers.

⁶³ Political elites in host states may be intensely committed to these projects for a number of laudable or venal reasons. This is particularly so when showcase public infrastructure projects are on the line.

Foreign Investor Reliance on Comprehensive Contracting and the Negative Demonstration Effects of the BIT for Rule of Law Reform

So far, the case against the BIT enclave is based on the way in which it dampens foreign investor interest in the production of good commercial laws and corresponding legal institutions in the host regime. However, these are not the only costs posed by the BIT to rule of law reform in developing states. Consideration of the bargains that parties will likely conclude in the BIT-based enclave reveals further problems for domestic rule of law reform. Specifically, I argue that the BIT unleashes powerful incentives for contracting parties to negotiate comprehensive, fully-specified, and typically non-transparent, contracts that allocate investment risks and responsibilities between the investor and the host government. Not only do these agreements increase the risk of significant personal benefits being illegitimately appropriated by domestic elites, but they are also likely to limit the state's capacity to respond to legitimate public policy concerns through the creation of credible, transparent and participatory regulatory institutions. In concert, these features of the BIT will enfeeble host state governments, and, in sharp contrast to the claims made by supporters of the BIT, will end up discrediting the normative legitimacy of the BIT as a rule of law demonstration project.⁶⁴

The perverse effects of the BIT on the contracting incentives of host governments and foreign investors can be most readily demonstrated by considering foreign investments in public infrastructure projects, such as electricity networks, water and sewage systems, roads and highways, and public transportation facilities. Public infrastructure projects offer as a useful context in which to gauge the impact of the BIT for several different reasons. Because of their significant welfare enhancing effects, the funding of public infrastructure projects is often viewed as an urgent priority by

⁶⁴ However, McConnaughay argues that use of international commercial arbitration for disputes involving developing states will fuel domestic support for the role of the rule of law because it will instill "an incipient belief in the capacity of institutions to administer justice impartially". Philip J. McConnaughay, "The Scope of Autonomy in International Contracts and Its Relation to Economic Regulation and Development" (2001) 39 Colum. J. Transnat'l L. 595.

developing states, and by international financial institutions.⁶⁵ In fact, the infrastructure funding requirements of developing states was one of the principal rationales for the development of the BIT. Further, public infrastructure projects pose a series of vexing challenges for contracting parties in the design of their legal relationship. Specifically, these projects characteristically involve significant up-front and sunk investments in long-lived assets, which make foreign investors particularly vulnerable to *ex post* opportunism by host states.⁶⁶

Perhaps the most significant challenge posed by public infrastructure projects relates to several innate characteristics of these projects that mandate public intervention in a liberal state. Public infrastructure projects, for instance, often generate significant externalities, pose risks of excessive market power, possess public goods properties, and have concentrated distributional consequences. *Ex post* intervention by the host state aimed at responding to these concerns is likely to reduce the investment returns to foreign investors. Of course, to the extent that this intervention can be predicted *ex ante*, its effect can be impounded into the investment price of the project (like any other risk), and rational investors will not suffer any loss. The difficulty, however, for the parties is in predicting accurately the level and character of future intervention by the state. This is a particularly demanding exercise in developing states where the underlying political environment of the country is in flux and where it is hard for parties to anticipate how future governments will respond to the public policy concerns generated by these projects.

The predictive problems are compounded further by the risk that the existing host government or another future government may invoke its general regulatory powers to

⁶⁵ The significant welfare gains that are alleged to be associated with public infrastructure projects emanate from a number of different sources. Public infrastructure often complements or undergirds private investments. In the absence of sound public infrastructure, private investors will be loathe to invest funds in various projects. See the discussion in Daniels and Trebilcock, *Public Private Partnerships: The Next Privatization Frontier*, (1996) 46 University of Toronto L.J. 375 For a discussion of the importance of public infrastructure in the developing world, see the World Development Report 1994, *Infrastructure for development* 1994. Harris, *infra*, observes that 1 billion people lack a safe water supply, and 2.4 billion don't have access to effective sanitation systems.

⁶⁶ Daniels and Trebilcock, *Ibid*.

appropriate the investment value of the project from the foreign investor. This is a longstanding problem for private investment in public infrastructure projects. Host states often fail to accurately price the value of infrastructure concessions, and they will later seek to make up for investment shortfalls by expropriation of the value of the project through naked nationalization or through a series of regulatory interventions.⁶⁷ The risks of subsequent expropriation are enhanced when the host government can demonstrate that the conferral of the infrastructure project on the private investor was the result of fraud or graft.

In a developed state, with well developed regulatory institutions and a stable liberal political environment, investors will be able to predict with some accuracy the future regulatory actions of the state. Further, to the extent that investment in public infrastructure is governed by a legitimate, transparent selection process, investors can lessen their vulnerability to future government intervention that seeks to disgorge any ill-gotten gains. However, the situation confronting a prospective foreign investor in a public infrastructure project in a developing state is entirely different. Given the political volatility that is endemic to many developing countries, there will always be greater risk (in comparison to developed countries) that future governments will seek to characterize – perhaps correctly -- the foreigner’s investment as being one-sided and therefore illegitimate. These allegations may arise even when the projects are awarded to foreign investors through robust selection regimes. A further problem for investment in public infrastructure in developing states concerns the relatively under-developed state of the host state’s regulatory institutions. Lacking the expertise, the traditions, and the resources necessary to develop credible regulatory regimes, host state regulators, to the extent that they exist at all, will be unable to provide credible assurances of future regulatory conduct to skittish foreign investors.

To reduce investment uncertainty, the foreign investor could insist that the host state establish credible and stable regulatory institutions before investing. This is not fanciful. Foreign investors in public infrastructure are often large international consortia

⁶⁷ Hence the term “creeping expropriation” that is used to describe this phenomenon.

that specialize in the design, construction, and operation of these projects in both the developed and developing world and, consequently, they will have considerable first hand experience with, and understanding of, appropriate and effective regulatory institutions. By conditioning their investments on the creation of good regulatory institutions, they could simultaneously reduce their risks of subsequent unanticipated regulatory action, while promoting the adoption of good institutions generally in the host country.

But if a BIT exists, this is less likely to occur. The foreign investor will prefer to secure protection from the risk of subsequent host state regulatory debasement by way of well specified, comprehensive, long-term contract.⁶⁸ These contracts are, in many respects, functionally equivalent to government regulation administered by an independent regulatory agency.⁶⁹ These contracts allow the parties to specify in detail the precise character of the regulatory obligations that will be borne by the foreign investor, and the protections that the host state will provide in return. The more explicit and comprehensive the contracts, the greater the degree of protection obtained by the foreign investor against future risks of government debasement. Foreign investors will be particularly attracted to the use of these contracts knowing that their terms are likely to be strictly enforced by international commercial arbitral panels in proceedings that are non-transparent and which afford few, if any, opportunities for third parties who are affected by the public interest terms embedded in the contracts to participate.

Were these contracts perfect substitutes for independent credible regulation, then there would be no reason for favoring the adoption of one regime over another. However, they are not. First, these contracts are typically non-transparent whereas received models

⁶⁸ Harris, *infra*, notes that while developed countries rely on regulation of infrastructure operators to address public policy concerns, developing countries rely on comprehensive contracts.

⁶⁹ The host state could, for instance, include explicit permitted tariff formulae in the contract that respond to concerns over market power. Likewise, the host state could include explicit obligations respecting distributionally salient customers, environmental responsibilities and so on. The functional equivalence of utilities franchise contracts and external regulation via an expert tribunal is discussed in: Victor Goldberg, "Regulation and Administered Contracts" (1976) *Bell J. of Econ.* 426. See, also: George Priest, "The Origins of Utility Regulation and the 'Theories of Regulation' Debate" (1993) 36 *J. L.E.* 289.

of independent regulation are predicated on a high degree of public transparency and accountability. Contractual terms that are explicitly designed to respond to certain public policy concerns may never be reviewed or tested by interest stakeholder groups prior to execution and therefore lack public legitimacy.

Second, by specifying in detail the nature of public interest obligations that will be borne by the foreign investor during the life of the investment, the ability of the state to revise its regulatory structure in response to shifting societal norms or to initially misperceived social risks is significantly attenuated.⁷⁰ Host states will only be able to tighten the regulatory burdens that operate on the private investor if they provide appropriate compensation. But, in cash-strapped developing countries, the requirement that the host state compensate the foreign investor for heightened regulatory standards is tantamount to a straitjacket on future regulatory improvement. Further, as a normative matter, it is not at all clear that requiring the state to pay for enhanced regulation is socially optimal.⁷¹ Consequently, contracts under a BIT regime offer foreign investors protection not only against the risk of malign government opportunism (which is desirable), but, equally significantly, against more innocent and socially desirable forms of investment debasement that derive from legitimate regulatory intervention (which is not). In contrast, the regulatory regime that operates in most developed countries allocates the risk of future regulatory changes to the private investor, and therefore allows the regulatory apparatus of the state to evolve in concert with changing public expectations regarding the need for public intervention.

A third and final difference is that the higher degree of contractual enforceability that is related to the BIT regime provides a more congenial context than would a more

⁷⁰ The requirement for compensation to be provided to investors when the state is exercising its legitimate regulatory powers under NAFTA has been strongly and persuasively condemned by a number of commentators. See: Vicki Been and Joel C. Beauvais, (2003) 78 N.Y.U.L. Rev 30.

⁷¹ The classic article is by Louis Kaplow, "An Economic Analysis of Legal Transitions" (1986) 99 Harv. L.R. 509. See also: Susan Rose-Ackerman and Jim Rossi, "Disentangling Deregulatory Takings" (2000) 86 Va. L. Rev 1435 (governments should only be liable for providing compensation for takings when government is acting in its capacity as a purchaser but not as a policy maker). David Cohen, "Regulating Regulators: the Legal Environment of the State" (1990) 40 UTLJ 213 (government decision-makers have only weak incentives to minimize costs, as excess costs can be transferred to taxpayers or to different institutions of government). See also Been and Beauvais at 99.

transparent regulatory regime for host state politicians and bureaucrats to extract illicit side-payments from foreign investors in exchange for socially sub-optimal levels of future regulation. The host state politician may deliberately “back end” the weakening of regulatory standards knowing that public awareness of these concessions will only become apparent in the distant future when another government is in power. Because foreign investors are protected via compensatory damages from the risk of more stringent regulation, they will be willing to make investments on these terms, particularly when the provision of side-payments to host country elites is necessary to secure the investment in question. This problem is especially acute in situations where the initial franchise contract for the infrastructure project is awarded through a public selection process, and then modified soon afterwards via non-transparent negotiations.⁷²

In summary, by inducing both foreign investors and host governments alike to rely on comprehensive, well-specified and typically non-transparent contracts to protect their interests, the BIT subverts the developing country’s capacity to develop future regulatory initiatives that are responsive to legitimate public expectations for governmental intervention, and which constitute an indispensable part of the state building enterprise.⁷³ This is particularly relevant in the context of developing states, where the demand for certain regulatory interventions may change rapidly over a relatively short time period. Instead of encouraging confidence in public decision-making, the use of non-transparent contracting for often politically contentious investments in public infrastructure cannot help but sow suspicion, distrust and disaffection amongst the citizenry of the host state. Even if the public infrastructure projects supported by foreign investment are socially desirable, the “hollowing out” of the state’s future regulatory capacity will be deemed to be too high a price to pay for these projects.

⁷² See Luis Guasch, Draft Manuscript on contractual re-negotiation.

⁷³ It is for this reason, among others, that Been and Beauvais urge developed countries to eschew reliance on BITs as a means of structuring their economic relationship with developing countries.

The risks of an intense and broad-based public reaction against private investments in public infrastructure in the developing world are more than speculative. Over the last decade, foreign investors and supporting host governments have come under intense criticism from domestic opposition groups and international civil society organizations for the ways in which privately supported public infrastructure projects have been undertaken.⁷⁴ Critics have objected to the corruption and graft that often accompany these projects. They have taken issue with the failure to ensure that legitimate public concerns over the price and quality of infrastructure services are addressed. And they have reacted to the apparent neglect of a host of concerns regarding negative externalities and distributional impacts. In fact, in some cases, the public reaction against these projects has been so strong as to topple existing governments.⁷⁵

Significantly, and of importance to the rule of law reform enterprise, the public backlash against these projects often translates into a more general repudiation of Western-backed reform initiatives, including the support for rule of law reform. In the minds of many interest groups in the developing world, the rule of law that is supported by the West implies binding constraints on the capacity of the state to regulate fairly, openly and responsively in the public interest. It also implies a reliance on non-transparent and rigid contracts instead of more flexible and accountable regulatory mechanisms. At the core of these arrangements stands the corrosive influence of the BIT. In these terms, the BIT saps rule of law reform of its normative legitimacy in the developing world.⁷⁶

⁷⁴ See, for instance, Clive Harris, *Private Participation in Infrastructure in Developing Countries*, World Bank Working Paper No. 5 (2003). Include the discussion on various failed infrastructure projects in India, Latin America, and South Asia.

⁷⁵ Cochabamba and Buenos Aires.

IV. Conclusion

In this paper, I have argued that, contrary to the fond aspirations of its proponents, the BIT has not deepened the commitment of host states to the rule of law reform enterprise.⁷⁷ It has systematically diverted the interests of potentially influential foreign investors from demanding the creation of good generalized laws and legal institutions, and has further encouraged them to enter into long term arrangements that impair the state's capacity to regulate effectively in the public interest and which further increase the risk of corruption and abuse.

One possible solution is to radically reform the character of the international arbitral mechanisms that are used to review disputes over foreign investments in host states.⁷⁸ Instead of relying on shallow, non-transparent adjudication that is appropriate for commercial disputes between private parties, the panels would be encouraged to review the broad circumstances in which the investments were made, to determine whether foreign investors provided unwarranted side payments to secure their investments, and whether legitimate public policy interests were systematically neglected. To support this type of adjudication, the panels would have to commit to a much greater degree of transparency, including granting broader rights of standing that are available at present to disaffected stakeholders in the host country. While such a regime would increase the risks to foreign investors of investing in developing states, shifting these risks to investors will ensure that investors are more attentive to the circumstances in which they make their investments, and will make investors warier of investing in projects where host political elites are seeking to extract unwarranted personal benefits at the expense of the public at large.

⁷⁷ In contrast to the claim I advance against the impact of the BIT on rule of law reform, Reisman and Sloane argue the emergence of the BIT is "part of a broader movement that recognizes that the profits of the foreign investor, no less than the multiplier effect in the host state's economy, depend on appropriate legal, administrative and regulatory structures, all conducted through "transparent" procedures designed to ensure that things are actually done the way they are supposed to be done." W. Michael Reisman and Robert D. Sloane, "Indirect Expropriation and Its Valuation in the BIT Generation", draft article on file with the author.

⁷⁸ This approach is favored by a number of different commentators. See, for example, Joel C. Beauvais, "Student Article: Regulatory Expropriations Under NAFTA: Emerging Principles and Lingering Doubts" (2002) N.Y.U. Env't'l L.J. 245.

Another alternative solution is to encourage the revocation of BITs that seek to confer preferential treatment on foreign investors as against domestic investors. By committing to a regime of strict national treatment, the interest of foreign investors in advocating for good rule of law reforms will be enhanced, and, in this respect, will become more closely aligned with dispersed and often voiceless citizen interests in the host country. One way of achieving this goal would be the revival of the much maligned Calvo Doctrine, which was committed to equal treatment of foreign and host state investors under the municipal laws and courts of the host country.⁷⁹

Whichever option is chosen, it is clear that addressing the enclave-like attributes of the BIT regime constitutes an urgent priority for those who believe that rule of law reform is one of the most effective ways in which developing countries can achieve the freedom, prosperity and dignity enjoyed by citizens in the West.

⁷⁹ Donald R. Shea, *The Calvo Clause* (1955, University of Minnesota Press: Minneapolis) traces the evolution of the Calvo Doctrine, which was a response by a number of Latin American countries to the perceived excesses perpetrated by developed states on developing states in order to protect their investments. The author of the doctrine, Carlos Calvo, sought to put foreign and domestic residents on the same footing by denying any special diplomatic privileges to foreign residents in the host state. Shea argues that the Calvo Doctrine can be interpreted to require national treatment of foreign and domestic residents by the host state, adjudication of disputes by tribunals in the host state, and recourse to diplomatic protection by the home state only in the event of “denial of justice”. See also: Denise Manning-Cabrol, “The Imminent Death of the Calvo Clause and the Rebirth of the Calvo Principle: Equality of Foreign and National Investors” (1995) 26 *Law and Policy Int’l Bus.* 1169.