

# **REPUTATION COSTS IN INVESTOR- STATE DISPUTE SETTLEMENT**

by

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# **REPUTATION COSTS IN INVESTOR-STATE DISPUTE SETTLEMENT**

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**Keywords:** ICSID, FDI, bargaining power, developing country

## **ABSTRACT**

Previous studies on World Trade Organization (WTO) dispute settlement suggest different aspects as to how developing countries tend to fail in executing their bargaining power in dispute settlement. One aspect that has yet to be analyzed is developing country bargaining power with respect to likelihood of settlement in such international disputes. A further analysis on the topic sheds light on another dimension on how international dispute mechanisms do not necessarily bring forth “right” over “might”.

This thesis focuses on International Centre for Settlement of Investment Disputes (ICSID), a platform on which developing countries face foreign investors, and highlights how the established mechanisms of dispute resolution cannot protect the bargaining power of developing countries due to their dependence on further foreign direct investment (FDI). This study adds another dimension through which one can observe the relative weak stance developing nations have when it comes to international disputes.

A simple formal model emphasizes the role of reputation as a factor in determining the bargaining power a country has with respect to an investment dispute case. The indications of the model are tested by running a logit model on the outcomes of these dispute cases. Findings suggest potential loss of reputation increases the likelihood of observing a settlement as the bargaining power of the developing country decreases. Additional factors that affect the bargaining power are the country’s income level, level of available FDI in the world and the extent to which the state faces external turmoil.

# YATIRIMCI-DEVLET DAVALARINDA İTİBAR KAYBI

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**Keywords:** ICSID, doğrudan yabancı yatırım, pazarlık gücü, gelişmekte olan ülke

## ABSTRACT

Dünya Ticaret Örgütü dava çözümlerini inceleyen şimdiye kadar yapılmış arařtırmalar, gelişmekte olan ülkelerin dava çözümlerinde pazarlık güçlerini hangi açılardan koruyamadıklarını göstermektedir. Henüz arařtırılmamış bir nokta gelişmekte olan ülkelerin pazarlık güçlerinin, davalardaki uzlaşma olasılığı ile olan ilişkisidir. Bu konu üzerinde yapılacak bir analiz, uluslararası çözüm mekanizmalarının nasıl “dođru”nun deđil, “gücün” geçerliliđini yařattığını bize yeni bir açıdan gösterecektir.

Bu tez gelişmekte olan ülkelerin yabancı yatırımcılarla karşı karşıya geldiđi ICSID platform üzerinde yoğunlaşp, varolan çözüm mekanizmalarının, gelişmekte olan ülkelerin pazarlık güçlerini, ülkelerin doğrudan yabancı yatırım bađlılıđından dolayı, nasıl koruyamadığını göstermektedir. Bu arařtırma gelişmekte olan ülkelerin uluslararası davalardaki nispeten daha zayıf duruşlarının bir başka açıdan ortaya çıkarmaktadır.

Basit bir oyun kuramı modeli itibar faktörünün, yatırım davalarındaki pazarlık gücünü belirlemedeki önemini ortaya koymaktadır. Modelin endikasyonları logit modeli ile uluslararası davalara bakılarak test edilmiştir. Sonuçlar potansiyel itibar kayıplarının, davalarda uzlaşmaya varılması olasılıđını arttırdığını göstermektedir. Pazarlık gücünü ve uzlaşma ihtimalini etkileyen diđer faktörler, ülke gelirleri, dünyadaki mevcut doğrudan yatırım miktarı ve ülkelerin ne derece dış politikalarında sorun yařadıkları olmuştur.

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## **CHAPTER 1**

### **INTRODUCTION**

The political power of developing nations, when it comes to bargaining in the context of international disputes, has been a topic of interest, especially with respect to WTO dispute settlement. Whether or not economic power translates into political power, and under what circumstances are important aspects of international political economy. This study aims to pinpoint yet another dimension as to how and when developing countries fail to realize their political power, due to restrictions on economic status.

Foreign direct investment (FDI) has become increasingly important for developing host countries. The increase in its volume and scope has led to proliferation of bilateral investment treaties (BIT) across nations that act as mutual agreements on terms with respect to investments made across borders. One of the crucial goals of these agreements is to provide protection to foreign investors. The recent trend in offering such protection has been the inclusion of specific clauses that designate International Centre of Settlement of Investment Disputes (ICSID) as the primary legal arbitration platform. A massive increase in the number of disputes brought to ICSID in the past decade, along with its relative transparency with respect to dispute content, compared to other forms of arbitration, have led to another function the Centre came to provide; signaling international investment community the type of behavior a host government has conducted with respect to its treatment of foreign investors. The majority of disputes brought to ICSID are cases opened by investors due to alleged poor behavior of host governments. The negative effect of, signals of poor behavior, on the future levels of FDI have been studied by Allee and Peinhardt (2011). This study focuses on the effects of such signals as they are translated into loss of reputation that in turn, affect the bargaining power of host governments.

The central claim of this study is that the reputation costs incurred from previous involvement with ICSID arbitration will increase the likelihood of settlement in cases the host government will face in the future periods. Previous signals of poor behavior will weaken the bargaining power the host government has over the current dispute. This is due to the fact that already having a less than desirable reputation will create an incentive for the host government to settle the dispute as quickly as possible. Previous literature does not offer much on the reputation generating effect of international dispute arbitration. This is due to several reasons. First, even though it was formed in 1966, ICSID has emerged as the main platform of investment dispute resolution only recently in the past decade. Second, mechanisms of international arbitration, and various international institutions that were commonly used before ICSID, such as International Court of Arbitration or International Chamber of Commerce were not transparent with respect to their proceedings and thus, not enough information was available (Mattli, 2001). Third, domestic courts were the initial platform for disputes concerning a foreign investor and a host state, as the investments were considered to be made under the laws and regulation of the host country. Only when host states started to face international agreements, upheld in international organizations like ICSID more frequently that, behavior and consequently reputation, started to become public knowledge across international investment community. Therefore, this study fills an important gap in the literature, with its focus on the effect of this emerging dispute resolution mechanism on host state behavior. A formal model is presented to conceptualize the effect of reputation on host government behavior. In contrast to their opposing parties, the foreign investor corporations, for host governments being involved in a dispute not only implies legal monetary costs, but also implies additional reputation costs. This additional burden decreases the amount they are willing to settle for, increasing the likelihood of outcome for cases involving a host government with high values of potential reputation loss.

The implications of the model are tested using the data gathered on 222 concluded cases of corporation versus host state arbitration. The results suggest that greater amount of previous involvement in ICSID arbitration increases the likelihood of settlement significantly. This result holds under different specifications of the model.

## **CHAPTER 2**

### **THEORETICAL MOTIVATION**

#### **2.1. Literature Review**

The literature on WTO dispute settlement has various topics of interest one of which is the role and content of developing nations' involvement. Although some argue that it offers an egalitarian platform of dispute resolution, that lets developing nations to voice their stance, other argue that these suggestions are hardly correct (Busch, Reinhardt 2003). The relative power of developed and developing nations in international settings have been of interest to many ( Bown, and Hoekman, 2005, Büttler and Hauser, 2000, Bush and Reindhart, 2003), and this study aims to highlight another dimension in which developing nations tend to fail to execute their power in the context of an international setting.

The expansion of economic openness across developing countries has been a prominent economic movement during the past few decades. However, the political economy of disputes between investor corporations and host governments, that arise out of such movements, has not been investigated as much because its institutionalization evolved greatly only in the recent past. ICSID became the single most important institution concerning such dispute; since its first case in 1974, of the total 372 cases brought to ICSID, 303 of them were cases filed since 2000. Political economy concerning ICSID and the behavior of host countries are areas of research that can offer new insights into the power structures of world politics from the perspective of developing states.

One such paper is by Allee and Peinhardt (2010) where they estimate the choice of appointing legal delegation to ICSID, by including a clause in BIT, as a dependent variable explained by home and host government preferences. They run an ordered probit model of ICSID delegation (ICSID may not be included in the BIT, may be

included as one of the preferred options for dispute settlement, or may be included as the only legal delegation of dispute). The results suggest that when the home country has significantly higher bargaining power against the host state, then the host state is pressured into ICSID delegation even though it is against its best interest (full delegation to ICSID implies domestic courts are not an option for dispute resolution as they were before). Another study by the authors, published in 2011, investigates the effect of BITs on FDI. Several studies have focused on the effects of BITs on FDI and the results suggest that BITs increase both investment protection and the level of investment (Neumayer and Spess, 2005, Salacuse and Sullivan, 2005). However, Allee and Peinhardt (2011) argue that the increased effect on FDI due to signing of BITs is contingent upon full compliance of BIT rules. When the host governments do not comply fully with the bilateral agreement and the dispute goes to ICSID, host governments incur reputation costs that decrease the flow of FDI. Cross-sectional time-series analysis reveals that governments whose behavior is challenged by legal disputes brought to ICSID experience reduced FDI flows, because of the reputation loss that affect current and future investors.

While Allee and Peinhardt (2011) emphasize the role of ICSID in generating reputation, and ultimately, affecting FDI flows, my study focuses on the role of ICSID in generating reputation that consequently affect the bargaining power of host governments. That is, reputation generated by involvement in ICSID cases not only affects host governments with respect to future economic income, but also affects them in terms of their political power as international actors when concerned with disputes against foreign investors.

In the next section, I provide a simple formal model that highlights the effect of reputation on host government behavior. Game theoretical analysis of reputation costs have been mainly studied with respect to audience costs. When leaders make public commitments and fail to fulfill them, it affects their reputation, and credibility with respect to their future actions when it comes to international conflict (Leventoğlu & Tarar 2008, 2009). Audience cost literature has been extensive, the concept applied to various circumstances of international conflict such as crisis bargaining (Schultz 2001), economic sanctions (Hovi, Huseby & Sprinz 2005), economic coercion (Krustev, 2010) and domestic electoral competition as a commitment device for international crisis (Ramsay 2004). These studies offer models of state versus state bargaining where potentially both sides can incur additional costs by being involved in a dispute. This

study focuses on investor versus state bargaining in which only one side has potential losses of reputation. In essence, reputation costs host governments incur during international disputes are audience costs with respect to international investment community. If the government in a dispute is not cleared of the alleged accusations by the end of arbitration, it suffers costs that affect its future stance within the international community. Fearon (1994) offers a simple crisis bargaining model with audience costs, where incomplete information leads to war, and Rauchhaus (2006) presents a version of Fearon's model without audience costs but with third party mediation. To emphasize the effect of reputation, the next section introduces a formal model that is an extension of Rauchhaus (2006) without third party mediation, but with only one actor vulnerable to reputation costs. The goal of this study is to extend the literature on the reputation effects generated by ICSID arbitration that are borne by host governments, by first offering a formal model of bargaining and second by testing the implications of the model using available case load of investor-state dispute settlement.

## **2.2. Formal Model**

To analyze why reputation costs affect the likelihood of settlement in an investor-state dispute, I first present a simple game theoretical model of bargaining in which a dis-satisfied party requests a certain amount of compensation. The conceptualization emphasizes that when only the satisfied party is faced with additional costs of reputation, the equilibrium becomes tilted in favor of the dissatisfied party's preferences, which in turn affect the likelihood of outcome such that in order to avoid additional costs, settlement becomes a more likely outcome.

### **2.2.1. An Investor-State Bargaining Game**

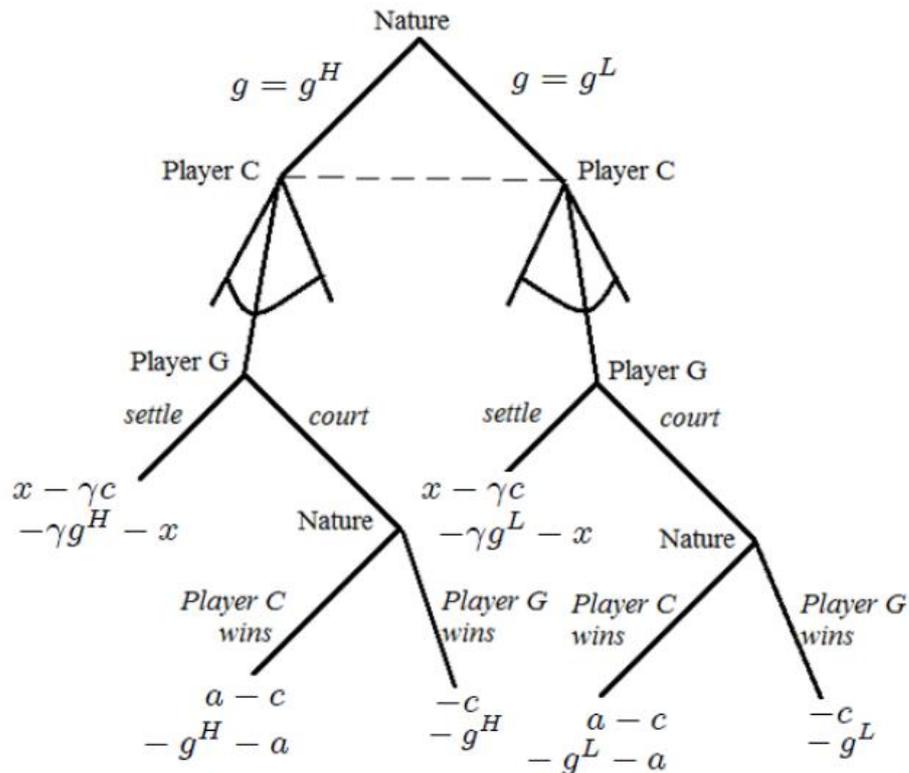
This bargaining game represents investor-state disputes over foreign direct investment, when the investor corporation brings its case to ICSID claiming a violation of a certain contract that adheres to the progression of the investment, and requesting a certain amount of compensation. The relevant notation adhering to the formal model can be found in Table 2.1.

Table 2.1 Formal Model Notation

Variable	Value	Description
$x$		Player C's negotiated settlement offer
$a$		Amount awarded to Player C at court
$r$		Player G's reputation cost
$p$	$\in(0,1)$	Player C's chance of winning at court
$1-p$	$\in(0,1)$	Player G's chance of winning at court
$c$		Player C's costs for legal proceedings
$g_H$		High resolve Player G's costs for legal proceedings
$g_L$		Low resolve Player G's costs for legal proceedings
$q$	$\in(0,1)$	Probability that Player G has high resolve
$1-q$	$\in(0,1)$	Probability that Player G has low resolve
$\gamma$	$\in(0,1)$	Players legal cost coefficient for settlement
$\lambda$	$\in(0,1)$	Player G's reputation cost coefficient for settlement
$\alpha$	$\in(0,1)$	Player G's reputation cost coefficient for winning at court

I offer a simple bargaining game between two players: Player C (Investor) and Player G (State). The strategy sets for each player are  $S_C = x \in (0,1)$ ,  $S_G = \{settle, court\}$  and the type space for Player G is  $T_G = \{g_H, g_L\}$ . In the face of international legal disputes, there exists uncertainty about the state's resolve, that is, its willingness to go along with legal action and suffer from legal costs. The outline of the model can be seen in Figure 2.1.

Figure 2.1 An investor-state bargaining game without reputation costs



I assume that The Nature moves first and chooses Player G's type: with probability  $q$  the type is "high resolve"  $g_H$  and with probability  $(1-q)$  the type is low resolve  $g_L$ , where  $g_H < g_L$ . The corporation moves second, at period  $t=1$ , and demands an amount  $x$  in compensation for the damages he claims to have suffered from. This demand is an out-of court settlement amount that the corporation makes after legal proceedings have been initiated. One can think of it as a take-it-or-leave-it offer that the corporation makes before the case goes to court to be fully investigated. If the state accepts to pay the demand and settle, the game ends and the legal proceedings are terminated, with the amount  $x$  exchanged between players, and legal costs incurred thus far, paid  $(\gamma c)$  for the corporation and  $(\gamma g_H)$  or,  $(\gamma g_L)$  for the state. I assume that because the legal proceedings are discontinued, the legal costs are realized only as a fraction  $\gamma \in (0,1)$  of the full amount that would have been realized if the case went to court.

If the state refuses to pay the amount demanded, then at period  $t=2$ , players go to court and the case is investigated. The probability that the corporation wins at court is  $p$  and the probability that state wins is  $(1-p)$ . If the corporation wins, the court decides on an amount  $a$ , that is to be paid by the state for the compensation of damages. If the state wins, then it means that the corporation's claims were not accepted and thus, the corporation receives nothing. In both cases players pay their respective costs for the proceedings that are fully realized,  $c$  for the corporation and  $g_H$ ,  $g_L$  for the state.

### 2.2.1.1. Equilibria Under Complete Information

The equilibrium is determined by backward induction. The expected utilities from going to court, for both players are:

$$EU_C(\text{court}) = p(a - c) + (1 - p)(-c) = pa - c$$

$$EU_G(\text{court}) = p(-a - g_H) + (1 - p)(-g_H) = -pa - g_H \text{ high resolve}$$

$$EU_G(\text{court}) = p(-a - g_L) + (1 - p)(-g_L) = -pa - g_L \text{ low resolve}$$

The state accepts to pay the amount demanded  $x$  if the utility from settlement exceeds its utility from going to court:

$$-x - \gamma g_H \geq -pa - g_H \text{ high resolve}$$

$$-x - \gamma g_L \geq -pa - g_L \text{ low resolve}$$

The optimal amount of  $x$  that the corporation demands will be the value that equates the state's return from settlement and going to court:

$$x_H^* = pa + (1 - \gamma) g_H \text{ high resolve}$$

$$x_L^* = pa + (1 - \gamma) g_L \text{ low resolve}$$

The corporation is strictly better off by demanding  $x_i^*$  and settling instead of demanding a higher amount and going to court as:

$$pa + (1 - \gamma)g_i - \gamma c > pa - c \quad \forall i$$

Thus, under complete information equilibrium the corporation demands the exact amount that would make the state indifferent between going to court and settlement. The unique complete information sub-game perfect Nash equilibrium is  $(x_i^*; \text{settle}) \forall i$ .

### 2.2.1.2. Equilibria Under Incomplete Information

Suppose now that the corporation is uncertain about state's resolve type. The corporation's probability of facing a high resolve type is equal to  $q$  and a low resolve type is equal to  $(1-q)$ . High resolve type implies  $g_H < g_L$  and therefore,  $x_H < x_L$  (states that consider the legal costs to be highly burdensome are less resolve as they need to pay a higher level of  $g$ ). That is, for  $x \leq x_H$  high resolve will accept the demand and settle, and for  $x \leq x_L$  low resolve will accept the demand and settle. For the interval  $x_H < x < x_L$  the low resolve will settle and the high resolve will choose to go to court. Thus, the corporation will choose to demand the small amount  $x_H$  as long as its return is greater than taking a risk and demand the large amount  $x_L$ :

$$EU_C(x_H) \geq EU_C(x_L)$$

$$x_H \geq q(pa - c) + (1 - q)x_L$$

$$pa + (1 - \gamma)g_H \geq q(pa - c) + (1 - q)(pa + (1 - \gamma)g_L)$$

$$pa + (1 - \gamma)g_H \geq qpa - qc + pa + (1 - \gamma)g_L - qpa - q(1 - \gamma)g_L$$

$$(1 - \gamma)(g_H - g_L) \geq -qc - q(1 - \gamma)g_L$$

$$-(1 - \gamma)(g_L - g_H) \geq q(-c - (1 - \gamma)g_L)$$

$$q^* \equiv \frac{-(1 - \gamma)(g_L - g_H)}{(-c - (1 - \gamma)g_L)}$$

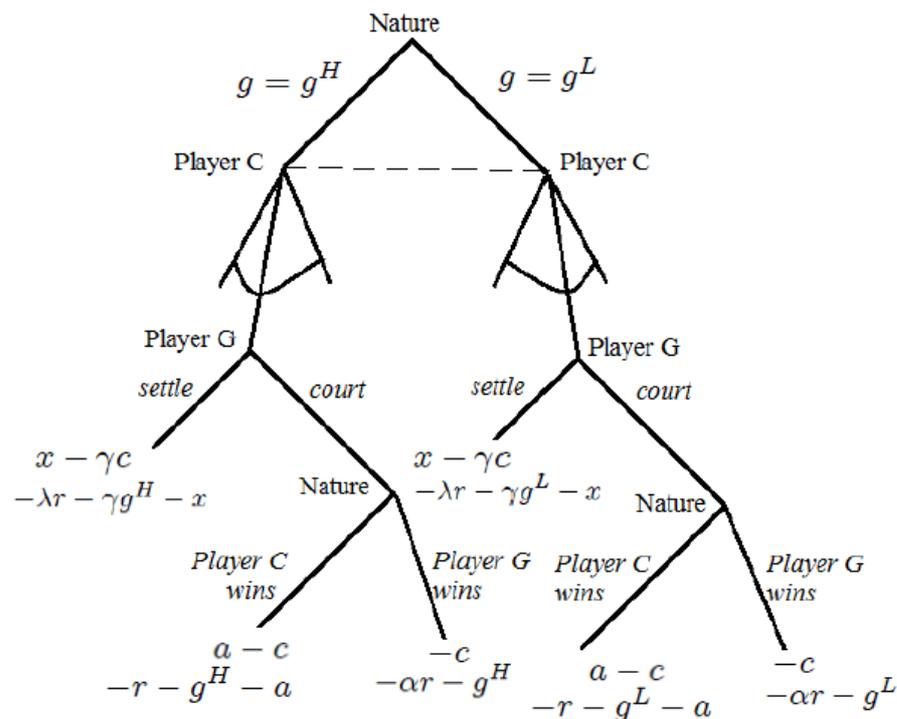
The critical value for the probability that the state has high resolve  $q^*$  determines the equilibria. For  $q^* > q$ , the corporation takes the risk and demands the

high amount  $x_L$ . The subgame perfect Nash equilibrium is  $(x_L^*; \text{court})$  for  $i = H$  and  $(x_L^*; \text{settle})$  for  $i = L$ . This equilibrium has the same risk-return trade off mechanism offered initially in Fearon (1996) where war becomes an optimal outcome under incomplete information as the dissatisfied state takes a chance under uncertainty. This is due to the fact that the dissatisfied state considers the chance of facing a high resolve type to be low. For  $q^* < q$ , the corporation avoids the risk and demands the small amount  $x_H^*$  and both players are better off with settlement. The subgame perfect Nash equilibrium is  $(x_H^*; \text{settle})$ .

### 2.2.2. An Investor-State Bargaining Game with Reputation Costs

I now assume that in addition to the legal costs, the state incurs reputation costs because of its involvement in an international dispute. Reputation costs increase as the legal proceedings continue but is realized in the smallest amount when the game ends with a court decision that is in favor of the state, such that  $\alpha r < \lambda r < r$ . It is important to note that, even if a state wins the case, the filing of a case against it brought on to ICSID itself affects a state's reputation as it still signals an unfavorable environment to the foreign investor. The outline of the model can be seen in Figure 2.2.

Figure 2.2 An investor-state bargaining game with reputation costs



### 2.2.2.1. Equilibria Under Complete Information

The equilibrium is solved through backward induction and the optimal amount of  $x$  that equates the state's return from settlement and going to court becomes:

$$\begin{aligned}x_H^{R*} &= (p + \alpha - p\alpha - \lambda)r + ap + (1 - \gamma)g_H \\x_L^{R*} &= (p + \alpha - p\alpha - \lambda)r + ap + (1 - \gamma)g_L\end{aligned}$$

The amount  $(p + \alpha - p\alpha - \lambda)r$  is the additional reputation factor that is increasing in  $p$  and  $\alpha$  and decreasing in  $\lambda$ . If the probability of losing is high ( $p \uparrow$ ), then the state is willing to pay a greater amount for settlement. Additionally, if the reputation cost incurred after a court win is high ( $\alpha \uparrow$ ) then, for greater values of  $x$ , the state becomes more inclined to settle than going to court. However, if the reputation costs already incurred is high ( $\lambda \uparrow$ ) then the state prefers to go to court rather than settling for higher values of  $x$ .

If the reputation factor is positive then Nash equilibrium is  $(x_i^{R*}, \text{settle}) \forall i$ . The corporation demands the exact amount that would make state indifferent between settling and going to court, that makes him strictly better off than demanding any other value of  $x$ . Compared to the model without reputation costs, the state is willing to settle for higher values of compensation. If the reputation factor is negative then  $(x_i^{R*}, \text{settle}) \forall i$  is still a Nash equilibrium if and only if  $(1 - \gamma)(g_i + c) \geq (\lambda p\alpha - p - \alpha)r$ . This condition insures that the corporation is still strictly better off with a settlement. If the reputation factor is large enough such that  $(1 - \gamma)(g_i + c) < (\lambda p\alpha - p - \alpha)r$  the corporation is better off by going to court as the equilibrium settlement amount it can demand becomes too low. Thus, in this case there is infinitely many Nash equilibria where the corporation demands a low enough value that both parties choose to go to court  $(x \in (0, x_i^{R*}), \text{court})$ .

### 2.2.2.2. Equilibria Under Incomplete Information

Under uncertainty, the corporation will avoid the risk and demand a small amount  $x_H$  if:

$$\begin{aligned}x_H^{R*} &\geq q(pa - c) + (1 - q)x_L^{R*} \\(p + \alpha - p\alpha - \lambda)r + (1 - \gamma)g_H + ap \\&\geq q(ap - c) + (1 - q)[(p + \alpha - p\alpha - \lambda)r + (1 - \gamma)g_L + ap]\end{aligned}$$

$$q^{R*} \equiv \frac{-(1-\gamma)(g_L - g_H)}{(-c - (1-\gamma)g_L - (p + \alpha - p\alpha - \lambda)r)}$$

For  $q^{R*} > q$ , the corporation takes the risk and demands the high amount  $x_L^{R*}$ . The subgame perfect Nash equilibrium is  $(x_L^{R*}; \text{court})$  for  $i = H$  and  $(x_L^{R*}; \text{settle})$  for  $i = L$ . For  $q^{R*} < q$ , the corporation avoids the risk and demands the small amount  $x_H^{R*}$  and both players are better off with settlement. The subgame perfect Nash equilibrium is  $(x_H^{R*}; \text{settle})$ . If  $(p + \alpha - p\alpha - \lambda)r > 0$  then  $q^{R*} < q^*$  suggesting that the corporation is less willing to take a risk and demand a high amount (and face court decision if the state is high resolve) as the tendency of the state to settle has increased.

### 2.3. Hypothesis

The equilibria of the formal model are summarized in Table 2.2.

Table 2.2 Equilibria of the Bargaining Game

	Without Reputation $r$	Condition	With Reputation $r$	Condition
Complete Information	$(x_i^*, \text{settle}) \forall i$		$(x_i^{R*}, \text{settle}) \forall i$	$\bar{r} \geq r$
			$(x \in (0, x_i^{R*}), \text{court})$	$\bar{r} < r$
Incomplete Information	$(x_H^*, \text{settle}) \forall i$	$q^* < q$	$(x_H^{R*}, \text{settle}) \forall i$	$q^{R*} < q$
	$(x_L^*, \text{court}) i = L$	$q^* > q$	$(x_L^{R*}, \text{court}) i = L$	$q^{R*} > q$
	$(x_H^*, \text{settle}) i = H$		$(x_H^{R*}, \text{settle}) i = H$	

Suppose there is complete information such that the corporation is aware of how resolute the host government can be when it comes to legal proceedings. That is, the state's willingness to go along with legal actions, and the ability to pay legal fees, is known by the corporation. The existence of reputation costs incurred during the duration of the dispute adds additional burden to the state and the equilibrium settlement amount increases such that  $x_i^* < x_i^{R*}$ . The state becomes more willing to settle for higher demands of compensation to avoid prolonging the dispute. For cases where too much negative information concerning the host government's behavior has already been public, the government may choose to settle or go to court depending on the level of exposure to foreign investors. The threshold level for reputation becomes:

$$\bar{r} = \frac{(1-\gamma)(g_i + c)}{(\lambda + p\alpha - p - \alpha)} \geq r$$

If there is uncertainty over the type of government such that there is incomplete information from corporation's point of view, in cases where the probability of facing a high resolve government is low, the corporation might take a risk and demand the high amount. Otherwise, the corporation asks for the low amount and both types of government choose to settle. The critical value for this probability is lower when there are reputation costs. The corporations are willing to take less risk by demanding the high amount. Thus, the lower limit of  $q$  for settlement decreases, which should imply an increase in the likelihood of observing a settlement. Similar to the outcomes under complete information, for cases when the reputation has already been harmed extensively, the effect is the opposite. The negative effect of the reputation already lost, increases the critical level for  $q$ , making the corporation take more chances as compared to the model without reputation costs, the state becomes more willing to go to court rather than settlement.

In short, the existence of potential reputation loss increases threshold demand level for settlement as ( $x_i^{R*} > x_i^*$ ) and furthermore, it positively affects the corporate preferences over settlement as ( $q^{R*} < q^*$ ). Consequently, in the context of ICSID dispute settlement mechanism, for cases concerning governments who face higher levels of reputation costs (higher values of  $r$ ) the likelihood of reaching a settlement out of court increases:

*Hypothesis:* Governments that pay higher reputation costs will be more likely to settle in the context of ICSID international investor-state dispute settlement.

## **CHAPTER 3**

### **DATA AND METHODOLOGY**

#### **3.1. The Data**

My main goal is to underline the effect of reputation on the likelihood of settlement, for cases concerning foreign investor-host state dispute. Thus, this research can be observed as an extension to Allee and Peinhardt (2011) where the emphasis is on the role of international institutions, and specifically ICSID, in generating state reputations. The previous involvement in a dispute creates a certain reputation which in turn affects the likelihood of settlement in cases brought on in later periods.

The data is comprised of concluded ICSID cases. The total number of concluded cases is 242, however, certain cases are excluded as they are beyond my model's application. A summary of cases is presented in Table 3.1. My focus is on cases where a foreign corporation files a dispute against a host government that faces potential losses of reputation by signaling an inhospitable business environment. Thus, I exclude cases of corporation versus corporation, and state versus a corporation. Additionally, I exclude conciliatory cases because by nature they are not as binding and formal as arbitration cases. The conciliators, as opposed to arbitrators, do not have the power to call in witnesses or evidence, and at the final order of the dispute do not issue a legal decision or an award. It should be noted that ICSID does not itself conciliate or arbitrate disputes but instead offers facilities for conciliation or arbitration. The international arbitrators and conciliators that are part of the decision making process, for instance, do not work for ICSID but are appointed independently for each case. From the 232 cases available I further exclude 7 cases because their host government state is a high income country (There are 3 cases against United States, and one against each of the rest: Spain, Germany, New Zealand and Iceland.) The reason for my exclusion is that for these states, being part of an ICSID dispute should not significantly affect their reputation in the eyes of foreign investors. Well established institutions with extensive property rights

Table 3.1 Summary of ICSID Concluded Cases

	<i>Type</i>	<i>Outcome</i>	<i>Rule</i>	<i>Frequency</i>
Corp v. Corp	Arbitration			2
		Award		2
		Settlement		0
		Discontinuance		0
State v. Corp	Arbitration			2
		Award		1
		Settlement		1
		Discontinuance		0
Corp v. State	Conciliatory			6
		Report		3
		Settlement		3
		Discontinuance		0
	Arbitration			232
		Award		139
		Settlement		60
		Discontinuance		33
			Rule # 44	13
			Rule # 43(1)	11
			Rule # 14(3)	8
			Rule # 49(1)	1
Total				242

protection are essential features of developed, high income states, and thus, involvement in international disputes should not significantly change their attractiveness for foreign investment. I do not include two cases against Guinea as in the year during the initiation of the cases there was a coup d'etat that brought forth lack of a government for two years. The last case I exclude is case no. ARB(AF)/04/2 Cargill, Incorporated v. Republic of Poland as the case itself has been moved to United Nations Commission on International Trade Law (UNCITRAL) for a decision due to jurisdiction, and no legal conclusion has been reached under ICSID rules.

A summary of respondent countries along with the number of cases against them can be seen in table 3.2.

Table 3.2 Summary of Respondent Countries			
<i>Country</i>	<i>Cases</i>	<i>Country</i>	<i>Cases</i>
Albania	3	Liberia	2
Algeria	2	Lithuania	1
Argentine	25	Macedonia	1
Armenia	1	Malaysia	3
Azerbaijan	3	Mali	1
Bangladesh	3	Mexico	13
Bolivia	2	Mongolia	1
Bosnia Herzegovina	1	Morocco	1
Burkina Faso	1	Nicaragua	1
Burundi	2	Nigeria	2
Cameroon	2	Pakistan	5
Central African Republic	1	Panama	1
Chile	2	Papua New Guinea	1
Democratic Republic of Congo	8	Paraguay	1
Republic of Congo	4	Peru	4
Costa Rica	5	Phillipines	2
Cote d'Ivoire	2	Romania	4
Czech Republic	1	Rwanda	1
Ecuador	10	Saudi Arabia	1
Egypt	10	Senegal	1
El Salvador	1	Serbia	1
Estonia	3	Seychelles	1
Gabon	1	Slovak Republic	2
Gambia	1	Slovenia	1
Georgia	5	South Africa	1
Ghana	2	Sri Lanka	2
Grenada	3	St.Kitts & Nevis	1
Guyana	1	Tanzania	1
Honduras	2	Togo	1
Hungary	4	Trinidad & Tobago	1
Indonesia	2	Tunisia	1
Jamaica	3	Turkey	5
Jordan	5	Ukraine	8
Kazakhstan	5	United Arab Emirates	1
Kenya	1	Uzbekistan	1
Korea	1	Venezuela	7
Kyrgyz Republic	1	Yemen	2
Lebanon	1	Zimbabwe	1

### 3.2. Operationalization of Regression Variables

The two estimation methods used are conducted using the same set of independent variables but defer in the specification of the dependent variable.

#### 3.2.1. Dependent Variables

The main hypothesis emphasizes the potential increases in the likelihood of settlement, when the respondent governments are prone to face high reputation costs. In order to measure the likelihood of settlement, I have generated two variables. I do so because the outcome of an ICSID proceeding can take three forms: settlement, award or discontinuance. Table 3.3 gives a summary of the outcomes according to their type.

Table 3.3 Summary of Cases by Outcome

<i>Outcome</i>	<i>Frequency</i>	<i>Percentage</i>
Award	132	59.46 %
In favor of State	42	
In favor of Investor	53	
Lack of Jurisdiction	28	
Not Public	9	
Settlement	58	26.13 %
Discontinuance	32	14.41 %
Rule #44	13	
Rule #43(1)	11	
Rule #14(3)	8	
Total	222	100 %

Even though ICSID regulations offer many clauses suggesting possible reasons for discontinuance, all cases with the exception of one are discontinued on the grounds of three ICSID rules. Rule 44 is titled “Discontinuance at Request of a Party”, and states that if a party requests the discontinuance of the proceeding, and the other party given notice of this request does not object to it within a fix time limit, then the Tribunal or Secretary-General takes an official notice of the discontinuance of the case. A very similar regulation is Rule 43 clause (1), “Settlement and Discontinuance”, which state that if, before an award has been rendered, the parties agree on a settlement or decide to discontinue the proceeding for other reasons, then the Tribunal or the Secretary - General issues an official note of discontinuance. Rule 14, clause (3), is part of the financial regulations, as opposed to administrative regulations that Rules 44 and 43 are

a part of, and states in short that ICSID has the right to discontinue the proceedings if payments regarding the case are not paid in due time.

Although the rules themselves suggest a potential existence of settlement reached by the parties, one cannot know for sure the outcome for these cases. Thus, my first dependent variable is a binary variable coded 0 if there is an award, and coded 1 if there's a settlement, and does not take into account cases that are discontinued. The second dependent variable takes into account the cases of discontinuance, and is an ordered variable coded 0 if there is a settlement, 1 if there is discontinuance and finally, 2 if there is an award. Discontinuance is taken as an outcome categorized in between a settlement and an award because of two reasons. First, the reasons for discontinuance need not imply a settlement. The discontinuance may be due to a change of heart on the side of the corporation or it could be that the government has privately defended its case against the accusations and the corporation decides that there is not a substantial enough case worth its time and expenses. Second, the average duration of cases that result in discontinuance is greater than the average duration of cases with settlement, but less than that of cases with an award. Thus, the outcome is coded such that the case duration is sorted in ascending order, in essence ranking the outcomes in terms of willingness to settle.

### **3.2.2. Independent Variables**

My primary variable of interest is the reputation cost, " $r$ ", and it is operationalized as an indicator that measures the number of ICSID cases concluded or pending against a country at any given time. During an ICSID dispute, as mentioned earlier, the host government incurs a loss of reputation in the eyes of the international investment community for three reasons. First, the filing of the case itself signals government's allegedly poor behavior and its reluctance in reaching an agreement. Second, the greater the duration of the case indicates shows a government being in a dispute for a longer period of time. Third, the published procedural orders and the award contain information on the specifics of each case, and government's alleged wrong doings. Therefore, for host governments who have been previously exposed through ICSID cases, potential losses of reputation should be higher as it suggests continuation of alleged poor behavior. Therefore, the an increase in the number of cases filed against a government before period  $t$ , increases the likelihood of settlement for a

case filed at period  $t$ , due to greater levels of potential loss of reputation  $r$ . Similar to Allee and Peinhardt (2011) three variables considering the varying lengths of time are used in estimation: the number of ICSID disputes filed against the government in the past 2 years ICSID(2), in the past 5 years ICSID(5), and the number of all cases filed since 1966 ICSID(All). settle.

### **3.2.3. Control Variables**

The likelihood of settlement or the type of outcome whether it be a discontinuance or an award, depends additionally on variables that affect the bargaining power of the host government. In order to address this issue, I include variables that are commonly used in foreign direct investment literature. The intuition is that the more vulnerable a host government is in terms of FDI dependence, the less bargaining leverage it will have against the investor. The dependence is measured by indicators of both economic and political factors.

The first of the economic indicators is the Market Size that affects the FDI inflows, positively. Campos and Kinoshita (2008), Li and Resnick (2003) and Neumayer and Spess (2005), find market size to be significantly and positively correlated with FDI inflows. A larger market indicates ample opportunities for future investment, greater FDI inflows, and therefore, greater bargaining power. Greater market size is expected to be negatively correlated with the likelihood of settlement as it implies greater bargaining power. Corporation's home country GDP is included in the model as a measure of its bargaining power. Allee and Peinhardt (2010) use aggregate measures of GDP in to capture the relative economic power of the home and host countries. Greater home GDP is expected to increase the likelihood of settlement.

Another important economic indicator of bargaining power is the level of Economic Development captured by GDP per capita. Campos and Kinoshita (2008), Li and Resnick (2003) and Neumayer and Spess (2005), again, find economic development to be significant factor affecting FDI inflows. Higher levels of economic development is expected to be negatively correlated with the likelihood of settlement because higher developed countries are able to attract greater FDI compared to less developed countries because of differences in essential preconditions for potential investments such as infrastructure, human or capital endowment (Li and Resnick, 2003).

A direct measure of FDI Dependence used in the estimation, is the amount of inward FDI flows as percentage of gross domestic product. The values of FDI should be positively correlated with the likelihood of settlement as economy's greater dependence on FDI decreases its bargaining power, as the government has more to lose through poor signals of an international dispute.

Another indicator that measures the international dependence of the host economy is Trade Dependence measured as exports of goods and services as a percentage of GDP. The results of Campos and Kinoshita (2008), and Jensen (2003) suggest greater levels of trade to be positively correlated with higher levels of FDI inflows. Greater dependence on exports is expected to be positively correlated with the likelihood of settlement as an international dispute sends poor signals of business dealings with foreign companies.

One of the important attractions of FDI, is the level of natural resources a host country possesses. Campos and Kinoshita (2003), Jensen (2003) and Neumayer and Spess (2005) all find this variable to be positively correlated with FDI. The variable Natural Resources measured as total natural resources rents as a percentage of GDP is included in the estimation to isolate this effect. Having abundant natural resources increases host government bargaining power as it makes the country attractive to many potential investors. Thus, the level of natural resource is expected to be negatively correlated with the likelihood of settlement.

The last control variable pertaining to economic factors that might affect the bargaining power of a host government is the level of net inward FDI in the world, for that year. The World FDI variable controls for the available amount of FDI for all the host countries. Allee and Peinhardt(2011), and Li and Resnick (2003) find available world FDI level to be a significant determinant of FDI inflows. An increase in the available FDI should decrease the likelihood of settlement suggesting a negative correlation.

Political factors affect a host governments attractiveness within the international investment community. Foreign investors expect host governments to honor their agreements and hope to avoid situations of unlawful acts. Thus, the bargaining power a host government has against a corporation is related to how much that state is considered politically risky. To estimate the effect of political risk on the likelihood of settlement, I employ several different indicators from the PRS Group's International Country Risk Guide (ICRG) that measure various components of risk perceived by

foreign investors. ICRG data has been used in estimations of FDI determination, extensively. Alle and Peinhardt (2010, 2011), Campos and Kinoshita (2003, 2008), Jensen (2003), Li and Resnick (2003), and Neumayer and Spess (2005) use ICRG data in order to measure political risk. Rule of Law and Bureaucracy Quality are used in every estimation, meanwhile Alle and Peinhardt (2011) aggregate four of the seven components below under one variable of *property rights protection* (the components are corruption, rule of law, bureaucracy quality and investment profile). In every study except for Jensen (2003) less political risk is significantly correlated with greater flows of FDI.

For every component, a lower score indicates higher risk therefore I expect every component to be negatively associated with the likelihood of settlement. Greater political risk, lower the score, a host government should be more likely to settle as it has less bargaining power.

Internal Conflict ranges from 0 to 12 and is composed of three subcomponents each worth 4 points: the existence of civil war/coup threat, terrorism/political violence and civil disorder. The variable is an assessment of political violence and its impact on political governance. External Conflict ranges from 0 to 12 with the following components: the existence of war, cross-border conflict, and foreign pressures. It measures the the risk to the incumbent government from violent and non-violent external pressures. Government Stability ranges from 0 to 12 including subcomponents of government unity, legislative strength, and popular support that measure the government ability to stay in power and carry out its programs. Investment Profile ranges from 0 to 12 and includes contract viability/expropriation, profits repatriation and payment delays as a measure of risk to investment not covered by economic or political factors. Bureaucracy Quality ranges from 0 to 4 and is indicator that measures the extent to which the administrative functions and policy formulations are affected by changes in government. Rule of Law ranges from 0 to 6 with two subcomponents of law and order, where law measures the strength and impartiality of the legal system and order measures the recognition of law. Corruption ranges from 0 to 6 and takes into account actual or potential corruption that includes instances such as patronage, nepotism and close ties between politics and business world.

In addition to economic and political factors that affect the bargaining process, the model includes economic sector variables. The categories are oil, gas and mining, electricity or other energy sources, services and trade, construction, water sanitation

systems or other, which includes sectors such as agriculture and tourism. These economic sectors are determined by how ICSID codes them in their analysis with respect to subject matter for each case. For cases in relation to oil, gas and mining and electricity and other power, the expected relation is positive as these investments require longer duration and higher amounts of capital, decreasing host governments bargaining power, making them more likely to settle. If there is a greater income at stake, the governments should be less willing to be observed as contentious.

In order to deal with skewed distributions, in the estimation logged values of GDP, GDP per capita and World FDI measures are used. Data on all economic variables except FDI dependence is from World Development Indicators. Data on FDI dependence is from United Nations Conference on Trade and Development (UNCTAD). All values are for the year the case has been registered. Summary statistics of all variables is presented in Table 3.4 and 3.5.

Table 3.4 Summary Statistics

<i>Variable</i>	<i>Observation</i>	<i>Mean</i>	<i>Std</i>	<i>Min</i>	<i>Max</i>
GDP, host	222	1.09e+11	1.70e+11	2.31e+08	8.49e+11
GDP, home	222	4.30e+12	4.80e+12	1.33e+10	1.46e+13
GDP per capita, host	222	3824.217	4297.171	86.7646	33740.84
FDI/GDP, host	222	3.81894	4.862215	-14.36902	45.50694
Exports/GDP, host	222	35.97748	19.22556	6.855818	121.3114
Natural Resources, host	222	12.00126	15.22485	0	92.63554
World FDI net	222	1.07e+12	6.46e+11	1.26e+10	2.35e+12
ICSID (2)	222	2.445946	5.735044	0	35
ICSID (5)	222	3.198198	6.40393	0	34
ICSID (All)	222	4.18018	7.74503	0	47
Internal Conflict	189	8.833774	1.902556	.4166667	12
External Conflict	189	9.863095	1.440207	4	12
Bureaucracy Quality	189	1.999118	.8943214	0	4
Rule of Law	189	3.189594	1.107739	.75	6
Government Stability	189	8.252706	1.717458	2.083333	11
Investment Profile	189	7.248457	2.368741	1	12
Corruption	189	2.228836	.7645918	0	5

Table 3.5 Summary Statistics, Economic Sector

<i>Variable</i>	<i>Observation</i>	<i>Percentage</i>
Oil, Gas & Mining	51	22.97 %
Electric Power & Other Energy	26	11.71 %
Services & Trade	31	13.96 %
Construction	42	18.91 %
Water, Sanitation & Flood Protection	15	6.75 %
Other	57	25.67 %
Total	222	100 %

### 3.3. Methodology

The data for each case is gathered based on the date of registration. The reputation effect, economic, and political factors of period  $t$  are the independent variables that affect the likelihood of investment at period  $t+1$  such that:

$$\ln(\text{Outcome}_{i,t+1}) = \alpha_i + \beta * ICSID_{i,t} + \gamma * ECON_{i,t} + \delta * POL_{i,t} + \theta * SECTOR_{i,t} + \varepsilon_{i,t}$$

where  $ECON$  is a vector of 8 variables of economic factors,  $POL$  is a vector of 7 variables of political factors and  $SECTOR$  includes dichotomous variables of economic sector that case  $i$  belongs to.

## CHAPTER 4

### RESULTS

The empirical model is estimated using two estimation methods, logit and ordered logit regressions were conducted, respectively.

#### 4.1. Logit Estimation Results

The results for the logit estimation are presented at Table 4.1. The binary dependent variable is coded 0 if there is an award and 1 if there is a settlement. The first column gives the results for the model without reputation costs. *World FDI* available is negatively correlated with the likelihood of settlement which was expected. The level of available investment in international economy decreases the bargaining power of recipient countries which in turn make them more likely to settle. Internal Conflict is significant, but interestingly, the coefficient sign is positive indicating that having less risky domestic environment increases the likelihood of settlement. The initial expectation was host countries with greater risk and turmoil, should have less bargaining leverage, as they are risky investment environments to begin with, and therefore be more likely to settle. This result suggests that perhaps government who are in turmoil due to domestic violence, have more important issues to deal with and that they are less willing to work on a settlement over an international dispute with a corporation.

*External Conflict* is significant and has the expected sign, countries with greater international, cross-border turmoil are more likely to settle, as having already a poor reputation decreases their bargaining power, and may initiate host governments to end the dispute as soon as possible. *Electric Power and Energy* is significant as well, suggesting that if the dispute is over a case concerning an investment that has to do with power generation in the host country, then the likelihood of settlement increases.

Table 4.1 The effects of reputation on the likelihood of settlement

	4.1	4.2	4.3	4.4
ICSID (past 2 years)		.088 **(.045)		
ICSID (past 5 years)			.069 *(.037)	
ICSID (all)				.055 * (.032)
GDP host, log	-.293 (.195)	-.371 * (.199)	-.385 *(.202)	-.384 * (.203)
GDP home, log	.057 (.126)	.065 (.125)	.063 (.124)	.065 (.124)
GDP capita host, log	-.037 (.395)	-.043 (.373)	-.023 (.396)	-.022 (.389)
FDI Dependence	.027 (.057)	.022 (.054)	.018 (.053)	.018 (.055)
Trade Dependence	-.002 (.011)	.004 (.011)	.004 (.012)	.003 (.012)
Natural Resources	.017 (.016)	.012 (.016)	.012 (.016)	.012 (.016)
World FDI Net, log	-.595 * (.335)	-.725 ** (.351)	-.737 ** (.354)	-.734 ** (.357)
Internal Conflict	.332 ** (.159)	.221 (.154)	.228 (.157)	.240 (.157)
External Conflict	-.329 * (.188)	-.287 * (.184)	-.292 * (.185)	-.295 * (.186)
Government Stability	.213 (.161)	.200 (.169)	.195 (.155)	.209 (.168)
Investment Profile	-.090 (.104)	-.015 (.121)	-.011 (.122)	-.027 (.116)
Bureaucracy Quality	.433 (.322)	.176 (.338)	.187 (.340)	.216 (.341)
Rule of Law	-.298 (.236)	-.139 (.246)	-.153 (.245)	-.170 (.244)
Corruption	.207 (.309)	.120 (.297)	.117 (.299)	.138 (.302)
Oil, Gas & Mining	.851 (.671)	.907 (.716)	.905 (.711)	.899 (.701)
Electric Power & Energy	1.119* (.631)	1.164* (.676)	1.190 * (.669)	1.197 * (.662)
Services & Trade	.746 (.685)	1.016 (.695)	1.010 (.698)	.965 (.695)
Construction	.625 (.683)	.805 (.683)	.837 (.691)	.801 (.688)
Water, Sanitation & Flood Protection	.336 (.849)	.486 (.829)	.527 (.838)	.514 (.838)
Constant	19.73** (8.94)	24.47*** (9.42)	25.12*** (9.58)	24.92*** (9.72)
<i>N</i>	163	163	163	163
<i>Pseudo R squared</i>	0.1331	0.1544	0.1517	0.1478

Notes: Robust standard errors in parenthesis, \*\*\* $p < .01$ ; \*\* $p < .05$ ; \* $p < .10$ .

Column 4.2 reports the results for the model with reputation costs operationalized as the number of ICSID cases filed against the host country, in the last two years. Compared to the other specifications of the reputation cost *ICSID(2)* is observed to be the most significant suggesting the negative impact of reputation loss is more immediate and loses its effect over the years. Even though the reputation effect is lessened over the years, it is still significant as *ICSID(5)* and *ICSID(All)* are both significant. Additionally, *World FDI* is significant at 5% level throughout different model specifications.

Host country GDP is significant and the coefficient has the expected negative sign. Greater market size leads to greater bargaining power and less likelihood of settlement. Another interpretation would be that GDP itself is picking up the effect of resolve type of the host government in that, greater GDP may imply greater government budget and consequently greater ability to go along with legal actions as legal costs as perceived less burdensome compared to poorer governments which may find the continuous legal spending unsustainable.

#### **4.2. Ordered Logit Estimation Results**

The ordered logit estimation results are presented at Table 4.2. The dependent variable is coded 0 if there is settlement, coded 1 if there is discontinuance and 2 if there is an award. Thus, the sign of the coefficients are expected to be the reverse of the previous model as governments with greater risk and less bargaining power are more likely to prefer outcomes that end the dispute as soon as possible.

All reputation cost variables are again significant indicating that greater loss of reputation, greater values of  $r$  increase the likelihood of settlement. *World FDI* and host government GDP are again significant throughout different specifications of the model with a positive coefficient as expected. Governments with greater market size and greater resources are more willing battle for longer international dispute. The results are similar to that of the previous section as other economic factors remains insignificant such as *FDI* and *Trade Dependence* or the level of *Natural Resource*.

However, political risk variables turn out not to be significant in this specification of the model. Instead the economic sector that a case belongs to gains importance and as expected, for investments that are relatively more long-term that need

Table 4.2 The effects of reputation on outcome

	5.1	5.2	5.3	5.4
ICSID (past 2 years)		-.064 ** (.029)		
ICSID(past 5 years)			-.056 * (.030)	
ICSID(all)				-.039 * (.022)
GDP host, log	.303 * (.170)	.373 ** (.175)	.375 ** (.176)	.380 ** (.179)
GDP home, log	-.024 (.107)	-.012 (.105)	-.010 (.105)	-.016 (.106)
GDP capita host, log	-.172 (.265)	-.251 (.280)	-.239 (.278)	-.257 (.285)
FDI Dependence	-.019 (.027)	-.016 (.027)	-.018 (.027)	-.014 (.027)
Trade Dependence	.002 (.010)	-.002 (.010)	-.002 (.010)	-.002 (.010)
Natural Resources	-.015 (.014)	-.011 (.014)	-.011 (.014)	-.010 (.014)
World FDI Net, log	.383 (.265)	.510 * (.288)	.475 * (.283)	.511 * (.294)
Internal Conflict	-.265** (.135)	-.162 (.138)	-.180 (.138)	-.178 (.141)
External Conflict	.288 * (.162)	.235 (.163)	.253 (.162)	.243 (.164)
Government Stability	-.113 (.120)	-.124 (.124)	-.107 (.122)	-.126 (.124)
Investment Profile	.148 * (.082)	.103 (.087)	.105 (.087)	.114 (.086)
Bureacracy Quality	-.321 (.261)	-.080 (.293)	-.121 (.286)	-.132 (.292)
Rule of Law	.175 (.201)	.036 (.209)	.048 (.209)	.055 (.210)
Corruption	-.134 (.257)	-.045 (.248)	-.047 (.252)	-.054 (.252)
Oil, Gas & Mining	-1.015** (.506)	-1.111** (.522)	-1.110 ** (.525)	-1.091 **(.521)
Electric Power & Other Energy	-0.996 * (.583)	-1.041* (.603)	-1.057 * (.602)	-1.061 * (.596)
Services & Trade	-.723 (.602)	-.909 (.605)	-.911 (.608)	-.870 (.606)
Construction	-.766 (.491)	-.805* (.486)	-.953 * (.501)	-.807 * (.483)
Water, Sanitation & Flood Protection	-.485 (.674)	-.528 (.671)	-.569 (.670)	-.566 (.666)
<i>N</i>	191	191	191	191
<i>Pseudo R squared</i>	0.0790	0.0907	0.0885	0.0863

Notes: Robust standard errors in parenthesis, \*\*\* $p < .01$ ; \*\* $p < .05$ ; \* $p < .10$

greater capital, the likelihood of settlement increases. For such investments, host governments can be more willing to settle as the potential loss of investment in those areas in the future, let alone for that period are higher than other types of foreign direct investment.

### 4.3. Analysis

The logit model results indicate that for each increase in ICSID disputes filed in the past two years, the likelihood of settlement is expected to increase on average by 9.09%, ( $\exp(0.087) - 1 = 1.0909 - 1 = 0.0909$ ), for disputes filed in the past five years, the likelihood of settlement is expected to increase on average by 7.03%, ( $\exp(0.068) - 1 = 1.0703 - 1 = 0.0703$ ) and for disputes filed since 1974, the likelihood of settlement is expected to increase on average by 5.65% ( $\exp(0.055) - 1 = 1.0565 - 1 = 0.0565$ ), while all other variables in the respective models are held constant.

Additionally, with respect to GDP host, log, for each unit increase in log(GDP) of the host country, the likelihood of settlement is expected to decrease on average by 30.65% while the other variables in Model 2 are held constant. This value is 31.61% in Model 3, and 31.55% in Model 4. (Model 2:  $1 - \exp(-0.366) = 1 - 0.6935 = 0.3065$ , Model 3:  $1 - \exp(-0.380) = 1 - 0.6839 = 0.3161$ , Model 4:  $1 - \exp(-0.379) = 1 - 0.6845 = 0.3155$ ).

Another significant factor affecting the likelihood of settlement is World FDI Net Inflows such that for each unit increase in log (World FDI Net Inflows), the likelihood of settlement is expected to decrease on average by 43.17%, while the other variables in Model 1 are held constant. This value is 50.24% in Model 2, 50.79% in Model 3, and 50.64% in Model 4. (Model 1:  $1 - \exp(-0.565) = 1 - 0.5683 = 0.4317$ , Model 2:  $1 - \exp(-0.698) = 1 - 0.4976 = 0.5024$ , Model 3:  $1 - \exp(-0.709) = 1 - 0.4921 = 0.5079$ , Model 4:  $1 - \exp(-0.706) = 1 - 0.4936 = 0.5064$ .)

Among political factors, for each unit increase in external conflict (an increase in the riskiness with respect to external politics), the likelihood of settlement is expected to increase on average by 28.68%, while the other variables in Model 1 are held constant. This value is 25.62% in Model 2, 26.07% in Model 3, and 26.29% in Model 4. (Model 1:  $1 - \exp(-0.338) = 1 - 0.7132 = 0.2868$ , Model 2:  $1 - \exp(-0.296) = 1 - 0.7438 = 0.2562$ , Model 3:  $1 - \exp(-0.302) = 1 - 0.7393 = 0.2607$ , Model 4:  $1 - \exp(-0.305) = 1$

- 0.7371 = 0.2629.) With respect to economic sector, cases concerned investments in electric power & energy are 210% more likely to have settlements than countries without electric power & energy, while the other variables in Model 1 are held constant. This value is 228% in Model 2, 238% in Model 3, and 241% in Model 4. (Model 1:  $\exp(1.133) - 1 = 3.10 - 1 = 2.10$ , Model 2:  $\exp(1.188) - 1 = 3.28 - 1 = 2.28$ , Model 3:  $\exp(1.218) - 1 = 3.38 - 1 = 2.38$ , Model 4:  $\exp(1.226) - 1 = 3.41 - 1 = 2.41$ .)

Ordered logit estimation results suggest the following predictions. For each increase in ICSID disputes filed in the past two years, the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) is expected to decrease on average by 0.0629, while the other variables in the model are held constant. This value is 0.055 for ICSID(5) and 0.038 for ICSID(all).

For each unit increase in  $\log(\text{GDP})$  of the host country, the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) is expected to increase on average by 0.301 while the other variables in Model 1 are held constant. In Model 2, this value is 0.368, in Model 3 0.370, and in Model 4 0.374. With respect to World FDI Net Inflows, for each unit increase in  $\log(\text{World FDI Net Inflows})$ , the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) is expected to increase on average by 0.485 while the other variables in Model 2 are held constant. In Model 3, this value is 0.450, and in Model 4 0.485.

The political factor External Conflict results in greater odds of settlement as for each unit increase in external conflict, the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) is expected to increase on average by 0.298 while the other variables in Model 1 are held constant. In Model 2, this value is 0.245, in Model 3 0.264, and in Model 4 0.254.

In terms of economic sector to which the investment belongs to if the case is under Oil, Gas and Mining category the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) for countries with oil, gas and mining is expected to be 0.994 lower than for countries without oil, gas and mining, when all variables in Model 1 are held constant. This value is 1.093 in Model 2, 1.094 in Model 3, and 1.075 in Model 4. If the case is under the category Electric Power & Energy, the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) for countries with electric power and energy is expected to be 1.038 lower than for countries without

electric power and energy, when all variables in Model 1 are held constant. This value is 1.085 in Model 2, 1.107 in Model 3, and 1.108 in Model 4. Finally, if the case is under Construction, the ordered log-odds of being in a higher settlement category (discontinuance vs. settlement or award vs. discontinuance) for countries with construction is expected to be 0.939 lower than for countries without construction, when all variables in Model 3 are held constant. This value is 0.795 in Model 4.

## **CHAPTER 5**

### **CONCLUSION**

Developing nations have become important economic and political actors in world politics as economic integration redefined bilateral and multilateral relations across the world. This thesis emphasizes, similar to several works on WTO dispute settlement, that international organizations under certain circumstances fail to acknowledge the relative stance developing nations hold with respect to the developed world. It adds to the literature on the politics of dispute settlement by highlighting the effect of economic interdependence on the outcome of ICSID arbitration.

This research pinpoints an important new way the common application of ICSID arbitration affects host government behavior. Inclusion of a clause that designates ICSID as the primary platform of dispute settlement in BITs, were not initially preferred by host governments as it negatively affects their sovereignty over investment made within the country. The fact that ICSID is able to generate negative reputation for host government, adds another dimension to the loss of power by these states. Previous involvement in international disputes affects host government behavior such that in order to avoid sending further signals of poor behavior, the governments become willing to settle the dispute as soon as possible. Thus, for ICSID cases involving states that have a potential to pay high levels of reputation costs, the likelihood of settlement increases.

The estimation results suggest a positive correlation between the number of cases filed against the host government previously, and the likelihood of settlement for the current case. Three different measure are used to operationalize potential levels of reputation loss: the number of ICSID cases filed against within the past two years, the number of ICSID cases filed against within the past five years and the number of ICSID cases filed against since 1974. Although every specification of reputation is significant,

the results suggest that more recent filing have a greater impact. Specifically, an one unit increase in the number of disputes filed against a country within the past two years, increases the likelihood of settlement by 9%., and decreases the likelihood of an award by 6%.

In addition to reputation costs, the estimation results indicate that the GDP of the host country, the total level of available net FDI in the world and the economic sector that the case belongs to are significant factors that affect the likelihood of settlement for an ICSID case.

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