ULUSLARARASI İLİŞKİLER

ISSN: 1304-7310 (Print) 1304-7175 (Online) http://www.uidergisi.com.tr

The Role of Democratic Governance and Indirect Expropriation in International Investment Treaty Violations

David CARLSON

Asst. Prof., Koç University, Department of International Relations

Jeffrey ZIEGLER

Asst. Prof., Trinity College Dublin, Department of Political Science

To cite this article: David Carlson and Jeffrey Ziegler, "The Role of Democratic Governance and Indirect Expropriation in International Investment Treaty Violations", *Uluslararasi Iliskiler*, Vol. 18, No. 72, 2021, pp. 37-49, DOI: 10.33458/uidergisi.1011808

To link to this article: https://dx.doi.org/10.33458/uidergisi.1011808

Submitted: 23 June 2020
Last Revision: 05 October 2021
Published Online: 18 October 2021
Printed Version: 20 December 2021

Uluslararası İlişkiler Konseyi Derneği | International Relations Council of Turkey
Uluslararası İlişkiler – Journal of International Relations
E-mail: bilgi@uidergisi.com.tr

The Role of Democratic Governance and Indirect Expropriation in International Investment Treaty Violations

David CARLSON
Asst. Prof., Koç University, Department of International Relations, Istanbul
E-mail: dcarlson@ku.edu.tr
Orcid: 0000-0002-9736-5369

Jeffrey ZIEGLER
Asst. Prof., Trinity College Dublin, Department of Political Science, Dublin
E-mail: zieglerj@tcd.ie
Orcid: 0000-0003-3905-7488

ABSTRACT

Democracies are thought to violate treaties less frequently than non-democracies, yet democracies violate bilateral investment treaties (BITs) just as often as non-democracies. Though democratic governments may intend to meet their international obligations, and though democratic institutions provide greater political constraints to encourage compliance, investment agreements may conflict with the goal of maintaining domestic public support. Specifically, we argue that credible elections create strong incentives for governments to side with domestic voters, and to pass legislation that violates investment agreements. The results suggest that the ability of voters to sanction leaders is an important mechanism that incentivizes governments to pass legislation that potentially violates investment treaties through indirect expropriation.

Keywords: Investment Treaties, Electoral Accountability, Indirect Expropriation, Political Economy

Uluslararası Yatırım Antlaşmalarının İhlalinde Demokratik Yönetişim ve Dolaylı Kamulaştırmanın Rolü

ÖZET

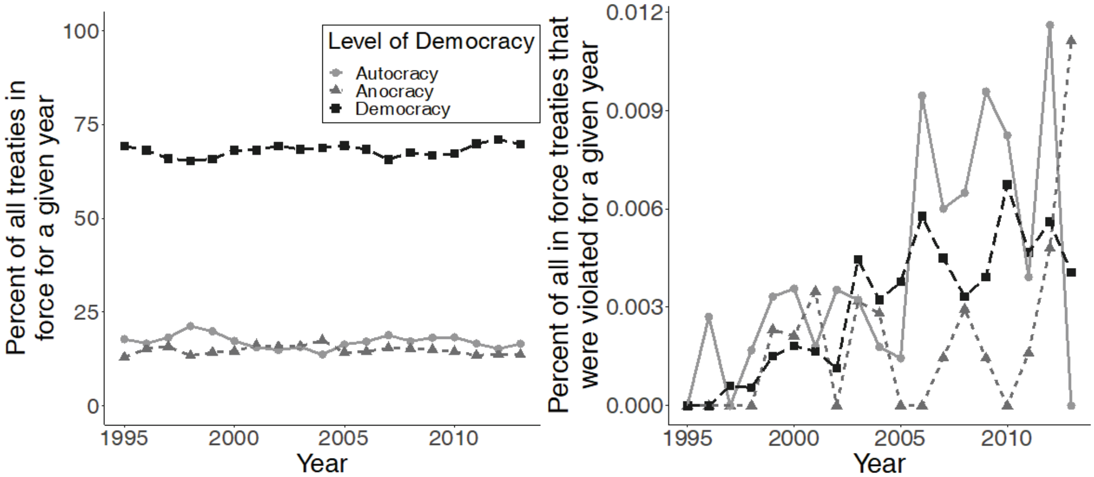
Demokratik rejimlerin, yaptıkları anlaşmaları demokratik olmayan rejimlerden daha nadir olarak ihlal ettikleri varsayılır; fakat demokratik rejimler, iki taraflı yatırım anlaşmalarını demokratik olmayan rejimler kadar sık ihlal eder. Demokratik hükümetler uluslararası yükümlülüklerini yerine getirme niyetinde olsa ve demokratik kurumlar bu yükümlülüklere riayeti destekleyen daha fazla siyasi kısıtlama sağlasa da yatırım anlaşmaları, yurtiçinde kamuoyu desteğini devam ettirme hedefleriyle çatışabilir. Bu çalışmada, meşru seçimlerin, hükümetleri yurtiçindeki seçmenlerin yanında durmaya ve yatırım anlaşmalarını ihlal eden yasalar geçirmeye teşvik ettiğini savunmaktayız. Araştırmamızın sonuçları gösteriyor ki seçmenlerin yöneticiler üzerinde yaptırım gücüne sahip olması, hükümetleri yatırım anlaşmalarını dolaylı kamulaştırma yoluyla ihlal edebilecek yasalar geçirmeye yönlendiren önemli bir teşvik mekanizması yaratıyor.

Anahtar Kelimeler: Yatırım Anlaşmaları, Siyasi Hesap Verebilirlik, Dolaylı Kamulaştırma, Politik Ekonomi

Introduction

Democracies are viewed as favorable treaty partners, and there is a fairly accepted consensus that democracies violate international investment treaties less than non-democracies.[1] Democracies should limit expropriation risk of foreign investments by constraining executive power and reducing investment uncertainty.[2] This expectation is partially confirmed empirically; we see in the left panel of Figure 1 that democracies are more likely to sign international investment treaties, such as bilateral investment treaties (BITs). The right panel of Figure 1, however, demonstrates that democracies are just as likely to be a defendant in investor-state arbitration. Why do democracies sign more investment agreements if they are just as likely as non-democracies to violate those agreements?

Figure 1: Signatures and violations of bilateral investments treaty (BIT) as a proportion of all BITs in force by regime type from 1995 to 2013.



Notes: The bilateral investment treaty data comes from the Investor-State Law Guide, which records public filings regarding bilateral investment treaty arbitration, for instance, with the International Centre for Settlement of Investment Dispute (ICSID).

We suggest that this paradox is driven by the various motivations that states have to protect investors, encourage future investment, discourage capital flight, but most importantly maintain domestic political support. For example, the Spanish company Técnicas Medioambientales Tecmed, S.A. owned a site for the containment and treatment of hazardous waste near the Mexican town of Hermosillo. This investment was protected under the Mexico-Spain BIT. The facility caused massive public uproar in 1997, and the public organized sit-ins to prevent trucks carrying the hazardous waste

1 Kurt Taylor Gaubatz, "Democratic States and Commitment in International Relations", *International Organization,* Vol. 50, No 1, 1996, p. 109–139; Stephanie J. Rickard, "Democratic Differences: Electoral Institutions and Compliance with GATT/WTO Agreements", *European Journal of International Relations,* Vol. 16, No 4, 2010, p. 711–729.

2 Nathan Jensen, "Political Risk, Democratic Institutions, and Foreign Direct Investment", *Journal of Politics,* Vol. 70, No 4, 2008, p. 1040–1052; Stephen Weymouth, "Political Institutions and Property Rights: Veto Players and Foreign Exchange Commitments In 127 Countries", *Comparative Political Studies,* Vol. 44, No 2, 2011, p. 211–240.

from entering the facility.[3] Local opponents challenged the site's technical viability, the lack of public participation in decisions regarding the facility, and the facility's proximity to the town. Because of the public controversy, the Mexican government refused to reissue the license for the site in November 1998, and Tecmed formally claimed that this was equivalent to expropriation and in breach of the Mexico-Spain BIT. Tecmed filed suit in the summer of 2000, and after a draining arbitration, the Spanish investor was awarded $5 million on May 2003.[4] Public pressure to act in favor of local domestic interests, at the peak of Mexico's democratic transition, impacted the Mexican government's decision to violate the international investment treaty.

Because citizens can credibly hold government leaders accountable through democratic elections, we argue there is a systematic difference in the propensity of democracies and non-democracies to pass legislation that potentially breaches investment treaties. We suggest that democracies are more likely to violate investment treaties, purposefully or not, because democratic elections pressure politicians to represent the broad interests of citizens. Therefore, we hypothesize that democratic governments will appear more likely to violate investment treaties as their time in office increases because they are more likely to pass legislation that may infringe on investment agreements.

We test our theory using data from the Investor-State Law Guide to measure perceived bilateral investment treaty violations. These public filings provide a better measure of potential treaty violations than other measures to date, including international arbitration, because they capture perceived violations that never make it to court, as well as violations that are disputed in *ad hoc* tribunals.[5] We show that democracies, on average, are more likely than non-democracies to be perceived as BIT violators. In particular, we derive an explicit functional form that demonstrates that the empirical relationship is strictly driven by the delayed effect of legislation that governments pass that cumulatively increases the risk of violating investment treaties. Importantly, our findings are robust to arbitration cases that are 1) eventually filed in court and 2) filed in venues other than ICSID, such as the International Chamber of Commerce (ICC) and Stockholm Chamber of Commerce (SCC) from the Investor-State Dispute Settlement (ISDS) database.[6]

The theoretical and empirical implications of this article qualify the widely held belief that democracies are less likely to violate international obligations that they have accepted, primarily due to their defining characteristics: broad governance and credible elections. We purposefully do not, however, advocate for regime type as a primary explanation of investment treaty violations. We argue, instead, that the credibility of elections and delayed implications of policies that appeal to a broader base are important sub-components of democracy that are worth studying. We hope our theory and empirical evidence spur future work that can more precisely test the relationship between the cycle of credible elections and indirect expropriation of foreign investment.

3 Krista Nadakavukaren Schefer, *International Investment Law: Text, Cases and Materials*, Cheltenham, Edward Elgar Publishing, 2020.

4 Luke Eric Peterson, "Mexico's Treatment of Hazardous Waste Site Violates Mexico-Spain BIT", *Investment Law and Policy News Bulletin,* 1 June 2003.

5 For instance, some studies use cases that are only officially filed, not publicly threatened, by a foreign investor. See Rachel L. Wellhausen, "Recent Trends in Investor–State Dispute Settlement", *Journal of International Dispute Settlement,* Vol. 7, No 1, 2016, p. 117–135; Krzysztof J. Pelc, "What Explains the Low Success Rate of Investor-State Disputes?", *International Organization,* Vol. 71, No 3, 2017, p. 559–583.

6 Wellhausen, "Recent Trends".

Incentives for Democracies to Sign and Violate BITs

Signing a BIT is often interpreted as a signal to the international investment community. It is largely assumed that states are in competition to attract foreign investment, so BITs offer an opportunity for states to increase their credibility by protecting international investors from the potential policies of the state in which these investments are made through dispute settlement mechanism (DSMs).[7] Though there is mixed evidence that these treaties *actually* promote FDI, there is stronger evidence that states sign them with the *intent* to promote international investment.[8] Many investment treaties may not actually lead to foreign investment in certain industries, so governments may not have consequential opportunities to expropriate.[9]

BITs may, therefore, be thought of as a bargain between political actors and business interests. Both parties know that harmful policy to business interests may need to be passed in the future. Acknowledging this, governments are not necessarily tying their hands *per se*; they are agreeing to pay damages to business interests if such policies are passed. And democratic governments are likely aware of their potential to pass legislation in the future that violates trade agreements because democracies push for more carve outs in treaty obligations.[10]

It seems intuitive as to why a democracy would have the incentive to sign a BIT. Across regime types, generally, there is a strong need to attract foreign investment many reasons. The investment benefits the host economy, overall, and does so through direct investment in the country, providing employment opportunities, increasing product availability and decreasing consumer cost, etc. Maybe the most important interests these treaties benefit, however, are the elite business interests. Economic elites, in general overlapping prominently with the political elite, have a strong desire to secure their assets and attract FDI. Both are accomplished with the signing of a BIT, because these companies that are protected by the treaties are often a conglomerate of stake holders. Therefore, governments have multiple incentives to sign. BIT participation may increase FDI through the commitment to either abide or pay damages, benefitting the economy and the government directly, may appease elite interests benefitting the government in the short-term, and arguably is beneficial to the general population through increased employment opportunities, increased consumption ability, and more.

That said, even though BITs are beneficial in the short-term, there is often eventually a backlash from the citizenry. As the Mexico example above illustrates, this backlash could be due to environmental or regulatory concerns. The backlash may also be due to economic nationalism and pro-

7 Powerful signatories to ICSID typically obtain preferrable outcomes in BIT negotiations in comparison to litigation through poor domestic institutions in host countries. In Todd Allee and Clint Peinhardt, "Delegating Differences: Bilateral Investment Treaties and Bargaining Over Dispute Resolution Provisions", *International Studies Quarterly,* Vol. 54 No 1, 2010, p. 1–26. Therefore, effectiveness of the litigation replacement is often believed to be a good approximation for compliance. In Beth Simmons, "Treaty Compliance and Violation", *Annual Review of Political Science,* Vol. 13, 2010, p. 273–296.

8 Yackee finds little to no evidence that stricter bilateral trade agreements lead to greater amounts of foreign investment. In Jason Webb Yackee, "Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?", *Law & Society Review,* Vol. 42, No 4, 2008, p. 805–832.

9 Thus, we include trade flows as a percent of GDP in the empirical analysis. In Andrew Kerner and Jane Lawrence, "What's the Risk? Bilateral Investment Treaties, Political Risk and Fixed Capital Accumulation", *British Journal of Political Science,* Vol. 44, No 1, 2014, p. 107–121.

10 Daniel J. Blake, "Thinking Ahead: Government Time Horizons and The Legalization of International Investment Agreements", *International Organization,* Vol. 67, No 4, 2013, p. 797–827.

tectionist views, anti-globalization as an attempt to secure jobs and avoid outsourcing, or other ideological concerns. These concerns are much more likely once a treaty has been passed. Most citizens do not even know what a BIT is, let alone with which countries their home country has signed, the stipulations of the agreements, the damages that need to be paid when in violation, or what constitutes a violation. It is generally once the treaty is in force, and the ramifications are realized, that the general population may take issue with the obligations. This is unlikely to vary based on regime type conditional on confounders. However, a democracy is much more likely to appease the interests of the public, and this likelihood ought to increase as the threat of credible elections near, and/or the longer the government or individual politicians are in power.[11]

The notion that democracies have greater incentives to violate BITs stands in contrast to the common assumption that democracies are inherent treaty-compliers due to greater political constraints.[12] We agree that an important reason for why democracies have traditionally been thought of as treaty compliers is that as the number of "veto players" increases, the propensity of a government to directly seize assets that violate an investment treaty should theoretically decrease. Democratic governments, however, can still violate investment agreements in different ways. For instance, Graham and Kingsley show domestic political constraints reduce the likelihood of direct expropriation, but these political restraints do not impact governments' propensity to engage in transfer restrictions of investment agreements, which are often a sub-component of BITs.[13]

In fact, the vast majority of disputes in contemporary investment litigation do not arise from the direct seizure of assets or establishment of discriminatory taxation, rather from indirect expropriations.[14] Since expropriation causes the government to incur a cost, violations are most often the result of policy concessions. Indirect expropriation occurs when a state passes policy or regulation that harms the earning potential of a firm or industry. The most common instances of indirect expropriation involve environmental regulation, public health regulation, and public policy concessions.[15]

We acknowledge and expect that democracies are far more likely to have the regulatory regimes that produce policies in these areas and to produce the types of policies that lead to disputes, even if they do not necessarily view their regulatory actions as "violations." Given that indirect expropriations are largely unintentional, we contend violations are a function of the heterogeneity and types

11 As an aside, because economic nationalism may be growing, awareness of economic ties is increasing, anti-globalization may be on the rise as protectionist values triumph over open markets, particularly as the global economy is experiencing a downturn, these pressures to violate BITs in democracies may be an increasing concern.

12 Jensen, "Political Risk"; Nathan Jensen et al., *Politics and Foreign Direct Investment*, Ann Arbor, University of Michigan Press, 2012.

13 Benjamin A.T. Graham et al., "Even Constrained Governments Take: The Domestic Politics of Transfer and Expropriation Risks", *Journal of Conflict Resolution,* Vol. 62, No 8, 2018, p. 1784–1813.

14 Investment disputes in the 19th and early 20th century were the result of direct seizure of private assets by autocratic governments and/or insurgents. By the mid-20th century, expropriation was primarily caused by the nationalization of assets after colonial liberation. Modern investment disputes now center around regulatory regimes and foreign firms. In Pelc, "What Explains the Low Success"; Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment*, Cambridge, Cambridge University Press, 2017.

15 Though, there is some debate in international law regarding when and which regulatory policies constitute expropriation. In David Gaukrodger and Kathryn Gordon, "Investor-State Dispute Settlement: A Scoping Paper for The Investment Policy Community", *OECD Working Papers on International Investment*, No 3, 2012; Andrew Newcombe, "The Boundaries of Regulatory Expropriation In International Law", *ICSID Review,* Vol. 20, No 1, 2005, p. 1–57.

of interests represented in a polity as a whole. Undoubtedly, democratic governments are necessarily representative of more heterogeneous interests because policymakers must be responsive to numerous intersecting, dynamic preferences.[16] Since an investment treaty is inherently rigid and might often be at odds with democratic decision-making,[17] the longer a democratic government is in power and has opportunities to enact its preferred policies, it is reasonable to expect that it is more likely to be a violator.

Our central argument suggests that BITs provide differing incentives, largely due to the occurrence of elections, to pass potentially expropriating regulation. Legislation is not enacted immediately, and the impact of policies is not instantly realized, so democratic governments' propensity to violate investment treaties increases as a function of their electoral term. It may, however, be the case that democracies are not persistent violators, rather democracies are attractive targets of indirect expropriation arbitration. There is a strategic logic to which suits are brought, and suits targeting democracies, though they are much less successful, may attempt to induce regulatory chill rather than to win the actual case.[18] Unfortunately, it is impossible with the available data to distinguish between the motivations of investors to file claims, the validity of those claims, and legitimate violations. Nonetheless, even if democracies are targeted in an attempt to limit future regulation, we argue that arbitration initiation against democracies is unlikely to explain any effect of national legislative and executive elections due to the great uncertainty, costs, and time associated with litigation. Therefore, if a relationship exists between level of democracy and violations, it is improbable that it is due to a latent increase in the incentives to file complaints against democratic governments the longer they stay in power given the uncertainty in arbitration duration.

Our principal expectation is that democracies are more likely to violate an investment treaty than non-democracies precisely because the political pressure within democracies is more likely to be felt when voters are able to hold leaders accountable. Other sources of potential violation, such as wealth extraction, unintentional violations, or elite-motivated policy concessions, are unlikely to differ between regime types. If there is a conflict between the public's preferences and an existing investment agreement, we hypothesize that a democratic government is more likely to violate the treaty to appease the public because political leaders stand for election and this effect is cumulative.

Data and Analytic Strategy

Limiting the bilateral investment treaty filings to one per case from 1990 through 2013 results in 280 unique cases. The final data includes over 75,000 bilateral investment treaty-years among 178 countries, with each treaty-year in the data twice for both potential dyadic violations. For example, the United States and Bolivia signed a bilateral investment treaty in 1998. The United States as a potential violator of this treaty is in the data 15 times, one for each year, and Bolivia as a potential violator 15

16 We do not necessarily believe democratically elected legislators react to domestic citizens that have preferences over FDI regulatory policies, rather citizens care about regulatory policies that frequently involve FDI. In other words, we do not argue that democratic populations know or care about investment policy and support expropriation. Rather, we believe that citizens in democracies have a wider set of preferences that inherently encourages governments to pass legislation that may result in indirect expropriation.

17 David Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise*, Cambridge, Cambridge University Press, 2008.

18 Pelc, "What Explains the Low Success".

times.[19] Finally, the sample of BITs that are included in the analysis only contain the state-pairs that are required to publicly file.[20]

The data includes arbitration proceedings, but also include complaints, intents, and other signals of bilateral investment treaty violations that never make it to court or are argued in front of an *ad hoc* tribunal. This minimizes some of the bias of using arbitration as a proxy for treaty violation, however, not all violations are challenged and not all challenges are violations. We discuss in the next sub-section how we account for these shortcomings in the data, but we argue that measuring potential violations is most appropriate to model trends in indirect expropriation. Our outcome variable, therefore, is whether any perceived violations occurred by a contracting state in any given year. We estimate logistic regression models because the fully specified model would allow the categories to increase without a bound, as the number of violations is potentially infinite, but there are no observations above four.[21]

The first predictor of interest is a potential violator's level of democracy, which we measure using the combined Polity IV score.[22] A testable implication of our theory is that the marginal effect of election timing is smaller, or potentially not distinguishable from zero, for less democratic regimes. As such, we include an interaction between the time until the next national election and a potential violator's level of democracy. We anticipate that the estimated coefficient of a potential violator's level of democracy will be increasingly positive as a government's time in office increases. Since the log odds of the logit are already non-linear, this may be enough to capture the underlying relationship. Nevertheless, we use both a continuous and trichotomous measure of democracy based on the Polity regime type thresholds (*autocracy* [-10 to -6], *anocracy* [-5 to 5], *democracy* [6 to 10]).

To measure election timing, we take advantage of the National Elections Across Democracy and Autocracy (NELDA) data set because the data includes any national executive or legislative election (e.g., parliament, legislature, constituent assembly), regardless of competitiveness, fairness, or legitimacy.[23] If democracies pass legislation that is more likely to violate BITs, the propensity to violate an agreement should increase as government duration and level of democracy increase. We can test this further implication of our theory by examining all national elections, even for non-democratic governments.

We additionally consider other variables that may be causally prior to a potential violator's level of democracy and the likelihood of a treaty violation. These include the log of GDP (purchas-

19 We do not model any dyadic or intra-country dependence because we do not have any strong theoretical justification to estimate fixed-effects (or clustered standard errors) at the country, dyad, or directed-dyad level. Further, given that there are over 60 countries and 400 unique dyads, this strategy reduces the effective number of observations and would likely artificially inflate the standard errors.

20 All replication files and the Appendix are available at https://doi.org/10.7910/DVN/TBKLWV.

21 We acknowledge that the number of BIT violations relative to treaty-year dyads is rare, such that only about 0.33% of potential violations occurred. To specifically address the excess of zeroes in the outcome we also consider rare events logistic and zero-inflated negative binomial logistic regression models in the Appendix. We additionally analyze the outcome as a count, as well as ordered categories in the Appendix by estimating negative binomial logistic and ordered logistic regression models. The models in the manuscript do not differ substantively or statistically from those models estimated in the Appendix.

22 Monty G. Marshall et al., "Polity IV Project: Political Regime Characteristics and Transitions, 1800-2016", *Center for Systemic Peace*, 2017.

23 Susan D. Hyde and Nikolay Marinov, "Which Elections Can Be Lost?", *Political Analysis,* Vol. 20, No 2, 2012, p. 191–210.

ing power parity), the annual change in GDP (PPP), the percentage of GDP accounted for by trade, and the percentage of GDP accounted for by natural resource rents available from the World Bank's World Development Indicators. Further, given that foreign direct investment flows differentially into signatory states by regime type, we include the net inflows of FDI as a percentage of GDP. It may also be the case that it is not the timing of constraints (elections), but the intensity of political institutional constraints that explains the propensity of democracies to violate treaties. As such, we include a commonly employed measure of political institutional constraints from the Political Constraints Index Dataset.[24] This is not an exhaustive set of potential predictors of BIT violations, but we contend that these variables account for theoretically meaningful differences in economic conditions across regime types that might affect violation rates, which provides a better estimate of whether democratic governance has a direct association with the propensity of a state to violate an investment treaty.[25]

Four regression models constitute the main analysis. The first regression utilizes all the relevant theoretical predictors, including a continuous measure for level of democracy, while excluding the time until the next election. The second regression uses the same set of predictors, but the level of democracy is a factor representing whether a government is an autocracy (-10 to -6 on the Polity scale), anocracy (-5 to 5), or democracy (6 to 10). The last two regression models include an interaction between the level of democracy (for each measure) and the time until the next election, as well as all the relevant covariates.

Accounting for Government Duration and Selection into BITs

A central concern of our research design is our ability to accurately measure the timing of potential violations in relation to governmental terms (i.e., elections). As such, we do our best to use the contemporaneous value of all predictors in the primary analysis. It is not possible, however, to disaggregate the temporal nature of the data from the treaty-year to treaty-quarter or treaty-month. Unfortunately, the scarce information and data provided in BIT filings is not only a limitation of our data, but is a constraint irrespective of data source.

The lag structure, therefore, is selected based on the empirical patterns of BIT violations. In most instances, the offense usually occurred at some point in the time range of zero to four years before the filing or publication of documents. We acknowledge that when we observe a complaint, we do not know when the actual violation occurred; we simply observe and measure the complaint, which could be years after the decision to violate was made. Further, we cannot track complaints that are dropped after an election to investigate whether frivolous complaints are filed to damage domestic governments prior to election. Still, if litigants strategically time complaints, we account for this by

24 Witold J. Henisz, "The Political Constraint Index (POLCON) Dataset", 2002. It is likely that the constraints placed on leaders leading up to (by other democratic or judicial institutions) and during elections (due to the fairness of the electoral process and increased competition) are greater in democracies. Yet, this relationship is unlikely to be altered by the marginal effect of government duration or election timing. In other words, although greater political constraints may decrease the ability of a government to violate an investment agreement, the effect of political constraints should not impact the occurrence of democratic elections, nor their effect (if one exists) on the propensity of governments to violate an investment agreement. Therefore, this variable is included as an additive term in our analyses.

25 In analyses not shown, the length of time a treaty has been in place was also included as a control. Outdated treaties are likely a source of potential violation. The estimate was reliable and substantively significant, but did not change the reliability of the Polity estimate and had only very minor impacts on its magnitude. Because the duration of one BIT is unlikely causally prior to levels of democracy, we omit it in the main analysis.

also conducting additional analyses with one, two, and three-year lags. The results in the Appendix support the approach taken in the manuscript and indicate that regime type only impacts a government's propensity to violate as their electoral term comes to an end.

Additionally, there are selection processes that may make democracies more likely to appear as targets of arbitration that may be unrelated to our argument about democracy and elections. Countries are not randomly selected into BITs and the criteria for self-selection into treaties may be associated with regime type. Estimating a model of treaty violation without first estimating an equation of whether a country is a BIT signatory could bias our results. We estimate Heckman selection models, therefore, in the Appendix because one may suspect the processes of deciding to violate an investment treaty and signing a BIT in a given arbitration forum are related.[26] The results, in fact, more strongly suggest that the marginal effect of credible elections is conditional on government shifts and vice versa.

A further limitation of our data is that we largely capture potential violations lodged by ICSID signatories, but not all violations are filed in venues such as ICSID. This is potentially more problematic as states increasingly turn to other courts for arbitration. Yet, approximately 75% of complaints within our data are registered with ICSID, which is comparable to other ISDS sources on arbitration (approximately 65% of arbitration cases in the Wellhausen[27] data set are filed through ICSID). This should alleviate some concerns that our data does not capture disputes that would appear in alternative venues. Nevertheless, we conduct the same analysis using the Wellhausen[28] data set to further estimate the likelihood that an arbitration case is actually filed since the data only represent those arbitrations that were formally registered. We report in the Appendix that our findings are robust to 1) an alternative measurement of the outcome (potential violations versus filed cases), and 2) alternative arbitration regimes, not only ICSID.

We cannot, moreover, know if potential violations are real violations, though we do not assume that complaints by foreign investors are always legitimate. Even if there are many complaints and arbitration cases against democracies, that does not necessarily mean that democracies are breaking their treaty commitments. As such, we estimate in the Appendix whether a violation is successfully litigated with the ISDS data. We find that democracies are less likely to win cases that have been filed against them, suggesting that potential violations are a good indicator of real violations and not merely a measure of firms greater gained understanding of investor-state dispute mechanisms to challenge unwanted policy changes in democracies with cases of declining merit.[29]

Results

The estimated coefficient for level of democracy is positive and statistically reliable across all specifications, including both the continuous and factor operationalizations.[30] Importantly, the level of democracy is positive and reliable in the two models that include an interaction with governmental

26 James J. Heckman, "The Common Structure of Statistical Models of Truncation, Sample Selection and Limited Dependent Variables and A Simple Estimator for Such Models", Sanford V. Berg (ed.), *Annals of Economic and Social Measurement*, Cambridge Massachusetts, National Bureau of Economic Research, 1976, p. 475–492.

27 Wellhausen, "Recent Trends".

28 Ibid.

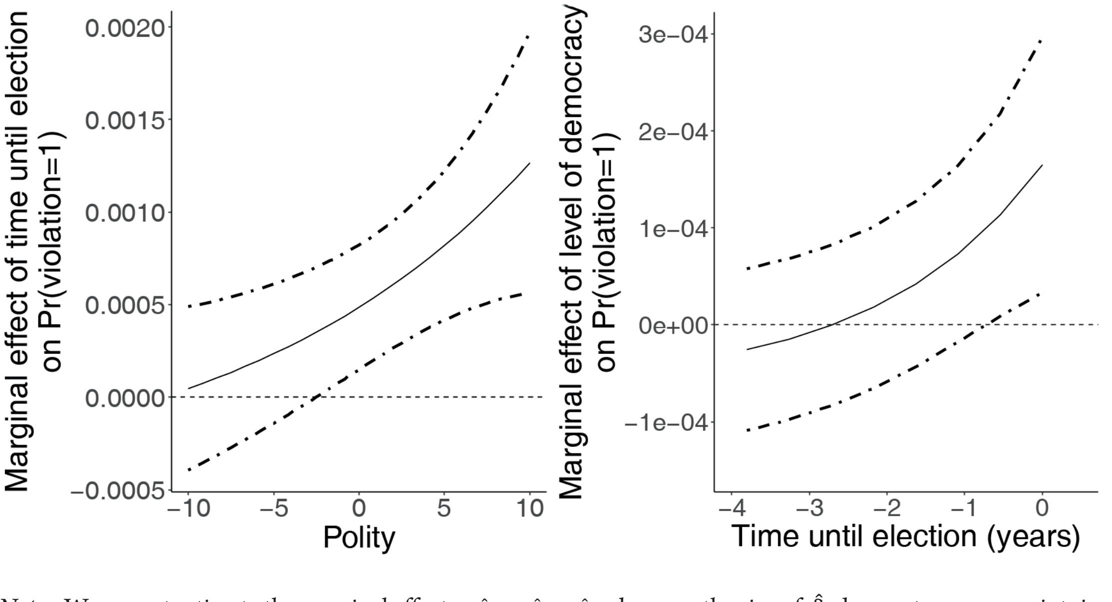
29 Pelc, "What Explains the Low Success".

30 The full estimates and analysis of covariates for the logistic regression models are presented in the Appendix.

terms, which suggests that during an election year (when *time until election* = 0) a government is more likely to have a complaint lodged against it as the level of democracy increases. The exponentiated coefficient estimates, or odds ratios, from the interaction model reveal that one unit increase in the continuous Polity score during an election year is associated with a change in the odds ratio of over 1.05 (2.5% and 97.5% confidence intervals: 1.01, 1.08). This, however, understates the non-linear relationship between the credibility of elections, government shifts, and investment treaty violations.

To demonstrate, Figure 2 highlights the marginal effect of the level of democracy and time until the next election on the predicted probability that a given country violates a treaty. First, we calculate the marginal effect of election timing on the probability of violation while varying the Polity score. For instance, the marginal effect given a shift from the beginning of a typical four year term (newly elected, -4 years away from election) to the midterm (-2 years away from election) results in a 0.001 [0.0008, 0.001]) increased probability of violation. This is a relatively large increase in the likelihood of violating a bilateral treaty considering that the probability a full democracy (*Polity* = 10) has any violations in a given year is 0.00097. The effect increases even more as a typical four year term comes to an end, such that full democracies have a 0.0013 [0.0006, 0.002]) greater probability of violating a treaty in the year leading up to an election (-1 year away to election year). Though the marginal effect appears to be small, the probability that a democracy will violate a treaty during an election year compared to an average year is approximately 1.34 times greater.

Figure 2: Change in the predicted probability of violation given the interaction between the continuous measure of democracy and time until election.



Notes: We cannot estimate the marginal effect as $\hat{\delta}_1 = \hat{\beta}_1 + \hat{\beta}_2 x_2$ because the size of $\hat{\delta}_1$ does not convey any intuitive interpretation of the size of the effect of a given moderating variable. Therefore, we estimate the change in the predicted probability, $\hat{y}$, given a shift in the moderator, while also varying x_2 (plotted along the x-axis). 95% confidence intervals are shown.

We also consider the effect of elections on autocracies (*Polity* = -3), which is the first quartile of the pooled sample. We find no discernible impact on the probability of violating a BIT. The marginal effect on the likelihood of violating a BIT given a shift from the beginning of a four-year term to the year of election is not statistically differentiable from zero (0.001 [-0.00005, 0.002]). This intuition is also displayed in Figure 2, which shows that the occurrence of elections only impacts the probability of violation when elections are increasingly credible and democratic. This evidence supports our theory that when elections lack credibility and are not democratic, we would not expect a positive relationship between the electoral cycle, the level of democracy, and a government's potential to violate an investment agreement.

As a further illustration of this phenomenon, consider the case of Venezuela, a state notorious for expropriations of foreign investment. Throughout most of the analyzed time period Venezuela was not considered a democracy, and it violated 10 treaties. The Venezuelan government has, for example, serviced their sovereign debt crisis by using the state run oil company (PDVSA) to expropriate foreign assets (e.g., Conoco-Philips), despite widespread calls for them to default to alleviate domestic economic suffering.[31]

For comparison, nearest neighbor matching on our covariates determines Argentina to be a very similar state, except with respect to level of democracy and number of treaties violated. Argentina was a democracy for the entire time period, and yet, Argentina violated three times the number of treaties (30) than did Venezuela. In response to their own financial crisis and currency devaluation, the Argentine government conversely enacted policies to help citizens and businesses, which increased the likelihood of indirect expropriation and investment arbitration.[32]

We consider this a very telling example because Venezuela is known as a frequent violator, but its democratic counterpart violated many more treaties. Interestingly, Argentina had seven presidential and parliamentary elections from 1990 to 2013, while Venezuela had six national elections during the same period. Although both countries held nearly the same number of elections, we suggest that the pressure on governments to pass potentially expropriating legislation caused by credible elections may explain why the two countries differed so dramatically in their propensity to violate bilateral investment treaties.

Discussion

The central contribution of our analysis is that a state's level of democracy, because political leaders stand for credible elections, impacts the propensity of a state to violate an international investment treaty. Our theory and evidence are in line with a growing literature on authoritarian regimes, FDI, and BITs that asserts autocrats are better treaty compliers because the positive (and possibly negative) economic effects of BITs are largest in autocracies.[33] Leaders, elected or not, stay in of-

31 Chris Arsenault, "To understand Venezuela's Future, Look to the Bond Market, not Politics and Protests", *Canadian Broadcast Company*, 6 September 2018.

32 Argentina lost a large portion of its cases (approximately 62% in comparison to the cross-country average 45.8%), meaning the arbitration tribunals ruled that Argentina did violate its investment treaties more often than not when they were sued. In Facundo Perez-Aznar, "The Recent Argentina-Qatar BIT and the Challenges of Investment Negotiations", *Investment Treaty News*, 12 June 2017.

33 Eric Arias et al., "Cooperative Autocracies: Leader Survival, Creditworthiness, and Bilateral Investment Treaties", *American Journal of Political Science*, Vol. 62, No 4, 2018, p. 905–921.

fice more easily and longer when the economy is doing well, so autocrats that do not face credible elections, have a strong incentive to not violate BITs to maintain strong sovereign credit.[34] Our argument compliments this logic; elected leaders that face credible exits from office are more likely to side with their domestic voters and pass legislation that may lead to indirect expropriation and treaty violation.

Rather than arguing that we are explaining BIT violations in their entirety, we are arguing that regime type and election timing of the host country is one of several factors influencing treaty compliance. Further work is needed to explore more in-depth and more nuanced relationships. For example, we do not look at the regime type of the companies' home countries. Based on democratic treaty theory, it may be the case that BITs between two democracies are less likely violated than a BIT between an autocracy and a democracy. However, because the suing party is a company, not a government, we do not believe that there will be heterogeneity here, but because we do not analyze it this requires future work, as it is outside the scope of the paper. Further, there is likely heterogeneity in sectors as targets of complaints. This is again outside the scope of the paper and requires further work but is potentially more problematic. As democracies may be less likely to have natural resources as the main sector exploited by BITs, for example, this could indirectly cause a bias in our operationalization of the problem. This certainly is a potentially fruitful avenue for future research. We are agnostic about this in the current paper, because we are interested in aggregate trends, and are making the rather simple argument that democracies violate BITs more than non-democracies. While we discuss potential mechanisms throughout, we are only directly testing regime type and election timing. Therefore, another avenue of future research would be exploring the causal mechanisms in a more individual-level analysis.

We believe this is a topic that is academically, practically, and normatively interesting. Academically, scholars should consider which types of investment agreements are more likely to conflict with the general interests of the public, and whether those agreements are more likely to be violated. Practically, investors may want to consider this research in making investment decisions, and governments may want to consider this when anticipating future costs and benefits of treaty design. Normatively, if democratic states are signing investment treaties to appease business interests, knowing they will likely have to pay damages in the future, they are essentially subsidizing business with taxes without any, or almost any, awareness by the general public.

Bibliography

Allee, Todd, and Clint Peinhardt (2010). "Delegating differences: Bilateral investment treaties and bargaining over dispute resolution provisions", *International Studies Quarterly*, Vol. 54, No. 1, p. 1–26.

Arias, Eric, James R. Hollyer and Peter Rosendorff (2018). "Cooperative Autocracies: Leader Survival, Creditworthiness, and Bilateral Investment Treaties", *American Journal of Political Science*, Vol. 62, No. 4, p. 905–921.

Blake, Daniel J. (2013). "Thinking Ahead: Government Time Horizons and the Legalization of International Investment Agreements", *International Organization*, Vol. 67, No. 4, p. 797–827.

DiGiuseppe, Matthew and Patrick E. Shea (2016). "Borrowed Time: Sovereign Finance, Regime Type, and Leader Survival", *Economics & Politics*, Vol. 28, No. 3, p. 342–367.

34 Matthew DiGiuseppe and Patrick E. Shea, "Borrowed Time: Sovereign Finance, Regime Type, and Leader Survival", *Economics & Politics,* Vol. 28, No 3, 2016, p. 342–367.

Gaubatz, Kurt Taylor (1996). "Democratic States and Commitment in International Relations", *International Organization,* Vol. 50, No. 1, p. 109–139.

Gaukrodger, David and Kathryn Gordon (2012). "Investor-state Dispute Settlement: A Scoping Paper for the Investment Policy Community", *OECD Working Papers on International Investment*, No. 3.

Graham, Benjamin A.T., Noel P. Johnston and Allison F. Kingsley (2018). "Even Constrained Governments Take: The Domestic Politics of Transfer and Expropriation Risks", *Journal of Conflict Resolution,* Vol. 62, No. 8, p. 1784–1813.

Heckman, James J. (1976). "The Common Structure of Statistical Models of Truncation, Sample Selection and Limited Dependent Variables and a Simple Estimator for Such Models". *Annals of Economic and Social Measurement*, p. 475–492.

Henisz, Witold J. (2002). *The Political Constraint Index (POLCON) Dataset*.

Hyde, Susan D. and Nikolay Marinov (2012). "Which Elections can be Lost?" *Political Analysis,* Vol. 20, No. 2, p. 191–210.

ICTSD (2010). "Tobacco Company Files Claim against Uruguay over Labelling Laws", *Bridges*, Vol. 14, No. 9.

IFC (2009). *Stabilization Clauses and Human Rights*.

Jensen, Nathan (2008). "Political Risk, Democratic Institutions, and Foreign Direct Investment", *Journal of Politics,* Vol. 70, No. 4, p. 1040–1052.

Jensen, Nathan, et al. (2012). *Politics and Foreign Direct Investment*. Ann Arbor, University of Michigan Press.

Kerner, Andrew and Jane Lawrence (2014). "What's the Risk? Bilateral Investment Treaties, Political Risk and Fixed Capital Accumulation", *British Journal of Political Science,* Vol. 44, No. 1, p. 107–121.

Marshall, Monty G., Ted Robert Gurr, and Keith Jaggers (2017). *Polity IV Project: Political Regime Characteristics and Transitions, 1800-2016*. Center for Systemic Peace.

Newcombe, Andrew (2005). "The Boundaries of Regulatory Expropriation in International Law", *ICSID Review,* Vol. 20, No. 1, p. 1–57.

Pelc, Krzysztof J. (2017). "What Explains the Low Success Rate of Investor-State Disputes?", *International Organization,* Vol. 71, No. 3, p. 559–583.

Perez-Aznar, Facundo (2017). "The Recent Argentina-Qatar BIT and the Challenges of Investment Negotiations", *Investment Treaty News*, 12 June.

Peterson, Luke Eric (1 June 2003). "International Treaty News: Mexico's Treatment of Hazardous Waste Site Violates Mexico-Spain BIT", *Investment Law and Policy News Bulletin.*

Rickard, Stephanie J. (2010). "Democratic Differences: Electoral Institutions and Compliance with GATT/WTO Agreements", *European Journal of International Relations,* Vol. 16, No. 4, p. 711–729.

Schefer, Krista Nadakavukaren (2020). *International Investment Law: Text, Cases and Materials*. Cheltenham, Edward Elgar Publishing.

Schneiderman, David (2008). *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise*. Cambridge, Cambridge University Press.

Simmons, Beth (2010). "Treaty Compliance and Violation", *Annual Review of Political Science,* Vol. 13, p. 273–296.

Sornarajah, Muthucumaraswamy (2017). *The International Law on Foreign Investment*. Cambridge, Cambridge University Press.

Taylor, Adam (2019). "How Citgo, a U.S. Oil Company, Became Venezuela's Lifeline", *Washington Post*, 29 January.

Wellhausen, Rachel L. (2016). "Recent Trends in Investor–state Dispute Settlement", *Journal of International Dispute Settlement,* Vol. 7, No. 1, p. 117–135.

Weymouth, Stephen (2011). "Political Institutions and Property Rights: Veto Players and Foreign Exchange Commitments in 127 Countries", *Comparative Political Studies,* Vol. 44, No. 2, p. 211–240.

Yackee, Jason Webb (2008). "Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?", *Law & Society Review,* Vol. 42, No. 4, p. 805–832.