# Is International Commercial Arbitration a Substitute for Domestic Legal Institutions?*

Michael O. Allen
Yale University
michael.allen@yale.edu

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**Abstract**

The growth of private, transnational legal institutions presents states with new and under-examined mechanisms for integrating into the global economy. This paper investigates the interaction between one such institution, international commercial arbitration (ICA) and its domestic counterpart: national courts. In recent decades, ICA has become a central pillar of modern global economic governance. I argue that the growth of ICA has eroded the link between domestic rule-of-law and foreign direct investment by offering an extra-judicial, de-localized system of contract enforcement. I find that while investors are attracted to states with strong rule-of-law institutions, this association is negated by the enactment of arbitration-friendly laws. ICA thus serves as a substitute for local legal institutions. The results are robust to a variety of data sources and model specifications. These findings contribute to our knowledge of the political economy of international arbitration as well as the interactions between transnational and domestic legal institutions.

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# 1 Introduction

Foreign direct investment is risky. Not least among these risks are legal risks: what do you do if your local partners (be they private or public actors) do not fulfill their obligations? Local courts are an unattractive option if they are slow or corrupt. To circumvent such courts, global commercial actors developed a private, transnational system of resolving contractual disputes called international commercial arbitration (hereafter, ICA. See Mattli, 2001; Hale, 2015*a*). Over the last half century, ICA has enjoyed consistent growth in its caseload, the range of disputes subject to arbitration as well as the authority afforded to arbitrators (Stone Sweet and Grisel, 2017). Unlike international dispute resolution bodies such as the World Trade Organization's Dispute Settlement Body, ICA is a transnational mechanism of cross-border commercial contract enforcement with highly circumscribed levels of state involvement. ICA also provides parties the freedom to set arbitral procedures, select what law will govern the dispute and select their own arbitrators to decide the case. The parties to ICA tend to be private actors, but states are also frequent participants. States have gradually granted greater authority to private arbitrators to interpret and apply public law. The contemporary ICA regime has thus successfully enlisted domestic judiciaries in the enforcement of arbitration agreements and awards[1] while at the same time placing strict limits on public and judicial oversight over arbitration.

The privatization of commercial dispute resolution through ICA is more than a pure technical or procedural matter: it may hinder the authority of a country's domestic legal institutions to define, interpret and apply its own public law (Kronstein, 1963). Consider the case of *Process & Industrial Development Limited (P&ID) v. Nigeria*, concerning an aborted wet-gas processing agreement. The dispute arose in 2010 when the foreign investor, P&ID, took advantage of a provision in its contract with the Nigerian government stipulating that disputes be sent to binding arbitration. While the law governing any dispute is Nigerian law, London was chosen as the "venue" for the arbitration. The London-based arbitral tribunal ruled in favor of P&ID, awarding the firm $6.6 billion in damages.[2]

[1] In arbitration parlance, an "award" refers to the arbitration panel's final decision.

[2] At the time of writing, the value of the award has ballooned to about $10 billion, or nearly a third of Nigeria's 2020 budget. See https://www.reuters.com/article/nigeria-budget/nigerias-president-submits-

Nigeria, meanwhile, fought the arbitration in Nigerian court, which ultimately nullified (or "set aside") the award. A central feature of the modern international arbitration system, however, allows P&ID to ask a court almost anywhere in the world to enforce the award against Nigeria by seizing Nigerian-owned assets that are beyond Nigerian jurisdiction. Indeed, English courts have refused to recognize the Nigerian annulment and are presently considering enforcing the award on Nigerian assets under UK jurisdiction. The legal dynamics illustrated in this example serve to illustrate what I refer to as institutional substitution: ICA enabled an English court to supplant a Nigerian court in the interpretation and application of Nigerian law to a contract signed between a foreign investor and the Nigerian government.

In this paper, I demonstrate that, through the diffusion of domestic laws protecting ICA, global commercial actors have successfully developed a transnational system of contract enforcement that has excised commercial disputes from local judicial control. I contribute to the extensive literatures exploring the complex relationship between international and domestic institutions in international political economy (e.g. Jensen, 2006; Elkins, Guzman and Simmons, 2006; Nunn and Trefler, 2014; Li, Owen and Mitchell, 2018; Beazer and Blake, 2018). Specifically, I build on prior work on the political economy of international arbitration by examining whether access to a system of transnational dispute resolution provides a substitute or complement for domestic legal institutions (see Mattli and Dietz, 2014; Hale, 2014, 2015*b*; Myburgh and Paniagua, 2016). Specifically, I demonstrate empirically what Nougayrède (2013) refers to as "legal outsourcing," whereby legal services that have traditionally been provided by domestic institutions are increasingly bought and sold on international markets, thereby diminishing dependence on (and, consequently, the authority of) local political and legal institutions. By reducing dependence on local institutions arbitration may lead to the atrophy of domestic legal institutions (Ginsburg, 2005; Davis, 2010; Schultz and Dupont, 2014; Bodea and Ye, 2020). This argument is particularly salient within global economic governance literature, in which scholars have argued that transnational, private institutions such as arbitration may lower the opportunity costs faced by autocratic countries with weak legal institutions

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(Massoud, 2014; Sharafutdinova and Dawisha, 2017; Cooley and Heathershaw, 2017). The goal of this paper is to take one step back and examine empirically whether substitution is occurring or not. My findings suggest that ICA indeed serves as a substitute for local legal institutions. Using panel data from 1985–2019, I show that the association between a country's legal institutions and its attractiveness as a site for investment is eliminated by the enactment of domestic reforms promoting ICA. I find highly consistent results despite using a wide variety of model specifications as well as different data sources measuring the three main variables of interest: the rule of law, domestic arbitration laws, and FDI.

In what follows, I first discuss why FDI offers a good case study for transnational institutional substitution. In short, foreign investors sit at the intersection of domestic and transnational institutions: investment decisions are highly sensitive to potential host states' political and legal institutions. ICA provides an avenue for circumventing domestic institutions that investors perceive to be risky. Following that, I provide a brief outline of the contemporary ICA regime, highlighting the importance of a 1985 model law promulgated by the United Nations (and the focus of this study): the United Nations Commission on International Trade Law's (UNCITRAL) Model Law on International Arbitration (hereafter, the Model Law). I then present the empirical analyses. I find evidence consistent with prior work that foreign investors are indeed attracted to states with strong rule-of-law institutions. But I also show that this relationship is moderated by the enactment of strict domestic protections for ICA. I find no relationship between a host state's legal institutions and FDI inflows among states that have implemented the Model Law. The modern ICA regime serves as a substitute for domestic legal institutions.

## 2 Foreign Investment, Contract Enforcement & the Rule of Law

Variation in global FDI flows offers a window into the interaction between ICA and domestic legal institutions because investors are both users of ICA and highly sensitive to contractual and institutional risk. With foreign investors at the intersection of transnational and host-state institutions,

we can use variation in FDI flows to tease out what impact the growth of ICA might have on the authority of national courts over cross-border commercial contracts. If implementing ICA protections reduces that sensitivity (i.e. if a politically motivated or inefficient legal system becomes less of a deterrent to investment) then we can infer that ICA is substituting for those institutions by providing a functional alternative—an exit option for commercial actors. In what follows, I discuss the extensive literature on the rule of law, FDI and the kinds of private legal risks that ICA is designed to mitigate. I end the section with a brief overview of the broader political and legal ramifications of the increasingly complex interactions between public and private institutions in the governance of global commerce.

Direct investors are particularly sensitive to a host state's political and legal institutions, often even more so than they are to the macroeconomic conditions within the country (Ahlquist, 2006). Much of the early literature on the institutional determinants of FDI focuses on the threat of political risk from unanticipated state action, or the possibility that a host state will expropriate foreign capital or impose policy changes that diminish the economic viability of an investment. Early work in this area found that foreign investors tend to be attracted to democratic institutions (Jensen, 2006; Busse and Hefeker, 2007). Scholarship has since added nuance to our understanding of the mechanisms driving the link between democracy and FDI (Pandya, 2016, 462-4). To alleviate these risks, capital-exporting states created a set of international rules and institutions (such as bilateral investment treaties, BITs) for protecting foreign investors from expropriation or other violations of a country's international legal obligations towards foreign investors (Elkins, Guzman and Simmons, 2006). The literature studying the effectiveness of these institutions has found mixed results, however (Tobin and Rose-Ackerman, 2005, 2011; Neumayer and Spess, 2005; Büthe and Milner, 2008; Kerner, 2009). As I describe in more detail below, ICA presents an alternative international institution for states to mitigate risks associated with their domestic legal and political institutions that is often overlooked by the otherwise extensive scholarship in this area.

But outside the possibility of unexpected, harmful state action, foreign investors are also exposed to significant risks from their relationships with local partners, including both public and private

actors. The possibility that a local partner may not uphold their end of a bargain; the uncertainty over what exactly it means to abide by some provision in an agreement; or the inability to resolve these kinds of disputes all limit the incentives for parties to search for and create commercial partnerships. While disputes over such agreements are "private," their resolution is structured by state legal institutions. This is in part why strong rule-of-law institutions with an independent judiciary capable of efficient and neutral contract enforcement have long been associated with improved economic development (North, 1990; Rigobon and Rodrik, 2005).

Scholarship focused on such private, contractual risks has found positive relationships between efficient contract enforcement and investment. For example, the uncertainty caused by an ineffective contracting environment can deter foreign investors from entering into complex investment agreements or developing relation-specific technologies (Aboal, Noya and Rius, 2014). Other scholarship has found increased exports in complex products in countries with stronger legal institutions and access to international arbitration (Berkowtiz, Moenius and Pistor, 2006). These authors argue that this is due to the importance of courts for mitigating the relatively high risk of disputes over quality, etc. arising from the production of complex products. Another study estimates that the gains to trade for ratifying the New York Convention (a treaty facilitating international commercial arbitration, see below) are about half that of joining the World Trade Organization, with larger gains found in countries with weaker legal systems (Hale, 2014). Lowering the cost of contract enforcement is particularly important for direct investors because their longer-term contractual relationships with local firms make their stake in the host country less mobile (Berger, 2003; Meyer et al., 2009). These attitudes are borne out in surveys of actors engaged in international trade and investment. One study finds that countries with a reputation for higher contract enforcement costs (as determined by a survey of law firms across over 100 countries) tend to experience lower levels of FDI (Ahlquist and Prakash, 2010). Another survey of CEOs of firms investing in Latin America find that two of the top-four most important institutional determinants of FDI (out of a possible 23 survey responses) are that the host state "adhere[s] to the rule of law" and "has a relatively efficient and effective court system" (Staats and Biglaiser, 2012, 199). The same study finds a positive association between the

quality of rule-of-law institutions and FDI inflows. The nature of the domestic legal institutions can influence patterns of FDI flows as well. Others find that common law countries are more attractive to investors for their efficient contract enforcement and stronger property rights (Lee, Biglaiser and Staats, 2014). These findings suggest that not only weak institutions but also mere diversity across legal traditions and practices may further deter foreign investors. As I demonstrate below, ICA mitigates the perceived risks that result from variation in quality and legal practice in potential host-states by providing an international substitute for those national legal institutions.

## 2.1 The Second-order Effects of Institutional Substitution

While I term these "private" risks (because they concern disputes between consenting parties), such disputes often carry important public ramifications at both individual and aggregate levels. At the individual level, it is not uncommon for states or state-owned entities themselves to be involved in such disputes, as witnessed in the case discussed above. At the aggregate level, public dispute resolution is an important mechanism by which the state and public can monitor and regulate private conduct. Shifting these disputes into a confidential, private sphere risks disrupting those public functions (Resnik, 2015). At the international level, Wai (2001) refers to this as the "transnational liftoff of international transactions from national regulatory oversight," which may carry similar negative consequences for the prospect of democratic governance over transnational business (Cutler, 2014).

Moreover, it has long been recognized that beyond simply resolving commercial disputes the growth of international arbitration carries with it a host of ramifications for domestic and global governance (Cutler, 2003). Limiting commercial actors' dependence on local institutions may reduce demands on the state to invest in improving the independence, competence and efficiency of local legal infrastructure. Similarly to ICA, the growth of investor-state dispute settlement (ISDS) has led scholars to examine the second-order effects of international investment law on domestic institutional and legal outcomes. At the core of the international investment regime is a system of international arbitration often called ISDS which allows private investors to take claims

against host-state governments to binding international arbitration. Given the strong similarities between ICA and ISDS, we can look to the literature on ISDS for clues concerning the effects of the growth of ICA on local institutional development.[3] Sattorova (2018) argues it was only after practitioners began to doubt the effectiveness of BITs at promoting FDI that they developed a "good governance narrative" whereby international investment law (and investor-state dispute settlement) were portrayed as complementary to local legal institutions and therefore enhanced the quality of local governing institutions through various processes of normative diffusion. Sattorova instead finds that government officials, often unaware of these agreements, fail to internalize good governance norms embedded within them. Cross-national analyses reinforce this conclusion. For example, one analysis finds a *negative* association between BIT ratification and subsequent institutional and legal development (Ginsburg, 2005). Ginsburg attributes this to the reduced pressure on states to invest in enhancing local institutions when well-resourced commercial actors have access to a international substitute for national institutions. The presence of such substitutes may also reduce the opportunity costs illiberal states face for having biased legal institutions. Sharafutdinova and Dawisha (2017) argue that the growth of transnational substitutes for national legal institutions has enabled illiberal states such as Russia to "escape from institution-building." Other scholarship finds that by empowering multinationals over local institutions, BITs can lead to worse human rights outcomes (Bodea and Ye, 2020).

Some legal scholars, however, argue that there may instead be positive externalities to the growth of private arbitration. These scholars highlight the importance of state-involvement in the management of ICA (Whytock, 2010). Franck (2007), for example, argues that the growth of ISDS may provide competitive incentives for national actors to improve local judicial practices. Others have suggested a similar dynamic at work in the context of ICA (Rogers, 2015; Rogers and Drahozal, 2022). While adjudicating between these conflicting arguments is beyond the scope of the present paper, it is clear that there are important second-order political and legal ramification for the growth of international arbitration.

[3]Indeed, Stone Sweet and Grisel (2017) conceptualized ISDS and ICA as mutually constituting a global international arbitration regime.

In sum, these broad literatures provide ample evidence for the sensitivity of foreign investors to the strength of a potential host-state's legal institutions as well as the presence of important interactions between domestic and global governance institutions that depend on the nature of that sensitivity. Key to these associations is the legal system's role in enforcing contracts. Importantly, though, this relationship is attenuated by a lack of experience with a given legal tradition or weak institutions. Below, I argue that ICA intervenes on this relationship by granting access to a transnational system of private dispute resolution that resolves both the informational (i.e. experience operating in weak institutional environments), and competence/independence issues investors face when contracting foreign partners. In other words, I argue that ICA provides a substitute or "exit option" for foreign investors from local institutions. I begin the next section with a brief historical overview of the ICA regime before examining it in the context of institutional substitution.

# 3 The Rise of International Commercial Arbitration

The early development of ICA was driven by international investors, traders and lawyers seeking to "delocalize" commercial disputes and limit their exposure to foreign legal institutions by shifting disputes out of national courts and into what they perceived to be as more neutral international arbitral tribunals (Hale, 2015*a*). By offering a transnational forum for commercial dispute resolution, ICA thus lessens the uncertainty foreign investors face when investing in states with unfamiliar or weak rule-of-law institutions. This is because, unlike judicial proceedings, arbitration allows the parties to choose their own arbitrators and determine what (potentially distinct) legal rules will govern: the merits of a dispute (i.e. what law will be used to determine the issues at stake); the rules governing the procedure of the arbitration (this is called the "seat" or legal home of the arbitration); as well as in what jurisdiction the award will be enforced. For example, a French firm that wins an award against an American firm in an arbitration that was "seated" in England but applied French law to the merits can take that award to an American court for enforcement (as if it were an American judicial ruling) if the American firm refuses to comply. This, of course, is

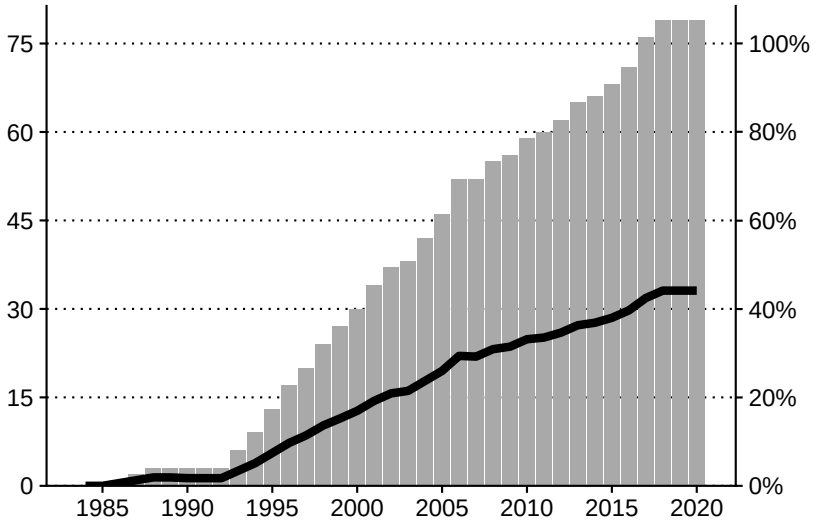
an idealized example meant to illustrate the flexibility commercial arbitration affords international business. In reality, there are numerous complexities and jurisdictional incongruities that may frustrate this process. Indeed, wide variation in local expertise, enforcement standards, and rules governing ICA limited early growth of the practice. In the 1950s, capital exporting states in concert with transnational arbitral and business organizations leaned on the United Nations to promote a common set of standards and rules for governing ICA.[4] These efforts culminated in a multilateral treaty, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958), commonly referred to as the New York Convention (NYC). The NYC combined and expanded two earlier protocols promulgated by the League of Nations in 1923 and 1927 that eased processes for enforcing arbitral agreements and awards through signatories' courts. The NYC thus allows someone to take an arbitral award that was issued in one country to a court in another country for enforcement. The NYC also set strict standards curtailing the ability of courts to set aside foreign arbitral awards. In sum, the NYC helped ensure arbitral agreements and awards were enforceable in more jurisdictions and under more circumstances, but problems within the ICA regime persisted.

A 1979 Report by the UN Secretary General found that while the New York Convention had eased the process of enforcing arbitral awards abroad, there still existed impediments to ICA due to the diversity of local laws governing the practice.[5] The report recommended that UNCITRAL consider efforts to "reduce the disparity [of national arbitration laws] by recommending uniform rules which would take into account the specific features of international arbitration agreements and awards."[6] UNCITRAL set out redress these persistent issues in ICA practice by developing a model law, a legal instrument written such that it could essentially be copied and pasted it into a country's law books. This represented a new technique for UNCITRAL which had theretofore promoted the harmonization of domestic commercial laws by creating guidelines or individual model legislative provisions (Block-Lieb and Halliday, 2007). In 1985, the UN General Assembly endorsed the

[4]Early drafts of what would become the NYC were written by the International Chamber of Commerce. See ICC Publication no 174 1953, which was presented to the United Nation's Economic and Social Council in September 1953.

[5]"Study on the application and interpretation of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958)." 20 April 1979. UN Doc. A/CN 9/168.

[6]Ibid., 108.




**Note:** Grey bars represent the number of countries that have enacted legislation based on the UNCITRAL Model Law; black line plots percentage of all countries that have done so. The population of countries is defined by inclusion in the V-Dem Dataset, Version 10.

Figure 1: Enactment of the UNCITRAL Model Law on International Commercial Arbitration

resulting Model Law noting its contribution "to the establishment of a unified legal framework for the fair and efficient settlement of disputes arising out of commercial relations." Key features of the Model Law include restricting the scope of judicial oversight of arbitration by requiring courts to enforce both arbitration agreements and awards except under a narrow set of conditions; defining arbitration clauses as "separable" from the overarching contract (i.e. an arbitration clause is valid regardless of the validity of the contract of which it is a part); and empowering arbitrators to find their own jurisdiction. By the end of 2020, over 75 national jurisdictions had implemented legislation based on the Model Law.[7] Figure 1 shows that the rate of enactment has held fairly steady since an inflection point around the early 1990s. UNCITRAL's efforts appear to be paying off. It has made significant progress towards both creating a unified legal framework and "modernizing" national arbitration laws around the globe.

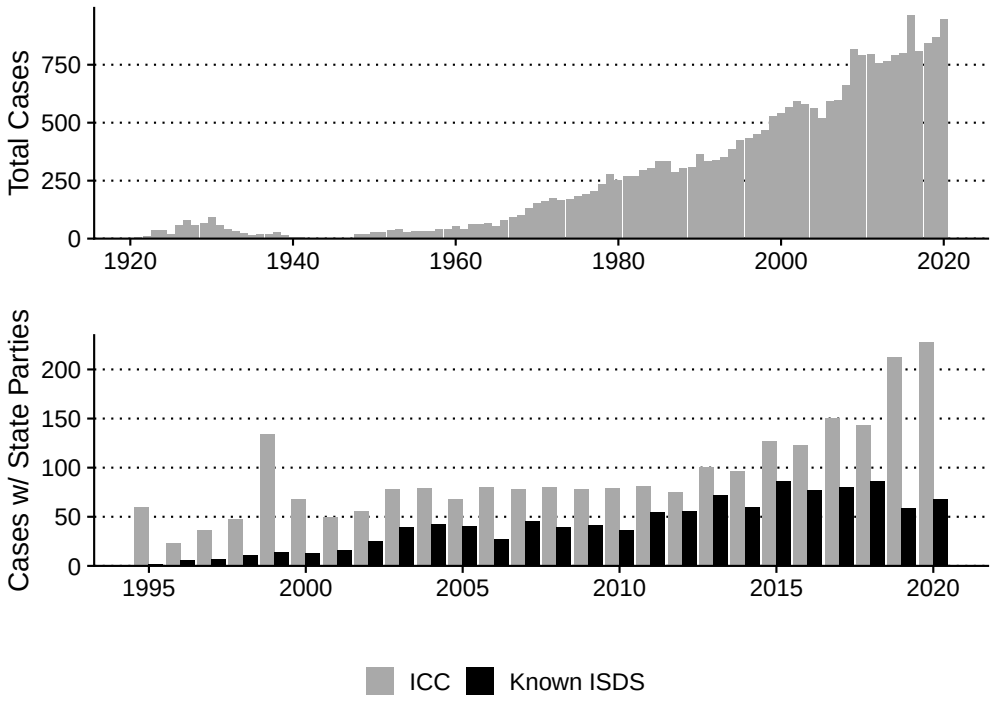
Given investors' sensitivity to the cost and efficiency of contractual dispute resolution along with the legal and institutional developments described above, it is no surprise that international

[7]See Table A1 for a comprehensive list of the national and subnational jurisdictions that have enacted legislation based on the Model Law to date.

commercial arbitration has been growing in popularity for decades. It has evolved into a central component of the network of legal institutions governing global commerce. ICA has grown in popularity because it provides commercial partners a mechanism for settling disputes in a neutral setting that is both confidential and tailored specifically to the particularities of their relationship. A 2018 survey of legal academics, practitioners and in-house counsel found that 97% of the respondents prefer either arbitration or arbitration together with some other form of alternative dispute resolution to cross-border litigation.[8] The top two reasons for respondents' preference for arbitration reflect the scholarship outlined above. Respondents were most concerned with the enforceability of awards (64% of respondents cited this reason) and "avoiding specific legal systems/national courts" (60%).

The centrality of ICA to modern global economic governance can be seen in the dramatic rise in the number of ICA centers serving a global clientele and their ever-expanding caseloads. While ICA is by its nature secretive, we can gain some insight into ICA's growth by examining statistics provided by the International Chamber of Commerce's (ICC) Court of Arbitration, the preeminent global ICA institution. Over the last decade, it has averaged roughly 800 cases per year. That figure is up from around 600 cases per year the decade prior. The top panel of Figure 2 plots the growth of the ICC's caseload from its inception in the 1920s through 2020. Other major ICA centers have experienced steady increases in their caseloads over time as well (Stone Sweet and Grisel, 2017, 47). And these are not "small" cases. At the end of 2020, the value under dispute at the ICC totaled over $250 billion, with an average of value of $145 million per dispute (ICC, 2021, 17). As the P&ID case outlined in the Introduction suggests, it is common for states or state-owned entities to appear before ICA panels managed by the ICC or other ICA centers. In fact, far more commercial disputes involving states are sent to ICA than treaty-based arbitration. To illustrate this, I plot the yearly number of cases at the ICC which involved a state or para-statal entity against the number of ISDS cases known to UNCTAD (see lower panel of Figure 2). The graph shows that state-involved ICA disputes at the ICC have outnumbered ISDS disputes every single year. Moreover, we see a fairly

[8]White & Case and Queen Mary, University of London 2018 (Accessible at https://www.whitecase.com/sites/whitecase/files/files/download/publications/qmul-international-arbitration-survey-2018-18.pdf)




**Note:** Yearly "Known ISDS" cases obtained from the UNCTAD Investment Dispute Settlement Navigator (https://investmentpolicy.unctad.org/investment-dispute-settlement). ICC case counts are derived from various issues of the *ICC Court of Arbitration Bulletin* from 1992–2021 (on file with the author). State parties includes governments and para-statal entities such as state-owned enterprises.

Figure 2: ICC cases compared to investor state dispute settlement

large uptick in such cases since around 2015. Interestingly, this is just as the number of treaty-based ISDS cases plateaued and even began to fall. This may be due to the backlash against ISDS or from adverse arbitration rulings against states which drive them to renegotiate treaties in order to limit their exposure to investor-state arbitration (Thompson, Broude and Haftel, 2019). While global commercial actors seem to backing away from ISDS, rather than backing away from public-private arbitration altogether it appears that these disputes are simply being shifted into the more secretive realm of ICA, about which we know comparatively less.

The stakes involved in contract-based arbitration can be just as high as those in ISDS. Unlike ISDS, however, the promotion of commercial arbitration serves as a more general entrance into international arbitration, whereas ISDS is typically limited to bilateral treaties. The growth of ICA has thus led to competition between public and private authorities over the allocation of governance

duties. Consider the case of Thailand. While Thailand has had an arbitration law on the books since 1987, deficiencies in the law prevented investors from relying heavily on ICA within the country. In 2002, Thailand enacted a new, more arbitration-friendly law based on the UNCITRAL Model Law, generally seen as the state-of-the-art in ICA legislation. This act was clearly intended to encourage foreign trade and investment. Thailand's Ministry of Judicial Affairs published an official English-language translation of the 2002 Act; in 2001 the government issues regulations required government agencies to comply with adverse awards even if they have not been judicially enforced;[9] the local Thai arbitral center promulgated updated rules and responsibility for it was transferred from the Ministry of Justice to the Office of the Judiciary—a move that was seen to have considerably improved the center's independence (Henderson, 2009, 56). But just two years later, the Thai government issued a decree banning arbitration clauses in concessionary contracts. This came after the Thai Ministry of Transportation lost an arbitration worth over worth $150 million stemming from a dispute with a Thai-German joint venture over the construction of the Bang Na expressway in Bangkok. Later—after another major loss in 2009—the Thai government broadened this ban: requiring arbitration clauses in *all* public sector contracts be subject to review by the Cabinet on a case-by-case basis.[10] In an effort to attract investors, Thailand has since walked back these restrictions (Nottage and Thanitcul, 2018, 139). And in 2015 Thailand established a new arbitration center focused on resolving cross-border disputes, the Thailand Arbitration Center. The Thai experience demonstrates that while scholarly attention has focused on treaty-based arbitration, states are also wrestling with how to balance the sometimes competing goals for promoting investment through commercial arbitration while maintaining some degree of regulatory control over transnational business.

[9] See Nottage and Thanitcul 2016, 17-27

[10] See Nottage and Thanitcul (2018).

## 3.1 ICA as a Substitute for Domestic Legal Institutions

Investors have at least two incentives to use ICA and help develop it into a what Stone Sweet and Grisel (2017) call an "autonomous legal order" and a substitute for local institutions. First, ICA provides legally binding contract enforcement mechanisms that are largely homogeneous across myriad jurisdictions. Second, ICA provides an viable "exit option" from local institutions that investors may perceive to be inefficient or biased against them. In response to these demands, governments and courts around the world have ceded a great deal of authority to arbitrators to even root their awards in their own interpretations of public law (Stone Sweet and Grisel, 2017, 171-186), leading to a commercial legal order increasingly decoupled from domestic, public institutions and oversight (Schultz, 2014). Such expansions of arbitral power have enabled the homogenization of both arbitral procedure (Kaufmann-Kohler, 2003) and substantive legal interpretation (Stone Sweet, 2006; Karton, 2013). Much like with the well-documented growth of ISDS, these developments have led to the construction of a cohesive, transnational regime for the enforcement of international contracts through arbitration, providing an alternative to public courts while also combating legal diversity that might otherwise deter foreign investors.

Increased homogenization is likely driven in part by the efficiency gains of standardization (Ginsburg, 2003). Others argue that the culture of the profession has driven the homogenization of ICA practice (Dezalay and Garth, 1996; Karton, 2013; Grisel, 2017). Analyses of ISDS are instructive on this point as there is a high degree of professional overlap between the two regimes. For example, social network analyses of appointments at the International Center for Settlement of Investment Disputes (ICSID), a popular arbitral body that hears disputes arising out of host states' international law violations against investors, finds that there is a small core of roughly 50 arbitrators who exert disproportionate influence over the practice (Puig, 2014; Langford, Behn and Lie, 2017). Data on appointment procedures are limited for ICA, but the influence of highly active and prestigious arbitral centers (such as the ICC, London Court of International Arbitration, among others) likely serve a similar role as the individual "power brokers" do in ICSID (Stone Sweet and Grisel, 2017, 55-60). In short, despite its flexibility, ICA is a more familiar process in the eyes of

foreign investors than whatever local judicial process an investor might encounter in cross-border litigation. Access to ICA thus helps mitigate the risks posed by both weak rule-of-law and variation in dispute settlement procedures across countries by offering a cohesive, transnational substitute for domestic legal institutions.

Access to this system provides real benefits to weak rule-of-law countries seeking to attract investors wary of the competence, efficiency or independence of national courts. Sudan serves as an illustrative case of this dynamic. While in the 1990s Sudan invested heavily in developing its local judiciary, the focus of these reforms was on criminal law as a means of exerting social and political control (Massoud, 2013, Ch. 4) Despite the increased investment in local courts, the lack of judicial independence and commercial competence made these courts too risky for investors. Sudan was thus in a bind: the government was in need of foreign capital to develop its oil fields, but its legal system was deterring prospective investors. The country found a way out by enacting an international arbitration law in 2005 in order to provide a transnational substitute for domestic courts to prospective investors. This helped placate foreign investors wary of dealing with Sudanese courts should a dispute arise. As Massoud (2014, 17) writes, "Lawyers in Sudan representing groups involved in the pipeline construction process told me that their clients 'don't know the risks [and] don't know about Sudanese law,' so they feel more comfortable applying international arbitration standards with which they are familiar." Arbitration allowed Sudan to provide an independent system of contract enforcement to investors without disrupting the pro-regime bent of the domestic legal infrastructure.

This example serves to illustrate how host-state's rule-of-law institutions begin to matter less to foreign investors when they have easier access to ICA, but this requires buy-in to the practice of arbitration from their local partners. The problem a foreign investor might face then is on the "supply" side of arbitration. Investors may encounter some difficulty persuading local parties to shift possible future disputes out of their own national courts and legal regime into the less familiar international commercial arbitration regime. This is where the Model Law comes in. Below I argue that the process and consequences of enacting reforms based on the Model Law, beyond simply

changing the domestic rules, contributes to increasing the local knowledge, legitimacy and use of commercial arbitration.

## 3.2 The Indirect Consequences of Enacting the Model Law

In this section I outline three indirect consequences of Model Law enactment that work to increase use of ICA within the enacting country. First, enactment of the Model Law signals to the international business and legal communities that a country takes arbitration seriously. Second, it increases international scrutiny of local arbitral practices which increase the cost of deviation from international arbitral standards. And third, the Model Law increases the legitimacy of arbitration within local legal and business communities. I discuss each of these in turn.

National arbitration reform based on the Model Law signals to both the international community as well as domestic business and legal communities that it seeks to protect and promote arbitration within its borders. In the words the South African Law Reform Commission, an official body charged with investigating reform of the country's national arbitration laws, "The standard by which a country's laws pertaining to international arbitration is measured today is the UNCITRAL Model Law...In Africa itself, South Africa is now seriously behind those jurisdictions like Kenya and Zimbabwe, which have adopted the Model Law" (SALC, 1998, 24). We can see the value of the Model Law as a heuristic in the reports of the US Department of State. Its yearly "Investment Climate Reports" have, for at least the past decade, reported on the status of commercial arbitration within each of the countries included in its reports. Beginning in 2016, the report has included a separate section detailing the legal regime governing ICA in each country, often noting with approval when countries have implemented the Model Law.

Model Law-based reform brings with it increased international scrutiny of a country's domestic ICA regime from a variety of international actors including UNCITRAL, international arbitration institutes and chambers of commerce, foreign ministries, practitioners, and academics. UNCITRAL monitors and assists states as they seek to enact and later adhere to the Model Law principles. Personnel from UNCITRAL often provide technical assistance to states' during the reform processes

(SALC, 1998, 32). Post-enactment, UNCITRAL monitors and distributes caselaw pertaining to the Model Law.[11] Because the Model Law serves as a heuristic and benchmark by which outsiders evaluate the arbitral environment of a potential host state, deviations from "modern" ICA principles become more salient.[12] This information then feeds into UNCITRAL's active efforts in identifying areas in need of reform within the ICA regime. This process culminated most recently in an updated Model Law in 2006 and one of UNICTRAL's working groups is currently considering drafting new guidelines governing arbitrator ethics and how to manage concurrent proceedings. In sum, UNCITRAL is actively engaged with the ICA regime. By joining the club of Model Law jurisdictions, a country enjoys both the publicity and technical assistance from UNCITRAL and other arbitration-promoting organizations that work to promote arbitral practice within the country.

Model Law reforms are also typically joined by increased investment in the domestic arbitral profession and the formation of linkages with transnational networks of arbitral institutions and professionals. We saw this domestic process in the Thai example above, with the government's investment in local commercial arbitration institutions at the same time it was reforming its laws. Rogers and Drahozal recount a similar investment in domestic arbitration practice in Georgia after it enacted a law based on the Model Law, including the establishment of a new arbitration center, the Georgia Arbitration Association (Rogers and Drahozal, 2022). Their case study demonstrates a high level of engagement with the reforms among local business, legal and judicial professionals. Interestingly, they find that the institutional reform and professional investments that came with enactment of Model Law-inspired domestic arbitration reforms went far beyond what occurred during the country's ratification of the New York Convention. Another analysis of Georgian arbitration rulings found that judges were often unaware that the state had even ratified the Convention (Austermiller, 2015, 683).

At the international level, for example, the Mauritian national arbitration law creates numerous explicit legal and institutional linkages with the Permanent Court of Arbitration (PCA) in the

[11] States that have enacted any of UNCITRAL's model laws typically appoint a "National Correspondent" who updates the database with cases from their jurisdiction that are relevant to the jurisprudence of a given model law (See http://www.uncitral.org/uncitral/en/case_law/national_correspondents.html).

[12] And deviations are rare, see Table B1.

Hague.[13] The PCA established an office in Mauritius soon after the enactment of the law.[14] The Government of Mauritius also collaborated with the London Court of International Arbitration to create a jointly-run ICA institution.[15] Catherine Rogers, reporting on her own experience assisting the Palestinian Authority (PA) to promote ICA, notes that the PA "work[ed] closely with the International Chamber of Commerce of Palestine and its Arbitration Committee, which in turn works closely with a network of international arbitration organizations and international arbitration experts, including myself" (Rogers, 2015, 51).

Egypt presents another good example of what happens in a country after enacting ICA reforms based on the Model Law. Yves Dezalay and Bryant Garth provide a thorough description of the Egyptian arbitral profession in the early-to-mid 1990s, shortly after the country enacted a national arbitration law based on the Model Law (Dezalay and Garth, 1996, 219-249). While the authors could find little evidence that arbitration within the country was increasing, they witnessed local arbitral centers or institutes such as the Islamic Arbitration Center at the University of El-Azar, host a flurry of professional activities, conferences and workshops meant to promote arbitration within the country (p. 244). Interestingly, they also noted a shift in the rhetoric of such institutions. They write that the Islamic Arbitration Center was created in part to advocate for an Islamic alternative to international arbitration. This sentiment changed, however, after the Model Law reform as the Egyptian arbitral profession sought to increase its linkages with the Western-dominated international arbitral profession: "...in order to build legitimacy in the international community, the proponents of the new center now emphasize how Islamic law will really lead to no difference in outcomes...There is competition [between arbitration centers], but the 'competitors' cannot get into the field without buying the basic rules developed and maintained in the ICC world" (p. 243).

In sum, we can conceptualize the mechanisms by which enacting legislation based on the Model

[13]Here are two examples: the law grants arbitral tribunals jurisdiction to rule on whether an issue is "international" or not. But if a tribunal has not been established, then the question may be referred to the PCA instead of a national court. The law also grants parties the right to ask the PCA to appoint a third (or sole) arbitrator if the party-appointed arbitrators cannot agree.

[14]The only other international PCA office is in Singapore, also a Model Law country.

[15]i.e. the LCIA-MIAC Arbitration Centre. This was collaboration was discontinued in 2018. The institute is now wholly independent of the LCIA and known as the Mauritius International Arbitration Centre.

Law will influence arbitration practice in two ways. First, the Model Law is a set of concrete institutional reforms meant to increase protections for international commercial arbitration, ease the process of global enforcement and curtail judicial oversight. To that end, the Model Law has defined (and help spread) the framework of what constitutes a "modern" ICA regime. Second, enactment of the Model Law carries with it indirect, social changes that help promote the legitimacy of ICA practice within local business and legal communities. It fosters the arbitration profession, while also creating incentives for the local profession to fashion itself after the ICC's transnational vision of the arbitration profession. Enactment of the Model Law increases the "supply" side of arbitral clauses to better meet investor "demand." By thus easing the process of negotiating arbitration clauses, the Model Law contributes to shifting commercial disputes out of public courts and into private arbitration panels thereby eroding the ability of state legal institutions to structure dispute settlement within its own borders.

# 4 Examining Institutional Substitution: Data & Methods

In short, the social and legal changes brought on by enactment of Model Law-based legislation diminish the relevance of the domestic legal regime as they remove the work of dispute resolution out of the hands of domestic legal institutions. We should see therefore foreign investors becoming less sensitive to the quality of domestic legal institutions where countries have enacted the Model Law. In this section, I present a quantitative test of this hypothesis on a panel of countries from 1985 (the year the Model Law came into being) to 2019.

## 4.1 Dependent Variable

I exploit variation in global FDI flows to examine whether the introduction of laws protecting and promoting ICA influence how sensitive foreign investors are to a country's domestic legal infrastructure. I measure this using the net inflow of FDI to a country per year, taken from the World Bank's World Development Indicators. There is some controversy over how to operationalize FDI.

Due to wide variation in FDI flows over time and between countries, outliers can be tricky for the study of FDI. While some have used FDI as a percentage of GDP to limit the influence of outliers, employing this measure presents theoretical problems for this analysis (Li, 2009). Theoretically and empirically, FDI/GDP and FDI flows measure different concepts (Li, Owen and Mitchell, 2018). The former is a measure of the importance of FDI to a country, not the level of FDI itself. Because I expect high rule-of-law countries to experience increased FDI—not necessarily an increase in the importance of FDI to the overall economy—net FDI inflows is a more appropriate measure for this study. Due to the presence of zeros and negative values (where capital outflows are greater than inflows), I transform net FDI inflows using the inverse hyperbolic sine to reduce the skewness of the data.[16]

## 4.2 Explanatory Variables

I use two primary independent variables: enactment of the Model Law and the strength of a country's legal institutions. To measure a high level of protection and support for ICA, I compiled data on the enactment legislation based on the UNCITRAL Model Law. The data were collected from UNCITRAL's annual status reports which I supplemented with information from various sources where there were inconsistencies in the reports.[17] A country is coded as 1 on the year in which the Model Law came into effect and every year thereafter, and 0 otherwise.

One potential problem with relying on enactment of the Model Law as a proxy for a country's national arbitration regime is that the Model Law is just a model law. States have the right to make whatever changes that they see fit. It turns out that few do so (Binder, 2010).[18] Binder's analysis accords with the UNCITRAL's own assessment of the relatively high degrees of uniformity in adoption of the Model Law's core principles. Moreover, UNCITRAL will not recognize states that deviate too far from the key principals of the Model Law. For example, while many aspects of

[16] On the IHS transformation see Burbidge, Magee and Robb (1988); Busse and Hefeker (2007). This function closely approximates other commonly used functions such as $\log(|FDI|+1)$ then multiplying by $-1$ if the raw value is negative, e.g. Kerner (2009); Allee and Peinhardt (2011); Tobin and Rose-Ackerman (2011); Moon (2015)

[17] See Table A1 in the Appendix for a list of Model Law countries and years of initial enactment

[18] See Appendix B.

Romania's 1994 law were inspired by the Model Law, the country lacks official recognition as a Model Law state because of various meaningful discrepancies (Babiuc and Capatina, 1994). One point of divergence is that Romanian awards may be set aside if some legal provision on which the award was based is later deemed unconstitutional (See Leaua, 2013, 17-8). This represents a strict form of judicial supervision over arbitration in Romania that advocates of arbitration tend to oppose.

The second independent variable seeks to measure the strength of each country's domestic legal institutions for each year. I use the Rule of Law Index from the Varieties of Democracy dataset. The index runs from 0 to 1. The index is constructed from a handful of expert-coded rule of law indicators and is heavily influenced by V-Dem's indicators on the judiciary such as compliance with the high court, lower and high court independence, judicial accountability, access to justice, and so on. This measure is ideal as it provides a consistent indicator of the predictability and transparency of a country's legal system as well as the strength of its judicial system over the full span of the time series and for a large cross-section of countries. Other measures of rule of law are used in the robustness checks following the main results.

## 4.3 Control Variables

I include two institutional control variables. First, I include a dummy that is coded as 1 if a country has ratified the New York Convention (NYC), which has been found to be positively associated with FDI flows (Berkowtiz, Moenius and Pistor, 2006; Myburgh and Paniagua, 2016). Second, I include a count of the number of bilateral investment treaties a country has in force in a given year given the relationship between BITs, international arbitration and FDI. These data were obtained from the UNCTAD International Investment Agreements Navigator. Finally, I include a variety of economic variables that have been found to be associated with FDI, all of which were obtained from the World Bank's World Development Indicators: GDP; GDP per capita; GDP growth; and trade openness, defined as the total value of trade (imports + exports) as a percentage of GDP. I include a lagged dependent variable to account for any unobserved heterogeneity potentially biasing the results. I also include country- and year-fixed effects to account for any time-invariant unit-level factors or

common temporal shocks. All explanatory variables are lagged by one year. In all, this results in a panel of 165 countries spanning 35 years from 1985 (the year the Model Law was introduced) to 2019 (the most recent year for which FDI data is available). I estimate the following equation using OLS with panel-corrected standard errors to account for heteroskedasticity:

$$\begin{aligned} \text{FDI}_{i,t} \;=\; & \beta_1 \text{FDI}_{i,t-1} + \beta_2 \text{Rule of Law}_{i,t-1} + \beta_3 \text{Model Law}_{i,t-1} + \\ & \beta_4 \text{Rule of Law}_{i,t-1} \times \text{Model Law}_{i,t-1} + \gamma \mathbf{X}_{i,t-1} + \delta_t + \omega_i + \varepsilon_{it} \end{aligned}$$

$\mathbf{X}$ is a vector of controls; $\delta_t$ and $\omega_i$ represent year- and country-fixed effects. I then estimate the marginal effect of the Rule of Law—conditional on Model Law—on FDI flows to assess my hypothesis that the marginal effect of the Rule of Law on FDI Flows in non-Model Law countries will be greater than than its marginal effect in Model Law countries.

I expect the strength of domestic rule of law institutions to be positively correlated with FDI inflows, but conditional on the Model Law entering into force. If substitution is at work, foreign investment decisions should be less sensitive to variation in the strength of local rule-of-law institutions in countries that have enacted the Model Law.

# 5 Results

The main results are reported in Table 1. The first column reports the results of a non-interactive specification of the independent variable to replicate how the relationship between Rule of Law and FDI has been modelled in prior studies. The positive and significant coefficient on Rule of Law suggests that investors do prefer countries with higher quality rule of law institutions. This is consistent with prior work on host state legal institutions (Staats and Biglaiser, 2012). The next column reports the results from adding Model Law to the model. Interestingly, the effect of the Model Law is estimated to be negative. This flips, however, after interacting Model Law with Rule of Law (Columns 3-5). The estimated coefficients remain largely stable as various sets of control variables are progressively added. Note that the magnitude of the coefficient on Rule of Law

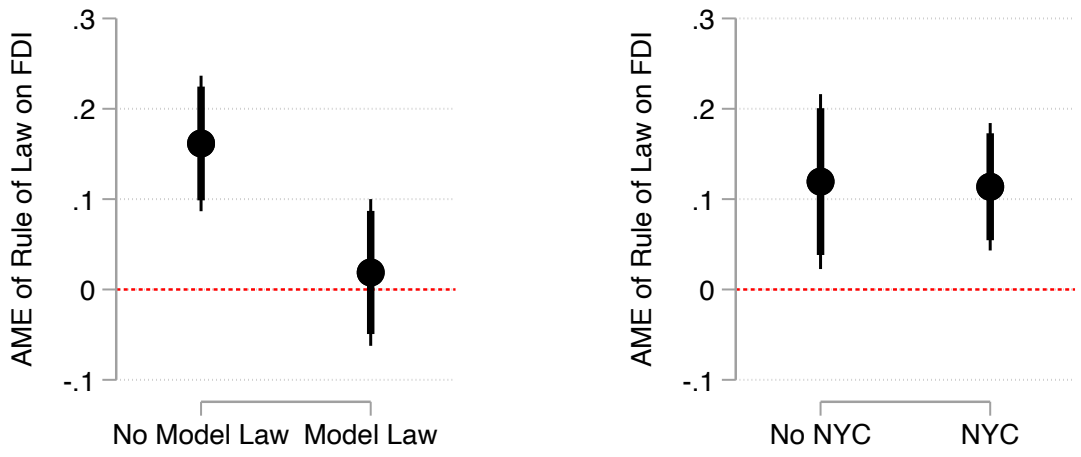
| | (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|---|
| Rule of $Law_{t-1}$ | $4.276^{***}$ | $4.031^{***}$ | $6.309^{***}$ | $6.350^{***}$ | $5.650^{***}$ | $4.175^{**}$ |
| | (1.226) | (1.230) | (1.293) | (1.289) | (1.338) | (1.727) |
| Model $Law_{t-1}$ | | $-1.030^{**}$ | $2.244^{***}$ | $2.049^{***}$ | $2.092^{***}$ | $-1.031^{**}$ |
| | | (0.466) | (0.782) | (0.770) | (0.793) | (0.466) |
| Model $Law_{t-1}$ × Rule of $Law_{t-1}$ | | | $-5.863^{***}$ | $-5.497^{***}$ | $-4.992^{***}$ | |
| | | | (1.288) | (1.275) | (1.310) | |
| $NYC_{t-1}$ | $1.188^{**}$ | $1.224^{**}$ | | $1.366^{***}$ | $0.998^{**}$ | 1.316 |
| | (0.500) | (0.500) | | (0.476) | (0.500) | (0.884) |
| $NYC_{t-1}$ × Rule of $Law_{t-1}$ | | | | | | −0.200 |
| | | | | | | (1.513) |
| $BITs_{t-1}$ | 0.000 | 0.054 | | −0.309 | −0.055 | 0.052 |
| | (0.258) | (0.258) | | (0.223) | (0.254) | (0.258) |
| ln $GDP_{t-1}$ | $3.178^{**}$ | $2.975^{**}$ | | | 2.056 | $2.955^{**}$ |
| | (1.420) | (1.411) | | | (1.407) | (1.429) |
| $Growth_{t-1}$ | $0.075^{***}$ | $0.074^{***}$ | | | $0.070^{**}$ | $0.074^{***}$ |
| | (0.029) | (0.029) | | | (0.029) | (0.029) |
| ln GDP per $cap._{t-1}$ | $-4.491^{***}$ | $-4.157^{***}$ | | | $-3.394^{**}$ | $-4.138^{***}$ |
| | (1.346) | (1.342) | | | (1.340) | (1.348) |
| ln Trade $Openness_{t-1}$ | −0.383 | −0.339 | | | −0.363 | −0.344 |
| | (0.479) | (0.481) | | | (0.481) | (0.485) |
| Lagged DV? | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Year FE | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Country FE | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Observations | 4,969 | 4,969 | 5,657 | 5,657 | 4,969 | 4,969 |
| Adjusted $R^2$ | 0.289 | 0.289 | 0.316 | 0.317 | 0.291 | 0.289 |

**Note:** $^{*}$ $p < .1$, $^{**}$ $p < .05$, $^{***}$ $p < .01$ The table reports the results of OLS regressions with panel-corrected standard errors in parentheses. For results from alternative specifications see Appendix C.

Table 1: Model Law and FDI flows

increases in this set of models. In line with my theoretical expectations, this estimate suggests that the quality of rule-of-law institutions should exert a greater effect on FDI for countries that have not implemented the Model Law. Moreover, the coefficient on the interaction term largely offsets the effect of the Rule of Law constituent term. To examine this dynamic directly, I plot the standardized conditional marginal effects in Figure 3a. For non-Model Law countries, I estimate an increase of .162 ($SE = 0.038$) standard deviations for each SD increase in Rule of Law. By contrast, Model Law countries enjoy no such gains. I estimate a much lower (and statistically insignificant) .012 SD ($SE = 0.041$) increase for each SD increase of the Rule of Law. I thus estimate a statistically significant difference between the effect of the Rule of Law between Model Law countries and non-Model Law countries to be $-.143$ ($SE = 0.037$). In sum, these results support the hypothesis that the effect of Rule of Law is moderated by Model Law. The positive and significant estimate for non-Model Law countries suggests that FDI inflows are directly related to the strength of host state rule of law institutions but only if the country has not implemented the Model Law. Conversely, if a country has enacted the Model Law then the quality of its domestic legal institutions have no discernible influence on FDI inflows. These results are robust to alternative modelling decisions including different fixed effect structures (see Table C1), a first-order auto-regressive process (see Table C2), and estimating standard errors clustered by country (see Table C3).

Next, I interact NYC with Rule of Law to serve as a placebo test of the mechanisms described above. I interpret the NYC as a placebo because of the absence of domestic reforms that tend to accompany its ratification. For example, Rogers and Drahozal (2022) report that many Georgian judges and legal elites were largely unaware that their country had signed the NYC, while the signing of the country's domestic arbitration law in 2009 (based on the Model Law) set off a process of institutional and professional reform within the local legal and arbitration communities. The results are presented in Column 6. Unlike what we see with the Model Law interaction, the interaction here is highly insignificant and substantively small while the coefficient on Rule of Law largely reverts back to a magnitude similar to that of the non-interacted estimate from Column 2. The coefficient on the interaction term is near zero and highly insignificant. The conditional marginal effects of Rule




(a) Model Law

(b) NYC

**Note:** These figures plot the standardized marginal effects of the Rule of Law on FDI, conditional on the enactment or ratification of the Model Law or the NYC. The estimates are based on the results presented in Table 1, Column 3 (Model Law) and 6 (NYC).

Figure 3: Standardized marginal effect of Rule of Law on FDI flows conditional on Model Law enactment or NYC ratification

of Law conditional on NYC are plotted in Figure 3b. The estimated difference between the marginal effects are highly statistically indistinguishable from 0 (a difference of $-0.01$, $SE = 0.043$). This suggests that the Model Law may be exerting a greater influence through its domestic effects, as the primary goal of the NYC is not to reform domestic institutions but to integrate the jurisdiction into an international enforcement network—in other words, the largest legal consequences of ratifying the NYC may be felt outside of the ratifying jurisdiction. Perhaps the deeper local reforms that the Model Law entails tends to garner heightened attention domestically and therefore may do more to promote widespread acceptance of commercial arbitration amongst local business and legal communities.

## 5.1 Robustness to alternative data

Given the difficulty of measuring a concept like the rule of law, I rerun the full model (Table 1, Column 5) using three alternative measures. First, I rerun the full regression using the Worldwide Governance Indicator's (WGI) Rule of Law Index (Table 2, Column 1). The WGI Rule of Law Index

| | (1) WGI | (2) Doing Business | (3) LJI | (4) Alt. Model Law |
|---|---|---|---|---|
| Model Law = 0 | 0.298*** | 0.237*** | 0.163*** | 0.156*** |
| | (0.079) | (0.067) | (0.051) | (0.038) |
| Model Law = 1 | 0.089 | 0.138** | −0.012 | 0.008 |
| | (0.090) | (0.065) | (0.062) | (0.042) |
| Model Law Effect | −0.209*** | −0.099 | −0.175*** | −0.148*** |
| | (0.075) | (0.081) | (0.052) | (0.038) |
| Observations | 3,136 | 2,288 | 4,427 | 4,969 |

**Note:** This table presents the standardized marginal effects of Rule of Law conditional on Model Law as well as test of null hypothesis of their equivalence. In the Column 4, I recode the Model Law variable to equal 1 for major arbitration states: France, Switzerland, United Kingdom and USA. All models include full set of controls, year- and unit-fixed effects and a lagged DV. Full results are presented in Table D1.

Table 2: Standardized marginal effects of Rule of Law on FDI flows using alternative measures of Rule of Law and Model Law

is a composite index that measures popular perceptions of the quality of local courts, police, contract enforcement, etc. Second, I use the World Bank's Ease of Doing Business Contract Enforcement index (Table 2, Column 2). This index seeks to measure how costly and time consuming it is to enforce a contract in a given country each year. There are, however, two problems limiting the index's utility. First, data are only available beginning in 2005 which cuts the sample size by roughly half. And, second, the indicator's reliability is quite low because the methodology has changed three times since its inception. For my final indicator, I use a measure of latent judicial independence developed by Linzer and Staton (2015) (Table 2, Column 3). The value of LJI is its narrow focus on judicial independence, which the authors define as autonomy plus the power to make rulings that "greatly constrain the choices of other actors." Independence from political influence and authority are important judicial attributes for foreign investors, but this measure neglects other important factors such as the cost and efficiency of contract enforcement.

As seen in Table 2 (Columns 1-3), despite issues of reliability and data availability, the main results largely hold when using a mix of alternative rule of law indicators. While the Model Law does not negate the marginal effect of the Doing Business index (Column 2), the point estimate on

Non-Model Law countries is less than that of Model Law countries' though these differences are not statistically significant. One reason explaining the lack of a difference between Model Law and non-Model Law countries when using this measure might be that the index is designed to measure the ease of contract enforcement more directly. Therefore, it is possible that this measure is partly endogenous to Model Law enactment and may itself be influenced by enactment. Overall, I estimate similar standardized effect sizes of the Model Law's effect on the sensitivity of investors to domestic legal institutions, ranging from roughly $-0.1$ on the low end to $-0.2$ on the high end.

Next, I account for potential problems stemming from my use of the Model Law as a proxy for a country's ICA regime. Model Law implementation is not a perfect measure for how "modern" a country's international commercial arbitration regime is. Some countries offer similar protections to the Model Law but, because they have not based their domestic legislation on the Model Law, they are coded as non-Model Law countries. Such states include the most prominent arbitral seats such as the United States, United Kingdom, France and Switzerland that also attract large amounts of foreign capital. It is possible that the results are driven by these states' inclusion in the non-Model Law group given their high quality courts, strong protections for ICA and their attractiveness as sites for direct investment. If shifting these countries into the Model Law group dramatically alters the model's estimates, then it might not be the practice of arbitration driving the results but some other unobserved factor of the countries that have enacted the Model Law. Column 4 in Table 2 reports the marginal effects from the full model in which I code the US, UK, France and Switzerland as having enacted the Model Law over the full duration of the analysis. After shifting these countries into the non-Model Law group, we still see a positive and significant relationship between rule of law and inbound FDI for non-Model Law countries that goes away for "Model Law" countries.

Finally, recent scholarship has found that a very significant proportion of globally reported FDI is not tied to any "real" economic activity. A recent estimate puts this "phantom" FDI at nearly 40% of all reports flows (Damgaard, Thomas and Niels, 2019). The presence of phantom FDI could bias my results upward, for example, if tax havens are also likely to enact arbitration reforms based on the Model Law. To assess the robustness of the results reported in Table 1 to these errors in

the World Bank data, I re-run the main analysis using bilateral data adjusted to include only FDI that is connected with "real" economic activity in the host-state. Unlike the country-year set-up reported in the main results, this dataset has the advantage of providing yearly bilateral FDI flows. A disadvantage of these data, however, is that the time series is limited to 2009-2017. Unfortunately, 56 Model Law countries enacted the law prior to 2009 (about 75% of all Model Law countries). These results are therefore best interpreted as cross-sectional. The large percentage of Model Law countries with no variation in their Model Law status also prevents me from including host-state level fixed effects. To help account for potential confounding host-state level characteristics, I include standard controls used in gravity models of trade and FDI: logged GDP, GDP per capita of the host country (obtained from the World Bank WDI), the population-weighted distance between each country[19] as well as a dummy variable indicating whether there is currently a bilateral investment treaty in force between the country-pair. I adjust for time-varying home-state level characteristics by including home country by year fixed effects. As above, to reduce skewness and retain negative and zero values, I transform the FDI flows measure using the inverse hyperbolic sine. I estimate the following equation using OLS:

$$\begin{aligned} \text{FDI}_{ijt} = \; & \beta_1 \text{Rule of Law}_{it} + \beta_2 \text{Model Law}_{it} + \beta_3 \text{Rule of Law}_{it} \times \text{Model Law}_i + \\ & \gamma \mathbf{X}_{it} + \rho \mathbf{Z}_{ijt} + \delta_{jt} + \varepsilon_{ijt} \end{aligned}$$

The outcome in this equation is a measure of the aggregate value of real FDI flows from home-state $j$ to host-state $i$ in year $t$. $\mathbf{X}_{it}$ denotes a vector of time-varying covariates unique to host-state $i$ and $\mathbf{Z}_{ijt}$ denotes a vector containing time-varying, dyadic covariates. $\delta_{jt}$ denotes the home-state by year fixed effects.

The standardized marginal effects are presented in Table 3. Mirroring the results in the main analysis, enactment of the Model Law negates an otherwise positive association between the Rule of Law and *real* FDI flows. And in each case, the magnitude of the difference between the marginal

[19]Distance data were obtained from the Gravity Database maintained by the Centre d'Etudes Prospectives et d'Informations Internationales.

| | No Phantom FDI | | Only Phantom FDI | |
|---|---|---|---|---|
| | (1) | (2) | (3) | (4) |
| Model Law = 0 | 0.188*** | 0.079** | 0.188*** | 0.087 |
| | (0.051) | (0.033) | (0.067) | (0.062) |
| Model Law = 1 | 0.035 | 0.001 | 0.159*** | 0.069 |
| | (0.037) | (0.027) | (0.047) | (0.048) |
| Model Law Effect | −0.153** | −0.077* | −0.029 | −0.017 |
| | (0.060) | (0.042) | (0.078) | (0.077) |
| Controls | | ✓ | | ✓ |
| Home State×Year FE | ✓ | ✓ | ✓ | ✓ |
| Observations | 162,263 | 144,629 | 162,263 | 144,629 |

**Note:** * $p < .1$, ** $p < .05$, *** $p < .01$. Standard errors in parentheses clustered by the host country. Control variables include: Host GDP (logged), GDP per capita (logged), distance (logged), and a dummy variable indicating a bilateral investment treaty between each country-pair. Full results can be found in Table D.2.

Table 3: Standardized marginal effects of Rule of Law on FDI, adjusting for "phantom FDI"

effects is similar to the main results and is significant at the $p < .05$ or $p < .01$ level. In Columns 3 and 4, I report the results from an analysis using only phantom FDI as the dependent variable. I interpret these results as a placebo test because while phantom FDI is counted as "FDI," it is not connected to real economic activity, which implies less sensitivity to the quality of local legal institutions. As we can see, the marginal effect of the Rule of Law on phantom FDI is highly insignificant after the introduction of controls. Moreover, in both specifications the difference between Model Law and non-Model Law countries is highly statistically insignificant. In sum, investment in genuine, contract-reliant economic activity is sensitive to the strength of local legal institutions, while phantom FDI is not. Together, these results suggest that whatever error that may be introduced into the WDI data from "phantom" FDI is likely not driving the main results reported above.

# 6 Conclusion

As Mattli (2001, 919) wrote two decades ago, "The study of private settlement of cross-border trade and investment disputes through international commercial arbitration or other mechanisms has been much neglected by scholars of international political economy and international relations." The study of private authority, transnational legal processes and investor-state arbitration has expanded considerably in the last decade, but ICA—with some exceptions—has been neglected outside of mostly academic-practitioners circles.[20]

Mattli believed this neglect was due to the inability of extant institutional theories in international political economy to account for transnational organizational forms (Mattli, 2001, 923-925). But recent theoretical work on transnational authority has expanded the discipline's theoretical toolkit and provided a common language for better conceptualizing these new and often hard to grasp forms of authority governing the international economy today. The field has progressed due to important theoretical and empirical developments in the areas of transnational, autonomous legal ordering (Schultz, 2014; Stone Sweet and Grisel, 2017) and the role of transnational professionals in enacting global economic governance (Cutler, 2003, 2014; Hale, 2015*a*). One important difference between a private/transnational and public/international legal authority highlighted by this study is that the former supplants domestic rule of law institutions, while the latter imposes obligations from without. This distinction adds a new dimension to what Krisch (2014) dubbed the "decay of consent" in international (or transnational) lawmaking. Countries are signing up for an arbitration regime that has certain known characteristics today, while at the same time limiting their ability to influence the evolution of that regime in the future.

The policy implications of the findings are mixed. The Model Law provides countries with weak rule of law institutions an opportunity to jump start reform in the area of commercial regulation. But due to the secrecy of arbitration, we know little about the broader effects of shifting a substantial case load out of public view. Like ICA, public litigation helps resolve private disputes. Unlike

[20]These exceptions include Cutler, 2003; Whytock, 2010; Karton, 2013; Mattli and Dietz, 2014; Hale, 2015*a*,*b*; Stone Sweet and Grisel, 2017

ICA, litigation creates public goods in the form of credible information about the law and facts. Publicity helps build consistent case law which ensures like cases will be treated alike and allows for public debate which in turn leads to the development of interpretive practices more in line with public preferences (Resnik, 2015). Litigation signals possibly malicious behavior of the litigants to potential future counterparties. As it is currently practiced, ICA provides none of these public goods and limits public courts ability to provide them. We therefore know comparatively little about how arbitrators make their decisions.[21] Studies on the related field of ISDS jurisprudence are not encouraging. A textual analysis of hundreds of ICSID awards finds that it exhibits a distinct pro-investor bias (Van Harten, 2012). Finally, outside of its economic effects, FDI is often touted for the potential spillover of liberal values into illiberal states (Hewko, 2002; Blanton and Blanton, 2007; Neumayer and de Soysa, 2011). Through the introduction of parallel, transnational legal institutions, ICA effectively isolates commercial dispute resolution from the rest of the legal system thereby limiting the means by which rule of law norms could diffuse.

[21] With the notable exception of Karton (2013)

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# Appendix

## Table of Contents

# A Full List of Model Law Countries with Years of Enactment

| | | | | | |
|---|---|---|---|---|---|
| Canada | | Kenya | 1995 | Dominican Republic | 2008 |
| *Alberta* | 1986 | Sri Lanka | 1995 | Mauritius | 2008 |
| *British Columbia* | 1986 | India | 1996 | Peru | 2008 |
| *Manitoba* | 1986 | Malta | 1996 | Rwanda | 2008 |
| *New Brunswick* | 1986 | Zimbabwe | 1996 | Slovenia | 2008 |
| *Newfoundland and Labrador* | 1986 | Iran | 1997 | Brunei Darussalam | 2009 |
| | | Oman | 1997 | Georgia | 2009 |
| *Northwest Territories* | 1986 | Macao, China | 1998 | Australia | 1989 |
| | | Germany | 1998 | *New South Wales* | 2010 |
| *Nova Scotia* | 1986 | Madagascar | 1998 | *Northern Territory* | 2011 |
| *Prince Edward Island* | 1986 | Venezuela | 1998 | *South Australia* | 2011 |
| | | Azerbaijan | 1999 | *Tasmania* | 2011 |
| *Quebec* | 1986 | Belarus | 1999 | *Victoria* | 2011 |
| *Yukon* | 1986 | Greece | 1999 | *Western Australia* | 2012 |
| *Ontario* | 1987 | Honduras | 2000 | *Queensland* | 2013 |
| *Saskatchewan* | 1988 | Uganda | 2000 | *Australian Capital Territory* | 2017 |
| *Nunavut* | 1999 | Zambia | 2000 | | |
| Cyprus | 1987 | Bangladesh | 2001 | Hong Kong | 2010 |
| United States | | Croatia | 2001 | Ireland | 2010 |
| *California* | 1988 | Jordan | 2001 | Liechtenstein | 2010 |
| *Connecticut* | 1989 | Turkey | 2001 | Costa Rica | 2011 |
| *Texas* | 1989 | Bulgaria | 2002 | Lithuania | 2012 |
| *Oregon* | 1991 | Paraguay | 2002 | Saudi Arabia | 2012 |
| *Illinois* | 1998 | Thailand | 2002 | Belgium | 2013 |
| *Louisiana* | 2006 | Japan | 2003 | Bhutan | 2013 |
| *Florida* | 2010 | Spain | 2003 | Maldives | 2013 |
| *Georgia* | 2012 | Chile | 2004 | Slovakia | 2014 |
| Nigeria | 1988 | Norway | 2004 | Bahrain | 2015 |
| United Kingdom | | Philippines | 2004 | Montenegro | 2015 |
| *Scotland* | 1990 | Denmark | 2005 | Myanmar | 2016 |
| *Bermuda* | 1993 | Malaysia | 2005 | Republic of Korea | 2016 |
| *British Virgin Isl.* | 2013 | Nicaragua | 2005 | Turkmenistan | 2016 |
| Mexico | 1993 | Poland | 2005 | Fiji | 2017 |
| Russian Federation | 1993 | Armenia | 2006 | Jamaica | 2017 |
| Tunisia | 1993 | Austria | 2006 | Mongolia | 2017 |
| Egypt | 1994 | Cambodia | 2006 | Qatar | 2017 |
| Hungary | 1994 | Estonia | 2006 | South Africa | 2017 |
| Singapore | 1994 | Serbia | 2006 | Argentina | 2018 |
| Ukraine | 1994 | Macedonia | 2006 | United Arab Emirates | 2018 |
| Guatemala | 1995 | New Zealand | 2007 | Uruguay | 2018 |

**Note:** Data taken from UNCITRAL yearly status reports along with various others sources. The year given refers to when the law came into effect, not when the underlying legislation was passed. Subnational units are italicized.

Table A1: Model Law Countries, 1985–2020

# B Consistency of Model Law Implementation

Table B1 presents a list of key features and their adoption rates as coded by Binder (2010).

| Key Features of the UNCITRAL Model Law | % Adoption |
|---|---|
| *Agreement to Arbitration* | |
| Article 7: Def. of Arbitration Agreement | 100% |
| Article 8: Arb. Agreement and Claim Before Court | |
| 8(1): Court referral of dispute to arbitration | 99% |
| 8(2): Arb. may proceed while Court referral pending | 99% |
| *Choice of Arbitrators* | |
| Article 11: Appointment of Arbitrators | 100% |
| No nationality restriction on arbitrators | 100% |
| *Decisions of the Tribunal* | |
| Article 16: Competence to Rule on Own Jurisdiction | |
| "Kompetenz-Kompetenz" | 100% |
| Separability | 98% |
| Article 17: Interim Measures | 98% |
| *Enforcement of Awards* | |
| Article 34: Restrictions on Challenging an Award | 95% |
| Article 35: Enforcement of International Awards | 91% |
| Article 36: Grounds for Refusing Enforcement | 93% |

**Note:** Data obtained from Binder (2010). Adoption among Model Law countries. Adoption is coded as incorporating the relevant Model Law provision verbatim, with minor revisions, more or less detail or if Binder codes the state as arriving "at a similar result" to the Model Law but with different language. States that create a "different solution" or do not implement the respective Model Law provision are coded as not adopting.

Table B1: Key features of the UNCITRAL Model Law

# C Alternative Specifications for Main Results (Table 1)

Full tables for the alternative model specification are presented below. Conditional marginal effects for each specification are presented in Table C4.

## C.1 Various Fixed Effects Specifications

| | (1) | (2) | (3) |
|---|---|---|---|
| FDI Flows$_{t-1}$ | 0.369*** | 0.263*** | 0.357*** |
| | (0.021) | (0.021) | (0.021) |
| Rule of Law$_{t-1}$ | 3.094*** | 5.908*** | 3.382*** |
| | (0.655) | (1.344) | (0.642) |
| Model Law$_{t-1}$ | 2.975*** | 2.136*** | 2.791*** |
| | (0.557) | (0.811) | (0.560) |
| Model Law$_{t-1}$ × L.Rule of Law$_{t-1}$ | -4.118*** | -4.318*** | -4.378*** |
| | (0.984) | (1.342) | (0.976) |
| NYC$_{t-1}$ | 1.243*** | 1.583*** | 0.884** |
| | (0.349) | (0.493) | (0.354) |
| BITs$_{t-1}$ | 0.016** | 0.002 | 0.002 |
| | (0.008) | (0.013) | (0.009) |
| ln GDP$_{t-1}$ | 0.561*** | 5.683*** | 0.657*** |
| | (0.103) | (0.926) | (0.108) |
| Growth$_{t-1}$ | 0.083*** | 0.076*** | 0.075*** |
| | (0.028) | (0.028) | (0.029) |
| ln GDP per cap.$_{t-1}$ | -0.549*** | -6.004*** | -0.537*** |
| | (0.166) | (1.172) | (0.165) |
| ln Trade Openness$_{t-1}$ | 0.510* | 0.003 | 0.389 |
| | (0.261) | (0.488) | (0.257) |
| Lagged DV? | ✓ | ✓ | ✓ |
| Year FE? | | | ✓ |
| Country FE? | | ✓ | |
| Observations | 4,969 | 4,969 | 4,969 |

Standard errors in parentheses

* $p < .1$, ** $p < .05$, *** $p < .01$

Table C1: Alternative Fixed Effects

## C.2 AR1 Process

| | (1) |
|---|---|
| Rule of $\text{Law}_{\text{V-Dem}}$ | 6.479*** |
| | (1.809) |
| Model $\text{Law}_{\text{t-1}}$ | 2.685** |
| | (1.109) |
| Model $\text{Law}_{\text{t-1}}$ × L.Rule of $\text{Law}_{\text{V-Dem}}$ | -6.373*** |
| | (1.850) |
| $\text{NYC}_{\text{t-1}}$ | 0.835 |
| | (0.664) |
| $\text{BITs}_{\text{t-1}}$ | -0.069*** |
| | (0.023) |
| ln $\text{GDP}_{\text{t-1}}$ | 0.548 |
| | (2.136) |
| $\text{Growth}_{\text{t-1}}$ | 0.048* |
| | (0.028) |
| ln GDP per $\text{cap.}_{\text{t-1}}$ | -1.638 |
| | (2.161) |
| ln $\text{Trade Openness}_{\text{t-1}}$ | 0.153 |
| | (0.610) |
| Year FE? | ✓ |
| Country FE? | ✓ |
| Observations | 4,999 |
| $R^2$ | 0.131 |

Standard errors in parentheses

* $p < .1$, ** $p < .05$, *** $p < .01$

Table C2: AR1 process: Prais–Winsten regression with PCSE

## C.3 Clustered SEs

| | (1) |
|---|---|
| FDI Flows$_{t-1}$ | 0.250*** |
| | (0.033) |
| Rule of Law$_{V\text{-}Dem}$ | 5.459*** |
| | (1.964) |
| Model Law$_{t-1}$ | 2.271* |
| | (1.310) |
| Model Law$_{t-1}$ × L.Rule of Law$_{V\text{-}Dem}$ | -5.182*** |
| | (1.987) |
| NYC$_{t-1}$ | 0.829 |
| | (0.620) |
| BITs$_{t-1}$ | -0.053** |
| | (0.021) |
| ln GDP$_{t-1}$ | 0.450 |
| | (2.286) |
| Growth$_{t-1}$ | 0.066** |
| | (0.030) |
| ln GDP per cap.$_{t-1}$ | -1.433 |
| | (2.073) |
| ln Trade Openness$_{t-1}$ | -0.271 |
| | (0.466) |
| Year FE? | ✓ |
| Country FE? | ✓ |
| Observations | 4,969 |
| $R^2$ | 0.293 |

Standard errors in parentheses

* $p < .1$, ** $p < .05$, *** $p < .01$

Table C3: OLS with standard errors clustered by country

## C.4 Conditional Marginal Effects for Alternative Specifications

| | Table C2 | Table C3 | Table C1 | | |
|---|---|---|---|---|---|
| | (1) AR1 | (2) Clustered SEs | (3) No FE | (4) Unit FE | (5) Year FE |
| Model Law = 0 | 6.478*** | 5.459*** | 3.094*** | 5.908*** | 3.382*** |
| | (1.809) | (1.963) | (0.655) | (1.344) | (0.642) |
| Model Law = 1 | 0.106 | 0.277 | -1.024 | 1.591 | -0.995 |
| | (1.983) | (2.042) | (0.888) | (1.455) | (0.882) |
| Wald test p-value | 0.001 | 0.010 | 0.000 | 0.001 | 0.000 |

Table C4: Conditional Marginal Effects Using Alternative Specifications of Main Model

# D Full Tables for Alternative Data Robustness Checks for Main Results

## D.1 Alternative Measures of Rule of Law (Table 2)

| | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| FDI Flows$_{t-1}$ | 0.173*** | 0.096** | 0.237*** | 0.250*** |
| | (0.033) | (0.042) | (0.022) | (0.021) |
| Rule of Law$_{WGI}$ | 3.221*** | | | |
| | (0.848) | | | |
| Model Law$_{t-1}$ × Rule of Law$_{WGI}$ | -2.256*** | | | |
| | (0.804) | | | |
| Rule of Law$_{Doing\ Business}$ | | 0.179*** | | |
| | | (0.051) | | |
| Model Law$_{t-1}$ × Rule of Law$_{Doing\ Business}$ | | -0.075 | | |
| | | (0.061) | | |
| Rule of Law$_{LJI}$ | | | 5.930*** | |
| | | | (1.861) | |
| Model Law$_{t-1}$ × Rule of Law$_{LJI}$ | | | -6.354*** | |
| | | | (1.887) | |
| Model Law$_{t-1}$ | -0.586 | 2.898 | 2.452** | |
| | (0.565) | (3.470) | (1.021) | |
| Model Law Expanded$_{t-1}$ | | | | 2.274*** |
| | | | | (0.806) |
| Rule of Law$_{V\text{-}Dem}$ | | | | 5.461*** |
| | | | | (1.345) |
| Model Law Exp. $_{t-1}$ × | | | | -5.187*** |
| Rule of Law$_{V\text{-}Dem}$ | | | | (1.322) |
| NYC$_{t-1}$ | 0.812 | -0.064 | 0.673 | 0.829* |
| | (0.829) | (1.231) | (0.512) | (0.496) |
| BITs$_{t-1}$ | -0.089*** | -0.069 | -0.044*** | -0.053*** |
| | (0.034) | (0.052) | (0.016) | (0.016) |
| ln GDP$_{t-1}$ | 0.221 | 1.304 | 0.334 | 0.450 |
| | (2.289) | (3.539) | (1.632) | (1.469) |
| Growth$_{t-1}$ | 0.066 | 0.026 | 0.057* | 0.066** |
| | (0.041) | (0.055) | (0.029) | (0.029) |
| ln GDP per cap.$_{t-1}$ | -1.355 | 1.003 | -2.238 | -1.433 |
| | (2.157) | (3.329) | (1.646) | (1.476) |
| ln Trade Openness$_{t-1}$ | -0.525 | 0.311 | 0.022 | -0.271 |
| | (0.633) | (1.012) | (0.538) | (0.481) |
| Year FE? | ✓ | ✓ | ✓ | ✓ |
| Country FE? | ✓ | ✓ | ✓ | ✓ |
| Observations | 3,136 | 2,288 | 4,427 | 4,969 |

* $p < .1$, ** $p < .05$, *** $p < .01$.

Table D1: Full table of results for estimates presented in Table 2 in the main text

## D.2 Alternative measure of FDI: bilateral "Phantom FDI" data (Table 3)

| | No Phantom FDI | | Only Phantom FDI | |
|---|---|---|---|---|
| | (1) | (2) | (3) | (4) |
| Rule of $\text{Law}_{\text{V-Dem}}$ | 1.727*** | 0.721** | 1.086*** | 0.499 |
| | (0.464) | (0.305) | (0.389) | (0.360) |
| Model Law | 1.205*** | 0.503** | 0.257 | 0.165 |
| | (0.393) | (0.251) | (0.223) | (0.230) |
| Model Law × $\text{Rule of Law}_{\text{V-Dem}}$ | -1.407** | -0.707* | -0.168 | -0.100 |
| | (0.552) | (0.390) | (0.447) | (0.445) |
| $\text{GDP per cap.}_{\text{Host}}$ | | -0.068 | | 0.204*** |
| | | (0.049) | | (0.060) |
| $\text{GDP}_{\text{Host}}$ | | 0.389*** | | -0.057* |
| | | (0.038) | | (0.033) |
| Distance | | -1.054*** | | -0.438*** |
| | | (0.053) | | (0.076) |
| BIT | | 0.170 | | -0.049 |
| | | (0.139) | | (0.121) |
| Constant | 0.345 | 1.052 | -0.289 | 3.545*** |
| | (0.316) | (0.863) | (0.194) | (0.733) |
| Controls | | ✓ | | ✓ |
| Home State×Year FE | ✓ | ✓ | ✓ | ✓ |
| Observations | 162,263 | 144,629 | 162,263 | 144,629 |
| Adjusted $R^2$ | 0.388 | 0.499 | 0.129 | 0.175 |

**Notes:** * $p < .1$, ** $p < .05$, *** $p < .01$. Standard errors clustered by host country.

Table D2: Phantom FDI Robustness Check, Full Table