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**Explaining Pareto-Inefficient International
Cooperation Using Argentina's Bilateral
Investment Treaties**

Laura Collinson

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Development Studies Institute

London School of Economics and Political Science

Houghton Street

London

WC2A 2AE UK

Tel: +44 (020) 7955 7425/6252

Fax: +44 (020) 7955-6844

Email: d.daley@lse.ac.uk

Web site: www.lse.ac.uk/depts/destin

Abstract

Typical explanations for why developing countries engage in welfare-reducing international economic cooperation focus on how international pressures can turn cooperation into a country's least-worst option. Using Argentina's bilateral investment treaties as a case study, this paper finds that domestic politics also influence whether cooperation will be pursued. Specifically, welfare-reducing cooperation can result when economic elites are able to exert significant leverage over the state. In these circumstances, a high discount rate will be used to assess the short-term benefits and long-term costs of cooperation, in which case a country may willingly curtail their ability to develop using industrial policy.

Table of Contents

ABSTRACT	1
TABLE OF CONTENTS	2
1. INTRODUCTION	3
2. TWO EXPLANATIONS FOR PARETO-INEFFICIENT INTERNATIONAL COOPERATION	5
PARETO-EFFICIENT VERSUS PARETO-INEFFICIENT INTERNATIONAL COOPERATION	5
INTERNATIONAL PRESSURES INFLUENCING DOMESTIC CHOICE-SETS	6
DOMESTIC POLITICS AND WELFARE-REDUCING POLICY	7
3. CASE STUDY: ARGENTINA'S BILATERAL INVESTMENT TREATIES	9
THE PARADOX	10
ARGENTINA'S BITS	12
INTERNATIONAL POLITICAL ECONOMY EXPLANATIONS FOR BITS	15
<i>Applying international explanations to the Argentine's experience</i>	17
DOMESTIC POLITICS AND BITS: ECONOMIC REFORM AND STATE CAPTURE	21
<i>The captains of industry: Turning preferences into policies</i>	22
<i>Evidence of the accommodation of business preferences</i>	23
<i>BITs and the preferences of the powerful</i>	25
<i>Contrasting Argentina and Brazil: BITs, autonomy, and preferences</i>	26
4. FRIENDS OF INDUSTRIAL POLICY SPACE: STATE AUTONOMY AND LOW TIME-DISCOUNTING	27
5. CONCLUSION	29
6. APPENDIX	31
7. BIBLIOGRAPHY	32

1. Introduction

For developing countries, multilateral, regional, and bilateral economic agreements with industrialized nations can bring lucrative short-term benefits. Improved access to large, wealthy markets, specialization in new primary products for export, and increased FDI can fuel economic growth. Unfortunately, these benefits may carry a hefty price tag – prohibited use of the industrial strategy tools used by late-industrializers to develop. Late industrializers, including the US, the UK, France, Germany, Japan, Korea and Taiwan have become industrialized nations by using industrial strategy to developing new comparative advantages and move up the global value chain (Kohli 2004, Chang and Green 2003, Chang 2002, Wade 1990, Amsden 1989). Targeted subsidies, credit, trade barriers and insurance, followed by their careful dismantling, created incentives for producers to engage in the risk-laden business of developing increasingly value-added productive capacities. By strategically reserving national treatment for nationals, they achieved gains that vastly outstripped those possible in Ricardian free-trade models based on maximizing gains from static comparative advantages. As Kohli summarizes, “the preponderance of the evidence indicates that late-late-industrialization has always commenced under conditions of protection” (2004, 6).

While the TRIPS, TRIMS and GATS agreements of the GATT/WTO Uruguay Round reduce the ability of countries to develop new productive capabilities by utilizing industrial strategy (Wade 2003), regional and bilateral agreements between developed and developing countries are typically far more restrictive (Shadlen 2007, 2005, Amsden and Hikino 2000). Developing countries exchange further reductions in their industrial policy space, restrictive investment and intellectual property provisions, for sweeter inducements, such as greater market access. This exchange, which Shadlen (2005) terms deep for shallow integration, can be seen in many bilateral investment treaties (BITs), regional and bilateral trade agreements (RBTA, including NAFTA), and bilateral intellectual property agreements (BIPs). A crucial area of study, therefore, is determining why some developing countries choose to engage in economic cooperation above and beyond their WTO commitments, while others choose to preserve their industrial policy space. To address this question, this paper continues as follows.

Section 2 outlines two explanations for welfare-reducing international cooperation. Firstly, international political and economic pressures can alter the payoff matrix facing domestic policy-makers. Cooperation may become the least-worst option when international forces replace a country's status quo with an inferior option, such as occurs when countries are excluded from international arrangements (Gruber 1990). Secondly, domestic politics may result in welfare-reducing cooperation when politicians or officials with only themselves and/or a small, powerful constituency in mind conduct diplomacy. If this coalition has preferences that run counter to the country's development, they may lead the country into binding international agreements whose costs far exceed their benefits.

Section 3 illustrates the ability of both international pressures and domestic politics to explain Argentina's bilateral investment treaties with major capital exporters. While the BIT literature focuses on international pressure as a crucial determinant of the proliferation of BITs, (specifically, competition between developing countries for capital) the case of Argentina illustrates that domestic politics are also highly significant. It is arguably the combination of international competition for capital *and* the power and preferences of domestic interests that explains Argentina's particularly development-stifling foreign investment regime. The influence of the preferences of powerful economic interests and the autonomy of the state can be seen in the gulf between the BIT regimes of Argentina and Brazil.

Section 4 examines the determinants of a country's willingness to trade away their ability to utilize industrial policy tools more generally. While international pressures that replace the status-quo with inferior circumstances matter, the extent to which the political process is dominated by traditional industries is a particularly insidious. A state that is beholden to existing economic interests can be expected to heavily discount the future consequences of reduced industrial policy space. Thus, states that are autonomous and stable will have the ability to both implement industrial policy and preserve industrial policy space when faced with international pressure to cooperate.

Section V concludes.

2. Two explanations for Pareto-inefficient international cooperation

This section explores two theoretical explanations for why developing countries enter into cooperative arrangements that make them worse off, a controversial notion itself (2.1). Section 2.2 explores how developing countries might pursue cooperation if international economic and/or political pressures remove the status quo from their choice-set. Section 2.3 looks at Pareto-inefficient international cooperation as a component of domestic economic policy reform. Pareto-inefficient cooperation (and welfare-reducing economic reform in general) may result when domestic policy-making is driven by the preferences of a small segment of society.

Pareto-efficient versus Pareto-inefficient international cooperation

Pareto-inefficient cooperation runs counter to the mainstream study of international relations. Since Keohane's *After Hegemony* (1984), regime theory, later termed neoliberal institutionalism, has framed questions of why and how countries cooperate in terms of the creation of positive-sum international institutions (Martin 1999). Essentially, rational choice theory is used to explain how cooperative international arrangements are created to solve collective action problems and bring countries closer to the Pareto frontier. The prisoner's dilemma is this body of work's prime analogy, highlighting the importance of credible enforcement and commitment technologies to avoid the Nash equilibrium (welfare-reducing non-cooperation). Without these institutional mechanisms, imperfect information and free-riding will make all players worse off. (Martin 1999)

While Krasner's (1991) account of global telecommunications regimes (or lack thereof) explores the possibility of bargaining power being used to unequally divide the gains from cooperation, akin to the battle of the sexes game, cooperation is still framed in terms of Pareto improvement. It is when a single powerful country acts unilaterally, as in the cases of radio broadcasting and remote sensing, that weaker international players are left worse off.

In the case of Pareto-inefficient cooperation, when at least one party is made worse off

from the arrangement, the research-agenda begun by Keohane cannot explain either why or how international institutions are created. Plausible explanations, like those explored below, must take this possibility into account. While the decision to engage in international economic cooperation is likely determined by a number of factors, this paper focuses on two in particular. Firstly, international forces constrain the choice-sets of domestic policy-makers. Secondly, domestic power-relations can result in openness to international economic cooperation.

International pressures influencing domestic choice-sets

The counterintuitive notion of choosing something that is disadvantageous can be explained by Terry Moe's melding of power and the rational choice notion of voluntary exchange. Essentially, international cooperation can be seen as a voluntary choice made in the context of "power-constrained choice-sets" (2005). Power is exercised, intentionally or unintentionally, to alter the policy-maker's payoff matrix. Moe gives the example of a thief providing someone with a choice between their money and their life. He explains, "The victim's will is being expressed relative to a specific agenda of alternatives. And the criminal is now controlling the agenda"(2005, 227).

Force and coercion are the most evident means by which one player forces another to do something it would not have chosen, given the status quo ante. An international hegemon can threaten a weaker country with sanctions or physical aggression, reducing its choice-set to two utility-reducing options – agreement and punishment. The United States can threaten to terminate a country's GSP benefits if it does not enter into a 'cooperative' agreement.

However, the status quo can fall out of a country's choice-set without the intentional state-to state-exercise of force or coercion. A change in international market conditions or politics can increase the cost of non-cooperation for countries far removed from these new developments. Both Gruber (1990) and Simmons et al. (2006) explore mechanisms that create incentives to encourage participation in international cooperation. Exclusion from agreements involving nations with go-it-alone power (Gruber 1990), and agreements that give one's competitors a relative advantage, (plausibly the same

agreements) can replace the status quo with something worse.

Gruber (1990) critiques the logic of international cooperation accepted by most scholars – that cooperation leads to international institutions, which leads to welfare improvement, by focusing on the negative externalities of cooperation for non-members. Essentially, countries with “go-it-alone power” are able to create institutions that, simply by coming into existence, reduce the welfare of excluded non-members. Non-members must then choose between membership in the existing institution and exclusion. As long as potential losers cannot block cooperation and the original members are not made worse off through new membership, new members will join the bandwagon, leading to an explosive proliferation of cooperation. Countries will enthusiastically initiate their accession into “cooperative institutional arrangements they genuinely, and intensely, dislike” (1990, 10), and this enthusiasm for cooperation will be contagious. Gruber forwards that this explains why Mexico joined NAFTA.

A similar dynamic is explored by Simmons et al. (2006) to explain the spread of economic liberalism. Essentially, competition for mobile capital or export market share (shallow integration) results in policy diffusion between equals. Competition can result in a race to the bottom with stark distributional consequences. The competitors for the scarce resource will reduce their selling “price”, for example by offering large tax breaks for international investors to lure mobile capital, channeling the bulk of the gains from the exchange to foreign investors (Guzman 1998). In this case, it is not the threat of a new institutional arrangement involving at least one powerful country that sparks a wave of policy re-orientation towards cooperation in weaker countries. Instead, policy re-orientation (perhaps towards cooperation) is sparked in one nation when that nation’s economic competitors change their policies (Simmons et al. 2006).

Domestic politics and welfare-reducing policy

Pareto-inefficient international cooperation might also be pursued because it is in the interests of the powerful few. Pareto-inefficient cooperation that sacrifices long-term industrial policy tools may form part of a broader policy of economic reform designed to suit the preferences of a powerful minority. While Gruber admits that, “Only rarely can

governing elites afford to sacrifice the immediate material well-being of their core constituencies for the sake of longer-run or more diffuse societal gains (1990, 57),” he focuses on exogenous pressure, as opposed to powerful domestic interests, as the driving force of Pareto-inefficient cooperation. However, these international forces may be particularly influential in some countries because they face few obstacles on the domestic front.

Certainly, many authoritarian governments have stifled long- and short-term economic success to preserve domestic political and economic power asymmetries (Brett 2005, Olson 2000, North 1990). Yet states of various political stripes choose policies that lead to aggregate welfare reduction (in the short and long-term) because of the disproportionate ability of influential coalitions to influence policy (Olson 2000). Moe (2005) explores the possibility that, even in a relatively well-functioning democracy, binding institutions may be imposed by the winners, to the detriment of many in the short-term and almost all in the long-term. “So, when they lose under the democratic rules of the game, they have to suffer the consequences – and the winners are well aware of this. The latter can impose the institutions they want. There is nothing to stop them (Moe 218)”.

In the case of international economic cooperation, the question of why countries cooperate is often closely related to how states overcome the heavy political costs of economic liberalization. The winners from the pre-reform status quo will utilize their political and economic resources to mobilize against reform, while the potential winners from reform are often unidentified and diffuse. This collective action problem resulted in the now discredited belief that only highly autonomous governments, perhaps only dictatorships, would be able to weather the political costs of economic reforms with a high ratio of redistribution to efficiency gains (Rodrik 1998, Panizza 2000).

Many scholars have since explained non-authoritarian liberalization by examining what Schamis (1999) terms “the politics of empowering the winners” of reform, as an alternative to the “politics of neutralizing the losers” which in its extreme is exemplified by Pinochet’s authoritarian imposition of market-led reform. The political costs of reform can be drastically reduced if the winners from reform are known, and lobby for reform,

ex ante. This notion forms the basis of Schamis' response to the classic rent-seeking literature. "At no point does [the rent-seeking] approach consider whether analogous distributional coalitions [to those that perpetuate ISI] could organize in order to induce governments to *withdraw* from the economy in anticipation of market reserves made available by liberalization" (1999, 240).

The tension between exogenous and endogenous explanations for welfare-reducing cooperation is best highlighted in the debate concerning whether international institutions are used as scapegoats by domestic politicians. Discussing the European Monetary System, Gruber (1990) cites Krugman's (1994) belief that cooperation-inclined politicians (and presumably their closest domestic financial supporters), stave off domestic opposition to cooperation by convincing their wider base of supporters that there is no alternative. Gruber disagrees, raising the possibility that when politicians claim that there is no alternative to cooperation, they might be telling the truth.

In reality, both notions likely contain some truth, and these forces are quite plausibly mutually reinforcing. This complementarity can be seen in the wave of efforts to bring domestic politics into international relations, and international relations into comparative politics. Shadlen (2007) finds that both international forces (increased trade, investment and capital mobility, and coercion) and "domestic power asymmetries" are significant in explaining the proliferation of regional and bilateral trade agreements (RBTA) between the US and Latin America and the Caribbean.

3. Case study: Argentina's bilateral investment treaties

Bilateral investment treaties, particularly those signed between Argentina and large capital exporters, are a particularly interesting example of cooperative international arrangements that are potentially devastating for the developing country partner, and yet are enthusiastically created. This section explores the paradoxical multilateral opposition and bilateral acceptance of foreign investor protection exhibited by developing countries, and the costs and benefits of Argentina's particular BIT regime. The next section

examines the leading body of literature on why developing countries sign BITs, which examines how international competition between developing countries for capital makes BITs increasingly tempting. Finally, the competition for capital thesis is utilized to partially explain the Argentine's BIT regime.

The paradox

Up until the 1970s, the Hull Rule was the principal mechanism available to aggrieved foreign investors seeking recourse. Host governments who had expropriated foreign property were expected to provide "prompt, adequate and effective" compensation, or suffer retribution from the investor's home state. However, the sense of legal obligation required for the Hull Rule to remain customary international law began to be eroded by heated debate between developing countries who were concerned with the preservation of their sovereignty and capital exporters in the post-war period. Their campaign to change customary international law focused on maintaining state sovereignty and establishing host country justice systems as the appropriate venue for dispute resolution between investors and host governments, known as the Calvo Doctrine in Latin America. Finally, a series of resolutions passed by developing countries in United Nations General Assembly in the 1970s rendered it defunct. A 1973 Resolution on Permanent Sovereignty over Natural Resources stated the following:

...The application of the principle of nationalization carried out by States, as an expression of their sovereignty in order to safeguard their natural resources, implies that each State is entitled to determine the amount of possible compensation and the mode of their payment, and that any dispute which might arise should be settled in accordance with the national legislation of each State carrying out such measures...(Guzman 1997)

In the 1990s, developing country positions during the Uruguay and Doha Rounds at the GATT/WTO have followed a similar logic. As a result of cleavages between capital exporters, the TRIMs agreement is notable in its relative weakness compared to the other components of the Uruguay Bargain. Less than 40% of the US's proposed trade related investment measures were eventually prohibited by the agreement (Graham 1997), leaving many strategies available for states wishing to utilize foreign investments to meet long-term domestic objectives (Shadlen 2007, Amsden and Hikino 2000). Developing

countries, most notably the Like Minded Group¹ and the LDC/ACP/AU, have since worked to keep investment (one of the so-called Singapore issues) off the WTO negotiating agenda (ICTSD 2003, 2001).

Remarkably, the exponential growth of BITs between developing countries and capital exporters has occurred amidst developing country opposition to multilateral cooperation on foreign investment protection. The number of BITs concluded each year crescendoed in the 1990s, and with over 2300 in force, very few countries have signed none.

Compared to the Hull Rule and the TRIMS agreement, BITs radically increase the costs of taking steps that might be considered expropriation, defined in the broadest possible sense. The sharp teeth of the mandatory state-investor arbitration clauses contained in the vast majority of BITs provide host states with a commitment technology². This theoretically provides even uncredible states with a mechanism to overcome the dynamic inconsistency problem of foreign investment. The promise not to expropriate the investors' resources once they have been invested becomes far more credible because they can be severely punished for renegeing on this promise. Reducing the risk of investment reduces the costs of investing, which, all else remaining equal, should at least incrementally improve a country's ability to attract capital inflows. While some researchers have found a significant positive relationship between BIT-signing and FDI (Neumeyer and Spess 2005), the ability of BITs to attract FDI (as well as the usefulness of FDI once BITs have been signed) is hotly contended. In the spirit of 'stacking the cards against oneself', this paper assumes that some developing countries derive short-term benefits from BITs, certainly the case for Argentina.

While there may be benefits to be reaped from signing BITs, the typical BIT drastically reducing the industrial policy space left available under the TRIMs agreement (Amsden and Hikito 2000, Shadlen 2005). Capital exporters rarely make concessions in terms of national treatment of investors, regulation of capital movements, performance requirements and dispute settlement (Chowla 2005). The danger of an investment regime

¹ Members of the Like-Minded Group are Cuba, Dominican Republic, Egypt, Honduras, Indonesia, India, Kenya, Malaysia, Sri Lanka, Tanzania, Uganda, Zimbabwe and Jamaica. (ICTSD 2001)

² Elkins et al. (2006) explains that BITs can be viewed either as a commitment technology, or signaling device, with roughly similar theoretical implications.

based on non-discrimination is that it prevents countries from incubating local producers until they reach the point of successful insertion into the global economy, a crucial outcome of Taiwan's strategic treatment of investment. Wade explains,

The rules governing entry of direct foreign investment – as to industry, technology transfer, local content, and exports – enable the government to use direct foreign investment as another way, in addition to public enterprises, of creating incentives and pressures for further growth of domestic firms and industries the government wishes to encourage. (1990, 304)

Chang and Green emphasize the crucial role played by strategic investment policies for almost all late developers. They find, “when they were net recipients of foreign investment, all of today's developed countries imposed regulations on foreign investment in order to ensure that such investment contributed to their long-term development” (2003, xiii).

Thus we arrive at a crucial question. Why would a developing country far exceed their WTO commitments by signing a BIT? Why choose the chance to attract FDI while sacrificing the ability to harness FDI towards industrial development? In Shadlen's terms, why enter into cooperative agreements designed to attract FDI “in exchange for diminished space for the use of industrial policy instruments to create new productive capacities?” (2005, 750). The following section examines the particular costs and benefits of Argentina's BIT regime.

Argentina's BITs

This section explores the costs and benefits of Argentina's BITs. While Argentina's BITs may have been associated with increased FDI to support their ambitious program of macroeconomic stabilization through extensive privatization, these cooperative international agreements will likely prove welfare-reducing in both the short and long-term. The country not only faces a swath of arbitrations that may prove extremely costly, but has also drastically reduced their ability to harness foreign investment to the

country's development of higher value-added productive capacities³.

The connection between BITs and privatization, a crucial element of the Menem government's market-led economic reform, in Argentina is striking. Privatization formed the core of the state's reform plan to achieve macroeconomic stability after debilitating inflation throughout the 1980s and hyperinflation in 1989 and 1990. Fanelli and Damill (2004) report:

A key objective of the structural reforms introduced by the Menem administration was to create a 'climate of investment' that would make sustained growth viable. The tools selected were market liberalization and deregulation, economic integration with the rest of the world, and reform of the public sector, all of which revolved around an ambitious privatization program (36).

Confronting flush global capital markets and desperate to reverse the flow of capital out of the country and balance the fiscal account, attracting foreign capital by selling the bulk of the state's state-owned enterprises was chosen as the core of their economic policy reform. Phillips (2004) indicates that, "some 75 per cent of total capital inflows between 1990 and 1995 were associated with the privatization process" (68). There is little doubt that the BITs signed between Argentina and their major sources of capital in North America and Europe were designed to make this happen. The vast majority of BITs signed between Argentina and capital exporters were signed in 1990 and 1991 (see Table 1); the epicenter of the first wave of privatizations. In this sense, Argentina's BITs were highly successful. Tobin and Rose-Ackerman (2006) find that Poland is the only other country that's BITs are as closely associated with increased FDI flows as Argentina's.

Even with these benefits, Argentina's BITs will likely prove welfare-reducing in both the short and long-term. In the short-term, Argentina is feeling the sharp teeth of their mandatory investor-state arbitration clauses. The state had been party to over 30 arbitration cases under ICSID and UNCITRAL rules by 2004, 70 per cent of which relate

³ The potential costs of BITs likely extend beyond arbitration awards and lost industrial policy space. Daniels (2004) explores how BITs might stifle the development of the rule of law in developing countries because BITs "dull an interest or incentive on the part of foreign investors to seek to condition their investments in the host developing state on the creation of good rule of law institutions that would be generally accessible to foreign and domestic investors alike" (24).

to the emergency measures taken by the Argentine state in early 2002 (Towil 2004). While most of these cases are still pending, awards granted to aggrieved investors could prove extremely costly, given past precedent (Van Harten 2005). Early ICSID rulings ordered Argentina to pay US companies CMS and Azurix \$133.5 million and \$165 million, respectively, for violating the US-Argentine BIT (Dow Jones Newswire, July 18, 2006). Senior Argentine officials have since denounced the investor-state arbitration process and threatened to return to the Calvo Doctrine regime, in which foreign investors are limited to seeking recourse within the host-country's legal system (Towil 2004)⁴. This would prove difficult. The Argentina-US BIT, for example, can be terminated with one years notice after its initial 10-year period, but remains in force for existing investors for another 10-year period (Article 14).

Far more insidious, Argentina's BITs drastically curtail their ability to harness FDI flows towards national industrial development. The Argentina-US BIT (UNCTAD 2007b) is among the 'naughtiest', including almost all of the variables Chowla (2005) deems most threatening to industrial policy space. It defines investment widely, including debt, equity and intellectual property as investment, and grants investors in almost all sectors pre-establishment rights (Article I). This prohibits the government from screening entry or compelling joint ventures in all but six sectors⁵. It outlaws all forms of performance requirements (Article II), requiring the motor vehicle sector to phase-out existing performance requirements within eight years. This includes the export, technology transfer, staff nationality and local content purchasing requirements widely utilized as industrial strategy in the past (Chang and Green 2003). It grants unrestricted repatriation of returns (Article V), and mandatory and binding investor-state arbitration (Article VII). Thus, it is no surprise that the long-term trend towards "premature deindustrialization" in Argentina continues (Shafaeddin 2005, 10). Industry's share of GDP shrank from 40 percent in 1980 and 36 percent in 1990, to 28 percent in 2000 (Bustelo 2004). Phillips explains,

Investment in the early 1990s was channeled primarily into the non-

⁴ At least Russia (Luz 2001) and Bolivia (Washington Post: Latin leftists mull quitting World Bank arbitrator, April 29, 2007) have also publicly condemned their BIT regimes.

⁵ Air transport, shipbuilding, nuclear energy centers, uranium mining, insurance, and fishing.

tradables sector and very little progress was made in shifting away from low value-added exports of agriculture and energy products towards higher value-added exports, indicating clearly the sustained lack of coordination between macroeconomic and microeconomic strategies. (2004, 69 citing Pastor and Wise 1998: 12-13)

Given the strong possibility that the developmental costs of Argentina's BITs will far outstrip their benefits both in the short and long-term, understanding why Argentina signed these welfare-reducing agreements is crucial. This paper forwards that while international political and economic pressures changed Argentina's choice-matrix in favour of signing BITs, explored in the following section, domestic politics worked in tandem with these international forces. Arguably, Argentina's decision to sign particularly policy-space reducing BITs with most major capital exporters in a period of less than 24 months can be explained by the leverage exerted over the state by a small group of powerful intermediate goods conglomerates.

International political economy explanations for BITs

The literature on BITs typically explains the rapid proliferation of BITs between developed and developing countries by focusing on how international political and economic pressures constrain the domestic policy-maker's choice-set. Typically taking a cross-country approach, these international political economy-oriented explanations focus on how competition between nations for capital flows, as well as the increasingly mobile nature of capital flows, triggers a 'race to the bottom' in terms of foreign investor protection. This explains the seemingly irrational behaviour of developing countries that oppose investor protection in multilateral fora while actively seeking out BITs. While BITs pose a much greater threat to the nation's development prospects than the Hull Rule and the TRIMS agreement, BITs come with either sweeter signing bonuses, or more likely, higher non-participation costs.

Both competition and coercion influence domestic policy-choice by altering the domestic choice-set. However unlike coercion, (when the powerful use 'sticks' to induce more favourable policies in weaker nations), cooperation is more decentralized. Guzman

(1997) forwards that BIT-signing becomes more attractive to developing countries as their competitors sign BITs and the price of non-cooperation increases as they become comparatively less attractive to foreign investors. To avoid being left behind (what Gruber (1990) terms the ‘fear of exclusion’), developing countries engage in an investment protection race to the bottom. Akin to the conditions in a perfectly competitive market that reduces the economic profit of sellers to zero, in this competitive dynamic between developing countries, “the benefits of investment will all go to the investor, leaving no surplus for the host” (Guzman 1997).

Elkins et al. (2006) find empirical support for the notion that the proliferation of BITs can be explained by competition between developing countries for foreign capital. “The evidence suggests that potential hosts are more likely to sign BITs when their competitors have done so...the diffusion of BITs is associated with competitive economic pressures among developing countries to capture a share of foreign investment” (Elkins et al. 2006, 838). Using multiple measures of competition (similar export trade relationships, similar export products, and similar infrastructure and labour force), their empirics suggest that in the late 1990s, a country whose average competitors had signed 15 BITs would be at most 20 percent more likely to sign BITs themselves than a country whose competitors had signed none.

Elkins et al. (2006) find scant evidence of BIT diffusion via coercion, learning from the outcomes of BITs signed in the past, or emulation of the policies pursued by more prosperous nations⁶. Coercion is an unlikely explanation because the global pattern of BIT-signing between developed and developing countries suggests that the developing country partner initiates BITs. Elkins et al. illustrate that developing countries typically sign a number of BITs in a short time period, supporting Chowla’s findings that “generally capital importers first approach capital exporters proposing a BIT at which point the developed country produces their model text as the starting point for negotiations” (2005, 34).

Several other international economic pressures may have contributed to the competitive

⁶ Simmons et al. (2006) poses these four mechanisms as potential explanations for the diffusion of liberalism.

dynamic identified by Guzman and Elkins et al. The proliferation of BITs occurred amidst the acceleration of capital flows and expansion of transnational corporation production to new parts of the world in the late 1980s and 1990s (Bulmer-Thomas 2006). As well, the demise of the Hull Rule left foreign investors with less recourse in the case of expropriation, and potential host countries with one less mechanism to assure investors of their credibility. Thus, while developing countries may have had more to gain from making themselves more attractive to international capital by signing BITs, they may also have had more to lose. The following section explores the applicability of these ideas to the case of Argentina.

Applying international explanations to the Argentine's experience

Elkins et al. (2006) find that international economic pressures created a context that made signing BITs increasingly appealing to developing countries. These countries faced the prospect of increased returns from cooperation as global capital flows increasingly surged into the so-called 'emerging markets'. Concurrently, the price of non-cooperation increased due to the increasingly mobile nature of capital, with the onus on governments to draw in and retain these flows (Oman 2000). Most importantly, the increasing ubiquity of BITs made them harder to resist.

The pace and timing of Argentina's BIT-signing is particularly consistent with the notion that an international competitive dynamic between developing countries fuelled BIT-signing in the 1990s. Gruber (1990) predicts that countries enter into Pareto-inefficient cooperative agreements for fear of being excluded from a regime that will occur with or without their participation. If this is the case, developing countries will face mounting pressure to sign BITs as these agreements are increasingly concluded around them, especially if their competitors sign (Guzman 1998, Elkins et al. 2006). Figure 1 demonstrates that the pattern of BIT-signing exhibited by the 22 developing countries used in the S&P Emerging Markets Index⁷, arguably Argentina's closest competitors,

⁷ Based on the International Finance Corporation Index of emerging markets: Argentina, Brazil, Chile, China, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Rep. Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey.

closely resembles that of Argentina. Argentina starts signing BITs when the average 'emerging market' has signed just over six, and almost immediately surpasses the average. The number of BITs signed by Argentina is consistently greater than the number signed by the countries who most forcefully fought against the Hull rule, Brazil, India and Mexico, (Elkins et al. 2006), and less than China and Poland (see Appendix).

Figure 1: BITs signed by emerging markets⁸

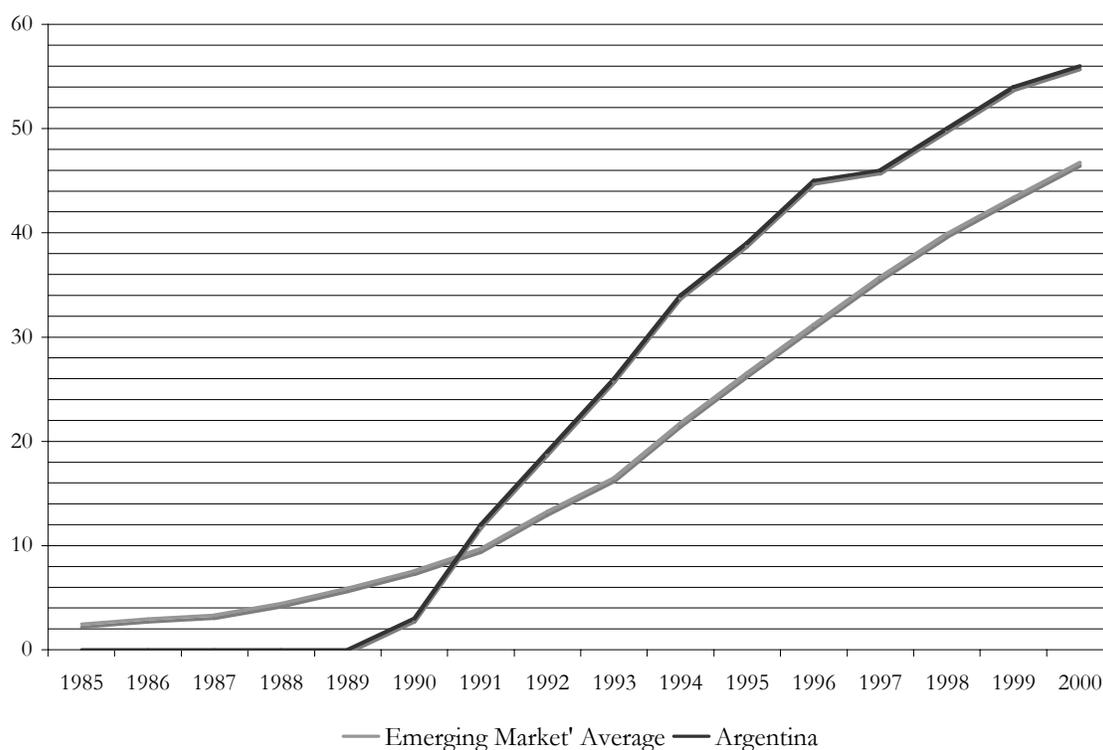


Table 1 more explicitly illustrates the applicability of Guzman's competition for capital thesis in the case of Argentina. Argentina signed BITs with ten of the twelve largest capital exporters in less than two years, following many other middle-income countries. Argentina often signed a BIT with a home country soon after several of them—Czechoslovakia, Hungary, Poland, and Russia. This suggests that the transition from Soviet communism in these Eastern European countries in 1989 and in Russia may have played a significant role in catalyzing Argentina's decision to sign. By entering the

⁸ BIT data from (UNCTAD 2007a).

market and increasing the number of global competitors for capital, they may have effectually raised the 'price' of attracting the same amount of investment as before.

Table 1: Argentina's BITs with the twelve largest capital exporters⁹

<i>Capital Exporter</i>	<i>Signature Date of BIT with Argentina¹⁰</i>	<i>BITs with Emerging Markets Signed Prior to BIT with Argentina</i>
Japan	None.	--
Germany	April 9, 1991	Czech Rep. (1990), Hungary (1986), Israel (1976), Malaysia (1960), Poland (1989), Russia (1989), Turkey (1962)
France	July 3, 1991	China (1984), Czech Rep. (1990), Egypt (1974), Hungary (1986), Indonesia (1973), Israel (1983), Malaysia (1975), Poland (1989), Russia (1989)
United States	November 14, 1991	Czech Rep. (Oct. 1991), Egypt (1986), Morocco (1985), Poland (1990), Turkey (1985)
United Kingdom	December 11, 1990	China (1986), Czech Rep. (July 1990), Egypt (1975), Hungary (1987) Indonesia (1976), Malaysia (1981), Morocco (Oct. 1990), Philippines (1980), Poland (1987), Russia (1989), Thailand (1978)
Sweden	November 22, 1991	Czech Rep. (1990), Egypt (1978), Hungary (1987), Malaysia (1979), Morocco (1990), Poland (1989)
Netherlands	October 20, 1992	Czech Rep. (1991), Hungary (1987), Malaysia (1971), Morocco (1971), Philippines (1985), Poland (Sept 1992), Russia (1989), Thailand (1972), Turkey (1986)
Italy	May 22, 1990	China (1985)), Egypt (1989), Hungary (1987), Malaysia (1988), Philippines (1988), Poland (1989), Rep. Korea (1989)
Switzerland	April 12, 1991	Czech Rep. (1990), Egypt (1973), Hungary (1988), Indonesia (1974), Malaysia (1978), Morocco (1985), Poland (1989), Russia (1990), Turkey (1988)
Belgium and Luxembourg	June 21, 1990	Czech Rep. (1989), Hungary (1986), Indonesia (1970), Rep. Korea (1974), Poland (1987), Russia (1989), Turkey (1986)
Canada	November 5, 1991	Czech Rep. (1990), Poland (1990), Russia (1989)
Spain	October 3, 1991	Czech Rep. (1990), Russia (1990)

While compelling, the competition for capital thesis is less adept at explaining why

⁹ Ranked by 1990 direct investment outflows (OECD Statistics). BIT data from (UNCTAD 2007a).

¹⁰ Following Elkins et al. (2006) I focus on the signature date, arguably when the treaty begins serving as a signaling device and/or commitment technology, instead of the ratification date.

Argentina is in the upper part of this range, why their BITs are particularly stifling, and why they signed BITs with the largest capital exporting countries long before their regional competitors such as Brazil and Mexico. Given Shadlen's findings that both international and domestic factors are significant in explaining the proliferation of regional and bilateral trade agreements (2005), it is likely that cooperation on investor protection is also influenced by the power and preferences of domestic interest groups. The next section illustrates that, while international pressures likely influenced Argentina's BIT regime, the combination of these pressures *and* the domestic political context more comprehensively explains the country's rapid creation of a far-reaching BIT regime. The preferences of the most powerful interests in Argentina created a domestic political context that was particularly favourable to the creation of BITs. Both the state and the most powerful large economic conglomerates – the captains of industry – weighted the benefits of BIT-signing far more heavily than the costs.

Domestic politics and BITs: Economic reform and state capture

Understanding why Argentina's domestic political context was so favourable towards BITs involves utilizing a political economy approach, essentially assessing the power and preferences of different interest groups in the early 1990s. Section 3.4.1 examines how Argentina's economic elites – the captains of industry – were particularly able to influence policy. The state's political survival depends on their ability to restore economic stability, and they chose to utilize economic adjustment to achieve this purpose. Facing the collective action problem of economic policy reform, but without the power to “neutralizing the losers” (Schamis 1999), the state overcame the collective action problem by satisfy the preferences of the captains of industry, essentially “empowering the winners” (Schamis 1999). Section 3.4.2 illustrates how the preferences of both these groups favour achieving economic stability, and thus attracting foreign capital to purchase state-owned enterprises and restore fiscal stability. Most importantly, neither group has an incentive to worry about the future costs of the mechanisms used to attract foreign capital, such as BITs. Section 3.4.3 contrasts Argentina and Brazil. While powerful economic groups are able to exert some over the state of Brazil as well, BITs

have faced significant domestic political barriers in Brazil because both the state and powerful economic groups have a powerful interest in the continued use of industrial policy tools.

The captains of industry: Turning preferences into policies

Argentina's lack of a business peak association, a body to "represent, aggregate, and organize business interests across the entire economy" (Acuña 1998, 52), is a strong indication that business preferences are well accommodated by the state. Acuña finds that encompassing peak organizations for business interests manifest themselves only when are demanded by their potential members. When economic elites have the power to veto government policy by withholding investment, refusing to purchase public bonds or curbing imports and/or exports, there is little incentive to organize (1998, 53). A strong and autonomous state that threatens business interests or a powerful labour lobby is often the impetus for their creation. Conversely, political vulnerability drives the state to seek the support of business by creating channels of access for individuals or non-peak business associations, leaving economic elites with no need for a peak association (Schneider 2004).

The captains of industry, massive Argentine conglomerates such as Bunge y Born, Alpargatas, Siam, Perez Companac, and Bidas (Phillips 2004, 188-9), were the economic elites most capable of exerting leverage over the Argentine state in the early 1990s. They were strengthened by the *Proceso* military dictatorship (1976-1983), which continued granting subsidies and high tariff protection only to their industries. As a result, their share of the total value of output rose from 27.6 percent in 1975 to 33.5 percent in 1982 (Peralta-Ramos 1992, 77-76). These conglomerates are concentrated in intermediate goods industries, industrial chemical products, petroleum refining, nonmetallic minerals, iron and steel, and non-ferrous metals, and are characterized by high levels of internationalization and access to foreign capital far before the liberalization under Alfonsín (1983-1989) and Menem (1989-1999) (Phillips 2004).

Evidence of the accommodation of business preferences

The ability of the captains of industry to exert leverage over the state and influence the policy-making process is evident in the late 1980s and early 1990s. Menem's government was sent a strong message by the 'economic coup' perpetrated by business elites in 1988, which sabotaged the vestiges of the Spring Plan, a price agreement between industry elites and the government designed to stem inflation, and Alfonsin's political legitimacy (Schamis 1999). When the central bank terminated their dollar-selling policy due to rapidly dwindling reserves, the largest firms retaliated by attacking the currency market (Schamis 1999, Peralta-Ramos 1992).

Perhaps heeding the lessons painfully learned by Alfonsin, Menem and his senior officers cultivated strong informal channels between themselves and the most powerful business leaders (Schneider 2004, Phillips 2004). Menem appointed Miguel Roig, from the massive, internationalized conglomerate Bunge y Born as his first economic minister, followed by Born's handpicked Nestor Rapanelli (Phillips 2004). Negotiations between the state and these economic elites spilled into formal channels as well. Peralta-Ramos describes how, after the first seven months of Menem's incumbency, "the national cabinet had become the battlefield of the most powerful economic groups, and official policy was the product of the pressures exerted on it" (1992, 164).

The fingerprints of the captains of industry are readily apparent on the privatization policies of 1989 and 1990. These businesses were initially extremely hostile to the opening of state companies to foreign capital, and had stymied Alfonsin's attempts to do so. The largest businesses in the powerful intermediate goods industries benefited from the existence of state-owned enterprises, receiving subsidized inputs and/or selling to them at premium prices (Peralta-Ramos 1992). Thus, through a variety of mechanisms¹¹, the most powerful business leaders ensured that they benefited from the privatization process. The economic emergency bill and privatization of state companies bill, both passed in 1989, are often cited as evidence of Menem's success in consolidating power within the executive. Yet these laws were weakened significantly after negotiations with the private sector. In exchange for the support of intermediate goods business leaders,

¹¹ These mechanisms included sending death threats to the economic minister and his family (Peralta-Ramos 1992, 151).

“the state companies reform gave preferential rights in the purchase of state companies to firms that did business with these same state entities” (Peralta-Ramos 1992, 151).

The collective action problem of economic policy reform

The Menem government’s dependence on the support of economic elites was especially acute because of the large distributional consequences of its ambitious economic adjustment program. The political barriers to economic reform, such as the shift from import substitution industrialization to a market-led economy, can be chalked up to distributional consequences and imperfect information (Schamis 1999, Rodrik 1998). Essentially, reformers confront a collective action problem, whereby the status quo’s winners will utilize their ample resources to successfully mobilize against reform, because the eventual winners from reform remain unidentified, diffuse, and relatively less powerful. This logic spawned the once-popular stylized fact that only relatively authoritarian governments with a significant degree of autonomy and insulation will be able to weather the political costs of the huge distributional consequences of market-led reform (Panizza 1999, Rodrik 1998).

Given this logic, many scholars attribute Argentina’s ability to overcome the reformer’s collective action problem to the executive’s autonomy and insulation from pressure groups. This leads to a focus on how economic crisis and neopopulism led to a concentration of power in the executive (eg. Weyland 2002). Certainly, Menem did manipulate the judiciary and overriding Congress by passing 336 pieces of legislation using decrees of necessity and urgency (Phillips 2004, 230). However, what is often omitted from this classic story is the commanding role played by the country’s most elite economic players. Given this picture of state-business relations explored above, it appears that the success of Menem’s far-reaching economic adjustment is best explained by the state’s ability to “empower the winners” (Schamis 1999, 238) of liberalization. Instead of “neutralizing the losers” (237), Menem overcame the collective action problem by implementing a two-track reform program that insulated a group of pre-determined winners from the harsh realities of liberalization.

BITs and the preferences of the powerful

Given this power structure, Argentina's BITs can be viewed as a reform that reflects the preferences of small groups of elites, particularly the captains of industry, and the state. When the short-term benefits and long-term costs of BITs are viewed in light of these preferences, the sweeping nature of Argentina's BIT regime is quite understandable. For economic elites and the state, the cost of future arbitration awards and sacrificed industrial policy space paled in comparison to the benefits of increased FDI inflows and increased legitimacy in the eyes of domestic and foreign investors.

Argentina's economic elites were set to profit from inclusion in the spoils of privatization, as well as the success of the government's larger reform program in general. They had the ability to further insert themselves in the global economy and gain greater independence from the domestic and regional economy, which ultimately allowed them to thrive during the Mexican peso crisis (Phillip 2004). The state's interest in achieving credibility in the eyes of investors and attracting FDI was even more acute – the government's political survival likely depended on the ability of the reform program to slay inflation and revitalize the tanking economy. Panizza describes how a pervasive sense of crisis in Argentina was driven by economic crisis and “the near collapse of the state in the past months of the Alfonsín government, the resignation of the first democratically elected president after the years of military rule and by the public order disturbances that afflicted several provincial cities throughout 1989” (2000, 742). Essentially, “the deep crisis of the state in Argentina...gave a much greater sense of urgency to the promotion of reforms at any cost” (2000, 747).

While this sense of urgency can explain the willingness of economic and political elites to sacrifice industrial policy tools, the preferences of the captains of industry are also rooted in their incentive to preserve Argentina's existing productive capabilities and product mix. Industrial policy designed to foster the development of new productive capacities might not be beneficial for intermediate goods producers, especially those that enjoy lavish special-treatment from the state.

Contrasting Argentina and Brazil: BITs, autonomy, and preferences

The importance of domestic politics in determining the extent to which developing countries exceed their WTO commitments and sign BITs can be illustrated by the contrast between Argentina and Brazil's BIT regimes, as well as their domestic politics. In essence, Brazil's economic elites held more developmentalist/statist preferences in the 1990s partially because the Brazilian state has demonstrated its ability to successfully utilize industrial policy. This success can be traced to the state's ability to achieve a relative degree of autonomy from these economic interest groups.

Brazil was one of the principle opponents of the Hull rule at the UN (Elkins et al. 2006) and one of the last middle-income countries to sign BITs (see Appendix). Despite protestation from developed countries, domestic political opposition to the binding investor-state arbitration clauses in Brazil's 14 BITs has so far prevented them from being ratified (Peterson 2005, 2003). This opposition to BITs can be explained by the private sector's greater acceptance of state intervention given Brazil's successful utilization of industrial policy to develop new productive capacities. Phillips explains, "In Brazil, [in contrast to Argentina], the relatively greater success of ISI meant that traditional priorities and structures associated with developmentalism and industrialization came to permeate the version of neoliberalism that emerged in the 1990s" (2004, 70), a vision that was certainly shared by many economic elites.

Kohli (2004), Evans (1992), Wade (1990), and Amsden (1989) forward that the late-industrializers who have effectively utilized industrial strategy were autonomous and powerful states. While neither Brazil or Argentina come close to Kohli's archetype of the cohesive capitalist state, with authority concentrated in a state which is "ruthlessly procapitalist" (2004, 11), Brazil has been much closer, especially for the duration of the Estado Novo (1937-1945), and Kubitshek's government (1956-1961) (Kohli 2004, Sikkink 1991). The Argentine state, marked by political instability, "lack of capacity and [a] lack of centrality to the political process" (Sikkink 1992, 12) for the better part of the twentieth century, diverges sharply from those that have successfully implemented industrial strategy to move up the global value chain.

The case of Brazil demonstrates that it takes a relatively autonomous state to provide the private sector with the incentives to invest in new productive capacities, and support industrial policy politically. With state autonomy, and hence political stability, a crucial prerequisite for successful industrial policy, it is not surprising that Argentine economic interests spent their energies mobilizing for policies that would prove beneficial in the short term, such as government subsidies. The Argentine elite's indifference to the sacrifice of industrial policy tools can be viewed as a reaction to political instability and state incapacity from 1955 to 1983. These businesses likely had little faith in the Argentine governments capacity to implement industrial strategy, with a history of political instability and negligible experience 'governing the market'. As well, the largest Argentine businesses were presumably wary of industrial strategy because they were the ones who thrived during prior periods of liberalization in the 1970s and 1980s.

To conclude the discussion of BITs, it is worth returning to the debate between Keohane and Gruber mentioned at the end of section 2. Keohane forwards that cooperation-inclined politicians may deflect domestic criticism by convincing their skeptical constituency that there is no alternative, to which Gruber replies, sometimes international forces make cooperation the least-worst option. What the case of Argentina's BITs teaches is that both can contain some truth. Flush capital markets and a competitive dynamic left Argentina with more to gain from cooperation, and more to lose from non-cooperation, essentially altering the country's payoff matrix. However, the state-business alliance created a particularly far-reaching BIT regime because they were motivated by the short-term benefits of restored investor confidence and fiscal stability through privatization, placing little emphasis on the costs of BITs.

4. Friends of industrial policy space: State autonomy and low time-discounting

The case of Argentina's BITs illustrates how international pressures and domestic politics can work in tandem to promote development-stifling cooperation, in which developing countries sacrifice industrial policy tools for the chance to access short-term benefits.

How can these findings be applied to welfare-reducing cooperation, and indeed other policy choices, more generally? While Gruber (1990) and Guzman (1998) explore how Pareto-inefficient cooperation can become the least-worse option in a country's choice-set given the potential cost of being excluded from international cooperative arrangements, Argentina's experience illustrates that domestic politics can have a similar effect. Domestic political circumstances that increase the discount rate used to weigh present benefits against future costs push in the same direction as these international forces (a similar argument is made by Gadgil 2005). Both make it increasingly tempting to enter into agreements that promise lucrative short-term benefits at the expense of long-term underdevelopment. The result, is that autonomy from the private sector, as well as stability, are crucial attributes of a state that is both able to protect, and utilize, development policy space.

This exposes the particular challenges of utilizing industrial policy tools to improve a nation's position in global value chains for late-late-industrializers. Constrained choice-sets that turn development-stifling policies into least-worst solutions, especially when viewed with a high discount rate, are particularly at odds with industrial strategy. The time-horizon of industrial policy makes it a rational policy choice only when viewed with a relatively low discount rate (Gadgil 2005), which requires a relatively autonomous and stable state. Only then might rational policy-makers sacrifice immediate benefits, such as temporarily being seen as a more attractive foreign investment destination, to invest in future prosperity.

It is powerful economic interest groups that can encourage policy-makers to heavily discount the future in favour of the present if they are able to exert leverage over the state. Especially when combined with a choice set that is constrained by international forces, a government with minimal autonomy from economic elites may utilize an increasingly high discount rate to view policy choices. While Schamis (1999) argues that powerful economic interests may mobilize in favour of adjustment from ISI to liberal economic reform, finding interest groups in favour of adjustment from liberal economics to industrial strategy is perhaps far more difficult. Industrial upgrading involves significant and *continuous* distributional costs that will likely run counter to the preferences of the existing dominant economic sectors, based in low value-added,

primary product-based sectors (Gadgil 2005). Thus, successful industrial policy relies on the state's ability to manipulate the incentives of the private sector. If these low value-added sectors can pass their preferences on to the government through state capture (or something similar), the government will heavily discount eliminated development policy space.

As discussed in the case of Brazil, a relatively autonomous state (which is additionally embedded in industry in order to facilitate the flow of information) is highlighted as a key element of successful industrial policy (Evans 1992). Kohli (2004) and Evans (1992) highlights the particular challenges of implementing strategic, long-term industrial development plans in states with limited autonomy and close ties to particular interest groups. Similarly, Wade emphasizes the "hard" nature of the East Asian states, defined as "states that are able not only to resist private demands but actively to shape the economy and society" (1990, 337). What emerges from Argentina and Brazil's BIT regimes is that a somewhat insulated state is essential for both the implementation of industrial strategy, *and the protection of industrial policy space*. A developing country whose policy-making is controlled by the private sector will be both incapable of using industrial policy, and increasingly unwilling to protect its ability to do so.

5. Conclusion

There is significant evidence that industrial policy tools have played a crucial role in the ability of all late-industrializers to 'catch-up to the rest' by developing new comparative advantages. Thus, understanding why developing countries engage in international cooperation that reduces their industrial policy space is particularly vital from a development perspective. Given that regional and bilateral treaties between developed and developing countries typically involve relinquishing even more policy space, determining why developing countries *exceed* their WTO commitments is most pressing. Argentina's decision to sign particularly "naughty" BITs (Chowla 2005) lends credence to Gruber's (1990) notion that Pareto-inefficient international cooperation that reduces the welfare of the weaker partner stems from the "fear of exclusion". As Guzman (1998) predicts, Argentina began signed BITs with major capital exporters directly after a

number of other emerging markets had done so, notably then-Czechoslovakia, Poland, Hungary and Russia.

However, this paper forwards that domestic politics also plays a significant role in determining the extent to which developing countries will exceed their WTO commitments. Argentina's willingness to relinquish industrial policy space can be traced to the ability of economic elites to exert leverage over the state. The ability of the 'captains of industry' to influence and veto public policy explains why Argentina created a BIT regime that was simultaneously exceptionally development-stifling and investor-friendly. These economic elites, and the state that was beholden to both restoring economic stability and accommodating the elite's preferences, had little incentive to look beyond their immediate expected benefits.

What can be distilled from the case of Argentina's BITs is that international pressures *and* domestic politics influence how policy-makers treat the costs and benefits of international economic institutions. When faced with a deteriorating status quo because of competition between developing countries for the benefits of shallow integration (Shadlen 2005), cooperation may eventually become the least-worst option. It is domestic politics that determines when this point is reached. The state's relative level of insulation from interest groups, as well as the preferences of the state and economic elites, determines how the short-term benefits of cooperation (shallow integration) are weighed against the long-term costs of cooperation (deep integration involving the shriveling of development policy space). Thus, the state that is best placed to resist international pressure to cooperate turns out to be the same state that is best able to utilize industrial strategy. Being able to successfully implement credible industrial policy tools seems to require the same long-term time horizon and state autonomy used to resist trading one's future development prospects for short-term benefits. States that do not utilize their industrial policy space are likely the first to trade it away.

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