

# Reputation and Investment under Ambiguity

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# Investment

- Investment is Inherently Risky
- Investment Treaties Encourage Investment, but How?
  - Deterrence/Punishment
    - Provide recourse to investors<sup>1</sup>
    - Attach Reputation Costs/Shadow of Future<sup>2</sup>
  - Provide Information
    - Enhance Assessment of Reputation

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<sup>1</sup>Elkins, Guzman, and Simmons, 2006.

<sup>2</sup>Axelrod, 1984.

## Some Considerations:

- Violation is comparatively rare
  - ICSID cases < 700
  - about 200 unique BITs cited ( about 5% of total)
- As many as 44% of Greenfield Investment announced w/o covering treaty
- Suggests more reputation/information based mechanism for effect of BiTs
- But how can Bit's provide information if membership is broad and *untested*?

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# Reputation

- Reputation is beliefs about actor's type based on observed prior behavior<sup>3</sup>
  - Implies at least 2 actors: State and Firm
- Reputation comes from specific sequence:
  - ① State joins agreement
  - ② State demonstrates (non)compliance with treaty obligations
  - ③ State is *observed* demonstrating (non)compliance by Firm
  - ④ State comes to *hold* a reputation for (non)compliance with that Firm
- What happens if step 2 doesn't happen? If alliance is *untested*?
- How can this help the State's reputation?

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<sup>3</sup>Dafoe, Renshon, and Huth, 2014; Tomz, 2007, and others.

# Entry Endorsement

- Entry into prior agreement *benefits* State, even if untested
  - Reason: entry endorsement
  - Concept: Entry into agreement is indication of partner State's belief in reliability of the State
  - Ex. Meeting someone who worked at Google
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# Endorsement Quality

- Not all endorsement is created equal
- Quality of endorsement based on characteristics of endorser
- Punishment for signing violated agreements motivates endorsement quality
  - Makes endorser State more selective
  - Makes endorsement stronger *because* it is more selective



# Endorsement Quality

- Two potential channels for vulnerability<sup>4</sup>:
  - Electoral Vulnerability → electoral institutions
  - Interest Vulnerability → Economic interests/importance of FDI to economy
- Expectation: Reputation benefit from endorsement is greater when endorser is *more vulnerable* to punishment

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# Implications and Testing

- Implications for reputation observable in terms of investment, specifically the announcement of new (greenfield) projects:
  - Entry into an agreement confers reputational benefit via entry-endorsement, but decays over time. States that have recently entered into untested agreement are more likely to host new FDI projects than (1) States who have less recently entered into untested agreements and (2) States whose most recent agreements were tested by arbitration
  - Endorser quality enhances the benefits from entry-endorsement. States are more likely to host new FDI projects when they have recently entered an agreement with an endorsing state that is (1) Democratic and/or (2) where foreign assets are large part of the economy

# Models and Measurement

- DV: Greenfield Investment Project Announcements (FDI Markets, Monthly 2003-2014, Bilateral)
- Crucial Measures:
  - Ambiguity: Has claim been brought against host state since last agreement signing? (0,1)
  - Entry Recency: Time of entry-endorsement relative to last ICSID arbitration claim and investment date
  - Audience Costs: (2 measures):
    - Voter pressure (Polity)
    - Special Interest Pressure (FDI Assets/GDP, IMF IFS data)
- Other Controls:
  - Yr Splines, GDP (source, host, endorser), host foreign asset/GDP, destination, source polity

$$\text{Alliance Formation}_{ijt} \sim \text{Poisson}(\log(XB + ZC + \epsilon_{jit})) \quad (1)$$

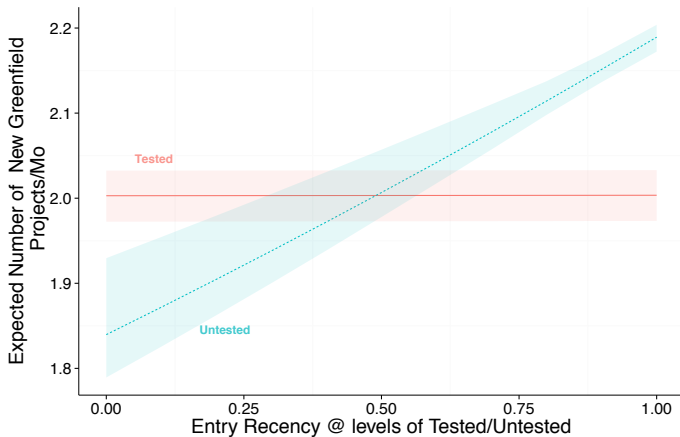
$$X = \begin{bmatrix} \text{TESTED}_{it} \\ \text{ENTRY RECENCY}_{it} \\ \text{TESTED}_{it} \times \text{ENTRY RECENCY}_{it} \\ \text{ENDORSER FDI ASSETS/GDP}_{it} \\ \text{ENDORSER FDI ASSETS/GDP}_{it} \times \text{TESTED}_{it} \\ \text{ENDORSER FDI ASSETS/GDP}_{it} \times \text{ENTRY RECENCY}_{it} \\ \text{ENDORSER FDI ASSETS/GDP}_{it} \times \text{TESTED}_{it} \times \text{ENTRY RECENCY}_{it} \\ \text{ENDORSER POLITY}_{it} \\ \text{ENDORSER POLITY}_{it} \times \text{TESTED}_{it} \\ \text{ENDORSER POLITY}_{it} \times \text{ENTRY RECENCY}_{it} \\ \text{ENDORSER POLITY}_{it} \times \text{TESTED}_{it} \times \text{ENTRY RECENCY}_{it} \end{bmatrix} \quad (2)$$

- Interactions make for difficult interpretation<sup>5</sup>
- Simulations used to calculate average treatment effect (ATE) using observed cases<sup>6</sup>
- Graphical interpretation

<sup>5</sup>Ai and Norton, 2003.

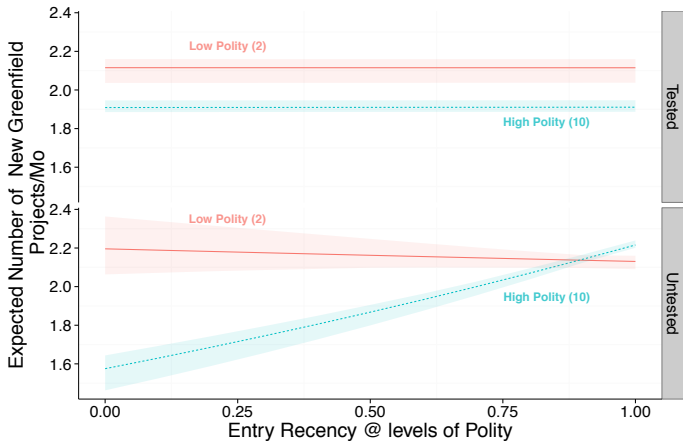
<sup>6</sup>Hanmer and Ozan Kalkan, 2013.

# Influence of Mere Membership and Time Since Entry:

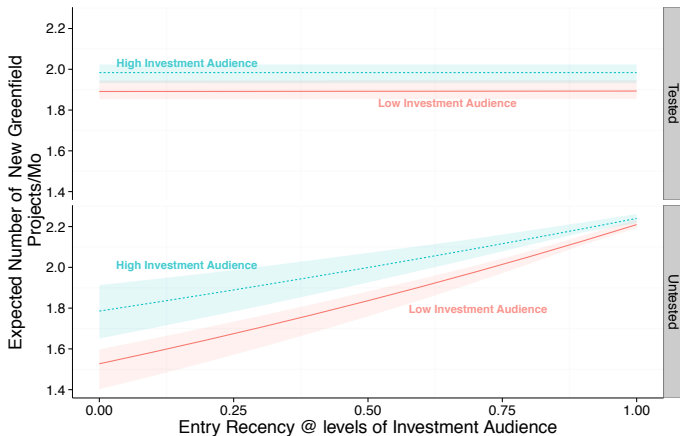




# Influence of Voter Audience



# Influence of Investment Audience

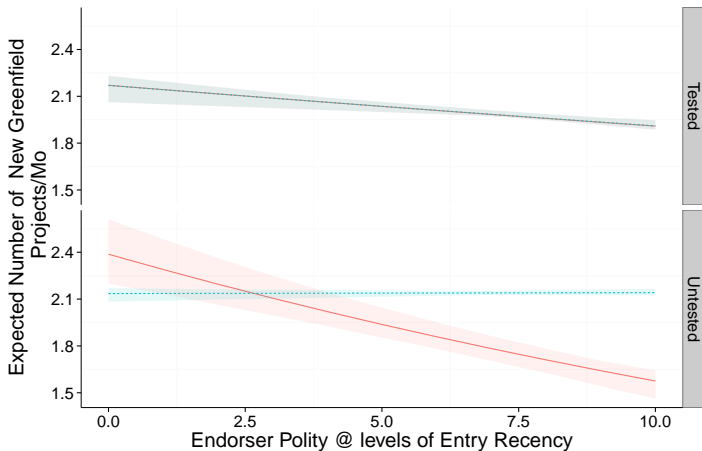


# Implications

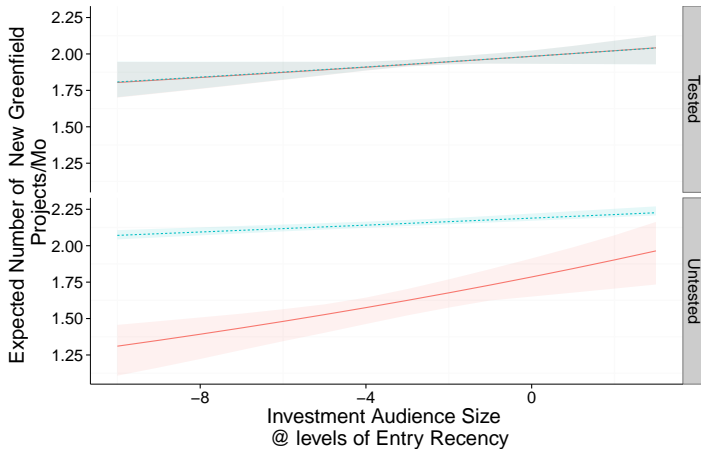
- Generally, support for role of entry endorsement
- Suggests that mere-membership in agreement matters
- Suggests indirect influence of BITs on reputation
- Potential implications for cheap talk



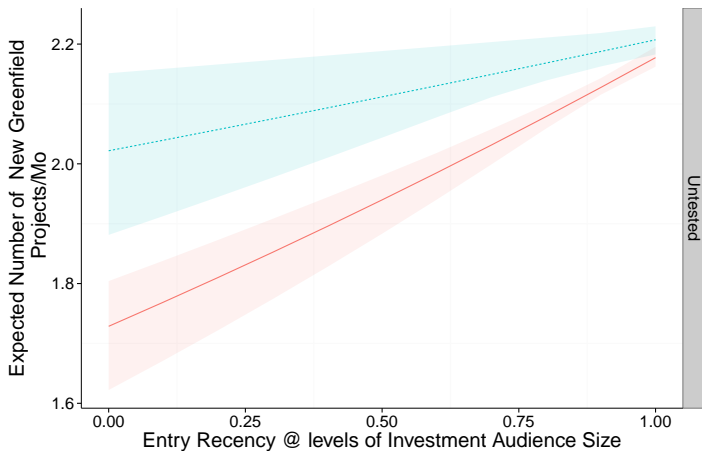
# Influence of Voter Audience Costs by Entry



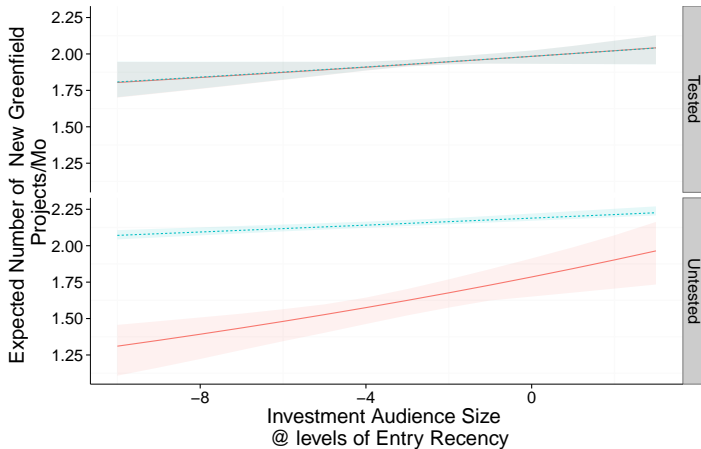
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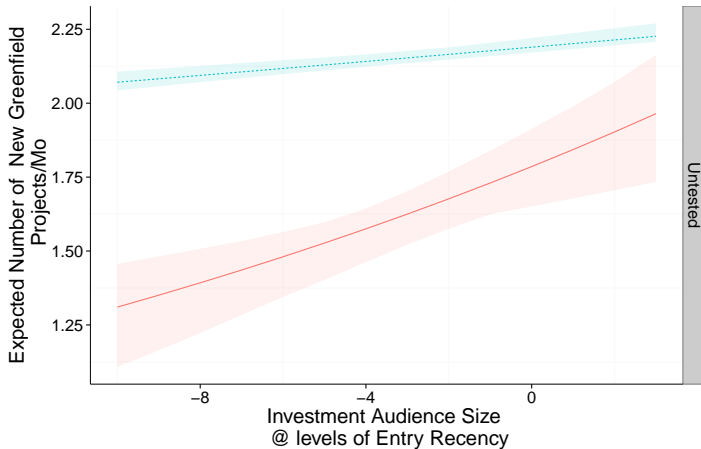


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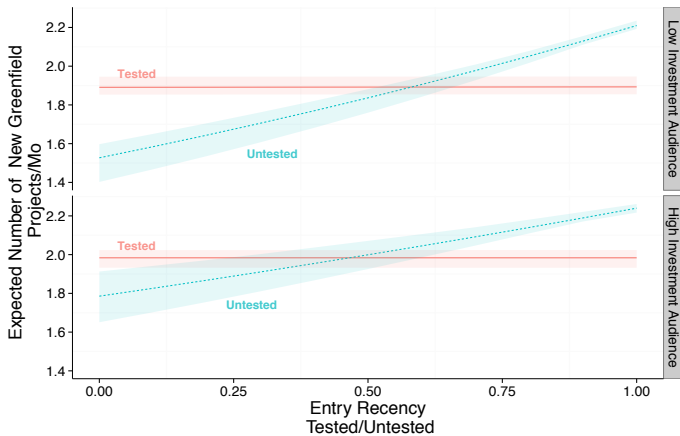




# Influence of Investment Audience by Entry



# Influence of Investment Audience



# Decay

- Strength of entry-endorsement decays over time
- Decay driven by potential for change over time
  - That the state is not the same today as it was yesterday
- Decay rate modeled on Observer expectations about frequency of change (reliable, unreliable)
- Same effect as typical decay term, except:
  - Decay rate endogenous to Observer's perspective
  - Decay rate varies from Observer to Observer
  - Bad reputations are forgiven over time (not tested here)

## Core Model:

	<i>Dependent variable:</i> total_projects
Tested	0.210* (0.110)
Foreign Assets/GDP	0.008 (0.006)
Entry Recency	-0.001 (0.002)
Endorser Polity	-0.012*** (0.004)
Tested:Foreign Assets/GDP	0.025 (0.015)
Tested:Entry Recency	-0.249** (0.111)
Foreign Assets/GDP:Entry Recency	-0.0002 (0.0001)
Tested:Endorser Polity	-0.030*** (0.012)
Entry Recency:Endorser Polity	0.0001 (0.0002)
Tested:Foreign Assets/GDP:Entry Recency	-0.029* (0.015)
Tested:Entry Recency:Endorser Polity	0.048*** (0.012)
Constant	-15.593*** (0.134)
Observations	30,505
<i>Note:</i> Control Variables Omitted for space considerations	* p<0.1; ** p<0.05; *** p<0.01