

International Law, Territorial Disputes, and Foreign Direct Investment *

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Abstract

Contentious interstate disputes are widely thought to depress foreign direct investment (FDI). We argue that foreign investors' incentives vary greatly across different disputes, even territorial disputes, which are known to be slow to resolve and prone to militarization. Investors are both forward-looking and profit-seeking, which gives them incentives to use information over contentious disputes to gauge whether peace or violence is likely. We posit that the legal status of the territory in dispute is a key variable that informs investor decision-making. When international law identifies one side in the dispute as having clear legal advantage, investors leverage the fact that such a legal focal point is generally peace-promoting. We find support for these arguments using new data on legal focal points in territorial disputes from 1980–2010. While a growing body of work demonstrates how international law influences state behavior, we show that it also has profound influence on the investment patterns of firms.

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Introduction

Given the heightened risk associated with countries embroiled in contentious interstate disputes, the conventional wisdom is that financial actors in general and multinational corporations in particular balk at investing in such countries. This may be particularly true of territorial disputes, which are known to be long-lasting and to carry a relatively high risk of militarized conflict.¹ Even in the absence of militarization, the threat of armed conflict in territorial disputes can disrupt the transportation of goods and supplies throughout the country, leading firms up and down international supply chains to look elsewhere for partners. Broadly, the uncertainty generated by hostile bilateral relations resulting from territorial disputes and the associated international controversy they can generate can have a chilling effect on cross-border as well as third-party trade and investment opportunities.² Although the idea that contentious territorial disputes should depress such economic activity seems intuitive, we argue that important variation across territorial disputes matters greatly for their influence on investment patterns.

To date, the focus has been on the political risks that territorial disputes bring and has consequently under-emphasized the fact that investors are often willing to take on some risk if the potential for profit seems real. Some extremely risk-seeking investors (sometimes called “vulture” investors) see opportunities even in states embroiled in highly contentious disputes if the price is low and there is some possibility of positive returns. Yet even investors that are more risk-averse can see opportunities in the midst of interstate disputes over territory. We argue that investors recognize and respond to the considerable variation in territorial disputes regarding the threat of violence and the possibility of peaceful settlement. In cases where settlement is likely and therefore peaceful relations are a real possibility, we expect savvy economic actors to take advantage. In particular, we argue that foreign direct investment (FDI) accrues at higher rates before a settlement is concluded: at least some investors “get in on the ground floor” and reap the greater benefits of the anticipated settlement.

One important source of information on the prospects for the outbreak of violence or for a peaceful settlement of a territorial dispute is the legal status of the territory in question. While investors are not lawyers or legal scholars (though they can and do hire such consultants), investors

¹See Vasquez 1993 or Huth 1996 among many.

²Lee and Mitchell 2012; Simmons 2005; Carter and Goemans 2018. See Schultz 2015 for an overview of the literature.

can take signals about the probable trajectory of a dispute from the kind of rhetoric and environment to which a dispute’s legal status contributes. The prospects for the investment climate are better when a “legal focal point” exists, or when the international legal principles relevant to a given dispute are clear, well-established, and also are asymmetric in the sense that they strongly favor one of the two states in the dispute.³ Recent evidence shows that the presence of such a legal focal point has a pro-investment influence on almost all aspects of a dispute, as it reduces the probability of the onset of military conflicts, increases the chances for settlement, and makes settlements more likely to endure.⁴ In the post-World War II era, and especially since the mid-1970s, the legal status of disputed territory is of great importance to how states manage their disputes and how the international community views disputes.⁵ In the same period, states have grown to nearly universally seek FDI. We establish an essential piece of the logic that links these trends and demonstrates their power: variation in international law explains not just one-off vulture investors’ willingness to take risks, but is powerful enough to shape the aggregate accumulation of FDI so important to modern states.

Consider the territorial dispute between Peru and Ecuador, settled in 1998, in which a legal focal point existed that favored Peru, and so-called ABC countries (Argentina, Brazil, and Chile) all made it clear that international law favored Peru. Already by 1995, Peru had success attracting FDI as the government sold off dozens of state-owned enterprises to foreign investors, and the state’s “luster for investors” led FDI stock to reach US\$6 billion. Peru’s FDI stock continued to increase from 1994–1996, more than in any other period from 1980–2010. This broad, long-term activity took place despite short term fluctuations in the Lima stock market, “apparently reflecting concern about Peru’s border dispute with Ecuador.”⁶ Indeed, limited armed clashes between the two states broke out in 1995. Despite those military clashes, by 1997 foreign firms operating in Ecuador were also investing and reinvesting in gold mining, and others aggressively responded to privatization processes in telecommunications and airport construction.⁷ FDI stock in Ecuador also increased from 1993–1998 at the highest rates it would experience from the early 1980s until 2010. Oil industry analysts suggested that the 1998 peace would “unleash” more FDI in both

³Chayes and Chayes 1995; Huth, Croco and Appel 2011.

⁴Carter and Goemans 2011; Huth, Croco and Appel 2011, 2012, 2013; Prorok and Huth 2015.

⁵Zacher 2001; Huth, Croco and Appel 2011; Goertz, Diehl and Balas 2015.

⁶Brooke, James. 31 January 1995. “Peru: On the Very Fast Track.” *New York Times*.

⁷Leon, Craig. 1 March 1997. “Ecuador: Renewed Tranquility.” *Institutional Investor* 31(3).

states: “Ecuador has a lot of oil under the ground that can’t get out, and Peru has a pipeline that is half full.”⁸ But that “unleashed” post-settlement investment would build on years of prior activity by a variety of foreign (and domestic) oil and gas firms that had developed new fields and pipelines in both states.⁹

At least some of these savvy investors (or their consultants) in Peru and Ecuador may have directly understood the prospects for peace signaled by international law. Others likely responded to the environment that the legal focal point generated, particularly via its influence on the behavior of powerful third parties. Consistent with the legal focal point that favored Peru, the United States and the ABC regional powers conveyed to Ecuador the need for a settlement based on the 1942 Rio Protocol that it had signed. As mediators of the dispute, the weight of these states’ united interpretation surely reinforced the movement toward peace. In a 1998 letter to the editor of the *Wall Street Journal*, Ecuador’s Ambassador to the U.S. was confident enough to call the state a “peaceful island in the continent” and tout Ecuador’s deepening economic integration, when settlement was just appearing on the horizon.¹⁰

In an economically integrated world, states in search of foreign capital have reason to prioritize behaviors that attract capital. Given that FDI is a key component of most states’ long-term development strategies, our finding that foreign investors are willing to invest in anticipation of peace is of crucial practical importance. That international law can contribute to an environment suggesting a realistic possibility of peace, and thus associate with more FDI, provides new evidence of the importance of international law in the political economy of conflict.¹¹ In this article, the relationship between international law, peace, and FDI provides an alternative economic explanation for why militarized disputes over territory are on the decline,¹² which has to date been explained with the idea of a territorial integrity norm.¹³ Thus, international law around conflict has profound effects for both state and non-state actors.

Our hypotheses contend that foreign investors are quite adept at responding to variation in

⁸Chetwynd, Gareth. 18 August 2000. “Fists fly south of Rio Grande.” *Upstream*.

⁹*Ibid.*

¹⁰Flores, Fernando. 18 September 1998. “Letters to the Editor: Ecuador Wants to End Long Border Dispute.” *Wall Street Journal*: A11.

¹¹Huth, Croco and Appel 2011; Goertz, Diehl and Balas 2015; Gent and Shannon 2010; Davis 2012; Owsiak 2013; Schultz 2014. See Schultz 2015 for an excellent overview.

¹²Pinker 2011.

¹³Zacher 2001; Atzili 2012; Goertz, Diehl and Balas 2015.

investment climates in the shadow of a territorial dispute. We rigorously assess our arguments using new data on legal focal points in territorial disputes from 1980-2010, showing that the strength of disputants' legal claims in territorial disputes has significant influence on these states' abilities to attract FDI. Moreover, our evidence suggests that investors understand how the law impacts the trajectories of territorial disputes, with implications for pre- and post-settlement periods. Our approach and findings speak to the larger research agenda suggested by "new interdependence."¹⁴

Economic Integration and Conflict

Literature on interstate conflict and economic relations focuses on how trade and investment flows increase the opportunity costs of conflict for leaders,¹⁵ or how conflict increases risk and uncertainty for firms.¹⁶ Several scholars look at the relationship between FDI and conflict in general or territorial disputes in particular,¹⁷ arguing for example that global FDI flows influence the number of territorial disputes in the world and bilateral FDI flows reduce escalation within territorial disputes.¹⁸ Indeed, among the universe of international economic actors, multinational corporations engaging in FDI are particularly likely to be influenced by the contours of the investment environment in the shadow of territorial disputes. FDI is characterized by long-term investments in which foreign owners have managerial control of assets abroad. As territorial disputes are known to be hard to resolve quickly, their characteristics overlap with foreign direct investors' tendencies to calculate over the long-term.

We examine the substantial variation in interstate disputes to answer a prior question: how do investors react in the face of disputes that pose quite different risks of militarized conflict? A focus on territorial disputes facilitates our goal. While a large literature shows that territorial disputes are closely associated with the outbreak of militarized conflict and war,¹⁹ a majority of territorial disputes do not become militarized.²⁰ Further, in the post-World War II era, there are

¹⁴Farrell and Newman 2014.

¹⁵Oneal and Russett 1997; Gartzke and Li 2003; McDonald 2009; Li and Vashchilko 2010; Lee and Mitchell 2012; Simmons 2005.

¹⁶Mansfield 1994; Gowa 1995; Mansfield and Pevehouse 2000; Gowa and Mansfield 2004; Jensen and Young 2008.

¹⁷Brooks 2005; Jensen and Young 2008; Li and Vashchilko 2010; Garriga and Phillips 2014.

¹⁸Lee and Mitchell 2012. Others examine how firms find ways to invest despite the presence of political risks (e.g. Jensen 2008; Li 2009; Wellhausen 2015).

¹⁹Kocs 1995; Vasquez and Henahan 2001; Senese and Vasquez 2008.

²⁰Huth 1996; Huth and Allee 2002.

very few instances of one or both parties rejecting or overturning a peaceful settlement once reached, such that settlements are very durable.²¹ This durability suggests that firms that respond to—or anticipate—peaceful relations will be able to reap the benefits for a long period of time, a fact that is surely not lost on profit-motivated foreign direct investors. We contend that investment decisions in the shadow of interstate conflict, and specifically territorial disputes, should be conditional on information that points to the likelihood that political risks will dissipate. International law can facilitate such information.

International Law and Territorial Disputes

We begin by outlining our baseline expectations over how the presence of territorial disputes will influence patterns of foreign direct investment. Subsequently, we specify how variation in the strength of disputants’ legal claims in territorial disputes influences the behavior of investors (and the stock of FDI that states accumulate). In theorizing over the influence of international law on investment stocks, we are careful to highlight theoretical implications derived from cross-country analyses, i.e., hypotheses 1–4, as well as within-country variation where we analyze the affects of settlement across cases where international law provides clear guidance versus those where the law is more ambiguous, i.e., hypotheses 5–6.

First, we agree that, all else equal, territorial disputes bring increased risks for international capital. Whether or not a firm has investments in the conflict zone, territorial disputes suggest disrupted supply chains, politicized export policies, and a potential loss of government prioritization of international financial actors’ preferences, as territorial disputes can siphon away government resources for economic development toward military spending and security needs.²² Despite the variation we focus on, territorial disputes on average have been found to be most prone to escalating into militarized interstate disputes (MIDs), enduring rivalries, and wars.²³ With armed conflict comes a greater risk of economic sanctions being imposed on one or both sides that could weaken the investment environment. In short, there is ample reason to believe that states entangled in a territorial dispute should have lower levels of FDI, whether from the belligerent country or from

²¹Huth 1996.

²²Gibler 2012; Dai and Beamish 2013.

²³E.g., Hensel and Thyne 2008; Vasquez 1993; Colaresi and Thompson 2007.

other countries, because they receive less reinvestment and less entry of new FDI.

Hypothesis 1. *All else equal, foreign direct investment is lower in states involved in a territorial dispute.*

Nonetheless, we argue that investors are attuned to important sources of variation in the conflict risks posed by territorial disputes. Investments are made in anticipation of how politics will affect investors' bottom lines both at the time of investment and in the future. If a conflict is moving toward stability and peace, then early investment is a means of gaining first-mover competitive advantages especially via lower prices. To the extent that information about a dispute allows investors to anticipate stability and the potential for settlement, FDI should increase in the volume and clarity of information that suggests a more positive investment environment.

International law can provide a key source of information about the potential for peace in territorial disputes when legal principles are well-established, clear, and asymmetric such that they favor the position of one side of a territorial dispute. In such instances, a "legal focal point" emerges, because international law indicates a particular territorial settlement with clarity.²⁴ Legal focal points come about as a combination of customary state practice, historical evidence, and/or legal principles backed by court rulings.²⁵ One example of such a legal principle is *thalweg*, or the principle that the boundary line lies in the center of a river's main navigable channel. Another is *uti possidetis*, or the principle that territory remains with the party that exercised administrative authority and control prior to de-colonization or secession, barring treaty provisions on the point. We conceptualize legal focal points as static, a conflict fixed-effect. Relevant international law and norms are very slow to change, and we feel safe in presuming that they do not change in the period under question (1980-2010). Thus, the kind of information investors learn from a legal focal point does not change over the life of a territorial dispute.

Legal focal points are associated with a higher probability of settlement, fewer military conflicts between disputants, and more durable peace. Huth, Croco and Appel (2012) show that the presence of a legal focal point significantly increases the probability that two neighbors will peacefully settle a dispute through negotiations or adjudication. Both sides of a dispute, and in particular the challenger state, have fewer incentives to resort to the use of military force in the

²⁴We use the concept of a legal focal point as developed by Huth and coauthors. Our definition and coding rules are identical to Huth, Croco and Appel 2011.

²⁵Huth, Croco and Appel 2011: 426-427.

presence of a legal focal point, because the legal focal point can provide grounds for negotiations that dis-incentivize military escalation.²⁶ For example, Carter and Goemans (2011) show that over 60% of territorial settlements follow prior administrative frontiers (*uti possidetis*); when boundaries follow prior borders, the use of force is much less likely for neighbors.²⁷ Prorok and Huth (2015) show that transfers of territory are much more likely to result in lasting peace in the presence of a legal focal point.²⁸ In short, while a legal focal point need not deter a territorial dispute from arising, it is likely to shape the progress and outcome of that dispute.

This scholarship can be interpreted in the context of “new interdependence” theory, which argues that norms and rules governing interstate relations can powerfully constrain the activities of national governments.²⁹ The core application of new interdependence thus far has been on the effect of interstate economic relations on domestic political economy outcomes, for example, how international commitments to economic globalization affect domestic corruption.³⁰ Scholarship on international legal focal points in the presence of territorial disputes parallels this approach: interstate legal commitments affect domestic security outcomes, particularly the likelihood of peace. A major contribution of our theory is to identify links between interstate legal commitments and domestic political economy outcomes, via the intermediary of the effect of interstate commitments on conflict outcomes. Thus, we see our theory as an opportunity to marry insights that have developed both under and outside specific reference to new interdependence.

We contend that even foreign investors lacking expertise in legal principles relating to title to territory can respond to the positive effect of a legal focal point on state and third-party behavior. Indeed, given the importance of the legal standing of investments to profitability, foreign investors (and their consultants) are primed to think the investment environment from a legal perspective.³¹ Of course, our argument that international law affects FDI would be muted if the peace-promoting effects of legal focal points are hidden. But disputants with a legal focal point on their side have every reason to make their advantage widely known and not keep it confined to only inter-

²⁶Huth, Croco and Appel (2013).

²⁷Carter and Goemans 2011. See also Goertz, Diehl and Balas 2015. The majority of territorial claims in Europe arose around former international boundaries (Abramson and Carter, 2016).

²⁸Other important work on legal focal points includes Mitchell and Hensel (2007); Gent and Shannon (2010, 2011).

²⁹Farrell and Newman 2014; Fioretos 2011.

³⁰Pinto and Zhu 2016.

³¹Garriga 2016; Wellhausen 2015; Jensen et al. 2012; Beazer 2012; Bauer, Graham and Cruz 2012; Allee and Peinhardt 2011.

governmental relations. Public information can make it more difficult for the opposing government to justify aggressive or obstructionist policies to domestic or international audiences. Moreover, publicity about the opposing government's decision to reject a clear, legally based solution to the dispute could weaken that government's reputation for favoring reliable, cooperative relations. It could also set a negative precedent that the opposing leader ignores international law, not just around territory but also around issue areas like foreign investors' property rights. For example, Russian actions in Ukraine widely recognized as inconsistent with international law have had real influence on investors' willingness to stay in (or enter) the Russian market.³²

In sum, we contend that investors, like states, react to incentives for long-term peace and settlement that legal focal points provide. Accordingly, FDI will be significantly higher in states involved in a territorial dispute when the law provides a clear legal advantage to one of the disputants.³³

Hypothesis 2. *All else equal, foreign direct investment is higher in states involved in a territorial dispute when international law provides strong legal advantage to one party in the dispute.*

An implication of the logic behind Hypothesis 2 is that if firms and investors are “getting in on the ground floor” in states that have disputes with a relatively high likelihood of being peacefully settled, the positive investment effects of settlement will be “used up” by the time settlement occurs. Early entry into a market can allow investors to secure access to the best resources, capture market share, and benefit from lower domestic wages before increasing foreign demand for workers bids wages up. The idea that the “peace dividend” is anticipated prior to settlement in cases with a legal focal point is consistent with our emphasis on investors as proactive, forward-looking, and interested in entering markets before costs go up.³⁴ This argument parallels that in Gray (2013): as countries make international legal commitments in the process of acceding to the European Union, investors perceive improvements in investment environments and increase investments accordingly. But the significant effects of accession are used up in the time between the opening of legal accession procedures and accession itself, because political realities strongly suggest that states will (eventually) accede once they start the process.

³²For example, see Emmott, Robin. “Sanctions Impact on Russia to be Longer Term.” 12 January 2016: Reuters.

³³We explore in great detail below that this holds for both challenger and respondent states.

³⁴Similarly, firms likely factor in the probability of militarization upon entry or at the start of a territorial dispute; if militarization is expected, then any ex post change with the occurrence of a MID might be quite small. Li 2006: 237-238.

Recall that we conceptualize legal focal points as conflict fixed-effects, such that the type of information does not change over time. Nonetheless, we further expect the peace dividend to occur pre-settlement in the presence of a legal focal point, because public reporting on potential settlement likely increases as legal processes proceed. The population of investors receiving that information also increases over time. In contrast, in the absence of a legal focal point, we do not expect similar reporting increasing in quantity and confidence in the pre-settlement period, because we do not expect the characteristics of the dispute to so clearly increase the likelihood of peace. In the absence of a legal focal point we would not expect a group of investors as large and broad as in cases with a legal focal point to be willing invest in belligerents' economies prior to settlement. These points leads us to develop the following hypothesis, which focuses on a comparison of the *pre-settlement* period across territorial disputes that are at some point formally settled.

Hypothesis 3. *All else equal, the pre-settlement accumulation of foreign direct investment is higher in states involved in a territorial dispute with a legal focal point than in states involved in a territorial dispute without a legal focal point.*

Directly implied by Hypothesis 3 is that territorial disputes without a legal focal point that nevertheless are eventually settled should not reap a pre-settlement peace dividend. Even if public reporting in such a context anticipates a settlement, that settlement is more “surprising” because it came about with a significantly lower probability. We expect surprising settlements to generate increased aggregate FDI in their wake: there should be more of a peace dividend following the settlement of territorial disputes that lack a legal focal point.

Hypothesis 4. *All else equal, the post-settlement accumulation of foreign direct investment is higher in states involved in a territorial dispute without a legal focal point than in states involved in a territorial dispute with a legal focal point.*

Hypotheses 3 and 4 focus on cross-country (cross-sectional) comparisons. However, our theoretical framework also has implications for the dynamics of investment pre- and post-settlement within disputant states. Absent the risk-alleviating environment around a legal focal point, investors must expend their own resources to mitigate political risk and improve expected returns. For example, foreign investors buy political risk insurance; cultivate ties to their home country diplomats in case a conflict arises; act to form strong relationships with local leaders, for example

through corporate social responsibility; or pay costs associated with repatriating capital rather than leaving it in the risky host country. These costs of risk-mitigation depress the amount foreign firms are putting into actual production through FDI. Rather than incur them, investors may delay entry until estimated political risks are lower, whether by diverting potential FDI to other foreign host countries or by keeping their capital at home.

In the absence of a legal focal point, settlement is decisive in mitigating political risk. After settlement, foreign investors can reduce the amount they spend on political risk mitigation and increase estimates of expected returns. Among the ex ante population of investors interested in a given host country, we expect more of that population to invest more once expected rewards are higher. Higher expected rewards in a given market should also grow the population of interested investors. Given that settlement reduces risks and thus costs for all investors, reduced political risk in the wake of settlement should increase FDI at the aggregate country-level.

In the presence of a legal focal point, investors accrue benefits from low political risk mitigation expenditures even while the dispute is ongoing. It is in this pre-settlement period that the population of interested investors grows and more investors increase their investment. Settlement itself does not change the risk-reward ratio in the market, because peace and likely settlement was anticipated, so neither the population of investors interested in a given host country nor the accumulation of FDI should increase post-settlement (holding other determinants of FDI constant). In fact, net investment costs may go up by the time settlement comes, as the best resources are already being exploited, and there is no offsetting decline in firm expenditure on political risk mitigation. Thus, for a given territorial dispute with a legal focal point, pre-settlement FDI in a disputant state should outpace post-settlement FDI.

These observable implications allows us to conduct empirical tests identifying off of the more difficult setting of within-unit over-time variation.

Hypothesis 5. *All else equal, the accumulation of foreign direct investment in a state involved in a territorial dispute with a legal focal point is higher before settlement than after settlement.*

Hypothesis 6. *All else equal, the accumulation of foreign direct investment in a state involved in a territorial dispute without a legal focal point is higher after settlement than before settlement.*

Research Design

Per the standard IMF definition, FDI occurs when a foreign investor owns a 10% or greater stake in operations in the host state. This threshold is an indicator of managerial control, which separates the behavior and incentives of longer-term direct investors from those of shorter-term portfolio investors. We specify the dependent variable as (logged) monadic FDI stock data, or the cumulative value of foreign direct investors' stakes in host state operations.³⁵ Monadic FDI stock is the concept of interest, because we are interested in the effect legal focal points have in aggregate, on firms from any foreign country. Our time-series cross-sectional analysis allows us to better draw inferences about the implications of legal focal points for state interest in maximizing access to FDI, rather than a micro-level analysis demonstrating that some individual firms behave as expected.

We use and extend the data of Huth and co-authors to identify and code the population of territorial disputes from 1945-2010.³⁶ Territorial disputes occur when executive leaders of one state lay claim to the territory of another state or contest that state's sovereignty, and the targeted government's leadership, in response, rejects the claim. Given that our unit of analysis is country-year, we measure territorial disputes in which a state is the challenger as well as disputes in which a state is the target of a claim. We expect both types of disputant status to affect FDI; we ensure that this is the case by analyzing measures of territorial disputes that distinguish among challengers and targets as well as measures that aggregate all territorial disputes.

We follow Huth, Croco and Appel (2011) exactly in extending their data on legal focal points (2001-2010). We identify the strength of the target and challenger's legal claims to disputed territory based on customary state practice; legal principles, particularly those backed by court rulings; and the weight of historical evidence (426-427). This labor-intensive process relies on data sources from third parties that are not written by state governments or by nationals from either side of the territorial dispute. Claims are coded as weak, moderate, or strong. Claims are considered weak if the state's position is ambiguous or poor on all relevant legal principles, and moderate if a

³⁵We follow the literature in adding a constant to keep negative values and logging for right-skewness. We use UNCTAD data that measure stock with historical cost, market value, and cumulative FDI flows. We measure FDI stock levels, and not scaled levels, because our hypotheses are about investor behavior and not the saturation of FDI in a host country's economy; it is more appropriate to control for scale factors on the right-hand side. On FDI data, see Kerner 2014; Li, Owen and Mitchell 2016. Our hypotheses are not industry-specific; results are signed as expected but are less precise when we analyze only the subset of FDI stock in fixed capital Kerner (2014). Our aggregated results speak to the reality that political risk shapes investor behavior in all industries. See Appendix.

³⁶Huth and Allee 2002 and updated in Huth, Croco and Appel 2011.

state's claims are strong in some areas and weak or ambiguous in others. To have a strong claim, the state's position must be consistently supported by the relevant legal principles. A state also has a strong claim if a majority of the state's sub-claims are strongly supported while the remaining claims receive no worse than moderate support. Following the literature, we conservatively code a legal focal point as present when one state's legal position is coded as strong and the opponent's legal position is coded as weak. This means that a legal focal point can favor either the target or the challenger state.

As detailed below, we thoroughly evaluate our theory in states with single or multiple disputes. We employ a measure of the proportion of disputes with legal focal points in a given state. We also conservatively code a legal focal point if, in a state with multiple territorial disputes, all disputes have this feature. It is worth emphasizing that in over 75% of all cases in which a state is the challenger in a territorial dispute, there is only one territorial dispute. Moreover, over 92% of all such cases involve one or two territorial disputes. The percentages are similar (although slightly lower) for disputes in which the state is the target.

Table 1 provides a reference list of all territorial disputes after World War II in which one side had a legal focal point. In our sample, there are a total of 733 country-years composed of 40 countries in which a territorial dispute is ongoing and a legal focal point exists (about 20 percent of observations). Of these 733 country-years, the legal focal point favors the target in 80 percent of observations and the challenger in 20 percent of observations. The descriptive statistics for all variables are very similar across these subsets of the data, which indicates that the states in disputes with legal focal points are not systematically different on some important dimension, e.g., more wealthy, populous, or democratic.³⁷ Our data include 32 settlements from 1980–2010. Most settlements are conducted through bilateral negotiations and third-party legal rulings by the International Court of Justice or arbitration panels. In a small number of cases, the challenger unilaterally withdraws territorial claims. Additionally, our data also include 34 militarized interstate disputes (MIDs) involving 21 states in territorial disputes between 1980–2010.

A very large literature models explanations for increases in FDI stock.³⁸ We follow the

³⁷See Appendix.

³⁸For a meta-analysis, see Blonigen and Piger 2011.

Table 1: Post- World War II Territorial Disputes with Legal Focal Point

Challenger	Target	Year of Settlement
Paraguay	Argentina	1945
Afghanistan	Russia	1946
Austria	Italy	1946
France	Italy	1946
United Kingdom	France	1946
Yugoslavia	Greece	1946
Czechoslovakia	Hungary	1947
Romania	Hungary	1947
Iraq	United Kingdom	1948
India	Pakistan	1948
Ethiopia	United Kingdom	1949
France	United Kingdom	1953
USSR	Turkey	1953
Egypt	United Kingdom	1954
United Kingdom	Ethiopia	1954
Germany	France	1957
Netherlands	Belgium	1957
Greece	United Kingdom	1959
Liberia	France	1960
Nicaragua	Honduras	1960
China	Mongolia	1962
China	Afghanistan	1963
Ghana	Ivory Coast	1966
Ghana	Togo	1966
Iran	United Kingdom	1970
Nicaragua	United States	1970
Argentina	Uruguay	1971
Greece	Albania	1971
Uganda	Tanzania	1979
Somalia	Kenya	1981
Greece	Cyprus	1982
China	United Kingdom	1984
Egypt	Israel	1988
Saudi Arabia	Qatar	1992
Chad	Libya	1994
Iraq	Kuwait	1994
Namibia	South Africa	1994
Guatemala	Belize	1995
Botswana	Namibia	1996
Ecuador	Peru	1998
China	Kyrgyzstan	1999
Portugal	Indonesia	1999
Serbia	Macedonia	2001
Indonesia	Malaysia	2002
Malaysia	Singapore	2008
Brunei	Malaysia	2009
Philippines	Malaysia	Not Settled
Venezuela	Guyana	Not Settled
Thailand	Laos	Not Settled
China	Bhutan	Not Settled
Egypt	Sudan	Not Settled
Guatemala	Belize	Not Settled
Iraq	Iran	Not Settled
Namibia	South Africa	Not Settled
United Arab Emirates	Iran	Not Settled
Cyprus	Turkey	Not Settled
Somalia	Ethiopia	Not Settled
Lesotho	South Africa	Not Settled
Togo	Ghana	Not Settled
Vanuatu	France	Not Settled

conventions of this literature closely to ensure good model specification and comparability to existing studies. Both *(log) Population* and *(log) GDP per capita* (constant 2005 US\$) indicate market size and development level.³⁹ *GDP growth* (%) captures the health of the economy and speaks to variation in states' attractiveness as investment destinations. *Democracy* codes a state's regime type.⁴⁰ *Trade/GDP* captures the economy's openness to international trade. The relationship between FDI and Bilateral Investment Treaties (BITs), intended to promote FDI, has been found to be quite complex.⁴¹ Regardless, we include the count of *Total BITs (in force)* to indicate the scope of protections enjoyed by investors in the host state that have the potential to mitigate expected political risks of territorial disputes.⁴² We control for *Capital account openness* as a marker of the state's economic integration with capital markets in general.⁴³ Countries with different resource endowments may have distinct investment environments. We include *Resource rents/GDP* as a measure of the importance of natural resources to an economy and, usefully, one that captures variation over time. Following the literature, we lag all independent variables by one year as effects on FDI stock often take some time to take shape.⁴⁴

In general, FDI stock increases over the time period (1980-2010), as more states open to FDI in the post-Latin American debt crisis and post-Cold War era.⁴⁵ In our models, we account for time in two straightforward and flexible ways. First, we include a linear time trend to ensure that any findings are not reflective of the upward trend in FDI across time.⁴⁶ Second, we control for any unmeasured shocks that occur yearly by including year-fixed effects in all model specifications.⁴⁷

We account for time-invariant country-specific factors in several ways. Crucially, our key

³⁹Data are from the World Bank World Development Indicators unless otherwise stated.

⁴⁰Geddes, Wright and Frantz 2014. Results are stronger with PolityIV, although several hundred observations are lost.

⁴¹For a review, see Sauvant and Sachs 2009.

⁴²UNCTAD. Results are robust to including Preferential Trade Agreements (PTAs) (Buethe and Milner 2008). See Appendix.

⁴³Chinn and Ito 2008.

⁴⁴In the Appendix, we also include deep lags of that measure each states' FDI in the first year of the sample (which is excluded). The results are robust to this specification. Might there be reverse causality flowing from FDI stock to the initiation of territorial disputes? Our main reason to be skeptical of this is that the majority of territorial disputes in our sample, as well as the conditions underlying them, began before the boom in FDI in the 1980s.

⁴⁵Pandya 2014. Might there be reverse causality flowing from FDI stock to the initiation of territorial disputes? Our main reason to be skeptical of this is that the majority of territorial disputes in our sample, as well as the conditions underlying them, began before the boom in FDI in the 1980s.

⁴⁶The results are unaffected if we include a non-linear time trend using polynomials.

⁴⁷To investigate whether FDI exhibits unit root, which could make year-fixed effects problematic, we implement the Fisher-type test for panel unit roots. Four tests all easily reject the null hypothesis that the panels contain unit roots.

territorial dispute and legal covariates do not exhibit much variation within each cross-section.⁴⁸ Thus, we begin with pooled models. We add common time-invariant covariates: *Region*, *Former colony*, and *State strength*. In our main specifications, we opt for country random-effects models rather than country fixed-effects as cross-country variation is important for Hypotheses 1, 2, 3, and 4. These are hierarchical linear models that still estimate country-specific effects but assume correlations do not exist between effects and other independent variables. We then estimate country-fixed effects models as appropriate to test Hypotheses 5 and 6, although the cost is that we drop several variables of theoretical interest that do not vary enough within unit.⁴⁹ In all models, Huber-White standard errors are clustered by state.⁵⁰

Results

We first provide simple descriptive statistics to probe the relationship between FDI stock and territorial disputes.⁵¹ We find that the average level of FDI stock in a country with a territorial dispute is significantly lower than in a country without a dispute, a significant difference using a difference-in-means test.⁵² Additionally, within the set of territorial disputes, cases in which a legal focal point exists are associated with higher levels of FDI, a significant difference both during and after the Cold War.⁵³ While this suggests that our argument about the role of international law has merit, it is difficult to make definitive conclusions because FDI stock is known to depend on a number of additional variables.

⁴⁸This would be the case even if we had FDI data back to 1946.

⁴⁹The analysis in Clark and Linzer (2015) suggests that random effects are preferable to fixed effects given the structure of our data.

⁵⁰Results are robust to jackknife approaches. See Appendix.

⁵¹To make levels of FDI stock reasonably comparable across states when using raw data, we use the ratio of FDI stock (USD millions) over GDP (USD millions). This normalization facilitates a simple comparison that takes into account the fact that much larger countries will naturally have higher levels of FDI stock accumulation than much smaller countries. It is important to note that this is not how we treat FDI in our regression models below, as we deal with confounders such as GDP by including them as regressors.

⁵²We allow the two sub-samples to have unequal variances, as this is the case in the data.

⁵³In the Appendix, we further explore the effects of the Cold War, finding that our results are even stronger when focusing on the post-Cold War era. However, the sign is always in the same direction for the Cold War period. The difference in statistical significance for the post-Cold War and Cold War periods could be due to there being about twice as many years of data post-Cold War.

Hypothesis 1: Territorial disputes disrupt FDI

Table 2 contains models that estimate the influence of active territorial disputes on states' FDI stock using OLS regressions. The models in Table 2 all contain binary indicators of territorial dispute, which essentially estimate a set of territorial dispute “fixed effects.” All models also include a variable indicating states that formerly had territorial disputes that have since been settled. This allows us to ensure that our results are not affected by comparing states with ongoing territorial disputes to states that have a history of territorial disputes that have been settled, perhaps very recently.⁵⁴

Model 1 in Table 2 shows that territorial disputes are disruptive of FDI stock. This model separates out whether the state is a target or a challenger in a territorial dispute. We find that territorial disputes in which a state is the challenger have greater substantive effect and that this effect is statistically significant at any conventional threshold, while the coefficient for being the target just misses statistical significance at the 0.10 level.⁵⁵ The results in model 2 aggregate all territorial disputes, meaning that the coefficient averages across the estimates for targets and challengers in model 1. The coefficient is still negative and statistically significant, at the 0.10 level. Substantively, the estimates in model 2 imply that, all else equal, a state embroiled in a territorial dispute has around 25% less FDI stock than it would if it did not have a territorial dispute, which translates into over USD 640 million in foregone FDI. In models 1 and 2, coefficients are also negative for states that were previously involved in a territorial dispute, though they are not statistically significant. These results provide support for our baseline expectation that territorial disputes depress investment (Hypothesis 1).

Table 3 contains four models that are identical to the four models estimated in Table 2 except for how we measure territorial disputes. Specifically, the models in Table 3 account for the fact that some countries are embroiled in multiple territorial disputes at some points in time, a feature that binary measures of whether a dispute exists (or whether a dispute with a legal focal point exists) do not capture. Accordingly, we analyze variables in Table 3 that count the number of territorial disputes in which a country is embroiled. Model 1 includes the sum of territorial

⁵⁴One reason why this is potentially important is because our arguments about firms' abilities to anticipate settlement suggest different dynamics within ongoing disputes and following settlement.

⁵⁵If we use Polity scores instead of the GWF measure of democracy, which leads to models with around 3700 observations, the target coefficient is statistically significant at the 0.10 level.

disputes in which a state is the challenger as well as the sum of disputes in which it is the target, while model 2 sums all territorial disputes. The results are largely consistent with those reported using the binary measures in Table 2 and provide further evidence in favor of Hypothesis 1.

Hypothesis 2: Legal focal points correspond with increased FDI

Models 1 and 2 in Table 2 do not speak to variation among territorial disputes in terms of the likelihood of outcomes that are usually bad or good for the investment environment. Table 2 models 3 and 4 more directly assess our central argument that foreign investors respond to information suggested by legal focal points to anticipate whether they disputes are likely to be violent or peacefully settled (Hypothesis 2). In both models, we include a variable that indicates all states that are not involved in a territorial dispute. This approach allows us to compare the coefficient(s) for the legal focal point variables with the coefficient for states not in territorial disputes, both of which are interpreted relative to all states in territorial disputes that lack a legal focal point. Model 3 separately estimates effects for challenger and target legal focal points, while model 4 measures the presence of a legal focal point favoring either side.

The results clearly show that FDI stock is sensitive to whether a state is involved in a territorial dispute with a legal focal point or not. Specifically, the results in model 3 demonstrate that if a state is involved in a dispute in which either the challenger or target has a legal focal point, then the state has significantly higher levels of FDI stock relative to all other states in territorial disputes without legal focal points (Hypothesis 2). The coefficient for disputes in which the challenger has the legal focal point is statistically significant and substantively large. The challenger coefficient is especially striking when compared with the coefficient for states with no territorial disputes (0.37). Huth, Croco and Appel (2011) find that when a legal focal point exists, the state it favors will avoid using force and prefer negotiations to resolve the dispute. Thus, when the challenger state initiates the dispute (by definition) and has the legal focal point, military escalation is particularly less likely and peaceful negotiations more likely. Our results suggest that foreign firms are aggressive in “getting in the ground floor” and investing in these states, all else equal. That being said, if we estimate 90% confidence intervals around the coefficients for *Challenger Legal Focal Point* and *No TDs*, they are not significantly different than from one another. However, this fact alone is striking as it suggests that the subset of territorial dispute

Table 2: Territorial Disputes, International Law, and FDI Stock

	Model 1	Model 2	Model 3	Model 4
Target TD	-0.303 (0.19)			
Challenger TD	-0.389** (0.15)			
Any TD		-0.279* (0.17)		
Settled TD	-0.240 (0.16)	-0.144 (0.16)		
Challenger Legal Focal Point			0.693** (0.19)	
Target Legal Focal Point			0.351 (0.21)	
Any Legal Focal Point				0.405** (0.20)
No TDs			0.365** (0.15)	0.364** (0.15)
Log Population	0.965** (0.05)	0.939** (0.05)	0.934** (0.05)	0.933** (0.05)
Log GDP pc	0.993** (0.06)	0.993** (0.06)	0.992** (0.06)	0.996** (0.06)
GDP Growth	0.041 (0.07)	0.028 (0.07)	0.031 (0.07)	0.034 (0.07)
Democracy	-0.098 (0.11)	-0.092 (0.11)	-0.120 (0.10)	-0.121 (0.10)
Trade/GDP	0.921** (0.16)	0.922** (0.16)	0.912** (0.17)	0.901** (0.17)
Total BITs	0.008** (0.00)	0.008* (0.00)	0.008* (0.00)	0.008* (0.00)
Openness	0.096** (0.05)	0.092** (0.05)	0.088* (0.05)	0.085* (0.05)
Resource Rents	0.003 (0.00)	0.003 (0.00)	0.003 (0.00)	0.003 (0.00)
Constant	-16.453** (1.02)	-16.134** (1.02)	-16.481** (1.02)	-16.484** (1.02)
Dependent Variable	Log FDI Stock	Log FDI Stock	Log FDI Stock	Log FDI Stock
Year Fixed Effects	Yes	Yes	Yes	Yes
Time Trend	Yes	Yes	Yes	Yes
Country Random Effects	No	No	No	No
N =	4190	4190	4190	4190
R ²	0.857	0.854	0.857	0.857

Standard errors clustered
by state in parentheses
** $p < .05$; * $p < .10$

cases in which the challenger has a strong legal advantage are indistinguishable from states that have no territorial disputes (with the baseline being the “worst-case scenario” of states in territorial disputes without legal focal points). At a minimum this suggests that our attention to distinctions among different kinds of territorial disputes, beyond the baseline Hypothesis 1, is merited.

We also find that disputes in which the target has the legal focal point are associated with increased FDI stock relative to other territorial disputes, although the coefficient is about half the size as for the challenger and again just misses the 0.10 level of statistical significance (model 3). Again, the difference in size between the challenger and target coefficients is consistent with existing evidence in that legal focal points are more associated with settlement when they advantage the challenger. Model 4 estimates the effect of a state being in a territorial dispute with a legal focal point regardless of which party has the legal focal point. The coefficient is positive, large, and statistically significant. Thus, the evidence assessed in models 3 and 4 is supportive of Hypothesis 2. Substantively, the estimates in model 4 imply that a state in a territorial dispute with a legal focal point enjoys about 50% more in FDI stock than it would if it had a territorial dispute without a legal focal point. In terms of dollars, this implies that over USD 1 billion in additional FDI accumulates in a state if, all else equal, its dispute(s) features a legal focal point.

Table 3 models 3 and 4 use non-binary measures of the legal focal point variables. While summing up multiple territorial disputes as is done in Table 3, models 1 and 2 is relatively straightforward, accounting for variation in the legal strength of these multiple disputes is more difficult. Our most preferred binary measures of legal focal points in Table 2 are conservative in that they only code countries with multiple disputes as having a legal focal point if *all* the disputes have this feature. However, it is possible that having, for example, three territorial disputes in which two have legal focal points but one does not also could produce some positive effects for FDI. To explore this possibility and also to make sure that the results in Table 2 are not too dependent on our coding decisions, we analyze the proportion of all territorial disputes a country is in that feature a legal focal point. Specifically, in Table 3 model 3 we construct two measures that capture the proportion of territorial disputes in which the state is the target and there is a legal focal point, as well as the proportion of disputes where the state is the challenger and there is a legal focal point. For example, a value of 1 on the *% of Challenger Focal Points* measure in model 3 indicates that all of a state’s disputes in which it is the challenger have a legal focal point. Model 4 sums

Table 3: Multiple Territorial Disputes, International Law, and FDI Stock

	Model 1	Model 2	Model 3	Model 4
Sum Target TDs	-0.081 (0.08)			
Sum Challenger TDs	-0.176* (0.10)			
Sum Any TDs		-0.118** (0.06)		
Settled TD	-0.108 (0.14)	-0.100 (0.14)		
% of Challenger Focal Points			0.824** (0.20)	
% of Target Focal Points			0.509** (0.23)	
Sum of Legal Focal Points				0.560** (0.21)
No TDs			0.458** (0.16)	0.458** (0.16)
Log Population	0.943** (0.05)	0.943** (0.05)	0.933** (0.05)	0.931** (0.05)
Log GDP pc	0.999** (0.06)	1.004** (0.06)	0.989** (0.06)	0.993** (0.06)
GDP Growth	0.042 (0.07)	0.042 (0.07)	0.031 (0.07)	0.034 (0.07)
Democracy	-0.119 (0.11)	-0.121 (0.11)	-0.124 (0.10)	-0.125 (0.10)
Trade/GDP	0.914** (0.17)	0.913** (0.17)	0.902** (0.17)	0.890** (0.17)
Total BITs	0.009** (0.00)	0.009** (0.00)	0.007* (0.00)	0.007* (0.00)
Openness	0.090* (0.05)	0.090* (0.05)	0.089** (0.04)	0.086* (0.04)
Resource Rents	0.003 (0.00)	0.003 (0.00)	0.003 (0.00)	0.003 (0.00)
Constant	-16.276** (1.03)	-16.313** (1.02)	-16.543** (1.01)	-16.544** (1.02)
Dependent Variable	Log FDI Stock	Log FDI Stock	Log FDI Stock	Log FDI Stock
Year Fixed Effects	Yes	Yes	Yes	Yes
Time Trend	Yes	Yes	Yes	Yes
Country Random Effects	No	No	No	No
N =	4190	4190	4190	4190
R ²	0.855	0.855	0.859	0.858

Standard errors clustered
by state in parentheses
** $p < .05$; * $p < .10$

these measures together to create a general measure of the proportion of all territorial disputes a state is involved in that have a legal focal point. Taken together, models 3 and 4 present similar results when we measure the proportion of disputes with a legal focal point as compared to the approach in Table 2. The effect of having a higher proportion of disputes with a legal focal point is positive for FDI flows regardless of whether we focus on challenger or target disputes (although we again find larger estimates for challenger disputes). These results indicate two key things. First, the results in Table 2 do not depend much on how we deal with legal focal points when there are multiple territorial disputes. Second, the positive and statistically significant coefficients on all of the legal focal point variables in Table 3 indicate that it is the case that FDI responds positively to the presence of a legal focal point, as the coefficients indicate that FDI stock is increasing in the proportion of disputes with legal focal point.

Hypotheses 3 and 4: Under a legal focal point, investors anticipate peace and settlement

Although the findings in Tables 2 and 3 that FDI stock is significantly higher in states with territorial disputes with legal focal point supports our argument, it is possible that FDI stock is simply higher in this set of states for unrelated reasons not captured by the other covariates in the models reported in Table 2. We help to rule out this possibility by estimating models with country-specific effects in which we test additional observable implications of our argument for the pre- and post-settlement periods of states' territorial disputes in the presence and absence of legal focal points.

In Table 4 we probe our argument that investors use information about the presence of a legal focal point to anticipate peace and settlement. In both models we assess the pre- and post-settlement periods in territorial disputes with and without legal focal points using interaction terms.⁵⁶ We do this by including a measure of whether a state has a territorial dispute with a legal focal point that is either ongoing or has been settled and interacting this variable with an indicator of whether the territorial dispute has been settled. We measure whether a country has fully settled its territorial disputes with the *Full Settlement* variable. This variable only takes a value of 1 if settlement results in a country having no ongoing territorial disputes. The interaction term

⁵⁶We thank an anonymous reviewer for suggesting this approach.

Legal Focal Point x Full Settlement indicates the FDI environment in states that were embroiled in territorial dispute(s) with a legal focal point but settled (them all). The direct estimate for *Legal Focal Point* indicates the FDI environment in a state with a dispute that has a legal focal point but has not experienced full settlement yet (*Full Settlement* is equal to zero). The estimates for *Full Settlement* indicate the effect of full settlement on FDI in the absence of a legal focal point. This strategy allows us to easily identify all the effects of interest while also making clear the differences between pre-settlement FDI in instances with and without a legal focal point.

In both models we measure conflict history with the logged time since a state experienced a MID and the count of pre-1980 MIDs a country experienced. These variables help us show that our international law variables are picking up an effect that does not wash out when we explicitly control for a state's participation in military conflict, whether contemporary or historical.⁵⁷ In both models we also control for countries that are not and never were in a territorial dispute with the *No TDs* variable.⁵⁸

The results in Table 4 provide evidence that FDI stock is accumulating at relatively high volumes prior to territorial dispute settlement, but only when the dispute has a legal focal point (Hypothesis 3). The coefficient for *Legal Focal Point* in the pooled OLS regression of model 1 is positive, large and statistically significant, which indicates that FDI is significantly higher in the pre-settlement phase of a territorial dispute. In contrast, FDI is significantly lower in states that formerly had disputes with legal focal points, as the coefficient on *Legal Focal Point x Full Settlement* is negative and statistically significant. This finding, especially when contrasted with the positive and significant coefficient on *Legal Focal Point*, clearly suggests that investors are reacting to the international legal status of states' territorial disputes. In real dollar amounts, these effects suggest that, all else equal, the average state in a dispute with a legal focal point enjoys almost 40% more in FDI stock prior to settlement relative to what the "same" state would enjoy without a legal focal point. This indicates an investment environment that has over USD 850 million in additional FDI stock. In contrast, the positive and statistically significant coefficient on the *Full Settlement* variable makes clear that the dynamics are quite different when states with

⁵⁷In the Appendix we also separate out fatal MIDs from those that do not result in fatalities to demonstrate that conflict severity does not affect our findings.

⁵⁸The territorial dispute data we use starts in 1919, so we can measure the history of territorial dispute as far back as 1918. The vast majority of states that exist at the start of our sample in 1980 did not exist in 1919, so it is unlikely that we miss cases due to the temporal range of the dispute data.

disputes that have no legal focal point settle. The positive coefficient is consistent with the cross-country hypothesis that there is a peace dividend following settlement of disputes without a legal focal point (Hypothesis 4). All else equal, this represents a modest peace dividend of around USD 175 million of additional FDI stock, which is a bit less than a 10% increase from the predicted pre-settlement FDI stock. In sum, these results strongly suggest that the dynamics for disputant states with legal focal points are quite different than those without legal focal points.

In model 2, we replicate the approach in model 1 but add country-specific random effects to guard against our findings being the artifact of some omitted country-level factor. The results are similar, although slightly more muted. Importantly for our arguments, we still find support for the stark difference in the volume of pre-settlement FDI stock as the coefficient on *Legal Focal Point*, which estimates the effect of a focal point prior to settlement, remains positive and significant at the 0.10 level. The coefficient on the interaction term *Legal Focal Point x Full Settlement* remains negative but becomes statistically insignificant. The *Full Settlement* variable, which assess the FDI environment post-settlement in the absence of legal focal point also retains its (positive) sign, but falls below conventional levels of statistical significance with the addition of country random effects. This result suggests that cross-country support for a peace dividend post-settlement in the absence of legal focal point is tepid, although the estimate does not rule out large meaningful effects as the upper bound on a 90% confidence interval of the estimate is a substantively large 0.40.⁵⁹ In sum, while support for Hypothesis 3 is robust to the inclusion of random effects, support for Hypothesis 4 is much more muted.

Hypothesis 5 and 6: Within-country pre- and post-settlement effects are consistent

We now focus on implications of our argument for within-country variation pre- and post-settlement. Table 5 models 1-4 include country-fixed effects to identify all coefficients off of within-country variation. Country-fixed effects have both clear advantages as well as costs relative to random effects in our context. One clear benefit is that, in contrast to random effects, we no longer need to assume that the regressors included in our specification are uncorrelated with the error term, which is often a rather strong assumption. Of key theoretical importance is that country-fixed effects allow

⁵⁹See Rainey (2014) for the logic behind making this point.

us to test the within-country variation posited in Hypotheses 5 and 6. One cost of country-fixed effects is that we cannot include variables that do not vary within country. Thus, the interaction strategy in Table 4 cannot be fully replicated in a fixed-effects model because *Legal Focal Point* does not vary within country as it takes a value of 1 before and after settlement. This means that the (theoretically interesting) effect of *Legal Focal Point* is subsumed (without any measurement error) in the country-fixed effect, along with any other variables that do not exhibit within-country variation (e.g., *Pre-1980 MIDs*). However, this is not a significant concern in assessing Hypotheses 5 and 6, as we can carefully estimate complementary models on the same sample. A model that includes *Legal Focal Point x Pre-Full Settlement* and *No Legal Focal Point x Pre-Full Settlement* will provide us with estimates of the pre-settlement FDI environment. These coefficients are identified off of the comparison to post-settlement FDI in a state. A model that includes *Legal Focal Point x Full Settlement* and *No Legal Focal Point x Full Settlement* will identify the post-settlement FDI environment relative to the pre-settlement FDI environment.

Table 5 model 1 interacts *Pre-Full Settlement* with *Legal Focal Point* and *No Legal Focal Point*, which provides within-country estimates of the pre-settlement period, in the presence and absence of a legal focal point, identified off of comparison with the post-settlement period. Results on this difficult within-country test provide strong evidence for Hypothesis 5 that foreign investors are anticipating settlement, as the real increase in FDI takes place before settlement when there is a legal focal point present (the coefficient on *Legal Focal Point x Pre-Full Settlement* is positive and significant). Substantively, this corresponds to a state with a territorial dispute that has a legal focal point enjoying around 80% more in FDI stock prior to settlement, which amounts to a little less than USD 2 billion in additional pre-settlement FDI. The same is not true in territorial disputes that lack a legal focal point and are eventually settled, as the small and statistically insignificant coefficient suggests that the pre-settlement period is not associated with significantly higher levels of FDI (Hypothesis 5). Taken together, these results suggest that international law does provide key information about the character of a dispute to investors. If foreign investors were simply able to anticipate settlement in general and this was not closely related to the presence of a legal focal point, we would also expect a positive and significant coefficient on the pre-settlement period in the absence of a legal focal point.

In Table 5 model 2 we further probe the dynamics of pre-settlement FDI by separating the

estimates for countries that are embroiled in only one dispute from those embroiled in multiple disputes. We do this by interacting an indicator of whether a state is involved in multiple territorial disputes or not with *Legal Focal Point x Pre-Full Settlement* and *No Legal Focal Point x Pre-Full Settlement*. We separate multiple-dispute from single-dispute states as the effect of settlement is easiest to identify in single-dispute states. Why? While states with more than one dispute can also experience full settlement, the effect of full settlement is potentially clouded by the more muted effects of partial settlements. In other words, if we focus on pre-full settlement FDI, these pre-settlement accumulations often occur in the context of instances of no settlement and instances of partial settlement in the set of states with multiple disputes. This could influence our results in several ways. First, it could be the case that our pre-settlement results are greater in magnitude because they are driven by cases of partial settlement. This is plausible because multiple dispute cases that are fully settled almost always involve multiple settlements spread across time. If this were the case it would be problematic for our theory as it would suggest that the pre-settlement boon to FDI in the presence of legal focal points is driven by increases following settlement of some disputes.⁶⁰ Second, it is possible that pre-settlement estimates are attenuated by the inclusion of partial settlements, as the first-mover advantage to investors plausibly lessens after the first settlement in multiple-dispute states. This is especially plausible in countries where multiple disputes all feature a legal focal point, as the first settlement likely signals a general interest in settling its disputes. Finally, it is also possible that our estimates are attenuated in multiple-dispute states, because the information over the legal environment is more diffuse when “averaged” across multiple disputes that are often with different states. In short, to guard against our results being driven by the aggregation of multiple disputes, we estimate separate coefficients for single and multiple territorial dispute cases.

In sum, the results in Table 5 models 1 and 2 provide a good deal of empirical support for Hypothesis 5 by showing even sharper pre-settlement effects in the set of states that are involved in only one territorial dispute. Specifically, the coefficient on *Legal Focal Point x Pre-Full Settlement* in the presence of a single dispute across the sample period becomes over two-thirds larger in magnitude and remains statistically significant. In dollars, this corresponds to a state with a

⁶⁰Recall that countries with multiple disputes are only coded as having a legal focal point if all the disputes have this feature.

single dispute with a legal focal point enjoying over USD 2 million more in FDI stock prior to settlement than post-settlement. In contrast, the effect is statistically insignificant in the smaller set of countries with multiple territorial disputes. The pre-settlement effects in the absence of a legal focal point remain statistically insignificant regardless of whether a country is involved in one or more disputes. These results establish that previous estimates are not errantly driven by aggregation across multiple disputes; rather, the relatively sharp effects in single dispute cases are attenuated by the cases where countries have multiple territorial disputes.

In Table 5 models 3 and 4 we directly estimate the post-settlement effects of settlement in the presence and absence of legal focal points (Hypothesis 6). Our empirical strategy is the same as it was in models 1 and 2, with the only difference being that we now estimate post-settlement effects, which are identified relative to within-country pre-settlement FDI stock. The estimates in model 3 are roughly consistent with the idea that settlement in the absence of legal focal point brings a peace dividend, as it is more surprising to investors. Specifically, the coefficient on *No Legal Focal Point x Full Settlement* is positive, but statistically insignificant, while the coefficient on *Legal Focal Point x Full Settlement* is negative and insignificant. While the estimated 90% confidence intervals around these insignificant coefficients make clear that *No Legal Focal Point x Full Settlement* is consistent with large and positive effects, the uncertainty over the estimate is too high to draw strong conclusions. Model 4 replicates the approach of model 2 to provide separate estimates of both *Legal Focal Point x Full Settlement* and *No Legal Focal Point x Full Settlement*. In the case of post-settlement FDI, it is possible that aggregating multiple disputes masks sharper effects for single-dispute cases because the hypothesized post-settlement boon to FDI in the absence of legal focal point starts to occur after the first settlement signals a willingness to settle. Thus, the post-full settlement effect in multiple-dispute states would be muted relative to the effect in single-dispute states. Alternatively, it could be the case that the settlement of multiple disputes without a legal focal point resolves a greater degree of uncertainty and risk for investors, making the peace dividend even larger than in single-dispute states. We again ensure that differences across single-dispute and multiple-dispute states are not clouding our estimated effects somehow by separately estimating the coefficients of interest in model 4.

The results of model 4 again show stark differences between states with one or more disputes. Specifically, we find that in the absence of a legal focal point the post-settlement increase in FDI

stock is substantively large and statistically significant in countries that have only a single dispute during the sample period (consistent with Hypothesis 6). Thus, there is a substantial peace dividend when countries have a single dispute without a legal focal point and settle it. In fact, the estimates in model 4 suggest that a state in a single dispute without a legal focal point enjoy a peace dividend of around 60% in additional FDI stock post-settlement, which amounts to just less than USD 1.4 billion in additional FDI. In contrast, when there are multiple disputes the effect of full settlement is negligible, as the estimated coefficient is small, negative, and insignificant. This contrast suggests that how “surprising” full settlement is really depends on whether it entails settling a single dispute or settling multiple disputes, which almost always occurs across a number of years. Finally, again consistent with Hypothesis 6, we find that there is not much evidence of a peace dividend following full settlement in the presence of a legal focal point. This result holds regardless of whether we separately estimate *Legal Focal Point x Full Settlement* for multiple- or single-dispute states.⁶¹

Illustration: Namibia

Our statistical results demonstrate that international law around territorial disputes affects FDI in aggregate. As such, we provide evidence that the incentives around legal focal points are significant enough to shape investment decisions in general, beyond simply a small number of “vulture” investors that are able to stomach considerable risk. Our research strategy thus provides clarity on the scope of rewards available to a capital-seeking state that is willing to comply by the implications of a legal focal point. Still, process-tracing the behavior of particular investors and a particular government is a valuable exercise that can shed further light on how investors get their information about legal focal points and what that means for their investment decisions. Therefore, we briefly consider FDI trends and government behavior in Namibia, a country involved in a territorial dispute with a legal focal point, as an illustration of our argument.

Namibia gained independence in 1990. For its first four years of existence, it had the legal focal point in a territorial dispute with South Africa over Walvis Bay. While many territorial disputes are over remote or less consequential territory, Walvis Bay is economically and strategically important: it had long been a key naval base for South Africa, and it is the only deep-sea port

⁶¹In general, results on control variables are signed as expected. However, democracy is generally negatively signed although insignificant. In contrast to much of the literature, we recover a relatively consistent, positive coefficient on *Total BITs*.

on Namibia's coastline. As a brand-new, impoverished state, Namibia already lacked the features associated with high levels of FDI; this territorial dispute stacked on top of those disadvantages. Has it nonetheless benefitted from the presence of a legal focal point? Of course, the counterfactual is unobservable. Nonetheless, the European Community, IMF, World Bank, Organization of African Unity, and more were integrating Namibia into the community of independent states, supporting its territorial integrity.⁶² With this backdrop, the behavior of a variety of foreign investors, in different industries and from different home states, suggests that many investors saw the dispute as a growing pain rather than a threatening source of long-term political risk. Indeed, South Africa peacefully gave up its claim and ceded the territory in 1994.

First, although their credibility is weakened by their inability to easily move operations outside of Namibia, investors in natural resources exhibited behavior and rhetoric consistent with expectations that Namibia would peacefully work out the Walvis Bay dispute. Walvis Bay is the point of departure for uranium from Rio Tinto's Rossing mine, 40 miles inland.⁶³ Despite several years of uncertainty over the status of Walvis Bay, Rio Tinto did not pursue alternative means of shipping uranium via airlifts or road transportation to Angola.⁶⁴ In fact, Rossing mine has been in continuous operation since 1966. In 1993, the director of a South African salt refiner that also used Walvis Bay was so copacetic with its uncertain status that he said, "If in the future we need to change to being a Namibian [joint venture], we are quite happy to do that."⁶⁵ DeBeers, too, continued to ship diamonds out of Walvis Bay, and the European Community (EC) was confident enough to provide financing to the local diamond industry that relied on it.⁶⁶ This record of continued and new investment, by multinationals and the EC, is consistent with the South African Foreign Minister's comment prior to the Walvis Bay handover, that "he did not understand what all the fuss was about as there had never been any doubt in principle about the incorporation of the disputed territory into Namibia."⁶⁷

Further, a diversity of foreign investors quickly poured into the new Namibian fishing

⁶²Woodsworth, Nicholas. "Survey of Namibia: Neighbourliness is crucial to success - Foreign relations." *Financial Times*: 22 March 1990.

⁶³Other foreign investors from South Africa, as well as the government of Iran, have ownership stakes in Rossing as well.

⁶⁴"In the 1970s..." *Lloyd's List International*: 23 March 1990.

⁶⁵The refiner had operated since 1986. "New Horizons Set to Open for Walvis Bay." *Lloyd's List International*: 27 August 1993.

⁶⁶"Juggling Act seen for Namibian Budget." *Reuters*: 26 May 1993.

⁶⁷Carlin, John. "Pretoria to quit Walvis Bay." *Independent*: 17 August 1993.

industry, despite the fact that the Walvis Bay dispute was particularly concerning for maritime jurisdiction. Although dominant South African firms' fishing quotas were disrupted at Namibia's independence, many of them nonetheless scrambled to regain market share. Investors from France, Portugal, the Netherlands, and Germany pushed the EC to open the market to them. When the EC's negotiations with Namibia slowed, Spanish investors were so anxious to grow their fishing interests that they formed several joint ventures with Namibian partners already in 1992.⁶⁸ In 1993, well before South Africa had announced its willingness to give up its claim, the Namibian Fisheries Minister said, "I agree with the press about the anticipated boom in the fishing industry. That is already visible."⁶⁹ The fishing industry's share of Namibia's GDP rose 37 percent from 1992 to 1993, and it rose another 39 percent in the year of the handover.⁷⁰ In short, Namibia welcomed a variety of forward-looking investors well in advance of settlement.

Namibia has also faced two other territorial disputes, both with legal focal points. Namibia had a territorial dispute with Botswana for which it had the legal focal point; the two states referred the dispute to the ICJ in 1996, and it was settled in 1999. The dispute over the Namibia-South Africa boundary at the Orange River, for which Namibia is the challenger and South Africa has the legal focal point, arose after Walvis Bay was settled. That dispute remains unresolved. Thus, all FDI going into Namibia, which averages 2.5 percent of GDP, has entered in the shadow of a territorial dispute with a legal focal point.⁷¹

While continued FDI despite these other territorial disputes is consequential, FDI during the Walvis Bay dispute best demonstrates how investment can accrue in advance of settlement – even when the territory in question is economically and strategically important. In fact, Namibia even hosted a major investment in the automobile industry in 1991, when the French firm Citroen began assembling luxury vehicles for export to South Africa. Citroen made the investment contingent on South Africa's promise to continue to allow sea shipping from Namibia via Walvis Bay – years before its status was seriously negotiated let alone settled.⁷²

⁶⁸ "Marin Criticises Namibian Government." Agence Europe: 20 April 1991.

⁶⁹ "Namfist opens new Walvis Bay Quay." Reuters: 23 September 1993.

⁷⁰ "Namibia will seine Fischverarbeitung Ausbauen." Nachrichten fuer Aussenhandel: 29 August 1994.

⁷¹ World Bank WDI (1991-2015). GDP growth averages 4.5 percent.

⁷² Ottaway, David B. "Neglected Namibia Marks Anniversary." Washington Post: 22 March 1991.

Conclusion

Today, nearly every government competes for FDI and the positive externalities FDI may bring for its country's economic development. Accordingly, governments have become quite cognizant of the many factors that increase the risks foreign investors may face within their borders. Contentious international disputes are one such risk. We find that firms invest at different rates in states embroiled in different kinds of territorial disputes, and, in particular, that firms invest differently in environments in which a clear legal focal point underpins the dispute. To come to this finding, we theorize a firm-level logic and present statistical evidence of it at the aggregate, country-year level. This research strategy, coupled with a brief discussion of Namibia and its territorial disputes, provides evidence that forward-looking investors willing to anticipate settlement are prevalent enough to shape aggregate FDI trends and, in turn, influence state behavior.

International law has been found to influence the probabilities of peace, conflict, and dispute settlement, but evidence over exactly why states are so responsive to the law is not well-developed.⁷³ Our finding that FDI pours into states involved in territorial disputes with a legal focal point at relatively high levels suggests that states, most of which aggressively court FDI, feel additional pressure to not militarize these disputes and to move towards peaceful settlement so as to safeguard FDI and attract more foreign firms. This suggests a material explanation for the decline of violent interstate disputes, consistent with a long literature on the political economy of conflict and yet worthy of further study: economic integration can push states towards peace.

Our theory operates in the context of historical institutionalism and “new interdependence,” a conceptual approach to international relations that emphasizes the effects of inter-state commitments on domestic outcomes.⁷⁴ We push this research agenda forward by linking interstate commitments to domestic governments, non-state actors, and to domestic governments' behavior toward non-state actors. First, we build on work that identifies the effects of security-related interstate commitments on domestic conflict outcomes. Scholars have demonstrated that clear international legal rules and norms over territorial conquest, particularly in the post-World War II period, are peace-enhancing. Second, we link security-related interstate commitments to the behavior of multinational corporations. When multinational corporations encounter an investment

⁷³Huth, Croco and Appel 2011, 2012, 2013; Prorok and Huth 2015; Goertz, Diehl and Balas 2015.

⁷⁴Farrell and Newman 2014.

climate marked by peace-enhancing features, we find that they are more likely to invest despite the presence of a territorial conflict. Third, we link the effects of interstate commitments to interactions between domestic governments and non-state actors. We identify an interstate commitment that incentivizes domestic governments to pursue peace, not just as a means of complying with accepted norms but also to promote foreign investment.

Table 4: Legal Focal Points, Dispute Settlement, and Logged FDI Stock

	Model 1	Model 2
Legal Focal Point	0.332** (0.04)	0.372* (0.21)
Full Settlement	0.091* (0.05)	0.033 (0.23)
Legal Focal Point x Full Settlement	-0.155* (0.09)	-0.310 (0.30)
No TDs	0.286** (0.04)	0.047 (0.17)
Log Years Since MID	-0.014 (0.02)	0.158 (0.14)
Pre-1980 MIDs	-0.026** (0.01)	-0.041 (0.04)
Log Population	0.944** (0.01)	0.750** (0.06)
Log GDP pc	0.989** (0.02)	1.062** (0.09)
GDP Growth	0.039 (0.05)	0.040 (0.03)
Democracy	-0.110** (0.04)	-0.097 (0.10)
Trade/GDP	0.934** (0.04)	0.179 (0.17)
Total BITs	0.008** (0.00)	0.013** (0.00)
Openness	0.090** (0.01)	0.066* (0.04)
Resource Rents	0.003** (0.00)	-0.001 (0.00)
Constant	-16.496** (0.31)	-13.563** (1.35)
Year Fixed Effects	Yes	Yes
Time Trend	Yes	Yes
Country Random Effects	No	Yes
Country Fixed Effects	No	No
N =	4190	4190
Countries =	170	170
R^2	0.857	0.833

Standard errors clustered
by state in parentheses

** $p < .05$; * $p < .10$

Table 5: Legal Focal Points, Dispute Settlement, and Logged FDI Stock

	Model 1	Model 2	Model 3	Model 4
Legal Focal Point x Pre-Full Settlement	0.609* (0.31)			
No Legal Focal Point x Pre-Full Settlement	-0.036 (0.22)			
Legal Focal Point x Full Settlement			-0.291 (0.26)	
No Legal Focal Point x Full Settlement			0.258 (0.23)	
One Dispute – Legal Focal Point x Pre-Full Settlement		1.029** (0.21)		
Multiple Disputes – Legal Focal Point x Pre-Full Settlement		-0.201 (0.12)		
One Dispute – No Legal Focal Point x Pre-Full Settlement		-0.410 (0.32)		
Multiple Disputes – No Legal Focal Point x Pre-Full Settlement		-0.240 (0.16)		
One Dispute – Legal Focal Point x Full Settlement				-0.473 (0.46)
Multiple Disputes – Legal Focal Point x Full Settlement				0.148 (0.16)
One Dispute – No Legal Focal Point x Full Settlement				0.761** (0.34)
Multiple Disputes – No Legal Focal Point x Full Settlement				-0.065 (0.25)
Log Population	-0.659 (0.45)	-0.621 (0.45)	-0.658 (0.43)	-0.647 (0.43)
Log GDP pc	1.022** (0.18)	1.041** (0.18)	1.008** (0.18)	1.016** (0.18)
GDP Growth	0.050 (0.03)	0.049 (0.03)	0.050 (0.03)	0.051 (0.03)
Democracy	-0.074 (0.11)	-0.088 (0.11)	-0.070 (0.11)	-0.082 (0.10)
Trade/GDP	0.115 (0.19)	0.121 (0.19)	0.102 (0.19)	0.097 (0.19)
Total BITs	0.007* (0.00)	0.007 (0.00)	0.008* (0.00)	0.008* (0.00)
Openness	0.054 (0.04)	0.056 (0.04)	0.055 (0.04)	0.052 (0.04)
Resource Rents	-0.002 (0.00)	-0.002 (0.00)	-0.002 (0.00)	-0.002 (0.00)
Log Years Since MID	0.348 (0.23)	0.349 (0.23)	0.350 (0.22)	0.354 (0.23)
Constant	8.383 (7.33)	6.390 (7.38)	8.446 (7.13)	6.806 (7.12)
Year Fixed Effects	Yes	Yes	Yes	Yes
Time Trend	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes
N =	4190	4190	4190	4190
Countries =	170	170	170	170
R ²	0.770	0.772	0.771	0.772

Standard errors clustered
by state in parentheses

** $p < .05$; * $p < .10$

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