

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**The Role of International
Investment Agreements
in Attracting
Foreign Direct Investment
to Developing Countries**

**UNCTAD Series
on International Investment Policies for
Development**



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NOTE

As the focal point in the United Nations system for investment and technology, and building on 30 years of experience in these areas, UNCTAD, through the Division on Investment and Enterprise (DIAE), promotes understanding of key issues, particularly matters related to foreign direct investment (FDI) and transfer of technology. DIAE also assists developing countries in attracting and benefiting from FDI and in building their productive capacities and international competitiveness. The emphasis is on an integrated policy approach to investment, technological capacity building and enterprise development.

The term “country” as used in this study also refers, as appropriate, to territories or areas; the designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. In addition, the designations of country groups are intended solely for statistical or analytical convenience and do not necessarily express a judgement about the stage of development reached by a particular country or area in the development process.

The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported.

Rows in tables have been omitted in those cases where no data are available for any of the elements in the row.

A dash (-) indicates that the item is equal to zero or its value is negligible.

A blank in a table indicates that the item is not applicable.

A slash (/) between dates representing years, e.g. 1994/1995, indicates a financial year.

Use of a hyphen (-) between dates representing years, e.g. 1994-1995, signifies the full period involved, including the beginning and end years.

Reference to “dollars” (\$) means United States dollars, unless otherwise indicated.

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates.

Details and percentages in tables do not necessarily add to totals because of rounding.

The material contained in this study may be freely quoted with appropriate acknowledgement.

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PREFACE

The secretariat of UNCTAD is implementing a programme on international investment arrangements. It seeks to help developing countries to participate as effectively as possible in international investment rulemaking. The programme embraces (a) policy research and development, including the preparation of a series of issues papers; (b) human resources capacity-building and institution-building, including national seminars, regional symposia, and training courses; and (c) support to intergovernmental consensus-building.

This paper is part of the *Series on International Investment Policies for Development*. It builds on, and expands, UNCTAD's *Series on Issues in International Investment Agreements*. Like the previous one, this new series is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers.

The series seeks to provide a balanced analysis of issues that may arise in the context of international approaches to investment rulemaking and their impact on development. Its purpose is to contribute to a better understanding of difficult technical issues and their interaction, and of innovative ideas that could contribute to an increase in the development dimension of international investment agreements.

The series is produced by a team led by James Zhan. The members of the team include Bekele Amare, Hamed El-Kady, Tamas-Pal Heisz, Joachim Karl, Jan Knörich, Ventzislav Kotetzov, Matthew Levine, Diana Rosert, Marie-Estelle Rey, Elisabeth Tuerk and Jörg Weber. Members of the Review Committee are Mark Kantor, John Kline, Peter Muchlinski, Antonio Parra, Patrick Robinson, Karl P. Sauvant, Pierre Sauv , M. Sornarajah and Kenneth Vandavelde.

This paper is based on a study prepared by Zbigniew Zimny. Hamed El-Kady, Jan Knörich, Joachim Karl, Elisabeth Tuerk and Jörg Weber finalized the paper. Specific comments were received from Rory Allan, Eric Leroux, Antonio Parra, Liza Sachs and Karl P. Sauvant.



Supachai Panitchpakdi
Secretary-General of UNCTAD

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ABBREVIATIONS

AFTA	ASEAN Free Trade Area
ANDEAN	Andean Community
ANZERTA	Australia–New Zealand Closer Economic Relations Free Trade Agreements
APEC	Asia–Pacific Economic Cooperation
ASEAN	Association of South-east Asian Nations
BIT	bilateral investment treaty
CARICOM	Caribbean Common Market
CEE	Central and Eastern Europe
CEO	chief executive officer
CER	Closer Economic Relations Trade Agreement between Australia and New Zealand
COMESA	Common Market for Eastern and Southern Africa
DTT	double taxation treaty
EEC	European Economic Community
EFTA	European Free Trade Association
EIA	economic integration agreement
EPZ	export processing zone
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GDP	gross domestic product
ICSID	International Centre for Settlement of Investment Disputes
IIA	international investment agreement
IPA	investment promotion agency
IPR	investment policy review
M&A	merger and acquisition
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MFN	most favoured nation

MLI	member liberalization index
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
PATCRA	Papua New Guinea–Australia Trade and Commercial Relations Agreements
PFI	policy framework for investment
PTA	preferential trade agreement
PTIA	preferential trade and investment agreement
RTA	regional trade agreement
SADC	Southern African Development Community
SME	small and medium-sized enterprise
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
TNC	transnational corporation
UNCTC	United Nations Centre for Transnational Corporations (1974–1992)
WAIPA	World Association of Investment Promotion Agencies
WTO	World Trade Organization

EXECUTIVE SUMMARY

Against recurrent concerns that international investment agreements (IIAs) are not effective enough in promoting inflows of foreign investment, the objective of this study is to reassess the impact of IIAs. Since they are a key instrument in the strategies of most countries, in particular developing countries, to attract foreign investment, policymakers need to know what role these treaties actually play and to what extent they can contribute to receiving more investment from abroad. Equally important is the question of whether the impact of IIAs on investment inflows also depends on the specific type of investment treaty concluded. A better understanding of the influence of IIAs on foreign investment can help to avoid unrealistic illusions, assess the costs and benefits involved and prepare the ground for more effective systemic host country policies that give IIAs their proper place in an overall strategy of attracting foreign investment and making it work for development.

The paper starts with a brief summary of the main host country determinants for foreign direct investment (FDI). They consist of (a) the general policy framework for foreign investment, including economic, political and social stability, and the legislation affecting foreign investment; (b) economic determinants, such as the market size, cost of resources and other inputs (e.g. costs of labour) or the availability of natural resources; and (c) business facilitation, such as investment promotion including investment incentives. All three determinants interact, enhancing or reducing the attractiveness of countries for foreign investment. IIAs are part of the policy framework for foreign investment, and are thus only one of the many factors that impact on a company's decision where to make an investment. As a consequence – and this is one of the key messages of this study – IIAs alone can never be a sufficient policy instrument to attract FDI. Other host country

determinants, in particular the economic determinants, play a more powerful role.

Against this background, the paper reviews a number of econometric studies that explore the impact of IIAs on investment inflows. It groups the different studies according to the type of IIAs they analyse: bilateral investment treaties (BITs) on the one hand, and various kinds of broader economic cooperation agreements on the other. For the purpose of this study, the latter category of treaties is called preferential trade and investment agreements (PTIAs). With regard to both types of agreements, the study reviews the findings of numerous econometric studies and, based on this analysis, then arrives at its own conclusions. It makes the point that – within their limited role as foreign investment determinants – IIAs can influence a company’s decision where to invest, and this impact is generally stronger in the case of PTIAs than with regard to BITs. The study does not cover the role of double taxation treaties (DTTs) in this context in light of a separate forthcoming UNCTAD study, but notes that the existing literature appears to associate with these treaties a positive impact on foreign investment inflows as well.

IIAs add a number of important components to the policy and institutional determinants for FDI, and thereby contribute to enhancing the attractiveness of countries. In particular, they improve investment protection and add to the security, transparency, stability and predictability of the investment framework. By liberalizing market access for non-tradable services, and effectively creating a “market” for such services, IIAs also improve an important economic determinant of foreign investment.

As far as BITs are concerned, their indirect impact on FDI has been measured in a series of econometric studies published between 1998 and 2008. This assessment is not an easy task, given the complexity of host country FDI determinants, the sometimes poor state of FDI data and difficulties with properly capturing and reflecting in econometric models all important FDI determinants. The findings of early empirical studies on the impact of BITs on FDI flows were ambiguous, with some showing weak or considerable impact, and one or two no impact at all.

However, more recent studies published between 2005 and 2008 – based on much larger data samples, improved econometric models and more tests – have shifted the balance towards concurring that BITs do have some influence on FDI inflows from developed countries into developing countries. Although most BITs do not change the key economic determinants of FDI, they improve several policy and institutional determinants, and thereby increase the likelihood that developing countries engaged in BIT programmes will receive more FDI. Important qualifications, however, remain regarding these later studies. The strength of the impact varies depending on the study and circumstances, such as the period of the analysis, the timing of the relationship, the selection of a dependent variable or the sample of countries. There is consensus in the literature that host-country market-size variables remain the dominant factor for inward FDI, including in developing countries and – as noted later in this paper – there is no and can never be a mono-causal link between the conclusion of an IIA and FDI inflows.

The possibility that BITs impact on FDI flows into developing countries is confirmed by investor surveys according to which BITs – and other IIAs – are important to transnational corporations (TNCs) in terms of investment protection and enhancing stability and predictability for FDI projects. For the majority of surveyed TNCs from all sectors, BIT coverage in host developing countries and transition economies plays a role in making a final decision on where to invest. Further evidence that TNCs increasingly make use of BITs is provided by the rapidly increasing number of investment arbitration cases based on these agreements.

With regard to PTIAs, they often embrace the investment protection provided by BITs and, in addition, improve the economic determinants of FDI, sometimes in a significant manner. This is particularly the case for market-related FDI determinants pertaining to tradable goods and services and non-tradable services. There appears to be consensus in the literature that PTIAs lead to further FDI inflows, including in developing countries that are members of PTIAs. Changes in FDI policies can and in some instances have stimulated additional FDI inflows. Some of these changes include (a) making them more FDI-friendly or addressing less visible barriers to FDI, such as internal regulation of services; and (b) the geographical expansion of integration or its deepening by, for example, removing restrictions on competition among firms or unifying competitive conditions.

More recent comprehensive PTIAs cover not only treatment and protection of FDI, but also competition policies,

liberalization of FDI in services, broader property rights, contract enforcement and, above all, access to a large market and stable and predictable trade policies. The latter element improves key economic determinants of FDI, but trying to isolate their impact from the impact of “pure” investment rules seems impossible. However, for the impact to occur, investors must believe that policy commitments of PTIAs are credible and, for example, abolished regional trade barriers will not be reinstated, as was sometimes the case in some South–South agreements.

Overall, developing countries stand to benefit from engaging in IIAs in terms of increasing their attractiveness for FDI, and therefore the likelihood that they receive more FDI. However, the obligations embedded in IIAs can also impose costs on developing countries, which “constrain their sovereignty by entering into treaties that specifically limit their ability to take necessary legislative and administrative actions to advance and protect their national interests” (Salacuse and Sullivan, 2005: p. 77).¹ Furthermore, – and this point cannot be emphasized enough – the conclusion of IIAs needs to be embedded in broader FDI policies covering *all* host country determinants of foreign investment. IIAs alone cannot do the job. Nonetheless, consideration could be given to further strengthen the role of IIAs as an investment promotion instrument. For the time being, IIAs do not contain commitments by capital-exporting countries other than vague language relating to investment promotion and mostly promote foreign investment only *indirectly* through the granting of investment protection. However, policymakers may wish to consider developing IIAs with effective and operational

provisions on investment promotion, aimed at attracting high-quality FDI and maximizing attendant development contributions.

Note

- ¹ This has also to be seen in the context of the increasing number of investor–State dispute settlement cases and the attendant challenges, including cost-related challenges (the cost of litigation, costs for awards), challenges regarding a country’s reputation as an attractive FDI destination and capacity-related challenges, particularly for developing countries.

INTRODUCTION

Since the mid-1980s, most developing countries have become much more open to FDI, with a view to benefiting from the development contributions which FDI – particularly high-quality FDI – can generate for host countries. Since the early 1990s, transition economies have joined in this trend. Both groups of countries, often hostile or at best distrustful vis-à-vis transnational corporations (TNCs) in the decades that followed the Second World War, began to perceive TNCs no longer as part of the problem but increasingly as part of the solution, bringing not only much needed capital to stimulate growth and development, but also technology, skills and access to foreign markets and creating employment. Consequently, previous restrictive and controlling policies and institutions were replaced by new ones aimed at attracting FDI. Thus, many developing countries and countries in transition¹ have reduced – to various degrees – bans and restrictions on FDI entry, improved the standards of treatment and protection of foreign investors and eased or eliminated restrictions on their operations. Finding themselves in increasing competition with other countries for attracting FDI, they often also implemented incentive schemes for TNCs. Efforts to promote FDI also included the establishment of investment promotion agencies (IPAs) and export processing zones (EPZs). The process of opening up to FDI and establishing enabling frameworks for FDI vastly accelerated during the 1990s and continues until today, although more recently there have also been signs of more restrictive FDI policies in several countries.

Generally reluctant to bind their FDI policies in multilateral agreements, developing countries have increasingly submitted some aspects of their investment frameworks, especially those concerning protection and

treatment of FDI to international treaties. The result has been an explosive growth of international investment agreements (IIAs). Until the end of 2008, more than 2,670 bilateral investment treaties (BITs) and more than 270 other IIAs – such as free trade agreements (FTAs) or economic integration agreements with investment provisions – had been concluded. All countries are parties to at least one IIA.²

In concluding IIAs, developing countries seek to make the regulatory framework for FDI more transparent, stable, predictable and secure – and thereby more attractive for foreign investors (UNCTAD 2003a: 84). However, a recurrent issue in the discussions about IIAs is to what degree IIAs *actually* fulfil their objective of encouraging more FDI. The debate on the impact of IIAs on FDI, previously perceived as a North–South issue, has recently gained new momentum. As a growing number of developing countries are becoming FDI exporters, they reconsider the role of IIAs as not only a device aimed at stimulating inward FDI from developed countries, but also as a means to encourage and protect their own outward FDI in developed and other developing countries.³ Consequently, South–South cooperation in investment rulemaking has increased considerably.⁴ In addition, new types of IIAs which also cover trade and other issues have emerged, and many countries have renegotiated their BITs in order to further improve investment conditions.

The objective of this paper is to explore the role of IIAs in attracting FDI into developing countries. To this end, the study will start with a brief overview of the overall determinants for FDI. Thereafter, the paper will focus on the role of IIAs as FDI determinants. It will review a number of

existing econometric studies on the impact of IIAs on FDI inflows into developing countries. As the investment provisions of different types of IIAs may differ and so may their possible impact on FDI, the discussion will be organized by the types of IIAs, starting with BITs, followed by other IIAs, such as FTAs and economic integration agreements with investment provisions. The study does not cover agreements on the avoidance of double taxation or so-called “double taxation treaties” (DTTs), as these constitute a special category of IIAs that deal foremost with the elimination of double taxation (although they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution).

While the paper offers a conceptual discussion of the impact which IIAs can have on FDI flows, it does not aim to conduct an in-depth critique of each individual study or its underlying econometric model and assumptions. Instead, the objective of this paper is to make the wealth of information included in these studies available to IIA policymakers, negotiators, legal experts and other interested stakeholders.

Notes

- ¹ In a later part of the study, the focus will be on developing countries, although studies on the impact of IIAs on FDI cover both groups of countries.
- ² The only known exception is Monaco. For updates on the evolution of the IIA regime, including detailed figures on each group of agreements see UNCTAD 2009c.
- ³ For details on the outward stock of FDI reported by developing countries, see UNCTAD, 2008b: 257–260 and UNCTAD 2007a: 255–258.
- ⁴ For example, a quarter of the BITs' universe is among developing countries; see UNCTAD, 2008a.

I. HOST COUNTRY DETERMINANTS OF FDI

A. A conceptual framework

While assessing the possible impact of IIAs on FDI, one has to put these treaties in perspective with their role and place among the overall host country determinants of FDI.

The conceptual framework for analysing host country determinants of FDI is part of a broader framework for explaining other aspects of FDI, known as the “OLI paradigm” (Dunning, 1993). “O” in the paradigm stands for ownership-specific advantages of firms and addresses the issue of why some firms become TNCs while others do not. The “I” component (internalization advantages) explains why firms may prefer to exploit these advantages (such as technology or other know-how) by “internalizing” them through FDI rather than selling them externally to third parties. “L” stands for locational advantages of host countries and embraces factors determining the choice by TNCs of a specific host country. It is the last element that is of special interest in the present context.

The “L” component provides a framework for assessing the host country determinants of FDI. In general, one can distinguish three groups of such determinants: the policy framework for FDI, economic determinants and business facilitation (table 1). It is the combination of these determinants that decides in an individual case whether a FDI will be made in a specific host country or not. The existence of IIAs is part of the policy framework for FDI, and constitutes therefore only one “sub”-element of the overall host country determinants of FDI.

Being aware of this limited role of IIAs for the attraction of FDI helps avoid frequent misperceptions about the impact of these treaties. Many developing countries seem to expect that, once they have concluded an IIA with another country, FDI from that country will almost automatically flow in. If this does not happen, disappointment about the role of IIAs may be huge and even result in criticism that these agreements are useless. However, such a critique is based on a wrong assessment of the role of IIAs. There is and can never be a mono-causal link between the conclusion of an IIA and FDI inflows. As explained in table 1, the existence of IIAs is by far not the only determinant that decides on whether FDI takes place or not. Other factors, such as the economic attractiveness of a host country, its market size, its labour force or its endowment with natural resources may be much more important.

To make economic attractions – key determinants of FDI – effective, many additional conditions are needed, some common to all types of FDI, some specific to particular FDI types. One common condition is that countries have to be open to FDI. Another key issue is the degree of political stability determining the political risk of investing in a host country. Other key FDI determinants include the physical and technological infrastructure of the host country, the cost and quality of resources and other inputs and business facilitation measures, such as FDI promotion, including incentives to foreign investors.

General host country policies affecting investment decisions, including those by foreign investors, embrace many areas. For example, the Policy Framework for Investment

(PFI) developed by the Organisation for Economic Co-operation and Development (OECD) – a programme aimed at the propagation of good policy practices facilitating investment – includes 10 broad policy areas: investment policy, investment promotion and facilitation, trade policy, competition policy, tax policy, corporate governance, policies for promoting responsible business conduct, human resource development policy, policies related to infrastructure and financial sector development and to public governance.¹ The programme formulates for these policy areas 82 recommendations, the observance of which is aimed at helping governments to formulate and implement policies and establish and/or improve the functioning of institutions conducive to increased and better investment (OECD, 2006). Some of them matter less and some matter more for foreign investors.

The Investment Policy Review Programme of UNCTAD, aimed at improving FDI policy frameworks in host developing countries, gives an idea of the broad range of policy issues that matter for foreign investors. Thus, these issues may cover foreign exchange regulations, taxation, employment, including employment of non-citizens, land issues, competition policy, rule of law and respect for property rights, intellectual property protection, corporate governance and accounting standards, licensing and administration of regulations and investment promotion including incentives.² In

Table 1. Host country determinants of FDI

Host country determinants	Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
<p>I. Policy framework for FDI</p> <ul style="list-style-type: none"> • economic, political and social stability rules regarding entry and operations • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M&A policies) • international agreements on FDI • privatization policy • trade policy (tariffs and NTBs) and coherence of FDI and trade policies • tax policy <p>II. Economic determinants</p> <p>III. Business facilitation</p> <ul style="list-style-type: none"> • investment promotion (including image-building and investment-generating activities and investment-facilitation services) • investment incentives • hassle costs (related to corruption, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc.) • after-investment services 	<p>A. Market-seeking</p> <ul style="list-style-type: none"> • market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets <p>B. Resource/asset-seeking</p> <ul style="list-style-type: none"> • raw materials • low-cost unskilled labour • skilled labour • technological, innovative and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication) <p>C. Efficiency-seeking</p> <ul style="list-style-type: none"> • cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conducive to the establishment of regional corporate networks 	

Source: UNCTAD, 1998a.

addition, judging from other IPRs, general policies and regulations that may affect an FDI decision may include labour market legislation, EPZs, and environmental and financial market regulation. In addition, sectoral regulations are examined, depending on locational advantages of client countries. They typically include mining codes for countries with natural resources, tourism regulations for countries with locational attractions for FDI in tourism or utility and infrastructure regulations.

In attracting FDI to an individual country, policy determinants interact with economic determinants in various ways, depending on the type of FDI. For instance, the combination of FDI determinants needed to attract efficiency-seeking FDI is different from that needed to attract market-seeking FDI (table 1). Also, determinants may be different depending on the economic sector involved – primary sector, manufacturing, or services.³ Moreover, TNCs, even from the same industry, may not react equally to the same FDI determinants (UNCTAD, 1998a: 91). For example, market size and growth may not matter for efficiency-seeking investors, which typically export goods and tradable services from host countries. For these investors, an open trade policy, the exchange rate policy as well as policies affecting the quality and cost of infrastructure services and human resources are more important. On the other hand, restrictive trade policies resulting in high import barriers served in the past as a magnet for market-seeking FDI in manufacturing – for example, in Brazil during the 1970s. Privatization policy matters greatly for investors in infrastructure services such as

telecommunication or electricity, as it determines conditions of entry and operations.

In conclusion, FDI flows into host countries are determined by a variety of factors, including the economic attractiveness of host countries, profitability of a possible investment, as well as a variety of policy and institutional determinants and business facilitation measures. Host country determinants of FDI are hierarchical: that is, some of them are more important than others. Some are necessary but not sufficient conditions for FDI. For example, FDI liberalization is a necessary, but not a sufficient host country determinant of investment, and other determinants have to come into play for investment to flow into a country. A liberal policy framework “determines” FDI in the sense that it enables TNCs to invest in a host country. However, there is no guarantee that investment will actually occur (UNCTAD 1998a: 96).⁴ The same can be said about the effectiveness of business facilitation measures (and especially of promotional measures and incentives) as FDI determinants. They can only play a supportive role and will rarely be decisive factors. If a host country does not have some basic economic determinants in place, or if other components of the investment climate are unsatisfactory, it is unlikely that promotional efforts or incentives will be successful in attracting significant FDI (UNCTAD 1998a: 104).

B. Evidence on host country FDI determinants

There is a long history of *econometric analyses* of factors determining FDI inflows. Over the years, the existing literature has confirmed the primacy of the “economic”

determinants of FDI in influencing FDI inflows, often in various combinations with policy or institutional determinants.

Among the economic FDI determinants, market-related factors clearly stand out. Variables related to the size and the growth of the host country market have appeared in almost all previous explanations of the amount of inward FDI. They include the size of the host country's domestic market, its growth rate and the average income per capita. Although the strength of the impact varies depending on the study and circumstances, such as the period of the analysis, the timing of the relationship, the selection of a dependent variable or the sample of countries, there is consensus in the literature that host country market-size variables remain the dominant factor for inward FDI, including in developing countries (UNCTAD, 1998a: 135 and 140; Nunnenkamp and Spatz, 2002). Consequently, market-seeking FDI has been the main type of FDI.

Trade liberalization – regional or multilateral – was expected to diminish the importance of domestic market size (and thus domestic market-seeking FDI) in favour of larger international, mainly regional, markets and efficiency-seeking FDI. But this is still debatable and several studies have shown that market-related factors continue to remain a key determinant of inward FDI (UNCTAD, 1998a; Nunnenkamp and Spatz, 2002). The explanation is that the positive interaction between trade openness and FDI, giving rise to efficiency-seeking FDI, is mainly limited to the manufacturing sector or, more specifically, tradable goods and services. However, the global FDI boom has largely taken place in non-

tradable services, in which, by definition, FDI is of a market-seeking type. Nevertheless, the determinants of efficiency-seeking FDI and variables used to measure this type of FDI – such as cost differences among locations, the quality of infrastructure, the ease of doing business, the availability of complementary local factors of production and the availability of skills – constitute the second most important group of economic determinants of inward FDI, in particular in many developing countries and transition economies (for a review of the recent literature, see Nunnenkamp and Spatz, 2002).

Furthermore, and in contrast to most developed countries, considerable amounts of FDI in developing countries are directed to accessing natural resources, although the relative importance of natural resource-seeking FDI has been declining. One of the reasons is the diminishing role of the primary sector for global gross domestic product (GDP). Another explanation is the opening of the service sector to FDI. While in absolute terms, FDI in all three sectors has increased, growth in services – especially in telecommunications, electricity and business services – has been very substantial after host countries started opening up to FDI.

More recently, studies have started to examine policy and institutional characteristics of host countries as FDI determinants. An UNCTAD study has found that institutional characteristic of a host country – combining ratings for the judiciary system, red tape and corruption – together with the host country market size – have a positive influence on inward FDI into developing countries (UNCTAD, 1998a: 138). As will be seen below, policy and institutional determinants are

especially important in developing countries, which are often characterized by weaker institutions and less consistent policies than developed countries.

The importance of policy and institutional factors for FDI decisions comes out clearly in investor surveys. They often disregard questions concerning motives for entry (market size, cost reduction or accessing natural resources) and focus on policy and other economic factors – other than those related to the principle motive of entry – that cause investors to choose a specific investment location.⁵ The Worldwide Survey of Foreign Affiliates, conducted jointly by UNCTAD and the World Association of Investment Promotion Agencies (WAIPA) in 2007 among 96 chief executive officers (CEOs) of foreign affiliates located in 57 developing countries on all continents, 25 developed countries and 14 countries from South-East Europe and the Commonwealth of Independent States, asked to rank on a scale from “1” – meaning “not at all important” – to “5” – “extremely important” 33 locational factors according to their importance in investment decision-making (UNCTAD, 2007b). Macroeconomic stability and political stability were considered the most important, with average scores of 4.3. Their importance applied to foreign affiliates across regions and industries, but foreign affiliates in developing countries put more emphasis on political stability, compared with those in other host economies. Other important factors included the quality of telecommunications, the supply and cost of skilled labour, corporate taxes and the quality of banking and other financial services. When asked to indicate where host country governments should devote more attention to make their locations more attractive to FDI, the largest

number of surveyed CEOs – one third – pointed to the need to strengthen the institutional and regulatory framework for investment. According to the survey, this category included stability, enhanced legal and regulatory environment, institutional strength, anticorruption measures and crime reduction.

C. IIAs as part of FDI determinants

1. The different functions of IIAs as FDI determinants

The overwhelming majority of IIAs, in particular the majority of BITs, promote foreign investment by protecting foreign investors against certain political risks in the host country (box 1). IIAs may impact on FDI inflows through improving individual components of the policy and institutional framework for FDI in the host country, thus contributing to an improvement of the investment climate. By guaranteeing foreign investors a certain standard of treatment and establishing a mechanism for international dispute settlement, IIAs contribute to reducing risks associated with investing in developing countries. In addition, the IIAs of some countries – notably Canada, Japan and the United States – grant foreign investors certain rights concerning their establishment in the host country. IIAs in general may also contribute to more transparency, predictability and stability of the investment framework of host countries, and may to some extent serve as a substitute for weak institutional quality in the host country concerning the protection of property rights. In the following, each of these three mechanisms is discussed in more detail with a view to assessing their impact on the attraction of FDI.

a. FDI protection

IAs seek to promote FDI by contributing to the creation of stable and favourable legal environment for investment. The assumption is that clear and enforceable rules protecting foreign investors reduce political risks and thereby increase the attractiveness of host countries (Salacuse and Sullivan, 2005: 95; Vandevelde 2005: 171). Furthermore, by granting foreign investors access to international arbitration, host country governments make a strong commitment to honour their obligations, which should further enhance investor confidence.

IAs might solve in particular the problem of “obsolescing bargaining”. Since the nationalizations of the second half of the past century, the risk of “obsolescing bargaining” has been widely recognized as a major potential deterrent to new investment in developing countries, especially in natural resources and infrastructure. Foreign investors may fear that once the investment is sunk, a host country might act opportunistically and unduly interfere with the profitability of investment (Wells and Ahmed, 2007: 66).

Box 1. Key provisions of IIAs

General standards of treatment (after entry)

- Fair and equitable treatment in accordance with international law;
- National treatment – foreign investors must not be treated less favourably than their domestic counterparts;
- Most favoured nation (MFN) treatment – i.e. non-discrimination among investors of different foreign nationality;

Protection of foreign investors

- Guarantees of compensation based on international standards in case of expropriation of foreign property;
- Guarantees of the free transfer and repatriation of capital and profits;

Dispute settlement

- In case of an investment dispute, the right of the foreign investor to challenge the host country measure before an international arbitration tribunal.

Source: UNCTAD.

While the risk of outright expropriation is relatively low in today's world, the risk of creeping or indirect expropriation has not disappeared and may take a variety of forms, such as non-payment to the investor, cancellation by the host country government of investment authorizations, or the denial of justice. IIAs address this issue by obliging host countries to pay compensation if as a result of such government action the foreign investor is *de facto* expropriated. In addition, many IIAs protect foreign investors against the breach of commitments that the host country has undertaken in an individual investment contract with the foreign investor (Aisbett, 2007: 5).

Another reason for concluding IIAs is that home countries may have doubts about the institutional quality in the

host country; that is, the quality of domestic institutions protecting property rights and resolving disputes. IIAs, by placing dispute resolution outside the domestic system of host countries, may thus substitute for poor institutional quality.⁶ In other words, IIAs may to some extent provide a shortcut to policy credibility in the international arena (Hallward-Driemeier, 2003).

The importance of IIAs also becomes clear when one compares the level of treaty protection with that in the pre-IIA era. Before IIAs were concluded, foreign investors who sought the protection of international investment law “encountered ephemeral structure consisting largely of scattered treaty provisions, a few questionable customs, and contested general principles of law” (Salacuse and Sullivan, 2005: 69–70). Consequently, international law failed to address important issues of concern to foreign investors. For example, international law did not deal with the right of foreign investors to transfer funds from host countries. Principles of customary international law were often vague and subject to conflicting interpretations, for instance with regard to the calculation of compensation in case of expropriation. There was also no effective mechanism to pursue investors’ claims against host countries that had harmed investments or did not honour contractual obligations.⁷ Foreign investors, who failed to settle their claims in the domestic courts of the host country, had no other option than to act through their governments in a lengthy and more political than legal process (Salacuse and Sullivan, 2005: 69–70).

Foreign investors who are concerned about political risks of investing in a host developing country can buy political risk insurance available from many sources: private insurers, home country state-supported investment agencies, MIGA or host country agencies. If an FDI project is financed partly by equity capital and partly by debt, as is typically the case with large infrastructure or mining projects, banks extending credit to such projects will routinely require a purchase of political risk insurance or buy such insurance themselves on a limited recourse basis. Political risk insurance policy may cover all political risks such as the risk of expropriation, revocation of permits, asset confiscation, currency inconvertibility or non-transferability, war, riots, etc. Furthermore, it can be suited to individual needs of investors. Thus, this insurance may serve and does serve for many investors as a substitute to BITs in their aspects concerning political risks, especially in countries with which an investor's home country does not have a BIT.

Political risk insurance may be also purchased for investing in host countries with BITs with home countries. In spite of a BIT providing a similar protection, investors may decide that risk insurance is a more convenient way to deal with political risks than a lengthy and costly litigation before international tribunals. If an insurer recognizes the claim, reimbursement is immediate and the insurer takes over the claim and litigation vis-à-vis the host government.

There is also an assertion that insurance agencies require a BIT as a condition of issuing political risk insurance or that in countries without BITs such insurance is more expensive. Little is known about this. UNCTAD's interviews

with several private and public insurance agencies, conducted in 2004, confirmed that this indeed might be the case but does not have to and that this depends on the track record of a host country and individual policies of insurance agencies.⁸

Finally, one special category of IIAs – agreements on the avoidance of double taxation or so-called “double taxation treaties” (DTTs) – address the concerns of foreign investors that they may be subject to taxation for the same income by both the home country and the host country. The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by the entities of a transnational corporate system is allocated among countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, among other things, to set out detailed allocation rules for different categories of income. While international tax agreements deal foremost with the elimination of double taxation, they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution (UNCTAD, 2004b).

Even in cases where there is no double taxation to relieve – e.g. if there is no tax in one State or if the country of residence unilaterally avoids double taxation – a tax treaty can be useful as it generally offers greater and more comprehensive protection than that available under domestic rules, which can be modified at will. Indeed, the single most important advantage of a tax treaty is the relative legal certainty it offers to investors with respect to their tax position in both the source and residence countries. In addition, a

country can create, through tax treaties, new business opportunities (UNCTAD, 2004b). Hence, DTTs may also have a positive impact on foreign investment inflows through their contribution to an improvement of the investment climate.⁹

b. FDI liberalization

Most IIAs, in particular most BITs, including those concluded recently, are confined to protecting established investments and do not include liberalization commitments concerning FDI (UNCTAD, 2007c: 21). However, as said before, some countries, such as Canada or the United States, also cover the pre-establishment phase in their agreements. For instance, in the “United States or NAFTA model”, both the principles of most favoured nation (MFN) treatment and national treatment apply to the entry of a foreign investment. In addition, United States BITs liberalize operations of foreign investors by removing or easing certain restrictions on employment of expatriate personnel and by prohibiting a number of specific performance requirements (Reiter, 2006: 211). Canada has adopted a similar approach since the entry into force of NAFTA and more recently Japan has also joined in. Consequently, looking from the perspective of developing countries, there are two BIT models: (a) “protection only” BITs mostly with European countries and other developing countries; and (b) liberalizing BITs concluded mainly with the United States and Canada, and more recently, with Japan (UNCTAD, 2007c: 23).

As regards the possible impact of IIAs on investment liberalization, one needs to distinguish between agreements that “only” confirm and lock in the already existing degree of

openness to foreign investment, and those that actually result in new liberalization. IIA-driven FDI liberalization is mainly an issue for natural resources and services. The latter sector continues to be the one with the highest degree of FDI restrictions (UNCTAD, 2006a). By contrast, most countries today are already open to FDI in manufacturing.

Service liberalization is negotiated mainly in the World Trade Organization (WTO) in the context of the General Agreement on Trade in Services (GATS). Aiming at “progressively higher levels of liberalization of trade in services... while giving due respect to national policy objectives”, liberalization under GATS is gradual and far from being complete. Service liberalization is also a key issue in some bilateral or regional economic integration agreements and will be discussed in more detail below (see chapter III).

As far as IIAs are concerned, countries undertaking liberalization commitments in services have reserved the right to take exceptions. This method ensures that liberalization goes only so far as the individual contracting party is ready to accept. In the United States and Canadian BITs, such exceptions are typically included in an annex to the treaties (the so-called “negative lists”). For example, the United States exceptions specified in NAFTA (used as a model for the United States BITs) include selected areas of telecommunications, media, transportation and social services (World Bank 2005: 101). In practice, it appears that liberalization commitments in IIAs have in general been limited to those service sectors that have already been open to foreign investment. This means that IIA-driven FDI

liberalization of services is relatively rare. This cautious approach is understandable since bilateral commitments may have to be extended to all WTO members through the GATS MFN clause.

In general, it is difficult to establish the extent of additional services liberalization in the United States or Canadian investment agreements. It differs between treaties, as negotiating partners have different sensitivities concerning the opening of service industries to FDI. In addition, the United States, after launching the programme of concluding bilateral free trade agreements, has considered these treaties, as regards foreign investment, as an extension of BITs, including in them many of the provisions typical for BITs. Furthermore, to identify if liberalization is new or only locks in already-existing liberalization, one would have to analyze prior FDI policies of the host country in each of the affected service industries.

What matters for the impact of IIAs on FDI inflows is the degree of actual liberalization of service industries. In the case of IIAs among countries with an already high level of openness in the service sector, the potential additional liberalization effect of these treaties would be limited to a handful of remaining industries. However, what also counts for the foreign investor is the “locking in” of the already existing unilateral openness in the service sector. Confirming this degree of liberalization in an international treaty, together with a commitment to refrain from any roll-back measure, increases investor confidence (World Bank 2005: 97).

Significant restrictions for foreign investors also exist with regard to extractive industries, as this sector is generally considered as having strategic importance. Some countries prohibit FDI in the oil and gas sector altogether. Others only allow minority foreign shareholdings. According to one estimate, in 2005, TNCs from developed countries had unrestricted access to only 10 per cent of the world's known oil reserves, and to another 7 per cent through joint ventures with State-owned national oil companies (UNCTAD 2007a: 159). Another entry impediment for foreign investors can be the existence of national oil or gas companies.

Recent years have even witnessed a trend towards more restrictions vis-à-vis FDI in extractive industries. In some countries, the energy sector has been re-nationalized and in others such steps are under consideration. Another important development relates to demands to renegotiate existing investment contracts between a foreign investor and the host country in the energy sector in order to achieve a more favourable rent distribution for the host country (UNCTAD 2007a: 159; and UNCTAD, 2008b). A number of foreign investors have been forced to disinvest or to reduce significantly their shareholdings.

c. Transparency, predictability and stability

As host countries' laws and regulations become more enabling for foreign investors and converge in key aspects, foreign investors increasingly put a premium on such features as policy coherence, transparency, predictability and stability. This has been confirmed by a recent UNCTAD survey of

TNCs, the results of which have been reported above: apart from the economic determinants, macroeconomic and political stability have been found to be most important FDI determinants.

Foreign investors often have to deal with several agencies in the host country during the duration of their investment – from entry and establishment through operations to the eventual termination of an FDI project. It is therefore important that these agencies act in a coherent and predictable way. One of the important functions of investment promotion agencies, existing in some 180 countries, and in particular of so-called one-stop-shops, is to ensure policy coherence.

Transparency means that intentions of host countries towards FDI are known and clearly spelled out in laws and regulations. According to some provisions of IIAs, new policies, if adopted, should be communicated to those affected well in advance and, at times, be prepared in consultations with stakeholders.

Furthermore, to the extent that FDI offers investments that are of a long-term nature, foreign investors also expect a certain degree of predictability and stability in the host country's FDI policies, i.e. that there will be no sudden changes in the policy parameters, affecting adversely or even ruining existing business plans. When entering highly regulated or government-controlled markets or industries with huge investments – which is typically the case in infrastructure and extractive industries – foreign investors often seek government promises in investment contracts to ensure predictability and stability of key parameters. In competitive

and less regulated industries, foreign investors have to rely on the host country's overall laws and regulations, its track record and general reputation as regards predictability and stability of key policies that matter for FDI.

It should be noted that coherence, transparency, predictability and stability do not prescribe any degree of openness of the host country to FDI or uniform enabling policy across the board. Neither do they impose any restrictions on host countries' policy choices. If a host country wishes to keep foreign investors out of certain industries, it may do so, but in a transparent and clear manner. If a host country wishes that investors behave in a certain manner – e.g. by buying a certain amount of inputs locally or employing nationals in the senior management – it may also do so, but these policies should be communicated to the investors before they make a decision to enter the country.

IAs may contribute to the coherence, transparency, predictability and stability of the investment frameworks of host countries in the following manner:

- IAs establish obligations that are binding on all host country authorities. For instance, all agencies dealing with FDI have to observe the principle of fair and equitable treatment. As a result, one can expect that they act vis-à-vis foreign investors in a coherent manner;
- IAs enhance transparency, as the basic rules of protection and treatment of foreign investors are clearly spelled out in a legally binding document. This also applies in the case of investment liberalization, since the agreements include

lists of exceptions or reservations. In addition, some more recent IIAs include specific transparency obligations of the contracting parties, e.g. concerning transparency in the domestic rule-making process of host countries, enabling interested investors and other stakeholders to participate in that process (UNCTAD 2007c; 76–80);

- IIAs also promote predictability and stability of investment rules as they establish legally binding international obligations from which a host country must not deviate unilaterally. This is reinforced by binding international investor-state dispute settlement procedures.

Since IIAs are legally binding documents, their contribution to meeting all these requirements might be greater than in the case of purely domestic administrative measures and decisions of host country agencies, which could be subject to more discretion.

Notes

- ¹ And these are yet not all policy determinants of investment in general and FDI in particular. For example, they do not include monetary and fiscal policies determining the parameters of economic stability and influencing growth, such as the rate of inflation and the state of external and budgetary balances, influencing all types of investment.
- ² See the IPR of Botswana (UNCTAD, 2003b).
- ³ In regulated sectors such as mineral mining or infrastructure, sectoral regulations (mining codes, electricity and telecommunications laws and regulatory agencies) produce several more FDI determinants very important for FDI in these sectors.
- ⁴ But the importance of liberalization varies by sectors. For example, in services such as telecommunications and other public utilities, the TNC response to FDI liberalization has been swift, as exemplified by the rapid increase of FDI in these services in developing countries. In manufacturing industries, where TNCs have more choices as regards locations and where countries often offer incentives to encourage FDI, liberalization has often not led to more FDI in many countries.
- ⁵ The reason is that the industry of origin of surveyed investors often determines the motive for, and the type of, investment. For a mining company, it is access to natural resources, for a telecommunication company it is access to a market. Only in the case of manufacturing companies it is not clear if a motive for investment is access to market or cost reduction.
- ⁶ Many other policy measures aimed at promoting FDI to developing countries are considered in the same way. EPZs are considered territories with better physical and institutional infrastructure in the absence of good infrastructure in the country and the lack of time and money needed to build it. Fiscal incentives to foreign investors are also considered as policy measures making up for inferior institutional quality or market failures in host countries.
- ⁷ The International Centre for Settlement of Investment Disputes (ICSID), established in 1965, considered its first case only in 1972.
- ⁸ Interviews were conducted in connection with UNCTAD's work on the Investment Policy Review of Brazil with the following agencies:

Zurich Emerging Markets, EDC, Hermes PWC, ECDG, MIGA and OPIC. General questions going beyond Brazil permitted to make some judgments concerning also other countries.

- ⁹ Double taxation treaties are the subject of forthcoming in-depth study by UNCTAD. Therefore, the present study does not deal with the impact of these treaties on FDI flows. However, it is noteworthy that the existing literature on these agreements is of the view that they also appear to have an impact on FDI flows (Davies, 2004). However, similar to BITs studies, early empirical works provide little evidence that DTTs contribute to increasing FDI activity (e.g. Blonigen and Davis, 2004 and 2005; Egger *et al.*, 2006), whereas more recent studies come to a different conclusion (Neumayer, 2007; Barthel *et al.* 2008).

II. THE IMPACT OF BITs ON FDI: A SURVEY OF THE LITERATURE

Among all kinds of IIAs, BITs continue to be the most numerous and most important type of investment treaties. Originally, BITs were concluded between developed and developing countries. For developed, capital-exporting countries, BITs have been part of long-lasting efforts to establish international rules facilitating and protecting foreign investments by their nationals and companies. Developing countries have concluded BITs as part of their desire to improve their policy framework in order to attract more FDI and benefit from it. By engaging increasingly in BITs among themselves, developing countries have begun to consider BITs as a device protecting also investment of their own investors.

A. FDI promotion effects of BITs

The econometric literature on the impact of BITs on FDI flows to developing countries has checked four major hypotheses about the possible effects of BITs:

- **Commitment effect:** A binding international commitment to satisfactory protection and treatment of foreign investors will reduce risks and increase FDI from home partner countries. Studies checking this hypothesis take bilateral FDI flows between pairs of developing host countries and developed home countries as a dependent variable, and examine whether and when the conclusion of BITs – typically its signing, rarely its ratification – contributed to increased FDI flows from home BIT partner countries to the host partner countries;
- **Signalling effect:** BITs signal seriousness about improved property rights in the host country applying to all investors, and thus may stimulate FDI from all countries, not only

from the BIT contracting parties. This hypothesis is typically checked using total FDI inflows into host developing countries and the number of concluded BITs – in most cases with OECD countries, and sometimes also with developing countries, as a key explanatory variable;

- Shortcut to improved institutional quality: As it takes time to improve institutional quality, i.e. the quality of institutions and policies that matter for FDI, BITs may be considered by foreign investors as a substitute to improved institutional quality and thus stimulate FDI inflows from these investors. This hypothesis may be checked using both aggregate and bilateral flows of FDI;
- BITs with “strong” provisions in favour of foreign investors have a greater chance to stimulate FDI. Such studies focus on the comparison of inflows from home countries having concluded “stronger” BITs with inflows from countries with “weaker” BITs.

B. Characteristics of empirical studies

One can easily observe that during the past two decades the rapid increase of FDI inflows into developing countries has been accompanied by a huge proliferation of BITs concluded by developing countries, initially with developed countries and more recently also with other developing countries. Is this development sufficient to conclude that BITs have actually promoted FDI into developing countries? The answer is not straightforward because, as indicated before, there are, in addition to BITs, many determinants of FDI inflows into countries – economic, policy determinants or business facilitation. The objective of

an econometric exercise is, based on as large a number of observations concerning bilateral flows of FDI between pairs of countries as possible, to assess the role of *all* key determinants in stimulating FDI and to isolate the role of BITS among these determinants. This is done through constructing a model (representing a mathematical equation), which reflects the relationship between the amount of or fluctuations in FDI – called a dependent variable – and key FDI determinants, including the conclusion or existence of BITS – called explanatory variables. In order to isolate the role of BITS, there is a need to identify other key explanatory variables and to calculate their impact on FDI (i.e. by estimating the numerical parameters of the relationship). Otherwise, all changes in the amount of FDI could be attributed to BITS, which would not be a reasonable proposition. Econometrics also enables one to assess the impact, or the lack of it, of a BIT variable in interaction with key variables of particular interest, such as institutional quality variables. If an econometric exercise finds a strong relationship – that is a strong correlation – between the conclusion of BITS and FDI inflows, its next task is to determine the direction or causation of the impact – do BITS stimulate FDI or does, vice versa, existing FDI results in the conclusion of BITS? Causality, however, can also be multidimensional and work both ways.

The estimation of relational parameters between FDI and its key determinants, including BITS, is not enough to verify an impact. Next comes the checking of the statistical significance of these parameters. There are additional tests available in econometrics permitting, for example, to answer the question whether the relationship represents a correlation

or causation. Before drawing final conclusions about the relationship between BITs and FDI, there should be a common sense reflection, based on the knowledge of FDI in general.

Dependent FDI variables, bilateral or aggregated, come in econometric studies in different varieties: they may consist of total annual FDI inflows, logged inflows (eliminating annual fluctuations), average inflows over a couple of years, inflows in constant dollars or shares or ratios, e.g. the share of global inflows, of those into developing countries or a ratio of FDI to GDP. Explanatory or independent variables include not only BITs but also other host country determinants of the size of FDI, known from the general FDI literature as key determinants of the location of FDI in host countries. However, these variables may be included only if they can be presented in a numerical form. This is not possible for all key variables and some measures come in the form of less-than-perfect substitutes or proxies.

Key explanatory variables other than BITs typically include the size of the host country's market measured by GDP, population, GDP per capita, economic stability – inflation, exchange rate fluctuations – and other than market-size related host country advantages. These include the availability of natural resources – measured by, for example, fuels and ores exports or natural resources intensity – or the attractiveness for efficiency-seeking FDI: that is, openness to trade measured as the ratio of trade to GDP or skill and/or cost gaps between host and home countries. Furthermore, institutional factors are typically included, such as the quality of the legal system, respect for the rule of law, political risk or aggregate measures of institutional quality. The annex

summarizes variables used in each of the reviewed studies, as well as the period covered in each study, the host and home countries for which the data on variables had been collected – i.e. the details and the size of the data sample – the econometric method used and key conclusions concerning the impact of BITS.

What follows is an overview of 15 major econometric studies examining the issue of the impact of BITS on FDI flows into developing countries. In reviewing these studies, the focus will be on their characteristics related to the central hypotheses checked, the size and period of the data sample and – above all – their conclusions concerning the BITS/FDI relationship. The studies will be discussed in chronological order, as they have been published. The reason is that if a study comes to different conclusions than a previous one examining the same issue, the author of such a study, in good scholarly tradition, typically explains why different results have been reached, thus helping the reader to understand the differences. A final caveat should be made. In spite of differences in their content, econometric studies treat BITS as homogenous and examine combined possible impacts of channels through which BITS may influence FDI. It is therefore not possible to distinguish the impact of *individual* BIT provisions on FDI flows, for example, the impact of investment protection provisions as compared to investment liberalization provisions.

C. Findings

A first econometric analysis by UNCTAD (1998b) had assumed that BITS should impact on FDI in bilateral flows

between BIT contracting parties close to the year of concluding the BIT. However, the analysis of time-series data on bilateral FDI flows – three years prior to and three years after the conclusion of a BIT – in relation to 200 BITs during 1971–1994 did not indicate an impact. The examination of the correlation between the amount of FDI and the number of BITs in 133 countries in 1995, however, showed an impact, although not a strong one. In explaining the difference, UNCTAD speculated that the impact of a BIT on FDI flows may materialize many years after its conclusion, when additional necessary FDI determinants are put in place, such as more openness to FDI or improvement of macroeconomic conditions and other components of the FDI framework (UNCTAD, 1998b: 117–118). In addition, after finding evidence that foreign investors often encourage their governments to enter into BITs with host countries – irrespective of whether they have already made an investment in these countries – and that BITs may matter as a special protection for small and medium-sized enterprises (SMEs), UNCTAD concluded that BITs do have an impact on FDI flows, although the investment amounts involved may be too small to affect significantly the total or bilateral flows of the host countries involved in these analyses.

Banga (2003) focused on FDI policy as a determinant of FDI, but also estimated the impact of the total number of signed BITs on FDI inflows (based on actual FDI data and on FDI approvals) for 15 developing economies of South Asia, East Asia and South-East Asia for the period 1980 to 2000.¹ Further, the study disaggregated FDI inflows into 10 host countries into FDI from home developed and developing countries, and examined, in the period from 1986 to 1997, the FDI response to government policies and the conclusion of

BITs. The latter test was based, because of a lack of sufficient data, on FDI approvals. The study found that the BITs with developed countries had a significant impact on FDI inflows. On the other hand, BITs with developing countries did not have a significant impact on aggregate FDI inflows. The author gives two possible explanations for this difference. First, developed countries account for more than 60 per cent of aggregate FDI into examined countries during the period under investigation. Therefore, it is possible that the number of BITs with developing countries, accounting for the minority share of FDI inflows into the countries in question, is still too small to show significance. Second, it is possible that determinants of FDI may differ between developed and developing home countries and issues with respect to treatment of foreign companies in the host countries may not be important for FDI from developing countries (Banga 2003, p. 29).²

Hallward-Driemeier (2003) analyzed the impact of BITs by looking at a relatively small sample of bilateral FDI flows from 20 OECD countries to 31 developing countries, that is, for up to 537 country pairs, over the period 1980 to 2000. The study examined FDI for the years preceding and following the ratification of a BIT during the 10-year period. A casual observation might suggest that BITs had an important role in increasing FDI flows to the signatory developing countries: while FDI into developing countries grew very rapidly, the share of FDI inflows into developing countries covered by BITs increased from less than 5 per cent in 1980 to about 50 per cent in 2000. Most of the FDI increase should be attributed to the growing BITs coverage of FDI into developing countries (i.e. extension of countries' BITs

networks) rather than to the impact of BITs on FDI. The study itself, after conducting several tests with different dependent variables – absolute amount of FDI, the ratio of FDI to host country's GDP and the share of host country's FDI in total FDI outflows of a home country – concludes that BITs do not serve to attract additional FDI (Hallward-Driemeier, 2003: 20).

The study also found that BITs act more as a complement to, rather than a substitute for, good institutional quality and local property rights. In host countries with weak domestic institutions, including weak protection of property, BITs have not acted as a substitute for broader domestic reforms. On the other hand, countries that “are reforming and already have reasonably strong domestic institutions, are most likely to gain from ratifying a treaty” (Hallward-Driemeier, 2003: 22–23).

In another study, Tobin and Rose-Ackerman (2003) analyzed, first, the impact of BITs on total FDI inflows – measured as a share of inflows into a host country in world FDI inflows – averaged over five-year periods, from 1975 to 2000 with some data going back to 1959, and covering 45 plus host developing countries. The authors were particularly interested in the interaction between BITs and political risk in host countries.³ Second, they also examined bilateral FDI flows (in United States dollars) between the United States and 54 host developing countries, either conditionally on the level of political risk or unconditionally. In the overall analysis, the study concluded that the number of BITs seems to have little impact on a country's ability to attract FDI. However, there appears to be an interaction between the conclusion of BITs,

on the one hand, and the level of political risk and property rights protection, on the other hand. Countries that are relatively risky seem to be able to attract somewhat more FDI by signing BITS. For those that are relatively safe for investors, the marginal effect of BITS is small (Tobin and Rose-Ackerman, 2003: 19). However, the data did not include either very risky or very safe countries, and the authors were confident in their findings for the middle range countries in the data set. As regards the impact of United States BITS, “signing a BIT with the United States does not correspond to increased FDI inflows. Additionally, it does not appear that the United States BIT alleviates political risk factors for investors based in the United States” (Tobin and Rose-Ackerman, 2003: 22).

Beginning in 2004, there has been a shift in the empirical literature towards a more positive assessment of the BITS’ impact on FDI. Studies showing a positive impact of BITS on FDI started to prevail, although those questioning such an impact have not altogether disappeared.

Egger and Pfaffermayr (2004) analysed the effect of implementing a new BIT on bilateral outward FDI stocks. In addition, the paper examines the potential anticipation effects after signing and before ratifying a BIT. Using bilateral outward FDI stock data from 19 OECD home countries (old and new) and 57 host countries (including 27 OECD member countries) the paper demonstrated that BITS exert a positive and significant effect on outward FDI of home countries in BIT partner host countries, if the treaties are actually implemented. Moreover, even signing a treaty has a positive – although lower and in most specifications insignificant – effect

on FDI. These results are robust to alternative measures of relative factor endowment differences, to the impact of trading blocs such as the European Union (EU) or the North American Free Trade Agreement (NAFTA), and to infrastructure endowments.

Büthe and Milner (2004) hypothesize that the greater the number of BITs to which a developing country is a party, the more attractive will foreign investors consider it to be as an investment location, and the more inward FDI will it receive, *ceteris paribus*. They examine this hypothesis for a sample of up to 122 developing countries with a population higher than 1 million people during 1970–2000. Using annual FDI inflows as a dependent variable and a total cumulative number of signed BITs as a key explanatory variable, they argue that BITs should increase total FDI inflows into a host country, and not only bilateral inflows from BIT partners. Their research uses a whole range of control variables relating to market size, economic development, economic growth, trade openness, domestic political constraints and political instability. They also make several alternative estimation tests as well as add qualitative analyses, based on interviews, internal documents and secondary literature.

They find that there is “the predicted positive, statistically and substantially significant correlation between BITs and subsequent inward FDI into developing countries” (p. 213). In spite of this finding, Büthe and Milner do not make a normative endorsement of BITs: that is, they do not make a policy recommendation that developing countries should conclude BITs as a measure to increase their inward FDI. The reason is that BITs carry costs to developing

countries in terms of constraining their policy choices and additional monetary costs in case of *ex post* violations of treaty commitments. Therefore each developing country has to weigh costs of BITS against their benefits of increased FDI and possibly other benefits. Büthe and Milner finally conclude that “BITS certainly are not required for attracting FDI, though the competitive dynamic may mean that retaining the status quo of no or few BITS might become increasingly costly over time” (p. 214).

Salacuse and Sullivan (2005) have checked the hypothesis that United States BITS, which in their view offer the strongest investor protection compared to BITS concluded by other OECD countries, would have a more significant association with FDI flows than less stringent BITS. The study is based, first, on the analysis of aggregate FDI inflows to more than 100 developing countries in a given year (1998, 1999 and 2000). Second, it analysed FDI flows from the United States to 39 developing and transition countries over a 10-year period (1991-2000). The results showed that United States BITS are more likely to induce FDI inflows than those concluded by other OECD countries. Another finding was that, with all other factors being equal, a host country that has concluded a BIT with the United States is more likely to increase its overall FDI from all OECD countries than a country without such a BIT (Salacuse and Sullivan 2005: 104).

The authors thus conclude that if a developing country wishes to promote inward FDI, it would be better to sign a BIT with protection standards like those included in the United States BITS, rather than an agreement with weaker standards

negotiated by some other OECD countries. A BIT with stronger standards would create a less risky investment climate than a BIT with weaker standards of protection. All other things being equal, foreign investors would tend to invest in a less risky investment environment (Salacuse and Sullivan 2005: 106–107). Furthermore, the correlations indicated that the ratification of a BIT has a more positive effect on FDI flows than the mere signing of such an agreement (Salacuse and Sullivan 2005: 109).

The study's final conclusions are that "1. A United States BIT is more likely than not to exert a strong and positive role in promoting United States investment. 2. A United States BIT is more likely than not to exert a strong and positive role in promoting overall investment. 3. A United States BIT is likely to exert more of an impact than other OECD BITs in promoting overall investment" (Salacuse and Sullivan 2005: 110).

Grosse and Trevino (2005) examined the impact of BITs on FDI in 13 countries of Central and Eastern Europe during 1990–1999 in the broader context of institutional changes reducing investors' uncertainty and costs concerning corruption, regulations on FDI and enterprise reform, privatization and political risk. As regards BITs, they specifically hypothesize that "the greater the number of host country BITs, the lower the foreign investors' uncertainty and costs associated with long-term capital investment, resulting in increased inward FDI" (p. 130). They introduce, as control variables, inflation, currency valuation and market size. The authors have found that "a greater number of BITs that Central and Eastern European (CEE) countries had signed was highly

significant in attracting FDI to the region” (p. 139). They interpret this finding as an indication that foreign investors view BITS (together with other institutional improvements) that assure equal treatment of foreign and domestic investors as a critical component of institution building, reducing the cost of doing business in CEE.

Gallagher and Birch (2006) examined the impact of the total number of BITS and BITS with the United States on the total and bilateral (from the United States) inflows of FDI into 24 host countries of Latin America during the period 1980–2003. They concluded that the total number of signed BITS has an independent and positive effect on total FDI inflows into a host country. But while an increase in the total number of BITS may be conducive to greater FDI in South America, this may not be the case for other countries of Latin America included in their examination. But BITS with the United States are not associated with higher FDI inflows (p. 972). Commenting on the difference between their findings and those by Salacuse and Sullivan concerning the impact of BITS with the United States, they noted that the latter included only three countries from Latin America in their sample of countries and that this might explain the difference.

According to Neumayer and Spess (2005), previous studies – in particular those by Hallward-Driemeier, Tobin and Rose-Ackerman and Salacuse and Sullivan for non-United States BITS – did not find a significant impact of BITS on FDI inflows because they were based on a rather restricted sample of countries, used FDI data for only one year – that is, they were based on so-called cross-sectional regressions – or

focused on bilateral FDI flows, or ignored signalling effects of BITs – i.e. the impact of BITs on FDI from all sources (Neumayer and Spess, 2005: 1572, 1582). To overcome these problems, the authors employed a much larger data panel over the period 1970–2001, covering up to 119 countries. Thus, they not only increased considerably the sample size, but also used the data set allowing for comparisons across countries over a long period of time. By examining the relationship between the number of BITs and overall FDI – measured as the absolute amount of FDI inflows in constant 1996 United States dollars and as a share of these inflows in total inflows into developing countries – they focussed on the hypothesis about the signalling effects of BITs. They found a positive effect of BITs on FDI inflows that is consistent and robust across various model specifications. Therefore, developing countries that sign more BITs with developed countries receive more FDI (Neumayer and Spess, 2005: 1567, 1582). The impact was, however, sometimes conditional on institutional quality, but nevertheless always positive at all levels of institutional quality. Thus, BITs with developed countries fulfil their stated objective of promoting FDI into developing countries (Neumayer and Spess, 2005: 1582).

There is also some limited evidence that BITs function as substitutes for institutional quality. Countries with particularly poor domestic institutional quality possibly stand most to gain from BITs, but there is no robust and consistent evidence for this conclusion (Neumayer and Spess, 2005: 1582).

The study also addressed the issue of how much more FDI a developing country can expect if it aggressively engages

in a programme of concluding BITs with developed countries. To answer this question, the study looked at a standard deviation increase in the BIT variable (equivalent to an increase of around 27 in the weighted cumulative BIT variable running from 0 to 99). Since in some regressions the interaction effect between the BIT variable and institutional quality is statistically significant, the overall effect of concluding BITs sometimes depended on the level of institutional quality, in which case the study fixed the institutional quality at its median for simplicity reasons. Based on the estimations, a country experiencing a one standard deviation increase in the BIT variable is predicted to increase its FDI inflows by between 43.7 per cent and 93.2 per cent. Or such a country is predicted to increase its share of FDI inflows relative to the total inflows to developing countries by between 42 per cent and 104 per cent. However, it is difficult to say whether the demonstrated benefits of concluding BITs in the form of increased FDI inflows are higher than the substantial costs developing countries may incur in negotiating, signing, concluding, ratifying and complying with the obligations typically contained in such treaties (Neumayer and Spess, 2005: 1583).

Also Tobin and Rose-Ackerman, whose first study did not find an impact of BITs on FDI (see above), have joined in a positive assessment of a BITs impact on FDI. They undertook another study, examining the signalling effects of BITs (Tobin and Rose-Ackerman, 2006). The authors increased vastly the host country coverage from 40 developing countries with data on all variables to 137 countries, using best data predictions and other techniques on missing variables.

They modified and expanded dependent and explanatory variables, especially those related to BITs. As before, they took five-year averages of total FDI inflows into developing countries (for 1980–2003), but added five-year averages of total outflows of OECD countries to developing countries – however, this time not in current values but in constant 2000 dollars. They added to the total number of BITs and BITs with developing countries weighted and unweighted BITs indexes by the GDP of the home OECD country. They also examined the implications of an increasing number of BITs worldwide on the power of BITs to attract FDI. In a clear distinction from their previous study, they concluded that the number of BITs a host country signed with high-income countries has a positive and significant effect on FDI inflows (Tobin and Rose-Ackerman, 2006: 21). As, however, the number of BITs between developing countries and OECD countries increases worldwide, this impact, although still positive, becomes weaker. In other words, the increased popularity of BITs “means that each extra BIT has a decreasing effect on inflows of FDI to the country that is part to the BITs” (Tobin and Rose-Ackerman, 2006: 21–22).

The 2007 study by Egger and Merlo aims at estimating the impact of BITs on bilateral stocks of outward FDI, and paying particular attention to the long-term impact of BITs on FDI. The authors note that previous studies were based on the presumption that BITs exhibit an exclusively contemporaneous, i.e. short-run, effect on FDI. However, the authors argue that FDI stocks are characterized by sluggish adjustment over time, responding to external influences (“shocks”) such as BIT conclusions only after a longer period of time. Hence, the presumption of a contemporaneous effect

seems likely to be unrealistic – particularly for FDI between developed and less developed economies. To avoid biased estimates in static models, Egger and Merlo apply a dynamic setting. Based on generalized method of moments (GMM) estimates, they find that the contemporaneous (short-run) impact of BITS is substantially lower than the long-run effect. They explain that half of the long-run effect is accumulated after only one and a half years. Accordingly, ignoring the dynamic nature of FDI would seem quite harmful. Egger and Merlo's study covers bilateral outward stocks of FDI of 24 OECD home countries in 28 OECD host economies and economies of transition in Central and Easter Europe (Egger and Merlo, 2007).

The next study by Aisbett used bilateral inflows of FDI as a dependent variable and examined FDI flows from 29 OECD countries to 28 host developing countries during 1980–1999, thus examining the direct impact of BITS on FDI from developed to developing partner countries. It also tested the signalling effects of BITS. The study found a positive and strong statistical correlation between BIT ratification and FDI inflows, similar to that found by Neumayer and Spess, and Salacuse and Sullivan. However, after further tests, especially the test for endogeneity of BITS and FDI – that is, a reverse relationship – the author did not attribute the correlation to a causation between the conclusion of BITS and increased FDI inflows, but rather to the endogeneity of BITS/FDI.⁴ The strong correlation appears to be driven by the endogeneity rather than the direct or signalling effects of FDI (Aisbett, 2007: 35). The study explains the difference in the conclusions by specification improvements in the model used and suggests

that the positive impact of BITs on FDI inflows indicated in both previous papers, namely those by Neumayer and Spess, and Salacuse and Sullivan has almost certainly been due “to misspecifications and insufficient attention paid to the endogeneity of BIT participation” (Aisbett, 2007: 34). More specifically, using specification similar to that used by Neumayer and Spess, Aisbett explains the different results by the fact that the other researchers used aggregate host-country FDI inflows, while she used bilateral FDI inflows (Aisbett, 2007: 34–35). The latter variable permits taking into account endogeneity of BITs as a potential for reverse causality between the conclusion of BITs and FDI – meaning that higher amounts of FDI may lead to the conclusion of BITs – and for omitted explanatory variables, such as changes in the host country’s policies and investment climate.⁵ Aisbett concludes that “controlling for either of these possibilities eliminates the statistically significant correlation between BITs participation and FDI flows”. However, because of data limitations and methodological problems, the author is cautious in her assessment. She does not conclude that BITs are not effective as a means to promote FDI, but rather that there is no evidence that they do have an impact. Some studies with positive findings probably did not account properly for the endogeneity of BITs and specification issues. Furthermore, the BIT coefficient in the equation, indicating that a BIT produces on average over a 50 per cent increase in bilateral FDI flows is implausibly large (Aisbett, 2007: 35) and “not even the most enthusiastic proponent of BITs would feel comfortable attributing such an increase to the causal impact of BITs” (Aisbett, 2007: 3).

Yackee (2007a) prepared a paper on the impact of BITs on FDI in response to the paper by Neumayer and Spess (2005). He was concerned about their findings that BITs have a very large impact on FDI inflows into developing countries. Using the same methodology, but making several justifiable small changes in both methodology and model specification (see annex table), he concluded that “the apparently positive effect of BITs on FDI largely (and in some cases entirely) falls from significance... And the case for BITs is far weaker than Neumayer and Spess suggest” (p. 1). In addition, the institutional quality test shows an opposite conditional relationship than that found by Neumayer and Spess (p. 12).

Yackee uses his analysis not to question Neumayer and Spess’s work (which he considers “professional, nuanced, thought-provoking and eminently worthy of emulation”, p.21), but to draw attention to the weaknesses of econometric tests by demonstrating how small changes in methodology can lead to different or even opposite results. Doubting the usefulness of such tests for this purpose, he states explicitly that “if we really want to prove that BITs do or do not matter, that they do or do not work as advertised, then we may want to consider whether larger statistical studies of aggregate FDI flows are the best means of empirically addressing the question” (p. 22). There may be many reasons for this. One, for example, is that many BITs were concluded simultaneously with dramatic opening up to FDI by developing countries. FDI liberalization may be, and may have been, a powerful stimulus to attracting FDI into developing countries, in particular in infrastructure services and mining. Yet, one may add, that in the absence of good liberalization variables, none of the econometric studies

tries to isolate the effects of BITs from those of FDI liberalization.⁶ The author postulates that case studies, based, among others, on surveys of those who are “best positioned to know” about the importance of BITs – the executives of TNCs making the investment decisions – would be perhaps a more promising methodology than modern methodologies. But he himself does not seem to believe that case studies would generate evidence in favour of a strong impact of BITs on FDI, by offering throughout his paper a list of factors weakening the impact of BITs on FDI, including (a) potential investors seem to have little awareness or appreciation of specific BITs; (b) BITs are not necessary to resolve problems of credible commitment; (c) the “credible commitment” risk premium is objectively low; and (d) even if BITs work, they are likely to decline in effectiveness as the treaties proliferate.

In the latest available study on the impact of BITs on FDI, the authors, Busse *et al.* (2008), employed the gravity-type econometric model and several other model specifications.⁷ They found that BITs do promote FDI flows to developing countries. Moreover, BITs may even substitute for weak domestic institutions, but not for unilateral capital account liberalization (Busse, *et al.* 2008: 3–4). The authors use extensive data on bilateral FDI flows collected by UNCTAD and attribute differences in findings in previous studies at least partly to the size of their data sample, which permits, in their view, avoiding a bias in the sample selection occurring when the sample is restricted to relatively advanced host countries. In addition, and in distinction to preceding papers, they isolate the effects of BITs on FDI inflows from the effects of unilateral regulatory changes on FDI inflows,

taking a degree of liberalization of the capital account of host countries as a measure of such changes.⁸

The authors justify the selection of the gravity model – typically used to explain bilateral trade – by pointing out that “the gravity equations for financial flows are comparable in terms of explanatory power to those of trade flows” (Busse, *et al.* 2008: 9–10). Concerning the BIT variable, only ratified treaties are taken into account. As regards the dependent variable, bilateral FDI flows are measured as the share of the home country FDI outflows to the specific host country in the total FDI outflows of the home country to all developing countries included in the sample. To smooth annual fluctuations of FDI flows, FDI data are presented as three-year averages. As a result of the three-year data, the BIT variable takes the value of “one”, if FDI flows during the three year period were governed by a BIT during the entire period, 0.66 during two years and 0.33 during one year. Two additional measures are added in a “robustness test”: bilateral flows in United States dollars and inflows as a share of the host country’s GDP.

The set of control variables is similar to that used in other studies and includes measures of market size, macroeconomic stability, trade openness, per capita GDP differences – in order to check for efficiency-seeking FDI – and membership of free trade agreements. As part of the gravity model, variables for a common border, common language, colonial ties and the distance between the host and the home country are added. The study also uses an index of the institutional development of host countries, based on

political constraints on the executive branch.⁹ And, as mentioned earlier, the inclusion of the capital account openness mitigates, according to the authors, for the omitted variable bias.¹⁰ In addition, the study performs endogeneity tests for the relation between the conclusion of BITs and FDI inflows.

The study covers the period 1978–2004. As a result of applying three-year averages for all indicators, nine observations are produced for this period for all indicators. The sample of countries includes 83 host developing countries and transition economies and 28 home countries, among them 10 home developing countries.

The study concludes that:

“BITs promote FDI inflows to developing countries. This result is fairly robust across various models. Moreover, the significantly positive effect of BITs on bilateral FDI flows holds for FDI flows from developed source countries to various sub-samples of developing host countries. BITs may even substitute for weak local institutions, though not for unilateral FDI-related liberalization measures. All this suggests that policymakers in developing countries have resorted to an effective means to promote FDI by concluding BITs” (Busse, *et al.*, 2008: 24).

D. Investors and BITs

The empirical econometric studies referred to above do not explore the extent to which foreign investors actually know about BITs and take them into consideration in their investment decisions. While surveys of investors’ perceptions

of the investment climate of host countries typically include questions about political risks, institutional quality or regulatory stability, they rarely ask about the direct relevance of BITS or other IIAs for investment decisions. The few exceptions indicate that many investors do indeed take BITS and other IIAs into account when making an investment decisions, and thus support the arguments about the impact of BITS on FDI inflows.

A recent survey (2007) of 602 TNCs asked as “to what extent does the existence of an international agreement (for example, a bilateral investment treaty) influence your company’s decision on which market to invest in?” Almost one fourth of the surveyed TNCs responded that they used IIAs, including BITS, “to a very great extent”, and another 48 per cent of TNCs used them “to a limited extent”. Only 23 per cent did not use them “at all”, with the balance of 9 per cent responding “don’t know” (Kekic and Sauvart, 2007: 96). This means that for an overwhelming majority of more than 70 per cent of the surveyed TNCs, IIAs played a role in making an investment decision.

Also, the 2007 UNCTAD survey cited above asked specifically about the role of BITS among 33 factors influencing the investment decisions of TNCs. The survey concludes that BITS are taken into account when deciding whether or not to invest in developing countries and transition economies of CEE and the Commonwealth of Independent States. Concerning developing countries, they have received a score above average (3.52 on a scale from 1 to 5), ranking in the middle of all examined host country FDI determinants. For

investments in transition economies, they were considered even more important, ranking among the most significant investment decision factors with an average score of 4.23 (UNCTAD, 2007b: annex table 2). Given that factors such as macroeconomic and political stability were identified as the most important factors affecting investment decisions and “strengthening the regulatory and institutional environment” as the most frequently cited area where developing countries could increase their attractiveness for FDI, one may assume that there is a link between BITs which generally seek improvements in this field and key policy and institutional determinants of FDI – although this issue was not specifically raised in the survey.

It has been argued that while BITs may be of little relevance to large powerful TNCs able to secure a satisfactory protection of their interests in direct contracts with host country governments, they matter much more for smaller investors that cannot rely on such contracts. There is anecdotal evidence from a number of home countries that SMEs are particularly interested in BITs. However, there is also an increasing awareness of foreign investors in general of the existence and the role of BITs. When the BITs movement started, companies did not know much about these agreements or did not consider BITs as having enough “teeth”. Nowadays, the protective potential of BITs is better known and it “would be a sign of negligent management and counsel if political risk management and investment protection were not planned with the potential of investment-treaty based arbitration in mind” (Waelde, in Orr, 2007).¹¹

If this is the case, BITS would matter for the overwhelming majority of global TNCs, whose number is estimated at close to 80,000 at the beginning of the twenty-first century (UNCTAD, 2007a: 218). Most of them are small- and medium-sized firms. Some evidence that BITS matter particularly for SMEs is that a significant number of BIT-based investment disputes were submitted to international arbitration by such companies that did not have individual investment contracts with host governments (comment by Schill S in Orr, 2007).¹²

There are signs that investor awareness about BITS is increasing. The growing number of international investment disputes is proof that foreign investors know about the existence of these treaties and the protection they offer to them.¹³ The large amounts of compensation that arbitration tribunals have sometimes awarded to foreign investors may further enhance their interest in BITS (Vandewelde, 2005: 186). This also means that BITS may impact on investor confidence – and thus on FDI flows – long after BITS have been concluded. Furthermore, there is evidence that law firms increasingly brief their TNC clients on taking into consideration BITS and other IIAs when choosing their investment location (Kantor, in Orr 2007).¹⁴

As mentioned above, it is sometimes argued that investment contracts – i.e. contracts concluded directly between foreign investors and host countries – would be viable alternatives to BITS.¹⁵ They may grant investors similar protection standards as those included in BITS and, in addition, are “tailor-made”, that is, they are adapted to the specific

characteristics and requirements of the individual investment. They may also include provisions for international dispute settlement. However, as long as such investment contracts are governed by the law of the host country or any other national law, they do not give the foreign investor protection under international law as is the case under BITs.¹⁶ In particular, foreign investors would not be protected against changes in these national laws that affect their contract rights negatively.

BITs including a so-called “umbrella clauses” provide additional protection precisely in such circumstances. Umbrella clauses require the host country to observe any obligation it has entered into with respect to an investment (UNCTAD, 2005: 7). Under this clause, a breach of the state contract may amount to a violation of the BIT. Foreign investors have already relied on the umbrella clause in many investment disputes.

E. Overall findings

The impact of BITs – as well as other IIAs discussed in the next chapter – has to be seen in the context of the overall host country FDI determinants. Key among them is the economic attractiveness of host countries concerning the size and growth of the market, and the availability and costs of natural resources, as well as inputs such as skills, infrastructure services, or intermediate goods. Economic determinants interact with policy and institutional determinants of FDI, enhancing or reducing the attractiveness of countries to FDI.¹⁷

BITs add a number of necessary components to the policy and institutional determinants for FDI, and hence impact FDI inflows into developing countries only indirectly. This indirect impact of BITs on FDI has been measured in a series of econometric studies, published between 1998 and 2008. Its assessment is not an easy task, given the complexity of host country FDI determinants, the sometimes poor state of FDI data and difficulties with properly capturing and reflecting in econometric models all important FDI determinants. Whereas the findings of early empirical studies on the impact of BITs on FDI flows were ambiguous, with some showing weak or considerable impact (and one or two no impact at all), more recent studies published between 2004 and 2008 – based on much larger data samples, improved econometric models and more tests – have shifted the balance towards concurring that BITs appear to have an impact on FDI inflows from developed countries into developing countries. Although most BITs do not change the key economic determinants of FDI, they improve several policy and institutional determinants, and thereby increase the likelihood that developing countries engaged in BIT programme will receive more FDI.

The potential for BITs to have an impact on FDI inflows is also confirmed by investor surveys. Accordingly, BITs – and other IIAs – are important to TNCs in terms of investment protection and enhancing stability and predictability for FDI projects. For the majority of surveyed TNCs from all sectors, BIT coverage in host developing countries and transition economies plays a role in making a final decision on where to invest. Further evidence that TNCs increasingly make use of BITs is provided by the rapidly

increasing number of investment arbitration cases based on these agreements.

However, it needs to be pointed out that it remains problematic to draw policy conclusions from econometric studies. Some of the difficulties go to the core of econometric/economic modeling. It is the very nature of “modeling” to work on the basis of a simplified description of a complex reality. Any possible policy recommendations – drawn from such a simplified reality – would, however, come to work in a much more complex real-world scenario. Along similar lines, the so-called “Lucas critique”¹⁸ suggests that it is impossible to predict the effects of a new policy entirely on the basis of relationships observed in the past, when the policy regime in question had not yet been in place.

A second set of difficulties emanates from the specific techniques of econometric modeling. Regressions, for example, suffer from the conceptual limitation that they can only ascertain relationships but not be conclusive about underlying causal mechanisms, an issue specifically mentioned in the 2007 Aisbett study. Hence they would have to be subject to further testing (robustness, etc. – Granger causality). A strong relationship (correlation) between two variables does not necessarily establish a cause–effect relationship. Instead, a correlation can frequently be explained by an external variable that had not been included in the study. Similarly, there are concerns with respect to the choice of and number of variables. When plugging in numerous predictor variables, usually at least a few of them will come out as significant. Isolating the effects of one variable can also be difficult. A particular economic policy (e.g. signature of an

IIA) is usually taking place in the context of a broader set of reforms, with numerous policy changes occurring simultaneously. Another problem arises from so-called outliers (extreme cases), which can seriously bias the results by pulling or pushing the regression line in a particular direction, thereby leading to biased regression coefficients. Often excluding a single extreme case can yield a completely different set of results. In sum, the results highly depend on the model's particular specifications, a point made by *Yackee*, who – in his 2007 study – points out that small changes in methodology and model specifications make the BITS' effect on FDI largely or entirely disappear.

A third set of difficulties arises from the lack of available data on which to base econometric studies that analyse FDI phenomena. While data on FDI flows and stocks has considerably improved over the years, county-specific, comparable time series data for e.g. least developed countries is hard to obtain. Similarly, when it comes to data involving the services economy, sector- and country-specific data remains scanty. Furthermore, regarding the quantification of barriers to trade and FDI services, it has been pointed out that even the best available methods are inadequate. Accordingly, some have even called refining estimation techniques and modeling to capture the specificities of trade in services.

While all of the above suggests caution with respect to drawing direct policy recommendations from econometric studies, some of the above concerns (e.g. simplification and lack of adequate data) also exist with respect to qualitative approaches, such as case studies. Moreover, some of the above

concerns can also be alleviated by, for example, controlling for a maximum of relevant variables, conducting robustness tests, or carefully eliminating outliers. Ultimately, the value of numerical models – and the results they produce – might lie less in their mechanical transformation into policy recommendation, but more in their complementary character, supporting and advancing economic reasoning through a specific, analytical approach.

Notes

- ¹ These economies are: Bangladesh, China, Hong Kong (China), India, Indonesia, the Republic of Korea, Malaysia, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Taiwan (China), Thailand and Viet Nam,
- ² In an additional test, the study has indeed found the differences in FDI determinants for FDI from developed and developing home countries. FDI from developed countries is attracted to large market size, higher education levels, higher productivity of labour, better transport and communications, and lower domestic lending rates, while cost factors play a more significant role in attracting FDI from developing countries (Banga, 2003: 34). The treatment hypothesis, however, has not been examined in the test.
- ³ They used the aggregate political risk measure including also some components that are not directly related to political risk, such as, among others, religious and ethnic tensions, armed conflict and socio-economic conditions such as unemployment and poverty. Hallward-Driemeier (2003) used individual components of institutional quality. Political risk indicators are available from the International Country Risk Guide (ICRG).
- ⁴ In econometrics, endogeneity implies the possibility that an independent variable is correlated with the error term. One of the reasons of that correlation might be reverse causality. This means the

possibility that a dependent variable (in this case FDI inflows) is not only affected by the size or changes of an independent explanatory variable (in this case BITS – their number or conclusion), but at the same time it may also influence the independent variable, hence reverse causality between variables. It has been observed that the conclusion of BITS may be prompted by already existing FDI in host countries. When existing investors see further investment opportunities in the host country, they might put pressure on their home governments to conclude a BIT with the host country. Or, the investors may simply seek enhanced protections for already undertaken investments, without the intention to increase it. In this case, existing FDI leads to the conclusion of BITS, and it should not be considered as an impact of BITS on FDI but rather as an impact of FDI on BITS.

⁵ “Due to the poor explanatory power of current theoretically motivated models of FDI, it is important that this literature consider carefully the influence of omitted variables. One advantage of using bilateral panel data is that country-pair fixed effects may be used to control for time-invariant variables affecting the bilateral FDI relationship” (Aisbett, 2007).

⁶ A later study by Busse, *et al.* (2008) attempts to do so using a highly unsatisfactory measure of the capital account liberalization as a proxy for FDI liberalization.

⁷ The “gravity model”, mimicking the law of gravity, predicts FDI (or trade) flows based on the economic size of the countries and their distance. In the model, the distance means not only geographical distance but also common border, language, cultural ties, or former colonial ties.

⁸ Specifically, they use the Chinn–Ito index of financial openness of countries, based on several dummy variables, including the presence of multiple exchange rates, restrictions on capital account transactions and requirements to surrender export proceeds. Higher index values indicate greater openness with a mean of zero.

⁹ The index takes the values from “0” (total political discretion) to “1” (no political discretion). The assumption is that less discretion makes commitments to foreign investors more credible.

- ¹⁰ As mentioned before, one of the problems of econometric studies is that they cannot include all important determinants of FDI as explanatory variables, either because a model becomes too complicated with too many variables or because there are no data on some variables. If an important variable is not taken into account – which is typically the case with a degree of FDI liberalization in host countries and which is a necessary condition for FDI to take place – a study may suffer from the omitted variable bias.
- ¹¹ But on the other hand, the cost, risk and time spent on investment arbitration may remain a serious barrier for small companies. Waelde gives an example of a company which arbitrated under NAFTA and won by saying that “had they known how the process works in reality they would have simply written off the investment as a loss and gone away”.
- ¹² This would call for the inclusion into the BITs impact analysis parameters that differentiate FDI projects by the size of an investor and the size of investment (Schill S in Orr, 2007). For an econometric analysis, this is wishful thinking because such data are not available. One could, however, think about qualitative analysis, based on investors’ questionnaires, differentiating them by size.
- ¹³ At the end of 2007, at least 290 treaty-based investor claims had been submitted to international arbitration. Out of these, 225 cases were based on BITs.
- ¹⁴ However, the expert has no doubt that a proper tax treaty is more important in locational decisions than a BIT.
- ¹⁵ Such contracts are, for instance, common for major investments in extractive industries and infrastructure services.
- ¹⁶ However, given the confidentiality of these contracts it is difficult to say how often they include such provisions, which could make them alternatives to BITs.
- ¹⁷ For a discussion, see also Sauvart and Sachs, 2009.
- ¹⁸ Lucas, 1976.

III. PREFERENTIAL TRADE AND INVESTMENT AGREEMENTS

A. Introduction

This chapter is concerned with the impact of preferential trade and investment agreements (PTIAs), and notably of economic integration agreements (EIAs) on FDI flows into developing countries. EIAs are treaties aimed at facilitating international trade and cross-border movement of factors of production among contracting parties. They may or may not discriminate against non-member States. While originally concerned mainly with trade in goods and rarely with factors of production, EIAs today also increasingly address investment issues, thus forming a special category of IIAs. If they include investment provisions, they are referred to by UNCTAD as economic integration investment agreements or PTIAs (UNCTAD, 2006b: 1). By end 2007, there were 254 such agreements. Investment provisions in PTIAs may be narrow or extensive and may address issues related to the promotion, protection, liberalization and other rules relevant for investment, such as competition policy. Thus, in many aspects, investment provisions in PTIAs are similar to provisions in BITs. In fact, BITs have influenced the investment provisions of many PTIAs (UNCTAD, 2006b: 2).

In a notable distinction from BITs – where investment liberalization has been an exception limited to a few countries such as Canada, the United States and more recently Japan – many PTIAs have included rules on FDI entry. More recent PTIAs tend to include liberalization rules in the form of pre-establishment and MFN commitments, while older PTIAs either establish a framework for cooperation on investment matters or move towards liberalization through a gradual

process taking place after their entry into force (e.g. ECOWAS or the Central American Common Market) or by changing – over time – previously restrictive regulations (e.g. the Andean Community).

Today, almost all countries of the world are members of at least one PTIA, and the majority of them are members of several such treaties. Developing countries participate widely in PTIAs. Countries in the Americas – including Canada and the United States – had concluded at least 99 agreements through the end of 2007, experiencing a sharp increase after the establishment of NAFTA in the mid-1990s. Asian countries had a late start, but by the end of 2007 had concluded 104 agreements. African countries, while among the first developing countries to conclude PTIAs, have entered into fewer agreements than other developing countries. By end 2007, African countries were parties to a total of 38 agreements.

The impact of PTIAs on FDI flows into developing countries will be examined on the basis of the existing empirical literature and a conceptual discussion. The literature on the impact of PTIAs on FDI flows is uneven and has several gaps. Initially, it focused almost exclusively on the European Union and was reactive rather than predictive, i.e. observed changes in FDI were explained by scholars *ex post*. The theory of regional economic integration, developed in connection with policies in Western Europe, and based on well-established trade theory, discussed and predicted *ex ante* the trade effects of the establishment of customs unions, free trade zones or common markets. It did not pay attention to FDI. One of the reasons was that in the early years of

European integration, a theory on FDI was only emerging, and FDI was mainly considered as a capital flow and a substitute to trade. At the same time, the establishment of the EU triggered a huge inflow of FDI from the United States into the manufacturing sector during the 1950s and 1960s, resulting in scholarly research to explain the mechanism of these inflows. The subsequent deepening and geographical expansion of the European economic integration also had a visible impact on FDI. This was most notable in connection with the 1992 Single Market programme concerning mostly FDI in services and having an impact not only on FDI from third countries but also on intra-EU FDI, and the expansion of the EU to Central and Eastern Europe in the early twenty-first century. In each of these and other cases, the literature has tried to identify the degree of the impact, its causes and determining factors, producing also useful analysis for a better understanding of the impact of other PTIAs on FDI flows.

As regards the impact of other PTIAs, some of them caught more attention than others. The impact analysis has continued to focus on regional agreements, such as NAFTA, MERCOSUR, and some Asian agreements such as the Asia-Pacific Economic Cooperation (APEC) or the Association of South-east Asian Nations (ASEAN). Bilateral economic integration agreements have up to now caught less attention, perhaps because of the lack of observable impact or because they are still too new. Recently, a number of econometric studies assessing the impact of PTIAs on FDI have been undertaken.

B. Economic mechanisms of PTIAs

1. Goods and tradable services

The economic effects of EIAs – i.e. regional integration agreements limited to trade liberalization and not including investment provisions – would be confined to trade effects, described in the literature as *trade creation* – that is, new trade among member countries – and/or *trade diversion* – that is, diversion of imports from third countries towards imports from other member countries. By adding investment provisions such as FDI liberalization or protection, PTIAs may trigger complex interactions between trade and investment in the area of tradable goods and services. As a result, FDI may become a key tool for companies both within and outside the PTIA to deal with threats and opportunities arising from the creation of a larger market that permits free trade between member countries and companies located in these countries, but which might discriminate against non-member countries and their companies.

This may have an impact not only on trade, but also on intraregional and interregional FDI flows, in some cases reducing FDI while in most cases stimulating it.¹ A simple explanation why a PTIA may stimulate FDI is that the removal of intraregional trade barriers affects a key economic determinant of FDI – the size of the market – as it equals the creation of a larger regional market compared to the size of the individual markets of member countries. However, there is more to it than merely the fact that a large market, especially if it is dynamic and grows fast, will attract FDI. This may

happen in different ways for TNCs already established in the regional market and for external companies. The effects on each group of investors depend on the importance, type and size of the market for existing and future investors, on whether investors believe that trade liberalization and discrimination will hold – which was often not the case for economic integration of developing countries – on whether the agreement involves only developed countries, developing countries or both, on whether the regional market will grow and on many other factors.

For investors in tradable goods, the creation of a large regional market represents a once-for-all change to which they have to adjust in different ways, depending on whether they are competitive or non-competitive and on whether they are firms from member States or from third countries.² Adjustments to changes associated with the creation of a new grouping are called static effects: that is, effects that will subside when adjustment is finished. But there may also be long-term effects associated with the creation of a larger regional market. Such a market may trigger new dynamics for all firms by permitting them to enjoy economies of scale and specialization, greater efficiency and lower costs of inputs as well as competitive pressures on firms. How can these static and dynamic adjustments translate into FDI effects?

If, before integration, FDI in manufacturing in member countries was motivated by national trade barriers – i.e. import-substituting FDI – trade liberalization may render such FDI non-competitive as there will be pressure from more competitive producers. Production on a large scale in the home

country of a TNC, together with increased exports, may be more efficient than keeping inefficient foreign affiliates, which existed owing to trade protection. In other words, the emergence of a new stream of trade as a result of the *trade creation effect* may lead to a reduction of FDI from other members of the regional integration area.

As regards third country firms, exporters to the members of the integration grouping may be the first ones to be threatened by the reconfiguration of trade barriers. While they continue to face such barriers to their exports – in the form of, for example, a common external tariff in the case of a custom union – producers from within the group no longer do. This may lead to *trade diversion*, i.e. replacing imports from third countries by imports from within member countries. Third country exporters may thus lose the market. Undertaking FDI in the grouping – provided that regional or national investment provisions allow it – is a tool to deal with such a threat. This would amount to new tariff-hopping FDI and thus FDI creation. On the other hand, as explained in the preceding paragraph, new and stronger competitors from within the region may make the business environment more difficult for investors from outside the region. However, as mentioned earlier, if a market is important and promising, it may encourage new third country TNCs to invest, skipping the export phase. Oligopolistic, worldwide competition among TNCs in many industries, such as the automobile, chemical or electronic industry, is a strong factor encouraging firms to follow their competitors to major regional markets of the world. A large regional market may accommodate more firms than pre-existing national markets, separated by trade barriers, and still permit efficient scale of production.

Regional trade liberalization may encourage existing TNCs – both from within the region and third country TNCs – to reorganize their networks into specialized production units serving the entire regional market.³ Serving the entire regional market may mean specializing in final products for the needs of the regional market or producing components delivered to final assembly affiliates. Such affiliates will enjoy economies of scale and specialization. If the region includes both developed and developing countries, labour-intensive phases of production may be relocated – or located in the case of new investment projects – to less-developed countries. The net effect of such reorganizations on FDI is difficult to predict. Inefficient affiliates in some countries may be closed, while affiliates in other countries may expand or new affiliates may be established, amounting to FDI diversion among member countries or, if the expansion effect is stronger than the reduction effect, to FDI creation.

If the establishment of an economic integration area will accelerate economic growth as it did, for example, in the early years of the EU integration, this may encourage new investment and trade by both domestic and foreign firms attracted to a large, dynamic market. Such investment may be based from the outset on specialized, more efficient affiliates than those existing prior to integration. Or, in other words, integration may lead to the creation of international integrated production networks.

To sum up, in the case of tradable goods and services, the combination of threats and opportunities of regional trade

and investment liberalization – while maintaining trade barriers vis-à-vis third countries – for firms from within and outside the regional integration area may sometimes result in reduced FDI, but in most instances in higher FDI flows, especially if the new regional market includes large, economically important countries, if liberalization commitments are credible and the market grows.

2. Non-tradable services

These mechanisms do not, however, apply to non-tradable services, which, in spite of the growing tradability of information-related services, still dominate the service sector. They include in particular large infrastructure service industries – telecommunication, power and water production and distribution and most transportation services – the tourism industry, construction, most financial services, trading services and several business services. These services can be sold or purchased internationally by the cross-border movement of consumers or professional service providers, the temporary movement of personnel or by establishing affiliates abroad – i.e. FDI. In fact, from the perspective of a firm, FDI is required in most cases to sell these services abroad. Even if a service might be technically tradable, regulations of countries may require a local presence to sell the service, as it is generally the case, for instance, for insurance.

Thus, for these services to be affected by PTIAs, FDI liberalization is required. Yet, services liberalization, in particular in infrastructure, is much less advanced than that of manufacturing and has mainly taken the form of unilateral actions. With few exceptions, developing countries are still

hesitant to subject the liberalization of infrastructure services to international regimes.⁴ While some countries, notably in Latin America, have opened their privatization programmes to FDI, others have preferred non-equity forms of investment. Overall, the service sector is still characterized by the highest degree of FDI restrictions in both developed and developing countries (UNCTAD, 2006a) and large service industries are rarely, if at all, included in the investment liberalization provisions of PTIAs, thus leaving these industries largely outside the scope of the PTIA's impact.

A few caveats need to be made on FDI liberalization in services. Simple liberalization of capital flows and even granting a right of establishment to foreign investors may not be sufficient to encourage FDI flows.

First, in many service industries FDI entry takes the form of foreign takeovers. Therefore, for FDI to take place this would, amongst others, require the absence of formal or informal restrictions on mergers and acquisitions. In the case of state-owned companies as a takeover target, FDI requires a decision of the government, first, to privatize the company and second, to let foreign investors participate in the privatization process. In the case of private companies having strategic importance, national governments often interfere when their takeover by foreign investors is at stake.⁵

Second, most service industries are highly regulated. Regulations differ among countries, and, if excessive or unreasonable, may serve as additional obstacles to FDI in spite of formal liberalization.⁶

Thirdly, it seems, as mentioned in chapter I, that the liberalization of some service industries – such as telecommunication, electricity, banking or insurance – has a greater power in attracting FDI than liberalization of FDI in manufacturing. Almost all countries are open to FDI in manufacturing and many offer incentives to its most desirable forms, such as export-oriented FDI. However, few developing countries receive satisfactory amounts of such FDI. By contrast, most countries, which invited TNCs to participate in their privatization programmes in service industries or opened their financial sectors to FDI, seemed to have received FDI. An explanation could be that for TNCs in the service sector, FDI is the only means to expand in international markets. In addition, given that many countries still restrict such FDI, TNCs in the service sector have fewer locational choices than TNCs in manufacturing. Thus, where service industries have been opened to FDI by international agreements, this has resulted or is likely to result in increased FDI flows. A case in point is Mexico, which, after joining NAFTA, opened its financial sector to banks from Canada and the United States. Moreover, the EU–Mexico FTA from 2000 extended the right to establish fully-owned and controlled affiliates to European-based banks. Both resulted in more FDI in the financial sector of Mexico (Hoeckman *et al.*, 2004: 14–15).

As table 2, based on an analysis of selected United States PTIAs, indicates, bilateral services liberalization can be relatively extensive, affecting in particular telecommunication and financial services.

Table 2. Additional services liberalization in the United States bilateral PTIAs

Industry	Chile	Australia	Bahrain	CAFTA	Morocco	Singapore
Banking			Yes		Yes	Yes
Insurance			Yes	Yes	Yes	
Telecommunications	Yes		Yes	Yes	Yes	Yes
Financial advisory services			Yes			
Broadcasting and audiovisual	Yes	Yes				
Retail and wholesale trade				Yes		
Foreign managers				Yes		Yes
Express mail delivery						Yes
Real estate						Yes
Legal services						Yes

Source: World Bank 2005: 100.

3. The distinction between inter-PTIA and intra-PTIA investment flows

There is evidence that PTIAs attract FDI around the year of their entry into force and also in later years, as firms have used FDI to adjust to changes caused by integration. The impact is more evident in the case of FDI from outside of the economic grouping; however, PTIAs can also stimulate some intraregional FDI (te Velde and Bezemer, 2004: 1). The latter impact can be particularly strong in North–South PTIAs, such as NAFTA.

What explains the difference between the impact of PTIAs on inter-PTIA and intra-PTIA FDI flows? If a regional market is significant, member countries have considerable economic potential, trade and investment provisions are

credible and other policies reasonable, third country firms that are disfavoured vis-à-vis companies from PTIA member countries by trade barriers, and sometimes investment restrictions, will have incentives to invest within such a market. One reason is to counteract trade protection and discrimination in a significant market. Another explanation has to do with dynamic effects of larger integrated markets permitting to enjoy economies of scale and specialization.

Evidence on the effect of PTIAs on *intra-PTIA investment* is more ambiguous, leading some analysts to believe that the impact is mainly on FDI from outside. It is true that “firms originally located in a member country receive access to the whole market without relocation and so have less incentives to invest in other members” (Hoekman *et al.*, 2004: 9). The evidence from the formative years of the EU has confirmed this contention: the establishment of the (then) European Economic Community (EEC) attracted large FDI inflows from the United States, while firms from member countries adjusted through trade and mergers and acquisitions (M&As) within their own countries. But there are some exceptions to this rule:

- One is when an PTIA is between developed and less developed countries, causing investment by firms from developed member countries in less developed member countries: this has been the case in both Mexico (within NAFTA) and CEE countries (within the EU), which have received much FDI from more developed members and, in addition, from third countries wishing to have access to cheaper inputs and the large markets of the developed part of the groupings. Some econometric studies have also

found an impact on FDI into developing countries by agreements that they considered as having “weaker” investment provisions – such as EU agreements with developing countries and some bilateral PTIAs between developed and developing countries;

- A second exception relates to non-tradable services. If investment provisions of a PTIA cover services and liberalize FDI, as they did within the Single Market Programme of the EU or within NAFTA, this will trigger intra-PTIA FDI, which may be substantial;⁷
- Third, some regional PTIAs (ANDEAN, ASEAN and MERCOSUR) seek to promote joint ventures between firms from different member countries. If successful, such measures – i.e. pure investment measures – would result in increased intraregional FDI. For example, in ASEAN, where the scheme is relatively advanced, joint ventures in manufacturing are offered tax and tariff incentives.

C. The impact of PTIAs on FDI: a survey of the literature

Apart from the case of the EU, which will be presented below separately, there are few empirical studies on the impact of PTIAs on investment. One explanation could be that most PTIAs are so new “that the data are simply not there” (Hoekman *et.al.* 2004: 9). Another reason is perhaps that, given poor FDI data, and complex interactions between trade and FDI, assessing the impact of an economic integration agreement among many countries on FDI flows is an even more difficult task than in the case of BITs. Most existing studies concern NAFTA and MERCOSUR. In addition, there

are some econometric studies attempting to isolate the impact of investment provisions in PTIAs on FDI flows.

1. The impact of NAFTA and MERCOSUR on FDI flows

FDI flows to the NAFTA region as a whole increased immediately before and after NAFTA's entering into force; however, it is uncertain whether this increase can be attributed to the establishment of NAFTA. The NAFTA impact was strongest on Mexico. "In the years immediately before NAFTA, FDI inflows to Mexico doubled to over \$4 billion annually and in the years following NAFTA they increased even more, to over \$10 billion in 1994, falling slightly to \$9.5 billion in 1995" (UNCTAD 1998a: 125). Mexico's liberalization of FDI policies, locked in and reinforced by NAFTA provisions, the proximity and guaranteed access to the United States market, and the availability of low-cost labour all led to substantially higher FDI inflows into Mexico, despite the peso crisis. In other words, FDI flows into Mexico in the context of NAFTA were governed by a combination of (a) economic determinants – market size, resources and efficiency; (b) policy considerations – the stronger FDI protection awarded by NAFTA; and (c) specific provisions at the sectoral level (Blomström and Kokko, 1997; UNCTAD 1998a: 125–126). The most visible impact of NAFTA on Mexico has occurred in the automobile industry. United States TNCs used Mexico for efficiency-seeking FDI before NAFTA. However, NAFTA encouraged them to significantly step up such investment. As a result, by 1997, 80 per cent of cars produced by these TNCs in Mexico were exported, compared to 48 per cent in 1994 (USITC, 1997). Also, Japanese TNCs relocated part of their FDI from the United

States and Canada into Mexico after the establishment of NAFTA.

The establishment of MERCOSUR in 1994 resulted in a regional market with a population of over 200 million in Argentina, Brazil, Paraguay and Uruguay – including also Bolivia and Chile as associated members since 1996. In practice, however, the market is dominated by Brazil, which accounts for 70 per cent of its population. MERCOSUR experienced increased FDI inflows immediately before and after its establishment in 1995 – \$10 billion in 1995, \$17 billion in 1996 and \$38 billion in 1998. Market-access considerations, in combination with trade liberalization and provisions to promote and protect FDI, seem to have helped in attracting more FDI. However, it is difficult to attribute any gains in FDI inflows to the MERCOSUR framework alone (Blomström and Kokko 1997; UNCTAD 1998a: 126). Macroeconomic reforms, the liberalization of trade and investment and, in particular, the privatization programmes of member countries, in particular in Argentina and Brazil, which coincided with the establishment and early years of MERCOSUR, all contributed to increased FDI flows. MERCOSUR has helped to consolidate these changes, especially in Argentina and Brazil, the two countries that have benefited most in terms of FDI inflows. Other factors, not related to MERCOSUR, notably the unilateral liberalization of FDI in natural resources in Argentina, have also increased FDI inflows. Chundnovsky and Lopez found that MERCOSUR had an impact on FDI, but mostly from extraregional sources and it took primarily the form of M&As (Yeyati *et al.* 2002: 7). Nevertheless, this impact was not particularly significant,

except in the automobile industry, where special regimes were applied by Argentina and Brazil (Chudnovsky and Lopez, 2007: 12).

2. Econometric studies on the impact of PTIAs on FDI

There are also some econometric studies assessing the impact of PTIAs on FDI inflows. They use similar dependent and control variables as those used in the BITs studies presented in chapter II above: FDI flows for dependent variables, and measures of GDP, inflation, trade openness, amongst others, for control variables. By necessity, these studies have to adopt simplifying assumptions concerning explanatory variables, that is, the coverage of investment and trade provisions in PTIAs. Early studies did so by examining only the difference between a membership of PTIAs, or the lack of it, for FDI flows, not looking into the content of investment provisions. Therefore, they are called “black box” studies. However, some recent studies have tried to assess the impact of the different coverage of investment provisions in PTIAs on FDI flows.

a. “Black box” studies

A key task of econometric studies is to isolate the impact of PTIAs on trade and investment flows from other influences. Initially, these studies focused on the trade impact, and in particular on assessing the extent of trade creation and diversion – and, consequently, welfare gains or losses for PTIA members and non-members. The key *ex post* econometric technique used to examine the determinants of bilateral trade flows has been a gravity model. The model for

trade flows is based on an analogy to the laws of gravity in physics. Trade between two countries is positively related to their size and inversely related to the distance between them. A number of additional variables are added, such as supply conditions in the exporting country and demand condition in the importing country as well as other trade-stimulating and reducing factors. With the emergence of PTIAs, the gravity model has been extended to evaluate their impact on investment between pairs of countries, and – as mentioned earlier – it was also used in the latest study on the impact of BITs on FDI.

The standard way of isolating the impact of a PTIA from the impact of other explanatory variables on bilateral trade flows and, later on, on FDI flows, has been to add to econometric models additional explanatory “dummy” variables reflecting a membership – or the lack of it – of partner countries in a PTIA. For countries – members of PTIAs – such a variable takes the value of “one” and for non-members the value of “zero”. Broadly speaking, after controlling for other explanatory variables, differences in trade and investment flows resulting from the introduction of 0/1 PTIA dummy variables to a model are explained by a membership or non-membership in the agreements (Dee and Gali, 2003: 15). This technique treats all PTIAs as equal, irrespective of differences in the PTIA’s trade, investment and other provisions, including their strength, scope and implementation. Therefore, it is called a “black box” technique. It means that one only knows that “black boxes” – or PTIAs – exist and that some countries are their members, while they do not exist for other countries. However, one does

not know or consider the content of the “black boxes”, i.e. what are the PTIA provisions.

Te Velde and Bezemer reviewed several econometric studies dealing with FDI and using a “black box technique”. The majority of studies found that most PTIAs increased FDI flows from third countries and in some cases also intraregional FDI (Te Velde and Bezemer, 2004: 12).

In an econometric study mentioned earlier, Banga (2003) included also investment agreements among explanatory variables explaining FDI inflows into 15 developing countries of South, East and South-East Asia during the period 1980–2000. The study focused on the APEC Non-Binding Investment Principles of 1994, and the ASEAN Investment Area Agreement of 1999 in which member countries committed themselves to open up industries and grant national treatment to all ASEAN investors immediately, except in some industries of national interest. The study found that while APEC membership had a significant impact on FDI inflows, ASEAN membership did not show any influence on the inflow of FDI. This is probably because the ASEAN Investment Area Agreement was still a relatively recent treaty at the time of the study and may have an effect only with a longer time lag (Banga, 2003: 28).

A World Bank study examined the effects of the participation of 152 countries in 238 regional and bilateral PTIAs on their FDI inflows during the 1980-2002 period (World Bank 2005: 109; Hoekman *et al.*, 2004: 10–12). The study used a refined “black box” methodology. Instead of using 0/1 dummy variables for the membership of countries in

PTIAs, or the lack of them, it measured the impact of the changes resulting from the increase of the market size due to joining PTIAs. Prior to signing a PTIA, the variable for each country equals zero. After the signing, the variable acquires a positive value, measuring for each country the enlargement of market access associated with economic integration. For example, in the case of Brazil's membership of MERCOSUR, the variable was determined by the sum of the GDP of Argentina, Paraguay and Uruguay, to whose markets Brazil gained access as a result of joining MERCOSUR. For Argentina, the variable would be determined by the GDP of Brazil, Paraguay and Uruguay (World Bank 2005: 120). As Brazil's market is much larger than that of Argentina, the variable is much higher for Argentina – and for that matter also for Paraguay and Uruguay – than for Brazil.

The study first confirms the importance of traditional determinants in attracting FDI, such as trade openness, economic growth and economic stability. Secondly, as regards PTIAs, those that result in the creation of larger markets, attract more FDI. The interaction between the establishment of a PTIA and the resulting enlarged market is “significant and positively related to FDI. On average, a 1 per cent increase in market size associated with a PTA [that is a PTIA] produces an increase [in FDI inflows] of 0.5 per cent” (World Bank, 2005: 11). The policy implication is that, if a host country wishes to use a PTIA to attract FDI, it should “seek to amalgamate with the largest possible markets” (World Bank, 2005: 11). By contrast, PTIAs among countries with small markets have little impact on FDI. However, PTIAs cannot substitute for an inadequate investment climate. Specifically, if

an economy suffers from poor macroeconomic management, high levels of corruption and weak infrastructure, a PTIA will not offset these disadvantages. In addition, the establishment of a PTIA will not have much effect on FDI inflows from outside the region, if restrictions on market access are severe and remain unchanged.

b. Studies assessing FDI provisions in PTIAs

A “black box” methodology can only indicate an impact of PTIAs on FDI flows, but it cannot answer the question of why some groupings are more successful than others in stimulating FDI and, consequently, does not serve to draw policy implications for designing PTIAs in a way that facilitates FDI.⁸ Recent studies increasingly try to step out of the “black box” and measure differences in trade and investment provisions among PTIAs. Some recent studies have tried to qualify the provisions of PTIAs by using a liberalization index or assessing investment provisions in PTIAs, attempting to isolate the impact of trade and investment provisions on FDI flows.

Dee and Gali (2003) use a gravity model to assess the impact of PTIAs on FDI for the period 1988–1997 for 77 countries. They cover nine PTIAs, including bilateral, regional and interregional agreements.⁹ For a dependent variable, they take the natural logarithm of the stock of outward FDI of a home country in a host country. Among explanatory variables, they use a member liberalization index (MLI) concerning trade and non-trade provisions, thus permitting to evaluate the separate impact of trade and investment provisions on FDI.

The indices are un-weighted averages for sub-categories of investment provisions.

The study considers a number of impacts of PTIAs on investment flows. First, it examines if investment responds to trade provisions in tariff-jumping or “beachhead” fashion. This type of FDI takes place when a third-country TNC undertakes FDI in a member country of a PTIA to serve the markets of other member countries. Secondly, investment may also respond to non-trade provisions of PTIAs. Production can be moved from a high-cost domestically-owned producer to a lower cost affiliate in another member country – resulting in investment creation – or from a low-cost non-member affiliate to a higher-cost affiliate within the PTIA – causing investment diversion (Dee and Gali, 2003: 23–24). The findings concerning these impacts are as follows:

- The study has found evidence – although rather weak – for beachhead or tariff-jumping FDI in response to trade provisions only for SPARTECA¹⁰ and the 1985 Israel-United States free trade agreement. Non-reciprocal trade preferences have allowed the Pacific island countries to attract FDI not only from Australia and New Zealand but also from other countries (Dee and Gali, 2003: 34);
- Most agreements covered in the study resulted in investment creation rather than investment diversion, thus leading to a more efficient geographic distribution of FDI. Investment creation was found in the case of EFTA, EU, NAFTA, MERCOSUR, SPARTECA and the CER agreement between Australia and New Zealand,¹¹ while

investment diversion occurred only in connection with the ASEAN Free Trade Area (AFTA). No such impacts were found in the case of ANDEAN and a 1985 United States-Israel agreement (Dee and Gali, 2003: 35–36, 39–41);

- As regards the origin of FDI, most PTIAs studied (including NAFTA, MERCOSUR, AFTA, CER and the EU) attracted investment mainly from non-member countries as a result of their “third wave” provisions (Dee and Gali, 2003: 34);
- Finally, the study concludes that there may be economic gains from the non-trade provisions of third wave PTAs – i.e. PTIAs – but the results also suggest that there are still economic costs associated with the preferential nature of trade provisions (p. 40). As regards policy implications, “this suggests there could be real benefits if countries could use regional negotiations to persuade trading partners to make progress in reforming such things as investment, services, competition policy and government procurement, especially if this is done on a non-preferential basis” (Dee and Gali, 2003: 40–41).

Te Velde and Bezemer (2004) try to isolate the impact of investment provisions in PTIAs on FDI flows. They take the real FDI stock of the United States and the United Kingdom in developing countries – in 97 countries for the United States stock, and in 68 countries for that of the United Kingdom – during the period 1980–2001 as a dependent variable. They measure the scope of key explanatory variables – investment and trade provisions of PTIAs. They go one step

further than previous studies in measuring the differences between the investment rules of PTIAs as well as changes of these rules over time by assigning scores to a number of investment measures, such as treatment, both national treatment and MFN treatment, performance requirements, transfer of funds, settlement of disputes, and expropriation rules, as well as to non-measurable trade rules, such as rules of origin. They include an additional variable measuring the degree of the implementation of the investment provisions.

Thus they use the following indexes for investment provisions across the seven PTIAs and over time: 0 for countries being non-members of PTIAs; 1 for some investment provisions in PTIAs (COMESA and SADC); 2 for improved investment provisions such as those in ANDEAN in the 1990s, compared to previous periods; 3 for complete investment provisions as Chapter XI of NAFTA; and -1 for more restrictive provisions such as those in ANDEAN during the 1970s. Similarly, indexes on the scale from 0 to 3 were assigned to trade provisions, such as the degree of tariff reductions and the intensity of the MFN clause. The hypothesis is that higher values of the investment index should lead to increased FDI in a grouping over time or across groupings.

Before the study moves to an econometric exercise, it tests the hypothesis looking at the changes of the United States FDI stock as a percentage of GDP of host countries in response to the introduction or improvement of investment provisions in ANDEAN, MERCOSUR and ASEAN. United States FDI in ANDEAN fell in the 1970s when ANDEAN

introduced restrictions on FDI from third countries known as Decision 24. The stock recovered gradually in the 1990s, after FDI restrictions were lifted and an ANDEAN free trade area was established. United States FDI increased also in MERCOSUR some time after its establishment. United States TNCs were also reacting to the gradual improvement of the trade and investment environment in ASEAN after the conclusion of the ASEAN Agreement for the Promotion and Protection of Investments (1987) as amended by the 1996 Protocol, the conclusion of the ASEAN Free Trade Area (AFTA) in 1992, and the establishment of the Framework Agreement on the ASEAN Investment Area in 1998. This simple statistical exercise, controlling only for the size of GDP of host countries, serves as a preliminary indication that FDI is responsive to trade and investment provisions of PTIAs (Te Velde and Bezemer 2004: 17).

In an econometric model, introducing additional usual determinants as control variables, the authors find that the real stock of FDI is on average 68 per cent higher if a host developing country is a member of one of the following seven PTIAs: NAFTA, MERCOSUR, CARICOM, ASEAN, ANDEAN, SADC or COMESA. Furthermore, in a comparison to non-member countries, the membership of CARICOM, ASEAN, ANDEAN and NAFTA attracted additional FDI from third countries. In explaining why different PTIAs attract different amounts of FDI, the authors attribute the discrepancy to more investment provisions in PTIAs (Te Velde and Bezemer 2004: 23). In other words, in a region with some common investment provisions, FDI stock increases by 41 per cent, while in a region with a higher number of common investment provisions it will increase by further 41 per cent.

For example, “ASEAN would have increased FDI by 123 per cent on average, while COMESA only by 41 per cent because so far it has fewer investment related provisions” (Te Velde and Bezemer 2004: 23).

The study also tests why some member countries of a PTIA receive more FDI than others. They find that the larger the country compared to other member countries, the more FDI it will attract “on the back of regional integration”. For example, United States stock of FDI as a percentage of a host country’s GDP increased three times in larger Argentina compared to a two-times increase in smaller Uruguay after the formation of MERCOSUR. They explain that investors seek to be closer to – that is, located in – the markets with the largest demand. Consequently, countries that are located further away from the largest member country of the PTIA attract less FDI. On the other hand, GDP per capita does not affect the investors’ locational choice within PTIAs (Te Velde and Bezemer 2004: 23–24). The above results are robust to a number of alternative specifications.

The study by Lesher and Miroudot (2006), based on a gravity model, analyses the consequences of including investment provisions in 24 North–South PTIAs, only one of which – NAFTA – is a regional integration scheme. Others include 11 treaties concluded by the EU and 2 by EFTA with individual developing countries. Likewise included are treaties of other developed countries (Australia, Canada, Japan, New Zealand and the United States) with individual developing countries (table 3). The study thus covers PTIAs rarely analyzed in the impact literature, which has focused on

regional PTIAs. The authors assume that, in geographically dispersed PTIAs, economic mechanisms influencing trade and FDI can be similar to those occurring in regional PTIAs, leading to market-seeking FDI, tariff-jumping and efficiency-seeking FDI as well investment creation and diversion (Te Velde and Bezemer 2004: 8).

Most of the analysed PTIAs represent a new generation of IIAs – 20 of 24 were concluded during 2000–2005 – thus supplementing the study by Dee and Gali, which focussed on older IIAs. As the data covers the period from 1990 to 2004, this raises the question about the impact of seven PTIAs, which entered into force during 2004–2005. The authors argue, however, that foreign investors anticipate investment provisions of the future agreement and start investing before its entry into force (Te Velde and Bezemer 2004: 28), which indeed may be the case as several studies have indicated.¹²

To assess the impact of FDI provisions on FDI, the authors create, for each PTIA, a synthetic index measuring the depth and extensiveness of these provisions. The index is based on assigning numerical values (0, 0.5 or 1) to 27 investment-related measures in six broad categories: the right of establishment and non-discrimination before entry, the right of establishment and non-discrimination after entry, FDI in services, FDI regulation and protection, dispute settlement, and FDI promotion and cooperation.¹³ Indexes for individual provisions are given equal weight and aggregated for each PTIA, resulting in the ranking of the PTIAs according to the coverage of investment provisions, used in the econometric analysis – with several usual control variables – to check the

“impact-on-FDI hypothesis” according to the strength and coverage of the FDI provisions.

Table 3. Index of investment provisions in selected PTIAs

PTIA between	Year of entry into force	Index
Agreement between Japan and the United Mexican States for the Strengthening of Economic Partnership	2005	0.76
Free Trade Agreement between Canada and the Republic of Chile	1997	0.72
Association Agreement between the European Community and the former Yugoslav Republic of Macedonia	2001	0.72
North American Free Trade Agreement	1994	0.68
Euro-Mediterranean agreement between the European Communities and Kingdom of Jordan	2002	0.64
Free Trade Agreement between Australia and Thailand	2005	0.64
Free Trade Agreement between Chile and the United States	2004	0.64
Free Trade Agreement between Singapore and the United States of America	2004	0.64
Free Trade Agreement between the EFTA States and Singapore	2003	0.60
Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership	2002	0.58
Agreement on Closer Economic Partnership between New Zealand and Thailand	2005	0.58
Agreement between New Zealand and Singapore on Closer Economic Partnership	2001	0.50
Free Trade Agreement between the EFTA States and the United Mexican States	2001	0.48
Agreement Establishing an Association between the European Community and Chile	2003	0.46
Free Trade Agreement between Australia and Singapore	2003	0.46

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**Table 3. Index of investment provisions in selected PTIAs
(concluded)**

PTIA between	Year of entry into force	Index
Cooperation Economic Agreement between the European Community and the United Mexican States	2000	0.44
Euro-Mediterranean agreement between the European Communities and Kingdom of Morocco	2000	0.42
Agreement on Trade, Development and Cooperation between the European Community and South Africa	2000	0.42
Euro-Mediterranean agreement between the European Communities and Tunisia	1998	0.42
Euro-Mediterranean agreement between the European Communities and Egypt	2004	0.38
Free Trade Agreement between the EFTA States and Chile	2004	0.38
Euro-Mediterranean agreement between the European Communities and Israel	2000	0.36
Free Trade Agreement between Jordan and the United States	2001	0.26
Papua New Guinea-Australia Trade and Commercial Relations Agreement (PATCRA)	1977	0.20
Average		0.52

Source: Leshner and Miroudot 2006: 19.

Of the 24 PTIAs analysed in the study, the Mexico–Japan agreement has the highest overall score of the depth and coverage of FDI provisions (0.76), followed by the Canada–Chile agreement (0.72) and that between the EU and the former Yugoslav Republic of Macedonia (also 0.72). At the bottom of the ranking are the Papua New Guinea–Australia Trade and Commercial Relations Agreement (0.2), the

agreements between the United States and Jordan (0.26),¹⁴ and the Agreement between the EU and Israel (0.36) (Leshner and Miroudot, 2006: 19). Among agreements not included in the analysis, the highest score, based on the Rome Treaty establishing the European Economic Community (1958), goes to the EU (0.78). NAFTA is close with 0.68 (table 3).

The dependent variable is bilateral FDI flows for the period 1990–2004 between developed countries, parties to the analysed PTIAs, on the one hand, and some 154 host developing and transition countries, on the other hand. The dataset of bilateral FDI flows included a total of 181 countries, but the study does not explain which of them are home and which host countries (Leshner and Miroudot, 2006: 49). The FDI analysis is based on an impressive number of 7,258 observations concerning bilateral FDI flows and 9,027 observations for bilateral trade flows.

The study finds that investment provisions of the analyzed PTIAs are positively associated with trade and even to a greater extent with FDI. Specifically, in the analyzed sample:

“The entry into force of a RTA [i.e. a PTIA] with substantive investment provisions is positively related to trade and net positive FDI flows. The coefficient is higher in the FDI model (0.456) than it is in the trade model (0.190), which is intuitive as one would expect that investment provisions more profoundly affect investment flows than trade flows”.

In percentage terms such an entry “is associated with a 57.1 per cent increase in FDI flows and a 20.8 per cent increase in exports” (p. 27).

Such estimates should be treated with caution, because the PTIAs dummy variables can also reflect the impact of other variables. Nevertheless:

“The sign and magnitude of these values tend to suggest that substantive investment provisions matter for both trade and investment, and that trade complements, more than it substitutes for, investment in the context of RTAs [i.e. PTIAs] that contain substantive investment provisions” (Leshner and Miroudot, 2006: 27).

Moreover, “this dual positive effect indicates that investment [stimulated by PTIAs] may be more efficiency-seeking than market-seeking” (p. 38).

Furthermore, more nuanced estimates suggest that “agreements with relatively more investment provisions impact FDI more profoundly than agreements with fewer provisions”. Investment agreements are also likely to increase investment flows from third countries and result in investment creation (Leshner and Miroudot, 2006: 28). In conclusion, the fact that PTIAs matter for trade and even more for FDI flows “is good news for developing countries, particularly since North-South agreements tend to include the most extensive investment provisions, and FDI can be an important stimulus for development” (Leshner and Miroudot, 2006: 39).

In a subsequent study, Miroudot (2008) builds on this work and offers a refined analysis of the economic impact, which investment provisions in RTAs can have. The 2008 study focuses on Asia, which exhibits many of the recent and most innovative agreements and specifically looks at the scope of services commitments (an area with particularly high amount of FDI restrictions). The study is based on a dataset of 18 countries, covering bilateral trade and investment agreements with 190 partner countries (reported 1990–2006). Miroudot uses a “simplified” version of the knowledge-capital gravity equation¹⁵ and – similar to Egger and Merlo (2007) – adds two variables to the FDI specification: the relative GDP and the relative skilled-labour endowment:

“Looking at the coefficient for investment provisions in RTAs, there is a positive and statistically significant coefficient for the RTA index variable (in both specifications) indicating that FDI is influenced by the content of RTAs and the preferential treatment granted to foreign investors...” (p. 205).

Based on the results of the quantitative model, Miroudot concludes:

“[t]he results confirm that investment provisions in RTAs are associated with higher inward and outward investment flows, as well as increased cross-border trade in services and higher trade flows in goods. The impact measured is, however, somewhat lower than in previous studies such as that of Adams *et al.* (2003) or Llesher and Miroudot (2006). This impact is

nonetheless economically significant and quite substantial for outward FDI and to a lesser extent inward FDI” (p. 206).

Nevertheless, as noted by the author, questions remain regarding the causality of the relationship between investment provisions in trade agreements and increased investment stocks. “It is still a possibility that countries tend to sign RTAs with partners where investment is (potentially or not) high and that these RTAs are more likely to include extensive investment provisions.”

Miroudot draws several conclusions from his analysis. The finding that the combination of trade and investment liberalisation seems to have a greater impact, would justify the new generation of RTAs with “deep integration” provisions on investment and trade in services. Given that the nature of the agreement’s provisions matter, Miroudot says that countries could be encouraged to be more ambitious. With respect to outward FDI, the finding that a country’s own liberalization efforts can encourage outward FDI, suggests that accepting more foreign companies in the domestic economy would make it easier for domestic companies to invest abroad.

D. The experiences of the European Union with FDI

Although this paper is primarily concerned with the impact of IIAs on FDI flows into developing countries, it is worthwhile to bring in briefly the experiences of the EU. The EU represents the oldest, largest, most advanced and most successful regional integration organization in the world. Its establishment, functioning, deepening and expansion have

exerted significant impact on FDI over the years. Hence, the EU experiences with FDI illustrate well which of the above mechanisms of the potential impact of PTIAs on FDI have worked in the most mature PTIA in the world and in what manner.

1. The early years of the European Economic Community

Preparations for the establishment of the EEC in 1958 and the gradual implementation of the provisions of the Treaty of Rome concerning customs union and the common market coincided with large FDI by United States TNCs in the manufacturing sector of EEC countries. United States FDI stock in the EEC increased three times between 1957 and 1964, much faster than its total outward stock. Between 1955 and 1972, the share of the six EEC member countries in the outward stock of the United States increased from six to 17 per cent (UNCTAD 1998a: 125). There is consensus in the literature that this inflow was to a considerable extent triggered by the dynamic effects of integration, especially by the creation and fast growth of a large regional market (Blomström and Kokko, 1997; Yannopoulos 1990; and UNCTC, 1993) and – to a smaller degree – by static effects related to trade diversion.¹⁶ The establishment of EFTA also attracted United States FDI into manufacturing, although on a smaller scale. The principal beneficiary was the United Kingdom.¹⁷

The adjustment of the EEC firms to integration took the form of trade – the share of intra-EEC exports in total EEC exports increased from 32 per cent in 1958 to 50 per cent in

1970 – and domestic M&As in manufacturing. Out of 2,118 M&As which took place in the EEC during 1961–1969, almost 90 per cent were transactions within individual countries.¹⁸ There is no evidence that the establishment that the EEC increased intra-EEC FDI. The service sector was unaffected not only by FDI but also by integration in general. As explained above, most services are not tradable and require establishment of production abroad and/or movement of persons. The Rome Treaty provided formally for both the right of establishment and the free movement of persons, in addition to the free movement of capital. However, it did not tackle internal regulations of countries on such issues as professions, provision of services or state-owned monopolies in telecommunications, electricity or air transportation, which proved to be formidable barriers to trade and FDI in services.

2. The 1992 Single Market Programme

The next boost to FDI in the EU came from the Single Market Programme. It was launched in 1985 and implemented during the second half of the 1980s and early 1990s. It aimed at the removal of remaining non-tariff barriers to the movement of goods, services, capital and people and, thus, the unification of competitive conditions for enterprises in the EU. Most importantly, it addressed barriers to trade and investment across service industries, initiating deregulation and liberalization of these industries.

Firms from the EU and third countries, in both manufacturing and services, started to adapt to the Single Market Programme by the mid-1980s, not waiting for its completion, and intensified these processes during the

implementation phase. They took various forms, which had three common threads. Firstly, when reorganizing their activities, enterprises, including EU-based companies, increasingly took a regional perspective, getting away from strategies geared towards serving separate national markets.¹⁹ Secondly, FDI played a very important role in restructuring. Its driving force was M&As, among which cross-border M&As took a much greater prominence than ever before. Thirdly, the pattern of FDI generated by the Single Market Programme was much different from that generated by the establishment of the EEC:

Firstly, the principal actors this time were TNCs from the EU and not from outside. Intra-EU FDI grew much faster than extra-EU FDI into the EU. As a result, its share in total FDI inflows of the EU increased from 30 per cent in the mid-1980s to 60 per cent in the early 1990s.²⁰

Secondly, as regards third country TNCs, the most active this time were those from Japan. Annual flows of Japanese FDI into the EU increased from \$2 billion in 1985 to \$14 billion in 1990, staying still in 1993 at a high level of \$8 billion (Kumar, 1994). At the end of 1993, cumulated Japanese investment in Western Europe – the bulk of it in the EU – stood at \$84 billion, of which \$70 billion, or 83 per cent, were invested during 1987–1993 in response to the Single Market Programme. Its principal motivation was to protect the market share gained through exports in face of a perceived growing EU protectionism directed against Japanese cars and electronic products making rapid inroads into EU markets. Japan feared at that time that the programme would transform the EU into a

“Fortress Europe”. Similar motivations led to investments from a few newly industrialized countries in Asia, such as the Republic of Korea.

Thirdly, a good part of FDI growth at the time, in particular among EU members, took place in the service sector, such as banking, insurance, trading, transportation, telecommunication, tourism and business services. As already noted, the Single Market Programme was essentially a programme of FDI liberalization in services. As a result, the share of services in EU FDI flows increased from 55 per cent in 1984–1986 to 64 per cent in 1990–1992. Third country investors in the EU also stepped up investment in services. Their share increased during the same period from 55 per cent to 62 per cent (Dunning, 1997: 21).

Fourthly, although United States FDI in the EU was not as dynamic as that by EU TNCs or Japanese TNCs, it accelerated compared to United States total FDI: the share of the EU in the United States outward FDI increased from 35 per cent in 1985 to 41 per cent in 1990 and stayed at this level for some time. The reason for the slower growth was that at the time of the Single Market Programme, United States TNCs held well-established positions in the EU market, better than those of Japanese TNCs and many EU TNCs. United States firms serviced the EU market in 85 per cent through local production and/or sales of foreign affiliates and only in 15 per cent through exports. In the case of Japanese firms this ratio was exactly the opposite: 15/85. Thus, the fear of trade protectionism on the part of United States firms was not very strong. Accordingly, United States TNCs in the manufacturing sector focused on restructuring and consolidation of their

already existing affiliates into regional networks. By contrast, United States TNCs in the service sector increased their FDI considerably, mainly through cross-border M&As.

In conclusion, the Single Market Programme was an important factor in strengthening the EU's position in international production worldwide with respect to both outward and inward FDI. Judging from FDI flows, which measure annual FDI outlays and lead to similar changes in stocks, consistent increases of the EU share in global inflows took place between 1986 and 1990 – from 26 per cent to 48 per cent of world total. When the effects of the programme weakened, and the recession of the early 1990s settled in, the EU's share in global FDI inflows and stock declined. The share, however, recovered by 2000–2001. In 2006, the EU-15 share of world inflows was 38 per cent and that of the world stock 42 per cent (UNCTAD 2007a: 251, 255).

3. The impact of the EU enlargement on FDI in the “old” accession countries

Since its establishment in 1958, the EU has gone through six rounds of enlargements: (a) 1973 (Denmark, Ireland and the United Kingdom); (b) 1981 (Greece); (c) 1986 (Portugal and Spain); (d) 1995 (Austria, Finland and Sweden); (e) 2004 (Cyprus, Czech Republic, Estonia, Hungary, Malta, Latvia, Lithuania, Poland, Slovakia and Slovenia); and 2007 (Bulgaria and Romania). Did enlargement impact FDI into the accession countries? In many cases, perhaps in most cases, the answer is yes, judging from the FDI inflows into accession countries before and after the accession in both absolute and

relative terms – as shares of the EU's and of other developed market economies' FDI inflows:

- Although accession took place in various periods, new EU membership was in most cases associated with a clear increase of FDI inflows, leading to increased shares of these inflows in total inflows to the EU and to other developed countries (table 4);
- The experience of two countries, Spain and Portugal, for which data were assembled for 15 years – from six years before accession to eight years after accession – shows that FDI may particularly increase as early as three years before accession and last until a few years after it;
- In the case of the 1995 entrants, increased FDI flows into Austria and Finland started before accession, while those into Sweden coincided with the year of accession. The increase could have also been affected by the participation of these countries in booming global M&As in the second half of the 1990s;²¹
- As regards absolute increases in FDI inflows, they were largest in Spain and Portugal. But they translated into smaller gains in terms of increased shares in total EU inflows, because the accession of these countries coincided with the announcement of the Single Market Programme, which, as noted above, accelerated intra-EU FDI flows. Ireland registered large increases in both its absolute FDI inflows and its share in EU inflows;²²
- The situation of the United Kingdom is ambiguous. Many foreign investors entered the United Kingdom market in the 1950s and 1960s, partly in response to the establishment of EFTA. But still, FDI inflows in the

United Kingdom increased considerably during the first two years of EU membership, as did the United Kingdom's share of EU FDI inflows. After that, both stabilized. The prevailing view in the literature is that the accession of the United Kingdom had much greater impact on British investment in the EU than on FDI in the United Kingdom;²³

- Both Denmark and Greece registered decreases in their FDI inflows after accession. The case of Denmark is not well researched. In the case of Greece, accession coincided with political and macroeconomic instability and social tensions, which kept foreign investors away from the country. In addition, the removal of trade barriers resulted in some divestment in manufacturing, as it exposed earlier import-substituting FDI to foreign competition. Rapid wage increases in the early 1980s did not help either (Georgakopoulos and Paraskevopoulos, 1994).

4. The impact of the EU “2004 enlargement” on FDI in the CEE accession countries

The 2004 EU expansion to new members from Central and Eastern Europe (CEE) affected their FDI determinants more strongly and positively than was the case with earlier accessions (which all related to advanced market economies at the time of their EU entry) and, consequently, helped the CEE entrants attract more and better FDI, notably efficiency-seeking, export-oriented FDI. It gave CEE countries access to the huge EU market, or consolidated such access. It helped completing FDI liberalization, raised protection and treatment

standards for foreign investors, and assured investors about the irreversibility of reforms in the new accession countries, thus reducing transaction costs and the risk of investing in these countries. Furthermore, EU funds, if properly used for purposes such as improving infrastructure or restructuring inefficient state-owned enterprises, have enhanced and can further enhance the long-term economic attractiveness of the CEE countries to FDI.

Expected EU membership of CEE countries had an impact on their FDI inflows in the years prior to accession, although it is impossible to estimate how big this impact was and when exactly it took place. One reason is that, since the early 1990s, these countries were linked to the EU through association agreements – Europe Agreements – which during the 1990s gave them gradually free access to the EU market for manufactured goods – the greatest benefit attracting export-oriented FDI. Between 1995 and 2002, FDI stock in these countries increased by more than four times, and much of it was received from the EU countries (Zimny, 2004: 47). During the 1990s, the share of foreign affiliates in the exports of CEE countries (directed mainly to the EU) increased rapidly, reaching around the year 2000 80 per cent in Hungary, 60 per cent in Estonia, 56 per cent in Poland, 47 per cent in the Czech Republic and 26 per cent in Slovenia (UNCTAD 2002: 154). This suggests that much of the FDI impact took place in the 1990s and that this impact was associated with association agreements.²⁴

Another reason are privatization programmes of CEE countries in infrastructure services such as telecommunications or power industries, in which FDI was permitted in most cases.

Privatization-related FDI is not necessarily related to the EU accession.²⁵ But it inflated FDI inflows in the years in which privatization intensified, or one or two large transactions took place, leading to sudden downward fluctuations when privatization weakened or ended. For example, Hungary completed its privatization programme during the 1990s, attracting its highest annual FDI inflows in 1995 – over \$5 billion – and for many years did not even come close to this level. The sale of a telecommunication company to foreign investors in Poland in 2000 boosted the country’s annual FDI inflows to an unprecedented level of over \$9 billion. Privatization “inflated” FDI inflows also into the Czech Republic and Slovakia.

Nevertheless, a commonly held view was that the accession countries largely exhausted the EU membership effect on their FDI inflows before the accession: they enjoyed free access to the EU market for many years before the accession and companies that wanted to benefit from it had invested in these countries long before they became full EU members in 2004. Therefore, large increases in FDI inflows around or following the accession were not expected.²⁶ This view, however, turned out to be unfounded, judging from the actual inflows after accession. During 2004–2006, average annual FDI inflows into all eight CEE countries almost doubled to \$34 billion compared to inflows in the two preceding three-year periods (figure 1). They increased significantly in all countries except Slovenia, reaching levels never attained before, even in the years of big FDI-related privatizations (figure 1). As regards relative FDI indicators

Table 4. FDI inflows into selected countries entering the EU in different EU enlargement rounds
(Millions of dollars and percentage)

Country/item	Year of accession	Annual average FDI inflows and shares				
		6 to 4 years before	3 to 1 years before	Accession year to 2 years after	3 to 5 years after	6 to 8 years after
Denmark, value	1973		131	240	-8	102
as % of EU inflows		...	2.5	2.5	-0.1	0.7
as % of DMEs ^a inflows		...	1.4	1.5	-0.05	0.3
as % of GDP		...	0.7	0.7	-0.02	0.1
Ireland, value	1973		29	87	228	275
as % of EU inflows		...	0.5	0.6	0.9	2.4
as % of DMEs inflows		...	0.3	0.6	1.3	0.7
as % of GDP		...	0.6	1.1	2	1.4
Untd. Kingdom, value	1973		1,490	3,470	3,743	7,490
as % of EU inflows		...	25.6	28.5	35.7	39.2
as % of DMEs inflows		...	15.7	22.2	21.9	20.3
as % of GDP		...	1.1	1.7	1.4	1.5
Greece, value	1981	239	571	465	468	781
as % of EU inflows		2.4	2.7	3.7	3.6	3.8
as % of DMEs inflows		1.6	1.9	1.3	0.9	0.6
as % of GDP		0.9	1.3	1	1.1	1.2
Portugal, value	1986	158	205	542	2,265	1,559
as % of EU inflows		...	0.9	1.6	1.4	2.8
as % of DMEs inflows		0.4	0.5	0.5	1.5	1.1
as % of GDP		0.6	0.9	1.3	3.3	1.7
Spain, value	1986	1,661	1,787	5,014	11,635	10,262
as % of EU inflows		9.6	9.9	13.9	13	14.3
as % of DMEs inflows		4.4	4.6	4.7	7.7	7.2
as % of GDP		0.8	1.1	1.7	2.4	2
Austria, value	1995	532	1,557	2,995	5,449	4,473
as % of EU inflows		0.6	3.1	2.5	1.2	1.4
as % of DMEs inflows		0.4	1.7	1.3	0.7	1.0
as % of GDP		0.3	0.8	1.3	2.7	2.0

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Table 4. FDI inflows into selected countries entering the EU in different EU enlargement rounds (continued)
(Millions of dollars and percentage)

Country/item	Year of accession	Annual average FDI inflows and shares				
		6 to 4 years before	3 to 1 years before	Accession year to 2 years after	3 to 5 years after	6 to 8 years after
Finland, value	1995	343	950	1,430	4,879	5,032
as % of EU inflows		0.4	1.9	1.2	1	1.6
as % of DMEs inflows		0.2	1	0.6	0.6	1.0
as % of GDP		0.3	1	1.1	3.9	3.6
Sweden, value	1995	3,378	3,385	10,284	34,643	9,352
as % of EU inflows		4	6.8	8.7	7.4	2.9
as % of DMEs inflows		2.3	3.6	4.4	4.3	2.0
as % of GDP		1.5	1.6	4.2	14.6	3.9
Czech Republic, value	2004	5,009	5,409	7,549	...	...
as % of EU inflows		1.0	1.7	1.8	...	...
as % of DMEs inflows		0.6	1.2	1.2	...	...
as % of GDP		8.4	7.6	6.1	...	...
Estonia, value	2004	424	582	1,841	...	...
as % of EU inflows		0.1	0.2	0.4	...	...
as % of DMEs inflows		0.1	0.1	0.3	...	...
as % of GDP		7.5	7.4	13.2	...	...
Hungary, value	2004	3,137	3,022	6,335	...	...
as % of EU inflows		0.6	1.0	1.5	...	...
as % of DMEs inflows		0.4	0.7	1.0	...	...
as % of GDP		6.5	4.8	5.8	...	...
Latvia, value	2004	372	230	1,005	...	...
as % of EU inflows		0.1	0.1	0.2	...	...
as % of DMEs inflows		0.04	0.05	0.2	...	...
as % of GDP		5.1	2.3	5.8	...	...
Lithuania, value	2004	597	452	1,215
as % of EU inflows		0.1	0.1	0.3
as % of DMEs inflows		0.1	0.1	0.2
as % of GDP		5.4	3.3	4.6

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Table 4. FDI inflows into selected countries entering the EU in different EU enlargement rounds (concluded)
(Millions of dollars and percentage)

Country/item	Year of accession	Annual average FDI inflows and shares				
		6 to 4 years before	3 to 1 years before	Accession year to 2 years after	3 to 5 years after	6 to 8 years after
Poland, value	2004	7,659	4,811	14,217	...	...
as % of EU inflows		1.6	1.5	3.3	...	...
as % of DMEs inflows		0.9	1.0	2.2	...	...
as % of GDP		4.5	2.4	4.8	...	...
Slovakia, value	2004	1,026	2,623	3,101	...	...
as % of EU inflows		0.2	0.8	0.7	...	...
as % of DMEs inflows		0.1	0.6	0.5	...	...
as % of GDP		4.9	10.3	6.4	...	...
Slovenia, value	2004	153	777	685	...	...
as % of EU inflows		0.03	0.2	0.2	...	...
as % of DMEs inflows		0.02	0.2	0.1	...	...
as % of GDP		0.7	3.5	2.0	...	...
Bulgaria, value	2007	1,272	4,961	...	...	...
as % of EU inflows		0.4	1.2	...	...	...
as % of DMEs inflows		0.3	0.8	...	...	...
as % of GDP		7.4	17.3	...	...	...
Romania, value	2007	1,498	8,095	...	...	...
as % of EU inflows		0.5	1.9	...	...	...
as % of DMEs inflows		0.3	1.2	...	...	...
as % of GDP		3.0	8.1	...	...	...

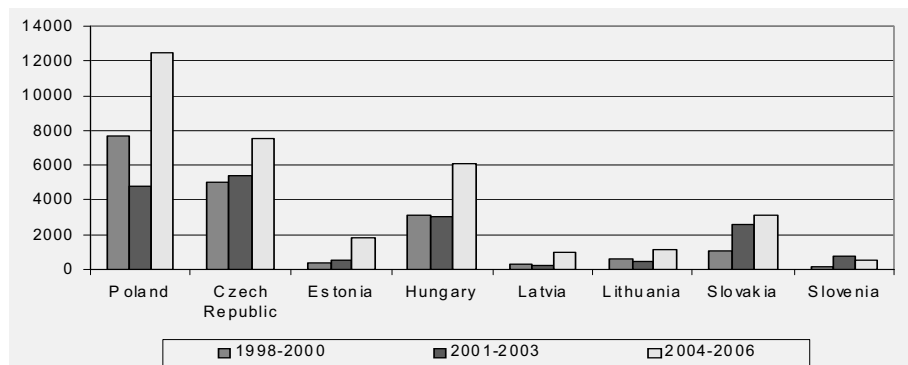
Source: UNCTAD, based on Zimny, 2004: 45; and UNCTAD FDI/TNC database, 2009.

^a "DMEs" in the table stands for developed market economies.

(FDI as a percentage of EU inflows, developed countries' inflows and as a percentage of the EEC countries' GDP), they also clearly increased in the period covering the accession year and two years after it (compared to two three-years periods

preceding the accession) in most countries and for most indicators (table 4). In the case of Bulgaria and Romania, which entered the EU in 2007, both absolute FDI inflows as well as relative indicators boomed 3 to 1 years before the accession, compared with the previous three years (table 4). Thus, as was the case with earlier EU enlargements, the 2004 and 2007 enlargements also boosted significantly FDI inflows into new member countries.

Figure 1. FDI inflows into EU 2004 accession countries, annual averages, millions of dollars



Source: UNCTAD FDI/TNC database.

E. Overall findings

There appears to be consensus in the literature that PTIAs lead to further FDI inflows, including in developing countries that are members of PTIAs. The impact is more evident in the case of FDI from outside of the economic grouping. PTIAs can also stimulate some intraregional FDI (Te Velde and Bezemer, 2004: 1). The latter impact can be

strong when PTIA membership includes both developed and developing countries. Both impacts have been observed, although with different intensities, in all types of agreements, involving developing countries, that is North–South (e.g., NAFTA) and South–South (e.g. MERCOSUR and ASEAN) agreements, but the impact of the latter seems to have been weaker than that of the former. Econometric studies covering large number of agreements have confirmed the impact of regional agreements and also often have demonstrated an impact of bilateral and interregional PTIAs on FDI flows into developing countries.

Notes

- ¹ The following paragraphs do not use the terms “intra- or interregional FDI”, but in each case indicate the firms concerned: member country firms, third country firms or all firms.
- ² For non-tradable services, the mechanism is different and will be discussed below.
- ³ Such units are sometimes also called multi-domestic stand-alone manufacturing affiliates.
- ⁴ For example, liberalization commitments under GATS related to so-called “commercial presence”, that is, FDI, are at a much lower level than a degree of unilateral liberalization.
- ⁵ Recent examples include several attempts of individual EU member countries to prevent foreign acquisitions of airline, power or gas companies.
- ⁶ See below the EU experience in this respect.
- ⁷ Stimulating intra-grouping FDI in services may not always be the case, if a PTIA involves only developing countries. The reason is that for FDI to occur, TNCs, or firms capable of becoming TNCs, are needed, and many developing countries do not yet have such firms. But, on the

other hand, services TNCs have emerged in more developed developing countries of Latin America, Asia and South Africa.

- ⁸ The World Bank study cited above is an exception.
- ⁹ These agreements include the Andean Community (ANDEAN), Asia-Pacific Economic Cooperation (APEC), European Free Trade Association (EFTA), European Union (EU), North American Free Trade Agreement (NAFTA), South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), the Closer Economic Relations Agreement between Australia and New Zealand (CER), the FTA between Israel and the United States and the ASEAN free trade agreement (AFTA) (Dee and Gali, 2003: 67–68).
- ¹⁰ SPARTECA – the South Pacific Regional Trade and Economic Cooperation Agreement – is a non-reciprocal agreement between Australia and New Zealand, on the one hand, and 12 South Pacific islands ranging from Cook Islands to Western Samoa, on the other hand. It came into effect in 1981.
- ¹¹ CER stands for the Australia-New Zealand Closer Economic Relations Free Trade Agreements (ANZERTA), commonly referred to as CER. CER is a series of agreements and arrangements, such as on free trade in goods and free trade in services, including FDI, which have been implemented after CER's entry into force in 1983.
- ¹² For example, studies on the impact of the EU single market programme on FDI.
- ¹³ For example, 1 if an agreement fully liberalizes FDI entry and 0 if it has many areas closed to FDI; 1 if it applies the highest standards of treatment or protection and low values if it has no or low standards. Then the scores for each IIA are added and an average is calculated (as given in table 3).
- ¹⁴ The United States and Jordan concluded a BIT prior to this agreement in 1997.
- ¹⁵ The model is based on the distinction between horizontal and vertical FDI, the former taking place between countries with similar skill endowments and the latter between countries with different skill levels.
- ¹⁶ Estimates are that, during that period, United States exporters lost some \$311 million as a result of trade diversion while United States

FDI increased by more \$3 billion, much more than needed to compensate for trade losses.

- ¹⁷ This explains a smaller impact of the United Kingdom's accession to the EEC in 1973 on that country's inward FDI: most of the main United States TNCs were already in the United Kingdom at the time of accession.
- ¹⁸ Commission of the EEC (1970), *La Politique Industrielle de la Communauté*, Part One, Brussels : 48.
- ¹⁹ Such strategies were pursued before by a few United States TNCs in Europe. The prominent example is the network of Ford's factories located in different EEC countries and specializing in different components assembled in an assembly plant. The single market prompted others – EU companies such as Philips and Siemens and United States companies such as 3M – to reorient their strategies from those based on national markets to those oriented to the regional market.
- ²⁰ Total EU inflows include both intra-FDI and inflows from third countries.
- ²¹ On the impact of Swedish accession on FDI, see Andersson and Fredriksson, 1993; and NUTEK, 1998.
- ²² On the impact of Irish accession on FDI, see Barry, 2003.
- ²³ Yannopoulos, 1990: 244-246. It should be noted that the United Kingdom was a great beneficiary of increased FDI inflows related to the "Europe 1992" programme. For example, out of \$70 billion of Japanese investment in the EU during 1987–1993, \$28 billion, or 40 per cent, was invested in that country (Kumar: 47).
- ²⁴ CEE accession countries have commonly used incentives to attract foreign investors into manufacturing, often in competition with one another, within limits imposed by the EU rules on state aid.
- ²⁵ The EU rules do not require member countries to privatize infrastructure services and state monopolies. Instead, they require member States to deregulate these services and introduce competition between providers, be it state-owned companies and/or private companies.
- ²⁶ The authors of a study published in 1999 concluded that they "do not expect a surge in FDI to the CEEC [that is, CEE countries] in future years" (Brenton *et. al.*, 1999: 119).

CONCLUSIONS

The past decades have seen a proliferation of IIAs, suggesting that IIAs are considered a useful element of FDI policymaking worldwide. IIAs have expanded both geographically and with regard to the number of participating countries. International investment rulemaking, in particular regional and bilateral, is becoming a widespread phenomenon covering all regions.

A recurrent issue in the discussions about the benefits of IIAs is to what degree these agreements fulfil their objective of encouraging more FDI. The debate on the impact of IIAs on FDI, previously perceived as a North–South issue, has recently gained new momentum. As a growing number of developing countries are becoming FDI exporters, they reconsider the role of IIAs as not only a device aimed at stimulating inward FDI from developed countries but also as a means to encourage and protect their own outward FDI in developed and other developing countries.¹

Since IIAs have become an important instrument in FDI strategies of all countries, policymakers need to know to what extent IIAs contribute to achieving this objective, including in comparison with the possible costs associated with these agreements -- such as the limitations they impose on national policy space and the costs of potential investor-State disputes that may arise on the basis of IIAs. Equally important is the question of whether the impact of IIAs on investment inflows varies by types of investment treaties. Enhanced understanding of the effects IIAs have on foreign investment can help avoid unrealistic expectations and facilitate more effective host country policies. This would include putting IIAs properly in the context of an overall strategy of attracting FDI with a view to maximising its

contribution to host countries' sustainable growth and development.

The host country determinants for FDI consist of (a) the general policy framework for foreign investment, including economic, political and social stability, the legislation affecting foreign investment and any other policies affecting FDI locational decisions; (b) economic determinants, such as the market size, cost of resources and other inputs or the availability of natural resources; and (c) business facilitation, including investment promotion. All three groups of determinants interact, enhancing or reducing the attractiveness of countries to foreign investment. IIAs are part of the policy framework for foreign investment, and are thus only one of many factors that impact on a company's decision where to make an investment. As a consequence, IIAs alone can never be a sufficient policy instrument to attract FDI. Other host country determinants, in particular the economic determinants, play a more powerful role.

The impact of IIAs on FDI has been measured in a series of econometric and other studies, published between 1998 and 2008. While these studies often arrive at different conclusions, and their findings are subject to important qualifications, several concur that IIAs can influence a company's decision where to invest. Several studies also concur that this impact is generally stronger (in terms of increased FDI inflows) in the case of free trade agreements, regional integration agreements or economic cooperation agreements than in the case of BITs. This is because PTIAs – more broadly – improve the economic determinants of FDI, as

opposed to BITs, whose influence is limited to the policy determinants of FDI.

IAs add a number of important components to the policy and institutional determinants for FDI, and thereby contribute to enhancing the attractiveness of countries to foreign investors. In particular, they improve investment protection and add to the security, transparency, stability and predictability of the investment framework. If IAs liberalize market access, as many of them do (in particular free trade agreements and regional integration schemes) they also improve an important economic determinant of foreign investment – the market size. The geographical expansion of regional integration schemes and/or deepening of integration, can, and in a number of cases did, stimulate additional investment inflows.

The impact of BITs on investment flows into developing countries is confirmed by investor surveys. For the majority of reviewed companies from all sectors, BITs' participation in host developing countries and transition economies plays a role in making a final decision on where to invest. Further evidence that TNCs increasingly make use of BITs is provided by the rapidly increasing number of investment arbitration cases based on these agreements – a development which is also creating increasing challenges for host countries.

In sum, developing countries wanting to attract more and better foreign investment may wish to strengthen the role of IAs as an investment promotion instrument. So far, most IAs promote foreign investment only *indirectly* through the

granting of investment protection and their contribution to the improvement of the economic determinants of FDI. One could imagine that IIAs could promote investment through more direct means, including home country measures (UNCTAD, 2004c). Such means could include a broad range of issues, for example, institutionalized exchanges of investment-related information, programmes towards fostering linkages between foreign investors and domestic companies, technical assistance and capacity-building programmes for investment promotion agencies, the granting of investment insurance, encouragement of technology transfer, easing informal investment obstacles, joint investment promotion activities, access to capital, financial and fiscal incentives, or the setting up of an institutional mechanism to coordinate the investment promotion activities (UNCTAD, 2008c). As policymakers develop IIAs with effective and operational investment promotion provisions, they may also wish to focus on targeting high-quality FDI and maximizing its contribution to sustainable host country development.

Note

- ¹ For details on the outward stock of FDI reported by developing countries, see UNCTAD, 2008b: 257–260; and UNCTAD 2007a: 255–258.

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Annex. A summary of econometric studies on the impact of BITs on FDI

Source	Dependent Variable	Period	Host and home countries	Explanatory variable related to BITs	Control variables	Econometric method	Econometric results	Conclusions
UNCTAD, 1998	1. Bilateral FDI flows; share of host country in home country's total outflows; share of home country in total host country's FDI inflows. 2. Total FDI inflows into a host country; FDI stocks; FDI/GDP	1971-1994	72 host developing countries, 14 OECD countries	Conclusion of a BIT	GDP of host country; population		BIT could cause small increase of FDI from a home partner country. But results are not robust. Small redirection of FDI to BIT partners	BITs appear to play a minor and secondary role in influencing FDI flows.
Hallward-Driemater, 2003	Bilateral flows of FDI; inflows/GDP; and share of home country outflows	1980-2000	133 host DCsa developing countries, 20 OECD countries. 537 pairs of countries	A total number of BITs concluded by a host country Conclusion of a BIT	GDP, population and domestic investment of host countries The size of the host and home country; inflation; trade/GDP; skills gap; components of institutional quality from ICRG (legal system and corruption). In addition, transition to a market economy and the conclusion of NAFTA	Cross-sectional stepwise regressions Fixed effects estimations.	BITs found to have a positive and statistically significant effect in three out of nine regressions No statistically significant effect of BITs on FDI inflows	BITs are complements to good institutional quality rather than substitutes
Banga, 2003	FDI inflows based on approved FDI from developed and developing countries	1980-81 to 1999-2000. 1986-87 to 1996-97 for panel data for 10 host countries	15 host developing countries from South, East and S-E Asia. All home developed and developing countries	FDI policies such as FDI liberalization, incentives, profit transfer and tariffs. Total number of BITs and dummies for APEC and ASEAN investment agreements	GDP and GDP growth; wages; education and labour productivity; cost of capital; exchange rate; infrastructure; debt and budget deficit.	Random effects estimation	FDI policies are an important determinant of FDI inflows, especially removal of restrictions. BITs play an important role in stimulating inflows, especially BITs with developed countries	

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Annex. A summary of econometric studies on the impact of BITs on FDI (continued)

Source	Dependent Variable	Period	Host and home countries	Explanatory variable related to BITs	Control variables	Econometric method	Econometric results	Conclusions
Tobin and Rose-Ackerman, 2003	1. Total FDI inflows, 5-year averages. Share of world inflows.	1975-2000	45 DCs	Total No. of BITs; No. of BITs with high- and low-income countries.	Log of GDP per capita; population; fuels and ores exports; black market rate of exchange premia; aggregate political risk; host country distance from equator	Fixed-effects estimation. In some cases random effects estimation is considered	BITs appear to have little impact on FDI. Negative effects at the high level of risk. Positive effect at the low level of risk. Majority of DCs are in the high risk category	
	2. FDI inflows from the United States	1980-2000	48 DCs	A BIT with the United States	Same specifications as above plus distance of host country from the United States; exchange rate stability; skill differences	Fixed effect estimation (in some cases pooled estimation)	Little relationship between a United States BIT and inflows from the United States. Where there is relationship it is weakly negative	
Egger and Paffermayr, 2004	Bilateral stocks of outward FDI in constant 1995 \$	1982-1997	19 home OECD countries (old and new) and 57 host countries (including 27 OECD countries)	Signed BITs (BITS) and ratified BITs (BITR) between countries during the period 1982-1997	Country size (GDP), factor endowments (tertiary enrolment), trade and FDI friction and interaction terms. In some specifications in addition (or instead): EU and NAFTA membership, real GDP per capita or secondary school enrolment (for factor endowments)	Fixed effect estimation	Positive impact of ratified BITs on FDI on bilateral stocks of FDI. In most of the cases positive impact of even only signing BITs on outward FDI, although at a lower significance level	Implemented BITs exert a positive and significant effect on real stocks of outward FDI
Büthe and Milner, 2004	Annual inflows of FDI into host countries	1970-2000	Up to 122 host developing countries with a population over 1 million	A total number of signed cumulative BITs	Variables for market size, economic development, economic growth, trade openness, domestic political constraints and political instability	Fixed effect analyses. Additional tests for heteroskedasticity and autocorrelation	Statistically and substantially significant correlation between BITs and subsequent inward FDI into developing countries	Each developing country has to weigh costs of BITs against their benefits of increased FDI and possibly other benefits

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Annex. A summary of econometric studies on the impact of BITs on FDI (continued)

Source	Dependent Variable	Period	Host and home countries	Explanatory variable related to BITs	Control variables	Econometric method	Econometric results	Conclusions
Salacuse and Sullivan, 2005	1. Total FDI inflows (% changes)	1998-1999 and 2000.	More than 100 DCs	A. United States BIT; a total No. of BITs with other OECD countries; a total with DCs	Host country GDP, GDP per capita, real effective exchange rate, population and rule of law	Multivariate Ordinary Least Squares (OLS) and cross-sectional regression. Fixed effect estimation	United States BITs have a large, positive and significant association with a host country's overall FDI inflows. Impact of other OECD BITs is weaker	Strong evidence that BITs have attained to a significant extent their stated goal of promoting FDI. Better to sign BITs with higher protection standards (like those in US BITs)
Neumayer and Spees, 2005	2. Bilateral FDI flow from the United States to a host country in constant 1996 \$; share of a host country's total inflows of DCs	1991-2000	31 DCs, USA. 300 observations	A. BIT with the US; no. of other OECD BITs	As above plus total FDI inflows	Random and fixed effects estimations	Positive effect of BITs with developed countries on FDI. Consistent and robust across various model specifications. The effect depends sometimes on institutional quality	Subsuming by developing countries to the obligations of BITs does have a desired payoff of higher FDI inflows. DCs signing more BITs with developed countries receive more FDI. But it is impossible to tell if benefits from increased FDI inflows are higher than costs of BITs for DCs
Grosse and Trevino, 2005	Annual FDI inflows into a host country	1990-1999	13 host countries from Central and Eastern Europe	No of BITs with OECD countries weighted by a share of a home country in world outward FDI flows	Log of per capita GDP and population size; GDP growth rate; WTO membership; no of bilateral trade agreements with home countries; inflation rate; natural resource intensity; political stability; institutional quality; investment risk index. Trade openness and secondary enrolment in sensitivity analysis	Standard multiple regression	BITs tend to stimulate inward FDI, together with the degree of enterprise reform and repatriation rules	The finding should be of interest to international organizations, including UNCTAD, and to host developing countries

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Annex. A summary of econometric studies on the impact of BITs on FDI (continued)

Source	Dependent Variable	Period	Host and home countries	Explanatory variable related to BITs	Control variables	Econometric method	Econometric results	Conclusions
Gallagher and Birch, 2006	Total FDI inflows; FDI inflows from the United States	1980-2003	24 host countries from Latin America	Total no. of BITs with the United States	Inflation, GDP, total exports or imports/GDP, literacy rate, GDP per capita, GDP growth, no. of privatizations	Fixed-effects estimation	Neither the total No. of BITs nor BITs with the US have an independent and positive effect on total FDI inflows or inflows from the United States	It may not be worthwhile to carry the costs of BITs such as lifting performance requirements and applying broad expropriation rules
Tobin and Rosen, 2006	Total FDI inflows into DCs in constant 2000 dollars. OECD outflows to DCs in constant dollars. Five-year averages	1980-2003	137 DCs (Increased from 40 DCs with all data, using best data predictions and other techniques)	Total number of BITs; Signed BITs, Weighted and un-weighted BITs index by the size of the home OECD country; interaction between host country BITs and total no. of BITs in the world	Political risk; GDP per capita; population; GDP growth; natural resource endowments; trade/GDP	Fixed-effects estimation.	Number of BITs with high income countries has a positive and significant effect on FDI inflows. More worldwide BITs reduce the marginal benefit of an extra BIT to a host country	As each extra BIT has decreasing benefits in terms of stimulating FDI inflows, host countries may be less eager to sign BITs over time
Egger and Merlo, 2007	Bilateral stocks of outward FDI	1980 - 2001	24 host countries; 22 of the 28 host countries are OECD countries	Dummy variable for BIT ratification (or conclusion)	Once-lagged FDI stocks; joint size of home and host country markets in terms of GDP; home-to-host country relative GDP; home-to-host country skilled-labour endowment ratio	Generalised Method of Moments (GMM) estimation	The variable for BIT ratification has a positive and significant impact on outward FDI stocks; the short-run impact of BITs is smaller than the long-run impact	There is a substantial difference between the existing positive short-run and long-run impact of BITs on FDI. Hence there is a need to take the dynamic nature of FDI more into account
Aisbett, 2007	Bilateral (log) inflows of FDI	1980-1999	28 DCs, 29 OECD countries. Less than 672 observations per year	Lagged BIT ratification	Host and home country GDP; population; share of trade in GDP; the skill gap between host and home country	Fixed effects estimation.	BITs are positively and significantly correlated with FDI inflows. But this does not imply that BITs cause large FDI increase (of up to 50%) because of endogeneity of BITs	The lack of evidence on the impact of BITs on FDI is important information for countries weighing the cost and benefits of beginning or expanding BITs programme

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Annex. A summary of econometric studies on the impact of BITs on FDI (concluded)

Source	Dependent Variable	Period	Host and home countries	Explanatory variable related to BITs	Control variables	Econometric method	Econometric results	Conclusions
Yackee, 2007	As in Neumayer and Spess, 2005, but adding a constant start to FDI share variable	1984-2003	Host developing countries and 18 home capital exporting countries	A weighted count of BITs signed by capital importing countries with 18 capital-exporting countries. Added to BITs FCN treaties and FTAs with investment provisions	As in Neumayer and Spess, 2005, with trade openness replacing the number of FTAs)	Same methodology as in Neumayer and Spess, 2005, with some changes, e.g., excluding year dummies	The case for BITs is far weaker than suggested by Neumayer and Spess. Small changes in methodology and model specifications make the BITs effect on FDI largely or entirely disappear. Institutional quality test shows an opposite conditional relationship than that found by Neumayer and Spess.	
Busse, Koeniger and Nunnenkamp, 2008	Three-year averages of bilateral FDI flows measured as a share of a host country in the outflows of a home country to all host countries in the sample. In tests for robustness bilateral FDI flows in US dollars and inflows as a share of host's country GDP	1978-2004	83 host DCs and transition economies and 28 home countries, including 10 DCs	Ratified BITs	Market size, macroeconomic stability, trade openness, per capita GDP differences and a dummy for free trade agreements. As part of a gravity model, dummies for a common border and language, colonial ties and the distance between host and home country. Political constraints on the executive branch for institutional development. Unilateral liberalization measured by a degree of a capital account openness	A gravity model using fixed effects estimation as well as General Method of Moments (GMM) estimation	BITs promote FDI inflows to developing countries from developed countries. The result is fairly robust across various models. BITs may substitute for weak local institutions	Policymakers in developing countries have resorted to an effective means to promote FDI by concluding BITs

Source: UNCTAD.

a. "DCs" stands for developing countries.

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