

Bilateral Investment Treaties, FDI, and Developing Countries

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Introduction

Bilateral investment treaties (BIT), which offer specific protections and rights for foreign investors in host countries with the hope that doing so will attract or maintain foreign direct investment (FDI), have increased tremendously since the conclusion of the first BIT between Germany and Pakistan in 1959. Since then, the number of BITs has increased to over 2950 by 2016 (see fig 1). While most literature have focused on the effects of BITs between developed capital exporters and developing host countries, little research to date has focused on the effects of BITs between developing countries . These so-called 'South-South' BITs are proliferating. Yet the impact of these BITs on investment flows is largely unknown.

Work on the impact of BITs and investment flows between developing countries is thin. There are several questions remain unresolved: Does a BIT between two developing country partners affect FDI inflows between the two? Is this affect focused regionally? What are the determinants that influence FDI flows between developing countries and are these different to determinants for FDI with a developed country partner?

Previous empirical research on the determinants for FDI, including the impact of BITs on FDI, have mainly focused on FDI flows from developed source countries to developing destinations. This paper is different in that it focuses on the link between BITS and FDI flows between developing countries. The link has been rarely investigated due to sparse bilateral data on fdi flows between developing countries. However, this hurdle has been partially overcome by the publication of more complete bilateral FDI statistics by UNCTAD, which allowed me to create a new dataset that includes bilateral FDI inflows for all developed-developing, developed-developed, and developing-developing country pairs where the data is available from 2001-2012. In addition, by utilizing a gravity model that treats BIT partnership as an endogenous determinant of bilateral investment flows and that also allows for zero bilateral investment flows, this paper extends previous research on BITs and FDI flows. Further, this paper looks at the relationship between domestic institutional quality and BITs. Few studies have assessed the complementarity or substitutability of institutions and investment treaties and no paper to my knowledge has assessed if and how this relationship differs between North-South and South-South country pairs.

This paper proceeds as follows. Section 2 reviews literature on the determinants of FDI, focusing primarily on literature that addresses the impact on BITs on FDI. Section 3 describes the variables and data used for the empirical estimation. Results are presented in section 4 and section 5 concludes.

2. Related Literature

Bilateral investment treaties have been touted as tools for attracting foreign direct investment; that aspiring host countries sign BITs in the hopes of boosting their overall attractiveness to foreign investment firms. The subsequent proliferation of BITs between developed and

developing countries is claimed to be the result of competition between host countries for a limited pool of FDI (Elkins, Guzman and Simon 2006).

Yet the empirical literature has come to conflicting conclusions about the effect BITs have on levels of foreign direct investment. Salacuse and Sullivan (2004) and Neumeyer and Spress (2005) find strong correlations between BITs and FDI using both aggregate and bilateral data. Whereas Hallward-Dreimeier (2003) and Tobin and Rose-Ackerman (2005) find little correlation between BITs and FDI inflows. In a subsequent study, however, Rose-Ackerman (2009) show that these conflicting findings are the result of underdeveloped conceptual frameworks, finding that, in contradiction to her earlier results, that BITs do indeed stimulate FDI inflows, but under complex domestic circumstances. Also attempting to tackle these earlier discrepancies, Buthe and Milner (2009) advance a theoretical argument concerning the political nature of BITs to explain the varied results of previous studies, ultimately finding that BITs substantially increase FDI inflows from developed countries to developing host countries, using monadic data.

The United Nations Conference on Trade and Development (UNCTAD), in 1998, first examined the impact of BITs on FDI using bilateral data for 14 home and 72 host countries. Their time series study found that BITs have a positive, yet slightly weak, effect on total FDI flows. A separate cross-sectional analysis of the study found a positive impact of BITs on total FDI flows and FDI flows relative to GDP. Their overall conclusion is that while BITs do play a role in attracting FDI, the impact is minor compared to leading determinants such as market size.

Hallward-Dreimeier (2003) reaches a similar conclusion after examining the impact of BITs on bilateral FDI flows between 20 home countries to 31 host (developing) countries from 1980 to 2000. Her findings show both negative and little positive impact of BITs on increasing levels of FDI and argues that this impact is partially obscured by other interactions between home and host countries, including trade barriers, other economic treaties, and imperfect information. She further finds that BITs act as compliments rather than substitutes for strong domestic institutions, leading her to conclude that "This undermines the central rationale for some of the less developed countries to enter into these agreements hoping to bypass the need to strengthen property rights and institutions more generally (pages 21-22)".

Other more recent studies have found a positive impact of BITs on FDI. Egger and Pfaffermayer (2004), in another dyadic analysis, look at signaling effects and find that both signed and ratified BITs have a positive effect on the stock of outward FDI of 19 home countries and 54 host countries from 1982-1997. While both treaty types have an effect, they find that ratified treaties have a greater impact than those merely signed, indicating that investment treaties act as a mechanism of credible commitment and enforcement, than signaling. Similarly, but with monadic data, Neumeyer and Spress (2005) look not just at whether BITs increase FDI, but whether they are compliments or substitutes for strong domestic political and economic institutions. They find that BITs do increase FDI between capital exporters and host (non-OECD) countries, but that results are inconclusive as to whether BITs are substitutes for good

governance and institutions. Tobin and Rose-Ackerman (2006) find that the number of treaties has a positive impact on FDI in early periods, but that their marginal effect diminishes and the number of global treaties increases. Further, they find that BITs and political environments for investment are compliments.

Why would BITs increase FDI flows as predicted? Bilateral investment treaties could be seen as legal instruments that are part of the fairly recent legalization of international politics (Goldstein and Martin 2000; Buthe and Milner 2009). As legal instruments, they signal to potential investors that host countries are prepared to provide a favorable host environment to foreign firms, without the fear of expropriation and excessive taxation. Looking at investment treaties between the US and developing countries, Haftel (2007) argues that BITs act as credible commitments that increase FDI when they are ratified, not just signed: only when BITs are in force do they carry strong legal obligations and are capable of being penalized for non-compliance, which is important for investors. Elkins, Guzman and Simmons (2006) and Neumayer and Spress (2005), on the other hand, find that all BITs (signed and in force) act as signaling devices to foreign investors, indicating that the host country is prepared to undertake liberal reforms and/or honor investment provisions outlined in the treaty in anticipation of signing more BITs in the future.

Buthe and Milner (2009) take a comprehensive look at previous studies on the relationship between BITs and FDI and propose a political theory of BITs and investment to explain why investment treaties should affect FDI flows. As legal instruments that establish specific rights and obligations, they are part of the “legalization” of international politics in the recent decades (Goldstein et al 2001). From the provision of most favored nation status, to the inclusion of arbitration clauses, allowing private parties to initiate binding arbitration proceedings against the government of the other signatory, these treaties serve an international legal function. But while they are firmly legal instruments (created to address legal concerns), Buthe and Milner argue that they exist to address a political problem: that host country concerns mainly arise from a lack of knowledge regarding the host government’s future commitment to economically liberal policies. Including the provisions they do, BITs give foreign investors rights that go well beyond unimpeded capital flows and guarantee compensation for expropriation. Rather, they constitute a commitment to economically liberal policies across a broad range of issues, as underlined by arbitration decisions.

3. Model and data

3.1 Model

The empirical analysis is based on the standard gravity model, commonly used to test trade flows between country pairs. Traditionally, the standard gravity model relates bilateral trade flows to the sizes of both source and host economies, the distance between them, and common language. Head and Reis (2007) provide theoretical support for a gravity model of FDI. The basic model specification is as follows:

$$\ln(FDI_{ijt}) = \beta_0 + \beta_1 \ln(GDP_{it}) + \beta_2 \ln(GDP_{jt}) + \beta_3 \ln(POP_{it}) + \beta_4 \ln(POP_{jt}) + \beta_5 \ln(D_{ijt}) + \beta_6 Cont_{ijt} + \beta_7 ComLan_{ijt} + \beta_8 BIT_{ijt} + \varepsilon_{ijt}$$

where FDI_{ijt} is the bilateral flow of FDI from country i to country j in time t . The standard gravity variables distance, contiguity, and common language are captured by D_{ijt} , $Cont_{ijt}$, and $ComLan_{ijt}$, respectively. WGI_{jt} is a proxy for the institutional quality of the host country, BIT_{ijt} is a dummy variable for a bilateral investment treaty between country i and country j in time t , ε_{ijt} are the error terms.

3.2 Data

FDI: The dependent variable is bilateral FDI inward flows. The data is from the United Nations Conference on Trade and Development's (UNCTAD) Bilateral FDI Statistics. This database, published in 2014, provides bilateral FDI inflow data for the years 2001-2012.¹ One problem with the dependent variable, that is common with log-specification of the gravity model, is the prevalence of zeros. To deal with negative FDI inflows and zeroes when taking the log-specification, I equate all negative and zero values to 1 to avoid dropping the zero values.

BIT: The main explanatory variable is a dummy variable for a signed BIT between two countries.² The data is from UNCTAD's International Investment Agreements database. It is predicted that bilateral FDI inflows would be positively influenced by the signing of a BIT.

Other explanatory variables: GDP and population are from the World Bank's *World Development Indicators* database. Market size (GDP) is predicted to attract FDI due to larger market access. The sign on the host country population is ambiguous; on the one hand, it may indicate a larger consumer base so the impact would be positive, on the other, population is often correlated with lower income levels. D_{ijt} , $Cont_{ijt}$, and $ComLan_{ijt}$ are from the CEPII.³ Both contiguity and common language are predicted to positively impact FDI, while distance, which is a proxy for transaction costs, is predicted to be a negative determinant of FDI.

Fixed effects: In the main models, year, host, and source fixed effects are included. In alternate estimations, year-country fixed effects are used.

3.3 Estimation

Poisson pseudo-maximum-likelihood (PPML) is the preferred estimator due to its ability to account for zeroes in the dependent variable arising from the log specification of the gravity model.

¹ UNCTAD's Bilateral FDI Statistics database provides data on inward and outward FDI flows and stock. Inward FDI flows are used in this analysis, while stock would have been preferable as they are less volatile than flow data. However, inward FDI stock statistics in this database are missing or incomplete for most developing countries.

² In additional analysis I look at the impact of only BITs that are entered into force.

³ www.cepii.fr

4. Results

Results for the basic model, using PPML, are displayed in Table 2. Model 1 includes all country pairs in the sample, whether developed-developing, developed-developed, or developing-developing. Model 2 includes only country pairs where the source (originating) country is considered a developed economy, while Model 3 includes only developing country pairs. Regarding control variables, a large market and shared language are positive and significant across all models, while distance is negative and significant, as predicted. Host country population is not a significant determinant of FDI flows, nor is contiguity, except in the case of developing country pairs. This may support previous research and data that suggests a significant amount of FDI flows between developing countries is intraregional, and thus more likely to be contiguous. The main explanatory variable, whether a BIT has been signed between a country pair, is positive and significant across all models, with a larger effect between developing countries (Model 3). This result may suggest that firms from developing source countries gain more mileage from a BIT; that they may not possess the internal and external expertise (networks, legal options, etc.) that larger firms from developed countries may have when investing in developing countries.

Table 2: Impact of bilateral investment treaties on FDI

Model/Estimator	(1) PPML	(2) PPML	(3) PPML
ln GDP source	0.64*** (0.04)	0.61*** (0.05)	0.30*** (0.11)
ln GDP host	0.39*** (0.06)	0.35*** (0.04)	0.40*** (0.12)
ln POP source	0.09 (0.15)	0.12 (0.15)	-0.79 (0.81)
ln POP host	1.47*** (0.20)	1.20*** (0.21)	2.11*** (0.62)
ln Distance	-0.45*** (0.02)	-0.43*** (0.02)	-0.51*** (0.06)
Contiguity	0.03 (0.05)	-0.10 (0.06)	0.28*** (0.13)
Common Language	0.36*** (0.04)	0.37*** (0.04)	0.24** (0.11)
BIT	0.17*** (0.03)	0.15*** (0.03)	0.31*** (0.08)
Constant	-26.76*** (1.64)	-24.92*** (1.79)	-18.54*** (5.37)
Year fixed effects	Yes	Yes	Yes
Country fixed effects	Yes	Yes	Yes
Country-year FE	No	No	No
R2	0.42	0.44	0.38
N	49,851	39,452	10,284

As mentioned previously, location decisions of MNCs may be influenced by the quality of host country institutions. To capture this influence, variables for institutional quality and colonial relationship are added to the main model, as well as a dummy variable for the presence of a free trade agreement. Further, there are unanswered questions concerning whether BITs are substitutes for or compliments of domestic institutional quality. On one hand, by signing a BIT, a host country offers foreign investors an external institutional framework that credibly commits them to protect their investment better than the domestic institutions are able to. In this case they are substitutes and we would expect a negative relationship. On the other hand, the signing of a BIT may act as a signaling device, declaring to foreign investors that the country is serious about protecting their investment and that the BIT is another layer on top of domestic institutions. To test this relationship, an interaction term between BIT and institutional quality is added to the expanded model.

The results for the expanded model, which includes institutional variables and interaction terms, are reported in Table 3. Models 1 and 2 include all country pairs in the sample, whether developed-developing, developed-developed, or developing-developing. Models 3 and 4 include only country pairs where the source (originating) country is considered a developed economy. Models 5 and 6 include developing country pairs. In terms of control variables, market size, host country population, colonial relationships, and FTA are all positive and significant. Similarly to the basic model, distance negatively impacts FDI inflows, while contiguity is a positive determinant only for developing pairs. Institutions exert a positive impact on FDI, as do BITs. Like the basic models, the effect of BITs on FDI is larger for developing country pairs. The interaction variable between BITs and institutional quality is negative across all country pair groups, suggesting substitutability; however is this result significant in the case of developing country pairs.

Table 3: Impact of bilateral investment treaties on FDI

Model/Estimator	(1) PPML	(2) PPML	(3) PPML	(4) PPML	(5) PPML	(6) PPML
ln GDP source	0.62*** (0.04)	0.62*** (0.04)	0.60*** (0.05)	0.60*** (0.05)	0.28** (0.11)	0.28** (0.11)
ln GDP host	0.33*** (0.04)	0.32*** (0.04)	0.30*** (0.04)	0.29*** (0.04)	0.36*** (0.13)	0.35*** (0.13)
ln POP source	0.11 (0.15)	0.12 (0.15)	0.13 (0.16)	0.13 (0.16)	-0.85 (0.81)	-0.85 (0.81)
ln POP host	1.59*** (0.20)	1.56*** (0.20)	1.31*** (0.21)	1.29*** (0.21)	2.29*** (0.63)	2.28*** (0.63)
ln Distance	-0.39*** (0.02)	-0.38*** (0.02)	-0.37*** (0.02)	-0.37*** (0.02)	-0.47*** (0.06)	-0.47*** (0.06)
Contiguity	0.03 (0.05)	0.03 (0.05)	-0.06 (0.06)	-0.07 (0.06)	0.20** (0.08)	0.20*** (0.08)
Common Language	0.29*** (0.04)	0.28*** (0.04)	0.30*** (0.04)	0.29*** (0.04)	0.12 (0.12)	0.12 (0.12)
Former Colony	0.48*** (0.08)	0.50*** (0.07)	0.50*** (0.08)	0.51*** (0.08)	0.47** (0.22)	0.47** (0.22)
Colonial Sibling	0.32*** (0.08)	0.30*** (0.08)	0.18* (0.09)	0.17* (0.09)	0.47** (0.18)	0.47** (0.18)

FTA	0.20*** (0.03)	0.20*** (0.03)	0.16*** (0.04)	0.16*** (0.04)	0.22*** (0.08)	0.22*** (0.08)
Institutions	0.26*** (0.06)	0.31*** (0.06)	0.24*** (0.07)	0.29*** (0.07)	0.29* (0.15)	0.32* (0.17)
BIT	0.17*** (0.03)	0.20*** (0.03)	0.15*** (0.03)	0.19*** (0.03)	0.31*** (0.07)	0.28*** (0.09)
BIT x Institutions		-0.107*** (0.03)		-0.09*** (0.03)		-0.06 (0.13)
Constant	-25.55*** (1.66)	-25.19*** (1.66)	-24.05*** (1.82)	-23.78*** (1.82)	-17.20** (5.42)	-17.05*** (5.41)
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Country fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Country-year FE	No	No	No	No	No	No
R2	0.43	0.43	0.44	0.44	0.39	0.39
N	49,851	49,851	39,452	39,452	10,284	10,284

Gravity models typically include multilateral resistances to control for the influences of third parties. Table 4 displays results for the expanded model with the inclusion of source-year and host-year fixed effects to control for multilateral resistances. Models 1 and 2 include only country pairs where the source (originating) country is considered a developed economy. Models 5 and 6 only include developing country pairs. The results are relatively consistent, minus the lack of significance for some control variables, with the last 4 models in Table 3, most notably larger coefficients on the BIT dummy variable between two developing countries.

Table 4. The impact of BITs on FDI, country-year FE (control for multilateral resistances)

Model/Estimator	(1) PPML	(2) PPML	(3) PPML	(4) PPML
ln GDP source	1.28 (0.03)	1.12 (3.05)	0.44 (0.30)	0.43 (0.30)
ln GDP host	0.97 (2.39)	0.87 (2.36)	-0.12 (0.27)	0.11 (0.20)
ln POP source	-1.46 (3.77)	-1.28 (3.74)	-0.62*** (0.10)	-0.62*** (0.10)
ln POP host	0.10 (0.41)	0.07 (0.41)	0.46 (0.35)	0.14 (0.26)
ln Distance	-0.38*** (0.02)	-0.38*** (0.06)	-0.47*** (0.06)	-0.48*** (0.06)
Contiguity	-0.07 (0.06)	-0.07*** (0.11)	0.20** (0.08)	0.19** (0.08)
Common Language	0.30*** (0.04)	0.29*** (0.04)	0.13 (0.12)	0.13 (0.12)
Former Colony	0.49*** (0.08)	0.51*** (0.08)	0.40* (0.22)	0.40* (0.22)
Colonial Sibling	0.17* (0.09)	0.16* (0.09)	0.53*** (0.18)	0.53*** (0.18)

FTA	0.14*** (0.04)	0.15*** (0.04)	0.24*** (0.09)	0.24*** (0.09)
Institutions	-1.19 (3.15)	-0.99 (3.12)	0.08 (0.40)	-0.19 (0.38)
BIT	0.15*** (0.03)	0.18*** (0.03)	0.31*** (0.07)	0.29*** (0.09)
BIT x Institutions		-0.08*** (0.03)		-0.05 (0.13)
Constant	-47.80 (120.22)	-42.13 (119.24)	-4.55 (6.94)	-8.87 (7.28)
Year fixed effects	No	No	No	No
Country fixed effects	No	No	No	No
Source-year FE	Yes	Yes	Yes	Yes
Host-year FE	Yes	Yes	Yes	Yes
R2	0.47	0.47	0.46	0.46
N	37,153	37,153	8,375	8,375

However, we cannot rule out that the signing of a bilateral investment treaty might be endogenous to FDI. Once investors are located within a country they may demand protections in the form of accountable institutions, whether internal or external, thus providing a feedback effect on institutions and treaty signage. Further, outward looking countries (those embracing and seeking foreign investment) may well have higher quality institutions and have signed BITs. In order to address these issues, I re-estimate the base models with instrumental variables. Due to the lack of acceptable external instruments, I rely on internally generated instruments from lagged values of the endogenous variables. Because of the time invariant nature of many of the variables, I use the Hausman-Taylor estimator, a transformed random effect model with instrumental variables that can distinguish between time variant and time invariant variables.

Results for the expanded instrumental variable model are reported in Table 5. Models 1 and 2 include all country pairs in the sample, whether developed-developing, developed-developed, or developing-developing. Models 3 and 4 include only country pairs where the source (originating) country is considered a developed economy. Models 5 and 6 include developing country pairs. In terms of the main explanatory variable, BIT, the variable is positive and significant for developing country pairs, while not significant for the full model and developed-developing pairs.

Table 5: The impact of BITs on FDI, IV (Hausman-Taylor)

Model/Estimator	(1) IV	(2) IV	(3) IV	(4) IV	(5) IV	(6) IV
ln GDP source	0.44*** (0.04)	0.45*** (0.04)	0.44*** (0.06)	0.44*** (0.06)	0.28*** (0.07)	0.29*** (0.07)
ln GDP host	0.50*** (0.04)	0.49*** (0.04)	0.49*** (0.05)	0.48*** (0.05)	0.44*** (0.07)	0.44*** (0.07)
ln POP source	0.19	0.20	0.29**	0.30**	-1.64***	-1.64***

	(0.13)	(0.13)	(0.14)	(0.14)	(0.41)	(0.41)
ln POP host	1.80*** (0.20)	1.75*** (0.20)	1.77*** (0.23)	1.72*** (0.23)	1.80*** (0.36)	1.79*** (0.36)
ln Distance	-0.78*** (0.03)	-0.77*** (0.03)	-0.81*** (0.04)	-0.80*** (0.04)	-0.51*** (0.06)	-0.51*** (0.06)
Contiguity	0.53*** (0.07)	0.51*** (0.09)	0.63*** (0.11)	0.61*** (0.11)	0.55*** (0.13)	0.54*** (0.13)
Common Language	0.56*** (0.07)	0.56*** (0.07)	0.65*** (0.08)	0.64*** (0.08)	0.40*** (0.12)	0.40*** (0.12)
Former Colony	0.62*** (0.13)	0.63*** (0.13)	0.67*** (0.15)	0.68*** (0.15)	1.44*** (0.30)	1.44*** (0.30)
Colonial Sibling	0.37*** (0.10)	0.36*** (0.08)	0.40*** (0.14)	0.38*** (0.14)	0.20 (0.15)	0.20 (0.15)
FTA	0.16*** (0.03)	0.16*** (0.05)	0.21*** (0.05)	0.21*** (0.05)	-0.07 (0.08)	-0.07 (0.08)
Institutions	0.26*** (0.07)	0.34*** (0.07)	0.26*** (0.08)	0.34*** (0.09)	0.27*** (0.10)	0.29*** (0.11)
BIT	0.04 (0.03)	0.06 (0.05)	-0.01 (0.06)	0.05 (0.07)	0.20** (0.09)	0.17 (0.11)
BIT x Institutions		-0.18*** (0.06)		-0.19*** (0.07)		-0.06 (0.13)
Constant	-22.16*** (1.59)	-21.74*** (1.60)	-22.54*** (2.07)	-22.14*** (2.07)	-11.85*** (2.98)	-17.05*** (5.41)
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Country fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Country-year FE	No	No	No	No	No	No
Sigma u	0.99	0.99	0.96	0.95	0.84	0.84
Sigma e	1.54	1.54	1.62	1.63	1.15	1.15
rho	0.29	0.29	0.26	0.26	0.34	0.34
N	49,869	49,869	39,482	39,482	10,387	10,387

5. Conclusion

Most of the literature on the impact of BITs on FDI has focused on the relationship between developed and developed countries, largely ignoring investment flows and treaties between developing countries. This is not surprising given the dearth of bilateral investment data between developing countries until recently. Would we expect BITs to act on investment flows the way they are hypothesized for flows between large, developed countries and small, developing ones? On one hand, firms from developing countries themselves may be inured to less robust institutional environments in other developing countries, and thus less likely to need credible commitment mechanisms to overcome that obstacle. On the other, ‘neighborhood effects’ might not matter and given that firms from developing countries are generally smaller than MNCs from developed countries, they may have less resources at their disposal to deal with similarly less robust, yet different, institutional environments. In this case, a BIT may offer more protection to these firms and may matter more. Empirical results indicate that BITs do

matter for investment, across most country pairs, but they matter for developing country pairs. This is an interesting result that deserves to be theoretically addressed on its own in future research. This paper also sought to address whether BITs and host country institutions are complements or substitutes. The results indicate that they are indeed substitutes, but that this results is not significant for developing pairs.

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