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World Development Vol. 33, No. 10, pp. 1567–1585, 2005
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Printed in Great Britain
0305-750X/$ - see front matter

doi:10.1016/j.worlddev.2005.07.001

Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?

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Summary. — Foreign investors are often skeptical toward the quality of the domestic institutions and the enforceability of the law in developing countries. Bilateral investment treaties (BITs) guarantee certain standards of treatment that can be enforced via binding investor-to-state dispute settlement outside the domestic juridical system. Developing countries accept restrictions on their sovereignty in the hope that the protection from political and other risks leads to an increase in foreign direct investment (FDI), which is also the stated purpose of BITs. We provide the first rigorous quantitative evidence that a higher number of BITs raises the FDI that flows to a developing country. This result is very robust to changes in model specification, estimation technique, and sample size. There is also some limited evidence that BITs might function as substitutes for good domestic institutional quality, but this result is not robust to different specifications of institutional quality.
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Key words — foreign direct investment, bilateral investment treaties, institutional quality, protection, risk

1. INTRODUCTION

Developing countries sign bilateral investment treaties (BITs) in order to attract more foreign direct investment (FDI). In recent decades, BITs have become "the most important international legal mechanism for the encouragement and governance" of FDI (Elkins, Guzman, & Simmons, 2004, p. 0). The preambles of the thousands of existing BITs state that the purpose of BITs is to promote the flow of FDI and, undoubtedly, BITs are so popular because policy makers in developing countries believe that signing them will increase FDI. But do these treaties fulfil their stated purpose and attract more FDI to developing countries that submit to the obligations of a BIT? Despite the large and increasing number of BITs concluded, there exists very little evidence answering this question. Most existing scholarships, typically written with a legal perspective, simply restrict themselves to an analysis of the BIT practice of one country or certain similar provisions in a range of BITs (Vandevelde, 1996, p. 545). This omission is strange given that the question is of great importance to developing countries. They invest time and other scarce resources to negotiate, conclude, sign, and ratify BITs. Such treaties represent a nontrivial interference with the host countries' sovereignty as they provide protections to foreign investors that are enforceable via binding investor-to-state dispute settlement. While the motivations driving developing countries to incur these costs may be varied (see Elkins *et al.*, 2004; Guzman, 1998; Neumayer, 2005), the costs might be justified if the ultimate outcome is an increase in the inward flow of FDI. [1] But is this what actually occurs?

In the absence of hard, quantitative evidence, some observers have been rather pessimistic toward the effect of BITs on FDI location. Sornarajah (1986, p. 82), for example, suggests that "in reality attracting foreign investment depends more on the political and economic climate for its existence rather than on the creation of a legal structure for its protection." An expert group meeting sponsored by the

* We thank three anonymous referees as well as Anne van Aaken, Ken Shadlen, and Susan Rose-Ackerman for many helpful comments. Eric Neumayer acknowledges financial support from the Leverhulme Trust.

United Nations Conference on Trade and Development (UNCTAD) in 1997 reportedly held a similar position (Raghavan, 1997). Supportive of this view is that some major hosts of FDI such as Brazil or Mexico for a long time were reluctant to sign BITs. As UNCTAD (1998, p. 141) has put it in a review of BITs from almost a decade ago: "There are many examples of countries with large FDI inflows and few, if any, BITs." And yet, most developing countries have signed a great many BITs by now. Is there evidence that those that have signed more BITs have also managed to attract more FDI?

Two studies analyze this issue over the period 1980–2000 (Hallward-Driemeier, 2003; Tobin & Rose-Ackerman, 2005) and one over the period 1991–2000 (Salacuse & Sullivan, 2005). The first study by Hallward-Driemeier (2003) does not find any statistically significant effect. The second study by Tobin and Rose-Ackerman (2005) finds a negative effect at high levels of risk and a positive effect only at low levels of risk, with the majority of developing countries falling into the high-risk category. The third study by Salacuse and Sullivan (2005) finds a positive effect only for United States BITs, but not for BITs from other countries of the Organization of Economic Co-operation and Development (OECD). The existing evidence goes against expectation and would suggest that the enormous amount of effort developing countries have spent on BITs has basically been wasted. One of the problems of existing studies is that they infer results from a rather restricted sample of countries (31 and 63, respectively) or are based on cross-sectional regressions. In contrast, we employ a much larger panel over the period 1970–2001, covering up to 119 countries. Importantly, we find a positive effect of BITs on FDI inflows that is consistent and robust across various model specifications. The effect is sometimes conditional on institutional quality, but is always positive and statistically significantly different from zero at all levels of institutional quality. To our knowledge, we provide the first hard evidence that there is a payoff to developing countries' willingness to incur the costs of negotiating BITs and to succumb to the restrictions on sovereignty contained therein.

Having demonstrated that BITs successfully increase the flow of FDI coming to a country, another important question that we address is whether BITs function as substitutes or complements to good institutional quality. Naturally, one would expect them to be substitutes, that is, they provide security and certain standards of treatment to foreign investors where domestic institutions fail to deliver the same security and standards. However, some, like Hallward-Driemeier (2003) argue that BITs might only be seen as credible in an environment of good institutional quality. This would imply that BITs are most effective in countries where they are least needed. Our results provide some limited evidence that BITs might function as substitutes to poor institutional quality, which would suggest that they are most effective where such quality is low and that they are most successful where they are needed most. However, this result is not robust to different specifications of institutional quality.

This article is structured as follows: Section 2 briefly describes the well-known fact of increasing importance of foreign investment to developing countries, illustrates the growth of BITs, and analyzes the role of their main provisions for the promotion of FDI. We then review the three existing empirical studies and discuss their shortcomings, which we aim to overcome in our own analysis. After presenting our research design, we report results and test the sensitivity of results to important changes in model specification. The final section concludes.

2. BITS AND FDI

The flow of FDI has dramatically increased in the past several decades to become a major force in the worldwide allocation of funds and technology. Prior to 1970, world trade generally grew at a greater pace than that of FDI, but in the decades since then, the flow of FDI has grown at more than twice the pace of the growth of worldwide exports. By the early 1990s, the sales of worldwide exports would be eclipsed by the sales of foreign affiliates of multinational firms (Dunning, 1998). Not only has the flow of FDI increased worldwide, but the importance of FDI as a source of funds to developing countries in particular has also significantly increased. Private international flows of financial resources have become increasingly important to developing countries. In the 1980s, tight budgets, the debt crisis, and an overall decreased interest in providing traditional development aid led to a decline in official development assistance from the developed world. When capital flows to developing

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