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Foreign direct investment and bilateral investment treaties: An international political perspective

Rodolphe Desbordes [a], Vincent Vicard [b,*]

[a] University of Strathclyde, United Kingdom
[b] University of Paris I Panthéon-Sorbonne and Banque de France, France

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ABSTRACT

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This paper investigates the effect of the implementation of bilateral investment treaties (BITs) on the bilateral stocks of foreign direct investment (FDI). We argue that the understanding of how BITs affect FDI requires recognizing that multinational enterprises (MNEs) are not Stateless and that their investment return may well depend on the quality of political relations between the home and host countries. Using bilateral FDI data and event data to measure political interactions between countries, we show that the effect of the entry into force of a BIT crucially depends on the quality of political relations between the signatory countries; it increases FDI more between countries with tense relationships than between friendly countries. We also find evidence that BITs and good domestic institutions are complementary. BITs should therefore be understood as a mechanism for host governments to credibly commit not to expropriate investors in the future. *Journal of Comparative Economics* **37** (3) (2009) 372–386. University of Strathclyde, United Kingdom; University of Paris I Panthéon-Sorbonne and Banque de France, France.
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1. Introduction

"*Ulysses, too, saw the value of binding himself to the mast. Constraints on sovereignty are, therefore, the aim of the exercise. In a world of international transactions and multiple jurisdictions, constraints on sovereignty are also desirable. Otherwise, the potential for conflict and unpredictability seems almost limitless.*" (Wolf, 2005, p. 91)

The reduction in trade barriers over the second half of the last Century went hand in hand with increasing regulation of international trade flows, via the creation of supranational institutions – preferential trade agreements at the regional level, and the World Trade Organization at the multilateral level – and interaction between domestic and international institutions, such as the New York Convention (Berkowitz et al., 2006). On the contrary, international capital flows, especially foreign direct investment (FDI), do not benefit from global governance mechanisms enforcing common rules: the property rights of foreign investors are instead protected by bilateral investment treaties (BITs).

BITs are signed between two countries in order to encourage, promote and protect investments between them (UNCTAD, 2000). They include expropriation clauses defining what is deemed to be expropriatory behavior and specify compensation and dispute-settlement mechanisms, such as the recourse to international arbitration courts. In this respect, BITs are

* Corresponding author. Address: 106-112, bd de l'hôpital, 75647 Paris Cedex 13, France.
E-mail address: vincent.vicard@malix.univ-paris1.fr (V. Vicard).

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considered to reduce both the risk and the cost of investing abroad. Using bilateral panel data, Egger and Pfaffermayr (2004) find that the implementation of a BIT increases the outward FDI stock by 30%.[1] This average effect may nevertheless hide heterogeneity in the effectiveness of BITs across country pairs. As suggested by Martin Wolf, in the absence of constraints on the host country's sovereignty, the activities of multinational enterprizes (MNEs) are subject to the host governments' actions. BITs are thus a means for host governments to credibly commit not to expropriate MNEs in the future. In this paper, we argue that, as a commitment device, the effectiveness of a BIT should depend on the risks to which MNEs are exposed in the host country.

MNEs face two kinds of political risks when investing abroad: systemic domestic risk, which is common to all investors, related to the quality of domestic institutions, and an idiosyncratic risk specific to each pair of home and host countries, resulting from interstate political relations. As the existing literature on FDI has largely considered that FDI takes place in an international political vacuum, the latter risk has been ignored.[2] Anecdotal evidence and survey work however suggest that interstate political relations have a significant effect on MNEs' decisions to invest abroad. This effect may be positive or negative. Transparency International (2002) emphasizes that, after corruption, diplomatic pressure is an important means for MNEs to gain business advantages. More crucially, foreign firms may suffer from the retaliatory consequences of deteriorating diplomatic relations between their home and host countries, through various types of expropriation (Boehmer et al., 2001). Foreign investors are, therefore, likely to be sensitive to the quality of interstate political relations, as any deterioration may increase the risk of seizure of their investment return in a given host country. In this framework, BITs should increase the volume of bilateral FDI not only directly by reducing costs, but also indirectly through two channels: first, by offsetting political tensions between states and the resulting expropriation risks; second, as a costly signal that the host government will not diminish the protection of property rights granted by domestic institutions. A BIT and good domestic institutions are complements in attracting FDI (Hallward-Driemeier, 2003).

The link between FDI and interstate political relations has only rarely been investigated, due to the lack of information on the quality of these relations over recent decades. We overcome this obstacle by the use of a new database compiling a large number of recent interstate political interactions. This indicator allows us to estimate their impact on bilateral FDI stocks between 30 OECD countries and 62 OECD and non-OECD countries over the 1991–2000 period. We control for the self-selection of countries into BITs by including country pair fixed effects, as suggested by Baier and Bergstrand (2007) in the context of regional trade agreements. We first show that the quality of political relations between countries significantly increases bilateral FDI flows. We then find that the positive effect of a BIT on FDI stocks depends crucially on the quality of interstate relations, increasing FDI more between countries with political tensions. We also find that the effectiveness of the host government's credible commitment increases with the quality of domestic governance. Good domestic institutions and BITs are indeed complements.

This paper proceeds as follows: Section 2 reviews the different arguments explaining the links between interstate political relations, bilateral investment treaties and FDI. Section 3 describes the indicators used to evaluate the quality of interstate political relations, and explains the specification and data used in the empirical estimation. The impact of interstate political relations and BITs on bilateral FDI stocks is then presented in Section 4. Section 5 concludes.

2. Related literature

The number of BITs dramatically increased starting in the 1990s. By the end of 2005, 2495 treaties had been signed, of which 1891 had entered into force, suggesting that an increasing number of countries see them as a way of attracting FDI and protecting their FDI outflows. The number of BITs by region is shown in Fig. 1.

The emergence of BITs as the main way of protecting foreign investors' property rights[3] occurred during an uncertain and changing period regarding the regulation of international investments (Guzman, 1998). The classic formulation of the customary international law on FDI, known as the "Hull Rule", requires "prompt, adequate and effective compensation" in the case of expropriation by the host government. This rule has been challenged by Latin American countries and former colonies, and weakened by resolutions adopted by the UN General Assembly in the 1960s and 1970s. The Charter of Economic Rights and Duties of states adopted by the UN General Assembly in December 1974 emphasized the sovereignty of host countries regarding their treatment of foreign investors (Guzman, 1998, 2007). In the framework of this charter, domestic courts are the only authority which can determine appropriate compensation.

Bubb and Rose-Ackerman (2007) point out that the protection provided by the customary international law on FDI is weak: any claim by an expropriated foreign investor has to be supported by its home government in order to proceed. Moreover, claims can only cover egregious expropriation and not simple breaches of contract. These cases of open expropriations

[1] Work using aggregate FDI data has found an ambiguous impact of BITs on FDI, ranging from positive (Neumayer and Spess, 2005) to insignificant (Rose-Ackerman and Tobin, 2005).

[2] Nigh (1985) is one of the few papers in the international business literature to have considered this subject. He finds that conflictual and cooperative diplomatic relationships exert, respectively, negative and positive effects on US manufacturing FDI in developing countries. The empirical work is however restricted to US diplomatic relationships, does not account for other FDI determinants, and only covers the particular period of the Cold War (1948–1978).

[3] UNCTAD (2008) reports that, in 2007, 78% of the investor-state cases filed under international investment agreements were initiated following a violation of a BIT provision, 13% under NAFTA, and 6% under the Energy Charter Treaty.

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