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Journal of Comparative Economics 32 (2004) 788–804

Journal of COMPARATIVE ECONOMICS

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# The impact of bilateral investment treaties on foreign direct investment

Peter Egger [a,*], Michael Pfaffermayr [b]

[a] *Helen Kellogg Institute for International Studies at the University of Notre Dame, 130 Hesburgh Center, Notre Dame, IN 46556-5677, USA*

[b] *University of Innsbruck, Universitaetsstrasse 15, 6020 Innsbruck, Austria*

Received 2 June 2003; revised 12 July 2004

**Egger, Peter, and Pfaffermayr, Michael**—The impact of bilateral investment treaties on foreign direct investment

This paper uses a large panel of OECD data on stocks of outward foreign direct investment (FDI) to evaluate the impact of bilateral investment treaties. For several variants of the knowledge capital model of multinationals, we demonstrate that investment treaties exert a significant positive effect on outward FDI, if they actually are implemented. Moreover, even signing a treaty has a positive, although lower and in most specifications insignificant, effect on FDI. *Journal of Comparative Economics* **32** (4) (2004) 788–804. Helen Kellogg Institute for International Studies at the University of Notre Dame, 130 Hesburgh Center, Notre Dame, IN 46556-5677, USA; University of Innsbruck, Universitaetsstrasse 15, 6020 Innsbruck, Austria.
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*JEL classification:* C23; F12; F23

* Corresponding author.
*E-mail address:* pegger@nd.edu (P. Egger).

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doi:10.1016/j.jce.2004.07.001

## 1. Introduction

The first bilateral investment treaty (BIT) was signed between Germany and Pakistan in 1959 and came into force in 1962. Up to 1999, another 1856 BITs have been signed and further BITs are expected in the future (United Nations, 2000). BITs are designed to facilitate foreign direct investment (FDI) from economies with abundant capital and skilled labor, i.e., mainly OECD countries, to the less developed economies. Many of the existing BITs between the current OECD economies involve one old and one new OECD member. For example, the Czech Republic, Hungary, Poland, and the Slovak Republic concluded BITs with old OECD members in the early 1990s and then joined the OECD afterwards. The theoretical literature on the expected impact of BITs on FDI is not conclusive. Hoekman and Saggi (2000) argue that, due to some differences in national rules, BITs may be the source of higher transaction costs and uncertainty from a firm's perspective. Although this point would support an argument for a harmonized global BIT, i.e., a multilateral investment treaty, these authors concede that differences in cultural, political, and general business climate characteristics are more important determinants of the transaction costs associated with FDI.

Formally, BITs regulate FDI-related issues such as admission, treatment, expropriation, and the settlement of disputes at the bilateral level. Ex ante, they establish transparency about risk and, thus, reduce the risk of investing in a country. Ex post, BITs ensure that firms have certain rights, e.g., property rights, and preserve them from expropriation.[1] According to the Fact Sheet on the US bilateral investment treaty program released by the Office of Investment Affairs of the Bureau of Economic Business Affairs, the program's basic aims are the following.[2] First, BITs should protect US FDI in those countries where US investors' rights are not protected through existing agreements. Second, they should encourage host countries to adopt market-oriented domestic policies that treat private investment fairly. Third, they should support the development of international law standards consistent with these objectives.[3] In some sense, BITs extend an investor's property rights and regulate how host governments must arbitrate disputes covered by the treaty. Further, BITs define what is deemed expropriation, formulate how and under which conditions property may be expropriated, and determine how quickly and comprehensively investors must be compensated.

The UNCTAD (1998) study summarizes the following features of BITs, which are designed to attract FDI. First, BITs facilitate and encourage bilateral FDI between the contracting parties. To achieve this goal, most BITs guarantee foreign investors fair and equitable, non-discriminatory, most-favored-nation and national treatment in addition to access to international means of dispute resolution. Moreover, BITs usually provide legal protection of both physical and intellectual properties under international law and investment guarantees with a special focus on the transfer of funds and expropriation, including

[1] Maskus (2000) addresses the issue of protecting intellectual property. Drabek and Payne (2002) considers the importance of the risk of expropriation.

[2] Hallward-Driemeier (2003) provides further details.

[3] Hoekman and Saggi (2000) remark that, with the notable exception of those negotiated by the US, BITs do not usually address the question of market access liberalization.

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