The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows

Lauge Skovgaard Poulsen, *London School of Economics and Political Science*
With thousands of bilateral investment treaties (BITs) and double taxation treaties (DTTs) in existence, an expanding literature has over the last decade begun to ask whether the treaties actually impact international investment flows. With respect to BITs, their stated purpose is to protect and promote foreign investments. Bearing in mind the potential costs of BITs, some argue that if the last part of this objective is not fulfilled, developing countries should perhaps consider alternative instruments to attract foreign investors. Similarly, DTTs are intended to reduce the administrative complexities of foreign investments as well as confront double taxation problems. But if developing countries’ reduced tax revenues due to DTTs are not matched by increases in foreign investments, perhaps it would be prudent for developing countries to preserve their jurisdiction to tax foreign investors. The two types of international investment agreements (IIAs) therefore present developing countries with the same underlying strategic question: are they effective legal instruments to attract foreign investors?

Karl Sauvant and Lisa Sachs have compiled a long list of the most widely quoted studies investigating this question as well as a number of hitherto unpublished papers. Reflecting the balance in the literature the majority of the studies investigate the impact of BITs and practically all contributions apply econometric techniques. But while most of the authors may share a quantitative approach as their methodological foundation, their chapters differ starkly in conclusions: some find that IIAs have a strong effect on international investment flows, some find only a weak effect, some find no effect, and some even find negative effects. Unfortunately for policy-makers, anything close to a consensus on the economic implications of IIAs is therefore nowhere in sight.

Space constraints naturally preclude one from commenting on all contributions. The volume does, however, provide an opportunity to take a step back and ask why the literature to date has been so divided in its conclusions. While different statistical estimation strategies are obviously relevant, the editors of the volume also briefly point to more fundamental reasons in their useful introductory chapter. Some of these are worth discussing here, along with a few challenges not mentioned by the editors.

First of all, while DTTs are more or less standardized documents, BITs can vary markedly in their substantive and procedural provisions. So perhaps the different results are partially a result of not controlling for such variation in content. For instance, one would expect that BITs with market access provisions have a greater impact on investment flows than BITs.
only covering the post-establishment phase.\(^1\) Similarly, BITs which incorporate a legally binding consent to arbitrate a wide range of investment disputes with private investors are likely to be valued more highly by investors than BITs where such consent is limited or absent. While in his contribution, Jason Yackee finds that even BITs with ‘strong’ arbitration provisions do not appear to have an impact on FDI, there is certainly much scope for further work in this area.

Secondly, the endogenous relationship between investment flows and the presence of IIAs makes it difficult to disentangle causation from correlation: do investors choose to invest in certain countries as a result of IIAs, or are treaties signed among countries already exchanging large investment flows? No matter how many covariates quantitative studies try to include, they will have to address this difficult problem. In their study on the effects of US DTTs, for instance, Bruce Blonigen and Ronald Davies focus on treaties entered into during the 1980s and 1990s, since the US did not pursue DTTs with already ‘important’ investment partners during those decades. Some of the earlier contributions in the field, however, fail to confront the endogeneity problem. In her important analysis, Emma Aisbett, for instance, shows that a widely quoted study included in the book fails carefully to control for the possibility of reversed causality, which in turn questions its conclusion that BITs have a strong impact on FDI.

Thirdly, developing countries have often entered into IIAs as part of broader economic reform packages, which means the treaties come into effect alongside a number of other domestic and international economic instruments. To the extent that simultaneous initiatives, such as free trade agreements or reforms in domestic investment and taxation codes, have an impact on investment flows, they would have to be taken into account.

Fourthly, a related point is that developing countries often enter into IIAs when heads of state meet at home or abroad. Such high-level meetings typically involve many other bilateral economic cooperation initiatives, however, and to the extent such initiatives lead to investment projects between the two countries they could also result in systematic biases if not controlled for.\(^2\) To my knowledge, no studies have directly confronted this possible source of endogeneity.

Fifthly, the effects of IIAs are likely to depend on a range of political and social conditions which can be difficult to measure. The statistical analysis of Henry Louie and Donald Roussland, for instance, implies that if one does not take into account the ‘quality’ of host-country governance, it results in the misleading conclusion that DTTs encourage outward US FDI. But irrespective of recent advances in quantitative indexes measuring ambiguous concepts such as governance or institutions, it remains a challenge carefully to control for such intangible variables.

Finally, perhaps the most daunting challenge for all quantitative studies is that bilateral FDI data are inherently poor, whether measured as flows or stocks. This makes any econometric evaluation of the determinants of FDI a difficult task. IIAs are, for instance, likely to be more important in certain sectors than others. Although limited in sample size, one survey indicates that executives of foreign affiliates in manufacturing sectors find DTTs more important to their investments than those in other sectors.

\(^1\) Note that two recent econometric studies come to conflicting conclusions as to whether US BITs (which include liberalization provisions) have an impact on investment flows. See Peinhardt and Allee, ‘The Costs of Treaty Participation and Their Effects on U.S. Foreign Direct Investment’, paper presented at American Society for International Law’s International Economic Law Interest Group Meeting, Washington, DC, USA, Nov., 2008 [finding that they don’t], and Haftel, ‘The Effect of U.S. BITs on FDI Inflows to Developing Countries: Signaling or Credible Commitment’, paper prepared for the workshop on Globalization, Institutions and Economic Security (GIES), The Ohio State University, Nov. 30, 2007 [finding that they do].

\(^2\) Thanks to Mahnaz Malik for bringing this point to my attention.
their counterparts in service sectors. And with respect to BITs, historical experience – as well as recent developments in parts of Latin America – shows that resource extraction sectors are particularly prone to discriminatory, or even predatory, government interference. Accordingly, natural resource investors may take more notice of BITs than investors in less politicized sectors. The importance of IIAs for the investors’ decision-making process is also likely to depend on the size of the investment. This may particularly be the case for BITs, as their enforcement mechanism can involve significant arbitration costs for the investor should it come to a dispute with the host state, which may make the treaties more or less redundant for small investors. On the other hand, very large multinationals can often rely on diplomatic protection by their home state and are moreover able to bargain for investor-state contracts with similar or greater legal guarantees than those provided in BITs. In turn, this implies that if BITs are important in the pre-establishment phase of foreign investment decisions, it would mostly be for medium-scale investors. Unfortunately, however, these hypotheses are inherently difficult to test using international investment data, which are too incomplete and often incomparable at disaggregated levels.

Given these constraints, one could therefore ask – as indeed Yackee does in his contribution – whether econometric techniques are in fact particularly useful for investigating the effect of IIAs on investment flows. A useful approach for future studies would perhaps be to ask foreign investors themselves whether they take these treaties into account when deciding where, and how, to invest? This could be in the context of surveys or detailed empirical case studies, but practically no such work has been done, and one can therefore hardly blame the editors for not complementing the quantitative contributions with further qualitative evidence. Instead, the editors have included a few studies engaging in legal analyses of why IIAs may, or may not, attract foreign investments. Allison Christians’ very insightful contribution, for instance, is a hypothetical case study of a DTT between the United States and Ghana. She argues that, given the global competition to attract foreign investments, DTTs provide little tax relief for multinationals investing in least developed countries, and countries like Ghana are therefore not likely to benefit substantially from DTTs. The volume also includes Andrew Guzman’s often-quoted argument that BITs’ unique enforcement mechanism constitutes a ‘credible commitment’ for foreign investors by ensuring that pre-investment promises are not broken after the investment has been made. Whatever the merits of such arguments, the volume undoubtedly benefits from including non-quantitative contributions as it provides a much-needed balance in a book otherwise dominated by statistical debates.

All in all, Sauvant and Sachs have therefore managed to compile a comprehensive

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overview of the state-of-the-art within the literature on IIAs and FDI. Irrespective of methodological challenges, the volume is a valuable point of reference for scholars and practitioners alike. It reminds the reader that it would be imprudent to rely on any one individual study to infer how, if at all, IIAs impact the flow of international investment, as this question essentially remains unresolved. Furthermore, reading the book from one end to the other convinced this reader, at least, that while there is definitely scope for improvement within the econometric literature, the debate could gain tremendously from carefully constructed qualitative studies.

**Individual contributions:**

Kenneth J. Vandervelde, *A Brief History of International Investment Agreements*;
Peter Muchlinski, *The Framework of Investment Protection: The Content of BITs*;
Andrew Guzman, *Explaining the Popularity of Bilateral Investment Treaties*;
Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction*;
Jeswald W. Salacuse and Nicholas P. Sullivan, *Do BITs Really Work: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*;
Tim Büthe and Helen V. Milner, *Bilateral Investment Treaties and Foreign Direct Investment: A Political Analysis*;
Eric Neumayer and Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*;
Peter Egger and Michael Pfaffermayr, *The Impact of Bilateral Investment Treaties on Foreign Direct Investment*;
Robert Grosse and Len J. Trevino, *New Institutional Economics and FDI Location in Central and Eastern Europe*;
Kevin P. Gallagher and Melissa B.L. Birch, *Do Investment Agreements Attract Investment: Evidence from Latin America*;
Susan Rose-Ackerman, *The Global BITs Regime and the Domestic Environment for Investment*;
UNCTAD, *The Impact on Foreign Direct Investment of BITs*;
Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract FDI? Only a Bit … And They Could Bite*;
Jason Yackee, *Do BITs Really Work? Revisiting the Empirical Link between Investment Treaties and Foreign Direct Investment*;
Emma Aisbett, *Bilateral Investment Treaties and Foreign Direct Investment: Correlation Versus Causation*;
Deborah L. Swenson, *Why Do Developing Countries Sign BITs?*
Bruce A. Blonigen and Ronald B. Davies, *Do Bilateral Tax Treaties Promote Foreign Direct Investment?*
Bruce A. Blonigen and Ronald B. Davies, *The Effects of Bilateral Tax Treaties on U.S. FDI Activity*;
Peter Egger, Mario Larch, Michael Pfaffermayr and Hannes Winner, *The Impact of Endogenous Tax Treaties on Foreign Direct Investment: Theory and Empirical Evidence*;
Henry J. Louie and Donald J. Rousslang, *Host-Country Governance, Tax Treaties and U.S. Direct Investment Abroad*;
Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*;
Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?*;
Tom Coupé, Irina Orlova and Alexandre Skiba, *The Effect of Tax and Investment Treaties on Bilateral FDI Flows to Transition Economies*.

Lauges Skovgaard Poulsen
London School of Economics
Email: l.n.poulsen@lse.ac.uk
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