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Financing Global Development: Can Foreign Direct Investments be Increased through International Investment Agreements?

Summary

The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.

Foreign direct investment (FDI) is hailed as an important source of external financing for many developing countries. Improving developing countries' access to global FDI flows is thus a central aim of the international community, as documented by the past two United Nations Conferences on Financing for Development, in Monterrey in 2002 and Doha in 2008. The need to set up a "stable and predictable investment climate" as a precondition to attract FDI was emphasised in the outcome documents of the Monterrey and Doha conferences. International investment agreements (IIAs) are mentioned as effective policy instruments to promote FDI flows. In fact, many developing countries signed IIAs to attract FDI and, in turn, promote economic development.

This standard justification is increasingly being questioned by critics of IIAs. An increasing number of policy-makers, scholars and non-governmental organisations argue that IIAs, by and large, have not resulted in increased FDI flows and, worse still, they fear that IIAs excessively restrict host countries' ability to adopt public policies aimed at promoting sustainable development. Incidentally, this scepticism has also set the tone of the draft for the accord to be adopted at the Addis Ababa conference. It emphasises that FDI can have a positive impact on development, but only if foreign investors adhere to social and environmental standards, and if IIAs do not constrain domestic policy space to implement development-oriented policies.

The overview of the empirical evidence on the effects of IIAs on FDI flows suggests that this scepticism is well-justified. Although various studies find a positive impact of IIAs on FDI, in light of methodological challenges to actually measure this impact and alternative evidence, these results should be interpreted with great caution. Furthermore, researchers have only recently tried to account for different treaty designs. They find that treaty content matters and not all IIAs have the same effect on FDI flows. For example, treaties with market-access provisions have a positive effect on FDI, in particular if they are included in preferential trade and investment agreements (PTIAs). The hotly debated investor-state dispute-settlement (ISDS) clauses, on the other hand, have no effect on FDI.

Policy-makers in developing countries hoping to attract FDI should therefore pay closer attention to the actual design of IIAs. The empirical evidence suggests that they have some room to improve the compatibility of IIAs and national policy objectives by reformulating the standards of investment protection. In Addis Ababa, the international community should come up with proposals for how developing countries can be supported in order to reform their IIAs.

Origins, motives and design of IIAs

IIAs were invented by West European countries after the Second World War to tackle a very specific problem – the political insecurity faced by Western companies in the developing world. Many governments of newly independent countries adopted policies aiming at expropriating the property of foreign companies and restricting the transfer of funds. Traditional investment treaties included a core of substantive provisions that ensured that foreign investors would enjoy fair and equitable treatment by their host state, were compensated in the case of direct or indirect expropriation and had the right to move investment-related capital freely across borders. The majority of the more than 3,000 IIAs that have been concluded to date are modelled on this approach (see Box 1). Often these IIAs also include provisions that required host states to honour individual investment contracts signed between investors and host states. Since the late 1980s, investor-state arbitration mechanisms have become a standard feature of IIAs. Importantly, these traditional IIAs only protect foreign investments after they have been admitted by the host state. In other words, most IIAs do not include provisions that liberalise the market access of foreign investments.

This set of investment provisions that was designed in response to a historically unique problem – namely widespread expropriation, discrimination of foreign investors and denunciation of contracts from the 1950s to the 1970s – is still at the core of modern investment treaties. The open-ended and often vague drafting of these core protection standards already seemed less relevant in the 1980s. Despite this fact, IIAs became popular among developing countries during the phase of the Washington Consensus, when liberalisation was the gospel of the time. Since the 1990s, policymakers in Latin America, Africa, Eastern Europe and Asia signed IIAs *en masse* in the hope of attracting foreign investment flows (see Figure 1). At this time, this policy choice was a relatively safe bet, as the consequences of IIAs on host countries' policy-making seemed negligible.

The calculation changed when foreign investors discovered IIAs as a powerful instrument to enforce their property rights *vis-à-vis* their host states. The first ISDS case was filed in 1987, but the majority of cases only appeared after the turn of the new millennium in the context of the North American Free Trade Agreement (NAFTA). According to the United Nations Conference on Trade and Development (UNCTAD), the number of known investment arbitration cases amount to 608. In 2014 alone, 42 new ISDS cases were filed. The sudden rise of these cases took most countries by surprise, as they underestimated the actual risk of being sued by foreign investors when signing IIAs in the past (Poulsen, forthcoming). As a result, the number of newly signed standalone investment treaties has abated considerably since the early 2000s. At the same time, investment rules are increasingly being negotiated in the framework of PTIAs. Many modern PTIAs also include provisions that liberalise market access for foreign investors and prohibit the use of performance requirements such as local content policies and technology-transfer obligations.

Box 1: Key provisions of IIAs

Investment protection
- fair and equitable treatment
- compensation for (indirect) expropriation
- national and most-favoured-nation treatment
- free transfer of funds

Investment liberalisation
- market-access commitments
- prohibition of performance requirements

Dispute settlement
- investor-to-state investment arbitration

Source: Author

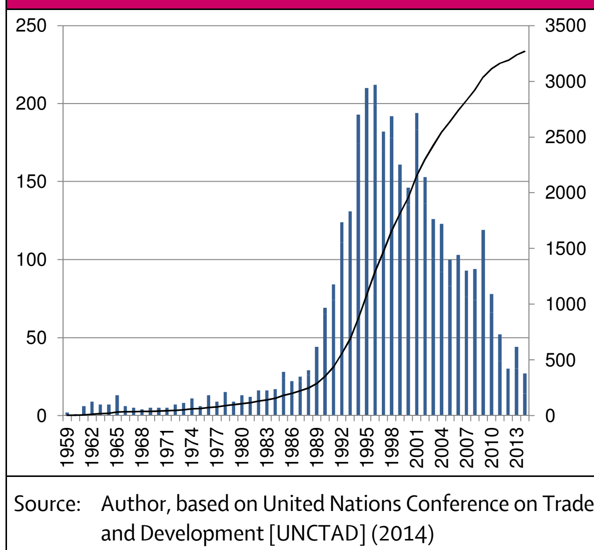
What do we know about the effects of IIAs on foreign investments?

The first studies to analyse the effects of these treaties on FDI flows did not emerge before the late 1990s and early 2000s. This is striking insofar as many, if not all, of the developing countries that have signed these treaties since the late 1950s did so in the hope of attracting more FDI. Many of the more than 3,000 IIAs have thus been signed on the basis of a hypothetical connection between IIAs and FDI without any empirical support for this claim.

The empirical evidence available on the effects of IIAs on FDI flows is inconclusive. Although most of the econometric studies tend to find a positive relationship between IIAs and FDI flows, there are others that find no – or even negative – effects of IIAs on FDI flows. This inconclusiveness is not surprising in light of the empirical challenges to measure the impact of IIAs on FDI flows. These challenges relate to the applied methodologies as well as to data. With regard to the first aspect, econometric methods are often sensitive to changes of the estimation technique – in the case of IIA effects on FDI, even slight changes have generated very different results. Another methodological challenge relates to the so-called endogeneity problem, which questions the role IIAs play in promoting FDI. More specifically, it may be the case that high FDI flows lead to the signing of IIAs ("reverse causality") and that unobservable variables are responsible for increases in FDI rather than IIAs. For example, empirical studies on the effects of IIAs do not sufficiently take the adoption of liberal economic policies – which often go hand in hand with the signing of IIAs – and their effects on FDI into account.

Furthermore, the data that is being used to measure the effects of IIAs on FDI is insufficient. The main challenge for econometric estimations is the fact that bilateral FDI data is often unavailable. If available, the bilateral FDI data usually does not allow for distinguishing between different motives of the investors, modes of market entry and targeted sectors. However, the effects of IIAs may differ depending on the specific characteristics of investment projects. The highly

Fig 1: Annual and cumulative signed IIAs, 1959–2014



Source: Author, based on United Nations Conference on Trade and Development [UNCTAD] (2014)

aggregated FDI data that is available does not allow for taking this into account.

One of the main deficiencies of many empirical studies is that they treat IIAs as black boxes, ignoring the fact that their specific contents may differ (Berger et al. 2013). One important variation of IIA design, for example, lies in the strength of the ISDS clause. Without comprehensive ISDS clauses, foreign investors find it more difficult to directly enforce their legal rights granted by the treaty. Interestingly, recent evidence suggests that strong investor-state mechanisms do not lead to more FDI compared to treaties that omit such a clause.

In addition to ISDS provisions, the effects of provisions that reduce market-access barriers for foreign investors have been tested. In contrast to the illusive effect of investor-state arbitration provisions, recent studies find that provisions that grant investors national treatment during the pre-establishment phase do have a significant positive effect on FDI flows; however, only when such provisions are integrated in PTIAs. Interestingly, this effect disappears when market-access clauses are included in IIAs. These findings indicate that foreign investors are more aware of investment rules in trade agreements – which typically received more public attention – than in standalone investment treaties, as they are often negotiated below the radar of public attention.

Related to the empirical literature on the effects of IIAs, studies on the effects of bilateral or regional trade agreements on FDI generally conclude that they have a positive impact (Büge, 2014). The positive effects of trade agreements on FDI, even if these treaties do not have comprehensive chapters of investment, may be explained by the fact that greater openness to trade also makes the signatories more attractive destinations for foreign investors.

In light of these challenges to empirically assess the impact of IIAs on FDI flows, one should only cautiously draw concrete policy conclusions from these econometric studies. Important alternative sources of empirical evidence on the impact of IIAs on FDI are surveys of multinationals' investment decisions (Yackee, 2010). The majority of these surveys conclude that, at the very best, IIAs play only a minor role in corporate decision-making concerning the volume and location of foreign investments. Yet, another source of evidence questioning the effectiveness of IIAs is found in large bilateral FDI, which do not have investment treaty protection. The most striking example is Brazil, which is a main destination for global FDI flows but does not have a single IIA in force. Also, foreign investments of US multinationals in China – and rapidly growing Chinese investments in the United States, for that matter – thrive without being protected by an IIA.

The overview of the empirical literature shows that IIAs are no panacea for developing countries hoping to attract foreign investors. Although IIAs may have positive effects on FDI flows in some instances, the existing empirical evidence surely makes it clear that policy-makers in developing countries should sign IIAs with the necessary caution, in particular in light of costly ISDS cases that may be filed on the basis of these treaties. IIAs are, furthermore, only one among a number of different legal, economic and business-related determinants impacting the investment decisions of multinationals (UNCTAD, 2009). Even among the legal determinants, IIAs are not the only instrument at the disposal of policy-makers in developing countries. The domestic regulatory framework is of utmost importance. Furthermore, IIAs are only one legal instrument to be employed by developing countries to complement their domestic regulatory framework in order to increase the confidence of foreign investors. Investment contracts, for example, can be signed by host-country governments with foreign investors for specific investment projects.

What policy options do developing countries have?

The inconclusive empirical evidence on the effects of IIAs on FDI suggests that policy-makers in developing countries have room to move when it comes to the signing – or the refusal to sign – and redrafting of investment treaties. In principle, developing countries have three options available: *do nothing, NAFTA-isation and termination.*

The first option, *do nothing*, means that developing countries continue with their past treaty-making practice, which often means signing IIAs that include sweeping provisions and grant investors considerable rights or legal protection. In light of the increasing number of ISDS cases and the inconclusive evidence on the impact of IIAs on FDI, this approach cannot be considered a viable alternative for developing countries.

The second option, *NAFTA-isation*, refers to the adoption of innovative treaty language developed in North America in response to a number of high-profile ISDS cases. The United States, Canada and Mexico have subsequently reformulated a number of substantive provisions to shift the balance between the protection of foreign investments and host countries' ability to regulate FDI in the public interest in favour of the latter. A number of important capital-exporting countries, including China and the European Union, have

emulated the NAFTA approach, which indicated that developing countries have a certain scope to insist on the inclusion of more balanced provisions in newly negotiated IIAs without risking alienating foreign investors. In fact, some countries such as India or the members of the Southern African Development Community already have put forward new treaty templates.

At the same time, the United States and Canada, followed by economies such as Japan and the European Union, include provisions aiming at increasing market access to foreign investors. The inclusion of market-access commitments in most recent IIAs and PTIAs represents a challenge for many developing countries. As previously discussed, these clauses are particularly suited to encouraging investment flows into developing countries within the framework of PTIAs. However, by agreeing to the inclusion of market-access clauses and rules on the use of performance requirements, host countries give up considerable rights to regulate foreign investments.

The NAFTA-isation of international investment rule-making is thus a double-edged sword for developing countries. The advantages of the introduction of more balanced post-establishment provisions have to be weighed against reduced policy space with regard to the ability to regulate the entry of foreign investors and the use of performance requirements.

Developing countries, in view of national development strategies, should thus consider precisely which sectors should be opened up during the negotiation of investment treaties.

A small number of developing countries – including Bolivia, Ecuador and South Africa – have announced their decision to *terminate* their IIAs. The South African example shows that a host country's decision to unilaterally terminate IIAs creates serious frictions with capital-exporting countries and may – at least in the short run – negatively affect its investment climate. Although a relatively attractive investment destination such as South Africa may continue to attract foreign investments, smaller and less successful economies might be more negatively affected by the unilateral termination of IIAs. Besides the fact that such an exit from the international investment regime cannot be achieved quickly – as most IIAs include a so-called survival clause, which stipulates that investors can rely on the legal protection provided by a terminated treaty for another 10 to 20 years – it runs the risk of severely alienating foreign investors, in particular when national investment laws are more restrictive than the provisions included in IIAs.

The Financing for Development conference in Addis Ababa should go beyond the stipulation that future IIAs should be designed in a way to not constrain host countries' policy space. A debate is needed about what type of IIAs and which clauses are most effective in promoting FDI flows. Also, developing countries need assistance in reforming their existing network of IIAs – often, the oldest treaties are used by foreign investors to sue host states. The international community should, furthermore, advance reforms of the multilateral arbitration regime, which should include a global investment court and an appeals mechanism.

Literature

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Axel Berger
Researcher
Department V: „World Economy and Development Financing"
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)

© German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)
Tulpenfeld 6 · 53113 Bonn · Germany · Tel.: +49 (0)228 94927-0 · Fax: +49 (0)228 94927-130
E-mail: die@die-gdi.de · URL: www.die-gdi.de
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