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Revisiting the Role of Bilateral Investment Treaties in Foreign Direct Investment

Alessandro Cusimano[1,*], Eun Sun Godwin[2], Stephen McKay[3] & Metka Potocnik[4]

[1]Department of Economics, Business and Statistics, University of Palermo, Italy

[2]Department of Business, Business School, University of Wolverhampton, UK

[3]College of Social Science, School of Social and Political Sciences, University of Lincoln, UK

[4]Law School, University of Wolverhampton, UK

*Corresponding author: Department of Economics, Business and Statistics, University of Palermo, Italy. E-mail: alessandro.cusimano@unipa.it ORCID: 0000-0001-7935-4116

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Abstract

This article revisits the role of Bilateral Investment Treaties (BITs) in Foreign Direct Investment (FDI). It investigates, in particular, the institutional quality of the host countries, the number of cases brought for resolution, plus a more nuanced formulation of numbers of BITs, focusing on developing host countries.

The analysis looks at more recent developments in BITs and incorporates economic freedom as a proxy of institutional quality of the host countries and considers the number of Investor-State Dispute Settlement (ISDS) in the BITs. We assume a non-linear relationship between BIT and FDI. Models are run using feasible generalized least squares (FGLS). Our new findings reveal that there is an optimum level of BITs in attracting FDI (higher and lower numbers do worse), constituting a re-appraisal of past analyses. Previous ISDS cases show a significant negative relationship with FDI. Economic Freedom has a strong positive and significant relationship with FDI/GDP, as previously found.

Keywords: Foreign direct investments (FDIs); Bilateral Investment Treaties (BITs); Feasible Generalized Least Squares (FGLS), Investor-State Dispute Settlement (ISDS)

1. Introduction

Foreign direct investment (FDI) has long been considered beneficial to the development of states through a positive impact on economic growth (An *et al.*, 2023; Cambazoglu and Kaapla, 2014; Onafowora and Owoye., 2019) and other spillover effects from investing Multinational Enterprises (MNEs) (Narula and Driffield, 2012; Ramasamy *et al.*, 2017; Villar *et al.*, 2020; Yamin and Sinkovics, 2009). At the same time, international investment agreements (IIAs) have also been increasingly encouraged in international, regional and bilateral trade and investment agreements as a vehicle of 'investment protection' for foreign investors (mainly MNEs) as they are expected to help signatories attract FDI to their countries (UNCTAD, 2023b). This is particularly so for developing and less developed countries where lack of transparent, efficient or effective institutional environment often deters FDI inflows to these countries. The most common form of investment treaties is Bilateral Investment Treaties (BITs) which are agreements between two countries aiming to promote and protect foreign investments. This paper studies the effects of the strength of BITs on FDI activity. We include measures of the strength of international dispute settlement provisions included in BITs in order to examine the role the content of BITs plays in attracting FDI. To this end, we make use of data from UNCTAD's International Investment Agreement Mapping Project and measure the provision strength of 2,571 BITs. Using panel data of bilateral and total FDI inflows and inward FDI stocks, we study the effect of BITs on FDI.

Despite the apparent desirability of the negotiated investment treaties to contribute and promote sustainable development, the text of most old-type treaties, BITs do not expressly refer to it. Instead, BITs in their Preambles refer to "prosperity" to be increased among all the signatories of the treaty (e.g. Australia/Hong Kong BIT in 1993; Nigeria/Germany BIT in 2000; Nigeria/China BIT in 2001) (Investment Policy Hub, 2024; UNCTAD, 2023a). This means that arbitrators that decide arbitration cases based on these treaties, under which a foreign investor is seeking damages against the host state, are under no obligation to take sustainable development into account when making their decision. To avoid any doubts as to the intended role of IIAs in promoting sustainable development, modern IIAs now expressly refer to the concept in their Preambles "REAFFIRMING their [contracting states] commitment to promote sustainable development and the development of international trade in such a way as to contribute to sustainable development in its economic, social and environmental dimensions" (CETA, 2016, Preamble, para. 9) (European Union, 2017a; 2017b).

However, several studies have been questioning the actual positive impact of IIA on attracting FDI (a good summary of evidence review can be found in UNCTAD 2014). Even with strong Investor-State Dispute Settlement (ISDS) provisions, the effectiveness of BITs in attracting FDI remains elusive (Berger *et al*., 2011). A recent UNCTAD IIA issues report also highlights the need for a speedy IIA reform, particularly in relation to investor-state arbitration decisions (UNCTAD, 2023a). Even though new-generation IIAs feature provisions aimed at safeguarding States' right to regulate and reform ISDS, the report's review suggests that the desired effects are not clear yet (ibid). At the same time, the ambiguity of the BIT effect on FDI inflows might still be determined by the host country's institutional environment (measured as a constructive business environment with effective and efficient regulatory

structure, openness, government intervention, etc.) (North, 1990; 2005). Hence, this paper revisits the role of BITs in FDI development with the following research question:

- *What is the role of BITs in FDI and how do institutional features shape that role?*

Here, our focus on institutional features includes the extent of cases brought for resolution, and the degree of economic freedom in each country.

It advances knowledge by:

a) Looking at more recent developments at a time of limited new arrangements.

b) Capturing information on BITs in a sufficiently non-linear manner to cast doubt on past analyses, or at least contextualise them.

c) Including information relating to economic freedom, proxy infrastructural information, and regarding dispute resolution in practice.

The structure of the study is as follows: the next section presents background of BITs and its relations to FDIs. The third section reviews legal implication of IIAs and discuss the theoretical background for discussion on IIA impact on FDI, which will be followed by methodology and analysis section. The final section discusses policy implication and methodological suggestions for future studies.

2. Background

2.1 Bilateral Investment Treaties

BITs have increased dramatically since the start of the 21st century. Falvey and Foster-McGregor (2017, p.2) track BITs development from having only 75 BITs at the end of the the 1960s, to 389 by the end of the 1980s, with around 2,832 at their time of writing (2,220 in force), with a further 455 investment agreements of other kinds (i.e., Treaties with Investment Provision, TIPs) (376 in force) (Investment Policy Hub, 2024). The period from 1990 to 2010 saw a significant increase in the number of BITs signed between countries. However, since around 2010, the number of new BITs being signed has mostly stagnated. Overall, the rise of BITs from 1990 to 2010 can be attributed to the increasing importance of foreign investment in the global economy and the desire of countries to attract that investment. The stagnation in the number of new BITs since 2010 can be attributed to a combination of criticisms of ISDS, shifting priorities among some countries, and the rise of regional agreements.

2.2 Bilateral Investment Treaties (BITs) and Foreign Direct Investment (FDI)

The literature presents mixed evidence regarding the link between BITs and FDI. BITs may significantly increase FDI inflows by providing an international legal framework that protects foreign investors against political risk in the host country (e.g. Neumayer and Spess, 2005; Oh and Fratianni, 2017) but results of studies which found IIA as a positive determinant of FDI are also complex depending on the contents of IIA (UNCTAD, 2014). Additionally, Sirr *et al.* (2017) show how BITs seem to be more positively related to vertical than to horizontal FDI.

The implication from these studies is that IIAs certainly play a positive role in attracting FDI, but whether the role is as decisive as a determinant has not been agreed. Moreover, there is lack of attention on whether IIAs play any role in impact of FDI on the host country at the post-FDI stage. These studies suggest that FDI is driven by factors such as market size, growth prospects, labour costs, political stability, and infrastructure of the host country, rather than the presence of BITs (e.g. Yackee, 2010). No doubt important, but less explored, is that any links will depend on the details of the specific terms and conditions contained in the treaty, and in particular on how such agreements are enforced in practice (Allee and Peinhardt, 2011). Given the propensity for publication of 'strong' results, Reite and Bellak (2021) used meta-analysis to try to uncover the likely effects of BITs on FDI, concluding that any true effects must be very small.

As IIAs exert additional costs to host countries, policy implication of IIAs in relation to FDI might need to be considered at an encompassing level incorporating issues regarding attracting, maintaining and utilising benefit from FDI (Büthe and Milner 2004; Gallagher and Birch, 2006; Neumayer and Spess 2005). Whilst there is a dearth of studies which explore whether and/or how legal instrument might help or hinder the process of a host country fully exploiting benefits from FDI, this issue is significant for 'sustainable development' of many countries. Legal instruments/treaties aiming at protecting MNEs' investment bring differing dynamism between MNEs and host country governments/societies.

There is also scepticism about the effectiveness of IIAs in relation to investment settlement disputes (Frenkel and Walter, 2018; Uttama, 2021) – e.g. *"Skovgaard Poulsen and Aisbett (2013) show that the likelihood of signing new BITs declines significantly after a host country has been subject to a claim itself"* (Aisbett *et al*., 2018, p.120). Others may have shifted their priorities away from attracting foreign investment and towards other policy goals such as environmental protection, human rights, and economic diversification.

Results are also affected by having two competing statistical design methodologies in published papers. Most use adopts the familiar gravity equation, relating bilateral FDI flows to standard gravity variables (e.g. distance and economic size) and a dummy variable taking the value one if a country-pair has formed a BIT (a dyadic approach). A related literature tests whether countries that sign BITs see an increase in aggregate FDI inflows (monadic approach). While, in principle, BITs only protect investors from the signatory states to whom binding commitments have been made, their existence may also signal that this host country protects the interests of foreign investors more generally. If this is the case, then BITs encourage FDI inflows from both BIT partners and non-BIT sources.

3. Literature Review

The literature on the history and role of international investment treaties is vast and has changed with time, to keep pace with the developments in treaty practice. In this section, we will introduce a brief legal context of BITs and other IIAs with institutional theory as the theoretical background to conceptualize the specific of 'how', 'in what way', 'to what extent' IIAs play

their role in attracting FDI.

3.1 The Current Legal View: Criticism Towards ITA and ISDS

Although it would seem obvious that there must be evidence that supports the proposition that investment treaties (in the broadest sense) boost FDI in states that have signed them, the empirical evidence on this is not that clear. There is undoubtedly empirical evidence to support that FDI is crucial for the development of any state. That however does not necessarily include the sub-proposition that it is investment treaties that increase inward FDI.

Without such clear evidence, the existence of investment treaties has recently undergone some serious criticism. The vast literature and policy response focus more specifically on the criticism of ITA and broad substantive protection in IIAs (UNCTAD, 2023a). ITA is a way to settle investment disputes between foreign investors from one (home) state and the state in the territory in which the investment has been made (host state) (Franck, 2009; Investment Policy Hub, 2024). In most cases, ITA is based on a dispute resolution provision in the investment treaty between the home and the host states. The treaty provision contains the state's offer to arbitrate any future dispute with the foreign investor, under the conditions set in the treaty (arbitration without privity) (Franck, 2009). Once the foreign investor files a notice of arbitration under this treaty, the offer to arbitrate is deemed to have been accepted and arbitration agreement formed (UNCTAD, 2023a).

ITA as the mechanism for settling investment disputes, has traditionally been identified as the main advantage and progress in international investment law. Investment arbitration offers control to individual investors over their investment dispute and involved interests, severing their dependence from their home states. ITA therefore gives independent legal standing to private parties (non-state) to enforce state's legal obligations under the international treaty (international law). This is a unique feature of ITA that does not have a comparator in international law. This gives the foreign investor control over the investment disputes and severs its dependency on its home state for the solution of its dispute with another sovereign (host) state. Foreign investors will have this advantage over any domestic competitors, who can only enforce their legal rights within the parameters of the domestic legal (court) system (Kaufmann-Kohler and Potesta, 2020; Marceddu and Ortolani, 2020)

However, ITA is dispute settlement system mostly delocalised and detached from any supervision. International arbitral tribunals deciding these cases have ample discretion in the law they apply: the only truly binding legal instrument in ITA is the relevant investment treaty. Moreover, there is no appeal to the arbitral awards made in ITA with limited review of international arbitral awards (e.g. under Article V of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards; ICSID Convention). Moreover, Arbitral tribunals in ITA are not permanent judiciary bodies. Their rules and procedures originate from international commercial arbitration. Arbitral tribunals are not bound by decisions of other tribunals, as there is no doctrine of precedent in international law.(Note 1) Although not desirable, arbitral tribunals do have the discretion to decide each case as it stands in front of them and based on the international agreement that applies. It is not unlawful to focus solely on the four corners of the investment treaty to decide a case (ibid).

The main criticism towards ITA is that its system is skewed in favour of the foreign investors. According to UNCTAD, there have been 1,229 ITA cases in total, up until the end of July 2022, with 1,212 having a status included and seventeen missing that information (see Table 1). (Note 2)

Table 1. Investment Dispute Settlement Navigator (till end July 2022)

Outcome	N	%
Data not available	17	1.4
Decided in favour of State	310	25.2
Decided in favour of investor	240	19.5
Discontinued for unknown reasons	113	9.2
Neither investor nor the State (liability found but no damages awarded)	22	1.8
Pending	360	29.3
Settled	167	13.6
Total	1,229	100.0

Source: Authors' elaborations.

Out of these, 852 cases have been concluded and 360 are still pending. The concluded cases show the following picture: 36.4% have been decided in favour of the state, and only 28.2% have been decided in favour of the investor. Moreover, 19.6% of cases have been settled; 13.3% have been discontinued; and 2.6% have not been decided in favour of either of the parties (liability under IIAs was found; but no damages were awarded).

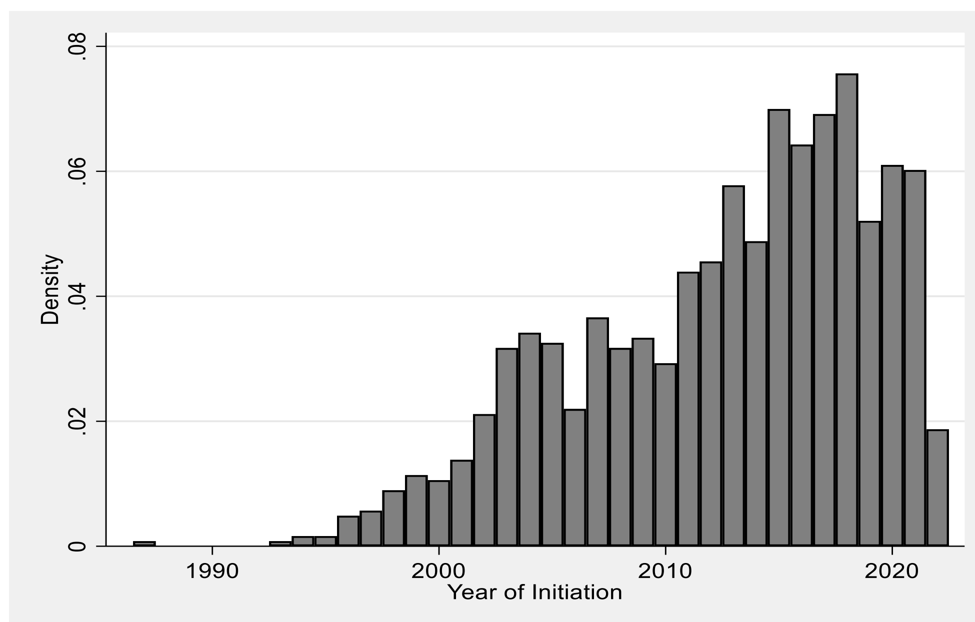

Figure 1. Year of ISDS Dispute Initiation (N = 1,229)

Source: Authors' elaborations.

As shown in Figure 1, many of these cases were only started after 2010, and were quite rare until the year 2000.

Although the numbers of the currently resolved ITA cases do not appear to confirm to an impression of the system as biased in favour of multinational enterprises (foreign investors), there are substantial transaction and litigation costs attached to complex ITA cases. Moreover, there is some evidence to support the argument that the existence of the ITA system can lead to regulatory chill (van Harten and Scott, 2016), particularly with regulation, which aims to protect the public interest in the areas of health or the protection of the environment. If ITA and broad substantive protection do not contribute to the development of the host state through increased inward FDI, we wonder what their benefit to the broader public interest and the state is.

3.2 Theoretical Background of FDI and IIA

3.2.1 FDI Impact on Host Country and Institutional Influence

Many developing and transition economies have been experiencing fundamental and comprehensive changes in their formal and informal institutions through national and international policies as a part of the globalisation and liberalisation process (Peng *et al.*, 2008). Here, following the well-known North (1990)'s definition, institutions are "the humanly devised constraints that structure human interaction" (p.3) and these "existing structure of rights and the character of their enforcement define the existing wealth-maximising opportunities of the players" (p.47). Hence, host country's institutional environment has been considered as a determinant or an important influencing factor on FDI. A growing number of FDI studies have considered institutional effects in their FDI analyses on various subjects such as (1) institutional influences on FDI entry (e.g. determinant studies; entry mode decisions) (e.g. Bénassy-Quéré *et al.*, 2007; Bevan and Estrin, 2004; Godwin and Cook, 2018; Schwens *et al.*, 2011) and (2) institutional influences on the post-investment stage in the host, such as MNEs' performance, embeddedness and strategies at the operational stage (e.g. Clark and Geppert, 2011; Oliver, 1991). However, whilst the argument that "institutions matter is hardly novel or controversial", "what is interesting is *how* institutions matter" (Peng *et al.,* 2008 p.921). To the latter question, this study proposes international agreements and/or legal instruments play a certain role in the relationship between institutions in host countries and FDI into the countries.

Studies and policy papers suggest importance of 'governance' or 'institutional development' at national level for 'sustainable development' (e.g. Acemoglu *et al.,* 2004). This is because institutions are usually created and characterised depending on the "given lumpy indivisibilities" of each country, and they in turn "shape the direction of long-run economic change" in those countries (North, 1990, p.16). Thus, in many developing countries, where "inefficient forms of exchange" (ibid, p.11) are common in markets, "the absence of... (market)…institutions is conspicuous" (Peng *et al.*, 2008, p.922) causing high transaction costs and challenges in operation to the businesses in these countries (Khanna and Palepu, 2010, p.6). This discussion leads to further considerations on substitute institutional arrangement to fill these voids. Here, legal instruments such as IIA have often been expected to work as substitute for poor

institutional environment of many developing host countries for the foreign investors. In this context, a substantial number of empirical studies have investigated whether these legal instruments determine FDI inflows to those involving host countries (see examples from Brada *et al*., 2021, Reite and Bellak, 2021 and UNCTAD, 2014).

3.2.2 Linking Legal Instrument and FDI – Brief Literature Review

Brada *et al*. (2021), a recent meta-analysis of studies on FDI and IIA summaries the theoretical assumptions between these two as the following three: 1) IIAs will address the time inconsistency issues which can create the bargaining power being shifted from the foreign investors to the host country government due to sunk cost at the entry and lack of mobility/flexibility of the investment from FDI, based on Vernon (1971)'s obsolescing bargain theory; 2) IIAs can work as substitute for weak and/or poor institutions and legal infrastructure in the host country for the foreign investors – i.e., as a "way of importing the even handed and effective application of international law into a country" (p.35); and 3) in line with the second theoretical assumptions IIAs can thus protect the foreign investors against political and economic uncertainty in the host country (Falvey and Foster-McGregor, 2017; Frenkel and Walter, 2019; Sirr *et al*., 2017;). For example, in Malesky and Milner (2021)'s survey of 1,583 foreign firms in Vietnam, foreign firms responded that IIA has larger positive impact on their perspective towards future profitability of their projects than simply learning about the commitments in domestic law.

Several studies have found a positive IIA working as a positive determinant of FDI into developing countries (e.g. Busse *et al*., 2010; Büthe and Milner, 2004; Neumayer and Spress, 2005; Salacuse and Sullivan, 2005; Yackee, 2011) whilst the positive effect seems to be stronger when these countries have BIT with developed sourcing countries (e.g. Banga 2008; Guerin, 2010; Neumayer and Spress, 2005; Salacuse and Sullivan, 2005). For example, Uttama (2021) examines the effects of IIAs on bilateral foreign investment by using a panel dataset that consists of bilateral FDI from ten Association of Southeast Asian Nations (ASEAN) countries plus six Regional Comprehensive Economic Partnership (RCEP) countries for the period 2009-2018 and the Driscoll-Kraay standard errors estimator. Results show that investment provisions in IIAs (BITs and TIPs) such as investment protection, facilitation, and promotion are a strategic policy instrument to increase inward FDI in both the ASEAN region and the RCEP region. Jung and Kim (2020), focusing on whether and to what extent South Korea's BIT with a partner country affects its outward direct investment to the country from 2001 to 2012. Through the implementation of multiple regression analyses with panel data, the study shows that the existence of a BIT between South Korea and a host country positively affects South Korea's FDI flows in the country.

Although some studies find a positive impact of both the signing and ratifying of IIAs on FDIs (e.g. Jung and Kim, 2019), some studies found only ratified BITs have significant positive effect on FDI determinant (e.g. Aisbett *et al*., 2018; Büthe and Milner 2014; Haftel 2010; Siegnamm 2008), which implies that host countries' strong 'signal' to commitment to these 'substitute institutional arrangement' might be a pre-requisite condition to utilise legal instruments in attracting FDI. For example, studies found strong protection represented by

provisions for investment dispute settlement has positive impact inward FDI. Frenkel and Walter (2018) focus on international dispute settlement as one of the most distinguished features of BITs. They derive a measure of the strength of international dispute settlement provisions and then estimate the effects of BITs on FDI activity in a panel data model using only bilateral FDI flows between the signatory countries. Results indicate that stronger international dispute settlement provisions in BITs are associated with more FDI activity. This relationship between international dispute settlement provisions and BITs holds also when FDI stock is used as a dependent variable instead of FDI inflows. Aisbett *et al.* (2018) employ an extension of the standard gravity-type model on the determinants of FDI in developing countries. The empirical analysis is based on bilateral FDI flows for a panel of eighty-three developing host countries and thirty-nine source countries, covering the period 1980–2010. The study allows for the possibility that disputes have different effects on FDI flows from BIT partner countries and non-partner countries. Findings confirm that BITs stimulate bilateral FDI flows from partner countries, but only so long as the developing host country has not had a claim brought against it to arbitration.

This is closely in line with the rationale that 'enforcement of law' is considered as key element of 'good' institutional/governance in several relevant indices as well as existence of rule of law (e.g. Economic Freedom Index by Heritage Foundation; Doing Business Index by World Bank; Global Competitiveness Index by World Economic Forum etc.). In other words, BITs with the provisions for 'enforcement' of the legal protection of the investors' investment in the treaty in the form of international dispute settlement provisions is more effective in attracting FDI than those without it. This trend is strong in the relationship between developed countries' investment and developing host countries also support this argument.

However, some studies argue host country institutions function as complementary rather than substitute (Hallward-Driemeier, 2003; Li and Zhao, 2021; Neumayer and Spess, 2005;) – i.e., the extent to which BITs can substitute poor institutional environment in the host to attract FDI is limited if the host country institutional environment does not improve. Indeed, the empirical results on the relationship between IIA and FDI are not always consistent. Empirical studies showing varying findings with some no significant impact of IIA on FDI (e.g. Gallagher and Birch, 2006; Siegmann, 2008; Tobin and Rose-Ackerman, 2003) whilst others find that their results are not statistically significant (e.g. Allee and Peinhardt, 2011; Hallward-Driemeir, 2003; Tortian, 2012; Yackee, 2007) or even negative (e.g. Gil-Pareja *et al.,* 2022; Tobin and Rose-Ackerman, 2011). Even in those studies finding their results of IIA as a positive determinant of FDI, show complex relationship between these two factors depending on the contents of IIA (e.g. Neumayer and Spess, 2005; Salacuse and Sullivan, 2005; Siegmann, 2008), the nature of impact of IIA on FDI (e.g. Aisbett, 2009; Büthe and Milner, 2004; Yackee, 2011) or firm/sector level decision (e.g. Colen *et al.,* 2014; Egger and Merlo, 2012) (please see more examples from Falvey and Foster-McGregor, 2017 and UNCTAD, 2014).

Nonetheless, overall, when the FDI flow is from developed to developing countries (e.g. Aisbett *et al.,* 2018; Gounder *et al.,* 2019; Uttama, 2021), studies find the positive impact of BITs on FDI. Moreover, several findings from these studies that investment provisions such as investment dispute settlement work as a strategic policy instrument in developing countries

(e.g. Frenkel and Walter, 2018; Uttama, 2021) support the theoretical assumption that IIA can work as substitutes or complementary to the existing institutional conditions in the host country. The implication from these studies is that IIA certainly plays a positive role in attracting FDI, but whether the role is as decisive as a determinant of FDI has not been agreed.

3.2.3 Linking Legal Instrument and FDI – Methodological Discussion

Brada *et al.* (2021) further categorise two types of methodologies frequently used in the studies looking into the relationship between FDI and IIA as 1) monadic and 2) dyadic. The first category, so-called monadic, examines the experience of one or several host countries following the signing of IIAs (e.g. Aisbett *et al.,* 2018; Beri and Nubong, 2021; Frenkel and Walter, 2019; Uttama, 2021). The dependent variable is FDI, either inward stock or flow, often normalized by host-country Gross Domestic Product (GDP). The explanatory variables are host-country characteristics such as the level of, or the changes in, GDP, the exchange rate, inflation, openness to trade and measures of country risk and political instability. The second category called dyadic, examines FDI flows or stocks for country pairs. Often, some form of the gravity equation is used, and a dummy variable is included in a way that the value is equal to one if there is an IIA treaty between the two countries and zero if there is not. A positive and significant coefficient for this dummy is taken as evidence that IIAs increase FDI. The majority of studies take the second approach. For example, Kox and Rojas-Romagosa (2021), estimate the potential impact of preferential trade agreements (PTAs) and other bilateral policies that affect trade and investment on the bilateral FDI stocks and flows between the countries signing these agreements. Their analysis employs an FDI gravity model based on the knowledge-capital interpretation of FDI, where this type of capital assumes proprietary knowledge that can be used on a non-rival basis in several locations. Grieveson *et al.* (2021) study how stabilization and association agreements (SAAs), BITs and free trade agreements (FTAs) impact inward FDI and exports of the Western Balkan countries. By considering a sample comprising country pairs between 22 FDI host countries (investment destinations) and the corresponding FDI home countries, they estimate a gravity model using the Poisson Pseudo Maximum Likelihood (PPML) estimator. Results are mixed as they show that BITs were not related to intra-regional FDI, nor to the FDI from other countries. Gounder *et al.* (2019), using panel data from 2000 to 2017, implement an augmented gravity equation aimed at explaining bilateral FDI stocks between Organisation for Economic Co-operation and Development (OECD) sources and ACP (African Caribbean Pacific Region countries) hosts. However, "[g]iven the lack of theoretical guidance on the specification of monadic or dyadic models of FDI, it is difficult to judge whether some specifications are more appropriate than others." (Brada *et al.,* 2021, p.37).

Another notable trend in recent studies is that they try to look at non-linear relationships between FDI and BITs. For example, Falvey and Foster-McGregor (2017) include zero and negative FDI flows (i.e. disinvestment cases) as well as additional controls for endogeneity and multilateral resistance, using a gravity equation of FDI flows from a sample of 22 OECD countries to a broader sample of 101 lesser developed host economies. Whilst their results highlight how BITs have a positive and linear effect on FDI flows from the OECD North to the developing South, they found the effects to be larger when zero and negative FDI flows are included. The authors also confirm the presence of non-linearities, with the effects of BITs

found to be increasing in differences in the levels of GDP and GDP per capita between source and host country, and decreasing in differences in political institutions between source and host. Their later study, Falvey and Foster-McGregor (2018), combines a difference-in-differences approach with matching techniques to control for observed differences in characteristics between BIT and non-BIT country-pairs, distinguishing between the impact of BITs on existing FDI relationships between countries (i.e., the intensive margin) and their impact in creating new FDI relationships (i.e., the extensive margin). They find that the development of new FDI relationships and the reinvigoration of deteriorating FDI relationships are the important sources of the observed increase in FDI in response to BIT formation. Oh *et al.* (2017) find that there are marginal diminishing returns of BITs on investment flows using network theory to explain this. They argue that by signing multiple BITs, host countries can raise their own reputation for protecting foreign property rights (Tobin and Rose-Ackerman, 2011). They further argue that this phenomenon can weaken the discriminatory feature of an individual BIT as non-BIT home countries might pick up the fact that this host country is under a BIT agreement as signal of investment protection even when the host country doesn't protect the property right strongly (and hence, previously was not considered as a potential host country).

4. Data and Methods

This paper opts for a monadic rather than a dyadic model. The primary reason for this choice is the added flexibility it offers in adjusting IIAs when incorporating them into the model. The dyadic model uses a binary (0 and 1) between pairs of countries, which can potentially limit the scope of analysis. The central research question this paper proposes in the introduction is whether signing IIAs positively impacts developing countries. This paper's investigation is not primarily concerned with the strength of the bilateral relationships between pairs of countries, but rather the broader impact of these agreements on developing economies. Therefore, given these considerations and the research focus of this paper, the analysis will proceed under the assumption that the monadic model is the most appropriate choice for this paper. The country sample includes both developing and transition economies considering that UNCTAD data base distinguishes these groups from developed countries and following examples of previous studies (e.g. Cusimano *et al.*, 2024; Sirr *et al.*, 2017). This choice is also in line with the arguments of the studies on emerging market and developing economies that radical institutional changes as well as poor institutional environment can render some countries not to be fully developed yet regardless of their economic status (e.g. Cuervo-Cazurra, 2012; Khanna *et al.*, 2010).

We model FDI as an outcome against a variety of relevant variables that are identified above, or in past empirical studies.

$$FDI/GDP_{it} = b0 + b1.(signedBIT_{it}) + b2.(ISDS\text{-}cases_{it}) + b3.(EF_{it}) + \ldots + u_{it} \quad (1)$$

where the dependent variable is the value of FDI inflows as a percentage of GDP, while the independent variables include the number of signed agreements, the economic freedom index

and a set of other variables we outline below. Subscripts “i” and “t” denote the cross-section (country, i) and time dimension (year, t, 2000-2019), respectively.

Our information on BITs comes from the UNCTAD site. Specific data on countries was extracted from the World Bank site (World Development Indicators) for the 19 years 2000-2019, covering FDI inflows and outflows, GDP, and total population. Many, indeed, most (57%), of the BITs from UNCTAD were signed before 2000. Hence, a large chunk of the data has pre-2000 deals, with 1990-2000 being an important period for making such arrangements. The other independent variables we use comprised:

BITSq: categorical number of BITs in place (signed)

ISDS cases: cumulative number of cases with disputes

GDPCAP_CUP: This variable represents the GDP per capita at current prices in millions of US dollars.

EF: This variable represents the Economic Freedom Index. It is a measure of the economic freedom in a country, based on factors such as bureaucratic burden, property rights, and effectiveness and efficiency of regulation.

PRIME: This variable represents the percentage of primary industry (to industries that extract natural resources, such as agriculture, mining, and forestry) as a proportion of GDP.

IHS_EXT_GDP: This variable represents the ‘IHS transformed’ values of the GDPs of the countries with whom the BITs were signed, similar to a logarithm.

The goal is to estimate the relationship between FDI and BITs. Two important additional variables in developing host country are considered. PRIME represents the country’s reliance on the primary industry with proxy of the percentage of the primary industry as a proportion of GDP. Natural resource endowment is often a major factor in attracting FDI in many developing countries (Dayan *et al.,* 2023; Tassdemir, 2022). EF represents ‘Economic Freedom’ that measures institutional efficiency and effectiveness as well as the economy’s openness. Considering BITs often play a signalling role that there will be legal/institutional provisions to protect foreign investment regardless of the institutional environment in the host country, this variable is an important factor to consider in the analysis. In terms of proxy, we used the Economic Freedom Index developed by The Heritage Foundation following an example of previous studies such as Cusimano *et al.,* (2024), Ghazalian and Amponsem, (2019) and Godwin and Cook (2018). To do this, the econometric technique of feasible generalized least squares (FGLS) is used because it can handle heteroscedasticity (unequal variances) and serial correlation (correlation between observations over time) in the data. FGLS is a ‘weighted least squares estimator’ that can be used to estimate a variance-covariance matrix when the structure of the individual data points is unknown. By using FGLS, following Zahid *et al.* (2021), we can obtain efficient estimates of parameters and standard errors in our analysis. In this particular study, the analysis assumes that each panel (i.e., each country) has errors that follow a different autoregressive (AR) process of order 1. This means that there is autocorrelation (correlation between observations over time) within countries, and the coefficient of the AR(1)

process is specific to each country.

5. Results

Table 2. Cross-Sectional Time-Series FGLS Regression

Coefficients: generalized least squares

Panels: heteroskedastic

Correlation: panel-specific AR(1)

Estimated covariances = 151 Number of obs = 2,460

Estimated autocorrelations = 151 Number of groups = 151

Estimated coefficients = 30 Obs per group (country):

min = 2

avg = 16.29139

max= 19

Wald chi2(29) = 361.08

Prob > chi2 = 0.0000

FDI_GDP	Coefficient	Std. error	z	P>z
BITS (ref = 5-9)				
None	-13.7533*	6.7550	-2.04	0.042
1-4	0.1650	0.4466	0.37	0.712
10-19	0.5672	0.3154	1.8	0.072
20-29	2.5621***	0.4851	5.28	0
30-49	-0.9299*	0.4494	-2.07	0.039
50+	-1.3424**	0.4038	-3.32	0.001
Previous ISDS cases	-0.0870**	0.0279	-3.12	0.002
GDPCAP_CUP	0.0001***	0.0000	5.51	0
PRIME	-0.0354*	0.01453	-2.44	0.015
EF	0.0906***	0.0137	6.62	0
IHS_EXT_GDP	-0.4103†	0.2180	-1.88	0.06
_cons	12.1728	6.7484	1.8	0.071

(Year variable also included, though results not shown).

*** p<0.001 ** p<0.01 * p<0.05 † p<0.1.

Table 2 provides estimates of the regression examining the relationship between FDI as a percentage of GDP and various explanatory variables, showing the coefficients of the independent variables and their standard errors, along with t-statistics and p-values for testing their significance. The overall model is significant at the 0.001 level, indicating that the independent variables together are useful in predicting FDI_GDP (FDI as a percentage of GDP).

The regression results suggest that higher numbers of signed agreements are positively associated with FDI_GDP. In particular, the model shown in Table 2 has a non-linear association between the number of agreements and the extent of FDI. To explore this, we ran the model with a categorical version of the number of BITs. This confirmed that having zero such agreements had a negative effect compared with having 5-9 – but so did having thirty or more. The 'optimum' number was between 20 and 29 such agreements, with no significant differences in the 1-19 range. In other words, there may be a 'Goldilocks' zone, where there are neither too many nor too few BITs to increase FDI.

The association with BITs was not the only interesting new finding. The higher the number of past ISDS cases, the lower the FDI: this may indicate potentially important effects on lowering FDI from countries having to resolve disputes in a more public manner.

There was also a positive association between greater Economic Freedom (EF) and higher levels of FDI per capita. In addition, we found that higher proportions of extractive industries (PRIME) are negatively associated with FDI_GDP, whilst there was a positive association between FDI and the level of GDP per capita in the country. The monetary value for external GDP (IHS_EXT_GDP) has a possible negative relationship with FDI/GDP, but it is not statistically significant at conventional levels (p-value of 0.06).

In summary, within the number of signed BITs, the 20-29 category had a strong positive and significant relationship with FDI/GDP. However, there are negative relationships for the '30-49' and '50+' categories. Economic Freedom (EF) has a strong positive and significant relationship with FDI/GDP, whilst previous ISDS cases show a significant negative relationship: an increase in the number of previous ISDS cases decreases FDI/GDP.

6. Discussion and Conclusion

We revisit our research question:

- *What is the role of BITs in FDI and how do institutional features shape that role?*

We began by reviewing the existing literature. That tended to show some scepticism about the effect of the number of agreements/BITs in place, tended to be based on older data, and did not look at some aspects of the relevant 'infrastructure' such as using mechanisms of dispute resolution rather than simply having clauses relating to such disputes. These helped to shape our process of investigation.

Whilst some found positive effects of BITs, others found no or negative effects. We help to

resolve such differences using a non-linear interpretation of BITs. We confirm that BITs have a 'signalling effect' that might substitute for a weak institutional environment in the host countries. Our findings support this assumption from previous studies to some degree, as having no BIT has a negative impact on attracting FDI. However, this signalling effect tails off once the number of BITs goes over certain limit, in our case, 30. So, having ever more BITs agreements is not necessarily the right strategic choice for developing countries to attract more FDI.

Our second key finding is of a negative relationship between the number of past ISDS cases and FDI inflow, which brings nuance to previous studies finding that BITs with ISDS provision have a stronger positive impact on FDI attraction (e.g. Aisbett *et al.*, 2018; Frenkel and Walter, 2018). This implies that although providing mechanisms to protect their investment itself is positively considered by investors, when investors actually chose to use those mechanisms it seemed to discourage further investment.

Lastly, as theoretically predicted, the quality of institutional environments in the host country is an important determinant of FDI inflow to the country. This finding of ours not only re-emphasise the important role of institutions in attracting FDI but also sheds light on this discussion in the context of BIT. As discussed in earlier sections, some studies found BITs role can be limited to 'complementary' rather than 'substitute'. In other words, institutional reform in a country is as important as, if not more important, providing investment protection through treaties in attracting FDI. The second finding above also supports this argument: actual cases of disputes, which can reflect the actual institutional environment in practice, discourage FDI.

We may draw out some implications from our findings. They imply that continuing to build BITs is generally beneficial from a low starting point, but of lesser value (and even negative value) beyond a certain point. They also imply that if it becomes necessary to take disputes into formal settings, rather than simply setting frameworks for resolving disputes, that the effect on FDI is likely to be negative. Further research may be needed to see for how long such effects persist, but they may form an important deterrent to taking such actions.

Overall, this study contributes to the body of knowledge by revisiting this topic with more recent data, highlighting and re-ensuring some important findings from the previous studies. At the same time, our findings on non-linearity manner in the relationship between BITs and FDI bring not only new insights to the body or knowledge but also policy implications to the developing countries in relation to their FDI strategy in relation to IIAs.

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Notes

Note 1. Statute of International Court of Justice, Arts 38 and 59.

Note 2. From https://investmentpolicyhub.unctad.org/ISDS. The general database released has not been updated since July 2022, see: https://investmentpolicy.unctad.org/publications/1277/investment-dispute-settlement-navigator-full-isds-data-release-as-of-31-07-2022-in-excel-format-

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The authors contributed equally to the study.

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Obtained.

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Data sharing statement

No additional data are available.

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