

**THE IMPACT OF INTERNATIONAL INVESTMENT AGREEMENTS ON FDI IN  
DEVELOPING COUNTRIES AND THE IMPLICATIONS FOR DEVELOPMENT  
POLICY**

**A thesis submitted in fulfilment of the requirements for the degree of**

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**The impact of international investment agreements on FDI in developing countries and  
the implications for development policy**

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## **DECLARATION**

I declare that the thesis entitled, ‘The impact of international investment agreements on FDI in developing countries and the implications for development policy’, which I hereby submit for the degree, Master of Commerce, at Rhodes University, is my own work. I also declare that this Thesis has not previously been submitted by me for a degree at this, or any other tertiary institution, and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

A handwritten signature in black ink, appearing to read 'D. Lomas', with a horizontal line underneath the name.

Djamella Lomas

Name Surname (*signed*)

## **ABSTRACT**

This study investigates the impact of international investment agreements, specifically bilateral investment treaties (BITs), on inward Foreign direct investment (FDI) in recipient developing countries and the implications of such agreements for development policy. The study estimates a log-linear gravity model based on a unique dataset created to investigate whether the presence of BITs has a positive impact on inward FDI stock in 36 developing countries. The selection of countries attempts to capture a set of bilateral relationships that accounts for a significant proportion of inward FDI in developing countries. To test the hypothesis that signing BITs has a positive effect on inward FDI in developing countries it was necessary that all recipient countries be developing economies. However, investor countries are both developed and developing economies. Therefore, each bilateral FDI relationship is either between a developing recipient and developed investor country or between a developing recipient and developing investor country. For each recipient country, FDI stock data from investor countries for 2019 was obtained from the ITC's Investment Map database (ITC, 2022). This yielded 1009 bilateral FDI relationships (observations for the dependent variable) after removing pairs for which certain explanatory variable data was not available.

For the gravity model, GDP data was collected from the World Bank's World Development Indicators Database (World Bank, 2023a), while the other traditional gravity variables were collected from the CEPII GeoDist Database (CEPII, 2011). Alongside the gravity variables, the study employs three additional control variables (two macroeconomic and one institutional) in certain specifications of the basic model, namely the exchange rate, inflation rate and an index of political stability. Data for the three additional variables was sourced from the IMF's World Economic Outlook Database (IMF, 2022) for the macroeconomic variables and the World Bank's Worldwide Governance Indicators Database (World Bank, 2023b) in the case of the political stability index.

To examine the key question of the impact of BITs on bilateral FDI, a number of BITs dummy variables are created to investigate, firstly, whether having signed a BIT impacts on FDI in developing countries and, secondly, whether having a BIT in force significantly impacts on FDI in developing countries. Thereafter, in each case, dummy variables are created to investigate whether there is a significant difference between the impact on FDI of having a BIT

signed or in force between a developed and developing country specifically, and having a BIT signed or in force between two developing countries.

In order to examine the implications for development policy, the thesis analyses case studies of selected BITs between developed and developing economies, as well as those between developing economies. The texts of the BIT documents were obtained from the UNCTAD Investment Policy Hub Database (UNCTAD, 2023b).

The results of the study reveal that, on average, signing and/or having a BIT in force has a significant positive impact on the inward FDI stock of the recipient developing country from the outward investor country. This positive impact is found to be even stronger in the case of BITs between developed and developing countries. However, there is no significant impact on inward FDI for BITs signed between two developing countries. The study finds that GDP of the recipient and investor country, existence of a common official language and the distance between countries all have a significant impact on FDI in the recipient developing country, and are signed as expected in the gravity literature. The existence of a common border is weakly significant in some specifications of the basic model and not significant in others. The additional control variables are all significant and signed as expected in the literature.

The study contributes to the literature by distinguishing, not only between the impact of BITs signed versus BITs in force on inward FDI in developing countries, but also by distinguishing between the impact of BITs on FDI when the partners are developed and developing countries versus when both partners are developing countries.

The study also finds that, in an effort to attract FDI, developing countries have signed BITs which carry obligations that extend significant protection measures to foreign investors. However, such protections are offered at the expense of sovereign interests. The study finds that this has served to significantly reduce the policy space available for developing countries to attract FDI that is aligned to their sustainable development needs.

The limitations of the study are as follows. The gravity specification is cross-sectional, and a panel data approach could be recommended for future work. Furthermore, the traditional OLS gravity specification has a number of disadvantages and different types of estimator could be used in future work, software permitting. In addition, the impact on FDI of the *termination* of

BITs could be investigated, as sufficient data is becoming available for such an approach. Finally, it is difficult to generalise from the case study analysis undertaken of specific BITs provisions because of the limited number of BITs examined in the thesis.

**KEYWORDS:** *Inward FDI; International Investment Agreements; Bilateral Investment Treaties; gravity model; policy space; developing countries*

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I wish to thank my supervisor, Ms. Nicolette Cattaneo, for the ways in which she empowered me to do and complete my research. Her guidance, patience and support made *all* this possible.

I dedicate this thesis to all my loved ones whose broad shoulders I continue to stand on. *Enkosi*.

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## **LIST OF ABBREVIATIONS**

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<b>Abbreviation</b>	<b>Definition</b>
AfCFTA	African Continental Free Trade Area
ANC	African National Congress
BEE	Black Economic Empowerment
BITs	bilateral investment treaties
BLEU	Belgium-Luxembourg Economic Union
BRICS	Brazil, Russia, India, China and South Africa
CEE	Central and Eastern European countries
CI	crowding in
CO	crowding out
COMESA	Common Market for Eastern and Southern Africa
DTI	Department of Trade and Industry
EEA	European Economic Area
EU	European Union
FDI	foreign direct investment
FPI	foreign portfolio investment
FTAs	free trade agreements
GATS	General Agreement on Trade in Services
GDP	gross domestic product
ICRG	International Country Risk Guide
ICSID	International Centre for the Settlement of Investment Disputes
ICT	information and communication technology
IAs	international investment agreements
IP	intellectual property
IPFSD	Investment Policy Framework for Sustainable Development
ISDS	investor-state dispute settlement
IT	Internalisation Theory
LDCs	least developed countries
M & A	mergers and acquisitions

MNEs	multinational enterprises
MPRDA	Mineral and Petroleum Resources Development Act
NAFTA	North American Free Trade Agreement
NIE	new institutional economics
NS	North-South
OECD	Organisation for Economic Co-operation and Development
OLI	Ownership advantages, location, and internalisation
OLS	ordinary least squares
PLC	Product life cycle
PPML	Poisson pseudo-maximum likelihood
PTAs	preferential trade agreements
SADC	Southern African Development Community
SMEs	small and medium-sized enterprises
SOEs	state-owned enterprises
SS	South-South
TIPS	Trade and Industrial Policy Strategies
TRIMS	Trade-Related Investment Measures
TRIPS	Trade-Related Intellectual Property Rights
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	The United Nations Conference on Trade and Development
UR	The Uruguay Round
USA	United States of America
USMCA	US-Mexico-Canada Agreement
WTO	World Trade Organization

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# Chapter 1

## Introduction

### 1.1 Background and context of the research

Foreign direct investment (FDI) is regarded as important for developing countries not only for the economic benefits that such countries obtain from the investments made by multinational organisations in their economies, but also for the social dividends gained (Agosin, 2008). FDI has been identified as a key determinant of growth and development (Agosin, 2008; Denisia, 2010; UNCTAD, 2022a), and as a crucial complement to trade (UNCTAD, 2022b). While there are many theories to conceptualise FDI, it cannot be said that there is a generally accepted theory (Kurtishi-Kastrati, 2013). With more empirical research done on FDI, newer evidence has been brought to light adding new elements and criticism to previous findings (Denisia, 2010).

The theoretical and empirical analysis of FDI has led to a set of determinants of FDI that are commonly identified in the literature. Apart from locational factors such as natural resources, shifts in global politics and economic conditions affect FDI flows into developing countries with upswings in foreign business cycles resulting in increased flows to developing countries (Addison and Heshmati, 2003). Political structure and information and communication technology (ICT) serve as pull factors for FDI (Addison and Heshmati, 2003; Kok and Ersoy, 2009). In addition to shifts in ICT, changes in global politics are a key determinant of FDI flows to developing countries (Addison and Heshmati, 2003). According to Addison and Heshmati (2003: 1), “since the early 1980s, a ‘third wave’ of democratisation has pushed aside many authoritarian regimes, and the opening up of political systems is often a catalyst for economic reforms that favour investors”. This is evidenced by the rapid rise in FDI activity in countries in South-East Asia, Eastern Europe, and sub-Saharan Africa (Jakubiak and Kudina, 2008).

The two waves of ICT and politics interact to reshape not only FDI flows, but also those of trade and capital. Furthermore, the third wave of democratisation facilitates economic reforms that are conducive for trade, capital accumulation and FDI (Addison and Heshmati, 2003: 1-5). It is important that these global forces (ICT, politics, and democratisation) are not assessed in isolation, but rather alongside other key FDI determinants that are long-standing in existing

literature. According to Addison and Heshmati (2003: 1), these key FDI determinants include “natural resource endowments, geographical characteristics (country location in particular), human capital, infrastructure, and institutions”. In addition, Grosse and Trevino (2005: 131-133) highlight traditional macroeconomic determinants such as market size, inflation, and exchange rate volatility, while Kok and Ersoy (2009), as well as UNCTAD (2022a), also emphasise the importance of labour costs, tax, total debt service as a share of GDP and trade openness.

In addition to the traditional determinants of FDI, membership of regional integration groupings, trade agreements and/or bilateral investment treaties have been identified as important potential determinants of bilateral FDI (Kox and Rojas-Romagosa, 2020). The international investment agreement landscape has expanded significantly in the past few decades and bilateral investment treaties (BITs) have become a controversial part of this arena (Erasmus, 2015; Kollamparambil, 2016; Njambi, 2018). A growing number of BITs have been signed involving developing economies, and questions have arisen concerning their effectiveness in promoting FDI into developing countries and the implications of their provisions for domestic development objectives (Naidu and Vickers, 2014; Erasmus, 2015; Kollamparambil, 2016).

Despite several studies in the literature that have attempted to address the question of the impact of BITs on the FDI received by developing economies, the findings are wide and varied (Salacuse and Sullivan, 2005; Shadlen, 2005; Grosse and Trevino, 2005; Kollamparambil, 2016). From the perspective of the capital-importing country, it is argued that the basic purpose of BITs is to facilitate the attraction of FDI. On the other hand, the perspective of the capital-exporting country regards BITs as instruments that serve the basic purpose of protecting foreign investors from political risks and instability as well as safeguarding the investments made (Spears, 2010; Shima, 2015). Scholars suggest that the two perspectives are the reason that BITs were originally concluded primarily between developed and developing countries, so that the former could provide what was needed by the latter whilst at the time having assurances that their investments would be protected in unstable markets (Shima, 2015).

However, sceptics claim that there is minimal evidence to suggest that foreign investors pay significant attention to BITs when making their decisions about where to invest (Sauvant, 2005, 2007; Zhan, 2021). This contrasts with the view that BITs help to proliferate international

investment through FDI because they reflect an investment climate that is favourable to international investors (Grosse and Trevino, 2005). Moreover, in the absence of multilateral investment frameworks, it is argued that BITs are effective instruments which developing countries can utilise to signal themselves as safe investment destinations for international investors (Kollamparambil, 2016).

Grosse and Trevino (2005) argue that the proliferation of BITs since 1990 is evidence that their adoption is highly regarded by foreign investors because it is a signal of a liberalised market. Furthermore, Grosse and Trevino (2005) point out that since the end of WWII, many BITs have been enacted specifically because they go beyond the realms of national law in their capacity to afford investors supplementary safeguards. Sauvart (2007) and Shima (2015), however, argue that BITs may not enhance and/or improve on existing instruments that seek to legally secure foreign investments deemed to be risky.

Literature on international investment treaties has highlighted numerous controversies around the implications of the provisions of BITs for domestic development objectives (Naidu and Vickers, 2014; Erasmus, 2015; Kollamparambil, 2016). The rise in the number and prominence of BIT disputes has led to the view of some developing economies that traditional BITs place undue risk on host nations but fail to put measures in place which obligate investors to take the necessary actions to fulfil the development requirements of host states. This is said to lead to the unequal distribution of rights and obligations between developed and developing countries (Kollamparambil, 2016: 2).

The high number of cases brought against developing countries by foreign investors in investor-state dispute settlement (ISDS) arbitration processes has been a source of much controversy in recent years. Research findings suggest that the controversy is expressed by the massive number of claims instituted by the investor litigants which place a huge fiscal strain on host states (Naidu and Vickers, 2014; Erasmus, 2015; Kollamparambil, 2016: 2). Moreover, the ISDS arbitration system for BITs is said to be controversial for several reasons. Several studies highlight inconsistent and contradictory awards by tribunals, lack of transparency and high costs of the proceedings, as well as the qualifications of arbitrators, as issues that have led to a crisis of legitimacy with respect to BITs (Kollamparambil, 2016). It is therefore not surprising that there have been more recent BITs between developing economies where the

provisions are reportedly designed to be less controversial and more development-policy oriented (Naidu and Vickers, 2014; Erasmus, 2015; Kollamparambil, 2016).

It is interesting to note that South Africa terminated its BITs with three developed countries (the Netherlands, Switzerland, and Germany) in 2014 and also served notice of termination of its treaties with three more (Belgium, Luxembourg, and Spain) (Kollamparambil, 2016). Soon thereafter, another developing country, Indonesia, followed suit by terminating its BIT with the Netherlands (Kollamparambil, 2016). Numerous developed economies such as Germany and Australia have also reviewed their BITs (UNCTAD, 2012).

In recent years, a number of developments have accelerated the reform of the international investment regime. These include the conclusion of new-style international investment agreements, extensive cancellations of old-style BITs, and more emphasis placed on issues of investment facilitation, climate change, and human rights. UNCTAD (2022a: 65) notes that, by 2020, the number of IIA (International investment agreement) terminations exceeded the number of new IIAs. In 2021, 13 IIAs were concluded by countries which terminated at least 86 IIAs, thereby reducing the total global number of IIAs to 3,288 (UNCTAD, 2022a: 65).

In line with UNCTAD's recommendations and reforms in the IIA policy space, recent agreements have begun to feature several reform-oriented provisions with the goal of simultaneously preserving regulatory space and promoting investment for development (UNCTAD, 2022a: 65-66). However, the total number of ISDS cases continues to escalate, bringing the total number to 1190 by the end of 2021 (UNCTAD, 2022a: 73). Data from UNCTAD (2022a) suggests that old-style IIAs are the core of the majority of current litigation, with the ongoing war in Ukraine likely to increase the number of cases related to war. In addition to making this area of study very interesting, the implications of developments in the policy space debate also highlight important avenues for future research.

## **1.2 Problem statement and goals of the research**

Research findings suggest that there is a positive relationship between FDI and economic growth and development in developing countries (Mishra and Jena, 2019; UNCTAD, 2022a). Furthermore, literature suggests that the conclusion of BITs is an effective policy tool for attracting and increasing levels of inward FDI in developing countries (Dorakh, 2020; WTO,

2022). In an effort to attract much-needed FDI, many developing countries in the Global South have increasingly signed BITs with primarily Global North counterparts. However, sceptics such as Njambi (2018) and Zhan (2021) argue that there is insufficient evidence to suggest that foreign investors pay significant attention to the conclusion of BITs when making decisions about FDI deployment. The lack of consensus on the overall impact of BITs and/or IIAs on inward FDI in developing countries leaves a literature gap that warrants further investigation.

The main goal of this research is to investigate the impact of international investment agreements on inward FDI into developing countries and the implications of such agreements for development policy. In order to achieve this goal, the following sub-goals are addressed. First, the growth and share of developing country inward FDI relative to aggregate inward FDI is analysed. Secondly, the growth and geographical distribution of international investment treaties is examined, with a focus on bilateral investment treaties (BITs) between developed and developing economies, as well as those between two developing economies. Thirdly, the impact of the presence of BITs on inward FDI in developing countries is estimated using a gravity model. Finally, the implications for development policy are assessed with reference to the provisions of traditional BITs between developed and developing economies in comparison to more recent BITs between developing economies, with a focus on BITs involving some of the BRICS (Brazil, Russia, India, China and South Africa) emerging economies.

### **1.3 Research approach, methods, procedures and techniques**

The research approach underpinning the study is mixed methods in nature (Creswell and Creswell, 2018: 41). Quantitative research methods are used to address the first three sub-goals in Section 1.2 above, while qualitative methods are used to address the fourth. While these research methods, together with the data sources used in the study, are set out in detail in Chapter 4, they are briefly described below, by way of introduction.

In the case of the first two sub-goals, descriptive statistical techniques, trend analysis, and graphical analysis are used to examine the growth and share of developing country inward FDI relative to aggregate inward FDI, and the growth and geographical distribution of international investment treaties, particularly BITs. Data on FDI stocks and flows were obtained from the International Trade Centre's Investment Map Database (ITC, 2022) and the UNCTAD FDI

Database (UNCTAD, 2023a), while the BITs data were obtained from UNCTAD's Investment Policy Hub Database (UNCTAD, 2023b).

In the case of the third sub-goal above, a gravity model of FDI is estimated to investigate whether the presence of BITs improves inward FDI in developing countries. In FDI applications of the gravity model, bilateral FDI is investigated as a function of the GDP of the recipient country and the GDP of the outward investor country, the presence or absence of a common border, the presence or absence of a common official language and the distance between the countries (Baccheta *et al.*, 2012: 103-109). In addition, a range of FDI determinants from the literature may be added to the model, as well as membership of regional groupings of varying depth and/or bilateral investment agreements (Dorakh, 2020; Kox and Rojas-Romagosa, 2020; Mishra and Jena, 2019).

The gravity model in the present study examines the determinants of bilateral FDI involving developing country recipients of inward investment from both developed and other developing economies. To investigate the impact of the presence of BITs on inward FDI in this context, a dummy variable is added to the model, alongside the traditional gravity variables and other FDI determinants from the literature. Two different dummy variables are used for BITs in alternative specifications of the model. In the first instance, the dummy variable indicates whether a BIT has been signed between the two countries (even if it is not in force, or no longer in force). In the second instance, the dummy variable indicates that there is a BIT in force between the two countries. Although a variety of estimation methods can be used for the gravity model, the double-log model is employed in this study, following Baccheta *et al.* (2012: 105-106) and Dorakh (2020). The exact model specification and justification for the technique used, the variables included and the data sources for the gravity model are described in more depth in Chapter 4.

The fourth sub-goal in the study is addressed using case study analysis (Creswell and Creswell, 2018: 311) of selected BITs between developed and developing economies, as well as those between developing economies. Comparative analysis of the provisions of the BITs for the selected cases is undertaken, with a focus on common and differing provisions in traditional versus more recent BITs. To make the analysis manageable, the focus is on BITs involving the emerging BRICS economies. These countries have been selected because of their interesting contrasting positions and differing degrees of participation in the international investment

agreement landscape, including in North-South versus South-South configurations. The texts of the BIT documents were sourced from the UNCTAD Investment Policy Hub Database (UNCTAD, 2023b).

#### **1.4 Thesis plan**

The remainder of the thesis is structured as follows. In Chapter 2, theories of FDI and its potential developmental benefits are analysed with reference to the published literature. Section 2.2 of this chapter outlines the concepts and definitions of FDI with its motives and modes of entry discussed in Sections 2.3 and 2.4, respectively. The main theories of FDI and its key determinants are discussed in Section 2.5. The potential benefits of FDI for developing countries are examined in Section 2.6 and the key points of Chapter 2 that are relevant for the remainder of the study are synthesised in Section 2.7, the conclusion.

Chapter 3 examines the international investment agreement (IIA) landscape. The chapter first discusses the evolution of the IIA landscape in Section 3.2. Section 3.3 then provides background on the World Trade Organization (WTO) Agreements relevant for investment in goods and services respectively, namely the Agreement on Trade-Related Investment Measures (TRIMS) and the General Agreement on Trade in Services (GATS). These are contrasted in general terms with the early BITs and investment chapters in regional trade agreements, with a view to highlighting emerging controversies. Section 3.4 examines the theoretical issues around BITs, with a focus on a new institutional economics approach to FDI determinants, while Section 3.5 reviews empirical literature analysing the impact that BITs have on FDI. Section 3.6 concludes the chapter, drawing out the important aspects for the rest of the study.

In Chapter 4 the methodology and data used in the thesis is outlined and explained with reference to the goals of the research set out in Section 1.2. Chapter 5 examines the question of whether bilateral investment treaties do significantly affect FDI in developing countries, using a gravity model. As background to the gravity analysis, Section 5.2 of the chapter investigates the growth and geographical distribution of developing country FDI over the period 1980 to 2021, while Section 5.3 examines the growth and geographical distribution of BITs since the 1950s. In Section 5.4, the results of the gravity model estimations investigating

the impact of the presence of BITs on the inward FDI that developing countries receive are presented and discussed. Section 5.5 concludes the chapter.

Chapter 6 analyses political economy, policy space and investment policy issues related to BITs. As background to the chapter, Section 6.2 elaborates on the main debates and controversies in the literature on the provisions of BITs between developed and developing countries. Section 6.3 analyses BITs provisions in old versus new-style BITs. Lessons from some of the BRICS countries' recent approaches to BITs are discussed in Section 6.4, while Section 6.5 concludes the chapter. Chapter 7 concludes the study with policy recommendations and some fruitful avenues for future research.

## Chapter 2

### Foreign Direct Investment: Theories and Concepts

#### 2.1 Introduction

According to Peng and Meyer (2020: 576), foreign direct investment (FDI) refers to “investments in, controlling and managing value-added activities in other countries”. This contrasts with foreign portfolio investment (FPI), which indicates “investment in a portfolio of foreign securities, such as stocks and bonds” (Peng and Meyer, 2020: 576). For a firm that owns foreign stocks and bonds, investors have little else to do other than collecting dividends or interest, in addition to constant monitoring of financial markets in order to determine the ‘right’ time to sell (Dalvi, 2016). This is an important distinction from FDI which requires substantial resource commitments from investors, as well as significant managerial time to oversee and/or monitor operations abroad. Therefore, FPI – in contrast to FDI where the key word is ‘direct’ (in reference to the direct management of foreign assets) – does not entail the active management of foreign business operations (Peng and Meyer, 2020: 149-153). In international business literature, a firm engaged in FPI is not considered a multinational enterprise (MNE) in terms of this definition (Peng and Meyer, 2020: 152-153).

Literature suggests that FDI is an important potential source of socio-economic benefits for developing countries (Agosin, 2008). It also serves as a crucial complement to trade. Institutional economic perspectives, which take account of the institutional environment and formal or informal ‘rules of the game’, suggest that developing countries wishing to attract FDI need to consider institutions that may enable FDI, such as bilateral investment treaties (BITs) or investment chapters in broader trade agreements (Grosse and Trevino, 2005). To understand these arguments, it is important to have a clear picture of the motives and determinants of FDI discussed in the theoretical literature. This will provide useful background to the new institutional economics approach to BITs, considered further in Chapter 3.

This chapter therefore aims to examine the theory of FDI with particular reference to key concepts, motives and determinants. In this chapter, theories of FDI and its potential effects on development are examined, with particular reference to the published literature. The concepts and definitions important for an understanding of FDI are outlined in Section 2.2, while FDI

motives and modes of entry are discussed in Sections 2.3 and 2.4, respectively. Section 2.5 considers the main theories of FDI and its key determinants. The potential benefits of FDI for developing countries are examined in Section 2.6, while the conclusion in Section 2.7 draws out the key points that are relevant for the remainder of the study.<sup>1</sup>

## 2.2 FDI concepts and definitions

In defining FDI, Duce (2003: 2) cites the IMF and OECD definitions which outline that FDI, “reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise)”. By ‘direct investment’ it is implied that the direct investor has “a long-term relationship with the direct investment enterprise and that the former holds significant influence over the management of the latter” (Duce, 2003: 2). The direct investment includes both “the initial transaction of investment and all subsequent capital flows between the parties and affiliated organisations”, irrespective of whether these are incorporated or not (Duce, 2003: 2). The IMF balance of payment manual defines a direct investor as an investor that owns “10% or more of a company’s capital” (Duce, 2003: 3).<sup>2</sup>

Although not always strictly adhered to, the requirement for the 10% threshold discussed above is generally accepted as a guideline for what quantifies FDI. Indeed Duce (2003: 3) notes that the IMF recommends this threshold as a means for distinguishing between FDI and FPI with respect to equity in an organisation. Translated loosely, this guideline means that when a resident citizen sells at least 10% of the shareholding in a domestic entity to a non-resident investor, the market value of the shareholding involved in the transaction amounts to FDI. Furthermore, all capital transactions between the non-resident investor and the domestic entity should accordingly be recorded as FDI (Duce, 2003: 3-4).

According to Duce (2003: 2), a ‘direct investment enterprise’ is one in which “a foreign investor owns 10% or more of the ordinary shares or voting power of the enterprise”. The three

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<sup>1</sup> The literature review in this chapter draws on an unpublished Honours research report completed by the author in 2020 (Lomas, 2020).

<sup>2</sup> Examples of a ‘direct investor’ include an individual, public, or private enterprise (incorporated or not), national or provincial government and/or sectors thereof, a group of related individuals or enterprises (incorporated or not), who – individually or jointly - have a direct investment enterprise which operates in a country other than their own country of residence (Duce, 2003).

types of direct investment enterprise are subsidiaries, associates, or branches. A ‘subsidiary’ is defined as an incorporated entity in which the foreign investor holds direct or indirect (i.e., via another subsidiary) control over half of the shareholders’ voting rights. When the investor and its subsidiaries’ voting shares in a foreign firm are between 10% and 50%, the enterprise is an ‘associate’. A wholly or jointly owned unincorporated enterprise is known as a ‘branch’ (Duce, 2003: 1-3).

According to Humanicki *et al.* (2017: 116-117), the main difference between FDI and foreign portfolio investment (FPI) is best explained in terms of motivation and time horizon. The motives for FDI, the duration and nature of the investment(s) involved differ from those in the case of FPI.<sup>3</sup> It is often the case that FDI and FPI are undertaken simultaneously (Humanicki *et al.*, 2017). The choice of investment route (i.e. FDI or FPI) is significant to both multinational investors and the developing countries in receipt of the investment. Humanicki *et al.* (2017: 116-117) point out that although in older literature clear distinctions have always been drawn between FDI and FPI, a joint analysis of the two concepts is necessary to determine whether they complement each other, or instead serve as substitutes for each other. The broader definition of foreign investment in certain international investment agreements, especially BITs, to include both FDI and FPI has been controversial,<sup>4</sup> so it is important to clarify the distinction between the two.

While both outward FDI (FDI outflows to the host country, invested by foreign direct investors) and FPI involve the acquisition of ownership in a foreign-based commercial entity, the two investment routes differ in terms of the nature of ownership, its term and associated degree of control (Surbhi, 2017). Surbhi (2017: 1) reiterates that while FDI investors invest in financial and non-financial assets such as resources, technical know-how, and so on, FPI investors only invest in financial assets, including stock and/or bonds of the foreign enterprise. Surbhi (2017: 1) further explains that unlike FDI, the goal of FPI is not to obtain significant control in the foreign entity, but rather to generate short-term financial gain for the investor. Notably, FPI investors mainly invest in highly liquid securities and are not necessarily committed for the

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<sup>3</sup> It is important to note that when the non-resident (whose initial acquisition is through FPI, i.e., less than 10%) purchases additional shares to reach or surpass the 10% threshold, it is only the market price of the additional shares purchased whose value is recorded as FDI in the Balance of Payments. The holdings previously acquired through FPI are never re-classified as FDI in the Balance of Payments. The total holdings (sum of FPI and FDI equity holdings acquired) is instead reclassified in the International Investment Position (IIP) (Duce, 2003: 3-4).

<sup>4</sup> See Chapter 3.

long-term. Indeed, the FPI investor seeks to maximise profits by investing in financial assets that are liquid and offer ease of global mobility.

A key point from the host country perspective is that even though FDI and FPI both involve investment in a foreign enterprise, FPI is not involved in the creation of productive capacity (Meyer, 2015). In the case of FDI, the foreign investor, according to Meyer (2015: 58), acquires foreign assets with the aim of enhancing “their capability portfolio in the home country or in third country markets”. This objective entails not only intensive capital investment, but also extensive time frames. Of strategic importance to the investing firm, FDI projects are often very large and have significant impact on stakeholders at home and abroad (Meyer, 2015).

In their definition of FDI, Büthe and Milner (2008: 3) note that it entails the acquisition and/or creation of productive capacity, with substantial involvement of some assets that cannot be moved without considerable loss to the investor, as well as implications of a long-term perspective. Büthe and Milner (2008) indicate, however, that in the case of so-called ‘vertical investments’ which form part of the multinational company’s global production chain, longevity of investment and the inability to move assets without loss may be less applicable. From the perspective of the developing country, inward FDI that involves a commitment from the multinational enterprise to invest capital and/or other resources in a domestic entity over a long period of time is crucial for both capital accumulation and long-term economic growth. In addition, investment in assets from which it is difficult to disinvest without incurring significant losses is of course preferred from the host country perspective (Büthe and Milner, 2008).<sup>5</sup>

Frenkel *et al.* (2004: 281) note that FDI flows “are driven by factors that push capital out of a country as well as by factors that pull capital into a country”. Developing countries are therefore not always able to influence FDI inflows because, for the investing multinational enterprises (MNEs), factors related to the domestic business cycle have a huge impact on the decision to acquire a foreign firm or set up a subsidiary entity abroad (Frenkel *et al.*, 2004). Thus, conditions influencing FDI outflows determine FDI inflows. These factors determine the

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<sup>5</sup> Examples of fixed assets which are not easily (or not always profitably) disposed of include manufacturing plants, warehouses, buildings, capital-intensive intellectual property (e.g., research and development and technical know-how) and other long-term infrastructure developments.

attractiveness – or lack thereof - of a developing country as an investment destination for FDI (Frenkel *et al.*, 2004; Wagner, 2020), as discussed further in Sections 2.3 to 2.5 below.

Agosin (2008: 3) notes that a substantial amount of FDI never evolves to become investment in the real sense. Certainly, in the case of many mergers and acquisitions, such foreign investment simply translates into domestic company balance sheet transfers of ownership of existing local assets from domestic firms to international ones (Agosin, 2008). The definition of FDI given by Bütthe and Milner allows for the inclusion of both acquired and created productive capacity in the concept (Bütthe and Milner, 2008). The question of whether FDI merely amounts to the balance sheet transfers of ownership of existing local assets (i.e., acquisitions of already existing productive capacity) instead of being investment in the real sense (i.e. the creation of productive capacity) highlights the importance of understanding not just the definitions of FDI, but also its varying motives and modes of entry (Agosin, 2008).

In cases where FDI fails to become investment in the real sense, Akyüz (2006: 4-5) argues that it is important to consider whether in such instances FDI “is serving more to redistribute investment and jobs among countries than to accelerate capital accumulation and job creation”. This is an important issue to explore in determining whether the inward FDI secured by a developing country is of an appropriate nature and supports its national goals for growth while also enhancing other developmental initiatives that are in place (Njambi, 2018; Zhan, 2021).

Although FDI and FPI are different concepts representing two ways in which foreign investment can occur, they can both be measured in terms of stocks and flows. According to OECD (2018b), FDI stock measures direct investment at a particular point in time, such as the end of a calendar year. On the one hand, outward FDI stock quantifies “the value of the resident investors’ equity in and net loans to foreign firms” while inward FDI stock measures “the value of foreign investors’ equity in and net loans to domestic organisations” (OECD, 2018b: 1). According to OECD (2018a), FDI flows measure the value of direct investment cross-border transactions during a particular period, usually a quarter or a calendar year. Examples of FDI flows include “equity transactions, reinvestment of earnings, and intercompany debt transactions” (OECD, 2018a). Outward flows reflect transactions which increase the investment held by a multinational enterprise in an outside market while inward flows “represent transactions that increase the investment that foreign investors hold in enterprises

which are resident in the reporting economy less the transactions which decrease the investment of foreign investors in resident enterprises” (OECD, 2018a: 1).

### **2.3 Motives for FDI**

In order to understand the nature of both inward and outward FDI, it is imperative to examine the motives behind it. The motives for FDI will often determine the modes of entry selected by the investing multinational enterprise as part of its FDI implementation strategy. The motives for FDI will also determine the level of risk that the multinational enterprise deems as ‘acceptable’ in its outward FDI strategy and will be influenced by the perceived potential benefits. The level of risk deemed acceptable and the potential benefits will in turn be related to a range of factors, both macroeconomic and institutional, some pull and some push in nature. Understanding the motives behind the inward FDI attracted by developing countries helps to facilitate the empirical analysis of its effects and enables the recipient countries to determine the appropriateness of the FDI they attract (Jakubiak and Kudina, 2008; Meyer, 2015). Such understanding is a pre-requisite for assessing impact and designing effective FDI strategies, as well as determining the potential effects of engaging in international investment treaties (Anwar, Iwasaki and Dornberger, 2022; Jakubiak and Kudina, 2008; Pananond, 2015).

Jakubiak and Kudina (2008: 3) note that because of the economic liberalisation undertaken by many countries in the latter part of the 20<sup>th</sup> Century, significant market and production opportunities opened up for multinational enterprises. FDI facilitates entry into foreign markets and provides MNEs with the tools with which to exploit production opportunities. There is consensus that the trend by MNEs towards globalised production and marketing has significant implications for the attractiveness of developing countries as destinations for FDI. The rapid rise of FDI flows into developing countries since the 1990s suggests that a number of these countries have become profitable investment destinations (Njambi, 2018; Kox and Rojas-Romagosa, 2020; Nunnenkamp, 2002: 1-2).

To gain an advantage in the competition for FDI, developing countries need to be well versed in traditional FDI motives and determinants. However, research suggests that because of globalisation, the motives and determinants of FDI have evolved so much that there is no longer a ‘norm’. Nunnenkamp (2002: 1) affirms that “the rules of the game have changed”, such that the offer of promising markets is no longer sufficient for attracting FDI. Policymakers face

complex challenges in the scramble for locational attractiveness to foreign investors (Nunnenkamp, 2002: 1-2; Wagner, 2020).

Motives for FDI vary depending on the circumstances of individual multinational firms, the economic challenges in home markets and opportunities in markets abroad, the political landscape domestically and abroad, and so on. The most common motives for FDI include market seeking, efficiency seeking, natural resource seeking and strategic asset seeking (Jakubiak and Kudina, 2008; Meyer, 2015). These motives serve as the drivers of FDI (Driffield, Jones, Kim and Temouri, 2021). They influence the outward FDI strategies of multinational investors, the inward FDI attracting initiatives of recipient developing economies, and economic activities of domestic firms (Jakubiak and Kudina, 2008: 1-3).

According to Meyer (2015), market seeking by multinational enterprises is influenced by their respective corporations' strategic decision to explore new opportunities due to adverse conditions in the domestic market, or favorable condition in foreign markets. Nunnenkamp (2002: 1) argues that, with many developing countries liberalising their import regimes, while at the same time relaxing local performance requirements such as local content rules, tariff-jumping FDI designed to serve large protected markets has increasingly become less relevant. Developing countries have also become attractive locations for foreign investors through membership of trade agreements with both developed and other developing countries (Kox and Rojas-Romagosa, 2020; Sauvart, 2007).

In market seeking FDI, foreign firms can outsource parts of their value chain and production to efficient lower income developing countries to reduce costs (Nunnenkamp, 2002; Pananond, 2015; Wagner, 2020). By having production facilities abroad, multinational enterprises also reduce the production and delivery costs in those markets as they enjoy close proximity to both the local supply chain and customer base. Local production furthermore improves customer service and the relationships the company has with its suppliers and other partners in logistics (Peng and Meyer, 2020; Anwar, Iwasaki and Dornberger, 2022).

Another reason for market seeking FDI can be the opportunities presented to an MNE when key customers of the firm move their operations abroad. By following key customers abroad, firms can prevent other vendors from serving these customers. To this end, the foreign investor may determine that it would be advantageous for actual production to be located close to its

key customers and/or the point of consumption. This is especially the case in service industries such as hotels and retail outlets, and for manufactured goods subject to high transportation costs. Therefore, in making investment decisions that are premised on market-seeking, the foreign investor seeks ways to reach its customers more effectively than its competitors do.

Furthermore, market seeking as a motive for FDI can also be used to compete with rival firms in their own market (Anwar, Iwasaki and Dornberger, 2022). Peng and Meyer (2020) note that in the case of market-seeking FDI, foreign investors pursue opportunities in countries offering new customers with strong demand for the firm's goods and services. Literature suggests that because many developing countries have relatively young populations compared to developed countries, such countries offer numerous growth opportunities for the products and services offered by MNEs (Meyer, 2015; Peng and Meyer, 2020). In the case of a market-seeking foreign investor, the enterprise would first identify the relevant market and determine where its potential future customers are located, before going on to secure locations for its sales, marketing and distribution operations in the domestic market of the host country (Mistura and Roulet, 2019; Peng and Meyer, 2020).

There are five motivations behind the efficiency seeking motive for FDI. The first of these is economies of scale. By undertaking an international expansion, the firm has the potential to increase its economies of scale (Dunning and Narula, 2000). Access to financial economies is also enhanced because of the power wielded by larger firms. Unlike smaller firms, large firms can borrow significant sums of money with relative ease and often at negotiable costs due to the preferential treatment financial markets and institutions afford them (Dunning and Narula, 2000; Wagner, 2020). Through increased economies of scale, the efficiency with which the daily operations of the firm are run is increased while production costs per unit are decreased.

Sourcing and production costs are reduced through access to inexpensive labor and cheaper inputs because of higher volumes in the production process. Such increased efficiency frees up time and resources that can be invested in strategic actions (Meyer, 2015; Driffield *et al.*, 2021). A second motivation, linked to economies of scale, is cost savings from economies of scope. These are attainable as the company uses managerial resources, facilities and other assets across a broader market area.

A third significant factor in efficiency-seeking FDI is that of access to relatively cheaper labour,

either skilled and/or unskilled. In an effort to cut costs and increase profits, multinational enterprises may utilise FDI to move production to countries where wages are lower. Peng and Meyer (2020) note that in an effort to enhance the efficiency of the enterprise, investors seek to reduce production costs. Therefore, the focus of investors is on locations which optimise the operations of the firm such as competitive labour costs, good transportation linkages, and economies of scale as noted above.

The fourth motivation behind efficiency seeking FDI is the objective of locating production near customers (Sauvant, 2007; Wagner, 2020). In industries that are sensitive to customer needs and/or vulnerable to swift changes in taste, it is possible to achieve efficiency through the location of production near customers (Meyer, 2015; Mistura and Roulet; 2019). According to Kurtishi-Kastrati (2013: 58), vertical FDI is seen as efficiency seeking, because the main objective is to reduce the overall costs of the firm's operations. Therefore, the main question asked by the foreign investor in this case is the one of how the firm can lower the costs of its operations in order to deliver its goods and services to its customer base efficiently.

A fifth motivation behind efficiency seeking FDI is to take advantage of government incentives (Driffield *et al.*, 2021; Kurtishi-Kastrati, 2013). Developing countries have to compete for the limited FDI resources of MNEs. In cases where competing countries offer the same locational advantages to investors, FDI may be won by those countries offering the biggest financial incentives and subsidies (Dunning and Narula, 2000). Many developing countries offer investment incentives to foreign companies as a strategy to attract FDI (Enright, 2009). Examples of these include preferential taxation schemes, preferential loans and special economic or development zones (Driffield *et al.*, 2021).

The motive behind resource seeking FDI is that multinational enterprises need raw materials in extractive and agricultural industries. With resource seeking as the motive behind FDI, foreign investors seek to access specific resources that they require in their production processes (Meyer, 2015; Peng and Meyer, 2020). These may include precious metals such as gold, silver, or platinum, as well as oil, coal, gas, or renewable resources such as timber or other agricultural products necessary to produce its products. In such circumstances, firms have little option but to locate their operations where the resources are found. The main question that faces resource seeking investors is therefore one which identifies where the firms can find these resources and how best to access them (Peng and Meyer, 2020). Notably, research

findings suggest that in the case of Africa, the effect of resource seeking FDI is larger than that of market seeking motive (Anwar, Iwasaki and Dornberger, 2022).

According to Meyer (2015: 60), strategic asset-seeking FDI is concerned with the capabilities of the investing firm, as well as its global competitiveness. Global, in this context, refers to markets other than those served by the target of the acquisition (Meyer, 2015). For example, an MNE seeking to strengthen its position in Namibia may acquire a South African company that has a strong and established footprint in the Namibian market. There are many reasons behind the FDI motive of strategic asset-seeking (Enright, 2009). These include knowledge, technological and managerial know-how (Meyer, 2015; Pananond, 2015; Chen, 2018; Zhan, 2021).

Technological capabilities of a developing country are a very important factor in attracting FDI (Meyer, 2015; Chen, 2018). The importance of technological capabilities is emphasised as a motive behind outward FDI from developing countries. Meyer (2015: 60) notes that a significant amount of outward investment emanating from emerging markets involves the acquisition of companies in economies that have superior skills and advanced technology relative to the investing company. These strategic acquisitions strengthen the investing firm's capabilities in both the local market and its global operations (Meyer, 2015: 60-61). The employment of FDI to establish local presence enables a firm to deepen its understanding of local markets, customers and distribution systems. According to Meyer (2015: 59), however, some empirical studies suggest that strategic asset-seeking is redundant as a concept because all FDI investments can be categorised under any of the other three motives.

## **2.4 FDI modes of entry**

FDI can take place either through the direct entry of foreign firms or through the acquisition of domestic firms by foreign firms (Mattoo *et al.*, 2004; Driffield *et al.*, 2021; Wagner, 2020). It is argued that the degree to which developing countries can obtain the potential benefits of FDI, such as technology transfer and greater market competition, is largely determined by the FDI modes of entry employed by foreign firms (Mattoo *et al.*, 2004). Peng and Meyer (2020: 342) refer to modes of entry as “the format of foreign market entry”. Developing countries expect inward FDI to bring about more competitive product markets while the degree of investing

firms' outward FDI is limited by the costs of transfer of modern technologies (Dorakh, 2020; Driffield *et al.*, 2021; Lall, 2000; Mattoo *et al.*, 2004).

Irrespective of whether a foreign firm chooses the direct entry or acquisition of domestic firm route in its outward FDI strategy, the methods available to implement its preferred mode are similar. The most common methods available for FDI modes of entry include wholly owned subsidiary, joint ventures, Greenfield investment, Brownfield investment, and mergers and acquisitions (Mattoo *et al.*, 2004; Zhou, Kumar, Yu and Jiang, 2021). According to Brandão *et al.* (2008: 8), most studies suggest that the decision on entry mode is primarily affected by firm, industry and country-specific determinants.

Of these modes, wholly owned subsidiaries and joint ventures are the overarching concepts in that they are the 'vehicles' through which resources are deployed in Greenfield investment, Brownfield investment, mergers and acquisitions (Fuming and Li, 2009; Zhou *et al.*, 2021). In the case of a fully owned subsidiary, the foreign firm is fully owned (i.e., the direct investor controls the entirety of the foreign firm's shareholders' voting rights) by the investing multinational entity. The foreign firm can either be an entirely new operation or plant set up by the investing firm, or it can be a foreign firm whose entire ownership (or more than 50% of shareholders' voting rights) is acquired by the investor through FDI. Harrison (1994: 10) points out that, as an FDI mode of entry, subsidiaries may not engage in technology transfer to local firms. A further disadvantage, according to Harrison (1994: 10), is that there may be adverse effects on local competitors. Their link to development is thus complex.

According to Graham and Spaulding (2005: 3), the conventional joint venture is a formal bilateral association between two parties who operate within the same industry and who are partnering to gain some strategic advantage. With a joint venture, the multinational investor acquires a joint interest in a foreign firm in conjunction with another firm. A joint venture with an experienced and established brand in a particular market facilitates quick entry into a market while also providing access to local resources (Estrin and Meyer, 2001; Peng and Meyer, 2020).

According to Makino and Yiu (2002: 667), the decision behind the investing firm's FDI entry mode choice is based on the firm's "deliberate, conscious efforts to enhance their competitiveness, efficiency, and control over critical resources". Other advantages include the pooling of resources (human resources, joint marketing arrangements and licenses, and so on),

opportunities for co-production, and the relative ease of integrating different corporate cultures when partners are few (Graham and Spaulding, 2005; Ro, 2022). Notably, FDI modes of entry “vary in terms of commitment, risk, return and control” (Peng and Meyer, 2020: 342).

In the case of technological and managerial know-how, there may be benefits from engaging in joint ventures in an industrial cluster. Presence in a key industrial cluster not only affords the company access to firms like itself, but it also opens the way to innovation and advancement. In addition, joint ventures often serve as a prelude to eventual full ownership FDI. In such circumstances, the initial partnership with domestic partners can reduce the risks associated with entry, while providing the entrant with local expertise before launching its own operations.

When a multinational enterprise enters a foreign market by setting up an entirely new plant, the mode of entry is called ‘Greenfield investment’ (Görg, 2000; Brandão *et al.*, 2008; Nguyen and Bhin, 2021). Unlike an acquisition where a degree of ownership in an existing firm is purchased through FDI, with a Greenfield investment, the new project is built from the start by the investor. While a Greenfield investment may give the multinational firm the opportunity to build something new and tailor-made to its requirements, entry into a new market can be slow and challenging (Estrin and Meyer, 2001). According to Brandão *et al.* (2008) and Zhou *et al.*, 2021, research suggests that Greenfield FDI has significant positive growth impacts in both developed and developing countries.

Described as a special case of acquisition, the Brownfield entry mode is one in which the resources transferred by the investor dominate over those provided by the acquired firm (Estrin and Meyer, 2001; Peng and Meyer, 2020). One of the advantages of a Brownfield investment is that through an acquisition, quick entry into the market is facilitated with access to local resources secured by the investing firm (Estrin and Meyer, 2001; Ro, 2022). Estrin and Meyer (2001: 575) caution however that in order to overcome a lack of synergy between the two organisations, it may be necessary for the acquired company to undergo deep restructuring. In emerging economies, the extent of restructuring can at times be so immense that the final product resembles a Greenfield investment; in such cases the Brownfield investment represents a hybrid mode of entry (Estrin and Meyer, 2001; Nguyen and Binh, 2021).

According to Brandão *et al.* (2008: 8), mergers and acquisitions (M & A) as a mode of FDI entry are different to Greenfields in that, by definition, M & A involves “a transfer of assets from domestic to foreign hands and, at least initially, does not add to the productive capacity of host countries”. Brandão *et al.* (2008: 8) argue that this in turn results in a range of challenges including inadequate transfers of resources, letting go of some of the labour force, stripping of certain assets, and so on. More importantly, M & A carry potential adverse effects on market structure and competition. Notably, Brandão *et al.* (2008), as well as Zhou *et al.*, 2021, cite key findings of several studies which suggest that, compared to Greenfields, M & A may initially yield undesirable outcomes with respect to the development of host countries, including adverse effects on growth.

In a similar vein, Agosin (2008) finds insufficient evidence to support the hypothesis that M & A may result in any increases in the physical capital of a host country. Agosin (2008) argues that almost akin to FPI, some cases of M & A do not improve the operation of the local companies, as evidenced in Latin America starting in the 1990s when those economies first became highly attractive investment destinations. Furthermore, there is scant evidence to suggest that M & A are followed up with further investment by the foreign investor (Agosin, 2008; Ro, 2022; Zhou *et al.*, 2021). Whilst there may be expectations of M & A leading to increased investment when those who sell their equity re-invest in other businesses in the domestic market, research findings suggest that this is not the case. Agosin (2008) finds that not only is the effect likely to be weak, but it is also improbable. The sellers of the shares purchased through M & A evidently more often use the proceeds to acquire other domestic and/or foreign financial assets than to make real investment in the domestic market (Agosin, 2008; Zhou *et al.*, 2021). It is therefore difficult to support the hypothesis of a causal relationship between acquisitions of local businesses by MNEs and real investment.

Similar to large portfolio inflows, large M & A potentially carry adverse macroeconomic externalities, including the appreciation of the exchange rate. Exchange rate appreciation can discourage investment for export markets, while simultaneously signalling to foreign manufacturers to reduce the production of importable goods and services (Agosin, 2008; Nguyen and Binh, 2021; Zhou *et al.*, 2021). This has adverse balance of payments implications in the economies of small countries, where such investments constitute the main drivers of growth. Therefore, in the case of M & A, Agosin (2008: 5) argues that “FDI is not investment in the national accounts sense, and it does not lead to investments later”.

In sum, it can be deduced from the analysis that of all the modes of FDI discussed, joint ventures, Greenfield investments and Brownfield investments are the most beneficial modes of entry from the perspective of the host country. Furthermore, studies suggest that both the motives and modes of entry of FDI are impacted on by a key set of determinants, both institutional and macroeconomic, discussed in the theories of FDI below.

## **2.5 Theories of FDI and key determinants**

Since the Second World War, FDI has played a significant role in international economics. The common notion in the main theories of FDI is that FDI makes a significant contribution to economic development in all countries, particularly those in the developing world (Denisia, 2010; Kurtishi-Kastrati, 2013). While there are many theories to conceptualise FDI, it cannot be said that there is a generally accepted theory (Kurtishi-Kastrati, 2013; Surbhi, 2017). With more empirical research done on FDI, newer evidence is brought to light adding new elements and criticism to previous findings (Denisia, 2010; Kamaly, 2014; Hartmann and Spruk, 2022). In the early days of FDI research, determinants and impacts of FDI were explained theoretically without the provision of accompanying empirical evidence. This has changed with the use of econometric models, equations and indices to deduce empirical results (Kurtishi-Kastrati, 2013).

Traditional trade theory, including Ricardian and Heckscher-Ohlin models, assumes that factors of production are immobile internationally and therefore does not allow for the occurrence of FDI. Once factor mobility is allowed for, however, neoclassical theory predicts that low-income countries will attract the most FDI as they would have the highest rates of return to capital flows, provided the identical technology assumption is retained (Zebregs, 1998). Once the assumption of identical technology is relaxed, there is more scope for neoclassical theory to explain FDI flows but Zebregs (1998) concludes that this is still not sufficient. The genesis of modern FDI theory is rather to be found in industrial organisation and international business theory.

Early FDI theory is associated with Stephen Hymer's landmark 1960 microeconomic theory of international production, published posthumously in 1976. According to Kurtishi-Kastrati (2013), Hymer (1976) argued that the reasons for the internationalisation of companies are of two kinds. The first concerns variables that are associated with the company's dimension and

ownership of specific assets. The second kind is associated with variables that owe their existence to market failures (Kurtishi-Kastrati, 2013). Hymer claimed that multinational enterprises possess specific advantages enabling them to operate profitably in foreign markets (Dunning, 1988).

Initially put forward in the national context by Coase and Fowler (1940) then internationally by Hymer (1976), the internalisation theory (IT) was further developed by Buckley and Casson in 1976, then by Hennart in 1982, and eventually Casson in 1987. The key FDI determinants identified by Hymer include the advantages possessed by certain firms in a particular activity (Dunning, 1988). Buckley and Casson (1976) demonstrated how multinational firms organised their internal activities in a manner that cultivated particular advantages to be exploited for profit maximisation. According to Denisia (2010: 56), Hymer, the author of the concept of firm-specific advantages, demonstrated that “FDI takes place only if the benefits of exploiting firm-specific advantages outweigh the relative costs of operations abroad”, recognising that “FDI is a firm-level strategy decision rather than a capital-market financial decision”.

The literature on FDI suggests that the evolution of main FDI theories is ongoing as the global and ICT environment changes. There are four headings under which the main contemporary FDI theories are commonly classified. These are the product cycle theory of Vernon, the theory of exchange rates in the context of imperfect capital markets, the internalisation theory noted above, and the eclectic paradigm of Dunning (Denisia, 2010; Banerji, 2017; Wagner, 2020).

Conceptualised in the 1960s by Raymond Vernon, the Product Life Cycle (PLC) theory postulates that products undergo various stages in their development (Vernon, 1966). The first phase that products pass through is known as the ‘introductory phase’. This is followed by the ‘growth phase’ which, in turn, is followed by ‘maturity’. The duration of each phase is determined by a variety of factors. The final stage, reached after the product’s output has reached its peak, is the ‘decline phase’. Vernon’s view is that when it comes to companies they have pioneered, firms will engage in FDI during particular phases of the product’s life cycle (Kurtishi-Kastrati, 2013: 59). Consequently, FDI is initiated in domestic markets and gradually ushered into foreign markets as product standardisation and market saturation create inevitable price competition and cost pressures (Vernon, 1966; Kurtishi-Kastrati, 2013).

With labour costs generally lower in developing countries, investment therein is regarded as an effective way to reduce costs (Kurtishi-Kastrati, 2013; Nguyen and Binh, 2021). Driven predominantly by cheap labour considerations, Kurtishi-Kastrati (2013: 59) conclude that, in the latter stages of the product phase, FDI will be export oriented. However, Lall (2000), as well as Huang, Sheng and Wang (2021) argue that the importance of labour costs as a source of competitive advantage is declining. Vernon's theory succeeded in explaining the kind of FDI made by American firms in Western Europe in the decades between 1950-1970 (Vernon, 1966; Denisia, 2010). While Vernon's theory may be applicable for some products, it has not been found to be practical in the case of vertically integrated MNEs (Kurtishi-Kastrati, 2013).

Another theory attempting to explain FDI considers the relationship between exchange rate fluctuations and FDI in the context of imperfect capital markets (Denisia, 2010; Grambovas, 2014; Fama *et al.*, 2021). With reference to the work of Cushman (1985), Denisia (2010: 56) explains that if the host country's currency depreciates, the foreign investing firm's wealth increases, exerting a positive effect on inward FDI to the host economy. Therefore, the stronger the domestic currency of the investing firm is, the higher their level of FDI to the host country, and vice versa. A weakness in the theory, Denisia (2010: 56) claims, is that "currency risk theory cannot explain simultaneous foreign direct investment between countries with different currencies".

John Dunning, in his extensive contribution to FDI theory, argued that the internalisation theory discussed earlier only succeeds in explaining a part of FDI. He nonetheless recognised it as very important, going on to use it in his eclectic theory, a mix of three different theories of FDI initially developed in 1973. The three theories were abbreviated by the acronym 'OLI' with 'O' representing ownership advantages, 'L' for location, and 'I' for internalisation (Dunning, 1988; Denisia, 2010; Banerji, 2017; Wagner, 2020). According to Denisia (2010: 57), the ownership advantages are intangible assets which initially belong exclusively to the company "and may be transferred within transnational companies at low costs, leading either to higher incomes or reduced costs". The ability to generate and sustain these ownership advantages is in itself a competitive advantage that the MNE possesses (Dunning, 1988). There are three types of ownership advantages: those that stem from the exclusive ownership or access to income generating assets, those that are enjoyed by a subsidiary company linked to a holding company, and those that are a consequence of geographical diversification (Dunning, 1988).

Denisia (2010: 57) outlines the firm-specific advantages stemming from exclusive ownership or access to income generating assets as “monopoly advantages in the form of privileged access to markets through ownership of limited natural resources, patents, trademarks, technology, knowledge broadly defined so as to contain all forms of innovation activities; economies of large size such as economies of learning, economies of scale and scope, greater access to financial capital”. The ownership advantages, described as ‘monopolistic’ or ‘competitive’, need to compensate for both the costs of setting up the value-adding operation in foreign territory plus the costs incurred by current or potential domestic producers in the domestic market (Dunning, 1988; Nguyen and Binh, 2021). To retain such firm-specific advantages, it follows that the company should retain them for its exclusive exploitation rather than passing the benefits on to foreign firms (Dunning and Narula, 2000; Denisia, 2010; Wagner, 2020).

The locational advantages of different countries are key determinants of which countries will become the recipients of FDI. Locational advantages include economic benefits that can be measured in quantitative and qualitative terms, political advantages relating to FDI-related government policies, and social advantages such as cultural diversity (Denisia, 2010). Findings of empirical studies on the locational determinants of FDI reveal that they are strongly dependent on the motivation for the FDI, the economic and business environment of the host country and its government’s FDI policies, and the mode of entry and/or expansion of the FDI (Bhandari, Zamborsky, Ranta and Salo, 2023; Dunning and Narula, 2000).

In the exploitation of ownership advantages, firms will often have a choice between internalising or externalising the market (Bhandari *et al.*, 2023; Chemsripong; 2023; Dunning, 1988). A firm internalises a market when it creates an ownership advantage or acquires it for its exclusive use. On the other hand, a firm can externalise a market through franchising (Casson and Wadeson, 2018; Luo, 2021; Dunning, 1988). I for ‘internalisation’ provides a framework with which to assess different ways for the company to exploit the advantages it has from its sale of goods and services and/or various agreements signed with other companies. An increase in host market benefits incentivises the MNE to undertake its own foreign production activities via FDI instead of issuing this right under license or franchise.

The eclectic theory demonstrates that OLI boundaries are context-specific and vary between companies while also reflecting the socio-economic characteristics of the host country (Denisia, 2010; Sharmiladevi, 2017). Consequently, Denisia (2010: 57-58) explains that the

objectives and strategies of the MNE, as well as the magnitude and pattern of production rely significantly on the challenges and opportunities offered by different types of countries.

As noted in Chapter 1, FDI theory and associated empirical work has led to a set of FDI determinants that are commonly identified in the literature. Traditional FDI determinants that are longstanding in the literature include locational factors such as natural resources, other geographical characteristics, labour costs and human capital endowments, as well as infrastructure (Addison and Heshmati, 2003: 1; Bezuidenhout and Kleynhans, 2018; Kok and Ersoy, 2009). Added to these are traditional macroeconomic determinants such as market size, inflation and exchange rate fluctuations (Grosse and Trevino, 2005), as well as tax, debt service as a share of GDP and trade openness (Kok and Ersoy, 2009; UNCTAD, 2022a).

As discussed in Section 1.1, in addition to the traditional determinants of FDI, shifts in global politics, democratisation and advances in ICT have served as significant pull factors for FDI into developing countries (Addison and Heshmati, 2003; Kok and Ersoy, 2009). In relation to these shifts, institutional economists have increasingly emphasised the importance of institutional determinants of FDI (Grosse and Trevino, 2005; Njambi, 2018). In this regard, factors such as political risk/stability, corruption, privatisation and FDI regulations, as well as membership of regional groupings, trade agreements and/or bilateral investment treaties have been highlighted in the theoretical and empirical literature (Grosse and Trevino, 2005; Kox and Rojas-Romagosa, 2020). The institutional economics approach to the determinants of FDI is particularly relevant for this thesis, as it provides an appropriate lens through which to consider the impact of bilateral investment treaty participation on FDI into developing countries.<sup>6</sup>

The combined effect of key FDI determinants has resulted in a skewed distribution of FDI among developing countries. Research findings suggest that FDI to least developed countries (LDCs) tends to be concentrated in natural resource intensive sectors, especially mining (Addison and Heshmati, 2003; Bezuidenhout and Kleynhans, 2018; Casson and Wadeson, 2018). Although FDI in mining provides foreign currency and public revenue, its overall economic multiplier effects on GDP and employment are more limited (Addison and Heshmati, 2003: 1-2). Such limitations undermine developing countries' expectations for FDI to deliver GDP growth.

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<sup>6</sup> See Chapter 3.

By contrast, investments in ICT and skills development enable developing countries to reduce their dependence on natural-resource endowments while also offsetting the geographical disadvantages of landlocked countries (Dunning and Narula, 2000; Peng and Meyer, 2020). Unfortunately, many developing countries lack the technological capability to facilitate the transfer from natural-resource dependence. Empirical studies suggest that spillovers from foreign investment are the most important channel for transferring technology to developing economies (Kok and Ersoy, 2009: 105). Nonetheless, by combining ICT and skills development with investor-friendly policies brought about by democratisation, several LDCs are beginning to position themselves to gain even greater shares of FDI.

## **2.6 The potential benefits of FDI for developing countries**

Developing countries seek FDI as a means for economic development and a way to transfer skills, managerial capability, and technology to local industries (Chen, 2018; Elfakhani and Mackie, 2015; Kurtishi-Kastrati, 2013; Swenson, 2005). Furthermore, developing countries prefer FDI as a means of increasing investment stocks because, unlike FPI, FDI is less likely to leave the host country in times of financial crisis (Swenson, 2005; Dorakh, 2020). Although MNEs have potential adverse effects on local markets, such as creating competition with domestic firms that may crowd out domestic companies, scholars usually find the net effect of FDI to be positive for host countries (Elfakhani and Mackie, 2015; Fu, Buckley and Fu, 2020).

The view that FDI is a significant contributor to economic growth and impetus to development is widely accepted amongst developing countries, including those in Africa which actively seek to attract it (Lall, 2000; Okafor, Piesse and Webster, 2015; Fu, Buckley and Fu, 2020). Although the impact of FDI varies in different regions, research has found positive effects on growth and development in developing countries through capital accumulation and knowledge transfers. FDI can enhance development by facilitating the incorporation of new production techniques and technologies in the production process and augmenting the knowledge base of the host country through the transfer of skills, technological know-how, alternative management practices and organisational structures (Brandão *et al.*, 2008: 22-23). The positive impact of FDI on economic growth can in turn increase FDI further, resulting in a cumulative beneficial effect on development (Brandão *et al.*, 2008: 19; Mishra and Jena, 2019; Pananond, 2015).

This view of the impact of FDI on growth and development is, however, challenged by some researchers. According to Demir (2016: 1), for example, “there is no strong evidence of any benevolent or malevolent effects of bilateral flows from developed or developing countries to [other] developing countries”. Hence, while there may be empirical evidence to support the positive relationship between FDI and development, there is also skepticism. Lall (2000: 5), for example, seems less convinced of the reliability of such evidence, claiming that “the economic effects are very difficult, if not impossible, to measure accurately”. The FDI ‘packages’ that MNEs present to Africa are not only complex, but they vary over time as they are continually adapted to each host country’s particular conditions. The intricate nature of these tailor-made adaptations makes it very difficult to separate and quantify the economic effects of FDI and related impact on development. While there may be credible research to support the positive impact, there are also empirical findings that are stubbornly agnostic (De Crombrughe *et al.*, 2014; Demir, 2016; Lall, 2000; Ro, 2022). Lall (2000: 5) suggests that “since growth depends on many factors whose effects are difficult to disentangle, and since FDI itself affects several of these factors, an agnostic conclusion is probably the most sensible”.

One key aspect of the debate on the benefits of FDI concerns the impact of FDI on domestic investment. FDI may crowd in, crowd out or have a neutral effect on domestic investment (Agosin, 2008; Ahmed *et al.*, 2014; Kamaly, 2014). Crowding in (CI) occurs when FDI leads to increased investment from domestic firms (Agosin, 2008; De Crombrughe *et al.*, 2014; Kamaly, 2014). FDI in this instance is complementary to domestic investment (Ahmed *et al.*, 2014: 421). CI is generally regarded as beneficial for economic growth and development because it stimulates competitive product markets and creates employment opportunities (De Crombrughe *et al.*, 2014). A key feature of CI is that the presence of MNEs facilitates new downstream or upstream investment by domestic firms that would not have taken place in the absence of foreign firms (Agosin, 2008; Kamaly, 2014; Elfakhani and Mackie, 2015; Luo, 2021).

The market entry of a foreign firm also increases domestic productivity because less efficient domestic-owned firms are pushed out of the market with those remaining forced to increase their investment (i.e., CI) in order to improve productive capacity (De Crombrughe *et al.*, 2014; Kamaly, 2014; Chemsripong, 2023). However, De Crombrughe *et al.* (2014: 1) caution that the dominance of foreign firms in domestic markets may cause markets to “become less efficient, with a potentially negative effect on growth and investment”.

On the other hand, Agosin (2008: 1) explains that crowding out (CO) occurs when FDI displaces or pre-empt investment “that would have been made by domestic firms in the absence of the foreign investor”. Ahmed *et al.* (2014: 421) suggest that FDI crowds-out domestic investment “if instead of augmenting capital accumulation in the recipient country, it displaces domestic investors through channels such as competition in the product market, financial market or via superior technology”. In such circumstances, the advantages held by MNEs make it difficult, if not impossible, for domestic firms to compete. Unlike CI, CO is considered to have a negative impact on investment and economic growth and is thus not regarded as beneficial for development (De Crombrugghe *et al.*, 2014; Agosin, 2008). Developing countries with domestic firms that have restricted absorptive capacity, limited investment opportunity, and inferior productive capacity are more likely to experience CO. The incidence of CO is also higher when the foreign firms’ advantage in productivity is due to access to finance, skilled labour, technological know-how, innovation and so on (De Crombrugghe *et al.*, 2014: 1-2).

The third possible effect of FDI on domestic investment is called the ‘neutral effect’. Ahmed *et al.* (2014: 421) explain that “inward FDI will have a neutral effect on domestic investment if it brings a one-for-one increase in total investment in the host country”. In other words, FDI has no displacing or stimulating effect on domestic investment. Given that FDI is expected to stimulate economic growth and development, it can be surmised that when FDI has a neutral effect on domestic investment, it fails to fulfil its potential to influence either growth or development in developing countries (Elfakhani and Mackie, 2015; Kamaly, 2014; Lall, 2000; Luo, 2021).

The full (or partial) ownership of domestic firms by multinationals may afford some developing countries access to international markets and supply chains that represent a potential for growth (Akyüz, 2006; Kox and Rojas-Romagosa, 2020). Akyüz (2006: 16) cautions, however, that it does not necessarily follow that such association with a global enterprise will result in success for the domestic firm and recipient developing country from an industrialisation perspective. Depending on the motives behind the multinational enterprise’s outward FDI and the modes of entry linked to it, the transfer of technology and intellectual capital to the domestic firm is not necessarily guaranteed (Akyüz, 2006; Chen, 2018; Zhou *et al.*, 2021). As with all types of investments, there are risks and benefits associated with FDI and neither growth nor success are guaranteed.

## 2.7 Conclusion

The aim of this chapter was to provide a picture of the motives and determinants of FDI discussed in the theoretical literature, with a view to understanding the arguments underpinning the perspective that developing countries wishing to attract FDI need to consider institutional determinants that may enable FDI, such as BITs or investment chapters in broader trade agreements.

As noted in Section 2.2, FDI is defined as an investment vehicle that MNEs utilise to acquire a lasting interest in a company that is resident in another country. For this ‘direct investment’ to qualify as FDI, the foreign company must acquire a minimum of 10% of the domestic company’s ordinary shares or voting rights. Although FDI and FPI are foreign investment tools that are used by MNEs to invest in foreign entities, they need to be carefully distinguished. The former involves the long-term investment in assets which are not easily disposed of while the latter seeks to obtain short-term financial gain without necessarily acquiring significant control (Surbhi, 2017; Wagner, 2020).

The most common FDI motives, discussed in Section 2.3, include market seeking objectives, resource seeking motives, efficiency seeking and strategic asset seeking. FDI motives often determine the mode(s) of entry selected by the MNE to execute its FDI strategy in foreign markets. FDI modes of entry, considered in Section 2.4, can either take the form of direct entry by the foreign firm, or through foreign firms’ acquisition of domestic firms (Mattoo *et al.*, 2004). The most common methods available for FDI modes of entry include wholly owned subsidiaries, joint ventures, Greenfield investment, Brownfield investment, and mergers and acquisitions (Mattoo *et al.*, 2004; Zhou *et al.*, 2021). The most beneficial of these, from the host country’s perspective, appear to be joint ventures, Greenfield and Brownfield investments.

The main theories of FDI, discussed in Section 2.5, have evolved from traditional theories such as Hymer’s landmark 1960 microeconomic theory of international production, to main contemporary theories such as the eclectic paradigm of Dunning (Denisia, 2010). The key determinants of FDI that flow from the theoretical and empirical literature include traditional locational and macroeconomic determinants, together with global and technological factors such as geopolitical shifts, democratisation and advances in ICT. In addition, institutional

economists highlight the growing importance of institutional FDI determinants, including political stability, corruption, regulation and participation in trade and investment agreements.

There is an increasing amount of empirical research providing evidence in support of a positive relationship between FDI and GDP growth (OECD, 2018a). As discussed in Section 2.6, FDI not only has the potential to bring capital for productive development into the host economy but also to transfer significant technical and managerial knowledge and skills (Bose and Kohli, 2018: 1). These benefits have the potential to spill over to domestic firms in the host economy. Cognisant of the importance of FDI, developing countries have increasingly liberalised their economies and organised their resources in line with policy frameworks that maximise their attractiveness to foreign direct investors (Bose and Kohli, 2018: 1). The key question that emerges is how best to attract optimal levels of FDI and direct such FDI for developmental purposes. In this regard, the following chapter considers the literature on the role of international investment agreements, and especially BITs, in attracting FDI to developing countries, with reference to the new institutional economics approach to the determinants of FDI.

## Chapter 3

### The international investment agreement landscape

#### 3.1 Introduction

Peng and Meyer (2020: 258) argue that the primary purpose of international investment agreements (IIAs) is to “protect the interests of foreign direct investors and establish arbitration procedures for conflicts between host governments and inward investing MNEs”. Signed between the home countries of international investors and potential host countries, BITs create a legal obligation binding the host country to accord equal treatment and/or advantages over domestic investors to foreign investors (Tobin and Rose-Ackerman, 2005). Researchers have emphasised that, despite the broadening of issues covered under the World Trade Organization (WTO), there is no major multilateral investment agreement (Kurtz, 2014).

The international investment agreement landscape is dominated by three main types of IIAs: bilateral investment treaties (BITs); free trade agreements (FTAs) with investment chapters or provisions such as the US-Mexico-Canada Agreement (USMCA, formerly NAFTA); and regional investment agreements such as the Common Market for Eastern and Southern Africa (COMESA) Common Investment Area Agreement, as well as the Southern African Development Community (SADC) Protocol on Finance and Investment (Naidu and Vickers, 2014: 10).

The aim of this chapter is to provide background on the international investment landscape, and especially the emergence of BITs, as context for the empirical investigation of the impact of BITs on inward FDI into developing countries in later chapters of the study. Section 3.2 discusses the evolution of the IIA landscape since the 1950s. Section 3.3 provides background on the World Trade Organization (WTO) Agreements that are relevant for investment in goods and services respectively, namely the Agreement on Trade-Related Investment Measures (TRIMS) and the General Agreement on Trade in Services (GATS). These are contrasted in general terms with the early BITs and investment chapters in regional trade agreements, with a view to highlighting the emerging controversies in the IIA environment. Section 3.4 examines the theoretical issues around BITs, with a focus on the new institutional economics approach to the determinants of FDI. Section 3.5 reviews empirical literature analysing the

impact that BITs have on FDI. Section 3.6 concludes the chapter by drawing out the important aspects for the rest of the study.

### **3.2 The evolution of the IIA landscape since the 1950s**

Since the inception of IIAs in the late 1950s to early 1960s, their principal advocates have been capital-exporting countries who sought legal instruments as a means to protect their citizens' investments. The move was in response to a perceived decrease in customary guarantees offered by host countries (Kurtz, 2012). The initial phase in the emerging IIA landscape was one which thus reflected the uncertainty of the period. For instance, following the transition to independence and regime change in post-colonial developing countries, there were concerns about whether domestic laws would be sufficient to offer the protection guarantees and safeguard measures sought by foreign investors. Therefore, IIAs were seen as instruments to reassure investors that their assets would be 'safe'.

The next major shift in the IIA landscape took place in the 1980s with an increasing number of IIAs concluded as developing countries significantly increased the number of BITs they entered into (Kurtz, 2012; Peng and Meyer, 2020). This was in response to major changes in development and economic policies globally in the face of debt and other economic crises. Trade, financial and investment liberalisation, not least as part of structural adjustment programmes, were a notable feature of this period of rapid globalisation. With the proliferation of BITs in the 1980s and 1990s, international investors increasingly relied on these instruments to set the general framework for the negotiation of FDI deals concluded with host countries (Tobin and Rose-Ackerman, 2005: 2).

The proliferation of BITs suggests that many foreign investors continued to lack confidence in the legal and political environment found in low and middle-income countries (Franck, 2009; Kurtz, 2012; Tobin and Rose-Ackerman, 2005). Since BITs encompass enforceable rules designed to protect foreign investment and reduce the risk faced by foreign investors in host countries, foreign investors believed that they would benefit from concluding BITs that on the surface were pro-foreign investor (Tobin and Rose-Ackerman, 2005). On the other hand, developing countries eagerly ratified BITs during this period, in the hope that this would deliver much-needed FDI for growth and development.

The third formative stage in the evolution of the IIA landscape took shape in the 1990s with the activation of dispute settlement within the space (Kurtz, 2012; Peng and Meyer, 2020). This stage was to some extent triggered by the joint decision of Canada and the United States to include so-called ‘investor-state arbitration’ within the North American Free Trade Agreement (NAFTA). Investor-state dispute settlement (ISDS) provisions in investment treaties or in investment chapters of regional trade agreements allow foreign investors to institute claims against host country governments. These can be brought to international investment arbitration institutions such as the International Centre for the Settlement of Investment Disputes (ICSID), set up by the World Bank in 1966.

According to Kurtz (2012), the assumption that the inclusion of ISDS in NAFTA would mainly be directed at protecting the interests of Canadian and US investors in Mexico proved to be flawed (Kurtz, 2012). This is because rather than advancing large claims against Mexico as envisaged, many cases brought by Canadian and US lawyers have instead challenged regulatory – and at times even judicial – measures in Canada and the US (Kurtz, 2012). This unexpected outcome placed developed country partners at odds with each other. According to Kurtz (2012), this in turn ushered in a fourth stage in the evolution of the IIA landscape.

With some of the earlier IIAs adopting an approach that was categorically pro-investor, the problematic biases of this approach triggered a concerted effort to tone down the extensive protections extended to investors by the classic BIT model (Gallagher, 2011; Kollamparambil, 2016; Kurtz, 2012, 2014; Muhandiram, 2020). Developing countries, for their part, became increasingly concerned about the implications of some of the provisions of BITs for domestic public policy objectives, as well as the effectiveness of BITs in promoting appropriate inward FDI. Coupled with the rise in number and prominence of ISDS cases brought against host countries by foreign investors, developing countries were increasingly of the view that traditional BITs placed undue risk on host nations, yet failed to obligate investors to take sufficient account of the development requirements of host states (Naidu and Vickers, 2014; Kollamparambil, 2016).

The ISDS system in particular was controversial. As noted in Chapter 1, numerous studies have highlighted inconsistent and contradictory awards by tribunals, lack of transparency and high costs of the proceedings, as well as issues regarding the qualifications of arbitrators, as

problems that have led to a crisis of legitimacy with respect to BITs (Kollamparambil, 2016).<sup>7</sup> Literature suggests that the fourth stage of ‘recalibration’ in the evolution of the BITs landscape has thus largely manifested itself in the form of states migrating away from the initial ‘classic’ model of BITs in favour of newer investment treaties (Kurtz, 2012; Chen, 2017). This evolution has involved both “the tightening of substantive obligations” and/or “the inclusion of general exceptions clauses” (Kurtz, 2012: 687).

Research findings reveal, however, that despite increasing changes in the sentiments of host countries towards IIAs, many developed countries have continued to replicate the same ‘classic’ template of BITs that was developed during the inception period decades earlier across different host economies (Kurtz, 2012). The fourth stage has thus arguably served to destabilise the IIA landscape with its most damaging impact being the mass exit - in varying ways - of host states from the investment treaty system, often citing their ‘negative’ experiences as respondents in investor-state litigation that is biased towards foreign direct investors (Kurtz, 2012; Peng and Meyer, 2020). Furthermore, developing countries have increasingly questioned the extent to which BITs do in fact attract sufficient FDI to warrant their negative aspects (Chen, 2017; Gallagher, 2011).

Reform of the IIA landscape in the face of growing discontent on the part of both developed and developing economies has progressed on a variety of fronts. In line with UNCTAD and other recommendations, “modern BITs” have emerged which seek to simultaneously preserve regulatory space and promote investment for development (UNCTAD, 2022a: 65-66).<sup>8</sup> In addition, legal mechanisms used in the WTO context, such as the right of WTO members to impose antidumping duties, as well as other WTO-based ideas, have been used to guide reform of investment commitments within the IIA landscape (Kurtz, 2012; Chen, 2017). However, ISDS cases under old-generation BITs continue to escalate (UNCTAD, 2022a: 73).

### **3.3 The WTO TRIMS Agreement, GATS and key BITs controversies**

The World Trade Organization (WTO) came into being following the conclusion of the Uruguay Round of multilateral trade negotiations and the entry into force of the Marrakesh

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<sup>7</sup> The main controversies with BITs provisions from a developing country perspective are highlighted in Section 3.3 below in the discussion of the WTO versus BITs setting.

<sup>8</sup> The contrasting provisions of old versus new-style BITs are discussed in more detail in Chapter 6.

Agreement on 1 January 1995. The Uruguay Round (UR), which took place from 1986 to 1993, was the eighth multilateral negotiating round conducted under the framework of the GATT (Cline, 1995; WTO, 2022). The broad mandate of the UR involved the extension of GATT rules to areas previously exempted as too difficult to liberalise (such as agriculture, textiles, and so on) and other increasingly important new areas which were previously excluded, such as trade in services, intellectual property rights, and trade-distorting investment policy measures (Cline, 1995).

The Agreement on Trade-Related Investment Measures (TRIMS) became the multilateral WTO Agreement to regulate rules governing investment in the production of goods. Under the TRIMS Agreement, WTO members are not permitted to impose certain regulations on foreign firms, including local content requirements, export performance requirements and other trade balancing policies (Shadlen, 2005; Chang, Hauge and Irfan, 2016: 126-127). While developing countries and LDCs were given transition periods at the end of the UR to phase out such investment policies, these transition periods ended in 2000 for developing countries and 2002 for LDCs. Despite these policy constraints, the TRIMS Agreement still permits host countries to require foreign firms to undertake certain obligations such as technology transfers and/or entering into joint ventures with domestic firms. Host countries also still have leeway to regulate hiring practices and to restrict or prohibit FDI in particular sectors that may be sensitive or strategic (Chang *et al.*, 2016: 126).

Furthermore, Shadlen (2005: 759) argues that because the TRIMS Agreement has a narrow scope that is fairly elementary, the agreement essentially fails to define trade-related investment measures clearly and merely provides examples of prohibited measures in an appendix. This leaves countries with room to determine what a TRIM actually is and, therefore, what measures they are expected to report to the WTO, although certain policies deemed to be TRIMS may still be challenged (Chang *et al.*, 2016: 126). Moreover, the IMF may recommend diversion from TRIMS rules in times of crisis and/or under an IMF financial programme, giving it jurisdiction.

The TRIMS Agreement applies exclusively to investment in goods production, while investment into services sectors is regulated under the WTO's GATS Agreement (Shadlen, 2005). The degree of policy flexibility that countries have under the GATS is determined by the degree to which they made commitments in areas such as financial services during the

Uruguay Round. These differ significantly amongst developing countries, with some undertaking only limited commitments (Shadlen, 2005). In such cases, there is more room under the GATS than under TRIMS to specify limitations on foreign investors, for example limits on foreign equity ownership. As in the case of TRIMS, countries may include requirements such as joint ventures in their GATS schedules.

Gallagher (2011: 394) points out that certain financial services commitments under the GATS require “simultaneous opening of the capital account”. This effectively restricts the signatory country’s ability to use capital controls related to capital inflows during times of crisis, although certain safeguard measures may be permitted. In terms of WTO rules, any country that does not have such financial services commitments under the GATS is permitted to utilise capital controls on both capital inflows and outflows. While WTO rules do not permit capital controls on current transactions, safeguards are allowed with IMF approval (Gallagher, 2011: 388-389; Shadlen, 2005). The contrast with BITs, particularly those involving the US, has been a source of controversy in the BITs landscape, considered further below.

In sum, despite some restrictions, there is still a fair amount of flexibility in the WTO setting, under the TRIMS Agreement and GATS, for developing countries to regulate FDI and conduct targeted investment policy. Nevertheless, criticism of the UR Agreements’ impact on developing countries led to the subsequent Doha Round (launched in 2001) being styled the ‘development round’ to pay more attention to the needs of developing countries. At the same time, however, developed countries were dissatisfied with the lack of prospects for a comprehensive multilateral investment agreement emerging under the auspices of the WTO. The stalling of the Doha Round negotiations thus saw a continued increase in the number of IIAs concluded outside of the WTO setting, most notably BITs, but also BIT-like investment chapters in broader trade agreements (Chang *et al.*, 2016: 139-141).

Shadlen (2005) argues that, from a development perspective, the policy space afforded to developing countries under BITs and investment chapters in trade agreements involving developed and developing economies is much more constraining than that under the relevant WTO Agreements. It is useful to highlight the main controversies surrounding BITs that are emphasised in this regard, in comparison to the WTO context. This will aid in understanding why these controversies have arisen, and thus provide important background to the analysis in subsequent chapters of the thesis.

Critics argue that traditional BITs provisions have a negative impact on regulation for public and environmental welfare and in effect actually serve to hinder development (Carim, 2015; Gallagher and Shrestha, 2011: 919; Shadlen, 2005). In the first instance, BITs and other IIAs are noted to prohibit even the FDI regulations which are permitted to host countries in terms of the WTO TRIMS Agreement or under the GATS as a requirement for establishing investment. For example, BITs and IIAs can limit the ability of host countries to regulate the employment practices of foreign firms. Secondly, BITs generally have a much wider definition of investment to include both FPI and FDI, and inherently cover a much greater investment scope (Chang *et al.*, 2016; WTO, 2022).

Critics argue that the inclusion of FPI is inappropriate because the host country is legally obliged to extend preferential conditions of entry and operation to different categories of investors (including those involved in hedge funds and other forms of speculative investments) who neither bring in FDI-related advantages, nor contribute to medium- and long-term national investments (IDEAS, 2011). As discussed in Chapter 2, FPI investors operate with the aim to acquire assets that can be sold quickly, with the profits moved out timeously.

A third controversy relates to the definition of ‘expropriation’ in BITs and other IIAs which, it is said, have been used to target the public policies of developing countries (IDEAS, 2011). BITs and IIAs offer an arguably problematic definition of ‘expropriation’ in that they extend unrestricted repatriation rights and expropriation protection to foreign firms (Chang *et al.*, 2016: 126-141). The broad definition of ‘expropriation’ in BITs and some IIAs includes both ‘direct’ and ‘indirect’ expropriation. The former refers to “nationalisation, transfer of title, or seizure of private property by the host government”, while indirect expropriation is defined as “expropriation by measures equivalent (or tantamount) to expropriation or nationalisation” (IDEAS, 2011: 4).

Although it is recommended for direct expropriation to be included in BITs, policy makers however caution against the inclusion of indirect appropriation (IDEAS, 2011; Chang *et al.*, 2016). This is because in numerous agreements, indirect appropriation is defined such that legitimate domestic regulation or legislation could be construed as having a negative impact on the operations of foreign investors in host markets (IDEAS, 2011). By implication, foreign investors are entitled to litigate against regulations imposed at any level of government in the host country, should they have reason to believe that any policy regulation(s) negatively impact

the profitability of their operations in the host country. Therefore, indirect expropriation should not be included in the definition of ‘expropriation’ in investment treaties.

Fourthly, many BITs and IIAs have stricter rules on capital controls than those that exist under the WTO’s GATS and under IMF rules (Gallagher, 2011: 387). Capital controls have been successfully used for decades, and were used by some countries before and during the 2008-2009 financial crisis, for example, as one of several possible instruments to manage the financial instability that can result from short-term capital movements, whether inflows or outflows (Gallagher, 2011: 387). For instance, in the years leading up to the 2008-2009 financial crisis, some developing economies in Asia like China, Colombia, India and Thailand used capital controls as a way to stem economic bubbles. Furthermore, countries like Iceland, Indonesia, Russia, Argentina and Ukraine imposed capital controls on capital outflows in order to mitigate the financial impact of the crisis (IMF, 2009). There is significant economic evidence in the literature to support the use of capital controls, especially on a temporary basis at times of economic crisis (Gallagher, 2011: 387).

There is thus increasing concern amongst policymakers and researchers that the proliferation of investment treaties across the IIA landscape may serve to deter the utilisation of tools intended to mitigate and/or prevent the financial instability caused by current and future financial bubbles and crises (Gallagher, 2011). BITs and IIAs involving the US in particular have stricter rules on capital controls compared to the WTO’s GATS or the IMF’s rules, as they permit neither capital controls on inflows or outflows nor safeguards (Gallagher, 2011: 388). Consequently, if a host state elects to restrict either type of capital flow, such country can be subject to investor-state arbitration whereby the host government would be forced to pay for any ‘damages’ incurred by the foreign investor. However, other developed countries such as those in the EU (European Union) bloc, Japan and Canada, as well as emerging markets like China and India, generally either allow safeguards or other host country legislation for crises in BITs and IIAs (Gallagher, 2011).

Finally, unlike the WTO, which uses a state-to-state dispute settlement mechanism, BITs and many other IIAs utilise an ISDS mechanism. As noted in Section 3.2, this enables foreign firms to institute claims against host governments. It is argued that several of the claims against developing countries have specifically targeted public welfare policies in these countries, thereby undermining the ability of their governments to cultivate institutional frameworks that

improve the welfare of citizens (Gallagher and Shrestha, 2011: 919). Moreover, the litigation costs as well as the amounts awarded to successful claimants are burdensome for developing countries to carry. Therefore, developing countries are wary of any measures which could render them in violation of such provisions (Gallagher and Shrestha, 2011: 919).

There has been a significant increase in claims brought by foreign investors against host governments, from just 1 in 1987 to 1190 by the end of 2021 (UNCTAD, 2022a: 73). UNCTAD (2022a: 74) reports that 65% of claims in 2021 were brought against developing countries. In addition, “about 75 per cent of investment arbitrations in 2021 were brought under BITs and TIPs [Trade and industrial policy strategies] signed in the 1990s or earlier” (UNCTAD, 2022a: 74). Similarly, the success rate for claims is also growing with over 85% of claims in 2021 decided in favour of investor states and corporations (UNCTAD, 2022a: 75). This is a major challenge for many developing countries - as well as least-developed economies - whose limited resources cannot match the financial resources of big MNEs.

It is also argued that the ability of foreign investors to sue host governments and take claims to international arbitration panels such as the ISDS gives them an unfair advantage over domestic investors who do not have the same right or resources. As noted in Section 3.2, ISDS processes are extremely controversial and have come under severe scrutiny in recent years with critics pointing out the unfairness of pro-investor dispute settlement processes, the biased composition of tribunals, the size of claims, and exorbitant awards and cost of litigation (Carim, 2015; UNCTAD, 2012).

However, an empirical study by Franck (2009) that is often cited concluded that there is no need to overhaul the current arbitration system as no evidence was found that developing countries were unfairly treated. Notably, Gallagher and Shrestha (2011) raise serious issues with Franck’s (2009) methodology, arguing that the dataset of just 49 cases is inadequate to reach the conclusions made by the study. In addition, Gallagher and Shrestha (2011) argue that Franck’s (2009) analysis is limited by its inability to control for key variables which may affect the outcome of the analysis.

Due to the increased discontent, many countries, both developed (for example, Australia and Germany) and developing (for example, South Africa, Indonesia and India), have reviewed their BITs and other IIAs in an effort to either reform the system, renegotiate investment

treaties, or to cancel and/or not renew existing treaties (Gallagher, 2011; UNCTAD, 2012). Furthermore, several studies which have investigated whether countries that have signed BITs and IIAs receive significantly more investment from the countries they have treaties with have found very little evidence of this (Carim, 2015; Chang *et al.*, 2016: 141). Some of the studies examining the key question of whether participation in BITs has a significant positive effect on FDI to developing countries are reviewed in Section 3.5 below.

### **3.4 The role of bilateral investment treaties: a new institutional economics approach**

New institutional economics (NIE) theory has a focus on connections between the institutional environment in countries and organisations arising from market imperfections (Harris, Hunter and Lewis, 1995). Peng and Meyer (2020) refer to institutions as ‘the rules of the game’ which structure interactions in societies. Notably, firms have to operate within the prevailing rules of the markets in which they operate. Evidence in the literature suggests that foreign companies operating in new host market environments need to adapt their over-all plan of action to the conditions they encounter in the domestic market (Hymer, 1976; Kindleberger, 1969). In the same vein, as governments in developing economies compete for greater shares of global FDI, there is growing evidence in the literature to show that such governments have reformed their institutional environments in their efforts to attract foreign investment (Meyer, 2001).

Literature suggests that although NIE theory has been studied widely in developed countries, there is, however, less theoretical and empirical research that uses an institutional framework to consider FDI determinants in the context of developing economies (Grosse and Trevino, 2005). Furthermore, because the NIE approach has primarily been applied in the context of developed economies, less is known about potential outcomes in developing economies (Hoskisson, Eden, Lau, and Wright, 2000). Thus, developing and transition economies are arguably well-positioned to provide a useful framework for advancing the empirical study of NIE approaches to FDI due to the extent and speed of political and economic change in such economies (Grosse and Trevino, 2005).

The NIE approach has a key focus on reducing transaction costs, in this case specifically those related to foreign investment decision-making and implementation (Grosse and Trevino, 2005: 125). In the case of the foreign investor and FDI decision making, it is posited that the closer the institutional environment is able to approximate zero transaction costs for the former, the

greater the likelihood that the latter will receive inward FDI flows, holding all else constant (Grosse and Trevino, 2005: 125). Therefore, an understanding of the interface between the investment strategy of foreign investors and the institutional conditions in host countries requires an analysis of the capacity of institutions to minimise FDI transaction costs which accrue from operating in unstable markets (Hoskisson *et al.*, 2000). It is thus necessary for empirical studies applying the NIE approach to investigate the different institutional environments across countries, as well as their effects on inward FDI (Grosse and Trevino, 2005).

NIE theory suggests that in the absence of a comprehensive multilateral investment framework, BITs are regarded as effective instruments which developing countries can utilise to signal themselves as safe investment destinations for international investors (Swenson, 2005; Mosoti, 2005; Kollamparambil, 2016). This contradicts sceptics' claim that there is minimal evidence to suggest that foreign investors pay significant attention to BITs when making their decisions about where to invest (Sauvant, 2007). Scholars adopting an NIE perspective argue that BITs are a useful instrument in the proliferation of international investment in developing economies (Grosse and Trevino, 2005; Sauvant, 2007). It is thus argued by NIE theorists that BITs reduce both uncertainty and FDI-related costs, while also sending a signal to foreign investors that the host country has implemented institutional reforms intended to build a market economy (Grosse and Trevino, 2005).

Apart from participation in BITs or trade agreements with investment chapters, other institutional determinants of FDI that are highlighted in the NIE approach include corruption, regulation, privatisation and political risk (Grosse and Trevino, 2005). Corruption is defined as any act which involves the exploitation of the power of public office for purposes of personal gain, in a manner that violates the 'rules of the game' (Grosse and Trevino, 2005). Foreign investment regulations and/or changes thereto play a key role in the host country's institutional environment. Such regulations are crucial elements in the host country's institutional environment because they can increase uncertainty and costs associated with FDI, thereby influencing the extent of inward FDI in the host economy.

Privatisation play a fundamental role in a host economy's institutional environment. Privatisation initiatives signal a host government's preparedness to allow greater participation of the private sector in its economy, thereby supporting the operations of foreign and domestic

firms in the host market (Grosse and Trevino, 2005). Research findings suggest that “privatization is a private-sector-friendly policy, which offers the potential for cost reductions by MNEs contemplating investment in the host country” (Grosse and Trevino, 2005: 130). Political risk includes any risk that a host government may unexpectedly modify and/or reform the institutional environment in which businesses function (Butler and Joaquine, 1998). Research findings suggest that a host country’s success in reducing its level of political risk lowers the levels of foreign investor’s uncertainty as well as the costs associated with FDI (Grosse and Trevino, 2005). This results in increased levels of inward FDI in the host economy.

### **3.5 A review of empirical literature on analysing the impact of BITs on FDI**

Notwithstanding the theoretical discussion above, numerous research findings have revealed a lack of evidence to support the hypothesised causal relationship between investment treaties and FDI in developing countries (Mosoti, 2005; Swenson, 2005; UNCTAD, 2022a). In order to examine this question empirically, two methods are recommended in the literature.

First, Swenson (2005) suggests that the relationship between previous foreign investment and the signing of BITs should be examined in order to determine whether foreign investors pay attention to the signing of BITs in their decision-making processes. Evidence of a positive relationship would suggest that governments of host signing states have an effect, along with the motives of foreign investors who seek extended safeguards for their investments (Swenson, 2005). Furthermore, evidence of the positive link may shed light on the findings that BITs only occasionally result in increases in FDI (Tobin and Rose-Ackerman, 2005), because signing BITs to suit the needs of current investors does not necessarily lead to increases in future investments (Sauvant, 2007; Carim, 2015).

Secondly, it is necessary to study how BITs affects FDI flows between countries when a broad range of control variables for the economic environment, such as recipient and investor country GDP and labour costs are factored in (Swenson, 2005). Unfortunately, although such controls are arguably key determinants of FDI, it is not practical to consider all country specific factors which may impact investors’ decisions on the location of FDI (Dunning, 2000; Erasmus, 2015). A possible solution in the study by Swenson (2005) is that instead of adding further control variables, it is recommended that previous FDI is included as a control variable in the

regression analysis in order to provide an indirect indicator of how attractive a country is as this would not be observable through direct measures.

There are several NIE studies in the empirical literature which attempt to address the question of whether developing countries which have signed more BITs also successfully attract more FDI (Grosse and Trevino, 2005; Neumayer and Spess, 2005; Mishra and Jena, 2019; Dorakh, 2020). Amongst notable earlier NIE papers which attempt to address this question are studies by Hallward-Driemeier (2003) and Tobin and Rose-Ackerman (2005). The first two studies analyse this issue over a 20-year period, from 1980 until 2000 (Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2005).

Hallward-Driemeier (2003) analyse twenty years of bilateral FDI flows from the OECD to developing countries. The Hallward-Driemeier (2003) paper uses bilateral FDI outflows from 20 OECD countries to 31 developing countries. The dependent variable in the regression analysis used in the study is the inward FDI of developing countries. The purpose is to determine whether BITs have stimulated additional investment in developing countries. Using data sourced from the World Bank's World Development Indicators, as well as the education variables from Barro and Lee, the panel regressions are estimated using distinct investor and recipient country dummies and including different bilateral variables such as distance between countries, a common official language, common border, and colonial links.

Two dummy variables are included in the regression analysis. The first dummy variable is used to record the impact of important political and economic reforms in Eastern Europe and the former USSR in the 1990s compared to the preceding decade (Hallward-Driemeier, 2003). The second dummy variable is added to capture the ratification of NAFTA (Hallward-Driemeier, 2003). Although strictly speaking NAFTA is not a BIT, it nonetheless shares similar language to BITs. It is for this reason that the Hallward-Driemeier (2003) study includes NAFTA in the measure of investment treaties. The results of the study by Hallward-Driemeier (2003) find no evidence that BITs have any statistically significant effect on the FDI received by developing countries. Furthermore, evidence from Hallward-Driemeier (2003) suggests that BITs have a negative impact on measures such as levels of FDI or the FDI to GDP ratio.

Notably, Hallward-Driemeier (2003) repeats the regression analysis using the International Country Risk Guide (ICRG) measures of law and order and corruption. These are measures

which include time variation in the quality of institutions (Hallward-Driemeier, 2003). With country dummies included, these measures capture the effect of changes in the quality of a country's institution. For the ICRG measures, the results of the analysis by Hallward-Driemeier (2003) suggest that the interaction term is both strongly positive, and significant. The results of Hallward-Driemeier (2003: 21) suggest that "BITs are more - rather than less - effective in settings of higher institutional quality and where institutions are already being strengthened".

Similar to findings by Hallward-Driemeier (2003), Tobin and Rose-Ackerman (2005) argue that there is insignificant evidence to conclude that BITs do increase foreign investment flows, or, that they improve the characteristics of the local investment environment in signatory countries. Tobin and Rose-Ackerman (2005) use empirical analysis to examine whether BITs stimulate FDI flows to host countries. Furthermore, the study investigates the impact of BITs on the environment for domestic private investment.

Tobin and Rose-Ackerman (2005) employ panel data modelling for low and middle-income countries covering a period from the 1950s until 2000. To account for the varying nature of some of the data used in the study, as well as to work around systemic statistical problems in cross sectional analyses, the authors of the study use datasets that are "based on various indicators of government performance, investment rates, social indicators, and investment treaties in up to 176 countries" (Tobin and Rose-Ackerman, 2005: 11).

The authors note that datasets used in the study were compiled from a variety of sources and therefore contain a different number of observations, for different variables (Tobin and Rose-Ackerman, 2005). Notably, the authors of the study claim that its findings are preliminary. With respect to what measure of a BIT is used in the empirical analysis of the study, the authors acknowledge the limitations of the study. Due to the analysis lacking the ability to differentiate between treaties, it is therefore not possible to determine "if certain elements within the treaties, rather than the overall number of treaties signed, or even the identity of the home country act as the causal mechanisms in the study" (Tobin and Rose-Ackerman, 2005: 12).

The impact on the dependent variable (i.e. the effects of BITs on FDI flows in host countries) in the analysis by Tobin and Rose-Ackerman (2005) is measured using a two-pronged approach. First, Tobin and Rose-Ackerman examine the interface between BITs and other determinants of foreign investment and how this impacts FDI inflows. Cognisant of the

expectation that the main benefit of BITs is increased FDI to developing countries, the analysis by Tobin and Rose-Ackerman takes the initial step towards testing this hypothesis. Second, Tobin and Rose-Ackerman (2005) analyse the impact of BITs and the business environment in host markets through their effects on local investment as well as property rights.

With FDI flows in host countries as the dependent variable, Tobin and Rose-Ackerman (2005) find no evidence of a strong relationship between BITs and FDI. The results of the study, however, suggest that the effect is greater for risky countries. Furthermore, the analysis by Tobin and Rose-Ackerman (2005) finds little evidence of a strong relationship between BITs and the domestic investment environment. Therefore, although BITs may not affect the local investment environment, it is possible they may also not achieve the main goal of stimulating FDI. The study by Tobin and Rose-Ackerman (2005: 30) suggests that BITs “have a positive relationship to private investment in developing countries except when political risk is low”.

The evidence from the studies discussed above goes against the stated purpose of BITs which is to increase the amount of FDI received by host countries which sign these investment agreements (IDEAS, 2011). Furthermore, the findings of these studies would suggest that the significant amount of effort developing countries have invested on BITs has not yielded expected outcomes. However, certain NIE authors who are sceptical of the findings of studies that question the positive impacts of BITs on inward FDI received by developing countries argue that one of the problems of such studies is that they infer results from a rather restricted sample of countries or are based on cross-sectional regressions (Neumayer and Spess, 2005).

In contrast, however, the NIE study by Neumayer and Spess (2005) uses a larger set of countries to investigate the impacts of BITs on FDI flows and their effects on the domestic investment environment in host countries. The Neumayer and Spess (2005) study employs a panel for the period 1970 to 2001, covering up to 119 countries. The results of the analysis by Neumayer and Spess (2005) find that BITs have a positive effect on FDI inflows. Furthermore, it is suggested that the positive impact is consistent and robust across various model specifications (Neumayer and Spess, 2005). The findings suggest that “the effect is sometimes conditional on institutional quality but is always positive and statistically significantly different from zero at all levels of institutional quality” (Neumayer and Spess, 2005: 4-5). Furthermore, the authors claim that the result is very robust to changes in model specification, estimation technique, as well as sample size (Neumayer and Spess, 2005). Notably, Neumayer and Spess

(2005: 5) claim to provide “the first hard evidence that there is a payoff to developing countries’ willingness to incur the costs of negotiating BITs and to succumb to the restrictions on sovereignty contained therein”.

After demonstrating that BITs successfully increase the inward FDI received by a host country, the study by Neumayer and Spess (2005) goes on to address whether BITs function as substitutes or complements to good institutional quality. The results provide some indication that BITs make up for poor institutional quality in host markets (Neumayer and Spess, 2005). This would therefore suggest that BITs have greater impact in host countries “where institutional quality is low and that they are most successful in countries where they are needed most” (Neumayer and Spess, 2005: 5). However, the authors caution that “this result is not robust to different specifications of institutional quality” (Neumayer and Spess, 2005: 5).

Drawing on an institutional economics framework to investigate the role of BITs in the growth of FDI, Grosse and Trevino (2005) also incorporate the number of BITs a country has signed as an explanatory variable in their empirical work. In their study, Grosse and Trevino (2005) link NIE with organisational decision making on FDI in order to examine the relationship between FDI inflows and institution building. With a focus on government policy initiatives intended to create a conducive environment for FDI, the study uses a panel data format for the regression model. The sample used in the study consists of 13 Central and Eastern European (CEE) countries and covers the period between 1990 and 1999 (Grosse and Trevino, 2005). In the words of Grosse and Trevino (2005: 123), their study extends the application of NIE theory by “combining institutional constructs with traditional factors that contribute to FDI decision-making and applying them to economies in transition”.

The study by Grosse and Trevino (2005) makes certain key findings. First, the findings suggest that there is a positive relationship between institutional variables that decrease uncertainty and costs facing foreign investors in CEE countries. The results of the study by Grosse and Trevino (2005: 123) reveal that “corruption and a measure of political risk were negative and significantly related to inward FDI”. The study finds that the presence of BITs and the absence of constraints on repatriating earnings by CEE affiliates were positive and significantly related to inward FDI (Grosse and Trevino, 2005). In addition, the authors found that traditional variables also matter in that the exchange rate coefficient was significant and inversely related

to FDI, while market size was highly significant and positively related to foreign investment (Grosse and Trevino, 2005).<sup>9</sup>

In addition, a number of recent studies use a gravity model framework that considers the presence of a BIT between two partner countries as a determinant of bilateral FDI (Mishra and Jena, 2019; Dorakh, 2020; Kox and Rojas-Romagosa, 2020). Although some of the traditional gravity variables such as distance between partners, the existence of a common border and a common language are usually associated with trade costs between countries, they have been deployed in studies of bilateral FDI in recognition of the importance of the regional dimension and ease of doing business in the FDI context (Grosse and Trevino, 2005; Kox and Rojas-Romagosa, 2020).

Adopting an NIE approach, Mishra and Jena (2019) use the basic gravity model consisting of traditional variables (i.e. common border, distance between countries and a common official language) as well as four augmented versions of the gravity model in their study. The aim of their study is to investigate the determinants of bilateral FDI flows from six major developed countries into four leading Asian economies.

The four augmented gravity models used by Mishra and Jena (2019) include additional macroeconomic variables such as the GDP growth rate, the inflation rate, corporate tax rate, interest rate, as well as the exchange rate. The study uses a dummy variable to measure a BIT between source and host country. With a data set consisting of 36 bilateral investment country pairs for a period of 12 years from 2001 to 2012, the authors of the study use the World Development Indicators, CEPII, KOF and Heritage Foundation data for the period 2001 to 2012 (Mishra and Jena, 2019). Notably, Mishra and Jena (2019) claim that their paper is the first empirical study to combine the globalisation index, economic freedom index, and distance variable alongside certain major macroeconomic variables.

The findings of the Mishra and Jena (2019) study suggest that in addition to the market sizes of the host and source country, the FDI decision-making process of foreign investors also takes

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<sup>9</sup> In Grosse and Trevino (2005), the exchange rate variable is measured such that an increase reflects a depreciation of the host country currency. Grosse and Trevino (2005: 132-133) hypothesise that host country depreciation may constrain *or* stimulate FDI, depending on the perceived risks (namely possible future currency volatility) versus opportunities (i.e. less expensive host country assets). The *direction* of the relationship between exchange rate movements and inward FDI is thus an empirical question, in their view.

into consideration other criteria. These include distance, common official language, as well as common border between the host and source country (Mishra and Jena, 2019). Furthermore, the study finds that in addition to macroeconomic factors such as the rate of inflation and real interest rate, institutional and infrastructural factors are among the key elements that attract inward FDI into host countries (Mishra and Jena, 2019). The findings of the study suggest that key institutional and infrastructural factors such as “telecommunication, degree of openness, index of globalisation and index of economic freedom also stimulate the international investors from the developed world to the major Asian countries” (Mishra and Jena, 2019: 5).

With a focus on new EU member states, the NIE study by Dorakh (2020) employs an augmented gravity model in order to investigate specific factors in explaining FDI inflows. In addition to the traditional variables used in standard gravity models, Dorakh (2020) augments the model to include macro-variables such as the unit labour cost in the host country, as well as variables indicating if the two countries are in the European Economic Area (EEA) at a given time and whether they had a colonial relationship. The dependent variable in the model is the logarithm of bilateral FDI inflows to the host country from the source country.

The FDI gravity estimation in the Dorakh (2020) study covers 39 OECD countries (33 source countries<sup>10</sup> and 6 host countries<sup>11</sup>) between 1991 and 2017. The author specifies a set of different ordinary least squares (OLS) and Poisson Pseudo-Maximum-Likelihood (PPML) specifications in order to account for all country-time-specific and country-pair factors (Dorakh, 2020). The findings of the Dorakh (2020) study suggest that membership of the EU bloc (i.e. a regional bloc) has both a positive and significant impact on FDI. This is determined by the results of the study which suggest that in the period under observation - between 1991 and 2017 - FDI inflows increased, on average, by approximately 23% (Dorakh, 2020). Furthermore, the findings of the study suggest that following the enlargement of the EU bloc, more FDI came from EU countries to the new EU members, while less FDI came from non-EU countries (Dorakh, 2020). This is deduced from the estimation results of the study which show that “EU membership has led to larger and more intensive FDI activity between EU members” (Dorakh, 2020: 448).

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<sup>10</sup> Germany, France, Austria, the USA, UK, the Netherlands, Italy, Luxembourg, Belgium, Canada, Denmark, Australia, Chile, the Czech Republic, Estonia, Finland, Greece, Hungary, Iceland, Ireland, Israel, Japan, Korea, Mexico, Norway, New Zealand, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, and Turkey.

<sup>11</sup> Poland, Hungary, the Czech Republic, Estonia, Slovakia, and Slovenia.

Similar to the methodology of the Dorakh (2020) paper, Kox and Rojas-Romagosa (2020) create a new gravity model in an attempt to explain the patterns of bilateral FDI. In line with recent literature, Kox and Rojas-Romagosa (2020) employ a Pseudo-Poisson maximum likelihood (PPML) estimator to analyse the impact of preferential trade agreements, BITs, as well as other policies on bilateral FDI. Kox and Rojas-Romagosa (2020) source data on bilateral FDI stocks and flows from UNCTAD's Bilateral FDI Statistics database. Notably, the UNCTAD database used by the authors distinguishes between zero observations and missing data, which provides valuable information for the analysis (Kox and Rojas-Romagosa, 2020). The authors use a large sample of 203 countries over a period of 12 years from 2001 until 2012.

In order to control for the varied nature of PTAs (Preferential trade arrangements), two contrasting indicators of PTA depth are used in the study by Kox and Rojas-Romagosa (2020). By contrast with the gravity model used by Dorakh (2020), the main dependent variable in Kox and Rojas-Romagosa (2020) study is the inward FDI stock from the origin country to the country of destination, at a given time. The other difference is that the former uses a log-linear format.

Similar to the Dorakh (2020) study, Kox and Rojas-Romagosa (2020) also use panel data and country-pair-fixed effects in order to account for unobservable time invariant FDI barriers. Research findings suggest that in a panel data setting using pair-fixed effects is a better measure of the bilateral costs than the standard set of gravity variables (Dorakh, 2020; Kox and Rojas-Romagosa, 2020).

Kox and Rojas-Romagosa (2020: 1) find that “on average, signing a PTA increases bilateral FDI stocks by approximately 30%”. Similar to the findings by Dorakh (2020), Kox and Rojas-Romagosa (2020) find that membership of the EU bloc has a strong impact on FDI. Kox and Rojas-Romagosa (2020) find in the period from 2001 to 2012, belonging to the EU bloc increased bilateral FDI by approximately 135%, and that signing a BIT has an impact that is similar to signing a PTA.

Although some of the NIE literature reviewed in this section finds a positive relationship between BITs and FDI, the varied findings discussed suggest a lack of unanimity on the actual impact of BITs. Furthermore, scholars recommend that in order to quantify the net benefits accruing from BITs to a developing country adequately, it is necessary to consider not only the

extent of FDI that a country attracts via BITs, but also the risk of litigation such BITs participation entails (Kollamparambil, 2016: 12). Others suggest that the impact of the *cancellation* of BITs on inward FDI is another fruitful avenue of research now that such data is increasingly available (Hartmann and Spruk, 2022).

### **3.6 Conclusion**

The signing of international investment treaties, in particular BITs, has proliferated since the 1990s (Swenson, 2005). On the surface, the reasons for the expansion in the number of treaty obligations signed is not clear given that several studies question whether the receipt of new foreign investment flows actually rewarded signatory countries (Swenson, 2005; Mosoti, 2005; Sauvants, 2007). Literature suggests that some of the analysts examining the economic impacts of BITs have not succeeded in finding evidence of a causal relationship between the signing of BITs and levels of inward FDI (Swenson, 2005; Mosoti, 2005; Sauvants, 2007).

Sceptics argue that in their ongoing struggle to attract FDI, developing countries have signed BITs in which they have made commitments that come at the expense of their development needs (Mosoti, 2005). Furthermore, critics claim that BITs have resulted in a corresponding diminishment of the policy space available for developing countries (Mosoti, 2005).

However, NIE theory suggests that in the absence of multilateral investment frameworks, IIAs - in particular BITs - are regarded as effective tools which developing countries can use to signal themselves as safe investment destinations for international investors (Swenson, 2005; Mosoti, 2005; Kollamparambil, 2016). This contradicts claims by sceptics that there is insignificant evidence to suggest that foreign investors actually pay significant attention to BITs when making their decisions about where to invest (Sauvants, 2007; Gallagher, 2011).

In the empirical literature reviewed in Section 3.5, the findings are mixed. For example, Tobin and Rose-Ackerman (2005) find insufficient evidence to conclude that BITs increase FDI flows, or improve features of the domestic investment environment in signatory countries. By contrast, however, studies by Neumayer and Spess (2005), as well as Salacuse and Sullivan (2005), use larger data sets to examine the impacts of BITs and find evidence of a causal relation between the number of BITs signed, and the FDI received by a developing country. Neumayer and Spess (2005) also discover that the positive impact is greater in high-risk

countries. This suggests that signing BITs would particularly benefit developing countries deemed to be ‘high-risk’.

The empirical findings of recent gravity studies including Kox and Rojas-Romagosa (2020) find that, on average, signing IIAs increases bilateral FDI stocks. Furthermore, Kox and Rojas-Romagosa (2020) find that comprehensive agreements which include provisions on investment, public procurement, and intellectual property rights provisions, have outcomes comparable to signing regular IIA (Kox and Rojas-Romagosa, 2020). Similar to findings made by Kox and Rojas-Romagosa (2020), the results of the study by Dorakh (2020) find that membership of the EU bloc has a strong impact on bilateral FDI. Both studies reveal that in the period from 2001 to 2012, EU bloc membership increased bilateral FDI by over 130%, and that signing a BIT has an impact that is comparable to signing a ‘deep integration’ agreement.

Nevertheless, the lack of consensus in the literature on BITs has led many researchers to question whether signing international investment treaties is *really* in the best interest of a developing country (Swenson, 2005; Mosoti, 2005; Sauvant, 2007; Gallagher, 2011). For instance, given that BITs effectively cause developing countries to relinquish some of their sovereign policy and regulatory space to foreign investors, even instruments and regulations that are permitted under WTO rules, questions arise about whether host countries receive adequate benefits in return for their participation in BITs and other IIAs that fall outside the ambit of the WTO.

Furthermore, given the proliferation in claims brought by foreign MNEs (with significant resources), against developing host countries (whose limited resources are no match to the international investors’ financial muscle), and the numerous concerns around the legitimacy and bias of ISDS tribunals, many developed and developing countries are revising provisions of current and future BITs in order to align them with national interests (DTI, 2010). Although NIE theory economic models in large part predict that BITs should increase the level of FDI, the wide range of empirical results and additional concerns discussed above suggests that the motives and the effects of BIT signing deserve more nuanced attention (Carim, 2015; Kollamparambil, 2016; Kurtz, 2012).

Notwithstanding the limitations of econometric estimations of the impact of BITs on FDI, the results of such studies are indicative. The empirical approach in the present study, therefore,

begins by investigating the impact of BITs on FDI in developing countries using econometric techniques in Chapter 5. Thereafter, in light of the shortcomings of such techniques in shedding light, on their own, on the approach that developing countries could adopt towards BITs as part of their investment strategies, the empirical method shifts, in Chapter 6, to adopt a case study approach to analysing BITs provisions to try and provide a more nuanced perspective than the aggregative econometric approach can provide. The methods, procedures and techniques adopted in Chapters 5 and 6, as well as the data sources used in the analysis, are described in more detail in the next chapter of the thesis.

## **Chapter 4**

### **Research methods and data**

#### **4.1 Introduction**

As noted in Section 1.2, the main objective of this study is to investigate the impact of bilateral investment agreements on the inward FDI received by developing countries. To address this main goal, a number of sub-goals were identified in Section 1.2. These are addressed in Chapters 5 and 6 of the study. First, the growth and share of developing country inward FDI relative to aggregate inward FDI is analysed. Secondly, the growth and geographical distribution of international investment treaties is examined, with a focus on BITs between developed and developing economies, as well as those between two developing economies. Thirdly, the impact of the presence of BITs on inward FDI in developing countries is estimated using a gravity model. Finally, the implications for development policy are assessed with reference to the provisions of traditional BITs between developed and developing economies relative to more recent BITs between developing economies, with a focus on BITs involving some of the BRICS emerging economies.

The thesis employs both quantitative and qualitative research methods to address its main goal and sub-goals. The research approach is of the mixed methods type, whereby information from quantitative and qualitative data sources are integrated in analysing the study's findings (Creswell and Creswell, 2018: 51). In Chapter 5 of the thesis, quantitative research techniques are used to address the first three sub-goals, while qualitative methods are used to address the fourth sub-goal in Chapter 6. These techniques are discussed further in relation to each sub-goal in Section 4.2 below, while the data sources used and their limitations are described in Section 4.3.

#### **4.2 Methods, procedures and techniques**

To examine the growth and share of inward FDI to developing countries relative to total FDI (the first sub-goal of the study), descriptive statistical techniques are employed, in particular graphical trends, shares and growth rates. The graphical analysis of trends in inward FDI to developing countries extends from 1980 to 2021, based on data availability, and compares developing country trends to developed country trends in nominal USD trillions over the

period. Developing countries' percentage shares in global FDI for the period 1980 to 2021 are then computed, followed by average annual growth rates for selected periods from 1980 until 2021, in order to provide a more nuanced picture of trends in developing relative to developed country FDI.

In order to address the second sub-goal, namely investigating the growth and geographical distribution of BITs between developed and developing countries and between two developing countries, a dataset of the number of BITs signed and BITs in force per annum, as well as per decade, for the two sets of partners was created by the author based on UNCTAD's Investment Policy Hub platform (see Section 4.3 below). Descriptive analysis of the trends emerging from this dataset is undertaken to address the second sub-goal. The dataset created by the author covers over seven decades, starting from the 1950s up to, and including, the year 2022. The first two sub-goals above provide important background to the remainder of the study on the impacts of BITs on inward FDI and development policy in developing countries.

To address the third sub-goal of the study, a gravity model of FDI is estimated to investigate whether the presence of BITs has a positive effect on inward FDI in developing countries. Inspired by Newton's basic gravity equation, the gravity model is highly regarded as one of the first theoretical models to be applied to explain bilateral trade flows, and later, bilateral FDI flows, between countries. The wide use of the gravity model emanates from literature on economic geography and the extensive use therein of gravity equations (Mishra and Jena, 2019: 8). The gravity model uses econometric techniques to examine numerous individual observations on trade and investment between countries "against the 'gravitational mass' of explanatory variables that describe the characteristics of bilateral trade and investment partners" (De Rosa, 2008: 45).

The gravity model in this study specifically examines the determinants of bilateral FDI involving developing country recipients of inward investment from both developed and other developing economies. In a gravity model in the FDI context, bilateral FDI is investigated as a function of the GDP of the recipient country and the GDP of the outward investor country, the presence or absence of a common border, the presence or absence of a common official language and the distance between the countries (Bacchetta *et al.*, 2012: 103-109).

In addition to the traditional gravity variables above, a number of FDI determinants from the literature are added in different variations of the basic model, together with a dummy variable to indicate the presence of a BIT between the partner countries (Dorakh, 2020; Kox and Rojas-Romagosa, 2020; Mishra and Jena, 2019). A number of different versions of the BIT dummy variable are created to investigate the impact of a BIT as a determinant of bilateral FDI in alternative specifications of the model. In some instances, described further below, the dummy variable indicates whether a BIT has been *signed* between the two countries (even if it is not in force, or no longer in force). In other instances, also described further below, the dummy variable indicates that there is a BIT *in force* between the two countries. Later specifications additionally investigate whether the results are affected by whether the BIT signed or in force is ‘North-South’ (i.e. between a developed and developing economy) or ‘South-South’ (between two developing economies).

As noted in Section 1.3, while a range of estimation methods can be used for the gravity model, this study follows Baccheta *et al.* (2012: 105-106) and Dorakh (2020) by using a log-linear model which is a convenient and straightforward specification. As Dorakh (2020) explains, a variety of methods can be used to deal with zero, missing or negative FDI values in a log-linear model. These were considered in the present study once the bilateral FDI dataset for the countries in the study was assembled (see Section 4.3 below).

The following basic gravity model specification is used in the study:

$$\ln \text{IFDI}_i = \beta_0 + \beta_1 \ln \text{GDP\_RECIPIENT} + \beta_2 \ln \text{GDP\_INVESTOR} + \beta_3 \text{CONTIG}_i + \beta_4 \text{LANG}_i + \beta_5 \ln \text{DIST}_i + \beta_6 \text{BIT}_i + u_i$$

where

IFDI<sub>i</sub> is the inward FDI stock (following Kox and Rojas-Romagosa, 2020) of the recipient country from the outward investor country in current US dollar billions for 2019.

GDP\_RECIPIENT is the GDP of the recipient developing country, measured in current US dollar billions for 2019.

GDP\_INVESTOR is the GDP of the outward investor country (developed or developing), measured in current US dollar billions for 2019.

CONTIG<sub>i</sub> is a dummy variable set equal to 1 if the two countries have a common border and 0 otherwise.

LANG<sub>i</sub> is a dummy variable set equal to 1 if the two countries share a common official language and 0 otherwise.

DIST<sub>i</sub> is the distance in kilometres between the largest cities in each country.

Six versions of the BIT<sub>i</sub> dummy variable have been created by the author for different specifications of the basic model:

BITS\_SIGNED<sub>i</sub> is a dummy variable set to 1 if the two countries have ever *signed* a bilateral investment treaty between them and 0 otherwise.

BITS\_FORCE<sub>i</sub> is a dummy variable set to 1 if the two countries have a bilateral investment treaty *in force* between them and 0 otherwise.

BITS\_SIGN\_NS is a dummy variable set to 1 if *a developed and a developing country* have signed a bilateral investment treaty between them and 0 otherwise.

BITS\_SIGN\_SS is a dummy variable set to 1 if *two developing countries* have signed a bilateral investment treaty between them and 0 otherwise.

BITS\_FORCE\_NS is a dummy variable set to 1 if *a developed and a developing country* have a bilateral investment treaty in force between them and 0 otherwise.

BITS\_FORCE\_SS is a dummy variable set to 1 if *two developing countries* have a bilateral investment treaty in force between them and 0 otherwise.

Additional FDI determinants from the literature are also explored in variations of the basic model, but the focus is on the impact of the presence of a BIT between countries on bilateral FDI. Drawing on the study by Grosse and Trevino (2005), the additional determinants in some of the specifications include two macroeconomic and one institutional variable as follows:

ER is the nominal exchange rate measured in US dollars per domestic currency, period average, such that an increase in ER reflects an appreciation of the domestic currency.

INF is the percentage change in average consumer prices.

STABILITY is a political stability perception index reflecting ‘political stability and absence from violence/terrorism’. The index ranges from -2.5 to 2.5 (see Section 4.3).

Six variations of the basic model (Models 1 to 6 below) are estimated using the BITS\_SIGNED versions of the dummy variable. Model 1 includes just the traditional gravity variables and the

BITS\_SIGNED dummy variable while Model 2 adds the additional exchange rate, inflation and political stability control variables as follows.<sup>12</sup>

Model 1:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGNED})$$

Model 2:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGNED}, \ln \text{ER}, \text{INF}, \ln \text{STABILITY})$$

Following the results of the first two models (discussed in Section 5.4 of Chapter 5), further estimations are undertaken in order to investigate whether there is a difference between the impact of BITs on inward FDI in developing countries if the BIT signed is between a developed and developing country (i.e. NS) or if it is between two developing countries (SS).

Models 3 and 4 below investigate the impact of North-South BITs specifically by including the dummy variable BITS\_SIGN\_NS in place of the more general BITS\_SIGNED version of the variable. Model 3 only includes the gravity variables and BITS\_SIGN\_NS, while Model 4 adds the additional control variable (exchange rate, inflation and political stability).

Model 3:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGN\_NS})$$

Model 4:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGN\_NS}, \ln \text{ER}, \text{INF}, \ln \text{STABILITY})$$

Models 5 and 6 below investigate the impact of South-South BITs only by including the dummy variable BITS\_SIGN\_SS in place of the more general BITS\_SIGNED version of the variable. Model 5 only includes the gravity variables and BITS\_SIGN\_SS, while Model 6 adds the additional control variable (exchange rate, inflation and political stability).

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<sup>12</sup> Note that it is not necessary to log the INF variable as it is measured as a percent, while dummy variables are never logged.

Model 5:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGN\_SS})$$

Model 6:

$$\ln \text{IFDI} = f(\ln \text{GDP\_RECIPIENT}, \ln \text{GDP\_INVESTOR}, \text{CONTIG}, \text{LANG}, \ln \text{DIST}, \text{BITS\_SIGN\_SS}, \ln \text{ER}, \text{INF}, \ln \text{STABILITY})$$

The results for Models 1 to 6 are presented in Table 5.4 of Chapter 5 and discussed in Section 5.4 of that chapter.

Six further variations of the basic model (Models 7 to 12) are estimated as above but using the BITS\_FORCE versions of the dummy variable in place of the BITS\_SIGNED versions. The results for Models 7 to 12 are presented in Table 5.5 of Chapter 5 and also discussed in Section 5.4 of that chapter. All estimations are undertaken with HAC (Newey-West) standard errors to account for autocorrelation and heteroscedasticity.

To test the hypothesis that signing BITs has a positive effect on inward FDI into developing countries it was necessary that all recipient countries be developing economies. However, investor countries are both developed and developing economies. Therefore, each bilateral FDI relationship is either between a developing recipient and developed investor country or between a developing recipient and developing investor country.

The number of recipient developing countries included in the gravity model – 36 in total - was informed by bilateral FDI data availability. Fifteen of the recipient countries included in the gravity model are located in Africa, seven are in Latin America and the Caribbean, while fourteen are in Asia.<sup>13</sup> The selection attempts to capture a set of bilateral relationships that account for a significant proportion of inward FDI into developing countries. 2019 was chosen as the year for the gravity estimation for two reasons: the most complete data was available for this year and also to avoid any distortion to the data from the COVID-19 pandemic.

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<sup>13</sup> The recipient countries are as follows: Botswana, Ghana, Kenya, Mauritius, Morocco, Mozambique, Namibia, Nigeria, Rwanda, Senegal, South Africa, Tanzania, Tunisia, Uganda, Zambia (from Africa); Argentina, Bolivia, Brazil, Chile, Costa Rica Mexico, Peru (Latin America and the Caribbean); and Bangladesh, Cambodia, China, India, Indonesia, Malaysia, Myanmar, Nepal, Pakistan, Philippines, Sri Lanka, Thailand, Turkey, Vietnam (Asia).

Whilst the inward FDI data for the majority of the developing countries captured in the gravity model is for 2019, there are a handful of countries for whom data for 2019 was not available. The study therefore uses 2017 inward FDI data for Tanzania and Zambia, and 2018 inward FDI data for Botswana, China, Ghana, Pakistan and Rwanda. Various other data availability constraints reduced the number of bilateral pairs used in the estimations of the gravity model from an initial total of 1052 pairs to the 1009 pairs used in the study. Hence  $n=1009$  for all 12 versions of the basic model estimated.

Finally, the fourth sub-goal in the study (examining the implications of BITs for development policy) is addressed in Chapter 6 using case study analysis (Creswell and Creswell, 2018: 311) of selected BITs between developed and developing economies, as well as those between two developing economies. Comparative analysis of the provisions of the BITs for the selected cases is undertaken, with a focus on common and differing provisions in traditional versus more recent BITs between developed and developing countries on the one hand and between developing countries on the other. The focus is on BITs involving some of the BRICS economies because of their differing approaches to BITs and their widely varying degrees of participation in the international investment agreement environment. The identification of common and differing provisions in these public documents is used to examine the implications of the different types of BITs for development policy.

### **4.3 Data sources and limitations**

In order to address the first sub-goal of the research, data on FDI stocks in developing and developed countries for the period from 1980 to the most recent year available (2021) were obtained from the UNCTAD FDI Database (UNCTAD, 2023a). To address the second sub-goal on the growth and geographical location of BITs, a dataset of the number of BITs signed and BITs in force per annum, as well as per decade, was created by the author based on the list of investment treaties in UNCTAD's Investment Policy Hub Database (UNCTAD, 2023b). The author categorised the treaties into those between developed countries, those between developed and developing countries, and those between two developing countries. As noted in Section 4.2, the dataset created covers over seven decades, starting from the 1950s up to, and including, the year 2022.

The dataset required to undertake the gravity model estimation for the third sub-goal of the study was created by the author from a number of sources. The dependent variable (bilateral FDI stock) was obtained for each recipient country from investor countries for which data was available for 2019 from the ITC's Investment Map database (ITC, 2022). This initially yielded 1052 bilateral FDI relationships (observations for the dependent variable). After removing pairs for which certain explanatory variable data was not available, 1009 bilateral FDI relationships remained, as noted in Section 4.2. FDI stock data from ITC (2022) was converted from USD millions to USD billions to match the GDP data. There were no negative bilateral FDI values found and the ones that were missing or zero were omitted.<sup>14</sup>

GDP data for the gravity model was sourced from the World Bank's World Development Indicators Database (World Bank, 2022), while the CONTIG, LANG and DIST variables were obtained from the CEPII GeoDist Database (CEPII, 2011). The CEPII GeoDist (Geographical Distance) Database provides numerous geographical variables, particularly bilateral distances which are measured with city-level data in order to verify the geographic distribution of population within each country (CEPII, 2011).

The various versions of the BIT dummy variable used in the gravity model were created by the author based on the dataset derived from the UNCTAD Investment Policy Hub Database (UNCTAD, 2023b).

The two macroeconomic control variables used in the study - the exchange rate and the inflation rate - were sourced from the IMF's World Economic Outlook Database (IMF, 2022). The third additional control variable, the political stability index, was obtained from the World Bank's Worldwide Governance Indicators Database (World Bank, 2023b). This is a perceptions index for "Political Stability and Absence of Violence/Terrorism" measuring "perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism".<sup>15</sup> The World Bank provides the estimate in units of the standard normal distribution, giving a range of approximately -2.5 to 2.5. It is important to emphasise that the political stability index is both a perceptions index and involves aggregation of different perceptions measures. The

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<sup>14</sup> See Dorakh (2020). No systematic bias is expected as a result as there were very few such instances and the number of bilateral pairs remaining (n=1009) captures a significant share of developing country inward FDI.

<sup>15</sup> See <https://databank.worldbank.org/metadataglossary/worldwide-governance-indicators/series/PV.EST>.

use of such indices in general, and in regression analysis in particular, should be undertaken with due acknowledgement of their limitations.

Finally, for the fourth sub-goal of the thesis (the case study analysis of the provisions of selected BITs), addressed in Chapter 6, the texts of the BIT documents were obtained from the UNCTAD Investment Policy Hub Database (UNCTAD, 2023b).

#### **4.4 Conclusion**

This chapter has examined the methods, procedures and techniques used to address the research goals of the thesis. The chapter also discussed the data sources and limitations for the study. In the remainder of the thesis, the first three sub-goals set out in Section 1.2 are addressed in Chapter 5, while the fourth sub-goal is addressed in Chapter 6.

The main purpose of Chapter 5 is to examine empirically the impact of BITs on the inward FDI of developing countries using a gravity model. The overarching goal of Chapter 6 is to analyse political economy, policy space and investment policy issues related to BITs, using case study analysis of selected BITs between developed and developing countries and between two developing countries. To conclude the study, Chapter 7 summarises the key findings of the research, and also offers policy recommendations and suggests areas for future research.

## Chapter 5

### **A gravity model of FDI: investigating the impact of bilateral investment treaties on FDI in developing countries**

#### **5.1 Introduction**

There is an increasing amount of empirical research on FDI which provides evidence of the positive impact that FDI has on GDP growth (OECD, 2018a). Chapter 2 of this thesis analysed the theory and concepts of FDI, as well as the motives behind FDI, its key determinants and modes through which it is deployed. The analysis in Chapter 2 suggests that in addition to attracting capital that host economies apply for productive development in their countries, FDI can also transfer substantial amounts of technical, as well as managerial knowledge and skills. Moreover, it is possible that these benefits will spillover to domestic firms in the host economy. As discussed in Chapter 3, cognisant of the potential benefits of FDI, developing countries increasingly liberalised their economies in the 1980s and 1990s, and developed policy frameworks to improve their attractiveness to foreign investors, including the signing of BITs (Bose and Kohli, 2018: 1).

Scholars such as Neumayer and Spess (2005), Salacuse and Sullivan (2005), Sauvant (2007), Franck (2009), and Hartmann and Spruk (2022) argue that there is a positive relationship between the number of BITs signed by a developing country and its inward FDI. However, as discussed in Chapter 3, literature suggests that there is a lack of consensus around the question of whether BITs increase FDI received, particularly in the case of developing countries (Ginsburg, 2006; Naidu and Vickers, 2014). On the one hand, scholars in favour of BITs argue that BITs improve FDI flows to developing countries because of the investment protection measures and guarantees that they offer to foreign investors (Franck, 2009). Foreign investors place a high premium on the protections BITs offer MNEs (Hartmann and Spruk, 2022: 34).

However, as indicated in Chapter 3, sceptics such as Gallagher and Shrestha (2011: 919) dispute this, arguing instead that the protections extended to developed countries through BITs have a negative impact on regulation for public and environmental welfare and in effect may hinder development in developing countries. Furthermore, authors such as Hallward-Driemeier (2003), Tobin and Rose-Ackerman (2005), Gallagher (2011), Gallagher and Shrestha (2011),

Kollamparambil (2016), as well as Chen (2017) and others argue that there is insignificant empirical evidence to suggest that BITs do improve inward FDI. In the light of the findings from the literature in Chapter 3, it is important to investigate the impact of BITs on FDI in developing countries using more recent data and applying appropriate theoretical models.

This chapter estimates a gravity model in order to investigate whether the presence of BITs has a positive effect on inward FDI in developing countries. As noted in Chapter 4, the gravity model is extensively used in quantitative studies of international trade and investment policy (De Rosa, 2008; Dorakh, 2020; Mishra and Jena, 2019). As Chapter 4 indicates, the gravity model used in this chapter examines the determinants of bilateral FDI involving developing country recipients of inward FDI from both developed and developing economies. Similar to recent gravity models in the literature, the gravity model incorporates indicators for BITs, thereby enabling the model to examine the contribution of BITs to bilateral FDI in developing countries. Whilst the focus of the gravity model in this study is on the impact of the presence of a BIT between countries on bilateral FDI, additional FDI determinants from the literature, namely exchange rates, inflation rates and political stability, are explored in variations of the basic model.

The rest of this chapter is organised as follows. As background to the gravity model estimation, Section 5.2 investigates the growth and geographical distribution of developing country FDI relative to developed country FDI over the period 1980 to 2021, while Section 5.3 examines the growth and distribution of BITs involving developing countries since the 1950s. In Section 5.4, a gravity model is estimated to investigate whether the presence of BITs positively impacts the inward FDI that developing countries receive from foreign investors. Section 5.5 concludes the chapter.

## **5.2 Developing country FDI: growth and geographical distribution**

Figure 5.1 below depicts the trends in inward FDI stock in trillions of US dollars for both developed and developing countries for the period 1980 to 2021 in nominal terms. It is evident that since 1980, FDI stocks in developed countries have exceeded that of developing countries, generally by an increasing margin. Despite following a similar upward trajectory in Figure 5.1, the absolute difference in the total FDI stocks commanded by developed and developing countries appears to be increasing in the decade from 1980 until 1989. World FDI stocks for

the period 1980 until 1989 stood at USD 0.700 trillion and USD 1.832 trillion respectively. During this period, developed economies' FDI stocks increased from USD 0.408 trillion in 1980, to USD 1.369 trillion in 1989. This means that FDI stocks in developed economies more than tripled during this decade (approximately 336%). In the same period, developing economies' FDI stocks grew by almost 158%, from USD 0.293 trillion to USD 0.462 trillion.

In the 1990s, as Figure 5.1 indicates, the absolute difference in FDI stocks between developed and developing economies widened further, even as both increased over the decade. Despite a brief narrowing in the early 2000s, the absolute difference appears to widen even further thereafter, although both increase more rapidly, up until the onset of the global financial crisis in 2007.

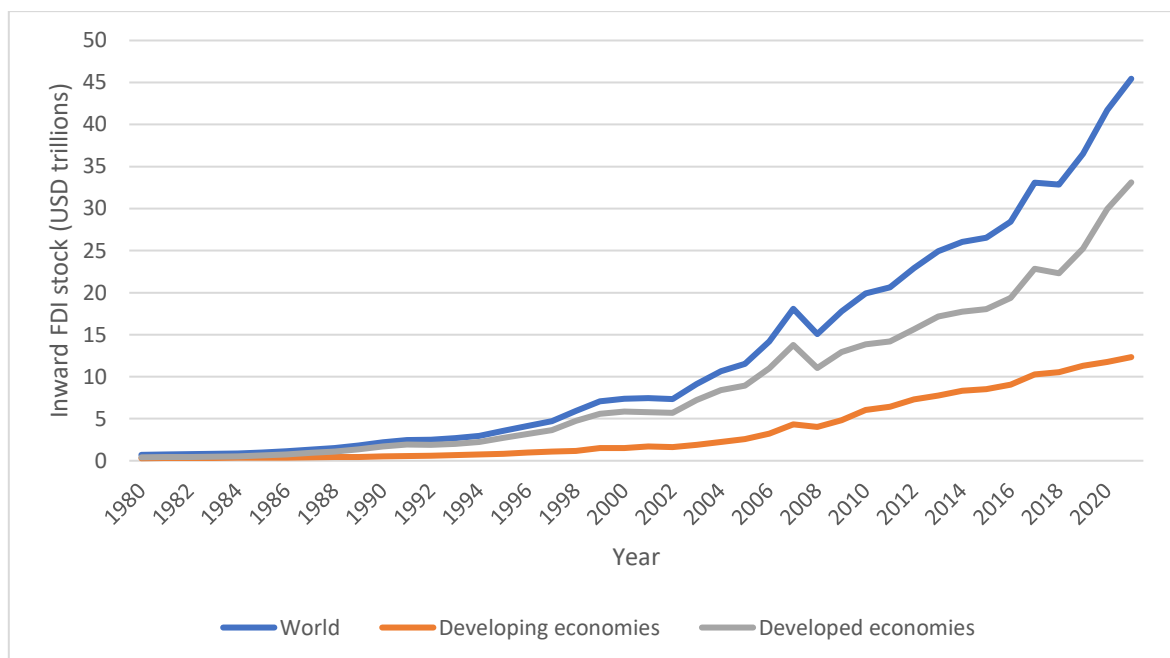


Figure 5.1: Foreign direct investment: inward stock (current US Dollar trillions), annual  
Source: Author's graph based on data from UNCTAD (2023a)

Figure 5.1 also reveals an increasing difference between developed and developing country FDI stocks following the global financial crisis, with the exception of 2017-2018. From 2018 developed countries' FDI stock appears to increase significantly, despite short term disruptions due to the COVID-19 pandemic in early 2020. This is in line with data from UNCTAD (2022a: 7) which suggests that approximately 75% of the global increase in FDI stocks in 2021 was the result of improved economic performance in developed economies.

Table 5.1 below shows that although, since the 1980s, developed and developing countries

seem to have experienced largely divergent trends in inward FDI stock, a closer examination of the shares and average annual growth rates for particular periods provide a more nuanced picture. Table 5.1 reveals that in the 5-year periods 1980-1985, 1985-1990, 1995-2000 and the most recent period 2018-2021, the average annual growth rate in FDI stock for developed countries exceeded that of developing countries. In particular, the decline in the developing country share of FDI in the 1980s, notably between 1985 and 1990, resulted in part from a significant rise in the average annual growth rate of developed country FDI of 22.32% per annum in 1985-1990 as European and North American integration intensified and global corporate restructuring accelerated.<sup>16</sup> By contrast, for the periods 1990-1995, 2000-2005, 2005-2010, 2010-2015, as well as 2015-2018, the average annual growth rate in FDI stock for developing countries exceeded that of developed countries.

*Table 5.1 Developing and developed country FDI stock: shares and growth rates*

<b>Percentage shares in global FDI</b>										
	<b>1980</b>	<b>1985</b>	<b>1990</b>	<b>1995</b>	<b>2000</b>	<b>2005</b>	<b>2010</b>	<b>2015</b>	<b>2018</b>	<b>2021</b>
<b>Developing</b>	41.79	37.31	22.93	23.24	20.57	22.51	30.45	32.07	32.11	27.13
<b>Developed</b>	58.21	62.69	77.07	76.76	79.43	77.49	69.55	67.93	67.89	72.87
<b>Average annual growth rates (%)</b>										
	<b>1980-1985</b>	<b>1985-1990</b>	<b>1990-1995</b>	<b>1995-2000</b>	<b>2000-2005</b>	<b>2005-2010</b>	<b>2010-2015</b>	<b>2015-2018</b>	<b>2018-2021</b>	
<b>World</b>	7.08	17.37	10.17	15.66	9.32	11.57	5.93	7.35	11.44	
<b>Developing</b>	4.68	6.48	10.47	12.86	11.31	18.51	7.03	7.40	5.34	
<b>Developed</b>	8.67	22.32	10.08	16.45	8.78	9.18	5.43	7.33	14.10	

*Source: Author's computations based on data from UNCTAD (2023a)*

Furthermore, the 1990s saw both developed and developing countries record double-digit average annual growth rates in FDI stock in nominal terms. For instance, from 1990 to 1995, developing countries' FDI stock grew at an average annual rate of 10.47% relative to developed countries' annual average of 10.08%. Similarly, between 1995 and 2000, developing and developed countries recorded average annual growth rates of 12.86% and 16.45%, respectively. Notably, the only periods during which double-digit rates of annual growth are recorded post-2000 are 2000-2005 (developing economies: 11.31%), 2005-2010 (developing economies: 18.51%), and 2018-2021 (developed economies: 14.10%).

<sup>16</sup> See Graham and Krugman (1993) for a detailed discussion of the FDI surge among industrialised economies in the latter part of the 1980s.

Figure 5.1 reveals that the global financial crisis of 2007-2008 resulted in a sharper fall in FDI stock for developed economies compared to developing countries in absolute terms. For instance, in the case of developed economies, inward FDI stock levels fell from USD 13.778 trillion in 2007 to USD 11.045 trillion in 2008. For developing economies, FDI stock fell slightly from USD 4.318 trillion in 2007 to USD 4.034 trillion in 2008. Table 5.1 reveals, furthermore, that the percentage share of global FDI stocks in developed economies decreased from 77.49% in 2005 to 69.55% in 2010, with a corresponding increase in developing countries' percentage share from 22.51% in 2005, to 30.45% in 2010.

Figure 5.1 also reveals that 2021 FDI stocks in developed countries increased by approximately 10% compared to the previous year (i.e. increased from USD 29.967 trillion in 2020 to USD 33.119 trillion in 2021). For developing countries, the corresponding figure was a 4.8% increase (from USD 11.760 trillion in 2020 to USD 12.330 trillion in 2021). This growth was achieved despite the COVID-19 pandemic and related economic lockdowns. In line with the growth trajectory achieved by developed economies in the same period, World FDI stocks increased by approximately 10% from USD 41.728 trillion in 2020, to USD 45.449 trillion in 2021. This is in line with data from UNCTAD (2022a) which shows that the main contributor to growth in World FDI stocks in the period 2020-2021 was growth in developed economies' FDI stock.

Data from UNCTAD (2022a) as well as UNCTAD (2023a) reveals that the 2021 global FDI recovery saw growth in all regions. However, as stated above, it is important to note that approximately 75% of the global increase in FDI during this period was the result of increases in developed economies' FDI stock (UNCTAD, 2022a). Notably, the growth seen in the inward FDI of developing countries in 2021 was primarily due to positive growth in Asia, improved growth performance in Africa, as well as modest recovery in Latin America and the Caribbean (UNCTAD, 2022a: 11).

Although global FDI stocks in Figure 5.1 appear to have increased – despite COVID-19 and related lockdowns - by the end of 2021, research findings suggest that the levels of Greenfield investments remain fragile, particularly in the case of developing countries (UNCTAD, 2022a: 6). Research findings reveal that despite the 2021 recovery in infrastructure-oriented international project finance which went up by 68%, and cross-border mergers and acquisitions which increased by 43%, the appetite of foreign investors for investing in Greenfield projects

abroad remained weak (UNCTAD, 2022a: 6). It is reported that Greenfield investment numbers increased by only 11% in 2021, a figure that is still 20% below pre-pandemic levels (UNCTAD, 2022a: 6).

Moreover, Greenfield activity in 2022 indicated greater sensitivity to risk among foreign investors with data for the first quarter of the year revealing Greenfield project numbers down 21% and international project finance deals down 4% (UNCTAD, 2022a: 6). This is a major concern given the key role that industry Greenfield investments play in economic growth and development prospects (UNCTAD, 2022a).

In addition to FDI stocks in developed economies accounting for most of the increases in global FDI stock in 2021, Table 5.1 reveals that the percentage share in global FDI held by developed economies had increased to 72.87% by 2021 (from 67.89% in 2018), with a corresponding decrease in the share of developing economies from 32.11% in 2018, to 27.13% in 2021.

Furthermore, for developing countries, data from UNCTAD (2022a: 27) suggests that in 2021, the total value of Greenfield announcements in Sustainable Development Goal (SDG) related sectors, as well as international project funding commitments, is approximately 10% above those recorded pre-COVID-19. Research findings suggest that most of the growth in developing economies went to renewable energy, with only a partial recovery recorded in other SDG-related sectors such as infrastructure, food, agriculture, health, and so on (UNCTAD, 2022a: 27). This is important given that renewable energy and energy-efficiency projects represent the majority of investments in climate change initiatives (UNCTAD, 2022a: 27).

When it comes to the geographical distribution of FDI in developing countries, research findings suggest that the picture continues to be skewed in favour of emerging markets (UNCTAD 2022a). For instance, in 2021, developing countries in Asia - despite the COVID-19 pandemic and associated lockdowns – saw their FDI inflows rise to an all-time high for the third year in a row, with an overall total of approximately USD 619 billion (UNCTAD, 2022a: 13). Furthermore, also in FDI flow terms, data from UNCTAD (2022a: 13) suggests that in terms of regional distribution, Asia is the largest recipient, accounting for approximately 40% of inward global FDI flows. However, research findings suggest that FDI flows in Asia remain highly concentrated with only six economies accounting for more than 80% of FDI to the

region. These are China, Hong Kong (China), Singapore, India, the United Arab Emirates, and Indonesia, in descending order (UNCTAD, 2022a: 13-14).

As Table 5.1 reveals, from 2000 until 2018 developing country FDI stock grew faster than developed country FDI stock, in average annual growth rate terms. However, for the years reflected in Table 5.1, developing countries held approximately 41.79% of global FDI stocks at their peak, as far back as 1980, while their lowest share was seen in 2000 with only 20.57% of global FDI stocks. While the share held by developing countries increased after 2000 until the onset of the pandemic, the global geographic distribution of FDI stock has remained significantly skewed in favour of developed countries despite the growing proliferation of BITs and other international investment agreements.

### **5.3 The growth and distribution of BITs involving developing countries**

Although the signing of BITs proliferated in the 1980s and 1990s, the very first BIT to be concluded between a developed and developing country was signed in 1959 by Germany and Pakistan and came into effect in 1962 (Tobin and Rose-Ackerman, 2005: 5). Most of the BITs signed in the early stages of the proliferation BITs were between African and Western European Countries. Developing countries in Asia began to sign BITs in the 1970s and soon thereafter, central and eastern European countries made their entry into the BITs landscape. Latin America was a late entrant into the BITs landscape because countries from this region of the Global South did not start signing BITs until the late 1980s (Tobin and Rose-Ackerman, 2005: 6).

Table 5.2 below confirms that the proliferation of BITs occurred during the two decades of the 1980s and the 1990s, and continued into the 2000s. As Table 5.2 indicates, the greatest increase in the number of BITs concluded between developed and developing countries took place in the 1990s, with the new BITs signed for this group rising nearly threefold from 224 in the 1980s to 663 in the 1990s. The signing of new BITs between two developing countries took off slightly later, increasing from 61 in the 1980s to 812 in the 1990s.

*Table 5.2: Developed and developing country BITs signed per decade (1950 - 2022)*

	1950s	1960s	1970s	1980s	1990s	2000s	2010s	2020-22
Developed-Developed	0	1	0	1	0	0	0	0
Developed-Developing	1	70	80	224	663	397	61	4
Developing-Developing	0	3	18	61	812	665	286	11
Total per period	1	74	98	286	1475	1062	347	15
Cumulative total	1	75	173	459	1934	2996	3343	3358

*Source: Author's calculations based on BITs data from UNCTAD (2023b)*

Table 5.2 reveals that since the very first BIT signed (between Germany and Pakistan) in 1959, the total number of BITs signed has grown from the single BIT concluded in that year (and decade) to 3358 by the end of 2022. The growth in the number of BITs signed was limited in the 1950s and increased in the two decades following that, before accelerating in the 1980s and peaking in the 1990s. Following the Germany-Pakistan BIT in 1959, the second BIT signed was in 1960, also between a developed country (Germany) and a developing country (Malaysia) (UNCTAD, 2023b). However, as Table 5.2 shows, the signing of BITs gained momentum during the 1960s, with a total of 75 BITs signed that decade.

It was not until the 1960s that a BIT was concluded between two developed countries (Germany and Greece in 1961) (UNCTAD, 2023b). It was also in this decade that developing countries first signed BITs with other developing countries, with three such BITs signed. The first of these was between Iraq and Kuwait in 1964, followed by Kuwait and the United Arab Emirates in 1966, as well as Egypt and Kuwait, also in 1966 (UNCTAD, 2023b). From just one BIT concluded between developed and developing countries in the previous decade, the 1960s saw a significant jump in this category of BITs reaching a total of 70 new BITs between developed and developing countries that decade.

As Table 5.2 shows, growth in the number of BITs signed continued in the 1970s across all categories except between developed countries which did not record a single BIT signed in the whole period. The number of new BITs signed per decade grew from 74 in the previous decade, to 98 in the 1970s. New BITs between developing countries grew from three in the previous decade to 18 in the 1970s, while the number of new BITs between developed and developing countries grew from 70 to 80.

During the 1980s, one further BIT was signed between two developed countries (Germany and Portugal). This is the last BIT noted in the UNCTAD (2023b) database to be concluded between two developed countries. Thus, of the 3358 BITs signed between 1959 and 2022, only two are recorded to be between two developed countries. As seen in Table 5.2, BITs involving either one or two developing countries make up the majority of BITs signed in the IIA arena. Other types of IIA, such as investment chapters in regional trade or deeper integration agreements, tend to govern investment relations among developed economies.

As noted earlier, the number of new BITs signed per decade between developed and developing countries grew from 80 in the 1970s to 224 in the 1980s, followed by 663 in the 1990s. Meanwhile, the number of new BITs per decade signed just between developing countries increased over three-fold from 18 in the 1970s to 61 in the 1980s. Notably, in the 1990s, 812 new BITs were signed between two developing countries.

Table 5.2 shows that the number of new BITs signed peaked during the decade of the 1990s, with a total of approximately 1475 BITs signed between countries in that period alone. BITs proliferation in the 1990s was related to the factors discussed in Section 3.2, such as the liberalisation and globalisation environment, as well as developed country dissatisfaction at not getting a comprehensive multilateral investment agreement finalised at the end of the Uruguay Round of trade negotiations. During the 1990s, BITs increased in their popularity as a tool for developing countries to promote FDI and protect the interests of MNEs.

For instance, in a very short space of just four years between 1994 until 1998, South Africa ratified nearly 20 BITs with mainly European countries. South Africa's newly elected democratic government took this step in 1994, as a policy measure, to reassure foreign investors that their investments would be protected under the administration of the African National Congress (ANC) (Carim, 2015: 4; DTI, 2010). Similar to China, which starting in the 1980s prolifically concluded BITs with foreign investor countries, South Africa regarded signing BITs as a diplomatic signal to the international community of the country's re-entry in the international trade and investment space following years of isolation under a closed Communist regime for the former and the Apartheid regime for the latter (Carim, 2015; Wei, 2012). Research findings suggest that in the case of countries deemed to be in transition by the international community – as China was in the 1980s under Deng Xiaoping and South Africa

under Nelson Mandela in the 1990s - BITs provide symbolic benefits to the current government as a quick way to gain policy trustworthiness on global platforms. (Martin and Simmons, 1998).

The distribution of BITs involving developing countries took a significant turn during the 1990s. Table 5.2 reveals that during this decade the number of BITs signed between two developing countries exceeded the number of BITs signed between developing and developed countries for the first time. While 663 new BITs were signed between developing and developed countries during the 1990s, 812 new BITs were signed between two developing countries in the same period. This is despite governments in developing countries like South Africa (post-Apartheid) and transition economies emerging from the USSR signing numerous BITs with developed countries in the same period to reassure the latter that their investments would be 'protected' under the new dispensations.

The 21<sup>st</sup> century has seen a sharp decline in the total number of BITs signed across all categories. Table 5.2 reveals that whilst the number of BITs signed continued to exceed 1000 during the 2000s, this changed during the decade of the 2010s as the total number of new BITs signed during a single decade dropped to just 347. The decline was across all categories, with the largest proportional decrease occurring for BITs between developed and developing countries which fell to just 61 new signings in the 2010s (Table 5.2). As discussed in Chapter 3, this has been due to the growing discontent amongst developing countries with the pro-investor nature of BITs and the ISDS arbitration system (Carim, 2015; Chen, 2017; Gallagher, 2011; Kurtz, 2012, 2014; Wei, 2012). Therefore, developing countries are increasingly opting to review and/or cancel BITs. In the period from 2020 to 2022, 15 new BITs have been signed thus far, with only 5 new BITs signed between a developing and developed country, compared to 11 new BITs signed between developing countries in the same period (Table 5.2).

The period since 2010 is significant in that it marks the year in which many developing countries like Indonesia, India and South Africa announced their intentions and took steps to review and/or terminate their traditional BITs. As Table 5.2 indicates, the number of new BITs signed between developed and developing countries, and between developing countries, declined significantly in the 2010s compared to the 2000s. This is despite the re-entry of Brazil into the BITs landscape in 2015 which saw this country signing BITs with other developing countries such as Angola and Mozambique. Notably, the BITs signed by BRICS countries with

other developing countries in the years 2015 to 2019 helped to increase the total number of BITs signed between developing countries in that decade (UNCTAD, 2023b).

Britain formally withdrew from the European Union (EU) on 31 January 2020. A number of countries that had investment agreements with the EU began to make their own new arrangements with the United Kingdom (UK) following its exit from the EU single market. This is reflected in the number of treaties with investment provisions (referred to as TIPs) signed by the UK with other countries in the period between 2020 and 2022. In 2020, data from UNCTAD (2023b) reveals that the UK signed 11 TIPs with 11 countries, and one TIP with the EU bloc. Of the 12 TIPs signed by the UK in 2020, four<sup>17</sup> are with other developed economies, whilst the remaining eight<sup>18</sup> are with developing economies. In 2021, the UK signed one TIP with another developed country (Australia) and two TIPs with two developing countries (Cameroon and Ghana, respectively). All three TIPs signed in 2021 are not in force. The UK only signed (not in force) one TIP in 2022, with New Zealand, another developed economy. According to data from UNCTAD (2023b), the UK has not signed a BIT with another country since the year 2010. In 2010, the UK only signed a single BIT, with Colombia, a developing country, which entered into force in 2014 (UNCTAD, 2023b).

Table 5.3 below suggests that in recent years, treaties with investment provisions (TIPs) have increased in significance in the IIA landscape, as BITs continue to decline in prominence. TIPs are broader agreements that cover other issues as well as investment, and may involve more than two partner countries. The data in Table 5.3 reveals that in the period between 2013-2019, the number of BITs signed in the IIA arena exceeded that of TIPs signed in the same period. For instance, Table 5.3 shows that whilst 33 BITs were signed in 2013, only 16 TIPs were signed in the same period. As seen in Table 5.3, a similar trend is observed until 2019 when 23 BITs were signed, compared to 19 TIPs in the same period. Notably, the number of TIPs signed in 2019 is almost double that of those signed in 2018, with 19 TIPs signed in 2019, compared to only 10 in 2018. This then narrows the gap between BITs and TIPs signed annually.

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<sup>17</sup> EU bloc (signed, not in force), Singapore (signed, in force), Canada (signed, in force) and Japan (signed, not in force).

<sup>18</sup> Turkey (signed, not in force), Vietnam (signed, not in force), Moldova (signed, not in force), Kenya (signed, in force), Egypt (signed, not in force), North Macedonia (signed, not in force), Côte d'Ivoire (signed, not in force) and Ukraine (signed, not in force).

Table 5.3: BITs and Treaties with investment provisions (TIPs) signed annually in the period 2013 – 2022

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BITs	33	34	32	36	31	39	23	8	6	1
TIPs	16	12	12	8	9	10	19	16	7	3

Source: Author's calculations based on BITs and TIPs data from UNCTAD (2023b)

Furthermore, Table 5.3 shows that since 2020, the number of TIPs signed annually between countries exceeds that of BITs. The data contained in Table 5.3 suggests that in recent years, BITs may be in the process of being replaced with TIPs to some extent. Table 5.3 reveals that a total of 26 TIPs were signed in the period between 2020 and 2022, compared to just 15 BITs signed in the same period. Data from UNCTAD (2023b) reveals that in 2020, two TIPs were signed between developed countries, 12 were signed between a developed and developing country, whilst two were signed between two developing countries. In addition, in 2020, two BITs were signed between a developed and developing country, and six BITs were signed between two developing countries (UNCTAD, 2023b).

In 2021, only a single TIP was signed between two developed economies, with another two signed between a developed and developed economy, and 4 signed between two developing economies (UNCTAD, 2023b). In the same period of 2021, no BITs were signed between developed economies, whilst 2 were signed between a developed and developing economy, and 4 were signed between two developing economies (UNCTAD, 2023b). Although 3 TIPs were signed in 2022 (1 between two developed economies, 1 between a developed and developing economy, and 1 between two developing economies), only a single BIT was signed in the same period, and it is between two developing economies (UNCTAD, 2023b). This may suggest that instead of reforming BITs - as proposed by many developing countries such as Indonesia, India and South Africa and developed countries like Australia and Germany - TIPs are instead gaining prominence in the IIA landscape (Htwe, Lim and Kanikaka, 2020).

The data in Table 5.2 suggests that the decision by many developing countries to cancel and/or renegotiate their existing BITs since the 2010s was matched by a drop in the average annual growth rate of the FDI stock in these countries, as seen in Table 5.1. Although there appears to be a slight recovery in the latter in the period between 2015-2018 (increasing to 7.40% per annum between 2015-2018, from 7.03% per annum in 2010-2015), the gains are nonetheless

temporary in that they drop again in the subsequent period between 2018-2021 (from 7.40% between 2015-2018, to 5.34% in 2018-2021). The period 2018-2021 is particularly unusual, however, because of the COVID-19 pandemic. It is nevertheless notable that 2017 marked the first time that the number of IIAs terminated exceeded those signed in a single year, a trend which has continued to date (UNCTAD, 2022a). Furthermore, nearly 70% of all BITs terminated were cancelled during the 2010s period (UNCTAD, 2022a: 65).

In order to investigate the relationship between BITs and inward FDI in developing countries more formally, the discussion now turns to the econometric estimation of the relationship using the gravity model outlined in Chapter 4.

#### **5.4 A gravity model of bilateral FDI**

This section presents the results of the gravity model estimations set out in Chapter 4 to investigate if the presence of BITs has a positive effect on inward FDI in developing countries. As noted in Section 5.1 and Chapter 4, the gravity model is used to examine the determinants of bilateral FDI and involves developing countries who receive inward FDI from both developed and/or other developing countries.

Recall from Chapter 4 that the following basic gravity model is specified for the study:

$$\ln \text{IFDI}_i = \beta_0 + \beta_1 \ln \text{GDP\_RECIPIENT} + \beta_2 \ln \text{GDP\_INVESTOR} + \beta_3 \text{CONTIG}_i + \beta_4 \text{LANG}_i + \beta_5 \ln \text{DIST}_i + \beta_6 \text{BIT}_i + u_i$$

where

$\text{IFDI}_i$  is the inward FDI stock (following Kox and Rojas-Romagosa, 2020) of the recipient developing country from the outward investor country in current US dollar billions for 2019.

$\text{GDP\_RECIPIENT}$  is the GDP of the recipient developing country measured in current US dollar billions for 2019.

$\text{GDP\_INVESTOR}$  is the GDP of the outward investor country measured in current US dollar billions for 2019.

$\text{CONTIG}_i$  is a dummy variable set equal to 1 if the two countries have a common border and 0 otherwise.

LANG<sub>i</sub> is a dummy variable set equal to 1 if the two countries share a common official language and 0 otherwise.

DIST<sub>i</sub> is the distance in kilometres between the largest cities in each country.

As noted in Chapter 4, six versions of the BIT<sub>i</sub> dummy variable were created by the author for different specifications of the basic model:

BITS\_SIGNED<sub>i</sub> is a dummy variable set to 1 if the two countries have ever *signed* a bilateral investment treaty between them and 0 otherwise.

BITS\_FORCE<sub>i</sub> is a dummy variable set to 1 if the two countries have a bilateral investment treaty *in force* between them and 0 otherwise.

BITS\_SIGN\_NS is a dummy variable set to 1 if *a developed and a developing country* have signed a bilateral investment treaty between them and 0 otherwise.

BITS\_SIGN\_SS is a dummy variable set to 1 if *two developing countries* have signed a bilateral investment treaty between them and 0 otherwise.

BITS\_FORCE\_NS is a dummy variable set to 1 if *a developed and a developing country* have a bilateral investment treaty in force between them and 0 otherwise.

BITS\_FORCE\_SS is a dummy variable set to 1 if *two developing countries* have a bilateral investment treaty in force between them and 0 otherwise.

Three further control variables (two macroeconomic and one institutional) were also used in certain specifications of the basic model:

ER is the nominal exchange rate measured in US dollars per domestic currency, period average, such that an increase in ER reflects an appreciation of the domestic currency.

INF is the percentage change in average consumer prices.

STABILITY is a political stability perception index reflecting ‘political stability and absence from violence/terrorism’. The index ranges from -2.5 to 2.5, as explained in Section 4.3.

Tables 5.4 and 5.5 below present the ordinary least squares (OLS) regression results of the log-linear gravity model estimations undertaken for the study. As explained in Chapter 4, six variations of the basic model (Models 1 to 6) were estimated using the BITS\_SIGNED versions of the dummy variable, while six further variations of the basic model (Models 7 to 12) were estimated using the BITS\_FORCE versions of the dummy variable in place of the respective BITS\_SIGNED versions.

Table 5.4 presents the results of the estimations of Models 1 to 6. Since these models use the BITS\_SIGNED versions of the dummy variable, their focus is on the impact of having ever

signed a BIT with the partner country on inward FDI in recipient developing countries. Table 5.5 presents the results of the estimations of Models 7 to 12 which use the BITS\_FORCE versions of the dummy variable. In this instance, the focus is on whether having a BIT *in force* with the partner country has a significant effect on inward FDI in recipient developing countries.

Recall that Model 1 includes just the traditional gravity variables and the BITS\_SIGNED dummy variable while Model 2 also includes the additional control variables, namely the exchange rate, inflation rate and political stability index. All of the estimated coefficients are statistically significant at the 1% level in both models, with the exception of the CONTIG coefficient which is significant only at the 10% level in Model 1 and statistically insignificant in Model 2.

Table 5.4: Regression results using BITs signed (Models 1 to 6)

ln (IFDI)	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
c	-3.418*	-4.870*	-1.680	-3.474†	-1.369	-2.957†
ln (GDP_RECIPIENT)	0.500*	0.610*	0.510*	0.630*	0.580*	0.692*
ln (GDP_INVESTOR)	0.898*	0.892*	0.844*	0.843*	1.015*	1.009*
CONTIG	0.656#	0.572	0.795†	0.706#	0.279	0.176
LANG	1.283*	1.257*	1.305*	1.293*	1.150*	1.122*
ln (DIST)	-0.963*	-0.994*	-1.110*	-1.149*	-1.233*	-1.281*
BITS_SIGNED	1.541*	1.509*				
BITS_SIGN_NS			2.100*	2.072*		
BITS_SIGN_SS					-0.155	-0.185
ln (ER)		0.136*		0.121*		0.148*
INF		-0.036*		-0.033*		-0.029*
ln (STABILITY)		0.618*		0.689*		0.702*
Adjusted-R <sup>2</sup>	0.353	0.380	0.370	0.398	0.314	0.344
F-statistic	92.583*	69.787*	99.825*	75.120*	77.922*	59.706*

\*Significant at 1% level

†Significant at 5% level

#Significant at 10% level

n=1009

Source: Author's own estimations using EViews, with HAC (Newey-West) standard errors to correct for autocorrelation and heteroscedasticity

Importantly, the coefficient of the BITS\_SIGNED dummy variable is positive and statistically significant at the 1% level in both Models 1 and 2, suggesting that, on average, inward FDI in recipient developing countries is significantly higher when a BIT has been signed with the

partner country, holding all else constant. This accords with the findings of Grosse and Trevino (2005), Neumayer and Spess (2005), Dorakh (2020), as well as Kox and Rojas-Romagosa (2020).

Furthermore, the other estimated coefficients have signs that could be expected from the literature (Blonigen and Piger, 2014; Mistura and Roulet, 2019). Beginning with the coefficients of the gravity variables, the results suggest that the larger the GDP (as a proxy for market size) of the recipient and also of the investor country, the greater the impact on the inward FDI of the former. This in fact applies not only in Models 1 and 2, but also in Models 3 to 6 (see Table 5.4). In a double log model, the coefficient of a quantitative variable is an elasticity, reflecting, in this case, the percentage increase in inward IFDI due to a percentage increase in GDP holding all else constant.

Literature suggests that the positive coefficient on the GDP\_RECIPIENT variable is due to a larger market or richer country being a more attractive target for FDI (Dorakh, 2020: 438; Grosse and Trevino, 2005). On the other hand, the positive coefficient on the GDP\_INVESTOR variable could be because the greater economic size of the investor country reflects greater capacity to engage in outward FDI to the recipient country as shown, for example, by the potential number of organisations with the capacity to invest and operate abroad (Mishra and Jena, 2019: 19).

As noted above, the CONTIG coefficient is the only one in Model 1 and Model 2 which is not statistically significant at the 1% level. It is however significant at the 10% level in Model 1. In the gravity literature a positive and significant coefficient is expected for CONTIG. It seems likely, however, that the existence of a common border may be less important as a bilateral *FDI* determinant than a bilateral *trade* determinant in a traditional gravity model, depending on the extent to which trade and FDI are complementary or substitutes. In addition, or alternatively, there may be correlation between CONTIG and some of the other gravity variables such as DIST.

As expected, the coefficient of the common language dummy (LANG) is positive and significant in Models 1 and 2, suggesting that having a common language has a positive impact on the inward FDI of the recipient country, all else held constant. Indeed, this applies for Models 3 to 6 as well. Furthermore, the DIST coefficient has the negative sign expected in the

gravity literature. In other words, the greater the distance between the recipient and investor countries, the smaller the likelihood of FDI activity between them (Kox and Rojas-Romagosa, 2020). Notably, research findings suggest that the greater the distance between the investor and recipient country, the more difficult it becomes for foreign investors to supervise and manage FDI, thereby discouraging it (Mishra and Jena, 2019: 19). In Model 1 and Model 2 the coefficients of distance are -0.963 and -0.994, respectively. In both models, as with the other models in Table 5.4, the coefficients of distance are not only statistically significant and signed as expected, they are also within what is usually obtained for traditional gravity models which ranges between -0.7 and -1.5 (Yotov, Piermartini, Monteiro and Larch, 2016).

The additional control variables in Model 2 (ER, INF and STABILITY) all have estimated coefficients that are significant at the 1% level. The coefficient of the exchange rate variable is positive, as well as being statistically significant at the 1% level. This suggests that an appreciation (depreciation) of the host currency has a positive (negative) impact on recipient developing country FDI, holding all else constant. This finding accords with that of Grosse and Trevino (2005), implying that in this instance exchange rate stability is considered to be more important by investors than access to cheaper assets in the case of host country depreciation (see Footnote 9, Section 3.5).

The sign of the coefficient of the inflation rate variable (INF) is negative. Thus, in Model 2, this means that – holding all else constant - a higher rate of inflation has a negative impact on the amount of inward FDI in recipient developing countries. Research suggests that the ability of countries to have a good record in managing price stability encourages FDI in the host country (Mishra and Jena, 2019: 21). In Model 2, the coefficient of the STABILITY variable is positive and statistically significant at the 1% level. This suggests that if the perceptions of political stability improve (reflected by an increase in the index) then there will be more FDI in the recipient developing country, holding all else constant. It is noteworthy that these additional control variables (ER, INF and STABILITY) are also statistically significant at the 1% level and similarly signed in the other models in Table 5.4 in which they are included (i.e. Models 4 and 6), confirming their importance as key FDI determinants in the literature.

Following the findings regarding the BITS\_SIGNED variable in Models 1 and 2, it was decided (as noted in Chapter 4) to investigate whether there is a difference between the impact of BITS

on inward FDI in developing countries if the BIT signed is between a developed and developing country (i.e. NS) compared to if it is signed between two developing countries (SS).

Models 3 and 4 in Table 5.4 above provide the results of the investigation of the impact of the signing of *North-South BITs* on inward FDI in developing countries. Model 3 only includes the gravity variables and BITS\_SIGN\_NS, while Model 4 adds the additional control variables (exchange rate, inflation and political stability). The results reveal that the coefficient for BITS\_SIGN\_NS (i.e. BITs signed between a developed country and a developing country) is positive and statistically significant at the 1% level. This suggests that signing a BIT with a developed investor country increases the amount of inward FDI that in the recipient developing country, holding all else constant. This impact is stronger than the impact for all BITs signed noted in Models 1 and 2.

Models 5 and 6 in Table 5.4 provide the results for the estimations of the impact of the signing of *South-South BITs* on inward FDI in developing countries. Model 5 only includes the gravity variables and BITS\_SIGN\_SS, while Model 6 adds the additional control variables (exchange rate, inflation and political stability). The results indicate that the coefficient of the BITS\_SIGN\_SS variable (i.e. for BITs signed between two developing countries) is negative and not statistically significant. This suggests that, holding all else constant, the signing of a BIT between two developing countries has no significant impact on the amount of inward FDI that the recipient country receives. Therefore, as seen in Table 5.4, BITs signing between two developing countries is not found to foster inward FDI in developing countries, whereas BIT signing between a developing and developed country is correlated with increased inward FDI in the recipient developing country, holding all else constant.

As indicated in earlier, the estimated coefficients of the gravity variables and other control variables (where the latter are included) in Models 3 to 6 have the signs and statistical significance noted and discussed for Models 1 and 2. The one difference in terms of statistical significance is the CONTIG coefficient, which is significant at the 5% level and 10% levels in Models 3 and 4 respectively, but not significant at all in Models 5 and 6.

As noted in Chapter 4, six further variations of the basic model (Models 7 to 12) were estimated as above but using the BITS\_FORCE versions of the dummy variable in place of the BITS\_SIGNED versions. In this case, the focus is thus on whether having a BIT *in force* with

the partner country has a significant effect on inward FDI in recipient developing countries. Distinguishing between BITs signed and BITs in force enables the study to ascertain whether the net benefits are different for the recipient developing countries who have signed BITs and those with BITs in force.

The results for Models 7 to 12 using the BITs in force dummy variable versions are presented in Table 5.5 below. Thus, Table 5.5 explores how BIT enforcement affects the inward FDI in recipient developing countries. In Models 7 and 8, the coefficient of the `BITS_FORCE` dummy variable is positive and statistically significant at the 1% level (like its `BITS_SIGNED` counterpart in Models 1 and 2, although the effect of `BITS_FORCE` is interestingly not as strong, which is counterintuitive).<sup>19</sup>

Similarly, the results for Model 9 and Model 10 in Table 5.5 show that the coefficients of the variable for BITs in force between a developing and developed country (`BITS_FORCE_NS`) are both positive and statistically significant at the 1% level. This result suggests that, holding all else constant, the enforcement of BITs between developed and developing countries fosters the inward FDI of recipient developing countries. As seen in Table 5.4, a similar outcome is observed when BITs are signed between developed and developing countries.

Models 11 and 12 present the results for the case of BITs in force between two developing countries. Similar to the result observed in Table 5.4 when BITs are signed between two developing countries, the coefficient of the variable for BITs in force between two developing countries (i.e. `BITS_FORCE_SS`) is negative and not statistically significant. This suggests that enforcing a BIT between two developing countries does not foster the inward FDI of recipient developing countries, holding all else constant.

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<sup>19</sup> It may be that the signal that a BIT has been signed is sufficient to reassure foreign investors of the existence of safeguards and policy measures which guarantee the protection of their investments in host developing countries (see Franck, 2009; Hartmann and Spruk, 2022).

Table 5.5: Regression results using BITS in force (Models 7 to 12)

ln (IFDI)	Model 7	Model 8	Model 9	Model 10	Model 11	Model 12
c	-2.880*	-4.550*	-2.169#	-3.956*	-1.470	-3.066†
ln (GDP_RECIPIENT)	0.534*	0.649*	0.546*	0.666*	0.579*	0.689*
ln (GDP_INVESTOR)	0.914*	0.904*	0.891*	0.883*	1.017*	1.011*
CONTIG	0.613#	0.539	0.691#	0.612	0.277	0.175
LANG	1.306*	1.288*	1.293*	1.280*	1.148*	1.119*
ln (DIST)	-1.018*	-1.044*	-1.084*	-1.118*	-1.224*	-1.269*
BITS_FORCE	1.316*	1.349*				
BITS_FORCE_NS			1.746*	1.777*		
BITS_FORCE_SS					-0.118	-0.127
ln (ER)		0.140*		0.134*		0.149*
INF		-0.037*		-0.035*		-0.029*
ln (STABILITY)		0.668*		0.703*		0.696*
Adjusted-R <sup>2</sup>	0.339	0.369	0.348	0.379	0.314	0.344
F-statistic	87.040*	66.589*	90.605*	69.215*	77.854*	59.628*

\*Significant at 1% level

†Significant at 5% level

#Significant at 10% level

n=1009

Source: Author's own estimations using EViews, with HAC (Newey-West) standard errors to correct for autocorrelation and heteroscedasticity

Similar to the outcomes obtained in Table 5.4, the coefficients of the other gravity variables and additional control variables (where included) are, with one exception, all statistically significant at the 1% level and signed as expected from the literature, and as discussed for Models 1 to 6. The exception again is the coefficient of CONTIG which, in Table 5.5, is significant at the 10% level only for Models 7 and 9, and statistically insignificant otherwise.

Notably, the similarities in the coefficients of the variables, as well as the adjusted-R<sup>2</sup> and F-statistic values, in both Table 5.4 and Table 5.5 suggest only slight differences in the net effects on FDI obtained by recipient countries who have signed BITs and those with BITs in force. The overall finding is that, holding all else constant, having BITs signed and/or BITs in force has a positive effect on the inward FDI stock of the recipient country from the outward investor country. This accords with the findings of Grosse and Trevino (2005), Neumayer and Spess (2005), and the more recent studies by Dorakh (2020), and Kox and Rojas-Romagosa (2020).

The novel finding of the present study, however, that has not been highlighted in the literature, is that there is a significant difference in the impact of BITs on FDI if the BIT is signed/in force

between a developed and a developing country compared to if the BIT is signed/in force between two developing countries.

## **5.5 Conclusion**

The literature reviewed in Section 3.5 of Chapter 3 suggested a lack of consensus amongst researchers on the question of whether BITs have a positive impact on FDI flows. Scholars such as Grosse and Trevino (2005), Neumayer and Spess (2005), as well as Dorakh (2020) argue that the FDI received by developing countries is positively related to the signing of BITs by those countries. Furthermore, these studies suggest that BITs have a positive impact on FDI flows to developing countries because of the investment protection measures and guarantees that they offer to foreign investors (Franck, 2009). In the words of Hartmann and Spruk (2022: 34), this is because “foreign investors care about investor protection by BITs”. On the other hand, some of the studies reviewed in Section 3.5 found no evidence that BITs improve the receipt of FDI by developing countries (Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2004).

In view of these contrasting findings, the aim of this chapter was to contribute to the empirical debate on the impact of BITs on FDI by investigating econometrically whether BITs signed and/or BITs in force between developing and developed, as well as between developing countries, have a significant effect on inward FDI in developing countries, using a log-linear gravity model specification.

As background to the econometric investigation, Section 5.2 of the chapter examined the trends in the growth and geographical distribution of developing country FDI, while Section 5.3 analysed the growth and distribution of BITs which involve developing countries. The discussion in Section 5.2 revealed that at the beginning of the 1990s, the share of global FDI stock distributed amongst developing countries was approximately 22.93%, with developed economies holding the balance of nearly 80%. Despite the proliferation of BITs during this period, Table 5.1 in Section 5.2 revealed that developing country share of global FDI stock grew modestly, peaking around 1995 at a level of 23.24%. At the beginning of the 21<sup>st</sup> Century only 20.57% of global FDI stock was distributed amongst developing countries.

It is evident from the analysis in Section 5.2 that for almost two decades since the beginning of the 21<sup>st</sup> Century, the level of FDI stock held by developing countries has grown faster than that which is held by developed countries, in average annual growth rate terms. Although this trend continued throughout the 2000s until the advent of COVID-19 in the year 2020, the discussion in Section 5.2 reveals that despite the proliferation of BITs and other prominent IIAs, the global geographic distribution of FDI stock has nonetheless remained significantly skewed in favour of developed countries. Notably, this is in line with the discussion in Section 3.5 which suggests that the increase in the number of BITs signed by developing countries only yielded modest increases in the levels of inward FDI received by signatory countries. As stated above, this accords with the findings in some of the literature reviewed in Section 3.5 of Chapter 3 (Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2004).

UNCTAD (2023b) data analysed in Table 5.2 of Section 5.3 suggests that the total number of BITs concluded between developed and developing countries grew three-fold from just 224 in the 1980s to 663 in the 1990s. This growth continued in the 2000s, though more slowly, then declined markedly in the 2010s. In the period 2020 to 2022, only four BITs were signed between developing and developed countries. Furthermore, the data in Table 5.3 suggests that as the number of BITs signed between countries has continued to decline in recent years, treaties with investment provisions (TIPs) have increased in significance in the IIA landscape. The analysis of Table 5.3 revealed that in the period between 2013-2019 the number of BITs signed in the IIA arena exceeds that of TIPs signed in the same period. However, since 2020, the opposite has occurred. While a total of 26 TIPs were signed in the period between 2020 and 2022, only 15 BITs signed in the same period.

Section 5.4 used a basic gravity model to examine whether BITs do actually have a positive impact on the inward FDI in developing countries. The gravity model examined the determinants of bilateral FDI and involved developing countries who receive inward FDI from both developed and developing countries. Additional control variables, namely the inflation rate, the exchange rate and an index of political stability were added to the traditional gravity model variables (the GDP of both countries, a common official language, common border and the distance between the capital cities of the recipient and investor countries) in different variations of the basic model.

In order to make comparisons between the effects of signing BITs and having BITs in force, separate OLS regression results were estimated separately for each scenario. With each Table containing six models, Table 5.4 presented the results of the former, while Table 5.5 presented the outcomes of the latter. The results in Tables 5.4 and 5.5 suggested that the signing and/or enforcement of BITs increases the inward FDI of the recipient countries from foreign investors, both overall and in the specific case of BITs between developed and developing countries. However, the regression results in both Tables 5.4 and 5.5 suggested that, holding all else constant, BITs between two developing countries fail to foster the inward FDI of recipient developing countries. Furthermore, there minimal differences in net effects of BITs signed compared to BITs in force on developing country inward FDI.

In line with empirical literature, the coefficients of the traditional gravity variables and the additional control variables in all the models in Tables 5.4 and 5.5 have the expected sign and are statistically significant, with the exception of the CONTIG coefficient. A common border has only a weak or negligible impact on bilateral FDI in developing countries in this study. In the case of the additional control variables, the results suggest that a higher rate of inflation does not foster the inward FDI of the recipient country. Furthermore, the positive sign and statistical significance of the exchange rate suggests that an appreciation (depreciation) of the host currency has a positive (negative) impact on recipient developing country FDI, holding all else constant. Lastly, the coefficient of the political stability variable suggests that perceptions about political stability and absence of violence affect the attractiveness of developing countries as FDI destinations.

The empirical analysis in Section 5.4 of Chapter 5 has contributed to the literature on BITs and FDI in two ways. First, by creating dummy variables for BITs signed versus BITs in force it was able to investigate the impact of both on the FDI in recipient developing countries. Secondly, the study disaggregated the overall effect in each case by investigating whether there was a significant difference in the impact of BITs on FDI if the BIT was signed/in force between a developed and a developing country compared to if the BIT was signed/in force between two developing countries.

There are a number of limitations of the type of econometric analysis undertaken in Section 5.4. For example, in addition to the OLS method of estimating the gravity model, more recent studies increasingly recommend the use of the Pseudo-Poisson maximum likelihood (PPML)

estimator as an alternative (Kox and Rojas-Romagosa, 2020). Other studies focus on FDI inflows or FDI as a share of GDP as the dependent variable in the investigation. Furthermore, the cross-sectional regression format has well-known shortcomings, despite its continued widespread use in this context. A number of studies recommend including the time series dimension by employing panel data modelling techniques (Dorakh, 2020; Kox and Rojas-Romagosa, 2020).

As a different type of extension or approach, Hartmann and Spruk (2022) suggest investigating the impact of BITs *terminations* on the inward FDI of developing countries, particularly as there is a growing amount of data available on such terminations. They suggest use of a quasi-experimental design technique such as the difference-in-differences method which compares changes in outcomes over time between the treatment group and a comparison group (Cameron and Trivedi, 2005; Hartmann and Spruk, 2022).

Furthermore, as noted in Section 3.6, in light of the shortcomings of econometric techniques such as those in Section 5.4 in illuminating, on their own, the strategies that developing countries could adopt towards BITs as part of their investment policies, the empirical method now turns, in Chapter 6, towards a case study approach to analysing BITs provisions in an attempt to provide a more nuanced perspective than aggregative econometric approaches can provide.

## Chapter 6

### Political economy, policy space and investment policy issues

#### 6.1 Introduction

As discussed in Chapter 3, the role of BITs in promoting foreign investment is now highly contested (Naidu and Vickers, 2014). While institutional approaches suggest that BITs do have the potential to improve FDI in developing economies, empirical studies of the impact of BITs on FDI have mixed findings. The results of the econometric analysis in Chapter 5 of the present study found that, on average, having a BIT signed or in force does have a significant positive effect on inward FDI in developing countries, holding all else constant. Once this finding was further examined, it was revealed that BITs between a developed and developing economy have a positive impact but those between two developing economies have no significant impact on bilateral FDI. There are, however, numerous shortcomings to such an aggregative approach to the question of the impact of BITs on developing country FDI, noted in Section 5.5 of Chapter 5.

Alongside the question of whether BITs do have a sufficient impact on inward FDI in developing countries, the debate amongst policymakers, NGOs, the private sector, and academics revolves around the extent to which BITs, and broader trade agreements whose investment chapters contain elements like BITs, subject developing countries to obligations that negate their developmental initiatives. At the centre of the criticism against, as well as controversies surrounding BITs, noted in Chapter 3, is the claim that BITs are biased towards the rights of foreign investors which come at the expense of development policies of host governments in developing countries.

Notably, critics of ISDS arbitration, which the classic BITs mandate for the settlement of disputes, argue that by enabling MNEs to litigate directly against host country governments, BITs negatively impact affected host countries' ability to develop appropriate institutional frameworks that improve welfare. As a result of the cumbersome litigation costs and settlements awarded to successful claimants, developing countries will be wary of implementing public policies which, given the broad and vague definitions of investment and expropriation in BITs, may be construed as violating such IIAs (Gallagher and Shrestha, 2011).

A number of developed and developing countries that cancelled or have revised their BITs and/or investment-related provisions in other international treaties have since signed new BITs or developed ‘model BITs’ to address some of the concerns they have about the classic or old-style BITs, discussed in Chapter 3. It is interesting to consider the extent to which the provisions of newer BITs differ from the classic BITs, with reference to case studies of specific bilateral treaties. As background to this analysis, it is useful to revisit the key controversies raised in Chapter 3, with reference to selected experiences of countries such as South Africa and some of its BRICS partners with the old-style BITs.

The aim of this chapter is thus to complement the empirical investigation of the impact of BITs on FDI in developing countries by examining BITs controversies with reference to some of the experiences of developing countries like South Africa in the BITs landscape and by investigating the extent to which some more recent BITs have addressed these controversies, using a case study approach.

The rest of this chapter is organised as follows. Section 6.2 discusses some of the current controversies surrounding the provisions of BITs that were raised in Chapter 3 in more detail, with particular reference to the definitions of investment and expropriation, the extent to which countries are hindered from using capital controls in times of crisis, and the ISDS mechanism used in BITs. In Section 6.3, the chapter examines BITs provisions in old-style BITs and compares these with their new-generation counterparts. Section 6.4 analyses lessons from recent approaches to BITs by some of the BRICS countries which may be relevant for other developing countries seeking to revise their BITs. Section 6.5 concludes the chapter.

## **6.2 Debates and controversies surrounding the provisions of BITs**

Despite the shifting IIA landscape, research suggests that since the advent of the classic BIT model in the 1950s, many developed countries have persisted in replicating the same old-generation model in their treaties with the developing world for decades (Bilder, 2004; Gallagher, 2011). This is in spite of rising discontent with the staunchly pro-investor approach and contentious investor-state arbitration mechanism the early BITs embody. As noted in Chapter 3, the controversies surrounding the classic BIT model have triggered a concerted push for reform of the IIA system by developing countries and also some developed countries, with UNCTAD leading the way. Developing countries including Indonesia and South Africa

initiated sovereign processes in order to review and/or cancel their BITs in the 2000s. Notably, a number of developed countries (for instance, Germany and Australia) and emerging markets like India have also made pronouncements calling for reform. Notably, India has furthermore initiated measures to withdraw from a number of previous BITs (Gallagher, 2011; Chen, 2017).

From the literature review in Chapter 3, it appears that some of the most controversial elements of BITs can be summarised under four categories. First, there is lack of clarity with respect to the definition of ‘investment’ in old-generation BITs. Secondly, the definition of ‘expropriation’ and/or the way it has been invoked in old-generation BITs is too broad. Thirdly, the impact on the use of capital controls in old-generation BITs is controversial. For instance, the ability of host countries to use capital controls in times of crises is highly restricted in terms of the provisions contained in certain old-generation BITs. Lastly, the discussions in Chapter 3 around dispute settlement mechanisms in old-generation BITs point to many controversies around the ISDS arbitration process.

### ***6.2.1 The definition of investment in BITs***

Critics of BITs provisions point to the challenges posed by the inclusion of broad definitions of investment (IDEAS, 2011; Carim, 2015: 2). A broad definition of investment typically includes both FDI and FPI in that it covers every type of foreign investment. Such broad definitions are problematic due to the wide range of tangible and intangible assets they cover. Broad definitions of investment problematically allocate the same status to Greenfield and Brownfield investments (i.e. tangible assets under FDI) and portfolio investments, private equity and hedge funds. Furthermore, intangible assets such as intellectual property rights, as well as management and consultancy rights and business concessions are defined as investment under BITs (IDEAS, 2011: 2).

There are several reasons why including FPI in a broad definition contained in BITs provisions is problematic. First, equating FPI and FDI in a broad definition of investment undermines the original purpose for which investment agreements were brought into existence. Secondly, FPI is often described in literature as ‘helicopter’ investment because of the relative ease with which it can be disinvested from a host country. By definition, FPI – unlike FDI - is therefore not expected to enable recipient host countries “to achieve faster industrial catching-up through technology transfer and increased export market access” (IDEAS, 2011: 1). Furthermore,

including intangible assets such as intellectual property rights in the investment definition erodes the flexibilities that developing countries worked hard to obtain under the WTO Agreement on Trade Related Intellectual Property Rights (TRIPS) (IDEAS, 2011: 2).

It is evident in literature that the inclusion of FPI assets in the definition of ‘investment’ has numerous other adverse implications (IDEAS, 2011: 2). For instance, recipient developing countries are obliged to extend exclusive operational advantages to different categories of investors which may include private equity entities that are involved in speculative investments. By definition, this class of investors does not bring in FDI-type advantages to the host economy. Furthermore, FPI does not contribute to national investments beyond the short term. This is because - by design - FPI is deployed in the short-term procurement and/or acquisition of intangible assets in foreign markets, with the goal of selling such assets at a profit, which the foreign investor may then move out of the recipient country, thereby disinvesting from the host economy.

The inclusion of sovereign debt in the definition of investment is another controversial element of BITs which can serve to undermine the efforts of governments in developing countries to restructure sovereign debt, even during times of economic crises when such action is arguably required. Due to the prohibition of any form of restriction(s) on the free movement of capital related to investments, including a broad definition of investment in BITs ultimately removes the power of host countries to control investment flows, (IDEAS, 2011: 2), as discussed in Chapter 3 and in Section 6.2.3 below. It may be argued that the broad definition of investment in BITs provisions not only results in a significant reduction of policy flexibility in host economies, but ultimately undermines the capacity of developing countries to maximise the advantages of FDI (IDEAS, 2011: 2; Carim, 2015).

### ***6.2.2 The definition of expropriation in BITs***

The protection provisions extended to foreign investors mean that not only direct investors, but also sovereign bondholders and investors in any of the categories of financial assets which fall under FPI, can sue host country governments, by interpreting valid domestic policies as expropriation (IDEAS, 2011: 2). Consequently, this can result in periods of macroeconomic distress which may lead to phases of economic crises at local and international level.

The definition of expropriation in traditional BITs has been said to be too broad, including both ‘direct’ and so-called ‘indirect’ expropriation. According to IDEAS (2011: 4), direct expropriation refers to “nationalisation, transfer of title, or seizure of private property by the host government”. In addition to direct expropriation so defined, several investment agreements define ‘indirect’ expropriation as “expropriation by measures equivalent (or tantamount) to expropriation or nationalisation” (IDEAS, 2011: 4). This has evidently been interpreted to mean a “change in foreign investors’ business profitability or prospects resulting from any policies or regulations imposed by the host Party” (IDEAS, 2011: 4). It is therefore implied that legitimate regulations in host countries can be litigated against on the grounds of impacting the profits of foreign investors.

The expropriation provision in BITs has indeed been invoked to challenge public policy goals and other legitimate regulatory practices in developing countries. For example, in South Africa, regulations designed as part of redress against past apartheid policies could be (and have been) challenged by foreign firms in this way (Stiglitz, 2013: 2). In the case of *Foresti (Italy, Luxembourg) v. South Africa* (2007), Foresti alleged that the Black Economic Empowerment (BEE) equity requirements of the Mineral and Petroleum Resources Development Act (MPRDA) amounted to “direct”, or failing that, “indirect” expropriation, and instituted a \$375million claim against South Africa. In this instance, the claim was dismissed, and claimants had to pay costs.<sup>20</sup> The case was brought under the BLEU (Belgium-Luxembourg Economic Union) - South Africa (1998) and Italy - South Africa (1997) BITs, both of which have since been terminated by South Africa.

The constraints on host country development policy space resulting from the broad definition of expropriation have led to the argument that ‘indirect’ expropriation should be excluded from the definition of expropriation contained in BITs and the investment chapters of broader trade agreements.

### ***6.2.3 Provisions regarding the use of capital controls***

In terms of the provisions contained in many BITs, host countries are prohibited from implementing capital controls which may constrain the free movement of funds related to

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<sup>20</sup> See <https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/262/foresti-v-south-africa>.

investments (IDEAS, 2011: 4). As noted in Chapter 3, provisions governing the use of capital controls are stricter in most BITs and IIAs than under WTO or IMF rules (Gallagher, 2011: 387). BITs and IIAs involving the US do not permit capital controls on inflows or outflows, nor do they allow safeguards (Gallagher, 2011: 388).

It was noted, however, that some developed countries such as those in the EU bloc, Japan and Canada permit the use of safeguards and/or the use of relevant host country legislation in crisis conditions. The same generally applies with BITs involving emerging economies such as China and India (Gallagher, 2011). Such interventions are, however, permitted only on a strictly temporary basis (IDEAS, 2011: 4).

Since there is significant evidence in the economic literature to support the use of capital controls in times of economic crisis, sufficient policy flexibility should be allowed in BITs and IIAs to give discretionary powers to governments in crises on the use of capital control to manage macroeconomic instability (IDEAS, 2011: 4; Gallagher, 2011: 387).

#### ***6.2.4 Investor-state dispute settlement system***

Investment provisions contained in BITs and many other IIAs state that the host country can be sued at international arbitral forums. This applies in cases where a host country is accused by a foreign investor of violating its obligations under the investment agreement. Furthermore, foreign investors are permitted by BITs investment provisions to claim compensation from the government of the host country, with arbitration generally escalated to ISDS arbitration systems for resolution (IDEAS, 2011: 4). At the time, literature suggests that with a cumulative number of 46 ISDS cases filed under IIAs in that year alone, 2011 was the year in which the highest number of investment treaty-based disputes were filed in a single year (UNCTAD, 2012: 86).

However, by the end of 2021, the total number of filed ISDS cases had reached 1190 with at least 68 cases filed for arbitration in that year alone (UNCTAD, 2022a: 73). Researchers caution that given that some arbitration cases can be kept confidential, it is therefore likely that the actual number of total cases filed in 2021 and previous years is much higher than those officially cited (UNCTAD, 2022a: 73). It is claimed that by 01 January 2022, a total of 130

countries and one economic bloc are known to have been involved in ISDS claims as respondents (UNCTAD, 2022a: 73).

The war in Ukraine has added another dynamic to the IIA landscape by bringing onto the platform of ISDS arbitration the role that armed conflict plays in past and potential future ISDS claims (UNCTAD, 2022a: 73). However, even before the war in Ukraine started, there were cases to suggest that indeed ISDS cases can be linked to events that relate to war and/or armed conflict (UNCTAD, 2022a: 74). For instance, in the past, it is noted that at least 30 known ISDS claims filed against states were directly related to “destruction or harm caused to investments in the context of war, armed conflict, military operations and civil unrest” (UNCTAD, 2022a: 74). The very first known ISDS case on an IIA that is related to armed conflict was filed by a claimant in 1987 (*AAPL v. Sri Lanka*) seeking recourse for alleged destruction of their investment as a result of a military operation that was conducted by the Sri Lankan security forces (UNCTAD, 2022a: 74).

Out of the 30 known ISDS cases that relate to armed conflict, the Russian Federation and Libya accounted for the most cases as respondents with 10 cases brought against each country (UNCTAD, 2022a). The cases against Russia relate to the 2014 invasion of Crimea, with Ukrainian companies accusing Russia of expropriation in violation of the provisions of a BIT signed between the two countries (UNCTAD, 2022a: 74). The ISDS cases against Libya mainly arose due to the State’s alleged failure to protect foreign investments during that country’s period of war and civil unrest (UNCTAD, 2022a: 74). Notable ISDS cases related to Libya include *Trasta v. Libya*; and *Cengiz v. Libya* (UNCTAD, 2022a: 74).

Literature suggests that from the perspective of MNEs, the advantage of using ISDS tribunals for adjudication of conflicts is that this process eliminates the potential for domestic biases of courts in host countries (Bilder, 2004; Peng and Meyer, 2020). However, some political analysts and NGOs in host countries argue that certain rules and procedures within the ISDS tribunals favour foreign direct investors at the expense of host countries (Spears, 2010; Muhandiram, 2020; Peng and Meyer, 2020). Such critics argue that the fact that ISDS tribunals consist of corporate lawyers instead of judges appointed through democratically appointed structures as their legitimate authority, validates their concerns over the impartiality and legitimacy of such tribunals (Muhandiram, 2020; Peng and Meyer, 2020).

Fundamentally, critics question whether private tribunals serve to undermine the national sovereignty of host countries and delegitimise domestic courts (Peng and Meyer, 2020). Literature cites the case of a former judge of the German constitutional court who argues that the special rights accorded to foreign direct investors not only undermine the very principles of the German constitution, but that they also pose a systemic breach of international law (Peng and Meyer, 2020). Specifically, it is claimed that the principle of equality before the law would be jeopardised if MNEs with vast financial resources were allowed to use private tribunals which are not accessible by private citizens, interest groups, small businesses, as well as poor developing countries with limited resources (Spears, 2010; Muhandiram, 2020; Peng and Meyer, 2020).

With respect to the shortfalls of the ISDS tribunals, the shortcomings of the ISDS system are well documented with the following eight issues standing out as main concerns. Critics argue that the jurisdiction of investment agreements such as BITs has widened beyond its original mandate. The lack of unanimity in the interpretation of key IIA provisions by ad hoc tribunals creates confusion around their intended meaning. ISDS annulment or national judicial review systems fail to adequately address errors that are made by tribunals at the first level of arbitration. The serial appointment of the same individuals to serve as counsel in certain instances, and arbitrators in others, creates the potential for conflict of interest. The nomination of arbitrators who are likely to represent the interest(s) of those who appoint them is problematic. The lack of transparency in many of the proceedings is problematic. The high costs of litigation and lengthy arbitration proceedings is highlighted as a major concern. Lastly, there are major concerns around the overall fairness and legitimacy of the system (Muhandiram, 2020; UNCTAD, 2012; UNCTAD 2023c).

Public debates on ISDS tribunals are informed by many recent high-profile cases. These involve foreign investors who object to changes in national laws (Muhandiram, 2020). Research findings suggest that the rapid increase in the number of IIAs signed as well ISDS arbitration cases in recent decades has drawn attention to the conflict that can result between the commitments made by host countries to foreign firms and the obligations they have to their own citizens (Spears, 2010; Shima, 2015). The biggest challenge facing the IIA arena is arguably how to balance the need to have policies that safeguard the interests of foreign investors on the one hand, and how to deliver on the expectations encapsulated in the social contract states have with their citizens on the other (Spears, 2010; Muhandiram, 2020).

With many countries increasingly expressing their concerns with the current ISDS system, several states have made significant strides towards addressing this challenge by “adding interpretive provisions, general exceptions clauses and new preambular language to a new generation of international investment agreements” (Spears, 2010: 1037). For instance, in 2011, the Australian Government announced through a trade policy statement that it would no longer include ISDS clauses in its future IIAs (UNCTAD, 2012). As a basis for this decision, the Australian Government stated that ISDS effectively accords greater legal rights to foreign MNEs relative to domestic firms, thereby limiting the sovereign government’s public policymaking ability (UNCTAD, 2012). In 2012, Venezuela, Bolivia, as well as Ecuador followed suit by announcing their intentions to withdraw from the ICSID Convention (UNCTAD, 2012).

Approximately 75% of IIA arbitrations in 2021 concerned BITs and TIPs that were concluded in the 1990s or earlier (UNCTAD, 2022a: 74). In line with trends in previous years, the majority (approximately 65%) of the 68 known ISDS cases initiated against 42 countries in 2021 were brought against developing countries (UNCTAD, 2022a: 74). With 6 known cases, Peru was the most frequent respondent, followed by Egypt and Ukraine with four known cases each (UNCTAD, 2022a: 74). UNCTAD (2022a: 74) notes that in 2021, five new cases were brought for the first time against Cambodia, the Republic of Congo, Finland, Malta, and the Netherlands (UNCTAD, 2022a: 74). According to UNCTAD (2022a: 74), By the end of 2021, approximately 807 ISDS proceedings had been concluded by the end of 2021 with “the relative share of case outcomes changed only slightly from previous years”. This indicates that within the IIA landscape, there is minimal reform.

Consequently, discontent with dispute settlement mechanisms has increased over the years with many ideas for reforming ISDS tabled at national level as well as multilateral platforms (UNCTAD, 2012). Despite this momentum, the lack of change in the ISDS system and the pattern of its arbitration outcomes imply that few, if any, of the reform ideas have actually translated into actions (UNCTAD, 2012; UNCTAD, 2022a).

Notably, the few areas where changes have made their way into recently concluded BITs include those which deal with time limits for initiating charges, the increased powers of countries in arbitration forums, the instant dismissal of ‘frivolous’ litigation, as well as the consolidation of proceedings that are related (UNCTAD, 2012: 88). However, although some

states have preferred a more radical approach to exiting the ISDS system such as “denouncing the ICSID Convention, terminating BITs or avoiding ISDS in future IIAs... others have not changed anything in their IIA practice” (UNCTAD, 2012: 88).

Scholars and policy makers claim that real change and sustainable reform requires a systemic review of the reform options available to signatory states (UNCTAD, 2012). It is recommended that an assessment should also be done on any steps made thus far towards reforming IIAs (UNCTAD, 2012). Furthermore, it is suggested that signatory states ought to engage in multilateral policy dialogue on ISDS arbitration as this may facilitate agreement on preferred outcomes for the reform and ways to implement it (UNCTAD, 2012).

A study by Chen (2017) calls for a fundamental revision of BITs that is based on empirical evidence on the ways in which countries attract FDI. Chen (2017) points out that the state of imbalance that is a product of investor-biased BITs necessitates not only a new approach to BITs, but also makes it clear that current proposals for reforming BITs are inadequate, or in some cases even counterproductive.. Furthermore, empirical evidence in political science and economic literature reveals that foreign investors place more weight on the quality of domestic institutions than they do on the rights afforded by BITs (Carim, 2015; Chen, 2017).

Therefore, Chen (2017: 548) concludes that BITs in their current format, fail to attract FDI because they are inadequate substitutes for domestic institutions, and fail to generate reform. Persuaded by the NIE approach, Chen (2017: 548) proposes a model that would “make domestic institutional reform the organizing principle of BIT design”. Chen (2017) the proposed approach would not only produce immediate benefits for host States, but it would also attract the buy-in of developing countries. Furthermore, the institutional reform model that Chen (2017: 548) proposes preserves the primary goal of all states which is to increase FDI. Therefore, this approach is more feasible than current proposals which seek to only benefit developing states (Chen, 2017).

Critics argue that there are serious problems with investor-to-state dispute settlement channels, such as those in USMCA and BITs, given their bias towards foreign investors as evidenced by repeated adjudication in favour of foreign investors and developed countries. As a result, policy makers caution developing country trade negotiators against entering into investment treaties that carry provisions which can adversely affect their respective economies (IDEAS, 2011).

### 6.3 BITs provisions in old vs new-style BITs

The recent approaches to BITs adopted by some of the BRICS countries have also made a valuable contribution to the discourse about the reforms that are needed in the IIA landscape. Some of the member states of the bloc have recently taken steps to withdraw from previously concluded BITs and/or re-negotiate the terms of these BITs. For instance, South Africa announced in 2009 that the country's Department of Trade and Industry (DTI) had initiated a review of BITs entered into by South African government since the advent of democracy in 1994 (DTI, 2010). The stated objective of the review was to enable DTI to make recommendations to the government "in respect of the policy and legal considerations which will impact on any future decisions taken by the executive in respect of the protection and promotion of investments, both from an inward and outward foreign direct investment perspective" (DTI, 2010: 3).

As stated in Section 6.1, the purpose of this section is to compare the provisions of old and new-style BITs using case studies of agreements downloaded from the UNCTAD Investment Policy Hub database (2023b). Table 6.1 below depicts the provisions of two old-style BITs between developed and developing countries, with South Africa as the developing country partner. These North-South (NS) BITs are between South Africa and the United Kingdom, and South Africa and the Belgium-Luxembourg Economic Union (BLEU). While both were signed in 1994, the former was terminated in 1998, and the latter was terminated in 2003.

Table 6.1 also contains two South-South (SS) BITs involving South Africa for comparative purposes. The first of these is between South Africa and China, signed in 1997, also in the post-apartheid period like the old-style NS BITs in the table. The second SS BIT in Table 6.1, by contrast, is from the late 2000s, signed between South Africa and Zimbabwe in 2009, the same year that South Africa announced its intention of reviewing and terminating some of its traditional BITs. Unlike the two NS BITs featured in the table, the two SS BITs are still in force.

In Table 6.1, the signatory countries are listed in Column 1, with the status of the BIT (signed, signed and in force, signed and not in force, or, signed and terminated) identified in Column 2. The core provisions of the BITs are contained in Column 3. The purpose of comparing old-style NS BITs is so that the study can identify similarities (if any) between these BITs.

Furthermore, the author attempts to compare old-style NS BITs with their SS counterparts. This also helps to assess norms and trends in provisions affecting development policy.

Table 6.1: Old-style North-South BITs and South-South BITs

Signatory countries	Status	Provisions
South Africa - United Kingdom	Signed (1994) and terminated (1998)	<p>1. Broad definition of 'Investment' includes FPI and FDI</p> <p>2. Prohibits all forms of "nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. Either Party to the dispute may refer arbitration to the <u>Convention on the Settlement of Investment Disputes</u>.</p>
South Africa - BLEU (Belgium-Luxembourg Economic Union)	Signed (1994) and terminated (2003)	<p>1. Broad definition of 'Investment' includes FPI and FDI</p> <p>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. In case of international arbitration, the investor may submit the dispute for settlement by arbitration to one of the following organizations:</p> <ul style="list-style-type: none"> <li>- "an ad hoc arbitral tribunal set up in terms of the arbitration rules laid down by the United Nations Commission on International Trade Law (UNCITRAL);</li> <li>- the International Centre for the Settlement of Investment Disputes (ICSID)"</li> </ul>
South Africa - Zimbabwe	Signed (2009) and in force (since 2010)	<p>1. Broad definition of 'Investment' includes FPI and FDI</p> <p>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. In case of international arbitration, the investor may submit the dispute for settlement by arbitration to one of the following organizations:</p> <ul style="list-style-type: none"> <li>“(a) the competent courts of the Party in whose territory the investment is made;</li> <li>(b) to arbitration by the International Centre for the Settlement of Investment Disputes (ICSID); or</li> <li>(c) an ad hoc arbitration tribunal, which unless otherwise agreed upon by the parties to the dispute, is to be established under the Arbitration Rules of the United</li> </ul>

		Nations Commission on International Trade Law (UNCITRAL).”
South Africa - China	Signed (1997) and in force (since 1998)	<ol style="list-style-type: none"> <li>1. Broad definition of ‘Investment’ includes FPI and FDI</li> <li>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except: <ol style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ol> </li> <li>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</li> <li>4. Either Party to the dispute may refer arbitration to the Convention on the Settlement of Investment Disputes.</li> </ol>

Source: UNCTAD (2023b)

In terms of the provisions of the two NS BITs, it is evident from the text in Table 6.1 that the provisions are identical with one noticeable variation in the template used for both of these BITs. In addition to the provision that the Convention on the Settlement of Investment Disputes shall be referred to for arbitration for purposes of dispute resolution, the BLEU BIT also offers the alternative option of referring settlement dispute matters to ad hoc arbitral tribunal set up according to the arbitration rules laid down by the United Nations Commission on International Trade Law (UNCITRAL). In line with the other provisions which are biased towards the protection of the interests of foreign investors as well as safeguarding their investments in host countries, the fourth provision of the BIT with BLEU also stipulates that *only* the foreign investor can refer a settlement dispute matter to the ICSID or UNCITRAL for arbitration. However, in the South Africa-UK BIT, either party may do so.

An interesting observation in Table 6.1 is that the two SS BITs closely resemble the template of the NS BITs. Furthermore, it can be seen that the SS BIT signed with China, which is much older than the BIT signed with Zimbabwe, appears to be identical to the NS BIT between South Africa and the UK (United Kingdom), including in its reference to the ICSID as the arbitration tribunal of choice for the resolution of disputes. Like the South Africa-UK BIT, the South Africa-China BIT states that “either party may refer arbitration” to the ICSID.

The main difference between the other BITs and the BIT signed in 2009 with Zimbabwe is that the latter allows for disputes to be referred ‘at the option of the investor’ to one of three places. In addition to allowing for foreign investors to refer matters arising from disputes to both the

ICSID and the UNCITRAL, the BIT between South Africa and Zimbabwe also permits the referral of such matters to the ‘competent’ courts of the host country in which the investment is located. Although this is arguably a step in the right direction in terms of arbitration, the broad definition of ‘competent’ is nonetheless vague and open to interpretation.

Table 6.1 reveals significant similarities between the old-style NS BITs which are pro-investor. Furthermore, Table 6.1 shows that the SS BITs under discussion largely replicate the classic NS BITs model, except for the dispute settlement provision of the later South Africa-Zimbabwe BIT, signed in 2009, during the period when developing countries were viewing classic BITs provisions with increasing concern. Nevertheless, both NS and SS BITs in Table 6.1 evidently carry a broad definition of ‘investment’ which problematically extends the same levels of protection and guarantees to foreign investors undertaking both FDI *and* FPI. Furthermore, both NS and SS BITs lack clarity in the definition given for ‘expropriation’, other than to state that nationalisation and expropriation are prohibited, except under very strict conditions. Table 6.1 also confirms that both categories of BITs prohibit the use of capital controls by governments in host countries. As discussed in the preceding section, the inability to use capital controls in times of crisis poses significant risks to developing countries.

Table 6.2 below depicts the provisions of a number of new-style BITs. The table also contains three columns indicating the signatory countries, status of the BIT and the provisions under discussion. Two of the BITs featured in Table 6.2 involve only developing countries. Signed in 2015 and enforced in 2017, the first SS BIT is one between Brazil and Angola. The second SS BIT is between Brazil and Mozambique, also signed in 2015, but not yet in force. The other two BITs contained in Table 6.2 are the South Africa Model BIT (gazetted in 2015) and the Southern African Development Community (SADC) Model BIT (released in 2012).

As seen in Table 6.2, the first three provisions of the new-style SS BITs signed by Brazil with replicate the old-style NS BITs featured in Table 6.1 above. These SS BITs also carry broad definitions of ‘investment’ and ‘expropriation’. The definition of ‘investment’ includes FDI and FPI, thereby protecting the assets of both types of foreign investment. As discussed earlier, including FPI in the definition undermines not only the objective of using investment agreements to attract FDI, but it also extends guarantees and protection to a category of investors who do not foster long-term development in recipient developing countries.

Table 6.2: New-style South-South BITs

Signatory countries	Status	Provisions
Brazil - Angola	Signed (2015) and in force (since 2017)	<p>1. Broad definition of ‘Investment’ includes FPI and FDI</p> <p>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. Mandates “the Focal Points and the Joint Committee to prevent, manage and resolve disputes between the states. The Joint Committee holds extraordinary meetings to consider the issues before it and may issue a recommendation. Only if the dispute is not resolved by the recommendation, the two parties may resort to state–state arbitration”.<sup>21</sup></p>
Brazil - Mozambique	Signed (2015) and not in force	<p>1. Broad definition of ‘Investment’ includes FPI and FDI</p> <p>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. Mandates “the Focal Points and the Joint Committee to prevent, manage and resolve disputes between the states. The Joint Committee holds extraordinary meetings to consider the issues before it and may issue a recommendation. Only if the dispute is not resolved by the recommendation, the two parties may resort to state–state arbitration”.<sup>22</sup></p>
South Africa Model BIT <sup>23</sup>	Model BIT	<p>1. Broad definition of ‘Investment’ includes FPI and FDI</p> <p>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except:</p> <ul style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ul> <p>3. Prohibits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress.</p> <p>4. “Any dispute between the Parties concerning the interpretation or application of this Agreement should, if possible, be settled through negotiations between the Governments of the two Parties. If the dispute cannot thus be settled within a period of six months, following the date on which such negotiations were requested by either Party, it shall upon the request of either Party be submitted to an arbitral tribunal. The arbitral tribunal shall decide the dispute according to this BIT Agreement and the principles of international law. The arbitral tribunal shall reach its decision by a majority of votes. Such decision shall be binding on both Parties”.</p>

<sup>21</sup> See Brauch (2015: 1-5).

<sup>22</sup> See Brauch (2015: 1-5).

<sup>23</sup> See RSA (2015).

SADC Model BIT <sup>24</sup>	Model BIT	<ol style="list-style-type: none"> <li>1. Broad definition of ‘Investment’ includes FPI and FDI</li> <li>2. Prohibits all forms of nationalization or expropriation in the territory of the other Contracting Party, except: <ol style="list-style-type: none"> <li>(a) if it serves the public interest;</li> <li>(b) is not in contravention of due processes of law; and</li> <li>(c) affected investors are compensated fairly, adequately, and timeously.</li> </ol> </li> <li>3. Permits the use of different capital control measures, which may be necessary to prevent serious difficulties during times of economic distress</li> <li>4. “A host state may initiate a counterclaim against the Investor before any tribunal established pursuant to this Agreement for damages or other relief resulting from an alleged breach of this Agreement. In accordance with its applicable domestic law, the host state, including political subdivisions and officials thereof, private persons, or private organizations, may initiate a civil action in domestic courts against the Investor or Investment for damages arising from an alleged breach of the obligations set out in this Agreement. In accordance with the domestic law of the Home State, the Host State, including political subdivisions and officials thereof, private persons, or private organizations, may initiate a civil action in domestic courts of the Home State against the Investor, where such an action relates to the specific conduct of the Investor, and claims damages arising from an alleged breach of the obligations set out in this Agreement”.<sup>25</sup></li> </ol>
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Source: SADC (2012); RSA (2015); UNCTAD (2023b)

Replicating the old-style NS BITs model, the new-style BITs depicted in Table 6.2 also prohibit all forms of nationalisation and expropriation, except under strictly defined conditions. However, in a notable deviation from the old-style NS and SS BITs, the new-style BITs featured in Table 6.2 do not include the requirement to refer disputes to the ICSID and/or the UNCITRAL for arbitration. On the contrary, the two new-style SS BITs place the responsibility of arbitration on the respective Focal Points and Joint Committees of the signatory states. Furthermore, it is only when the dispute is not resolved by the recommendations of the relevant Joint Committee that the parties can refer the matter for *state-to-state* arbitration. This eases the pressure and/or policy burden that traditional BITs dispute settlement provisions placed on governments of host countries.

As stated above, the two model BITs featured in Table 6.2 are the South Africa Model BIT, and the SADC Model BIT. Although not legally binding, both Model BITs nonetheless offer a bilateral treaty policy framework which could be emulated in future new-style BITs concluded by developing countries. A concerning implication for development policy space, however, is

<sup>24</sup> See SADC (2012).

<sup>25</sup> See Woolfrey (2014).

that both model BITs carry the same broad definitions and conditions of ‘investment’ and ‘expropriation’ seen in old-style NS BITs and their old-style and new-style SS counterparts. For instance, both allow the inclusion of FPI in the broad definition of investment, and both include indirect expropriation in the broad definition of expropriation. This hinders the policy agenda which calls for reform in BITs.

A notable controversy in the South Africa Model BIT is that, similar to old-style NS BITs, as well as both generations of SS BITs, the South Africa Model BIT prohibits the use of capital controls, even under conditions of economic distress. As seen in Table 6.2 however, an encouraging development is that the SADC Model BIT permits the use of capital controls which may be deemed necessary to reduce the impact of economic distress resulting from periods of economic crisis. However, it is important to note that the SADC Model BIT is merely a guideline for member countries when negotiating their BITs and carries no legal obligations. Similar to new-style BITs both Model BITs provide alternative dispute settlement provisions to the ICSID and/or UNCITRAL arbitration.

#### **6.4 Lessons from BRICS countries’ recent approaches to BITs**

A significant challenge currently facing the IIA landscape is how states can create a balance between institutions (i.e., ‘rules of the game’) which regulate the ways in which countries attract and retain FDI on the one hand, and those which safeguard the interests of their citizens and the environment on the other (Spears, 2010). Similar to developed countries such as Australia, Canada, Germany, Norway, the USA (United States of America) and the EU bloc, BRICS countries have for over a decade - since the early 2010s - made some strides towards addressing this particular challenge by adding interpretive chapters, general exceptions clauses, and revised terminology to a host of existing BITs, as well as future IIAs (Naidu and Vickers, 2014).

Literature suggests that by the end of 2013, over 1300 BITs had either been terminated or renegotiated, with developing countries accounting for nearly a third of these (Naidu and Vickers, 2014: 1). Furthermore, approximately 350 more BITs expired between 2014 and 2018, thereby creating “an opportunity to address inconsistencies and overlaps in the multi-faceted and multi-layered regime of international investment treaties, and to update the investment regime in light of development paradigm shifts” (Carim, 2015: 3-4). By the end of 2019, it is

estimated that more than 10% of all ratified BITs globally had been cancelled (Hartmann and Spruk, 2022: 2). According to Hartmann and Spruk (2022: 2), the trend in BIT terminations started slowly at the beginning of the 21<sup>st</sup> Century and reached a peak in 2017. For instance, within the BRICS bloc, India alone has terminated a total of 44 BITs since announcing its decision to unilaterally cancel its BITs in the early 2010s (Hartmann and Spruk, 2022: 2).

Whilst it is claimed that the reason behind the proliferation in BITs terminations by the BRICS countries is mainly due to the rise in ISDS claims aimed at host states located in developing countries, research findings suggest that the BITs that, for instance India, has terminated have not directly targeted the home countries of disputing foreign investors (Hartmann and Spruk, 2022). Instead, India chose to terminate *all* BITs, starting with Argentina in 2013 (Hartmann and Spruk, 2022: 2). Although India announced its intention to terminate its BITs in the early 2010s, it was however, as is generally the case, not practically possible to immediately invoke the termination (Hartmann and Spruk, 2022).

From 1994 until 1998, South Africa concluded approximately 15 BITs with mainly European countries in an attempt to reassure foreign investors that their investments would be protected under the administration of the new democratically elected African National Congress (ANC) government (Carim, 2015: 4). Signing these BITs was also seen as a diplomatic signal to the international community of South Africa's re-entry in the international trade and investment space following years of isolation under the Apartheid regime (Carim, 2015: 4).

However, research findings reveal that over the last decade, South Africa has been subjected to numerous actual and potential challenges related to several of its BITs (Carim, 2015: 4). In the case of South Africa, the threats posed by BITs challenges emphasise the fact that BITs fail to adequately address the "conditions found in South Africa, the complexities of socio-economic challenges and the broad objectives of government policy" (Carim, 2015: 4).

Contrary to the principal objective for signing BITs in the 1990s, South Africa's own investigations suggested that there is not positive relationship between signing BITs and inflows of FDI (Carim, 2015). Furthermore, research findings suggest that South Africa does not receive significant investments from many of the foreign countries with which it had signed BITs (Carim, 2015). Conversely, South Africa continues to receive significant investments

from countries with which it has not signed investment agreements (Carim, 2015). Therefore, BITs have not played a key role in attracting FDI to South Africa (Carim, 2015).

Furthermore, a series of global events in the IIA landscape - and in particular - the proliferation in ISDS arbitrations since the early 2000s, taught South Africa many important lessons on the threats that BITs pose to government policy (Carim, 2015). Another reason for discontent was that despite having a world-renowned constitution which prohibits discrimination between domestic and foreign investors, a 2008 assessment of the country's BITs revealed a series of inconsistencies with the country's constitution, prompting the government to review its BITs (Carim, 2015).

Subsequent to announcing the country's 2009 policy decision to review and terminate its BITs (DTI, 2010), in 2012, South Africa began to terminate its BITs and also enacted new domestic legislation as the primary mechanism for dealing with the protection of foreign investors (Mossallam, 2015). The decision to review the country's BITs, as well as change its policies on investment, was based on the government's concern that BITs and the ISDS arbitration system constrain the state's ability of to enact legislation and regulatory institutions aimed at advancing the government's public policy goals (Mossallam, 2015).

Notably, foreign investors have raised major concerns about the effect that South Africa's decisions are likely to have on its ability to attract FDI. Sceptical of South Africa's approach, critics suggest that terminating BITs may be part of a broader policy which enables government interference in FDI activities (Mossallam, 2015: 27). Despite these concerns, South Africa's foreign investment regime is widely regarded for being open by world standards. Furthermore, policy makers view it to be on par with OECD countries that are measured by the OECD FDI Regulatory Restrictiveness Index (Mossallam, 2015).

Although the approach taken by South Africa arguably has limitations - despite the criticism - it has nonetheless "been lauded as a thorough and critical approach through which it has sought to build its internal capacity on the topic of investment" (Mossallam, 2015: 3). However, with respect to the actual process of terminating its BITs, critics claim that the two areas where there is room for improvement concern the South African government's communication of the termination of its BITs, as well as the timing of the related draft bill (Mossallam, 2015). Notably, the termination of the country's BITs did not cause a major overhaul to the level of

protections and guarantees offered to current investors (Mossallam, 2015). This is because the protection clauses contained in BITs chapters effectively mean that the same terms of the investment treaty will be applied for up to two decades post-termination (Mossallam, 2015).

Key to South Africa's recent approaches to its BITs are the following strategic steps. The South African government has decided to not enter into any BITs in future, unless compelled to do so for socio-economic reasons. The government has committed to reviewing all old BITs that were signed after 1994 with a view to terminating them or renegotiating the terms in line with a new Model BIT being developed. The government also took a decision to strengthen the country's domestic laws with respect to protections extended to foreign investors. Furthermore, the government tasked an inter-ministerial committee (in charge of investment, foreign diplomacy, as well as developmental issues) with the responsibility of making all decisions related to BITs (Carim, 2015).

Subsequent to taking the above steps at Executive level, the following developments in South Africa's recent approach to its BITs reform strategy were put into operation. The government took steps to terminate the country's BITs and an announcement to this effect was published in the middle of 2010 on numerous multilateral platforms at the OECD and UNCTAD. Following several diplomatic consultations with affected states, from 2012 until 2013, the government formally notified all European countries with whom it had signed BITs that all these investment agreements would be terminated. Similar consultations took place with governments in Latin America where it was agreed that relevant BITs would be terminated.

Within the African continent, South Africa has pursued regional and continental approach with a view that these may replace any BITs the country has signed with other African states. Parallel to the above initiatives, South Africa also participated in the development of the SADC Model BIT released in 2012. At the domestic level, South Africa has promulgated new legislation which aligns the protection measures for investors that feature in BITs with the prescripts of the country's Constitution and existing legislation (Carim, 2015).

Although South Africa's process of revamping its BITs regime still arguably has a long way to go, its recent approaches to BITs nonetheless provide "valuable insights into the drivers of investment policy reform and useful lessons for other developing countries who may wish to embark on a similar exercise" (Mossallam, 2015: 3). It was important, according to Mossallam

(2015: 27), “that South Africa adopted a transparent and interactive strategy throughout the review process engaging the international community and not only the local public”.

Brazil is regarded as a good case study by those who question the effectiveness of BITs in attracting inward FDI to developing countries (Wei, 2012). Such sceptics argue that with Brazil being the world’s ninth largest economy, despite *not* participating in the IIA landscape, there may be lessons for countries who are in the process of reviewing or exiting their BITs (Muniz, Duggal and Peretti, 2017; Moraes and Hees, 2018). However, after nearly two decades of not entering the IIA landscape, Brazil adopted a new approach in 2015 by concluding BITs with other developing countries including Angola, Mozambique, Malawi, Chile, Colombia, and Mexico (Muniz, Duggal and Peretti, 2017: 404). In 2015, the Brazilian government also published the Cooperation and Facilitation Investment Agreement, which provided a template for the country’s model BIT (Muniz, Duggal and Peretti, 2017; Moraes and Hees, 2018).

Brazil’s recent approaches to BITs contrast sharply with the experiences of other countries. This is particularly the case in so far as dispute resolution is concerned (Muniz, Duggal and Peretti, 2017: 405). Notably, “at a time when most countries were promoting investment agreements, Brazil refused to participate in the regime” (Muniz, Duggal and Peretti, 2017: 405). The reasons for Brazil’s hostility in its approach towards BITs before 2015 are varied, ranging from concerns over maintaining its sovereignty to issues concerning appropriate mechanisms for settlement of disputes (Wei, 2012).

Despite its hostile approach towards BITs and its persistent refusal to participate in IIAs for over 16 years, Brazil succeeded in attracting FDI from foreign investors all over the world, becoming one of the three major destinations for FDI among the emerging markets by 2007 (Wei, 2012: 667). However, since 2015, Brazil has taken radical steps with major policy changes in its recent approaches to BITs. In sharp contrast to its previous approaches, research findings suggest that Brazil’s approach and heightened interest in playing an active role in the IIA regime is the polar opposite of the current wave which sees many countries currently taking a critical and/or sceptical stance against investment treaties (Muniz, Duggal and Peretti, 2017). Notably, the two largest economies within BRICS - Brazil and China – have historically adopted opposite approaches to IIAs, with China having a much more favourable approach to BITs (Wei, 2012).

Given that Russia has annexed even more territory from Ukraine since it seized Crimea in 2014 and has been accused of even greater destruction to Ukrainian properties and livelihoods since the war began in early 2022, it is therefore highly likely that even more cases will be brought against Russia before the ISDS in the future. The war between Russia and Ukraine therefore carries major potential impacts on FDI prospects both in and from Russia, but also as well as Ukraine (UNCTAD, 2022a: 2). Furthermore, the potential indirect impacts from sanctions that major economies around the world have imposed against the Russian Federation, coupled with the related shortages in energy and basic commodities, are expected to have a combined cooling effect on FDI prospects for many years to come (UNCTAD, 2022a: 2).

Consequently, it is predicted that a broader macroeconomic impact will arise from the ongoing conflict in Ukraine (UNCTAD, 2022a: 2). How Russia navigates its way through not only the current armed conflict in Ukraine, but also the mounting litigation it faces at ISDS tribunals will carry many lessons to other BRICS countries in terms of its approach to current and future BITs, as well as litigation arising from such BITs. Given that the litigation Russia currently faces in ISDS tribunals arises from its BITs, Russia may well elect to terminate its BITs as a means to release itself from the resultant obligations to partner countries and foreign investors.

## **6.5 Conclusion**

In line with findings in preceding chapters of the thesis, the discussion in Section 6.1 of this chapter revealed that in an effort to attract FDI, developing countries have signed/ratified BITs with foreign investors which carry obligations that offer protections to MNEs at the expense of sovereign interests (Carim, 2015). Some of the literature reviewed in Section 3.5 of Chapter 3 suggests that this has significantly reduced the policy space available for developing countries to attract FDI inflows that are aligned to their long-term development needs (Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2004).

As discussed in the literature review in Section 3.5 (Chapter 3), the lack of consensus amongst researchers and policy makers on the impacts of BITs on FDI in host countries has led many scholars to empirically examine the question of whether BITs do actually serve the best interests of developing countries (Mishra and Jena, 2019; Dorakh, 2020). The discussion in Section 6.1 also highlights recent escalations in the number of cases brought against the

developing countries by foreign investors in ISDS arbitration proceedings. It is suggested that this has caused several countries (developed and developing) to review their BITs.

The aim of this chapter was two-fold. In an effort to contribute to empirical literature that investigates the impacts of BITs on FDI in developing countries, the chapter examined the controversies surrounding BITs with a particular focus on some of the experiences of developing countries in the BITs arena. Furthermore, the chapter sought to investigate whether some recent BITs have actually succeeded to address such controversies. To address this goal, a case study approach was utilised.

The discussion in Section 6.2 suggested that the controversies surrounding provisions of BITs are centred around four main points. First, there is lack of clarity in BITs investment provisions with respect to the definition of ‘investment’. It is recommended for FDI – and not FPI – to feature prominently in the definition of ‘investment’. Secondly, the current definition of expropriation and/or the way it is invoked in current investment provisions is too broad. The recommendation is for expropriation to be confined to ‘direct’ expropriation. The impact on the use of capital controls is also a source of controversy and it is therefore recommended that host countries should be allowed to use capital controls to avert economic crises.

Finally, there is much controversy around the dispute settlement mechanisms provided for in current BITs. As discussed in Section 6.2, the ongoing debate in literature around the mandatory ISDS arbitration found in BITs chapters is framed around two lines of argument. Informed by NIE theory, one side argues in favour of BITs, claiming that they are important tools used by developing countries to attract FDI (Franck, 2009). Furthermore, NIE theorists argue that there is insufficient evidence to suggest that developing countries have been treated unfairly and therefore it is not necessary to reform the current BITs and ISDS format (Franck, 2009).

On the contrary, the discussion in Section 6.2 noted that authors such as Gallagher (2011), Gallagher and Shrestha (2011), and Chen (2017) argue that the modest increases in FDI in the same 1990s period that saw proliferation in the number of BITs concluded between developed and developing countries, serve to throw doubt on the hypothesis that a positive relationship exists between the number of BITs ratified by a country and the level of inward FDI such country attracts.

As discussed in Section 6.2, those who are critical of supposed unfair treatment of developing countries by investor-state ISDS arbitration, argue that several of the claims against developing countries have specifically targeted public welfare policies in host countries (Gallagher and Shrestha, 2011). Research findings suggest that in line with trends from previous years, the majority of cases at the ICSID continue to be brought against developing countries with the majority of outcomes favouring foreign investors (UNCTAD, 2022a), whilst simultaneously, the ‘classic’ 1950s model of BITs continues to be rolled out in many states across the world (Chen, 2017). This suggests that, very few - if any - of the reforms that are called for, have actually translated into actions (UNCTAD, 2012; UNCTAD, 2022a).

The analysis in Section 6.3 revealed strong similarities between old-style NS BITs. Furthermore, it is evident that older SS BITs closely resemble NS BITs. As discussed in Section 6.3, BITs provisions were originally intended to meet the primary objective of protecting the assets, and safeguarding the investment interests, of foreign investors in host countries. A secondary objective of BITs provisions is to attract FDI into developing countries. However, as discussed in the empirical analysis in Section 6.3, the broad definitions contained in BITs provisions only succeed in the primary objective. For instance, the broad definition of ‘investment’ – as seen in Tables 6.2 and 6.3 – include FPI. This is problematic because the provisions are legally binding on host governments and domestic courts, meaning that the rights and protections extended to FDI are, by definition, also accessible to investors in the FPI category.

Furthermore, the broad definition of expropriation, as well as the prohibition on the use of capital controls even in times of economic crises – except under strictly defined conditions – has controversial impacts on the development policy space available to policy makers in developing countries. Similar concerns have been raised with respect to the pro-investor ISDS arbitration processes which are mandatory in old-style BITs provisions. The analysis in Section 6.3 suggests that similar to old-style NS BITs, old- and new-style SS BITs also carry controversial broad definitions and policy-constraining prohibitions. Offering an alternative to the current BITs, the South African and SADC Model BITs offer a viable alternative to current format old-style and new-style BITs. Unfortunately, as discussed in Section 6.3, the two Model BITs are not legally binding on signatory states but merely serve as a guideline in the process of reviewing and/or reforming bilateral treaty policy frameworks in development policy space.

As states sought ways to renegotiate old BITs and/or reform future BITs - amidst widespread BITs terminations - scholars and policy makers observed the recent approaches of BRICS countries to BITs to gain lessons that other countries can emulate. The discussion in Section 6.4 features the recent approach to BITs implemented by India. Steps taken by India are highlighted as important lessons because the measures observed from India's experience can be emulated by other countries in their own future approaches to BITs.

The discussion in Section 6.4 reveals that despite adopting divergent approaches to their respective BITs, the experiences of the two largest economies in the BRICS bloc (India and China) nonetheless offer invaluable lessons for the BITs landscape. With an approach that is very pro-BITs due to the country's desire to achieve international integration, China's approach offers important lessons in the emphasis it places on the importance of ensuring that countries retain their power to use capital controls on capital inflows, as well as outflows. As seen in the analysis in Section 6.3, this is a policy measure prohibited in the classic BIT template. This is despite the capacity these instruments have to be implemented as effective measures in limiting financial instability which could arise from short-term capital inflows and/or outflows (Gallagher, 2011: 387).

The discussion in Section 6.4 reveals that prior to making a major policy shift in its approaches to BITs made in 2015, Brazil was vehemently opposed to any form of participation in the IIA arena. Despite the country's absence from the IIA landscape, Brazil succeeded to become the third largest destination for FDI amongst emerging markets by 2007. Brazil and also went on to become the 9<sup>th</sup> largest economy in the world as it continued to attract investments from foreign investors all over the world, despite its lack of participation in IIA (Muniz, Duggal and Peretti, 2017; Moraes and Hees, 2018). Thus, Brazil is featured in the discussion in Section 6.4 as the country offers vital lessons for those who are sceptical of the impacts of BITs on FDI in developing countries.

Since its return to the IIA arena in 2015, Brazil's recent approach to BITs has culminated in the conclusion of BITs with several other developing countries. As discussed in Section 6.4, developing countries with which Brazil has signed/ratified BITs since 2015 include Angola, Mozambique, Malawi, Chile, Colombia, and Mexico. As a template for the country's model BIT, the Brazilian government published the Cooperation and Facilitation Investment

Agreement in 2015. Lauded by policy makers, Brazil's model BIT offers vital lessons which other countries could emulate in the process of reforming their BITs.

Research findings cited in the discussion in Section 6.4 suggest that Russia's ongoing war against Ukraine could escalate the role played by war and armed conflict play in the IIA landscape. Data from UNCTAD (2022a: 74) suggests that Russia accounts for approximately a third of the 30 known cases related armed conflict that are currently before the ICSID. Brought by Ukrainian firms and businesspeople following the Russian annexation of Crimea in 2014, the current litigation accuses Russia of expropriating foreign assets and seeks recourse in terms of the Russian Federation–Ukraine BIT (1998) (UNCTAD, 2022a: 74).

As discussed in Section 6.4, policy measures taken by Russia in response to the ISDS litigation will carry important lessons for BRICS countries and others across the IIA landscape. Notably, the discussion in Section 6.4 highlights potential indirect impacts related to sanctions imposed on Russia by several of the major Western economies. Furthermore, literature cited in Section 6.4 suggests that the resultant shortages in energy and basic commodities, are likely to have a combined cooling effect on FDI prospects beyond the duration of the armed conflict (UNCTAD, 2022a: 2). It is expected that a broader macroeconomic impact will arise from Russia's ongoing armed conflict in Ukraine (UNCTAD, 2022a: 2).

In 2009, South Africa announced its intention to review all BITs entered into by the democratically elected post-1994 government (DTI, 2010). South Africa ratified numerous BITs with mainly European countries since 1994 as a way of reassuring foreign investors that their investments would be protected under the new ANC government (Carim, 2015). However, it soon became clear that in the case of South Africa, there was no evidence to suggest that there exists a positive relationship between the number of BITs ratified and the levels of inward FDI generated (Carim, 2015: 4).

The analysis of the South Africa case study in Section 6.4 reveals that despite several strides made since announcing its intention to review its BITs, the country's approach remains a work in progress. Nevertheless, the country's approach is considered useful by policymakers for its insights on drivers of investment policy reform, as well as the valuable lessons offered to other developing countries involved in the process of reforming their own BITs (Mossallam, 2015: 3). Measured by international standards, the review undertaken by the South African

government is said to be on par with that of the OECD countries (Carim, 2015; Mossallam, 2015).

## Chapter 7

### Conclusions and policy recommendations

#### 7.1 Summary and conclusions

Studies cited in the preceding chapters of this thesis reveal a lack of consensus in the literature with respect to the impact of BITs on the inward FDI of recipient developing countries. On the one hand, governments and policy makers in capital-importing developing countries in need of FDI as a key instrument to address socio-economic challenges such as poverty, unemployment and inequality initially considered BITs to be an effective potential means to attract outside foreign investment. On the other hand, foreign investors of the capital-exporting country regarded BITs as policy tools which serve the basic purpose of protecting their FDI in host countries from political risks and instability, as well as safeguarding the investments made. These views prompted a proliferation of BITs during the 1980s and 1990s in particular, in an environment of intensifying globalisation and liberalisation.

It is argued that these two perspectives are also the primary reason that BITs were originally concluded mainly between developed and developing countries. This is because the former provided the FDI needed by the latter, while the latter were often considered as high-risk markets. However, since the proliferation of BITs in the 1990s, many developing countries have gone on to sign and/or enforce BITs between themselves as a means of attracting FDI as a key source of foreign investment within the Global South.

Against this background, the main goal of this study was to investigate the impact of international investment agreements on inward FDI in developing countries and the implications of such agreements for development policy. In order to address this main goal, the following four sub-goals of the research were set out: (1) to compute and analyse the growth and share of developing country inward FDI relative to aggregate inward FDI; (2) to measure and analyse the growth and geographical distribution of IIAs, with a focus on BITs between developing and developed economies, as well as those between two developing economies; (3) to estimate the impact of the presence of BITs on inward FDI in developing countries using a gravity model, and (4) to assess the implications for policy space and investment policy in

developing countries with reference to the provisions of traditional BITs involving developing economies relative to more recent BITs between developing economies.

As stated in Section 1.3 and Chapter 4, the study used both quantitative and qualitative research methods to address the sub-goals above. More specifically quantitative techniques including descriptive statistical techniques, such as trend and graphical analysis, and econometric modelling were used to address the first three sub-goals of the study in Chapter 5, while qualitative techniques, specifically case study analysis, was used to address the fourth sub-goal of the research in Chapter 6.

As background to the empirical analysis in Chapters 5 and 6, Chapters 2 and 3 of the study discussed the literature on FDI and BITs respectively. The goal of Chapter 2 was to examine the theory of FDI with particular reference to key concepts, motives and determinants. With reference to the published literature, Chapter 2 examined theories of FDI, as well as its potential effects on development. The main conclusions of the chapter were as follows. FDI is defined as an investment instrument utilised by foreign investors to obtain a long-term interest in an organisation located in a foreign country. Unlike FPI, FDI requires long-term investment in assets which cannot be disposed of easily.

Authors such as Bose and Kohli (2018) claim that FDI is not only a key source of capital which can be utilised for productive development in the recipient economy, but that it also has the potential to transfer substantial technical and managerial knowledge and skills to the host country. Furthermore, it is expected that a significant amount of the benefits yielded through FDI may spillover to domestic firms in the host economy. Cognisant of these opportunities, developing countries have increasingly liberalised their economies and adopted policy frameworks that seek to maximise their attractiveness to foreign investors (Bose and Kohli, 2018).

The discussion in Chapter 2 revealed that the decision to engage in FDI is premised on the motives behind the foreign investment. Section 2.3 outlined the most common FDI motives which include market seeking objectives, resource seeking motives, strategic asset seeking, and efficiency seeking. Furthermore, the mode(s) of entry chosen by the foreign investor as their preferred tool for implementing FDI in a host country is often determined by the FDI motives. The analysis in Section 2.4 found that modes of entry can be implemented either

through direct entry by the foreign firm in the host country, or through the foreign firm's acquisition of a domestic firm in the host country. The most common modes of entry include wholly owned subsidiary, joint ventures, Greenfield investment, Brownfield investment, and mergers and acquisitions (Mattoo *et al.*, 2004).

The analysis in Chapter 2 revealed that since the conceptualisation of Hymer's landmark 1960 microeconomic theory of international production, the main theories of FDI have evolved to include main contemporary theories such as the eclectic paradigm of Dunning (Denisia, 2010). It was found that the key determinants of FDI include traditional locational and macroeconomic determinants, as well as evolving global and technological factors, especially geopolitical trends and developments in ICT. Furthermore, and of particular importance for this study, institutional economists highlight the increasing role of institutional determinants of FDI, including political stability, corruption, regulation and participation in trade and investment agreements such as BITs.

The purpose of Chapter 3 was to provide background on the international investment landscape. Section 3.1 on the emergence and evolution of BITs since the 1950s provided context for the empirical examination of the effects of BITs on FDI received by developing countries in later chapters of the thesis. Section 3.2 provided background on the WTO Agreements relevant for investment in goods and services respectively, and contrasted these Agreements with the early BITs and investment chapters in regional trade agreements to highlight the emerging controversies in the IIA environment.. Furthermore, Section 3.4 presented a theoretical discussion of issues surrounding BITs from the perspective of the NIE literature. Section 3.5 then reviewed some of the empirical literature analysing the effects of BITs on FDI in developing countries.

The main conclusions of the chapter were as follows. The outcome of the literature review suggested that despite significant expansions in the IIA arena in recent past decades, BITs have nonetheless increasingly become a controversial part of the arena. Furthermore, as the number of BITs signed which involve developing economies has proliferated since the 1990s, questions have increasingly been raised with respect to their actual effectiveness in promoting FDI into developing countries, as well as the implications of their provisions for domestic development policy objectives.

The literature review in Section 3.5 of Chapter 3 confirmed that despite several studies which examine the impacts of BITs in FDI received by developing economies, there remains lack of unanimity with respect to the conclusions of these studies. Influenced by NIE theory, the key findings of several empirical studies reviewed in Section 3.5 including those by Grosse and Trevino (2005), Neumayer and Spess (2005), as well as recent studies by Mishra and Jena (2019) and Dorakh (2020) suggest there is a causal relationship association between the number of BITs signed by, and the levels of FDI received by a host developing country. Furthermore, findings by Grosse and Trevino (2005) suggest that there is a positive relationship between institutional characteristics which reduce policy uncertainty and FDI-related costs for foreign firms and inflows of FDI into host developing countries.

By contrast, however, the literature review in Section 3.5 revealed that the findings of studies by other NIE researchers, including Hallward-Driemeier (2003) and Tobin and Rose-Ackerman (2005), find insignificant evidence to support the hypothesis that BITs do actually increase foreign investment flows. Furthermore, Hallward-Driemeier (2003) and Tobin and Rose-Ackerman (2005) find no evidence of a positive relationship between BITs and variables that capture the quality of the local investment environment in host developing countries. The contrasting findings of the NIE studies considered in Chapter 3 provide a basis for arguing that there remains a lack of consensus in literature as to the impacts of BITs on host country inward FDI.

Following the background literature reviews in Chapters 2 and 3, Chapter 4 of the study set out the methods, procedures and techniques used to address the research goals of the thesis (as outlined in Section 1.2 of Chapter 1). The discussion in Chapter 4 also outlined details of the variables which make up the gravity model database created by the author for purposes of the research undertaken in Chapter 5. Chapter 4 outlined and explained the dependent variable (i.e. the inward FDI stock, following Kox and Rojas-Romagosa, 2020) of the recipient country from the outward investor country, and the traditional gravity variables (GDP of recipient and investor countries, common official language, common border, and distance between the capital cities of the investor and recipient countries) used in the gravity model.

Chapter 4 went on to explain how dummy variables would be used to investigate the impact of BITs on FDI in developing countries in the gravity model. It was noted that dummy variables were created to investigate whether BITS signed impacted on FDI and, in alternative

specifications of the model, whether BITS in force impacted on FDI. Furthermore, in each case, dummy variables were then created to investigate whether there was a significant difference between the impact on FDI of BITS signed or in force between a developed and developing country and BITS signed or in force between two developing countries.

Furthermore, Chapter 4 discussed three additional control variables (two macroeconomic and one institutional) used in some specifications of the basic gravity model. These were the exchange rate, inflation rate and an index of political stability. The chapter also explained the qualitative research method to be used in the empirical analysis in Chapter 6. Lastly, Chapter 4 discussed the study's data sources and limitations.

The empirical work undertaken for the thesis was reported and discussed in Chapters 5 and 6. Chapter 5 of the study addressed the first three sub-goals set out in Section 1.2, with the fourth sub-goal addressed in Chapter 6. In light of the contrasting findings in the literature review from Section 3.5 of Chapter 3, the aim of Chapter 5 was to contribute to the ongoing debate in literature on the impacts of BITS on the inward FDI that host developing countries receive from foreign investors.

Using a log-linear gravity model specification (following Dorakh, 2020), the main goal of Chapter 5 (in particular, Section 5.4) was to investigate econometrically whether BITS signed and/or BITS in force between developing and developed, as well as between developing countries, have a significant effect on inward FDI in developing countries. In order to provide background to the gravity model estimation, descriptive statistical analysis was used in Section 5.2 to investigate the growth and geographical distribution of developing country FDI relative to developed country FDI. The analysis covered a period of over four decades, from 1980 to 2021. Starting from the 1950s, the analysis in Section 5.3 examined the growth and distribution of BITS involving developing countries.

The graphical analysis in Section 5.2 revealed that at the beginning of the 1990s decade, developed economies held nearly 80% of global FDI stock, with the balance of 22.93% distributed amongst developing economies. Despite the proliferation of BITS during this period, the analysis in Section 5.2 showed that throughout the 1990s, developing country share of global FDI stock grew modestly and reached a peak of 23.24% halfway through the decade. Despite its modest growth, the results of the analysis in Section 5.2 however, suggest that since

the beginning of the 21<sup>st</sup> Century (until around 2018), the level of FDI stock held by developing countries has grown faster than that which is held by developed countries, in average annual growth rate terms.

It is also evident from the analysis in Section 5.2 that despite the proliferation of BITs since the 1980s, the global geographic distribution of FDI stock has nonetheless remained significantly skewed in favour of developed economies. This is in line with some of the findings of the studies featured in the literature review in Chapter 3. As stated in Section 3.5, the findings of NIE studies by Hallward-Driemeier (2003), as well as Tobin and Rose-Ackerman (2004) suggest that the proliferation of BITs in developing countries yielded minimal increases in the levels of inward FDI received by signatory countries.

The analysis in Section 5.3 confirmed that the proliferation of BITs began in the 1980s, intensified in the 1990s, and continued into the 2000s. The analysis found that, the number of new BITs signed per decade between developed and developed countries tripled from just over 200 in the 1980s to over 600 in the 1990s. Although this growth trend continued (albeit at a much slower rate) into the 2000s, it began to decline significantly in the 2010s. Notably, just 4 BITs were concluded between developed and developing countries in the period starting in 2020 until the end of 2022. Further analysis in Section 5.3 suggests that at the same time that BITs were declining in prominence, TIPs were increasingly being concluded in the IIA arena. Although BITs continued to dominate the IIA landscape until 2020, since then, the number of TIPs signed between countries each year has exceeded that of BITs signed in the same period.

Based on a unique gravity model database created by the author, Section 5.4 presented the results of the econometric modelling used to examine the impacts of BITs on inward FDI in developing countries. The regression estimations in Section 5.4 involved developing countries who receive inward FDI from both developed and developing countries. To enable comparisons between the effects of signing BITs and having BITs in force, separate OLS regressions were estimated for each scenario.

Key findings were made in each scenario. The regression results found a positive relationship between the signing and/or enforcement of BITs and the inward FDI of the recipient countries from foreign investors, both overall and in the specific case of BITs between developed and developing countries. However, for BITs between two developing countries, no significant

relationship was found between BITs signed or in force and inward FDI. A novel contribution to the empirical literature was distinguishing between the impact on FDI if the BIT was North-South and the impact on FDI if the BIT was South-South. The results obtained for the coefficients of the gravity variables and the additional control variables were, with one exception, statistically significant at the 1% level and in accordance with the literature in terms of their sign. The exception was the CONTIG coefficient which was either weakly significant or not statistically significant at all in the present study. Notwithstanding the statistically significant results in general for each scenario, the discussion in Chapter also outlined the limitations of the type of econometric analysis undertaken in the study with reference to literature reviewed in Chapter 3.

The aim of Chapter 6 was to analyse policy space and investment policy issues related to BITs, using case study analysis of selected BITs between developed and developing countries and between two developing countries. As background to achieving its empirical objectives, Section 6.2 of the chapter re-visited the controversies surrounding BITs with a particular focus on some of the experiences of developing countries in the BITs arena. Furthermore, Section 6.3 of the chapter also investigated whether some of the BITs concluded in recent years have actually adequately addressed such controversies. In order to address the goals of the chapter, a case study approach was adopted.

The analysis in Section 6.2 of Chapter 6 suggested that the controversies surrounding provisions of BITs revolve around four points. Two of these concerns centre on the lack of clarity in the definitions found in BITs investment provisions. It was suggested that the broad definition of investment errs in its inclusion of FPI. This is because host countries are forced to extend equal rights and privileges to both FDI and FPI investors when one of the key purposes of BITs is to increase the levels of FDI received by host countries. Secondly, the definition of expropriation and/or the way it is invoked in current investment provisions was argued to be too broad and it was recommended that it should be narrowed to include only 'direct' expropriation.

The third controversy revealed in the analysis concerns the prohibition on the use of capital controls by host countries, even at times of economic distress. The literature review in Chapter 3 suggested that capital controls can be used effectively to avert economic crises emanating from periods of macroeconomic instability. Therefore, it is recommended in Chapter 6 that

host countries should be permitted to use capital controls to avert economic crises. The fourth point highlighted in the discussion in Section 6.2 concerns the controversies surrounding the dispute settlement mechanisms provided for in the classic BITs template.

The analysis in Section 6.3 revealed that in addition to close resemblance between old-style NS BITs, older SS BITs tend to replicate the model for NS BITs. As a way forward, it was suggested that the SADC Model BIT offers a step in the right direction in terms of reforming BITs concluded by developing countries. However, unlike current BITs, the SADC Model BIT is not legally binding on countries and at best, offers guidelines for countries to follow.

Section 6.4 discussed the recent approaches to BITs adopted by some countries in the BRICS bloc, and considered lessons from these approaches which might be emulated by other developing countries on their journey to reforming BITs. The discussion reveals that whilst China and Brazil (the latter more recently since making a policy shift in 2015) have continued to sign BITs with other countries, India and South Africa have initiated policies to review their BITs and terminate many old-style BITs. It was noted that South Africa's approach to its BITs review and subsequent domestic legislative reform in the investment policy arena was considered to be comparable to the standard of OECD countries, despite some criticism.

## **7.2 Policy recommendations and areas of future research**

Although the gravity model results in this study suggest that BITs between developed and developing countries increase the inward FDI in recipient developing countries, it is also clear that the significant concerns raised with respect to the controversies surrounding BITs warrant urgent policy attention. Using case studies, the thesis examined the unequal distribution of rights and obligations between foreign investor and recipient developing countries. The analysis concluded that BITs increase the risk of litigation for developing countries, with associated costs placing a burdensome weight on host countries. This threatens to constrain developmental policy space in developing countries and creates a need for these states to adopt a cautious approach towards the risks associated with traditional BITs whose primary concern is the extension of investment protection to foreign investors.

The analysis in the thesis finds support for the call from many countries, not just in the Global South but also developed economies like Germany and Australia, for a comprehensive new

generation foreign investment policy framework. Increasingly, several countries are advocating for a process to reform BITs in a way that together with promoting FDI, will also facilitate investment regulation in line with the public policies of host countries. As a result, it is critical to ensure that the socio-economic policy objectives of developing host countries are included in development provisions while negotiating BITs.

The newly updated UNCTAD Investment Policy Framework for Sustainable Development (IPFSD) is a progressive development in the process of reforming BITs (UNCTAD, 2023c). The present study recommends that, going forward, future BITs should follow IPFSD guidelines. Policy reform is required that synchronises investment policy with development strategies of the developing host country, the sustainable development goals, as well as responsible foreign investor performance.

The creation of new-generation megaregional economic agreements in the Global South - such as the African Continental Free Trade Area (AfCFTA) - has opened up new opportunities for incorporating progressive investment provisions in regional arrangements that address the concerns surrounding BITs and other North-South IIAs. Megaregional agreements are defined as “broad economic agreements among a group of countries that together carry significant economic weight and in which investment is only one of several subjects addressed” (UNCTAD, 2022a: 69). Areas of interest which are covered in megaregional economic agreements include trade in goods and rules of origin, trade in services, competition, e-commerce, intellectual property (IP), public procurement, regulation of State-owned enterprises (SOEs), as well as small and medium-sized enterprises (SMEs) (UNCTAD, 2022a: 69).

Research findings suggest that the wide range of economic issues which are covered in megaregional agreements “may have a more substantial positive impact on FDI flows and greater geopolitical relevance than BITs” (UNCTAD, 2022a: 69). Notably, megaregional agreements aim to liberalise host markets and strengthen regional ties amongst signatory states, thereby facilitating increased levels of FDI. Membership and active participation in regional economic agreements has been found to create avenues for promoting intra-regional FDI, thus providing a South-South alternative to problematic BITs.

The results of the study found that the signing of BITs between two developing countries has no significant impact on the inward FDI received by recipient developing countries. With respect to new-generation BITs ratified between developing countries, it is therefore recommended that initiatives aimed at reforming BITs should ensure that greater policy attention is given to investment facilitation, as well as other macro-economic issues of governance which have been highlighted as major challenges to development in the Global South. These include political stability, climate change, anti-corruption, human rights, as well as due diligence. It is also recommended that new-generation IIAs should aim to promote, facilitate, and protect intra-regional investment which fosters sustainable development. Moreover, reform should include the safeguarding of developing countries' right to regulate in new-generation IIAs.

As noted above, the discussion in Chapter 6 highlighted four key controversies surrounding the provisions of BITs. In this regard, it is recommended that FDI – and not FPI – should feature in the definition of 'investment', while the definition of expropriation in BITs should include only 'direct' expropriation.

Furthermore, it is recommended that host countries should be allowed to use capital controls in times of economic crises. The fourth point concerns the numerous controversies around the dispute settlement mechanisms provided for in current BITs. The study identified serious problems with ISDS dispute settlement processes which repeatedly adjudicate in favour of foreign companies and developed countries. It is recommended that developing country trade negotiators continue to explore and implement alternatives to the discredited ISDS system in future BITs and IIAs.

It is also recommended that the code of conduct regulating ISDS arbitration should be reformed. It is the recommendation of this study that policy reforms should be implemented to reign in the increasing number of ISDS cases. The updated rules should incorporate greater transparency in ISDS proceedings in order to foster legitimacy. Furthermore, policy measures should be implemented to deal with cases of inconsistent readings of key provisions of investment agreements, as well as poor treaty interpretation in ISDS litigation processes. It is also recommended that the process of appointing officials to serve on ISDS tribunals should be transparent and improved to ensure impartiality and quality of arbitrators (UNCTAD 2012).

The length and cost of litigation proceedings should also be reduced to ensure fairness and assist developing countries in handling ISDS cases. Furthermore, new disclosure requirements should be implemented for third-party funding of ISDS tribunals. Policy reforms should also allow for parties to shorten further the ISDS procedural calendar. It is also recommended that expanded access to the ISDS settlement mechanisms should be extended to all parties. The study recommends policy measures to address controversies surrounding the functioning of ISDS arbitration systems, including the lack of consistency in judgements (UNCTAD, 2012, 2022a).

Arguably, there are many other variables that could be included in the regression model used to address some of the research goals of the present study. The factors not included might influence the regression results obtained in this study, as well as factors that deserve attention in future studies. For instance, one factor not included in the regression model is the impact of alternative measures for promoting investment. An area of future research could involve the examination of the impacts of such measures on the inward FDI received by developing countries.

Grouping all investments together in a single category (of either BITs between a developed and developing country, or BITs between two developing countries) provides, at best, an estimate of the mean, i.e. the average response to BITs. An inherent problem with this approach is that it does not capture subtle heterogeneity and nuances across divergent FDI sectors (Dorakh, 2020). Therefore future studies could examine the be interesting for future researchers to explore the contrasting impacts of BITs on other FDI sectors, instead of just grouping all investments in a binary categorical variable.

It would also be very interesting to learn from future empirical studies whether the impacts of BITs vary by investment category, for instance if the effects are different on Brownfield investment compared to Greenfield investments, or more or less impact on wholly owned subsidiaries compared to mergers and acquisitions, and so on.

Lastly, the results of the analysis in this study suggest that some new-generation BITs continue to closely resemble old-generation BITs in certain key provisions, notwithstanding the new approaches to dispute settlement contained therein. It will be interesting for future studies to

investigate ways in which new-generation BITs could be modified to address the controversies surrounding BITs more effectively.

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