Bilateral Investment Treaties and Foreign Investments

What We Know, What We Think We Know

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Outline

I. Intended Contribution to Research Literature
II. What are BITs?
III. Why Do BITs Get Signed?
IV. Potential Contributions of Our Project
V. Limitations
VI. Data Sources
VII. Preliminary Analysis
VIII. General Comments
General Broad Themes

• What is the interplay between bilateral investment treaties and firm value?

• What are the benefits of bilateral investment treaties for firms or countries signing them?
Two Potential Strands of Contribution

(1) Do investment treaties protect foreign investments?
   - The study is about how effective a particular policy initiative is
   - e.g. The Value of Oil Reserves

(2) Do governments protect foreign MNCs better than local firms?
What Are Bilateral Investment Treaties (BITS)?

• Agreements that establish the terms and conditions for investments by nationals and companies of one country in the jurisdiction of another (UNCTAD, 2000)
Typical BIT Guarantees

• Fair and equitable treatment - enjoy treatment no less favorable than the treatment granted by the host state to its own investors

• Protection from expropriation unless...
  (a) for a public purpose,
  (b) under due process of law,
  (c) in a non-discriminatory manner, and
  (d) Against prompt, adequate (fair) and effective compensation.

• Free transfer of means - foreign investors the right to transfer the investment and returns

• Full protection and security – fairly broadly covering the host taking reasonable measures to protect foreign investors no implications for state liability
Possible effects of BITs

• Commitment device to sustain future government policy, especially in the area of property rights (+)

• Some BITs cover dispute resolution mechanisms, which can affect profitability of investments in case of legal problems (+)

• Can serve as a signal of unfavorable host environment (-)
BITs vs. DTTs

- BITs, in general, do not have a tax component
- Double Taxation Treaties cover
  - Taxation rates of foreign investors
  - Concerned with the avoidance of double taxation
  - Prevention of fiscal evasion
Four Things We Think We Know About DTTs’ Impact

• Primary goal is of the tax treaties is “removing the obstacles that double taxation presents” (Chisik and Davies, 2006)
• Reducing firms’ withholding tax burdens does not necessarily translate into higher investment (Sinn 1993)
• Treaties can stem from rent-seeking lobbying efforts of current foreign investors rather than governments trying to reduce distortions (Sinn 1993)
• Primary objective could also be to reduce tax evasion (Radaelli 1997)
BITs Govern 3 Key Areas

Admission / establishment conditions for investment

Establishment of dispute resolution mechanism

Treatment of FDI once invested
Time Consistency Problems

• Time consistent policy is policy that will be sustained as circumstances change over time.

• Adhering to a policy rule may require pursuing a policy at a particular point in time that is not optimal at that time.

• In contrast, policy that is time inconsistent will be reversed in the future due to predictable developments over time.
The Ulysses Example

- Time consistency in the story of Ulysses and the sirens.
- Sirens were creatures whose beautiful singing lured sea ships to doom on rocks near where the sirens sang. Ulysses knew that when he heard the sirens sing he would be unable to resist demanding control of his ship and steering to an inevitable end on the rocks near where the sirens sang.
- His solution was to order his crew to bind him to the mast before he came within earshot of the sirens. He then would be safe from the temptation of their song.
Nationalization Example

• Suppose privatization is beneficial for the government and the government faces no penalty for future re-nationalization.

• Once the government privatizes a set of enterprises, its optimal policy is to re-nationalize the enterprises so that the enterprises can be privatized again.

• Buyers, recognizing this, will not participate in the privatization. Thus the privatization policy will fail because it is time inconsistent.
Predictably Changing Incentives Over Time

• From an economic perspective, the issue of time consistency emphasizes the problem of predictably changing incentives over time.

• Solutions:
  – One approach to achieving time consistency in government policy is to limit policy to rules that the government will have an incentive to pursue in all normal future circumstances.
    • e.g. BITs
  – Another approach is to develop capacity for commitment to a policy path
Motivations For Signing BITs

• Solution to a time consistency problem (Salacuse, 1990)
  – Optimal government policy ex-ante becomes sub-optimal ex-post
  – BITs provide confidence about stability of bargain

• Competitive dynamics (Elkins et al, 2006)
  – BITs as source of advantage in competition for capital
  – Signing by one country spurs signing by its FDI competitors

Consistent BIT signing between capital exporting (developed) & capital importing (developing) countries with problems of credibility

BUT...
Increased Pace of BIT Signing

- 1959 – mid 1980’s ~ 20 treaties/year
- Late 1980s – 1990s ~ 100 treaties/year
Distribution of BITs Over Time

DC – Developed Countries (IMF)
LDC – All Others

40%
Different Motivations for Adoption

- **Solution to time inconsistency problem**
- **Competitive dynamics** – not to be left behind in the competition for FDI
- **Adherence to norms**
- **Legitimacy by conforming to accepted standards**
Worldwide BIT Density

Figure 3. Density mapping on BITs worldwide, 1 January 2000

Source: UNCTAD database on BITs.

- Black: > 91
- Blue: 61 to 90
- Light blue: 31 to 60
- Light purple: 1 to 30
- White: 0
Oil Industry And International Trade

- There is more trade internationally in oil than in anything else ($1000 billion - almost as much as the value of everything China trades!)

- One of the largest industries for cross-border investment.

- Generally, crude oil and petroleum products flow to the markets that provide the highest value to the supplier. Everything else being equal, oil moves to the nearest market first.
Two Potential Strands of Contribution

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First Potential Research Question

• Do investment treaties protect foreign investments?
• Question is related to the general impact of institutional arrangements on economic variables
• Most of recent literature related to ITs has focused on DTT impact on FDI (Blonigen and Davies, 2004; Buthe and Milner, 2008)
• Egger & Pfaffermayr (2004); Hallward-Driemeier (2003); Neumayer and Spess (2005); Aisbett (2007)
  – While most results seem to indicate positive effect, results are mixed and identification strategies suffer from endogeneity and selection bias problems that could potentially severely bias the results.
Value of Oil Reserves

• Previous focus is on welfare measures; our focus is on firms

\[ V_R = R(P^E - C^E) \] 
\[ V_R \] - reserve value, \( R \) - size of the reserve, \( P^E \) - expected petroleum prices, \( C^E \) - costs over the life of the reserve

• We take advantage of three features of petroleum reserve markets:
  − Active trading -- extensive database (J S Herold)
  − Variation in asset location across countries -- wide range of political risk, and largely exogenous
Capturing Costs

In practice, costs we can assume costs are proportional to prices:

- \( C^E = \phi P^E \)

- both because the main component of costs is output taxes, and because production costs tend to rise with prices.
Specification for Capturing Measurement

- \( V_R = R^*(P^E - C^E) \)

- \( C^E = \phi P^E \) (this is the proportionality assumption)

\[ = > \frac{V_R}{R} = P^E(1 - \phi) \]
Data Sources

• We have data on $V_R$ and $R$, and can easily obtain proxies for $P^E$

• John S. Herold Incorporated (JSH) database
  – Used in previous paper (Click and Weiner, 2009)

• UNCTAD BIT database
Theoretical Model

• See handout for a game theoretic model of BIT investment
Model Specification

- $Y = a + \theta_b \cdot BIT_B + \theta_s \cdot BIT_S + \gamma_B \cdot D_B + \gamma_S \cdot D_S$

  + $\delta_1 \cdot \text{polcon} + \delta_2 \cdot \text{pol risk} \cdot BIT_B$

  + $\delta_3 \cdot \text{pol risk} \cdot BIT_S + \delta_4 \cdot \text{pol risk} \cdot \text{firm size} \cdot BIT$

  + $X + \varepsilon_i$

Hypotheses: $\theta_b, \theta_s$
Internal Validity Threats for This Route

• OVB: other key variables that drive sales price that need to be included

• Measurement issues
  – Truncation due to bigger sales being included in the database

• Endogeneity concerns – reverse causality
Second Potential Research Question

• Do governments protect foreign MNCs better than local firms?

• Related to recent articles on the so-called “Liability of Localness”

• Particular context is emerging economies.

• Emerging economies are low-income, rapid-growth countries using economic liberalization as their primary engine of growth. They fall into two groups: developing countries in Asia, Latin America, Africa, and the Middle East and transition economies in the former Soviet Union and China [Hoskisson 2000]
Regulatory Framework

• Before the wave of regulatory punctuations in the 1990s domestic firms in emerging economies were protected by a cocoon of high tariffs, license fees, state ownership, and close business–government relationships.
Liability of Foreignness

• Generally, we can think of it as the socio-political and relational hazards associated with “being a stranger in a strange land”.

• Particular examples:
  – Unfamiliarity costs,
  – Relational costs,
  – Discriminatory hazards costs.
Liability of Localness

• Socio-political and relational costs imposed by regulatory punctuations on local firms in their domestic market.
• Perez & Eden (2008) argue that radically removing protectionist policies, local firms are the ones most adversely affected by their unfamiliarity with the new ‘rules of the game’.
• Liability of localness can also be understood as the added social costs faced by local firms, after a regulatory punctuation, “now being different from then”, due to pressures to conform to new cognitive, normative, and regulatory structures (i.e., the forming of new institutions).
Liability of Localness

• In Perez & Eden (2008), the focus is on firms’ ability and strategic capacity to cope with changes in their regulatory environment over time.

• Perez & Eden (2008) hypothesize that regulatory punctuations in emerging economies have a negative effect on the survival of local firms.
  – They rely on an (unjustified) assumption that local firms are no longer familiar with the new ‘rules of the game’ in their own countries.
Liability of Localness

• Previous research by Perez & Eden (2008) focuses on the Mexican banking industry during the 1990s as their study sample.
• At the start of the period local banks did not have to compete against foreign banks (1991 to 1994).
• The regulatory punctuations of the mid-1990's abruptly changed the ‘rules of the game’ for the local banks.
• They use maximum likelihood (ML) continuous-time survival methods to test their hypotheses.
• Their main conclusion is that abrupt change in the “rules of game” caused by liberalization policies increased the likelihood of exiting the industry by a local bank by 245%.
• But their design is subject to severe OVB.
Internal Validity Threats for This Route

• OVB
  – Particularly, ability to capture all changes in all incentives for both foreign and local firms in the period studied.
  – Essentially ideally, you want to capture everything that is captured in the Doing Business Reports

• Measurement issue related to capturing the incentives similarly for all countries in our sample
Data: Summary Statistics

• Summary Statistics in Handout
Data: Correlation Matrix

• In handout
Data: Determinants of Value of Petroleum in the Ground, Per Barrel
Data: Estimates of the Asset Discount by Country, relative to the United States
Data: Determinants of Value of Petroleum in the Ground, Per Barrel
Thank You!

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