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**Abstract**

This paper studies the impact of investor-state dispute settlement (ISDS) provisions in International Investment Agreements (IIA) on Foreign Direct Investment (FDI). Using a large sample of host and source economies over the period 1980-2011, we investigate the role of different ISDS provisions on FDI stocks. We find evidence that IIAs stimulate FDI for both developing and advanced economies only when they contain binding ISDS. Our results suggest that on average, the implementation of an IIA with binding ISDS results in an increase in the FDI stock of host economy by about 22 percent. In addition, we find that certain treaty provisions that limit the scope of ISDS tend to reduce FDI.

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# 1 Introduction

There are currently more than 2,300 Bilateral Investment Treaties (BITs) in force as well another 319 other types of international treaties with investment provisions. Most of these treaties contain investor-state dispute settlement (ISDS) provisions that grant foreign investors the right to have their complaints adjudicated through international arbitration. ISDS provisions generally provide foreign investors with increased confidence that their grievances (regarding expropriation, discrimination, and other forms of unlawful treatment) will receive relatively unbiased treatment compared to a domestic court in the host country. All else equal, international investment agreements (IIAs) that contain ISDS provisions should increase the likelihood of FDI more than IIAs without any ISDS provisions.<sup>1</sup> However, measuring the degree to which ISDS mechanisms stimulate FDI has remained somewhat elusive.

In the following paper, we seek to disentangle the effects of ISDS from other provisions found in IIAs that may also spur higher FDI between member countries. While numerous studies have tested the impact of BITs on FDI, there are very few articles that attempt to isolate the impact of ISDS itself. As part of this empirical investigation, we test the impact of several policy features that limit the scope of ISDS in order to discern whether restrictions on ISDS result in reduced FDI. A natural assumption is that ISDS provisions that provide the foreign investor with the broadest level of protection would be more likely to stimulate FDI. This is an empirical question, however, that must be taken to the data. It is also a question that has gained increased relevance recently, with some policymakers questioning the overall value of ISDS. For example, the USMCA is phasing out NAFTA's ISDS mechanism between the US and Canada, and reducing its coverage for disputes involving the US and Mexico.

The remainder of the paper is as follows. We review the relevant literature in the next

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<sup>1</sup>An IIA is defined as any international agreement (BIT, free trade agreement (FTA), economic integration agreement (EIA)) that includes investment provisions.

section. Our empirical model is presented in section three, and our data is discussed in section four. We present our econometric results in section five and conclude in section six.

## 2 Literature Review

The controversial nature of ISDS provisions in BITs, with countries agreeing to give up some of their sovereignty in order to attract foreign capital, has generated a voluminous literature testing the relationship between BITs and FDI. However, the evidence from this literature continues to be mixed with little consensus on whether ISDS and BITs does lead to more FDI. Broadly, the literature examining this relationship can be divided into earlier studies focusing on isolating the impact of BITs on FDI and more recent studies that have also included other IIAs in the analysis along with examining the strength of the ISDS provisions included in these agreements.<sup>2</sup>

### 2.1 Effects of BITs on FDI

Early studies on BITs and FDI can be distinguished by their choice of dependent variable in the analysis. Some studies focus on a country's aggregate FDI, either inward stock or flow, and examine whether countries that sign BITs experience an increase in their level of aggregate FDI. Other studies look at the bilateral nature of FDI with a gravity framework employed to determine if BITs lead to higher FDI between member countries.

Rose-Ackerman and Tobin (2005) examine aggregate FDI flows of 63 nations during 1980-2010, and find that BITs actually reduce FDI for countries with high levels of risk

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<sup>2</sup>In a recent meta-analysis of the impact of IIAs on FDI, including RTAs and BITs, Brada et al. (2021) find that the effect of IIAs on FDI is close to zero. However, they note, as highlighted by the contradictory findings in the literature, that this result may be due to imprecise research methods. It should be noted that the meta-analysis was undertaken to determine the impact of IIAs as a whole, but recent studies and our own results show that variation exists among IIAs and accounting for the strength of investment provisions is important.

(primarily developing countries), but increase FDI for low-risk countries, suggesting that BITs are complementary with institutional quality. Moreover, they find that BITs have no impact on US outward FDI to developing countries, regardless of the quality of institutional risk. Neumayer and Spess (2005) also look at aggregate FDI inflows to developing countries, but they employ a larger sample covering 119 countries during the period 1970-2001. They find strong evidence that BITs increase FDI to developing countries, a finding robust to different specifications, estimation method and sample period. They also find somewhat weak evidence that BITs serve as a substitute for domestic institutional quality.<sup>3</sup>

Hallward-Driemeier (2003) studies bilateral FDI flows from 20 OECD countries to 31 developing countries during the period 1980-2000. She finds no evidence that BITs impact FDI, regardless of whether FDI is measured in absolute terms, relative to host country GDP, or relative to home country FDI outflows. Interestingly, she finds that when she interacts the BIT dummy with host country institutional quality, the effect is positive, suggesting that BITs on their own do not serve as a substitute of institutional quality. Salacuse and Sullivan (2005) also study bilateral FDI inflows to 99 developing countries during 1998-2000, and find developing countries experience higher FDI flows after signing a BIT with the United States, but not after signing one with other OECD countries. Restricting the sample of host economies to only developing countries, Busse et al. (2010) find that BITs stimulate bilateral FDI flows to developing countries during the period 1978-2004. They also report a negative and statistically significant coefficient on the interaction between political risk of the host economy and BITs, suggesting that BITs do indeed serve as a substitute for political quality. Busse et al. (2010) argue that having a larger sample with less selection bias is the main reason why their finding on the substitutability of BITs for a host country's institutional quality differs from Hallward-Driemeier (2003) and Rose-Ackerman and Tobin (2005).

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<sup>3</sup>They capture institutional quality by including measures of political risk, which includes indices of law and order, government stability, and investment risk.

Egger and Merlo (2007) critique the static nature of the empirical models used to test the relationship between BITs and FDI. To account for the endogeneity between BITs and FDI, a gravity equation is estimated using a dynamic panel generalized method of moments (GMM) framework with all time-invariant variables removed between home and host economies. Their parsimonious model contains variables highlighted in the FDI literature, including the sum of parent and host country GDP (consistent with horizontal models of FDI) as well as the ratio of parent/host GDP and parent/host skill (consistent with vertical models of FDI). Unlike the majority of other studies in this literature, the authors use FDI stocks as their dependent variable instead of FDI flows. Their sample contains 28 host countries, 22 of which are OECD members, with the remainder transition economies. Their results indicate that BITs increase FDI by about 4.8 percent in the short-run (within 18 months) while the estimated long-run impact is an increase in FDI of 8.9 percent.

## **2.2 Accounting for the strength of IIA provisions**

In an effort to generate more robust evidence on the relationship between ISDS provisions and FDI, the literature has moved away from the studies discussed in section 2.1 in two directions. First, empirical analyses now account for other international agreements such as FTAs and RTAs with investment chapters which perform a similar role as BITs in regulating and protecting foreign investment (Dixon and Haslam, 2016). Second, rather than treating all IIAs as the same, there has been greater recognition that the strength and quality of the investment provisions can vary from one agreement to another. As noted by Jacobs (2017), the protection afforded by IIAs between countries depends critically on the terms incorporated in the agreement; studies that do not account for these differences will lead to faulty conclusions about their effect on FDI.

Berger et al. (2011) was one of the first studies to examine effect of BITs on FDI after accounting for the strength of ISDS provisions. They first compare the impact of BITs

without dispute settle provisions to those with effective dispute settlement provisions, i.e. provisions that guarantee that an investor can unilaterally pursue binding arbitration. They find that any positive FDI effects of BITs can be attributed to ISDS provisions. That is, BITs without dispute settlement are not associated with increased FDI. In contrast, the coefficient on BITs containing effective dispute settlement provisions is positive and significant coefficient at the 10 percent level. They then compared the impact of BITs with relatively weak dispute settlement provisions to those containing “strong” settlement provisions. Interestingly, coefficients on BITs with both weak and strong ISDS are not statistically significant, suggesting that the benefit of ISDS seems to disappear if the ISDS provisions are too lenient (i.e., little limitations on investors) or too restrictive (i.e., more limitations on investors). Moreover, they also find that the significance of ISDS disappears when Central and Eastern European (CEE) countries are removed from the sample. Thus, they conclude the effectiveness of BITs in promoting FDI inflows remains elusive even when controlling for the strength of ISDS provisions.

In a subsequent study, Berger et al. (2013) assess the impact of both BITs and FTAs on FDI and focus on the strength of the investment provisions embedded within these treaties. They compare commitments to national treatment (NT) and MFN treatment in the pre-establishment phase to commitments to refrain from discriminatory treatment in the post-establishment phase via ISDS. For ISDS provisions, the authors differentiate only between the degree to which the contracting parties give their consent to an arbitration prior to an investment claim. Their results suggest that NT commitments at the outset stimulate FDI significantly more than the threat of ISDS. Interestingly, they find that FTAs increase FDI more when they contain stronger NT or ISDS provisions, while BITs appear to stimulate FDI, regardless of the strength of ISDS or NT provisions.

Building on Berger et al. (2013), Frenkel and Walter (2019) analyze the effect on FDI from the strength of a BIT’s provisions addressing state–state dispute settlement (SSDS) and

ISDS. They find that stronger SIDS and ISDS provisions in BITs are associated with more FDI activity—examined here as both FDI inflows and inward FDI stocks. On average, a one point increase in their constructed index on the strength of a BIT’s international dispute provisions is associated with a 3.1 percent increase in FDI inflows from the partner country.

In another paper, Dixon and Haslam (2016) consider the effect on FDI from investment provisions in IIAs for eighteen Latin American host countries. Their analysis includes the full range of IIAs covering the host economies (BITs, FTAs with investment chapters; regional integration agreements). They also measure the strength of agreements using a more comprehensive textual analysis of all aspects of a treaty, not just dispute settlement alone. They find that signed treaties seem to impact direct investment relations between developed and Latin American countries, but that the effect disappears after controlling for possible endogeneity of IIA signing and ratification to FDI flows.

A key goal of our study is to investigate whether and to what degree different ISDS provisions impact FDI behavior. The few studies that include ISDS provisions in their empirical models have only utilized fairly basic features of ISDS. For instance, Berger et al. (2011) distinguish between weak and strong ISDS by looking at a single feature: whether investors have full consent (i.e., the right to unilaterally initiate binding arbitration), as opposed to only partial consent (i.e., the right to arbitration must be approved on a case-by-case basis). However, there are features contained in the underlying ISDS mechanism that undermine the strength or scope of the ISDS provision. For example, a treaty’s ISDS provision may only cover treaty claims, instead of covering any dispute related to investment. Policymakers may also decide to exclude certain policy areas from ISDS, thereby limiting the protection that the ISDS mechanism ultimately provides to the investor. In addition, they may set limits or explicitly exclude certain treaty provisions from the scope of ISDS. Finally, a treaty may specify that a special mechanism involving both parties is required to settle disputes involving taxation. ISDS mechanisms that contain some or all of these provisions

are seemingly weaker or less comprehensive than ISDS mechanisms that don't contain any of these features. Hence, limitations on the scope of ISDS and their impact on FDI behavior remains unexplored.

### 3 Empirical Model and Data

Any analysis on the effects of an IIA on FDI has to seriously address the issue of reverse causality: do IIAs generate FDI, or are they signed because of existing FDI inflows between member countries? Studies that do not account for this endogeneity in their empirical framework are liable to have their findings questioned and ignored. In order to accurately determine the impact on bilateral FDI patterns from IIAs with ISDS provisions, our empirical model uses a differences-in-differences approach and controls for all other factors that may also influence FDI through fixed effects in the estimation.

More precisely, we follow Kox and Rojas-Romagosa (2020) and use the following structural gravity model of FDI in our empirical analysis:

$$FDI_{ijt} = \exp\left(\sum_S \beta_S IIA_{Sijt} + \lambda_{it} + \eta_{jt} + \theta_{ij}\right) \times \mu_{ijt} \quad (1)$$

where  $FDI_{ijt}$  is the inward FDI stock from home country  $i$  to the host country  $j$  in period  $t$ .  $IIA_{Sijt}$  is a dummy variable taking a value of 1 if countries  $i$  and  $j$  have an IIA of strength  $S$  in year  $t$ .  $\lambda_{it}$  is the time-varying home-country fixed effects that control for the outward multilateral resistance terms and home-country's income.  $\eta_{jt}$  is the time-varying host-country fixed effects that account for the inward multilateral resistance terms and total expenditures in the host country. Time-invariant bilateral determinants of FDI, capturing geographical, historical and cultural characteristics between the country pairs are captured by the country-pair fixed effects  $\theta_{ij}$ . As discussed in Baier and Bergstrand (2007), country-

pair fixed effects in a gravity model are able to control for the potential self-selection of countries forming an IIA. Lastly  $\mu_{ijt}$  is the multiplicative error term.

Our dependent variable is the host country  $j$ 's inward FDI stock from home country  $i$ . In the literature, bilateral FDI has been captured in both a flow and stock basis. While the FDI flows record the value of cross-border transactions related to direct investment in a year, the FDI stock measures the total level of direct investment in a year. As discussed in Kox and Rojas-Romagosa (2020) and Anderson et al. (2019), the FDI stock measure is closer to the concept of knowledge capital stock used to derive the structural gravity model in (1) and so should be preferred to FDI flows. FDI flows are also more volatile and likely to have negative values than FDI stock. Our data on FDI stock is obtained from UNCTAD and includes 151 host countries and 212 source economies for the years 1980 up to 2012.

Information on a country's BIT agreements is also provided by UNCTAD through their Investment Policy Hub portal, where 2577 international investment agreements (IIAs) are mapped out according to a large array of policy provisions. One category of provisions concerns ISDS, with detailed information regarding not only whether each BIT contains an ISDS provision but also provides additional details on the scope and limitations of the ISDS provision. This includes whether investors can unilaterally initiate binding arbitration without consent from the host country, and whether the ISDS provision excludes policy areas or covers only treaty claims.

It is important to note here that the UNCTAD Investment Hub portal only provides the mapping of ISDS provisions from BITs and not other IIAs such as RTAs. To overcome this limitation, we mapped ISDS provisions contained in the investment chapters of RTAs, using information from the Design of Trade Agreements (DESTA) database and the World Bank's Deep Trade Agreements (DTA) database.<sup>4</sup> By including these variables we hope to disen-

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<sup>4</sup>Numerous studies on ISDS simply include a dummy variable for country pairs that have entered into a trade agreement, such as Berger et al (2011). Busse et al (2010) initially include a dummy variable for RTAs (and find it to be insignificant) but in sensitivity tests exclude them.

tangle the impact of RTAs on FDI, depending on whether or not they contain an investment clause, and whether they provide a high standard of treatment to foreign investors.

Using information from UNCTAD on BITs and DESTA on RTAs, we group bilateral IIAs by the strength of their ISDS provisions going from the weakest to the strongest in this order:

- IIA with no ISDS provisions
- IIA with no guaranteed ISDS and limitations on scope
- IIA with no guaranteed ISDS and no limitations on scope
- IIA with guaranteed ISDS and limitations on scope
- IIA with guaranteed ISDS and no limitations on scope

Since we utilize a structural gravity approach that includes host and source time fixed effects, many of the time-varying independent variables that are often included in horizontal and vertical models of FDI drop out, such as host- and source-country GDP, GDP growth, per capita GDP, inflation rate, and skill level. It also precludes the inclusion of host country political quality variables. Our central focus, however, is on IIA policy variables and determining their relationship with FDI, which remains elusive in the literature.

## 4 Main Findings

Table 1 presents estimation results regarding the impact of IIAs with ISDS provisions on inward FDI stock. We use a PPML fixed effects estimator to account for potential heteroskedasticity and zero FDI stocks. We include both host and source time fixed effects, so key horizontal and vertical variables generally included in FDI specifications, either separately or as ratios between source and host economies, such as GDP, GDP per capita, GDP

growth, inflation, and skill level, are all collinear with the host and source time fixed effects and therefore drop out of the model. Our empirical approach, however, allows us to isolate the impact of various ISDS provisions that are contained in IIAs, a central concern of our study.

In column 1 of Table 1, we test the impact of IIA's with ISDS that requires consent on a case-by-case basis against IIAs with ISDS that guarantees investors the right to arbitration. Our results suggest that IIAs with ISDS that require consent on a case-by-case basis do not have any significant impact on FDI. In contrast, IIAs with ISDS that guarantees investors the right to arbitration, have a positive and significant effect on inward FDI. Since there is a potential for investments to have a delayed response to the implementation of an IIA, column 2 of Table 1 reports estimates for the case where all the explanatory variables in (1) are lagged by 5 years. We continue to see a positive effect on inward FDI from IIAs with guaranteed ISDS provisions.

In column 3 of Table 1, we examine the impact of IIAs that limit the scope of ISDS. This usually includes a clause that restricts ISDS to claims that have been included in the investment treaty. Without such a restriction, investors can utilize ISDS in order to seek restitution involving any dispute related to investment. A second restriction involves a limitation of provisions subject to ISDS. A third limitation involves excluding policy areas from ISDS. Finally, treaties can contain special mechanisms for taxation that limit the scope of ISDS. We find that for IIAs to have a significant and positive impact on inward FDI, IIAs should not have any limitations on ISDS provisions. When there are limitations associated with ISDS provisions in an IIA, we find that they have no effect on FDI. Column 4 of Table 1 shows that the difference between IIAs without ISDS limitations and IIAs that restrict ISDS persist when the five-year lags of the independent variables are considered instead in the estimation.

In Table 2, we consider both the nature of consent and overall scope of ISDS provisions

Table 1: Effect of IIAs with ISDS provisions on Inward FDI Stock

	(1)	(2)	(3)	(4)
	No lag	Lags (5 years)	No lag	Lags (5 years)
IIA w/out guaranteed ISDS	-0.159 (0.19)	0.183 (0.12)		
IIA w/guaranteed ISDS	0.117** (0.06)	0.141* (0.07)		
IIA w/no limitations			0.186*** (0.07)	0.224*** (0.08)
IIA w/limitations			-0.005 (0.63)	-0.063 (0.09)
N	69,058	66,900	69,058	66,900
Host/Source Time FEs	Yes	Yes	Yes	Yes
Country Pair FEs	Yes	Yes	Yes	Yes
Pseudo R2	0.98	0.98	0.98	0.98

in the empirical analysis. We categorize IIAs with guaranteed ISDS provisions and no limitations as the strongest agreements with ISDS provisions (1,058 IIAs). In contrast, IIAs without guaranteed ISDS and having limitations are categorized as the weakest agreements with ISDS provisions (12 IIAs). The remaining IIAs with ISDS provisions are categorized as either IIAs with guaranteed ISDS and limitations (332 IIAs) or IIAs without guaranteed ISDS and no limitations (56 IIAs).

Table 2 shows that only IIAs with strong ISDS provisions (guarantee and no limitations) have a positive effect on FDI stock. The estimated coefficient on IIAs with strong ISDS provisions is highly significant and similar to estimates displayed in table 1. IIAs that have ISDS provisions without these characteristics are either ineffective or in the case of IIAs without guaranteed ISDS and no limitations can even have a negative impact on FDI. When considering a 5-year lag of the explanatory variables in column 2 on Table 2, we see there is

only a marginal change on the estimates for the different types of ISDS provisions found in IIAs.

Table 2: Effect of individual ISDS provisions on Inward FDI Stock

	(1)	(2)
	No lag	Lags (5 years)
IIA with no ISDS	0.148 (0.10)	0.182 (0.12)
IIA w/guaranteed ISDS and no limitations	0.200*** (0.06)	0.220*** (0.08)
IIA w/guaranteed ISDS and limitations	-0.053 (0.07)	-0.106 (0.10)
IIA w/out guaranteed ISDS and no limitations	-0.515** (0.23)	-0.464* (0.26)
IIA w/out guaranteed ISDS and limitations	-0.177 (0.54)	-0.12 (0.60)
N	69,058	66,900
Host/Source Time FEs	Yes	Yes
Country Pair FEs	Yes	Yes
Pseudo R2	0.98	0.98

Note: Standard errors in parentheses with \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

Overall, our results consistently point to a positive relationship between strong ISDS provision and FDI. We can use our estimated coefficients to calculate the estimated impact in percentage terms of an IIA with and without guaranteed ISDS on FDI (see table 3). Using estimates from table 2, column 1, which is our benchmark specification without lags, we find that an IIA with guaranteed ISDS and no limitations is associated with an increase in FDI by 22.1 percent. Additionally, IIAs without guaranteed ISDS and without limitations are associated with a reduction in FDI by approximately 40 percent.

Table 3: Percentage change in FDI Stock from an IIA with and without ISDS

	Initial	Lag (5 years)
IIA w/guaranteed ISDS and no limitations	22.1	24.6
IIA w/out guaranteed ISDS and no limitations	-40.2	-37.1

## 5 Conclusion

We investigate the effect of ISDS provisions on FDI behavior, testing the impact of a wider array of policy features compared to previous studies on ISDS. Our empirical results indicate that ISDS mechanisms that guarantee investors the right to unilaterally pursue binding arbitration result in increased FDI. In contrast, we find no evidence that FDI is stimulated by investment agreements that either exclude ISDS mechanism or instead contain ISDS that doesn't guaranteed the right to arbitration. Results regarding the impact of provisions that limit the scope of ISDS vary regarding the specific provision and the host economy.

We use our estimates to calculate that an IIA with guaranteed ISDS and no limitations is associated with an increase in FDI by 22.1 percent. These results are robust if we assume that the impact from an IIA occurs with a 5-year lag. In contrast, we find that IIAs without guaranteed ISDS and without limitations are associated with a reduction in FDI by approximately 40 percent. This is a sizeable impact that merits investigation in future studies.

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