

# Outward Investment: Selected Economic Issues

Trade and Investment Analytical Papers: Topic 15 of 18

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# 1. Summary

The UK is one of the largest outward investors in the world. On the whole, evidence suggests that this brings positive economic benefits. In particular, outward investment enables firms to take advantage of opportunities which would otherwise not be available to them, increasing their productivity, profitability and competitiveness. It generates earnings and complements exports which also contribute to economic growth. At the aggregate level, it has a neutral or positive effect on UK employment.

Research shows that the main determinants of where international investors locate are the economic and business environment in the host country. For example, the market size, infrastructure and political and economic stability all play a central role in international investment decisions. Bilateral Investment Treaties (BITs) are one instrument which can be used to improve the business investment environment. These promote and protect investment abroad and have been adopted by many countries. The evidence on the effectiveness of BITs is largely inconclusive, particularly given the many practical difficulties encountered when analysing their impact using econometric techniques. However, survey evidence has emerged which suggests that whilst BITs are not important to all, they are important for some international investment decisions.

## 2. Introduction

This paper summarises the available evidence on the impact of outward Foreign Direct Investment (FDI) on the UK economy and what drives outward FDI decisions. On this latter point, it considers what role Bilateral Investment Treaties play. It starts with a description of what FDI is and a summary of how important it is to the UK, including recent trends.

Foreign Direct Investment (FDI) is defined as investment abroad that adds to, deducts from, or acquires a lasting interest and effective voice in an enterprise operating in a different country to the investor<sup>1</sup>. This includes greenfield and brownfield investment abroad, equity purchases and M&A activity. For the purposes of compiling statistics, a lasting interest and effective voice is classified as an investor holding 10% or more of the equity share capital of the enterprise.

FDI is a financial measure and is not equivalent to capital investment in a foreign firm by a UK company. For example, an activity which might conventionally be thought to be investment, such as the construction of a new plant by a UK owned firm in a foreign country funded through a bank loan in that country, would not be captured as FDI. However, FDI offers the best available indicator of the scale of UK firms' investment activities abroad where they have a lasting and effective voice and the potential economic benefits UK firms can accrue from investing abroad.

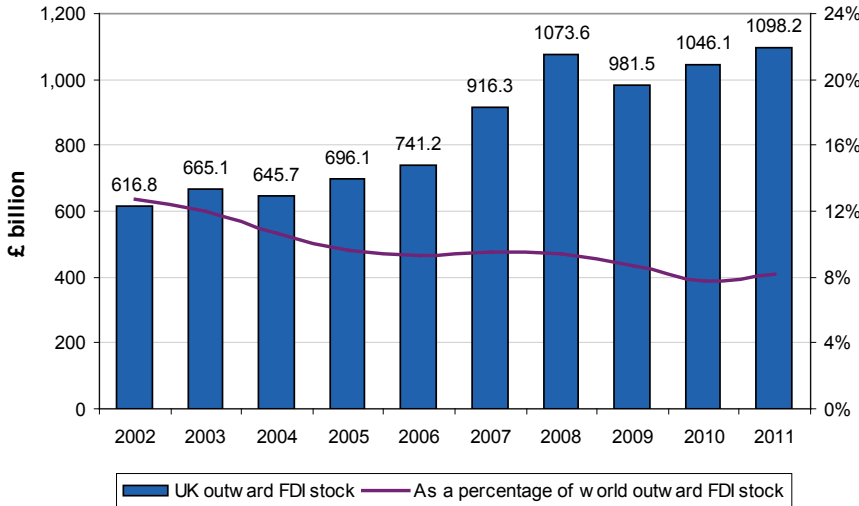
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<sup>1</sup> FDI is a component of foreign investment, which forms part of the balance of payments.

### 3. UK Outward Investment Trends

The UK is one of the world’s largest foreign direct investors, second only to the US. By the end of 2011 the UK’s stock of outward FDI was £1,098bn<sup>2</sup>, having risen by around 75% since 2002, as shown in Figure 1. Despite this large growth, the UK’s share of world outward FDI stocks fell over the last decade, mainly due to the expansion in foreign investment among Eastern and South-East Asian economies over the period.

**Figure 1: UK net outward FDI stock, 2002-11**



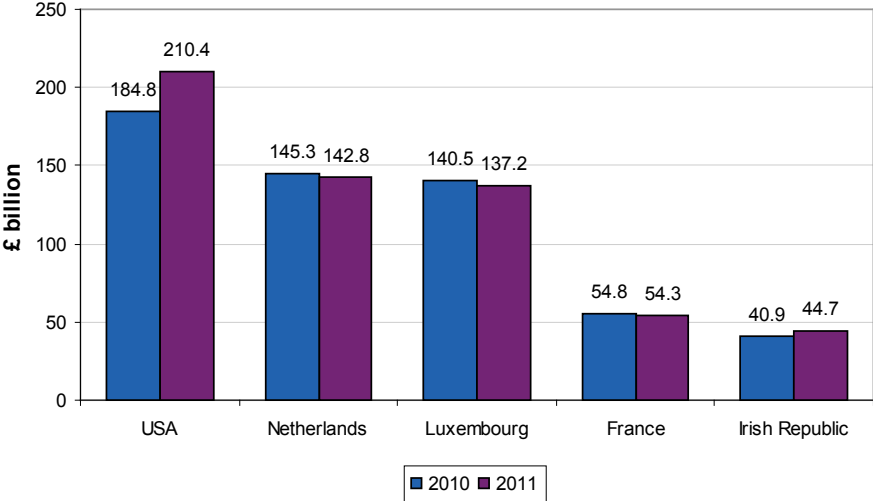
Source: ONS (bars), UNCTAD (line)

The main destination for UK outward FDI is the US, which accounted for around 19% of UK outward FDI stocks at the end of 2011. Other key destinations include the Netherlands, Luxembourg, France and Ireland which, together with the US, cover more than half of the UK’s outward FDI stock (Figure 2). The presence of the Netherlands and Luxembourg in the UK’s top five destinations is mainly a result of UK companies channelling funding through holding companies (Special Purchase Enterprises) in those countries to take advantage of their local tax regimes. As a

<sup>2</sup> Figures presented here are net outward FDI stocks, where net refers to the fact that these figures are net of disinvestment. Stocks are used as flows are highly sensitive to large M&A transactions. It is important to note that flows in a given year do not exactly equal the change in stocks as a result of changes in the valuation of the assets and currency changes.

result of this capital in transit effect, these economies, which only represent 5% of EU27 GDP, are the destination for 10% of EU27 outward FDI stocks<sup>3</sup>.

**Figure 2: UK net outward FDI stock by country, 2010-11**



Source: ONS

Brazil, Russia, India and China (BRICs) account for only 4% of UK outward FDI stocks despite investors in a recent UNCTAD survey stating these are some of the destinations where they would most like to invest<sup>4</sup>. The relatively low levels may reflect investor concerns about the existence and enforcement of property rights, inefficient bureaucracy, poorly developed infrastructure or restrictions on the type, level and location of investment. Copenhagen Economics (2010) suggest it may also be because companies prefer to outsource activities to other companies in these countries rather than directly invest in them. Nonetheless, these countries are becoming increasingly important to UK outward FDI. In 2011, 16% of net outward FDI flows were to BRICs and their share of the UK’s stock of outward investment has grown in every year since 2003.

The sectoral breakdown of FDI data is only available at a relatively aggregated level. This shows that the majority of UK FDI is in foreign enterprises in the services sector,

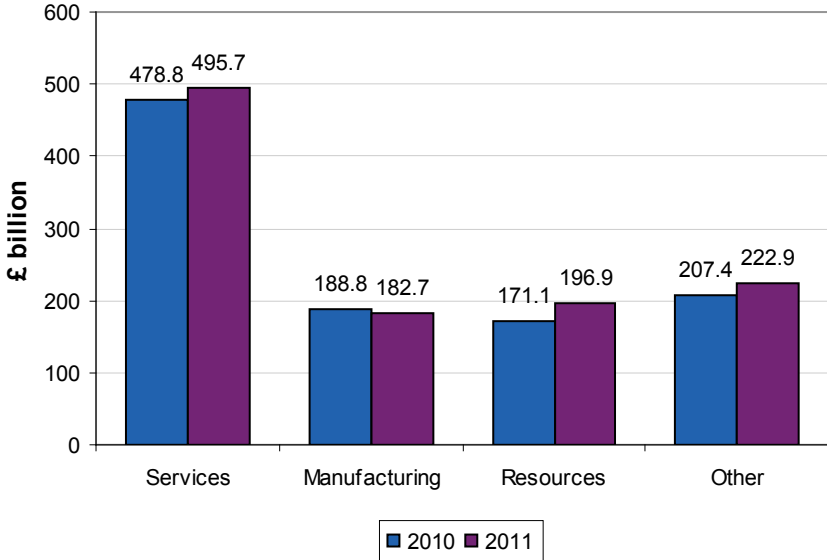
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<sup>3</sup> Attempts have been made to overcome the issue of capital in transit which makes it difficult to analyse the true determinants and impacts of FDI as the ultimate owner of an investment is often not known. Some countries do collect this type of data already (see the Eurostat Outward Foreign Affiliates Statistics (FATs)). As part of its work programme the OECD is also considering ways to Harmonise FDI and Activity MNE data (such as FATs) to improve policy makers’ understanding of foreign investment.

<sup>4</sup> See UNCTAD’s World Investment Prospects Survey 2012-14.

as shown in Figure 3. This is consistent with the idea that sales in services (e.g. a food retailer) are more likely to require a direct presence in the market. Within this category, the financial services and information and communications sub-sectors are the largest, representing £238bn and £124bn respectively of the 2011 outward FDI stock. Other key sectors include mining and quarrying, which account for £196bn of the £197bn outward FDI stock in the resources sector, and petroleum, chemicals, pharmaceuticals, rubber and plastic products (£83bn).

**Figure 3: UK net outward FDI stock by sector, 2010-11**



Source: ONS. “Other” includes outward investment by public corporations which the ONS has traditionally counted as services (see ONS MA4 2010 for example)

## 4. The Impact of Outward FDI on the UK Economy

Compared to research on the impact of inward investment, there have been relatively few studies which have considered the impact of outward investment on the UK economy. Those that have emerged have generally focussed on the manufacturing sector due to data limitations, despite the majority of UK outward FDI being in services.

In theory, outward investment could have both positive and negative effects on the home country. The net outcome will depend on a number of factors such as the type of investment pursued and the estimation of the counterfactual in which the firm does not invest abroad<sup>5</sup>. This section summarises the theory and available evidence on the impact of outward investment on the UK economy, considering the impact on different economic variables separately.

### Productivity, profitability and competitiveness

Firms invest abroad to take advantage of opportunities which may otherwise not be available to them in their home country, ultimately with the aim of increasing their profits. By acquiring knowledge or technology through investment they may be able to improve their productivity, increasing their competitiveness and potentially spurring competitors to improve their own operations. In addition, by accessing resources at a lower cost they may be able to improve their cost structure, further increasing their profits and competitiveness. It is often observed that multinationals tend to have higher profits, productivity and survival rates than non-multinationals in the same country<sup>6</sup>, but this in itself does not provide evidence that outward investment directly causes these gains.

A recent Euorstat survey of EU firms found that many EU firms (60%) report improvements in their competitiveness as a direct result of offshoring<sup>7</sup>. In addition,

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<sup>5</sup> The counterfactual refers to the scenario in which the firm does not choose to invest abroad. As it is not observed, it is difficult to estimate what would happen to the firm in this scenario. It could be that, if the firm did not invest abroad, its profits would fall as it loses its advantage over foreign firms which then take market share from the firm in the home country. The gains / losses from investing abroad need to be compared to this counterfactual to estimate the net gains from FDI.

<sup>6</sup> The stylised facts from empirical research shows a strong and clear productivity hierarchy, with multinationals being the most productive, followed by exporters and then non-internationalised firms.

<sup>7</sup> Offshoring is the relocation by a firm of a business process abroad. This may be to a firm's own affiliate or another company i.e. offshoring is not necessarily FDI.



around a fifth of firms surveyed reported better in-house know how and improvements in the quality of their products as a result of offshoring. Although this survey evidence includes both firms investing abroad and sourcing from other foreign companies abroad, the majority of respondents (70%) were international investors. Therefore, this survey provides some preliminary, though not complete, evidence that foreign investment can improve a firm's competitiveness and productivity.

This survey evidence is supported by the few empirical studies which have been carried out on the impact of outward FDI on UK productivity in the manufacturing sector. At an aggregate level, Bitzer and Gorg (2009) investigate the link between outward FDI stocks and total factor productivity across 10 manufacturing industries and 17 OECD countries. They find for the UK that a 1 percent increase in the outward FDI stock increases productivity by 0.05 percent. Interestingly, the authors find that only 5 of the 17 OECD countries tested saw a rise in total factor productivity as their stock of outward FDI increased. This may reflect that the short run reduction in home market production associated with FDI is not reversed through increased competitiveness in the long run in some countries<sup>8</sup>.

Although the overall productivity gains may be positive for the UK, there is evidence to suggest the impact varies by host country type and industry sector. Driffield et al. (2005) find improvements in total factor productivity in the UK manufacturing sector only when firms invest in countries which are low R&D<sup>9</sup> and low labour cost countries or high R&D and high labour cost countries<sup>10</sup>. Where a firm invests in a low R&D and high labour cost country or a high R&D and low labour cost country, they find no impact on productivity. At a sector level, Girma and Gorg (2004) find productivity gains are less pronounced in UK electronic firms compared to chemical and engineering firms.

Therefore, the available evidence suggests that outward FDI has a positive impact on firm level and aggregate productivity in the UK, although these studies focus on data for the UK manufacturing sector only. The estimated impact is not uniform and the outcome is likely to depend on the host country characteristics and the industry from which the outward FDI originates, among other factors.

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<sup>8</sup> In an earlier working paper, they suggest this could be down to rigidities in factor markets in these OECD countries and that firms in these countries are less competitive.

<sup>9</sup> R&D intensity is measured by R&D as a proportion of value added.

<sup>10</sup> The authors conclude that the result for high R&D and high labour cost countries is because companies are sourcing technology from these countries which boosts productivity. For low R&D and low labour cost countries, they argue the result reflects the "batting average" effect. That is, as low productivity activity is moved from the UK to a foreign country then this increases average productivity in the UK.

## Employment

One of the main concerns with outward investment is that it could lead to reduced employment in the home country as the investor uses foreign labour as a substitute for labour in the home country. In theory, however, employment could increase in the home country if the foreign firm sources materials and expertise from the firm's headquarters or suppliers in the home country. Equally, improvements in a firm's competitiveness could enable it to expand its operations both in the home and foreign country, to the benefit of employment in the home country. Furthermore, investing abroad may be critical to the survival of the firm, at least in the long run.

A recent literature review of the empirical studies that consider the change in employment as a result of EU outward FDI by Copenhagen Economics found that EU firms' investments have a neutral or even positive impact on employment in the home country at a firm level. They suggest that this is because the positive scale effects due to productivity and competitive gains, as described above, are sufficiently large to outweigh the negative effects of downscaling domestic production. At an industry level, they also do not find a negative impact of EU outward FDI on employment in the manufacturing and services sectors.

The review draws on a number of firm level studies which tackle the issue from different perspectives. The first of these focuses on the labour market impact of firms which have established a foreign affiliate. Within this grouping, Hijzen et al. (2009) find that French firms in the services sector which opened foreign affiliates experienced around 20% higher employment in the home country after three years compared to other firms that did not invest abroad<sup>11</sup>. Masso et al. (2007) and Castellani et al. (2008) find neutral and positive impacts on employment growth for Estonian and Italian firms respectively establishing foreign affiliates abroad.

Other firm level studies have considered the link between importing intermediate goods and employment. Firms that invest abroad to take advantage of lower labour costs are likely to see a rise in their imports of intermediate goods and services as they import these cheaper production inputs from their foreign affiliates. Hijzen and Swaim (2007) find no evidence that increased imports of intermediate services cause job destruction. In fact, they find employment in those firms that outsourced services actually grew faster<sup>12</sup>. Castellini et al. (2008) and Riihikaki (2009) find there was no fall in employment in Italian and Finnish firms as a result of increased imports of intermediate goods.

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<sup>11</sup> They find, for the manufacturing sector, market seeking FDI (e.g. replicating the business abroad) has a similarly positive effect on employment in the home country whilst efficiency seeking FDI (e.g. opening a factory in a low labour cost country) tends to have a neutral impact on employment. Importantly, they find no evidence that outward FDI has a negative impact on employment in the home country.

<sup>12</sup> This result, however, is based on firms offshoring as opposed to just outward FDI.

Evidence from a recent UKTI survey on UK firms with overseas sites supports these conclusions. Whilst the survey found the effect of having an overseas site on UK firm's employment varies, on balance it is positive. Of the 184 investors surveyed, 21% reported UK employees would have been lower without the overseas site, 61% reported no change and 16% reported UK employee numbers would have been higher without the site. In total, having one or more overseas sites is estimated to add an average of 3.5 employees to outward investing firms' employment in the UK. This suggests that the overall impact of outward FDI on UK employment is neutral or positive.

### **Skilled and unskilled workers**

Alongside the issue of employment, there is a concern that even if net employment effects are positive, they may not be felt evenly between skilled and unskilled labour. The pursuit of low cost labour resources (and hence the outsourcing or outward FDI to relocate specific activities) by firms may reduce their demand for unskilled labour in the home country, whilst the reliance on the headquarters in the home country by the foreign affiliate could preserve skilled jobs in the home country. This could lead to structural challenges for the home country, affecting those that would find it most difficult to find alternative employment.

The majority of evidence at the EU level suggests that outward investment has a negative impact on the demand for low skilled labour in the home country. Egger and Egger (2006) find that 4% of the observed changes in skill intensities in the EU manufacturing sector are a result of companies sourcing from abroad and Straus-Kahn (2003) finds the import of intermediate goods accounted for 11-15% of the decline in the share of unskilled workers in French manufacturers<sup>13</sup>. These studies are partly supported by findings by Driffield et al. (2005) which suggest there is a positive link between the demand for low skilled labour in the home country and the cost of labour in the host country (i.e. lower wages in the foreign country reduce demand for unskilled labour in the home country).

Outward FDI is consequently expected to lead to a decline in demand for low skilled labour. As with the case of productivity impacts, the literature focuses on the manufacturing sector, meaning the same evidence based conclusions are difficult to draw for the services sector.

### **Economic growth**

On the whole, the evidence presented above suggests that outward FDI is beneficial to the home country. This could translate into higher economic growth. Most of the current evidence on outward FDI, however, focuses on firm or industry level effects

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<sup>13</sup> As noted in footnote 7, sourcing from abroad (offshoring) includes both FDI and buying from other companies based abroad so this result may not directly apply to FDI.

and there has been limited analysis of the link between FDI and economic growth at an aggregate level.

One recently published study though suggests that outward FDI does increase GDP growth. Herzer (2010) using data on 50 countries from 1980-2000 finds that there is a bidirectional link between outward FDI and GDP growth. That is, increases in outward investment boost productivity and competitiveness, leading to higher GDP, which in turn enables firms to make more outward investment. Whilst they do test the robustness of the results extensively, there remains a possibility that these conclusions could be driven by other factors<sup>14</sup>.

In addition to the longer term impacts on economic growth, outward FDI can have accounting impacts which have a positive effect on GDP estimates. For example, the earnings on the stock of outward investment appear as a large credit item in the UK current account. In 2011 these earnings were £101.6bn, well in excess of the £43.6bn earnings by inward investors in the UK, meaning earnings on outward investment had a net positive impact on UK GDP in 2011.

Similarly, an increase in net exports would boost UK GDP. The link between outward investment and net exports is complex and is likely to depend on the type of outward investment being pursued. UKTI evidence suggests, however, that outward investment is predominantly used to access customers in foreign markets and that countries tend to have significant outward FDI in countries in which they are also strong exporters<sup>15</sup>. This implies outward investment and exports could be complementary and outward FDI could have a positive impact on net exports and GDP estimates.

These short term accounting impacts can still promote long term economic growth. For instance, there is a wealth of literature that shows trade is good for growth and the earnings on outward investment can be reinvested, boosting long term economic growth.

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<sup>14</sup> Some of these, such as reverse causation, are captured in the analysis on Bilateral Investment treaties below.

<sup>15</sup> See BIS Economics Paper No. 8

## 5. Why and Where do UK Companies Invest Abroad?

Given the conclusion that outward FDI can be good for host country prosperity, it is useful to understand what drives outward investment. This section provides a summary of the theory and evidence on this issue. It concludes with a review of the evidence that has emerged on the effectiveness of Bilateral Investment Treaties in supporting outward investment.

### **Motivations for investing abroad**

Several theories have been put forward to explain why firms choose to enter markets through FDI rather than by exporting, selling via agents or distributors, licensing, franchising or using other contractual agreements. As FDI is associated with higher costs of market entry than these other modes of entry, it must be that the advantages from FDI are large enough to compensate for these higher costs.

One of the best known theories explaining why firms use FDI is Dunning's (1988) "eclectic paradigm". This suggests a firm will enter a market using FDI if it has ownership, locational and internationalisation (OLI) advantages:

Ownership advantages exist when a firm has a specific advantage over overseas competitors, normally in the form of an intangible asset, which can be transferred within the firm at low cost. This could include a technology or brand name.

- Internationalisation advantages exist when the firm considers licensing or franchising this ownership advantage too risky, in terms of the risk of losing or damaging (in the case of brands) this knowledge capital, and thus prefers to keep these intangible assets within the firm.
- Location advantages exist when the host country has specific strengths which will enable the firm to exploit its ownership and internationalisation advantages.

The OLI framework therefore applies to technology exploiting motivations for FDI, where the firm attempts to take advantage of a technology it holds.

FDI can also be the preferred option of market entry where trade barriers are high in the target destination markets. For example, a UK firm exporting to another country outside of the EU would face the country's external trade barriers. Locating in the foreign country enables UK firms to sell into these markets without facing these barriers, although they may still experience non-tariff barriers by having to meet the local standards and rules of the country they are investing in. In these circumstances firms may be able to exploit their ownership advantages more efficiently by FDI than would be feasible by exporting.

Other theories highlight that for some sectors where exporting may not be feasible for practical reasons FDI can allow firms to sell to customers overseas who would otherwise not be accessible. These sectors are said to have a low degree of tradability and this type of FDI is referred to as horizontal FDI. Services are a notable example of this. For example, in the case of retailing, services suppliers and customers need to be co-located.

Firms also pursue outward FDI to improve the efficiency of their production. In recent years this type of FDI has led to the globalisation of production and the development of Global Value Chains. For example, parts made in one country are increasingly assembled in another and sold in a third. This type of FDI is referred to as efficiency seeking or vertical FDI.

### **Determinants in firm location decisions**

The theories above help to explain why, but not necessarily where, firms choose to invest abroad. There is clearly a strong link between the motivations for FDI and the factors that determine where an investor chooses to invest. For instance, a company investing abroad for efficiency seeking reasons will view the relative labour, raw materials or energy costs in the host country as a key determinant of where they locate.

Econometric studies suggest multinationals are mainly attracted by strong economic fundamentals in the host country. The OECD (2002) highlight the most important of these are market size, real income levels, skill levels in the host country, infrastructure, trade policies and political and macroeconomic stability. Other factors, such as international investment incentives in the form of lower taxes or grant aid, are found to have a limited influence over investment decisions. Instead, factors like market characteristics, relative production costs and resource availability explain most of the cross-country variation in FDI flows.

These conclusions are backed up by survey evidence. Ernst & Young's 2012 Investor Awareness Survey found the transparency and stability of the political, legal and regulatory environment to be the most important determinant in firm location decisions.

Bilateral Investment Treaties are one tool which can be used to increase the transparency and stability of the regulatory environment towards investment from foreign firms. The effectiveness of these treaties in promoting outward investment is reviewed in the section below.

# Bilateral Investment Treaties and outward investment

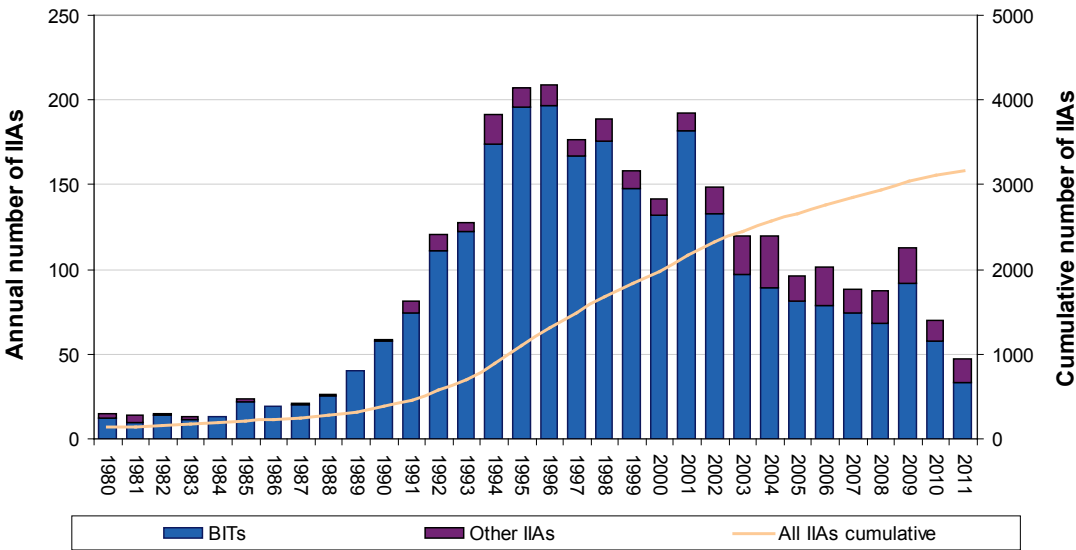
## An introduction to Bilateral Investment Treaties

Despite a number of attempts being made to agree a multilateral deal on investment protection through the OECD and WTO, no such deal exists today. In the absence of a multilateral deal, countries have sought bilateral agreements through Bilateral Investment Treaties (BITs).

BITs are agreements between two states on the promotion and protection of the investment of investors of one country in another country. They typically include provisions granting foreign investors 'fair and equitable treatment', protection from expropriation and access to dispute settlement procedures should a government expropriate a foreign investor's assets. They have long been seen by governments of outward investors as an important way of protecting their companies' commercial interests abroad. For countries hoping to attract inward investment, particularly developing countries, BITs have been viewed as a means of reassuring foreign investors that their assets will be safe in an attempt to attract inward foreign investment.

This belief in the influence of BITs was reflected in an explosion in the number of new agreements signed in the 1990s, as highlighted in Figure 5 below. By the end of 2011, 2,833 BITs had been signed along with 331 other International Investment Agreements, principally in the form of free trade agreements and economic partnership agreements with investment chapters in them.

**Figure 5: Annual and cumulative levels of BITs signed since 1980**



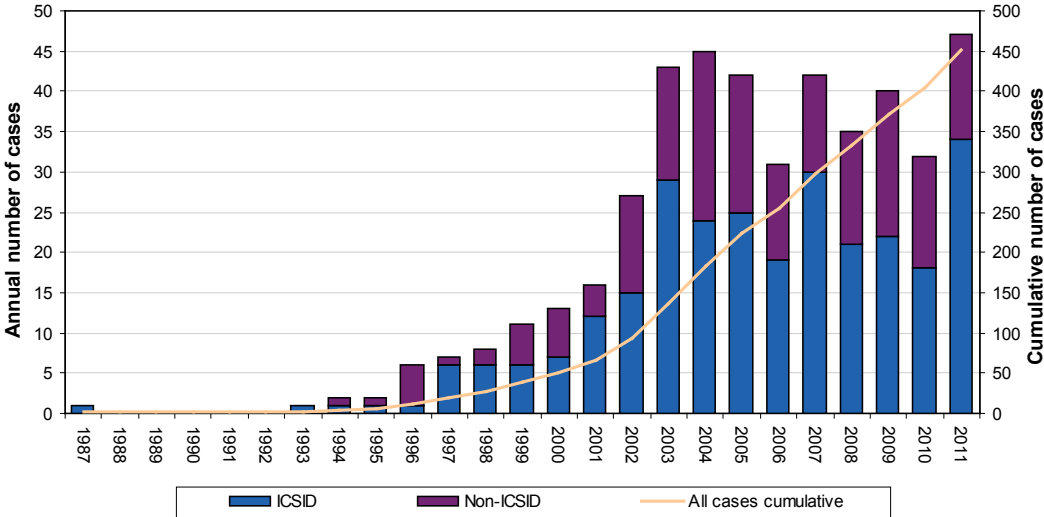
Source: UNCTAD



For the UK, as one of the world’s largest outward investors, BITs have been an important component of policy aimed at promoting the economic interests of companies overseas. Since signing its first BIT with Egypt in 1975 the UK has signed 106 BITs, mainly with developing countries, of which 94 have been ratified.

Despite this, until quite recently there was little evidence on the effectiveness of BITs in achieving their stated objectives. Moreover, in recent years there have been growing concerns around the potential costs imposed by BITs and that the costs might favour large businesses and dissuade medium and small businesses. In particular, since the mid-1990s there has been a sustained rise in the number of investor-state disputes under BITs (partly the result of an increase in the number of BITs in force)<sup>16</sup>. Some have questioned whether the benefits from BITs in attracting FDI outweigh the potential negotiation, litigation and sovereignty costs to host states associated with them, as well as whether the additional protections afforded to foreign investors are fair.

**Figure 6: Known investor-state treaty disputes**



Source: UNCTAD

The econometric literature that has emerged has not provided conclusive evidence on the impact of BITs, though a number of tentative conclusions can be drawn. The following sections explore these conclusions, identifying some of the difficulties in analysing the impact of BITs (which are common to the problems of estimating the determinants of FDI more generally), as well as a summary of the economic theory behind BITs.

<sup>16</sup> This is a worldwide trend. To date, the UK has not been the subject of a successful claim by an international investor.



## **The theory and econometric evidence on the effectiveness of Bilateral Investment Treaties**

One of the central aims of BITs is to reassure investors that their assets will be safe in a foreign country, promoting an increase in foreign investment in signatory countries, particularly developing countries. The theory supporting BITs suggests they can promote investment by providing a signal to foreign investors that their property rights will be respected if they invest in the country. In addition, BITs can be used as a mechanism to provide a credible commitment to investors that they will have access to compensation, should the country choose to renege on its agreement. BITs have, therefore, been proposed as an effective substitute for institutional quality.

Some econometric studies find that signing BITs does lead to an increase in foreign investment in signatory countries. Neumayer and Spess (2005) find that the cumulative number of BITs signed by a developing country has a large and significant effect on the amount of FDI flowing into that country. Similarly, Haftel (2007) shows that developing countries that have signed a BIT with the US experienced a 0.2 percentage point increase in their FDI/GDP ratio. This translates into a doubling of foreign investment flows given the average FDI/GDP ratio in these countries before signing a BIT was 0.2 percentage points. These findings are supported by other studies by Salacuse and Sullivan (2006), UNCTAD (1998) and Egger and Merlo (2007).

In contrast to this, a number of studies find BITs only have a small and declining impact on FDI. Elkins et al (2006) show that BITs provide developing countries with an advantage in attracting investment, but that this advantage falls as the number of BITs in force in other developing countries increases. Yackee (2007), on the other hand, finds that BITs only lead to a rise in FDI in politically stable countries. This finding goes against the standard theory that BITs act as a substitute for institutional quality in developing countries. Instead, it suggests BITs are complements to institutional quality which could be explained by the issue of reverse causation explained below.

Other studies go further, concluding BITs have no impact on the amount of foreign investment flowing into a country. An early empirical study by Hallward-Driemeier (2003) indicates that the rise in the amount of FDI covered by investment treaties is probably the result of the increase in the number of BITs as opposed to an increase in the amount of investment stimulated by BITs. Gallagher and Birch (2006) and Aisbett (2007) find a strong positive correlation between signing BITs and foreign investment, but show the rise in FDI is explained by other factors, such as the size, growth and macroeconomic and political stability of a country.

### **Practical issues in analysing the impact of Bilateral Investment Treaties using econometric techniques**

In principle, it would seem uncontroversial that an investor would prefer to invest in a country where a BIT is in place over one where such protections do not exist. That

this may not be observed in all of the econometric studies could be the result of a number of practical issues which make it difficult to estimate the impact of BITs using econometric techniques. Perhaps the most important of these issues is reverse causation and this, along with some of the other practical issues, are highlighted below.

Reverse causation may occur if the rise in foreign investment flows into particular countries prompts outward investor governments to pursue the signing of a BIT with that country to protect their investors, rather than BITs being signed and then leading to a rise in foreign investment in the foreign country. This endogeneity is difficult to take account of and may be the main driver of the positive link between BITs and foreign investment identified in the econometric studies.

Not all BITs are the same. Whilst BITs have typically been based on draft conventions aimed at establishing multilateral agreement on investment protection, they can differ in the types of investment they protect, at what point in the investment cycle they take effect and the access they provide to dispute settlement. On the issue of dispute settlement, Yackee (2007) finds that nearly a quarter of BITs do not provide full, guaranteed access to dispute settlement in the event a country breaches the treaty. This difference could mean investors value some BITs more highly than others and that the most valued BITs have a greater impact on FDI, but this is typically difficult to account for in econometric estimates.

As identified in Figure 5 above, BITs are not the only investment protection agreements in place. Other agreements, such as investment protection chapters in free trade agreements like NAFTA Chapter 11, may be partly or wholly responsible for the rise in foreign investment attributed to BITs in some studies. Where these agreements are accounted for the difficulty of determining the degree of protection they provide, and therefore their value to investors, remains.

BITs may be signed but not ratified. In most instances a signed treaty will need to be ratified by each country before it formally enters into force. Treaties which are signed and not ratified provide no investor protections and may actually deter investment by adding uncertainty. The distinction between signed and ratified BITs is not always captured correctly in the econometric studies.

The quality of the FDI data is poor. FDI data does not necessarily capture who the ultimate parent of the investment is. This means it may be incorrect to infer from the data why investors appear to invest in particular countries. In addition, at a detailed level, due to the lumpiness of flows the data may be restricted for disclosive reasons, restricting the extent of the analysis. This lumpiness also presents problems with using flows data which is often relied upon for econometric studies.

Other factors may drive the rise in investment which are difficult to control for. Hallward-Dreimer (2003), for example, emphasises that Japan is the second largest source of FDI but has only signed four BITs. In addition, Brazil is one of the main beneficiaries of FDI and has ratified no BITs<sup>17</sup>. There are also instances where major structural changes are partnered with the signing of BITs, as was the case with Eastern European countries after the collapse of the Soviet Union.

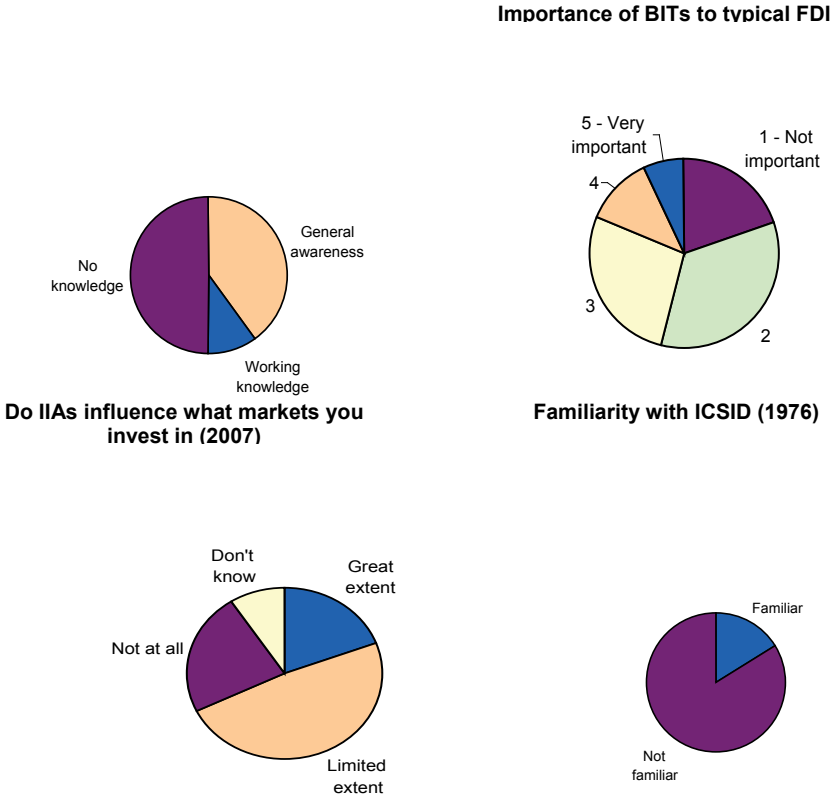
### **Evidence on the link between BITs and FDI using alternative analytical methods**

Given the difficulties associated with using econometric techniques to estimate the impact of BITs, some researchers have turned to alternative approaches. As in the case of the wider literature on firm location determinants, some survey based evidence has emerged which assesses investors' familiarisation with BITs and consideration of investor agreements when deciding where to invest. A few of the results from these surveys are captured in Figure 7 below.

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<sup>17</sup> ICSID data shows Brazil has signed 15 BITs, all between 1994 and 1999, but has ratified none of them.

**Figure 7: Survey evidence on the link between BITs and FDI**



Source: European Commission, 2000 (top left), Yackee, 2010 (top right), Shrinkman, 2007 (bottom left), Ryans & Baker, 1976 (bottom right)

The surveys suggest that whilst BITs may not be universally important to all investors, they are important to some. One survey of 602 corporate executives found that around a fifth of corporate executives took into account International Investment Agreements (IIAs) to a great extent when deciding where to locate their investment (bottom left). Another survey of 300 European investors carried out by the European Commission found that whilst 50% of investors did not know what BITs were, 10% had a working knowledge of BITs and 40% were generally aware of their existence (top left).

These surveys are not without their limitations. Some are based on small samples and it is often difficult for the surveyor to effectively target the correct person in each firm to answer the survey. Also, those reporting a working knowledge of BITs may only have acquired their knowledge of BITs through an investor-state dispute, rather than knowing of BITs before they invested in the country.

To corroborate these results, Poulsen (2010) tackles the question of the impact of BITs from a different angle, considering whether political risk insurance providers take into account the presence of BITs when calculating risk premiums. This would mean that investors may indirectly price the BIT into their investment decisions when

seeking insurance. Based on surveys of public and private political risk insurance providers, Poulsen finds BITs are only one of a large number of factors taken into consideration by public providers, and they are largely ignored by private providers.

In summary, it is unlikely that BITs have been a major driver of the surge in outward FDI that has been seen over recent decades. That does not mean BITs are irrelevant as a policy instrument. Instead, it appears there are a small but not insignificant proportion of investors that do incorporate BITs into their investment decisions. Understanding what types of investors do consider BITs in their investment decisions is key, and this is an area where future research could be targeted.

## 6. Conclusion

Although the available evidence on the impact of outward investment on the UK is relatively limited compared to inward investment, the evidence that has emerged suggests outward FDI has a positive impact on the UK economy. Outward FDI increases productivity, profitability and competitiveness of UK firms. It generates earnings and complements exports which also contribute to economic growth. It does lead to some negative impact on low skilled labour, but at an aggregate level it has a neutral or positive effect on UK employment.

Research shows that the main determinants of where international investors locate are the economic and business environment in the host country. For example, the market size, infrastructure and political and economic stability all play a central role in international investment decisions.

One instrument which can be used to improve the business investment environment is Bilateral Investment Treaties (BITs). These promote and protect investment abroad and have been adopted by many countries. The evidence on the effectiveness of BITs is largely inconclusive, particularly given the many practical difficulties encountered when analysing their impact using econometric techniques. However, survey evidence has emerged which suggests that whilst BITs are not important to all, they are important for some international investment decisions

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