RETHINKING INTERNATIONAL INVESTMENT GOVERNANCE:

Principles for the 21st Century

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1. PRAISE FOR *RETHINKING INTERNATIONAL INVESTMENT GOVERNANCE: PRINCIPLES FOR THE 21ST CENTURY*

Investment law has often been regarded as an isolated regime intended to ensure investors' benefits. This book radically rethinks such law as a component in global economic governance, and suggests changes to realign it with the Sustainable Development Goals, including the reduction of poverty and inequality. [The book] makes an original, well articulated, and solid contribution that will become essential in any process aiming at the reform of that regime.

Carlos Correa, Executive Director, South Centre

Foreign direct investment (FDI) holds tremendous potential to enhance economic growth and welfare. But FDI can also be beset by corrupt practices, market distortions, and environmental damage. To secure positive outcomes and avoid damaging results is an important objective for individual countries as well as global institutions. *Rethinking International Investment Governance: Principles for the 21st Century* provides a comprehensive assessment of rules and regulations that govern FDI activities, and proposes reforms to help rebalance

the rights of international investors and host states. This research will become the "go-to" work for academics and policy-makers alike.

Theodore H. Moran, Marcus Wallenberg Chair in International Business and Finance at the School of Foreign Service, Georgetown University

The neoliberal economic order based on the facilitation of global trade and investment, is being questioned. A significant part of this process relates to international investment law and investor-state arbitration. In recent years a system of privatized international economic law has come to dominate the relations between multinational enterprises and host states. This is based on a network of Bilateral Investment Treaties (BITs) that began in the years of post-World War II decolonization. No one then knew or foresaw how this system would develop. BITs lay dormant for many years until, in the 1990s, enterprising lawyers discovered the power of BITs, not least because they contained provisions for international investor-state arbitration. These treaties could be used to rescue foreign investors and their investments from deals that had gone wrong. In many instances, they had a good case against a host government that had abused its political and/or legislative power to undermine a good, productive, investment. However, more recently, BITs have gone further and have become a threat, inhibiting governments from the legitimate pursuit of public policy and development goals. A useful corrective for maladministration has turned into a private weapon of anti-government. Possibly good for business but bad for too many others.

This book seeks to assess and resolve the situation. It outlines how the system of BITs and investor-state arbitration has gone wrong, how the system needs to face up to the challenges and threats to humanity that the UN Sustainable Development Goals seek to correct, and how it can be rebalanced to meet those goals. Written by a team of expert authors, this short overview acts as an essential starting point for any interested person who seeks an accessible primer on the subject. It encapsulates the main trends of debate admirably and succinctly and leads the reader to thought-provoking answers. The authors are not under the illusion that changing the system of international investment law and arbitration will be straightforward: vested interests are powerful and

influential. However, it offers a road-map to change, which is always the first step toward it. I can recommend this book wholeheartedly.

Peter Muchlinski, Professor of International Commercial Law,
SOAS University of London

This book makes a compelling case for revamping the current international investment regime. It shows that the expansive interpretation of the principle of "fair and equitable treatment" of foreign investors by arbitration tribunals sometimes puts their rights ahead of those of domestic investors and, more importantly, of the social and environmental rights of citizens in a given territory. The book proposes, therefore, redesigning the regime as a system of governance based on basic principles and substantive priorities, restoring the regulatory autonomy of nation-states and the role of national court systems, while recognizing that international cooperation on investment-related issues is crucial for advancing sustainable development.

Jose Antonio Ocampo, Professor of Professional Practice in International and Public Affairs, Columbia University School of International and Public Affairs

These authors show us how investment law can and should be reimagined to advance the Sustainable Development Goals (SDGs). They go digging into the innards of the investment law system to make visible the difficulties and the insufficiencies. And then they give us a range of findings, observations, and critiques that show us how it could be done.

Saskia Sassen, Robert S. Lynd Professor of Sociology, Columbia University

The international investment law and policy regime is undergoing rapid change. Who would have predicted, three years ago, that, in 2017, UNCITAL would begin discussing the establishment of a multilateral investment court and the WTO a multilateral framework for investment facilitation? It is therefore very timely to discuss, from a critical perspective, weaknesses of the regime and outline how they can be remedied. Anyone interested in this discussion will find this slim booklet very useful.

Karl Sauvant, Resident Senior Fellow,
Columbia Center on Sustainable Investment

This innovative work, written by accomplished experts on various aspects of foreign direct investment, debunks many foundational myths of international investment law. These myths include the assertions that investment treaties invariably lead to greater investment flows, and consequentially to economic development, and that investor-state arbitration is a neutral method of dispute settlement. It is easy to be iconoclastic. The merit of the work lies in the fact that it is incredibly creative in suggesting an alternative formulation of governance standards that achieve desirable core values such as the eradication of poverty and the promotion of human dignity. The alternative formulation promotes sustainable development and avoids the fragmentation of international law by giving weight to other obligations that a state has under the law. The notion of balancing the interests of the foreign investor with those of the state, so as to create new forms of treaties, referred to as "balanced treaties," is not in itself new, but this volume achieves for the first time a reasoned statement of how the balancing should be effected. There are normative standards for the effecting of a meaningful balance. My criticism of such proposals based on the balancing of interests is that they prioritize investment protection, reducing public interest rationales into defences or exceptions after responsibility has been established. The primary function of the state is the protection of the public, to which function all other functions must yield. Yet, the practical preference for balanced treaties will be the manner in which immediate ground for progress can be achieved. This work promotes such a practical solution. It will provide guidance on the subject for many years to come.

M Sornarajah, CJ Koh Professor of Law, National University of Singapore

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2. ACKNOWLEDGEMENTS

This book is the product of thorough discussions among a group of lawyers, economists and political scientists about the way to move past the legitimacy crisis facing the international investment legal regime.

This book was made possible thanks to the leadership of the Columbia Center on Sustainable Investment of Columbia University, which convened a small group of high-level experts from different disciplines to produce an accessible text that explains policy options for ensuring that international investment advances, and does not undermine, sustainable development within and across countries.

The authors see tremendous potential for mutual gains that could be unlocked through better cooperation on international investment governance. This book is intended to serve as a guide to understand and navigate through the current regime, address some of the critical issues and suggest possible ways forward.

The task of discussing, gathering and organizing the input from our distinguished group of authors could not have been possible if it were not for the Book Sprints drafting method (*http://www.booksprints.net*). The Book Sprints process allows for the development of a fully conceptualized, drafted, and edited book in just five days. It should come as no surprise that those five days were filled with lively conversations, scribbles on an army of post-it notes, and endless hours scrutinising text to ensure its accuracy and accessibility. The outcome is a combination of information and insight that reflects our collective

knowledge rather than the personal opinions of the authors or the institutions that they represent.

We would like to thank our Book Sprint facilitator Laia Ros for her guidance and endless patience. We would also like to thank the Book Sprints' offsite team. A special thanks to Lisa Sachs and Olivier De Schutter who had to leave early in the process of writing but whose knowledge and insights were invaluable in the early discussions, to Mcrid Wang who contributed actively during the entire week, and to Nathan Lobel for his critical editing before publication.

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3. FOREWORD

The world economy is built upon global supply chains dominated by transnational companies. The leading international powers, especially Britain during the 19th century and the United States after World War II, have used military force, diplomacy, and international law, to bolster their transnational companies, by opening overseas markets, gaining access to vital resources, and warding off threats of expropriation. In recent decades, corporate power was built into the sinews of international investment law. The world has been made safe for transnational corporate capital. This important new volume aims to change that, to make the world safe for sustainable development.

In the global capitalist system, the highest aim of international investment law has been to ensure the easy entry of multinational companies into foreign markets to grow profits. International investment law aims to give the transnational companies as many legal defenses as possible against foreign regulations that would limit their profitability or expropriate their property. As this book importantly demonstrates, the system of International Investment Agreements (IIAs), including the thousands of BITs with terms modeled on templates largely established by the UK, US, and the Netherlands, among others, are part of this elaborate system to privilege and entrench transnational corporate capitalism.

Many of the IIAs' restrictive rules favor outward investment by powerful corporations, but perhaps none is proving so damaging and wrongheaded as the system of Investor-State Dispute Settlement (ISDS) embedded in these

agreements. ISDS has introduced a system of international arbitration that gives multinational companies the right to sue host governments for alleged violations of the investment agreements before ad hoc arbitral tribunals. In practice, these arbitration tribunals have turned out to be yet another way to deter host governments, typically in developing countries, from adopting vital regulations and tax policies for the common good of their citizens where such regulations would limit corporate profits.

As the volume makes clear, ISDS injects remarkable corporate power into the relations between companies and host governments. Tribunals operate without basic standards of the rule of law and adopt legal theories that essentially bar host governments from regulating to promote public health, environmental sustainability, or social justice (including protecting the rights of indigenous peoples, routinely trampled by powerful land-grabbing companies). They do this without basic standards of transparency, rights of interested parties to intervene, in accordance with national law, or even *stare decisis* (the principle of legal precedent). Moreover, and alarmingly, the process of ISDS is becoming corrupted, with high-priced law firms and professional arbitrators working with third-party hedge-fund investors who back ISDS cases for profit. The system is evolving into a kind of extortion racket against the host governments of developing countries, with the hedge funds, law firms, and arbitrators, sharing a growing pot of awards.

The ostensible motivation of the current system is that all foreign direct investment (FDI) is good for developing countries. Therefore, it is argued, developing countries should welcome opportunities to signal their determination to maintain pro-investor policies. ISDS is a kind of enforcement mechanism that prevents backsliding after investors sink their money into investments. The problem, of course, is that not all FDI is good, not by a longshot. When foreign investment wrecks the environment, circumvents the rights of indigenous communities, pays negligible taxes on rights to minerals and other valuable natural resources, or abuses the rights of communities and workers, then the FDI should be curbed, or forced to comply with the strictures of sustainable development and other international obligations. Yet ISDS is precisely undermining the regulation of such harmful practices.

More generally, investors should not be protected from – never mind compensated for – government measures of broad application, taken in good faith to address public policy concerns. Such a perverse system distorts government accountability, prioritizing the concerns and interests of companies – and their profits – over citizens and the environment.

This volume urges the redesign of global investment law on the basis of core purposes, most importantly the promotion of sustainable development and human rights. Specifically, how should investment treaties be redesigned to support the Sustainable Development Goals, Multilateral Environmental Agreements (including the UN Framework Convention on Climate Change (UNFCCC), the Convention on Biological Diversity (CBD), and the UN Convention to Combat Desertification (UNCCD)), as well as international human rights law?

The volume offers a solid foundation for possible future reforms, by emphasizing core principles of international law (including transparency, accountability, voice, subsidiarity, and reciprocity of responsibilities), a tightening of the possible bases for companies to make claims vis-à-vis governments, a limitation on the size of damages, and perhaps even the elimination of ISDS entirely, turning the responsibility for adjudication of international investment law over to domestic courts of host countries.

With FDI a vital part of the world economy, and with the challenges of sustainable development rapidly becoming the preeminent challenges of global economic governance, this volume is timely, smart, and successful in deepening the global debate over international investment law. It will be a key reference point for scholars, development practitioners, international organizations, and civil society activists around the world.

Jeffrey Sachs
Special Advisor to the UN Secretary General
on the Sustainable Development Goals
New York, 8 August 2018

4. EXECUTIVE SUMMARY

Roughly USD 3.9 trillion in investment is needed each year to achieve the globally agreed Sustainable Development Goals (SDGs); current expenditures barely reach a third of that value, leaving a yawning USD 2.5 trillion investment gap. In order to achieve those SDGs, governments need to strategically and conscientiously engage and leverage private sector resources and strengths.

Critically, governments' ability to leverage and regulate the private sector to fulfill the SDGs is substantially determined by an international legal framework of more than 3,000 international investment agreements (IIAs). These agreements govern the flow of foreign capital and enumerate benefits for private investors and corresponding obligations for host governments. Most IIAs follow a simple chain of logic: foreign investment is necessary to promote development, and a favorable and stable legal environment is necessary to promote foreign investment.

If only reality were so simple. To be clear, foreign investment can lead to improved development outcomes through infrastructure, employment, tax revenues, technology transfer, and other economic linkages. But these are in no way automatic results of foreign investment. Rather, the ability of states to benefit from foreign investment depends directly on their ability to attract the right kinds of investments, and the tools they have to leverage and regulate investments.

This book aims to serve as a practical resource for those interested in the elements of an international investment system that promotes sustainable development and achieves legitimacy by providing benefits to all stakeholders. This is a departure from the way that the regime is currently conceived by its proponents as a system to provide investor benefits in the hope that those benefits will spill over to others.

The objective of this book is to change the terms of the debate so that societal values and goals are at the center of discussions about each reform proposal and process. This book **rethinks international investment law as a key system in global economic governance** that should incorporate principles of transparency, participation, reciprocity, accountability, and subsidiarity. The book critically evaluates the current system of investment governance in light of those principles and goals. And finally, it proposes possible reforms – including multilateral reforms – that would **realign** the governance of international investment with 21st century goals including **reduction of poverty and inequality, and protection of human dignity, the environment, and the planet**.

Achieving such reforms will require:

- **A change to policy debates around international investment law** to genuinely and robustly address justice and governance concerns as central to policy debates throughout the international investment field.
- **A change to the institutional actors who formulate, implement and enforce investment law,** to include a far broader range of institutional actors in order to ensure that values such as sustainable development, human rights, and environmental justice are put at the heart of international investment law.
- **A more consistent public engagement with the current international investment regime,** to create a more globalized and persistent investment governance movement, making a compelling case to policymakers for more substantive and radical reform.

In conclusion, this book argues that the current widespread dissatisfaction with the international investment regime is no surprise in light of its lack of alignment with the global challenges of the 21st century. Even in purely economic terms, the case for the current international investment regime is hardly robust. This is unfortunate because well-governed international investment can be a powerful tool for sustainable development.

5. INTRODUCTION

"Something is rotten in the state of Denmark," or rather, in the international investment legal regime, and the smell can no longer be concealed.

The current regime consists of international investment agreements (IIAs) that allow foreign investors to go beyond traditional investment protection goals to use off-shore arbitration processes to claim compensation for losses. The presence of such agreements can undermine a state's ability to pursue legitimate public policy aims. These claims can run into billions of dollars – sometimes substantial fractions of the revenues of the governments required to pay them. Moreover, the system as currently structured does not engage meaningfully with contemporary sustainable development challenges.

The broad-based discontent with the current regime can be heard from the streets to the meeting chambers of venerable international institutions. As countries learn the potential costs of the current regime, they are increasingly reluctant to participate in it. While some reform processes are underway, they fail to deeply engage with the system's fundamental flaws or seize the opportunity to chart a new way forward. Treaties that seek to truly reorient investment towards broader social and environmental goals are not on the political agenda. At the same time, certain states have begun terminating international investment agreements.

This book aims to serve as a practical resource for governments, foreign investors, civil society actors, and other stakeholders interested in developing an

international investment system that promotes sustainable development and achieves legitimacy by providing benefits to all stakeholders.

The 2030 Agenda recognizes that international capital flows, including foreign direct investment and the activities of multinational enterprises, are essential to achieving the Goals. The jobs which can be created by foreign direct investment, the technologies it can transfer, broader spillovers it can generate, products and services it produces, and tax revenue it can provide, are core ingredients for achieving the Agenda. However, the contributions of FDI (and other forms of capital flows) are not always positive. FDI may undermine progress in discrete locations (e.g, an MNE violating labor standards) and/or even globally (as might be the case for a company seeking to expand development of fossil fuel reserves).

In light of these issues, this book explores how the protection of foreign investors may affect the abilities of governments to address the economic, social, and environmental dimensions of sustainable development. The book also provides examples of tensions in the current regime with achieving the sustainable development goals. A tripartite solution is suggested.

First, the book recommends a paradigm shift. Instead of attempting to design a better regime of legal instruments whose central aim is to promote and protect foreign direct investment (FDI), this book **rethinks international investment law as a key system in global economic governance**. This governance system should incorporate **principles of transparency, participation, reciprocity, accountability, and subsidiarity**.

Second, guided by these principles, the book proposes concrete reforms aimed at **rebalancing the rights of international investors and host states**.

Finally, it proposes possible reforms - including multilateral ones – that would **realign** the governance of international investment with 21st-century goals, including **the reduction of poverty and inequality and the protection of human dignity and the environment**.

6. INTERNATIONAL INVESTMENT LAW: AN OVERVIEW

6.1 INVESTMENT LIBERALIZATION AND PROTECTION

At the end of World War II, the United States and the United Kingdom shaped the Bretton Woods agreements that established the Western post-war international economic order. Institutions such as the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO) reflected the economic power and preferences of the United States and the United Kingdom. Over time, these institutions fostered the post-war recovery of European allies and helped boost the economic strength of the Western industrialized countries. Many now-developing countries were still colonies at the time; as a result, they had no say in the shape of the postwar economic order.

Beginning in the 1980s, the United States and some other industrialized countries promoted the so-called Washington Consensus, a suite of market-oriented policies that included liberalization of trade and international investment and privatization of state-owned enterprises. These policies accelerated economic globalization. The 1980s debt crisis in Latin America, the fall of the Soviet Union in 1991, and the 1997/8 Asian financial crisis resulted in regional adoption of pro-market policies that led a huge swath of countries to pursue neoliberal economic policies. The gradual opening of the Chinese economy in the late 1970s under Deng Xiaoping ultimately led to Chinese

accession to the World Trade Organization in December 2001. The integration of China into the global trading system assisted its spectacular economic rise, lifting over 300 million Chinese out of poverty. A number of formerly developing countries also entered the ranks of middle-income countries.

In the late 1990s and early 2000s, the shift in economic power, the rise of Brazil, Russia, India, China, and South Africa (the BRICS), and the relative decline of the United States and United Kingdom, helped to give voice to criticism of the multilateral institutions that were legacies of Bretton Woods and the Washington Consensus version of globalization. Dissatisfaction increased as Asian countries were forced to borrow from the IMF in the wake of the Asian financial crisis, and the IMF imposed austerity policies as a condition for lending. The resultant required draconian cuts in government spending harmed citizen welfare. Other developing countries have similarly protested other measures such as the World Trade Organization (WTO) Agreement on Trade-Related Intellectual Property Rights (TRIPs), which held the price of critical drugs high while the HIV/AIDS crisis caused millions of needless deaths in the early 2000s.

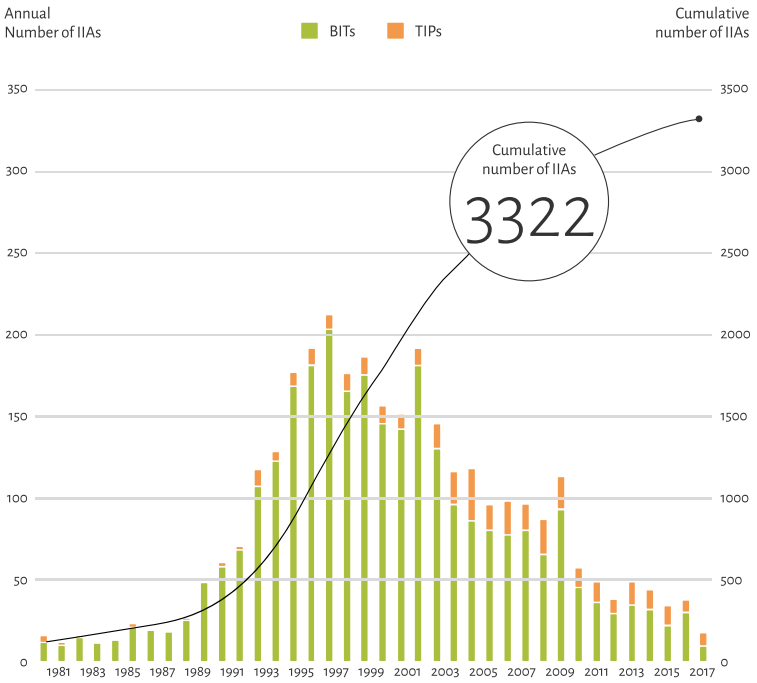
Multilateral institutions also faced strong pushback against efforts to establish rules on investment liberalization and protection. For example, the Agreement on Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS), incorporated into the WTO during the Uruguay round, were perceived as weak from the point of view of foreign investors seeking expansive rights of establishment and the elimination of restrictions on foreign investment. Dissatisfied with the result, capital-exporting states continued to push for an agreement that would have more bite. The Multilateral Agreement on Investment was a plurilateral attempt among the Organization for Economic Cooperation and Development (OECD) countries to craft a multilateral treaty that would give significant protections for foreign investors. The negotiations were conducted in secret between 1995 and 1998, until divisions between the US and European countries, and an energized civil society protest campaign, brought the negotiations to a halt.

In the face of multilateral stalemate, the industrialized countries pursued a vertical forum-shifting strategy and engaged in bilateral, regional, and

plurilateral negotiations, to seek agreements on a range of topics that could not be achieved at the multilateral level.

The shift to vertical agreements allowed stronger parties to more effectively leverage their economic power over weaker parties and to negotiate better deals than they could achieve at the multilateral level. One result has been a huge spike in the number of bilateral, regional, and plurilateral investment agreements.

DIAGRAM *Number of IIAs*



Thousands of bilateral investment treaties have been signed since the mid-1990s, and there have been a number of significant negotiations at the regional and plurilateral levels. These include early regional agreements, such as the North American Free Trade Agreement (NAFTA, 1994) and sectoral agreements such as the Energy Charter Treaty (ECT, 1998), and, more recently, texts such as: the Association of Southeast Asian Nations (ASEAN) Comprehensive Investment Agreement (2009); the 12-country Trans-Pacific Partnership Agreement (TPP, 2016), which subsequently became the 11-country Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP, 2018); the Protocol for Cooperation and Facilitation of Intra-MERCOSUR Investments (2017); the Pacific Agreement on Closer Economic Relations (PACER) Plus (2017); and the Regional Comprehensive Economic Partnership Agreement (RCEP) (launched in 2012 with negotiations continuing into 2018).

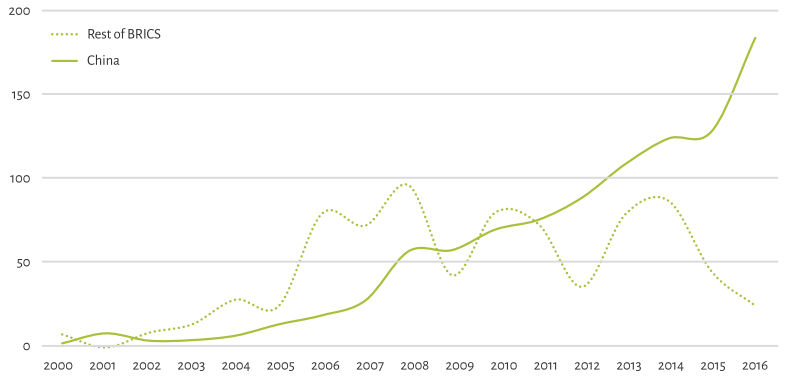
While many investment treaties owe their origin to power asymmetries among negotiating parties, with capital-exporting states seeking to impose strong investor protection obligations on capital-importing states, there has also been a view among at least some of those capital-importing countries that foreign direct investment would bring economic growth, and that the investment treaties could be useful, if not necessary, tools in attracting such investment.

6.2 CURRENT TRENDS

Today, some states (and their citizens) are pushing back against investment protection treaties. One key criticism is that the treaties are overly favorable to investors and overly restrictive for domestic regulatory autonomy. As an aspect of deep economic integration, investment treaties reach far into domestic regulatory regimes and may constrain a country's ability to regulate for environmental, social and economic objectives. Another mounting concern is that the treaties fail to deliver hoped-for benefits in terms of foreign direct investment promotion (and subsequent economic growth). A number of states, including Brazil and South Africa, have consequently rejected the IIA and the investor-state dispute settlement approach. Indeed, even long-time supporters of investment treaties and their investor-state dispute settlement provisions have recently changed course and highlighted concerns with those agreements. In 2017, the United States announced it would seek to excise the investor-state dispute settlement from the North American Free Trade Agreement (NAFTA), and in 2015, the European Commission declared that an investor-state dispute settlement is not suited to resolution of investment treaty disputes, and it began publicly pursuing development of alternative models.

But while IIAs and investor-state dispute settlement provisions have gained new foes, they have also apparently secured some new allies. In particular, China is signing IIAs with more countries each year, and countries with large sovereign wealth funds like the UAE have also recently been intensifying their pursuit of such treaties.

DIAGRAM *China v. Rest of BRICS Outward Foreign Direct Investment Flows 2000-2016 (in USD Billion)*



Source: UNCTAD

6.3 CRITICISMS OF THE CURRENT REGIME

The current international investment law regime has been criticised for a range of reasons. This chapter identifies some of the key critiques but is not meant to be exhaustive.

International Investment Agreements (IIAs)

Each state is free to negotiate its own international investment agreements. But there is often a misconception about the nature of investment treaties. Such treaties have long been seen as instruments of economic diplomacy, and often they have been signed in the margin of a bilateral diplomatic visit, without the involvement of key actors such as labor unions, civil society, and others. The process of designing investment treaties is still generally not inclusive enough to ensure that treaties being negotiated will serve the best interests of the state and people.

All international agreements impinge, to some extent, on a state's sovereign powers. Few international agreements, however, intrude as powerfully into a state's ability to regulate as do IIAs. International Investment Agreements give foreign investors (but not domestic investors or other constituents) the ability to

challenge conduct by host states, including laws and policies governing a range of public interest issues (such as tax policies, labor laws, and environmental laws).

For instance, the "fair and equitable treatment" (FET) standard has emerged as the provision most frequently invoked by investors in legal cases. It has also been the most common basis for successful claims. FET provisions have been interpreted by investment tribunals to include a right to a "stable and predictable regulatory environment" that does not frustrate investors' "legitimate expectations." Given the vague nature of the words "fair" and "equitable," and the varying interpretations given to the FET concept by tribunals, it is exceedingly difficult for governments and others to know what the standard requires or when it has been breached. This can lead to a "chill" or restraint on the formulation and/or exercise of government regulatory power. It also can generate unnecessary and undesirable litigation.

Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States (2003) *provides an example of a tribunal's interpretation of fair and equitable treatment that severely constricts a government's rights to act. This case was brought under a bilateral investment treaty between Mexico and Spain. The investor, Tecnicas Medioambientales, was awarded US$ 5.5 million in 2003 when renewal of the license for a hazardous waste facility was denied for environmental reasons. The tribunal said that fair and equitable treatment requires the government "to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments," concluding that the lack of fair and equitable treatment amounted to indirect expropriation.*

These broad protections are available to a wide range of foreign investors and investments. The definition of an investor eligible for protection is so broad that a foreign investor can gain the benefits of a treaty by simply incorporating an entity in the home country, without any substantive business activity or management control in that country. The result is that investors can shop for

treaties that are most investor-friendly. Additionally, foreign investments can benefit from treaty protection irrespective of whether that investment contributes to sustainable development in the host country.

The case Philip Morris Asia Limited v. Australia *(2012) exemplifies the temptations of treaty shopping. In November 2011 Australia enacted the Tobacco Plain Packaging Act. Until February of 2011, Philip Morrris Australia had been owned by its Swiss parent, Philip Morris International. However, Philip Morris Asia, based in Hong Kong, suddenly acquired all of the shares of Philip Morris Australia so that it could file an investor complaint against Australia. As a result of the acquisition, Philip Morris was able to rely on the Hong Kong-Australia Bilateral Investment Treaty (BIT) to assert investor rights and claim that the regulation affected its investment, Philip Morris Australia. Without shifting its investment, Philip Morris would not have been able to challenge the Australian regulation because there is no BIT between Switzerland and Australia. This move backfired, however, and the tribunal found that Philip Morris' hasty restructuring to avail itself of the Hong Kong-Australia BIT constituted an abuse of process. Nevertheless, the tribunal in this case and in others seem to have converged around the view that it is "uncontroversial that the mere fact of restructuring an investment to obtain BIT benefits is not per se illegitimate," but that such treaty shopping may not be permitted if done to gain treaty protection to help resolve a specific dispute that has already arisen or is foreseeable (para 540). Australia also had to bear significant costs, not covered by the investor, for defending the case.*

Issues with international investment agreements are exacerbated by their interactions with investment contracts. By virtue of the umbrella clauses in IIAs, contractual obligations become "internationalized," therefore giving investors the right to claim under both IIAs and investment contracts. This situation has in some instances resulted in parallel proceedings that could affect regime consistency and allow the investor to pursue multiple claims against the state in different venues. More generally, IIAs and ISDS permit investors to pursue contract-related claims against the state in multiple fora.

Following the 2007 expropriations of their heavy crude oil projects in Venezuela, ExxonMobil and ConocoPhillips pursued cases under ICSID, pursuant to the bilateral investment treaty between the Netherlands and Venezuela. Both investors also filed ICC cases for the same expropriations against PDVSA, the Venezuelan state-owned petroleum company, under arbitration provisions in their contractual arrangements. Similarly, following the denial of a mining license in 2011, the Australian subsidiary of Barrick Gold and Antofagasta filed an ICSID case against Pakistan under the Australia-Pakistan bilateral investment treaty and a parallel case against the province Balochistan under ICC rules and arbitration provisions in an investment contract.

IIAs therefore grant extensive rights to a wide range of foreign investors against host states. They do so without imposing any reciprocal obligations on those investors. Where broader concerns such as human rights or sustainable development are included within IIAs, they do not, for the most part, demand action from investors or states. As a result, the legal framework for investment operates on an understanding of justice where fairness to investors is the dominant principle.

Investor-State Dispute Settlement

Investor-State Dispute Settlement is the system through which investors can sue countries for alleged treaty breaches in front of panels of international arbitrators. When claims are successful, damages in individual cases can amount to hundreds of millions, if not billions, of dollars, which can be a huge financial burden for states, particularly smaller developing countries, or countries facing financial crises. Even if countries successfully defend cases, they can be left with millions of dollars of legal bills and suffer long-term reputational costs.

In the dispute between Tethyan Copper v. Pakistan (2012) in the Reko Diq project, the claimants are reportedly asking for damages in the amount of US$11.5 billion. The claim is based on the denial of a mining license to the claimants, who contended that they had invested around US$500 million in the purchase of the rights and in exploration and related activities which the mining operation had not established. In 2018, when the damages portion of the case was being heard, Pakistan's foreign exchange holdings amounted to less than US$18 billion, while the annual federal budget was around US$40 billion. The claimants are also seeking damages from the provincial Balochistan government. Balochistan is Pakistan's poorest and least populous province, with more than half the population living below the poverty line and an annual government budget of around US$3 billion. This claim is still in progress.

Until the early 2000s, investors only infrequently turned to ISDS to resolve investment disputes with host states. However, since then, investors have increasingly relied on expansive interpretations of vaguely-drafted provisions in IIAs, national investment laws, investment contracts, and the dispute resolution provisions contained within such agreements, to sue host states for alleged violations of treaty or contractual obligations. This practice of "contract, treaty and forum shopping" has contributed to the multiplication of ISDS cases. Litigants place their court cases in the court system perceived most likely to find in their favor. Accordingly, the legitimacy of the whole ISDS system has been affected and put into question.

The International Centre for Settlement of Investment Disputes (ICSID) and the Permanent Court of Arbitration (PCA) are the two primary institutional hosts for international investment arbitrations. Each organization offers some secretariat and administrative support, and in certain cases will appoint a third arbitrator if the arbitrators for competing parties cannot agree. The most commonly used arbitration rules to govern the cases are produced by ICSID and the United Nations Commission on International Trade Law (UNCITRAL). While there are important differences in these rules and institutions, all have been critiqued on various issues including their approaches to transparency, third party rights

(although this has started to change), systems for adjudicator appointment, and a lack of regulations against the involvement of third-party funding.

There are limited grounds for reviewing arbitral awards. In the case of ICSID, awards can be annulled only on very limited grounds. Since 2011, only 3% of cases have been annulled (ICSID Background paper on annulment, 2016). Awards issued under the auspices of other arbitral institutions can be challenged before domestic courts also on narrow grounds. But overall, under no circumstances can awards be challenged for inconsistency or incorrectness.

Divergent interpretation by arbitral tribunals of identical treaty clauses has led to a fragmentation of ISDS case law, thereby undermining the confidence of many countries in the system. This lack of confidence has been exacerbated by the fact that cases are litigated and decided by a small professional community of arbitrators and counsels who generally hail from western countries and elite socio-economic backgrounds. Furthermore, the systematic use of ISDS has excluded national courts from the process of hearing disputes involving public law/policy matters.

6.4 CONCLUSION

Investment treaties have been signed between states for many years. However, in the period since the 1990s, the numbers of investment treaties have expanded greatly. As they have become more prolific, IIAs have also faced increasing criticism from states, civil society and a range of other actors. IIAs grant extensive rights to investors and intrude into the sovereign powers of states and their rights to regulate. At the same time, they empower investors to bring cases through a troubling ISDS process that regularly awards large sums of damages. The concerns identified in this chapter are compounded when considering the evidence to support the economic case for IIAs, which has been traditionally used to justify this strong system of enforcement of investors' property rights.

7. AN ECONOMIC CASE FOR INTERNATIONAL INVESTMENT AGREEMENTS?

7.1 INTRODUCTION

Many claim that IIAs are economic policy tools that promote FDI. This chapter provides a succinct analysis of the economic arguments in support of IIAs. While the focus of the analysis is the host country perspective, this chapter also considers investors' home countries' interests.

The bottom line is that there is a possible case that IIAs affect FDI flows, but even this does not create a clear economic case for investment treaties. On the one hand, there is some evidence that investors and host states both believe that IIAs enhance the legal environment for foreign investment in host states, and that if these host states do not have IIAs, transactions may be more costly. On the other hand, the fundamental theoretical argument for IIAs is not strong, and the empirical evidence that IIAs promote FDI is complicated. Most importantly, there are strong reasons to shift the focus of the economic debate away from the aggregate FDI flows that IIAs might support.

In short, economic analysis supports the claim that the governance of international investment needs rethinking if it is to meet its potential to deliver broad-based economic benefits.

Before analyzing the economic case for IIAs, it is important to briefly introduce the economics of the FDI that they are supposed to promote.

Why and Where Does Foreign Investment Happen?

International investment occurs for a variety of reasons. These include: **reducing costs** (including labor); **accessing natural resources** (including fossil fuels, rare minerals, and arable farmland); **capturing strategic assets** (including technologies and brands), and **accessing markets** (including platforms for production close to markets). Market-seeking FDI will flow preferentially to the largest markets – often those with higher incomes and/or larger populations. Resource-seeking and asset-seeking FDI will flow to countries that have the resources and assets investors seek, and production cost-saving FDI will flow to countries in which the cost of labor or operations are low relative to productivity. These categories of FDI map, therefore, to the size and other characteristics of the host country.

Government policies can also have an impact on investment flows. Tax policies, particularly those providing preferential treatment of foreign firms – may attract more FDI. Other factors claimed to affect FDI attractiveness include the quality of domestic legal institutions, the quality of infrastructure, trade openness, and financial integration.

What Impact Does Foreign Investment Have on the Host State?

Most governments in the world seek to encourage foreign direct investment because of the many benefits it is believed to bring. The possible benefits of FDI include a transfer of knowledge and technology, tax revenue, foreign finance, greater connection to global value chains, expanded employment, higher wages and export earnings.

Foreign investment does, however, have some potential downsides. Some investors, for instance, exploit both workers and natural resources, drive out local businesses, and use their substantial market power to extract excess profits.

The balance of these positive and negative impacts depends on a combination of the host company's characteristics (such as population, level of development, and quality of institutions), policies, and the type of investment.

DIAGRAM *Impacts and drivers of FDI*

Drivers	Potential impacts
Reducing costs	Transfer knowledge
Accessing natural resources	Transfer technologies
Capturing strategic assets	Tax revenue
Accessing markets	Export earning
	Foreign finance

7.2 HOST STATE PERSPECTIVE

Countries all over the world promote their economies as attractive destinations for FDI in order to generate benefits such as tax revenue, job creation, transfer of technology and know-how. Developing countries, in particular, are encouraged to attract FDI in order to realize economic benefits. Though they may participate in these agreements for diplomatic reasons, the raison d'etre for IIAs is economic: to encourage inbound FDI.

What Is the Theory of Why IIAs Should Attract FDI?

When companies make international investment decisions, one of the factors they consider is political risk. Political risk arises from the fact that host government actions can negatively (or positively) affect the profitability of a company's investment. Host governments vary in the predictability of their policy and regulatory environments and in the quality, effectiveness, and independence of their legal systems. Hosts that have unpredictable policies or unreliable legal systems may fail to attract the level of foreign investment that they desire. Some argue that investors may be hesitant to invest for two reasons.

The first is that foreign investors suffer a "liability of foreignness." The argument is that foreign investors are politically disenfranchised (they do not have the

right to vote) and lack close familial or personal connections to government. As a result, host governments are biased against them as compared to domestic actors. This bias, if it exists, can lead to the regulatory environment being prejudiced against foreign investors in order to provide an advantage to domestic competitors. Bias towards domestic constituents could also lead to so-called "over-regulation" of the company's activities. For example, environmental regulations may be too stringent because the costs of these to the foreign investor are ignored.

The second argument made by proponents of IIAs is that there is an "obsolescing bargain" between the host and the foreign investor. The basic argument is that before the investor makes their investment, the host has an incentive to offer excellent conditions in order to encourage the investment. Once the investment has occurred, the investor usually has "sunk costs." That is, the investor has incurred some costs that cannot be recovered if it withdraws from the country. The presence of these sunk costs means that the investor is unlikely to shut-down or pull out from the country, even if the government makes some changes that are unfavorable to it. The argument goes that host governments exploit this and routinely make changes post-investment that shift the distribution of benefits toward it and away from the investor.

International investment treaties – particularly those that include investor-state arbitration – can help formalize a host government's commitment to sustaining their policies toward an investment in ways that are favorable to the investor. For example, if a government tries to nationalize part of an investment, the investor can threaten to bring a dispute to investor-state dispute settlement. If the threat of a dispute does not change the government's policy, then the investor may choose to bring the dispute to arbitration and may successfully win compensation for part or all of its losses. This combination, of deterring adverse government actions and providing some insurance in the case that an adverse action occurs, lowers the expected losses from political risk (Aisbett, Busse, Nunnenkamp, 2017). In some cases, the resulting increase in expected profitability can make the difference between whether an investment occurs or not. As a result, more investment should flow to the host country than it would in the absence of an IIA.

Some commentators have also suggested that participating in investment treaties might act as a signal to investors that the host government is offering a favorable investment climate. While a desire to signal this intention may be one of the motivations for host governments to participate in these agreements, neither economic theory nor empirical evidence particularly supports this idea. In particular, if participation in agreements is being used to act as a signal of a favorable investment climate, only countries with favorable investment climates should participate in them. The empirical pattern of agreement participation is, however, quite different. Countries with favorable investment climates do not have as much need to sign treaties in order to attract more investment.

Why Might IIAs Not Actually Increase Investment Flows?

A primary reason that international investment treaties might have little effect on FDI flows is that the need for these agreements is less than their proponents claim.

First, while the regulatory framework of a host country can be enabling, the economic determinants are key, including available resources, infrastructure, technology, markets, skills, and costs.

Second, the argument that there is greater systematic bias against foreign companies than there is against domestic actors is questionable. The revenue-generating potential of foreign investments is likely to mean that they are naturally given priority over concerns that have less money attached to them, including environmental protection or the protection of marginalized communities.

A recent paper by Aisbett and Poulsen (2016) also provides evidence that foreign companies are – if anything – treated more favorably than similar domestic

companies. Furthermore, the extent of this favorable treatment was found to be greatest in the poorest countries.

The theoretical basis of the obsolescing-bargain argument is also questionable. The obsolescing-bargain argument holds in the situation where the government does not care about its reputation or expect any future interactions with the investor. The reality, however, is that host governments which are trying to attract foreign investment care a great deal about their reputations and hope that existing investors will invest more in the future. The host will not change its treatment of the investor simply because costs have been sunk. The bargain between host and investor does not obsolesce. In this case, the investment agreement has no effect on FDI flows because it is a tool to solve a problem that did not exist.

Another reason that IIAs may not cause substantive increases in investment flows may be the existence of alternative mechanisms to protect investors. These mechanisms include strong contractual protections (such as pledges over government assets), government guarantees, and political risk insurance. These mechanisms are very popular in large infrastructure project finance and public-private partnership transactions.

What Is the Evidence that IIAs Attract More Foreign Investment?

Numerous studies have used econometrics (specialized statistical techniques) to try to test whether participating in investment agreements leads to an increase in the amount of foreign direct investment entering the country. There have also been multiple reviews of this literature (Sauvant & Sachs, 2009; Pohl, 2018). The reviews show that the studies often find conflicting results. The inconsistencies arise both from differences in data and different methods of analysis.

Some broad patterns do emerge across the empirical studies of the link between participation in IIAs and foreign investment flows. As a general rule, the correlation between participation in the agreements and investment flows is greatest for the eastern European states during the 1990s. The problem with this is that the 1990s was a period of enormous change in these economies. The fall of the Iron Curtain resulted in a revival of economic ties with western countries that until then had been prohibited.

For African states, the correlation between treaty participation and investment flows tends to be the weakest. The recent study by Aisbett et al. (2017) also finds that the investment-promoting impacts of participation in a treaty are conditional on the host never having been the target of an investment claim.

Of course, all of these empirical studies are only as good as the data on which they rely. A recent study by the OECD provides an excellent discussion of the limitations of this data and its implications for the reliability of the findings of the studies (Pohl, 2018 and "What Does FDI Actually Measure" box below).

Is the Focus on FDI Flows Justified?

The relationship between participation in IIAs and investment flows has been the focus of much of the policy debate as well as the academic literature. There are, however, several arguments against focusing only on the value of investment flows.

DIAGRAM *Long and short pathways to sustainable development*

Primary amongst these is that the real interests of host states revolve not around the foreign investment itself but rather around the tax revenue, development, jobs, and positive spillovers that foreign investment can - but does not necessarily - bring. Realizing these benefits depends on host government policies, investment characteristics, and the tools available to attract, leverage, shape, and regulate investments.

For some governments, for whom infrastructure investments are a priority, IIAs are perceived as helpful, not necessarily or only for attracting investment flows, but for reducing the need for government securities and international

investment insurance for infrastructure investments. IIAs are perceived to reduce the cost of insuring the investor against political risk, which, in major project finance transactions would typically increase the cost of borrowing for the host state.

There are other reasons to caution against using impacts on FDI flows as the measure of whether IIA participation is good policy. Economic theory shows that it is possible that IIAs generate too much foreign investment, to the detriment of the host state. For example, Aisbett, Karp, and McAusland (2010) show that by providing protections to foreign investors that are not available to domestic investors, IIAs can allow foreign investors to crowd out more efficient domestic investment.

IIAs may also encourage the wrong investments. Aisbett, Karp, and McAusland argue that the implicit insurance provided by IIAs to foreign investors against host regulatory changes is most valuable to firms investing in industries that are most likely to be regulated. Industries that have the potential to cause significant social or environmental harm are, of course, among the most heavily regulated. As a result, IIAs can lead to over-investment in the industries most likely to cause harm, potentially crowding out investment in industries that bring net benefits to the host. This reminds us that the objective of the host state is not to increase FDI *per se*, but rather to attract foreign investments that will bring net benefits.

Finally, IIAs can also affect the benefits that a host can obtain from a particular amount of foreign investment. Many IIAs contain provisions that explicitly prohibit the host from placing so-called performance requirements on investors. The performance requirements placed on investing firms by host governments are typically aimed at obtaining more benefits for the host. They include such requirements as employing local staff, using local materials, or exporting a minimum percentage of the firm's output.

IIAs can also reduce the benefits a host government receives from an investment in less direct ways. For example, the implicit threat that the host can expropriate or nationalize an investment increases the bargaining power of the host in

negotiations over the division of the benefits of the firm's production – such as tax rates and royalties (Markusen, 2001). By removing this implicit threat, IIAs shift the bargaining power – and hence share of the benefits – toward the investor and away from the host.

Perhaps the most controversial way in which IIAs may be harmful to hosts, despite increasing investment flows, is by reducing the host's ability to change regulatory policies in response to new information. The recent debate about reforming the international investment regime has been motivated, in no small part, by the need to safeguard host countries' right to alter general regulatory policies in areas such as health, safety, and the environment, despite such changes having secondary effects on foreign investors. In many instances, host states have been brought before international arbitration tribunals for such measures despite their being adopted for valid and non-investor-specific reasons. From that perspective, it can be argued that IIAs, if not reformed, may lead to a chilling effect on host country regulation.

What does FDI Data Actually Measure?

In order to understand and manage FDI, it is important to measure it. Indeed, policymakers pay much attention to figures revealing how well their countries are doing in attracting such investment. However, gross FDI data do not distinguish between "productive" and "non-productive" FDI, nor do they distinguish accurately between investments over which foreign management influence exists and those where it is minimal or absent. Moreover, the data is not as good as it ought to be in determining the origin of FDI flows.

The standard approach to measuring FDI is to count it as those investments in which the foreign investor owns at least 10% of the voting power of the investment enterprise. But the data on how much FDI is flowing across borders, where it is going, and what it is doing, may not be producing a meaningful picture.

For one thing, the 10% threshold may fail to capture some cases when the investor owns a smaller share of a foreign enterprise, but exercises control over that company. In addition, it may be overinclusive, capturing cases when the investor's shareholding, while over 10%, does not provide control or significant influence.

Another issue is that while data on FDI is meant to represent the amount and location of real and lasting commitments in foreign enterprises, FDI often behaves like portfolio investment, flowing in and out of firms with relative ease and speed. FDI can, for instance, include transactions when one company in one country lends to its affiliate in another country. Those types of intra-firm arrangements can be used by companies to take advantage of different interest and exchange rates across borders, but often do not represent the types of sticky investments FDI is generally thought to represent.

Similarly, FDI may not represent investment in actual productive activities. It can include, for example, establishment of a company in a tax haven, with FDI in that company being made in order to shield money from tax assessments.

A final issue is that data on the source and destination of FDI is often misleading. If, for example, a Chinese company establishes a subsidiary in Hong Kong and then uses that company to send investment back into China, data may include as FDI both the investment from China to Hong Kong, and then from Hong Kong to China.

DIAGRAM *Intra-company FDI*

Similarly, if the Chinese investor establishes a "mailbox company" in Hong Kong, and that Hong Kong firm establishes a wholly-owned manufacturing affiliate in Malaysia, data might include as FDI both the Chinese investment into Hong Kong, and the investment from Hong Kong to Malaysia, even though there is just one FDI project – an investment by a Chinese investor in a manufacturing company in Malaysia.

7.3 HOME STATE PERSPECTIVE

Over the last decade, the world has seen an increasing flow of capital from different regions and within regions. Trade integration has allowed countries to become more stable and more resilient to changes in external conditions. This process has encouraged investors to pursue new destinations abroad, seeking profits while managing risk. It has also reinforced the incentive of capital-exporting states to ensure that their nationals investing abroad enjoy a certain level of treatment by host governments. There are several views on why home states have been so pro-active in supporting the regime.

One argument is that outward investing firms are politically powerful and able to convince governments that what is good for them is good for the country.

A second argument used to explain the enthusiasm of home states for IIAs is the "de-politicization" of investment disputes. In the absence of an international method of settling disputes between investors and their host governments, investors turn to their home governments for support. Home governments can be under domestic political pressure to support their investors abroad, but this can come at a cost to foreign policy goals. It is better, home governments often believe, to be able to tell the investor that there is an international system to which it can turn for support. (In fact, however, investors still try to enlist support from the home government embassy.)

Costs resulting from home government help in resolving investment disputes can also be economic. The Japanese government, for example, has intervened to

support its investors by providing financial assistance to the host government. Investment treaties are attractive to home governments in shifting the problem of resolving disputes to international arbitration. (In fact, Japanese firms resist international arbitration and still turn to their home government.)

There are, however, potential costs to home states arising from IIAs. These agreements can, in fact, make FDI more favorable than domestic investment. An IIA provides broad protections and may encourage "regulatory chill" in a host country. If comparable protections are not available to the investor in their home country, these benefits may, in fact, advantage FDI in relation to domestic investment. In the case of adjoining countries, such as the United States and Mexico, regulatory chill resulting from an IIA can indirectly undermine regulatory actions in the home country because of the potential for regulatory arbitrage. In this sense, IIAs may act as an indirect subsidy of outward investment.

From an efficiency perspective, a home country policy toward FDI should be neutral - that is, without direct or indirect subsidies. There may be policy reasons to support certain types of outward investment, for instance, to support technology transfer or to support other investments or outcomes consistent with international commitments and cooperation.

7.4 CONCLUSION

The above analysis leads to the following main conclusions:

First, the empirical evidence about the impact of IIAs on FDI flows is not conclusive.

Second, the focus on assessing the economic case for IIAs predominantly on the basis of their impact on FDI flows is misguided. The benefits states are looking for and the costs that are imposed are not measured by the volume of FDI flows but rather by the contribution of the FDI to national development and any economic, social or environmental impacts of the investment. Focusing solely on impacts of FDI flows also fails to capture other impacts of IIAs, for example in compromising policy space.

The problems identified in relation to IIAs in chapter 2, combined with the lack of conclusive evidence of economic benefit for IIAs in this chapter, should prompt the rethinking of the investment law regime. These concerns are exacerbated when thinking about international investment agreements from the perspective of sustainable development.

8. THE GLOBAL INVESTMENT REGIME AND SUSTAINABLE DEVELOPMENT

8.1 INTRODUCTION

Sustainable development, according to the United Nation's Brundtland Report, is "development that meets the needs of the present without compromising the ability of future generations to meet their own needs." Sustainable development is viewed as being comprised of three inter-related dimensions: economic, social, and environmental.

Responding to these needs, the UN 2030 Agenda for Sustainable Development sets out the collective resolve of signatory countries to:

> *[E]nd poverty and hunger everywhere; to combat inequalities within and among countries; to build peaceful, just, and inclusive societies; to protect human rights and promote gender equality and the empowerment of women and girls; and to ensure the lasting protection of the planet and its natural resources. We resolve also to create conditions for sustainable, inclusive, and sustained economic growth, shared prosperity and decent work for all, taking into account different levels of national development and capacities. (2030 Agenda, para 3).*

Further, the Agenda emphasizes "that the dignity of the human person is fundamental," and that, while the aim is to see the 17 Sustainable Development Goals (SDGs) and their associated "targets met for all nations and peoples and for all segments of society," the priority is to "reach the furthest behind first." (2030 Agenda, para 4).

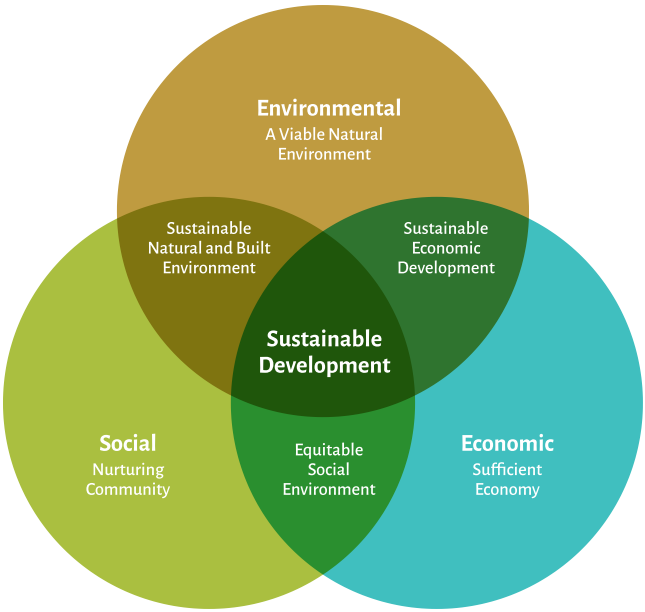
DIAGRAM *UN Sustainable Development Goals*

The 2030 Agenda further recognizes that international capital flows, including foreign direct investment and the activities of multinational enterprises, are essential to achieving the SDGs. The jobs foreign direct investment can create, technologies it can transfer, broader spillovers it can generate, products and services it produces, and tax revenue it can provide, are core ingredients for achieving the Agenda. However, the contributions of FDI (and other forms of capital flows) are not always positive. FDI may undermine progress in discrete locations (such as an MNE violating labor standards) and/or even globally (as

might be the case for a company seeking to expand development of fossil fuel reserves).

In light of these issues, this section explores some of the intersections between IIAs and sustainable development, focusing on how the protection of foreign investors may affect the abilities of governments to address the economic, social, and environmental dimensions of sustainable development. This section also provides examples of tensions between IIAs and some of the sustainable development goals.

DIAGRAM *Sustainable Development*



This chapter builds on the economic analysis of the previous chapter and shows that beyond the inconclusive economic benefits of IIAs they may also contain

provisions that constrain states from effectively harnessing FDI to pursue inclusive economic development. The chapter goes on to show that IIAs can also limit the ability of governments to pursue social and environmental policies. The chapter does not offer a comprehensive analysis but rather presents examples to illustrate broader themes, focusing on some of the problems with the status quo system of investment protection.

8.2 ECONOMIC DIMENSONS

Mobile Capital and Globalized Firms

Due to innovations in transport and technology and the proliferation of global rules requiring governments to allow capital, goods, and services to flow freely across their borders, companies have increasing freedom to structure their operations in complex global networks. Corporate decisions about that structure, including decisions regarding where to place production facilities, and where to hold their assets and book their profits, have important consequences for economic inclusion. For instance, when a company locates new production facilities in a host country, it can create jobs there. However, it may also use its market power to gain unfair advantages. A multinational enterprise entering a new host country may predatorily price out indigenous competitors and cause large-scale layoffs that exacerbate local economic inequality.

Additionally, decisions on how to allocate assets, liabilities, and profits across borders can significantly affect how much tax is assessed and by whom. This, in turn, impacts on the abilities of governments to provide public goods (such as health care, infrastructure, and education) and safety nets needed for reducing inequality.

There are some tools governments can use to try to ensure FDI leads to inclusive economic growth. In addition to tax policy tools (discussed further below), governments can, for instance, require that companies:

- locate facilities in certain areas of the country with low rates of employment;
- locate certain aspects of their operations in particular areas of the country;
- source (or accord preferences to) local service providers (including minority or historically disadvantaged groups) and;
- enable shared use of transport, power, and other infrastructure.

These provisions (often termed "performance requirements") are often critiqued on the ground that they interfere with the decisions of companies about how to most efficiently and effectively run their businesses. It is also often contended that these tools may even be counterproductive for the host state's objectives as, if too onerous, they can discourage companies from investing in the first place. Nevertheless, without such tools, governments may be unable to ensure that FDI generates benefits and that those benefits are captured by a diverse range of constituents.

A further challenge related to mobile capital is that governments often feel compelled to provide potentially costly incentives in order to attract or keep companies. By offering incentives, the government may be able to attract investment and create jobs benefitting some, but those incentives (which can be seen as tax expenditures) also represent a transfer of wealth with important distributional implications.

Investment treaties at present risk exacerbating these issues. A growing number of investment treaties contain liberalization requirements seeking to support cross-border movement of firms and capital. Moreover, a growing number also contain restrictions on performance requirements, preventing governments from trying to capture and/or direct firms' potential positive spillovers.

Focus on Tax Policy

The intersection between international investment law and tax policy is particularly important for issues of inclusive economic development. Indeed, achieving sustainable development goals relies critically on revenue mobilization by capital-importing host countries.

National income tax systems have been under stress from globalization and inter-nation tax competition to attract real investment as well as providing a record of profits. The prevalent use of tax incentives is in many cases unproductive and wasteful, in that it rarely increases the total amount of investment. International tax avoidance is a plague that undermines the ability of developing countries to address revenue needs. While the G20 and OECD have pushed forward a reform agenda to combat base erosion and profit shifting (BEPS) by multinational firms, the BEPS project was circumscribed in scope and initially directed at protecting the tax bases of developed countries. With the support of the G20 and working with the UN, IMF, and World Bank, the OECD has attempted a course correction to take account of some issues important to revenue mobilization in developing countries, but much more needs to be done.

Importantly, the UN has adopted a new model treaty article that permits greater taxation of remote technical services. Associated work is underway to agree on standards for host country taxation of offshore sales of assets that derive their value principally from the host country, such as interests in entities indirectly owning natural resource assets or telecommunication rights. It is necessary to go further and to build consensus for implementing more fundamental reforms that allow host countries to tax remote sellers into their markets (both in digital and physical goods commerce) and to rationalize income allocation to the market country. It is beyond the scope of this book to address all of the pressing tax issues that affect economic development. It is important that changes to international taxation rules be adopted in parallel with the recommendations in this volume regarding investment law.

In some cases, particularly in countries with extractive industries, tax revenues from the investor are an important host country benefit from FDI. And yet, it is common in investor-host country resource concession agreements to include stabilization clauses that attempt to freeze host country taxation laws or otherwise to cap or limit fiscal take, or economic equilibrium clauses which attempt to achieve the similar economic results by providing that the host country compensate the investor if changes to the fiscal regime adversely affect the investor. Fiscal stabilization limits fiscal and tax policy flexibility available to host countries. This raises sovereignty concerns in host countries and limits budgetary options, especially when windfall profits result from unexpectedly rich finds or high market prices.

IIAs have been used in various cases to enforce stabilization clauses, or, effectively, to act as stabilization clauses, as they have enabled challenges to changes in the fiscal regime as indirect expropriation or violations of FET. For instance, investors have used IIAs to challenge the imposition of windfall taxes, capital gains taxes, and other adjustments to tax laws, regulations, and administration. IIAs should not serve as an alternate forum for investors to contest host country tax policy, whether or not a bilateral income tax treaty is in place. This is a role for domestic dispute resolution or bilateral tax treaties, whose dispute resolution mechanisms ensure that home and host country governments are involved in the resolution of disputes consistent with the treaty.

8.3 SOCIAL DIMENSIONS

As with economic issues more broadly, international investment, including FDI, offers a mix of opportunities and challenges for the social aspects of sustainable development objectives. FDI can be an important channel for improving labor standards, generating employment, and sustaining livelihoods; but foreign investors do not always bring such benefits. This chapter identifies tensions between key social objectives and both FDI and the investment regime. It provides examples of how tribunals have addressed these tensions.

For example, as states compete for investment, they may be reluctant to take actions such as increasing labor protection or wages, actions that might raise the cost of doing business in their countries. Additionally, we know all too well that when multinational enterprises invest in a host country, their projects, especially mining and other extractive industry projects, can give rise to major conflicts over use of natural resources. These conflicts, which may turn violent and sometimes lead to murder or criminalization of those opposing the developments, often relate to fears about adverse impacts which the investment projects may have on the environment, lives, and livelihoods. These fears can be further intensified by concerns that, should harm occur, the multinational enterprise will be able to avoid responsibility by shielding its assets and actors from the host country's reach.

Conflicts also arise from international investment in infrastructure for provision of water, energy, or other services. While FDI in such projects can produce important benefits such as improving access to such essential public services,

common concerns among affected populations include worries that private foreign actors have different motives and duties than government entities, and are not subject to the same accountability mechanisms. These factors, in turn, may generate suboptimal outcomes from user, ratepayer, and taxpayer perspectives.

In addition to the ambiguous connections between FDI and social outcomes, there are also ambiguous connections between IIAs/ISDS and those outcomes. Some advocates of IIAs and ISDS have argued, for example, that the regime is important for protecting the human rights of investors from government abuse, and for preventing improper nationality-based discrimination from infecting government conduct. However, there are also concerns that both IIAs and ISDS have marginalized human rights issues.

International investment agreements have tended to be silent on the issue of human rights (Gordon 2015). A minority of IIAs contain provisions referring to labor rights (5.5% according to one study). Some of those affirm states' commitments to core labor standards or specific labor rights treaties, and/or contain provisions seeking to prevent governments from lowering or failing to enforce their labor law in order to attract or keep the investment. Studies of equivalent provisions in trade agreements (with investment chapters) have found them to have very limited effects (Harrison et al, 2018). An even smaller share of IIAs (.5%) includes express references to human rights (Gordon 2015).

More recently, some states have tried to impose positive obligations on investors to respect human rights. For instance, the Morocco-Nigeria bilateral investment treaty (BIT) declares that investors "shall uphold human rights," and also requires investors' home states to allow the investors to be sued for actions causing personal injuries or loss of life in the host state. (arts. 15 & 20). Similarly, the Brazil-Malawi BIT requires investors to develop “best efforts” to respect human rights (art. 9). However, it remains unclear whether such obligations will have any practical effect.

ISDS can place pressure on governments to prioritize the economic rights and interests of foreign investors over the social welfare and human rights of other

stakeholders. Some investment arbitrations, for example, have completely marginalized human rights issues. For instance, in *S.D. Myers v. Canada*, the Canadian government banned the transboundary export of PCB waste to prevent the possible impairment to human life or health. While the tribunal acknowledged the health risks associated with the transboundary movement of hazardous waste, it found that Canada should have used a less trade-restrictive measure to fulfill its health objectives. Similarly, in *Chevron v. Ecuador*, the tribunal issued orders seeking to prevent Ecuadorian citizens from enforcing a judgment they had obtained against Chevron for environmental harms caused by the company's affiliates, quickly dismissing concerns that the tribunals' orders negatively impacted the rights of those individuals.

Example: Human Rights, ISDS, and Water Services Concessions

Investment arbitrations have confirmed the intersection of human rights with foreign investment. For instance, the right to water has been implicated in eight investment arbitrations over a 10-year period. Generally, these investment arbitrations have addressed concession contracts that developing countries have awarded to private water suppliers. These have resulted in increases to water tariffs and, at times, reductions in the quality of the supplied water. But investment arbitral tribunals have mostly reacted to the human rights implications of water-related investment arbitrations by discounting or ignoring the state's human rights obligations. For instance, in *Biwater v. Tanzania*, amici curiae contended that investor responsibility had to be "assessed in the context of sustainable development and human rights." The tribunal noted that the amici's observations were "useful" but it did not make any explicit reference to them in their analysis. Similarly, in *SAUR International SA v. Argentina*, Argentina argued that its investment obligations should be read in light of its obligations with regard to the right to water. However, the Tribunal concluded that a state's right to protect human rights is not absolute and must be combined with respect for the rights and guarantees granted to the foreign investor. It

purported to balance investor rights against the right to water in its analysis, although again it made no explicit reference to the right to water in its decision.

In *Urbaser v. Argentina*, the tribunal did make a concerted effort, for the first time, to address Argentina's human rights obligations, noting that the investor's claims had to be assessed in the context of the states' authority to regulate. It also concluded that Argentina's constitutional obligations to ensure the population's health and access to water should prevail over its contractual obligations. However, the *Urbaser* case is highly unusual in that the arbitration also involved a counterclaim by Argentina against the investor, alleging that they had failed to meet their human rights obligations in operating the investment. Issues of human rights in the counterclaim may have therefore driven the comparable analysis in the main arbitration.

Example: Intellectual Property and Public Health

In recent years, intellectual property rights holders have challenged government efforts to regulate for public health by defining intellectual property (trademarks and patents) as protected assets under ISDS provisions (Dreyfuss and Frankel, 2014). This is a new frontier for rights holders to promote the expanded protection and enforcement of their intellectual property rights. Rights holders are now using the investment regime to seek compensation for what they see as a weakening of their rights. These intellectual property cases put into stark relief the tensions between protected investments under investment treaties and national regulation to promote the public good.

Three headline-grabbing cases have highlighted the potential dangers that this trend may pose to domestic regulation of public health. Intellectual property rights holders sued Uruguay, Australia, and Canada under BITs and NAFTA respectively. In two cases, Philip Morris sued sovereign governments, Uruguay and Australia, over their anti-smoking legislation. In the third, pharmaceutical

manufacturer Eli Lilly sued the government of Canada under NAFTA's investment chapter. While in each case, the state prevailed over the foreign investor, the circumstances and the rulings do not provide a robust deterrent against intellectual property owners making investment-related claims going forward.

Philip Morris International, headquartered in Lausanne, sued Uruguay in 2013 under the Switzerland-Uruguay BIT. Uruguay had adopted anti-smoking laws that included the requirement that 80% of each cigarette pack display graphic images highlighting the health dangers of smoking. Philip Morris claimed that the labeling laws reduced the value of its trademarks and investments in Uruguay. In 2016, the ICSID tribunal ruled in favor of Uruguay, ordering Philip Morris to pay all of Uruguay's costs of the litigation. Former New York City Mayor Michael Bloomberg had helped to fund the defense of Uruguay, as that country would have been hard-pressed to afford the process. The case was a victory for Uruguay's regulatory discretion. However, the unpredictability of the arbitral process and the disadvantages of resource-poor targets facing costly litigation in ISDS cases suggest that trademark interests will not be deterred by this one case.

Philip Morris Asia sued Australia in 2011 over its plain-packaging laws that banned the use of Philip Morris trademarks on cigarette packages. Philip Morris claimed that Australia had breached the 1993 Australia-Hong Kong investment agreement. The tribunal declined jurisdiction to hear the case because Philip Morris Asia had acquired its shares in Australia in 2011 only *after* it knew of Australia's plans to implement plain packaging policies. Australia won the case in 2015 on narrow procedural grounds and the case did not substantively address a government's right to regulate in the public interest. The narrowness of the decision is unlikely to serve as a deterrent to intellectual property rights holders aggressively pursuing stronger protection and enforcement through ISDS.

In March 2017, an ICSID tribunal ruled in favor of Canada in Eli Lilly's patent case under NAFTA's investment chapter. This was the first award addressing patents and international investment law. In 2010 and 2011, the Federal Court of Canada revoked Eli Lilly's patents on Zyprexa and Strattera on the basis that they failed

to meet Canada's standard of utility under its "promise utility doctrine." The Federal Appellate Court and Canada's Supreme Court affirmed the revocation. Eli Lilly filed a complaint with ICSID seeking damages; the idea that a private investor could challenge the decisions of the highest court in a sovereign country struck many observers as beyond the pale.

Canada is committed to containing health care costs and has a robust generic industry. Its "promise utility doctrine" is designed to ensure that pharmaceutical firms cannot obtain patents unless they can demonstrate that the patented product will fulfill the promise that it claims to fulfill. This doctrine helps reduce the issuance of frivolous patents that prevent generic entry, reduce competition, and keep drug prices high. Generic firms are the main beneficiaries of the promise doctrine. While Eli Lilly argued that Canada had dramatically changed its standards, the ICSID tribunal found that Canada's policy had evolved gradually and incrementally and thus had not violated Eli Lilly's rights. Even though Eli Lilly ultimately lost, the case established a new avenue for intellectual property rights holders to litigate patents. In this sense, it is a landmark case exemplifying the expansion of subject matter covered under international investment agreements. The narrowness of the ruling will not deter patent holders from continuing to litigate along the investment agreement route. Going forward, a rise should be expected in the numbers of intellectual property-based cases challenging state regulations for public health.

8.4 ENVIRONMENTAL DIMENSIONS

FDI can provide important contributions to addressing environmental problems. For instance, according to the "pollution halo" theory, when a company with modern practices purchases operations abroad, it may bring those cleaner practices with it, helping to reduce the environmental footprint of the company acquired. However, FDI can also be associated with negative environmental impacts. It may lead to excessive exploitation of natural resources in countries where property rights over these are poorly defined or enforced. These concerns are particularly relevant to forests and fisheries.

A further concern is that countries may seek to attract investment by lowering environmental standards (race-to-the-bottom) or failing to raise them sufficiently (regulatory chill).

Environmental Provisions in IIAs

Recognizing these issues, some IIAs contain provisions that seek to prevent governments from lowering or failing to enforce environmental standards in order to attract investment. The United States' model bilateral investment treaty, for example, states that Parties to the treaty shall not "waive or otherwise

derogate from" environmental laws in order to encourage investment. But the treaties typically lack strong and effective enforcement mechanisms to ensure adherence to these provisions.

More problematically, as is discussed below, international investment treaties generally allow companies to challenge government efforts to strengthen environmental laws or policies, and even to enforce existing ones. A limited number of investment treaties contain "environmental exceptions" that purport to protect environmental measures that meet a series of legal standards. The effectiveness of these provisions is unclear. Similar provisions in trade treaties have been heavily criticised for their failure to protect legitimate environmental and health measures. The few ISDS cases that have examined these types of exceptions illustrate that they fail to provide cover for even good faith measures adopted in the public interest to address concerns about environmental impacts.

The Right to Regulatory Stability and the Environment

The right to regulatory stability has already been successfully invoked to challenge environmental regulations and could be a significant impediment to necessary policy responses to climate change. One of the first successful investment treaty claims based on the right to regulatory stability was the award under NAFTA's Chapter 11 (Investment) in *Metalclad v. Mexico*. The case involved a United States corporation that was attempting to construct and operate a hazardous waste site in the Mexican state of San Luis Potosi. The state and municipal governments blocked the project on environmental grounds. In response, the investor brought a claim under NAFTA's investment chapter and received a multi-million dollar award of damages, based, *inter alia*, on the tribunal's conclusion that NAFTA's FET provision guaranteed the investor a right to a "predictable framework for … business planning and investment."

Cases that the Swedish energy firm Vattenfall AB brought against Germany highlight the tensions between energy investments and the public interest in the environment. The Swedish energy firm Vattenfall AB sued Germany in 2009 under the Energy Charter Treaty (ECT) to force Germany to relax environmental standards for a coal-fired power plant. Vattenfall AB argued that Germany had violated its obligation for fair and equitable treatment by adopting more stringent environmental policies *after* it had provisionally approved the project.

In another pending claim under the ECT, Vattenfall is challenging Germany's decision to phase out nuclear energy. This claim was filed in 2012 after Germany abruptly decided to accelerate the phasing out of nuclear energy in response to the March 2011 Fukushima nuclear disaster in Japan. The German government offered substantial compensation to all affected nuclear power generators, including Vattenfall. The company does not dispute that the German policy was geared to protect public health and the environment. It made use of its international treaty protection to sue for 4.7 billion Euros compensation for losses allegedly suffered, arguing that the German policy violated the doctrine of legitimate expectations under the fair and equitable treatment standard.

The right to regulatory stability could similarly be used to challenge efforts by governments to mitigate climate change. In order to meet the Paris Agreement's goal of keeping the average increase in global temperatures below 2 degrees Celsius, governments will need to implement aggressive new policies designed to shift investment away from fossil fuels and toward renewable energy. These policies will adversely affect existing investments in fossil fuels in a manner that could be held to violate investors' right to regulatory stability.

Subsidizing environmentally harmful investments

An additional consideration is whether IIAs operate as a subsidy for environmentally harmful projects. In the section discussing economic

implications of IIAs, this book considered how IIAs seek to reduce risks for foreign investors in order to encourage FDI (and coveted benefits). This book also discussed how IIAs appear to be ambiguous in actually influencing FDI flows. But if IIAs were successful, the implication is that the treaties serve to enable investments that otherwise might not have happened, even if those investments result in net environmental harms. This issue is particularly pressing in the context of fossil fuel investments. If an extractives project for the development of new coal or oil resources would not have happened without an investment treaty and the protections it offers, this suggests that investment treaties are exacerbating the climate change challenge, further threatening the 2 degree Celsius target and the objective of policy coherence reflected in the SDGs.

This highlights that IIAs can potentially be used to support climate and other environmentally friendly investments, but, at present, are equally geared to support projects that undermine environmental goals.

8.5 CONCLUSION

This chapter has explored how the economic, social, and environmental dimensions of sustainable development inter-relate to both FDI and IIAs. It has found that FDI can potentially have both positive and negative impacts on all three dimensions of sustainable development. But it has argued that: (1) IIAs pose a number of challenges to governments seeking to harness FDI to support sustainable development objectives; (2) various provisions in IIAs which seek to explicitly protect and promote social and environmental goals are not effective in that endeavor; and (3) significant decisions by international investment tribunals do not appropriately balance investor rights with broader sustainable development objectives.

Collectively, the extent of these problems suggests that the investment law regime is not sufficiently attuned to the challenges of sustainable development. In light of this, the next chapter will argue that there is a need to re-orient the regime towards addressing broader economic, environmental and social objectives.

9. RE-THINKING THE INTERNATIONAL INVESTMENT REGIME AS GOVERNANCE

9.1 INTRODUCTION

The previous chapters of this book have identified deficiencies in the international investment regime and its impacts on a variety of public policy goals. Thus far the book has focused on the undesirable *effects* of the regime, not on the institutional causes underlying its dysfunction. This chapter calls for a reconceptualization of the international investment law regime as a complex multi-party form of governance that should be contributing to broader economic, social and environmental goals. The chapter proposes a number of procedural principles and substantive priorities for developing a reimagined international investment regime.

9.2 WHY DO WE NEED INTERNATIONAL ECONOMIC GOVERNANCE?

International Investment Law as a Complex Multi-party Form of Governance

Instead of thinking about IIAs primarily as international treaties for protecting private property rights and expectations, they should be viewed as one part of a complex multi-party, multi-level form of global economic governance for managing the role of transnational capital in development. As a governance system, the IIAs structure the relationships between many different parties, such as home states, host states, transnational investors, domestic capital, and the full range of domestic host state constituencies (such as workers, consumers, other businesses, and citizens).

Understanding international investment treaties as a form of governance does not necessarily resolve the vexing questions facing international investment law today. However, it does help foreground questions which, while not new, have generally been in the background in international investment governance.

Chief among these questions is the fundamental governance question: who governs? In other words, who is making the decisions on the substantive and procedural rules of IIAs, decisions that involve the exercise of public authority and that impact critical public policies and the well-being of millions?

And, for whose benefit? Are key constituencies consulted appropriately during the negotiation, ratification, interpretation, and adjudication of international investment rules? If we are relying on states to ensure that stakeholder interests are properly taken into account, are states, in fact, capable of effectively ensuring such participation, given the collective action problems endemic to the global economic space?

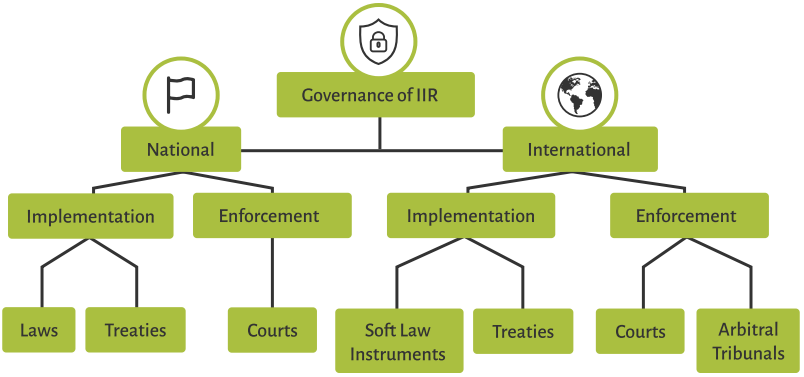
Finally, are there any rules that govern the governing? What international rules, norms, and principles apply to the exercise of public authority in the making and enforcing of investment rules?

At the same time, it is necessary to think about the appropriate levels and forms of international investment governance which is currently governed at multiple levels and in multiple forms, including:

- in the contracts signed between governments and investors;
- in national and subnational law created within individual nation states;
- in bilateral, regional, plurilateral and multilateral agreements between countries primarily addressing investment, including IIAs.

The following diagram provides an illustration of how the international investment law regime operates both in national and international spheres.

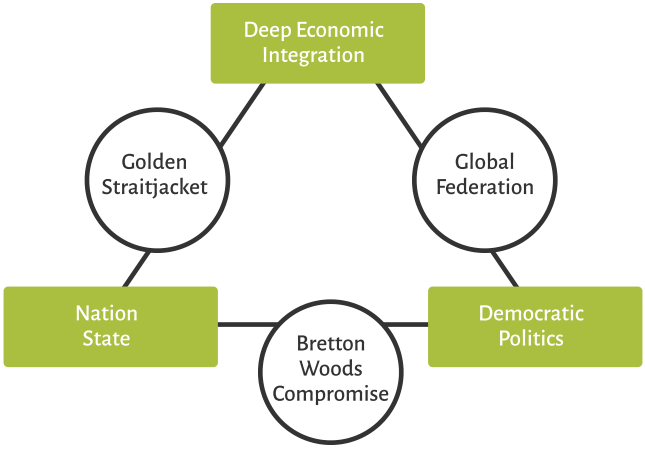
DIAGRAM *Governance of International Investment Regime*



The Challenge and Opportunities of Governing International Investment

One way to analytically simplify the key challenges that the international investment regime poses is through Dani Rodrik's conception of the "political trilemma" (Rodrik: 2007). According to Rodrik, this trilemma reflects the fact that it is not possible to simultaneously have deep economic integration, national autonomy ("sovereignty" in his version), and democratic politics. If parties want more economic globalization they must give up either some democracy or some autonomy (sovereignty).

DIAGRAM *Political Trilemma*



This diagram depicts three choices. If one seeks to engage in deep economic integration and preserve democratic politics, the choice would be "global federation." The European Union exemplifies this configuration; states surrendered monetary autonomy to integrate more deeply as a regional economic bloc.

The problem that states are having with a range of contemporary international economic policies, including the international investment regime, and also the globalization of intellectual property, is depicted in the segment connecting deep economic integration and the nation-state. Rodrik defines this configuration as "the golden straitjacket." Most of the countries that are experiencing harms from the international investment regime have engaged in a neoliberal economic version of deep economic integration (e.g. the Washington Consensus) and the golden straitjacket restricts their policy autonomy. The needs and demands of mobile capital and foreign investors sharply constrain the ability of a host country to regulate policy in response to its

constituents. Foreign intellectual property owners have challenged states seeking to respond to health crises such as HIV/AIDS; foreign direct investors have challenged host states seeking to reduce pollution, such as lead poisoning, or move out of fossil fuels and into clean energy.

Many of the calls for reform – across investment, intellectual property, and tax policy – directly address the balance between domestic regulatory policy autonomy and deep economic integration. Scaling back foreign investors' rights would loosen the strictures of the golden straitjacket, increase domestic policy autonomy, and might allow host states to increase democratic accountability to their citizens.

However, relying only on domestic political autonomy will not address all of the problems caused by capital mobility. Traditionally, international economic governance has been justified through its role in helping national governments to make the most of the opportunities provided by internationally mobile capital. For example, by providing international legal recourse, it can help governments keep the promises that they make in order to attract investors. By providing this commitment device, international economic governance can decrease the risk premiums which hosts may otherwise have to pay to attract investment. The existing governance regime has focused almost exclusively on this role. There are, however, several challenges for countries managing international investment that international economic governance also might address.

In the modern global economy, investors are able to make choices about where to invest, and how to structure or restructure their investments within and across borders. This provides a number of other rationales for international regulation. Firstly, there is a danger that states will engage in a "race to the bottom" as they compete with other nations to attract investment by, for instance, offering tax breaks, providing financial incentives, or weakening their social or environmental regulations. As states fight over who gets the investment, they may all forsake government revenues and/or decrease regulation of key social and environmental issues. Secondly, corporations with sufficient power and resources can use their ability to structure their operations across borders to

minimize their exposure to liability and damages and increase their ability to take advantage of favorable laws and incentives. Investors can also exploit a combination of domestic laws and investment treaties, and those instruments' respective dispute resolution processes, to maximize their opportunities for winning compensation from host state governments (or successfully pressing the government to shift policies in their favor). These challenges are very difficult for countries to address alone. Countries could benefit from international cooperation aimed at overcoming collective action problems and reducing the complexities of legal rules governing a group of corporate affiliates. International cooperation could be useful on issues such as climate change or the protection of fish stocks, as individual governments may prioritize specific efforts to attract or keep foreign investment notwithstanding consequent harms to global commons.

States concerned with the direction of the system, the well-being of their citizens, and the sustainability of this model of investment protection, can find themselves in a number of collective action dilemmas when they seek to govern investment and economic flows of all kinds, in the service of different values and allocations of rights. The hypermobility of capital means states that seek alternative regulatory models may fear capital flight, with resulting negative impacts on their development resources and plans. Moreover, leaving it up to individual states to decide how they wish to attract foreign investment and treat foreign investors may be detrimental for all states and citizens across the globe. Some forms of international cooperation, therefore, seem desirable. At the same time, effective international action is difficult to achieve and may constrain individual states from taking actions they might otherwise wish to take.

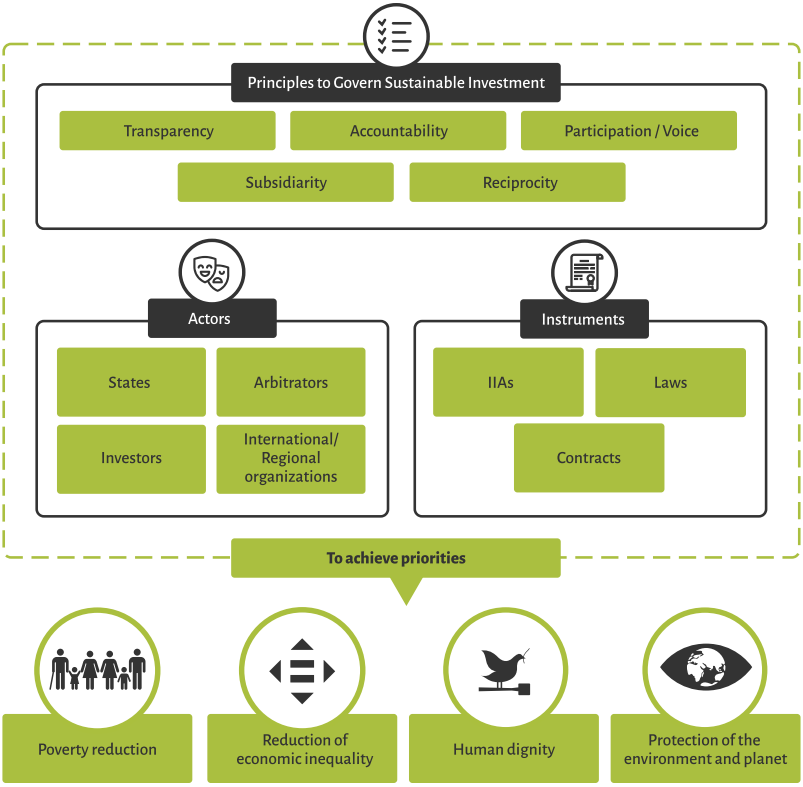
All of this means that effectively managing transnational capital for the good of all affected stakeholders – and in the process addressing the role of investment law in the current governance crisis – cannot be achieved solely from an investors' rights perspective. Principles are required to orient the goals of the regime and decide at what levels regulation should happen. It is all the more important to ask these questions when the investment regime is viewed against a background of profound imbalances in geopolitical and economic power. These imbalances were at the root of the first international investment treaties

signed in the 1950s. They continue to influence efforts to reform investment law today, and must, therefore, be taken into account in any effort to formulate a progressive vision.

9.3 PROCEDURAL PRINCIPLES AND SUBSTANTIVE PRIORITIES FOR A NEW SYSTEM

Recognizing international investment law as a form of governance does not by itself settle any of the vexing questions facing domestic and international policymakers around investment. However, it does help in identifying and formulating ways of answering those questions. This section first identifies a set of procedural principles that will help to steer international investment law towards an appropriate balancing of competing interests. It then moves on to set out a series of substantive priorities that can orient the international investment regime towards the broader social/sustainable development objectives outlined in previous chapters.

DIAGRAM *Principles and Substantive Priorities*



Procedural Principles

The current investment law regime reveals a remarkable absence of guiding procedural principles governing the behavior of the actors and the operation of the instruments that animate the system when the importance and effects of

transnational capital are considered. There are five core principles that should apply to all aspects of the system.

1. Transparency

Transparency is a fundamental norm of good governance and the rule of law. Given that the investment law regime involves many issues of public interest (rather than private interests between contracting parties), there is a need to enshrine transparency as a fundamental principle of the system. The presumption should be that in the formulation, implementation and enforcement of investment law, stakeholders should be able to find out about critical elements of the process, access key documentation, and witness important proceedings. For instance, drafts of investment treaties, national laws on investment, and proceedings of national courts and investment tribunals should be made publicly available.

2. Participation

Participation, understood as some form of voice for the governed, is a norm of good governance that can be found across a wide range of political and legal systems, including (but not limited to) Western democracies. In the investment context, it is not sufficient that stakeholders merely have access to information. They also need to be able to actively participate in and engage with the process by which investment law and policy is formulated, implemented, and enforced at both national and international levels.

Different kinds and levels of participation will be appropriate at different stages in the investment regulation process. A participation principle implies, for instance, that at the national level, governments should have consultation processes that allow meaningful contributions from citizens over the formulation of policies regarding international investment protection, liberalization, and contracts with investors that have significant implications for public services. At the international level, given the lack of democracy in many

states, non-state parties, including community representatives, should be able to participate in processes such as regional and international treaty-making processes and disputes between states and corporations.

3. Reciprocity

In the context of international investment governance, the principle of reciprocity means that when key actors are given valuable legal rights within an investment regime, good governance entails that they also bear appropriate legal duties and obligations.

The key beneficiaries of the current investment regime are corporations. Their rights are protected by national laws and international investment treaties. While investors also have responsibilities as set out in investment contracts and national legislation (e.g. on workers' rights, environmental laws), the power imbalances between investors and many states and the mobility of capital means that the responsibilities of investors are not always commensurate with the benefits they receive, nor are they as readily subject to judicial oversight as the rights of investors.

Good economic governance means ensuring that legally privileged actors such as, in the investment context, foreign investors, have responsibilities that are commensurate with the benefits they receive through the investment law regime, and that the interests of all key stakeholders and affected parties, not just investors, are represented or accounted for in an appropriate manner. For instance, international investment governance could be used to meaningfully reinforce key international legal principles from other areas of international law (such as the UN Guiding Principles on Business and Human Rights).

4. Accountability

Accountability is a fundamental norm of governance today. Without accountability, exercises of public authority, and private economic power **under the aegis of public law,** lose legitimacy.

Currently, the investment law regime only holds states accountable and not investors. This is inconsistent with the principle of accountability understood as a norm of good governance. Instead, there should be mechanisms for ensuring that corporations that fail to abide by their obligations are also held accountable for their conduct. This principle should apply to both narrower contractual obligations and broader legal obligations at both national and international levels, so that both states and affected communities have means of redress for significant harms done to them.

A more traditional form of accountability would be to reform the investment dispute system to incorporate some form of judicial or appellate review of arbitral tribunal decisions.

Another kind of accountability may be appropriate when a new investment contract or treaty is being negotiated. Imposing obligations of due diligence on the state and disclosure on the investor, could, if coupled with the transparency principle, ensure that affected constituencies and civil society receive the relevant information that would enable them to effectively participate in the obligation-formulation stage. This kind of accountability can also help downstream, should it become necessary to identify and enforce failures on the part of the investor to honor its commitments to abide by national and international law.

5. Subsidiarity

Subsidiarity is a principle that argues that issues should be decided only by a higher authority when the objectives of an action cannot be effectively achieved by a lower authority. The underlying rationale is that individual human beings should be no more separated from decisions that affect them than is necessary to protect their interests. The principle of subsidiarity in this context suggests that it is only when objectives cannot be met at the national level that it should be recourse to the international level to try to find solutions.

One of the key challenges for re-imagining international investment law is to decide what role the existing governance levels and forms should play in harnessing opportunities and addressing challenges. An international investment regime will necessarily include components at each level. Not all solutions are located at one level alone, nor is a "one size fits all" solution imminent. International efforts can and should support genuine democratic governance at the national level, while at the same time making a contribution to addressing important global problems that countries struggle to address by themselves.

The mobility of foreign investors causes some problems for individual states trying to make effective decisions about foreign investment. Thus there may be some situations where international rules governing investment are necessary to protect the ability of states to regulate and, for example, avoid "races to the bottom" and tackle global commons issues such as climate change. Even where there is a genuine rationale for raising issues to the international level, there should be a clear understanding of the likely costs of such a process (for example, in terms of possible democratic deficits) and the likely gains.

A systematic application of the principles of transparency, participation, reciprocity, accountability, and subsidiarity would contribute to shaping an enhanced international investment governance system.

Substantive Priorities

Recognizing international investment law as governance does not mean that the traditional functions of international investment law (in particular, protection of investment from direct expropriation, and preventing "gunboat diplomacy" by which powerful home states use force or threats thereof to protect their foreign investors) are irrelevant. They continue to be an important part of the system. But a governance perspective raises a number of important questions and concerns which, while not new, often remain in the background in the prevailing paradigm of investment law as a contract-like system for protecting private property abroad. Moreover, the evolution of investment law, the nature of international business, and the convergence around core sustainable development objectives that have occurred since 1959, have led to the identification of a number of shortcomings and deficiencies in this system when considered from the perspective of current governance norms, needs, and expectations. The traditional values of the investment law system must, therefore, be harnessed to achieve other values and goals that form part of the governance landscape, and where investment law has clear impacts. An investment regime should, at a minimum be **consistent with core and urgent global priorities** as reflected in the Sustainable Development Goals, including:

1. **Poverty reduction** (and, conversely, increase in prosperity), especially for those at the bottom. Despite significant progress in reducing global poverty, over one billion people still live on less than $1.25 per day (source: World Bank), making development-oriented investment a top priority.
2. **Reduction of economic inequality** within states (intra-national or domestic inequality), between states (international inequality) and among all people compared transnationally (global inequality). Although the empirical picture is muddled, the bulk of the research suggests that the way investment (and trade) is structured has a direct impact on inequality trends within and between states, and globally. (Source: Bourguignon; IMF Report;).

3 **Human dignity.** The way transnational capital is deployed and under what terms, its impact on host state constituencies such as workers, consumers, and other businesses, and the interaction of investment law with host state efforts to undertake social welfare legislation and regulatory reform, all directly affect the socioeconomic conditions for human dignity and the effective human rights that host state citizens can enjoy.

4 **Protection of the environment and planet**. Recent trends in the interpretation and application of investment law with respect to host state environmental regulations, and the perennial challenges of resource extraction in ways that minimize environmental and social costs, have together highlighted the importance of an investment law that fully embraces sustainable development goals and safeguards.

Moreover, if we calibrate investment law carefully with respect to its consistency with other norms, we can expect synergies. Reductions in inequality will mean increased protection of the environment, leading to higher standards of living, which can support higher returns on investment. Such calibration was not possible in 1959 when the first Bilateral Investment Treaty was created, because our scientific understanding of sustainable development was minimal at the time, and because many of these other norms simply did not exist then.

Consistency, in this case, means more than mere compatibility – it means an investment regime designed to work coherently within a regulatory framework, domestic and international – of laws aimed at ensuring safety and survival for the most economically vulnerable sectors of society, laws promoting their development and the development of all sectors of society, laws protecting the environment, and laws eliminating all forms of discrimination and the enhancement of human dignity.

9.4 CONCLUSION

When understood as a framework for governance, the international investment regime as it stands today has noteworthy deficiencies. This is the result of governance norms and tasks at the global level being poorly understood and relatively underdeveloped during the early period of the regime in the latter half of the 20th century. Governance in the investment space is necessarily a collective and disaggregated exercise. States, investors, arbitrators, international organizations, and civil society all have vital governance roles to play in formulating, applying, interpreting, and enforcing investment law norms. Application of the procedural principles and substantive priorities recommended in this chapter can stimulate the development of an investment regime fit for the 21st century.

10. REBALANCING INTERNATIONAL INVESTMENT LAW: SUBSTANTIVE REFORMS

10.1 INTRODUCTION

If the investment regime is to be reconfigured towards key 21st-century goals, values, and priorities, this book advocates a multi-pronged strategy of reconceptualization and reform. This chapter offers a number of recommendations for substantive and procedural reforms through which the principles laid out in this book for 21st-century international investment governance could be institutionalized.

The first step in this reform is the internalization of the fundamental paradigm shift advocated here. This book recommends a fundamental **re-conceptualization** of international investment law, not simply a menu of specific or ad hoc reform proposals.

Next is a process of **rebalancing** investor rights and duties, restoring the original scope of investor protection as envisioned during the emergence of the regime in the 1950s. This rebalancing also involves incorporating substantive investor duties, thus orienting investor incentives more closely with those of the global system within which investment operates.

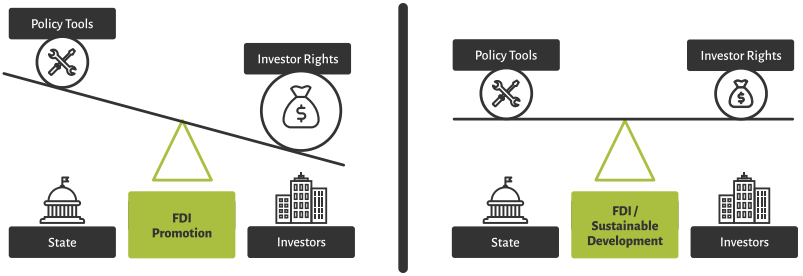
In the next chapter, a second target for rebalancing is to revisit the ISDS system. Finally, in the following chapter, the book advocates a **realignment** of the current IIA system towards greater coherence with, if not support for, 21st-century global priorities. This realignment should include negotiation of a new multilateral framework agreement, as set out in Chapter 8.

10.2 REBALANCING: PROTECTING THE SCOPE OF LEGITIMATE GOVERNMENT POLICY-MAKING

Currently, the expansive reading of investor rights, particularly through arbitral interpretations of the FET standard, has the effect of restricting sovereign rights to regulatory action and legislative enactments to achieve social, economic, and environmental goals, with adverse effects on foreign investors. Rebalancing investor rights means returning international investment law norms to their original intent as expressed in the early formative stages of the IIA system. Investor rights originally consisted of the right to compensation upon wrongful expropriation, together with the treatment consistent with customary international law rules on the treatment of aliens.

This aspect of rebalancing is required in order that IIAs do not continue to subvert states' regulatory efforts with respect to urgent 21st-century global priorities such as public health and the protection of the environment.

DIAGRAM *Rebalancing the scales*



The first set of reforms, therefore, focuses on reducing the costs of IIAs for host countries while increasing the benefits. This can be done by implementing the following 4 reforms (A-D):

A. Clarify and Restrict the Kinds of Investment and Nationality of Investors Covered by Agreements

1. **Clearly define the kinds of investment covered by the IIA**. While host countries signed IIAs to attract FDI, treaties have been interpreted as covering a broader range of 'investments,' including those providing more limited or no benefits to the host country, and in which investors assume little to no risk. For instance, the extent to which anticipated profits in a particular country should be protected from various kinds of government action (particularly where an actual investment in the country is minimal or non-existent) is an open question, as is the contentious issue of whether intellectual property should be protected under current investment treaties.

These underlying questions are likely to grow in importance with the expansion of business that blurs the line between investment and trade. What, if any, of the new forms of cross-border business should be covered under investment treaties or other investment agreements, and what should be covered by the very different agreements on trade in services?

Example: Defining Investment Clearly

The India Model BIT (2015) narrows the traditionally broad definition of a protected investment by stating that it covers "enterprises" such as subsidiaries established in the host country by a foreign parent company. This contrasts with the approach more commonly followed in investment treaties, which is to protect "all assets" of a foreign investor irrespective of whether the foreign investor had established an actual affiliate in the host country. The India Model BIT further narrows the scope of covered investments by identifying certain characteristics that covered investments should possess, such as significance for the host state's development. The Model BIT also explicitly excludes certain assets from the definition of an investment, including "(i) portfolio investments of the enterprise or in another enterprise; (ii) debt securities issued by a government or government-owned or controlled enterprise, or loans to a government or government-owned or controlled enterprise; (iii) any pre-operational expenditure relating to admission, establishment, acquisition or expansion of the enterprise incurred before the commencement of substantial business operations of the enterprise in the territory of the Party where the investment is made; (iv) claims to money that arise solely from commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party; (v) goodwill, brand value, market share or similar intangible rights; (vi) claims to money that arise solely from the extension of credit in connection with any commercial transaction; (vii) an order or judgment sought or entered in any judicial, administrative or arbitral proceeding; (viii) any other claims to money that do not involve the kind of interests or operations set out in the definition of investment in this Treaty."

2. **Tighten the definitions of nationality of investors to reduce their ability to take advantage of the most investor-friendly treaties that a host country has negotiated**. Under many current treaties, the definition of an investor eligible for protection is so broad that an investor from another country can gain the benefits of a treaty by simply incorporating an entity in the treaty country, without any substantive business activity or management control in the country. The result is that investors can shop for treaties that are most investor-friendly. Various proposals exist for closing this loophole, from basing coverage on the location of the firm's headquarters to the less stringent requirement of granting coverage to firms with substantial business activity in the treaty country.

> ***Example: Establishing an American company as a Dutch Entity***
> *By establishing a subsidiary in the Netherlands, US-based ExxonMobil gained protection from a Dutch treaty despite ExxonMobil being headquartered in the U.S.*

B. Narrow Interpretation of Key IIA Doctrines

1. Redraft national treatment provisions to specifically ensure that the focus of such provisions is on preventing nationality-based discrimination, for instance by including wording offering protection to investors from discrimination on the basis of nationality. IIAs often contain provisions relating to national treatment. Essentially, these provisions ensure that foreign investors are not treated less favorably than domestic investors in like circumstances. The rationale is to protect the foreign investor from discrimination on the basis of being a national of a different state. However, at times, the national treatment provision has been used as a gateway to protect foreign investors from any type of discriminatory treatment – in which they are not treated the same as domestic investors – even if the basis for that treatment is not discrimination based on the foreign investor's nationality. This form of protection is beyond the rationale of IIAs.

Example: National Treatment – Discrimination versus Discrimination Based on Nationality

In Bilcon v. Canada (2015), the tribunal concluded that Canada had breached its national treatment obligations towards the American investor by treating the foreign investor's environmental assessment process less favorably than the treatment afforded to domestic investors. The tribunal found that the foreign investor did not have to prove that the state's departure from national treatment had to be explicitly shown to be a result of the investor's nationality.

2. Remove the fair and equitable treatment obligation. The right to FET has emerged as both the provision most frequently invoked by investors and the most common basis for successful claims. FET provisions have been interpreted by investment tribunals to include a right to a "stable and predictable regulatory environment" that does not "frustrate their legitimate expectations." Given the vague nature of the words "fair" and "equitable," and the varying interpretations given to the FET concept by tribunals, it is exceedingly difficult for governments and others to know what the standard requires or when it has been breached. This uncertainty, in turn, can have negative impacts including over-deterring legitimate regulatory conduct (Bonnitcha 2014), and generating unnecessary and undesirable litigation.

Example: FET and Changes in World Mineral Prices

FET obligations have restrained governments from responding to significant changes in circumstances. For example, governments have not been able to defend tax or royalty increases in response to sharp and unexpected increases in mineral prices, even though the increases would leave the investor with adequate rates of return, often more than anticipated under the original lower price environment. In 2008, several petroleum firms brought claims against Ecuador after the country introduced new taxes on windfall profits and other measures to capture a larger share of the increased profits investors were receiving from higher oil prices. In 2014, a tribunal found that Ecuador's practice constituted a breach of its investment treaty obligations (Perenco v. Ecuador).

3. Limit investor protection to denials of justice. Foreign investors should only be protected against gross miscarriages of justice by domestic courts. Generally, claims for denial of justice are concerned with denial, unreasonable delay, or obstruction of access to courts; gross deficiency in judicial or administration processes; and failure to provide due process rights, among others. Such a provision prevents investors from suffering mistreatment by the host country's legal system and provides recourse if such mistreatment occurs. Denial of justice provisions generally require foreign investors to exhaust local remedies before claiming breach of this provision, as discussed in the following chapter.

Example: FET and Denial of Justice
The Colombia-India BIT (2009) defines fair and equitable treatment as "the prohibition against denial of justice in criminal, civil, or administrative proceedings in accordance with the principle of due process." A similar definition is found in the China-Peru FTA (2009) and the Colombia-United Kingdom BIT (2010). The Indian Model BIT (2015) includes protection against denial of justice, as it is defined under customary international law, without reference to fair and equitable treatment.

4. **Remove indirect expropriation from the definition of compensable expropriations in IIAs**. A common provision found in IIA is protection for foreign investors against indirect expropriation. This protects investors against governmental measures that adversely affect the value of an investment but do not actually transfer its ownership or control to the government. The notion of indirect expropriation is thought to be reflected in customary international law, although state practice indicates a very different understanding of indirect expropriation than is assumed under international investment law. Given the lack of consistent state practice in awarding compensation for forms of indirect expropriation, it is difficult to argue that protections against indirect expropriation amount to customary international law. Moreover, in instances of indirect expropriation due to state regulatory measures, "the reduction of the value of private property is not necessarily accompanied by an increase in public wealth" (Nouvel, 2002). Therefore the rationale for compensation is not as strong.

Example: Excluding Regulatory Action from Definition of Expropriation

Article 7 of the Brazilian Model BIT (2015) prohibits the direct nationalization or expropriation of investments, except when done for a public purpose, in a non-discriminatory manner, with effective compensation, and in accordance with due process of law, but Article 7(5) clarifies that the "article only provides for direct expropriation, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or ownership rights," thereby excluding indirect expropriations.

5. Prevent IIAs from being used to accord rights to investors who have not yet entered the market. Some home countries of investors have sought to use IIAs to guarantee access to host countries that are party to proposed IIAs. Extending IIA protection pre-establishment would move IIAs beyond protecting existing investors to ensuring rights to firms that have not entered the market. As a practical matter, it is hard to imagine what kind of damages a potential investor might claim for its being denied entry to a market when an IIA guarantees it. Any award would be highly speculative, presumably based on profits the investor would have made if it had been allowed into the market. Efforts to directly change government policy by, for example, requiring the government to abandon procedures that close sectors to foreign investors, or to review the proposals of individual investors, should not be covered in IIAs but rather by direct intergovernmental discussions or agreements.

Example: Prohibiting Pre-Establishment Rights

The Indian Model BIT (2015) limits pre-establishment protections for foreign investors. Article 1.4(iii) of the Model BIT specifies that "pre-operational expenditure[s] relating to admission, establishment, acquisition or expansion of the enterprise" do not constitute covered investments.

6. Exclude the MFN clause from investment treaties or clarify its scope. Many investment treaties contain a "most-favored-nation" (MFN) provision requiring

that a foreign investor receives treatment that is no less favorable than that given to an investor from any third country. In many instances, foreign investors have been able to rely on this provision in order to "import" more favorable provisions in other IIAs, including more favorable substantive protections and more favorable dispute resolution clauses. This has the effect of expanding the obligations of the host state to areas for which it did not originally offer its protection.

In reforming IIAs, it may be pertinent to remove these clauses from IIAs, such as India has done in its model IIA, or clarify their meaning to avoid unintended expansion of their scope.

Example: Narrowing the scope of the MFN provision
Article 8.7(4) of the Comprehensive Economic and Trade Agreement between Canada and the European Union and its Member States, states: "For greater certainty, the 'treatment' referred to [the MFN provision] does not include procedures for the resolution of investment disputes between investors and states provided for in other international investment treaties and other trade agreements. Substantive obligations in other international investment treaties and other trade agreements do not in themselves constitute 'treatment', and thus cannot give rise to a breach of this Article, absent measures adopted or maintained by a Party pursuant to those obligations."

C. Ensure that IIAs Do Not Limit the Scope of Legitimate Policy-Making by Governments

1. Remove restrictions on exchange controls. A significant number of investment treaties include language that prevents investors from being subject to measures that limit or otherwise govern their access to foreign exchange for dividends, remission of capital, debt service, or for the purchase of imports. While there are questions about the advantages and disadvantages of foreign

exchange controls for economic growth agendas, administrative efficiency, and other policy considerations, it is increasingly recognized that there can be important justifications for ensuring that governments **have the ability** to adequately regulate capital flows in or out. The issue of exchange controls is better left out of IIAs and instead addressed by an institution such as the International Monetary Fund where it can be viewed within the bigger picture of reducing or addressing volatile capital flows. Alternatively, and at a minimum, controls should allow governments to temporarily impose restrictions on access to foreign exchange by covered investors when the host country is faced with a potential or actual crisis. This is consistent with the growing international consensus that foreign exchange controls do, sometimes, have a role to play in stabilizing economies.

Example: The IMF and Capital Liberalization

In the 1990s, the IMF pushed for capital account liberalization as a tool to promote economic growth. This policy approach was reflected and advanced in many investment treaties concluded during that decade, as IIAs often contained broad commitments by governments to allow investors to freely move money in and out of their countries without restriction. However, lessons learned from a series of financial crises that rocked regions and the world in the decades before and after the millennium (such as the Asian financial crisis of 1997-98, and the global financial crises of 2008) provided lessons that governments may benefit from adopting capital controls to discourage occurrence of such crises and, when such crises do occur, to minimize their effects (Gallagher 2015). The IMF has revised its approach accordingly and has recognized the importance of these tools.

2. Remove restrictions on performance requirements. As discussed above, FDI may produce benefits for host countries in terms of increased employment, technology transfer, skills upgrading, and economic diversification. However, those benefits are not automatic, and their appearance can depend on the policy tools used by the host country and its efforts to encourage or even require the foreign investment's integration into and engagement with the domestic economy and actors. Those policy tools include measures to mandate or

incentivize foreign investors to purchase or accord preferences to local suppliers of goods or services, to employ domestic workers, to develop and implement education and training programs, and to conduct higher-value-added activities, such as research and development, in the host country. While these types of measures may not always have their intended effects, they have also been used successfully to help ensure that countries and stakeholders within them generate the benefits that FDI can, but does not necessarily, offer. (Johnson 2016).

As governments strive to harness private sector capital for sustainable development objectives, it is unclear whether it makes sense to establish broad, ex-ante bans on government use of these tools (often labeled as "performance requirements"). There are already some key restrictions on performance requirements in the WTO Agreement on Trade-Related Investment Measures (TRIMs) that have been agreed at the multilateral level. These are relatively basic limits on government efforts to require foreign (and other) investors to use local goods in ways that distort trade. The case for there being any global welfare benefits by going beyond those WTO-based limits, and imposing additional legal constraints on government efforts to generate positive spillovers from FDI, has not been made.

Example: The 2016 Draft Pan African Code (PAIC)

PAIC, developed under the auspices of the African Union Commission, represents a new way of thinking about 'performance requirements' and their impact on development. It explicitly allows states to impose performance requirements and local content. Article 17 of the draft PAIC states:

Member States may introduce performance requirements to promote domestic investments and local content. Measures covered by this Paragraph include, inter alia:

a. *measures to grant preferential treatment to any enterprise so qualifying under the domestic law of a Member State in order to achieve national or sub-national regional development goals;*

b. *measures to support the development of local entrepreneurs;*

c. *measures to enhance productive capacity, increase employment, increase human resource capacity and training, research and*

development, including of new technologies, technology transfer, innovation, and other benefits of investment through the use of specified requirements on investors; and
***d.** measures to address historically-based economic disparities suffered by identifiable ethnic or cultural groups due to discriminatory or oppressive measures against such groups prior to the adoption of this Code.*

3. Include policy carve-outs or protections. Increasingly, international investment agreements include exceptions or carve-outs aiming to exclude certain sectors, policy objectives, or government tools from the scope of the treaty (or its dispute settlement mechanisms). In some cases, the treaties also specify that determination regarding whether or not a measure is covered by those exceptions or carve-outs is subject to a special dispute resolution system.

Example: Public Welfare Carve-outs
The China-Australia FTA (2015) states that "Measures of a Party that are non-discriminatory and for the legitimate public welfare objectives of public health, safety, the environment, public morals or public order, shall not be the subject of" an ISDS claim (see Article 9.11(4), (5) and (6)).

D. Limit Damages and Make Them More Consistent

Under the current ISDS system, damage awards by arbitral tribunals differ substantially in comparable cases, and awards can be extremely large compared to the ability of a host country to pay. The inconsistency and large size of awards result from the fact that current IIAs provide very little guidance as to how damages should be calculated, and give no consideration to the possible impact of an award on the host country's economy. Standards such as Fair Market Value, or restoring the investor to the position it would have been in without the host

government action that caused the damages, provide only limited guidance to tribunals.

1. Minimize inconsistencies in discount rates used. The majority of damages calculations in cases of expropriation rely on attempts to calculate the Fair Market Value (FMV) of assets taken. The most common method used to calculate FMV is some version of discounted cash flow (DCF). Although the claimant or the respondent sometimes proposes the use of "comparable transactions" as an alternative to DCF to determine FMV, this approach has generally not been accepted, since it has been so difficult to find comparables that are acceptable to a tribunal.

Awards based on DCF calculations are very sensitive to the discount rate that is used. The implications of gaps between projections of cash flows made by claimants and respondents have often been dwarfed by the difference in discount rates they propose. In one of the ExxonMobil cases against Venezuela, the claimant proposed a discount rate of around 5% while the respondent argued for close to 20%. The impact of the different rates amounted to billions of dollars. In fact, a large part of the variations in damages in Venezuelan expropriation cases resulted from the use of different discount rates by tribunals. And the major part of differences in proposed discount rates resulted from the country risk premium that tribunals applied to projects that arguably faced very similar risks. The question of whether IIAs could reduce the disparity in damage calculations by addressing the relevance and determination of country risk premium has not been addressed by critics of the system. Doing so would reduce the variability of awards.

2. Ensure only sunk cost compensation for companies without a track record of profitability. The principal exception to the use by tribunals of DCF has been for cases where the expropriation for FET violation involved an enterprise with no track record of profitability, such as a potential mine that has not actually reached the production stage. In many such cases, tribunals have awarded only the costs incurred by the investor, arguing that the projections required to use DCF are too speculative to determine a damages award. On the other hand, some tribunals have attempted to use DCF even when there is no track record

that can be used to determine costs or even feasibility. The result of this different treatment in similar cases has been very dissimilar damage awards. Treaties might call for the use of methods other than DCF when the project is highly speculative, and especially when there is no on-going enterprise to base projections on.

3. Provide exceptions for some government actions in extenuating circumstances such as financial crises. Award calculations have varied even in the same country according to whether a tribunal accepts the argument that government actions can be excused in the case of extenuating circumstances during a financial crisis. Thus, some tribunals made smaller awards in Argentina during its financial crisis by recognizing that adverse government actions resulted from the financial crisis itself, and therefore the government should be excused from its obligations for a period. At the same time, other tribunals ruled against extenuating circumstances, blaming the government's actions themselves for creating the crisis. IIAs could possibly contain provisions that excuse some government actions in a crisis.

4. Minimize inconsistencies in interest rates used. Tribunals have come to different conclusions about the rate of interest to be applied to damages for pre-award and post-award periods. Parties have argued for the risk-free rate, the investor's borrowing rate, the investor's rate of return on investments ("opportunity cost") or the same discount rate used for calculating a net present value, and the borrowing rate of the host country. Moreover, parties have argued for compound interest and for simple interest. Different tribunals have accepted different arguments, while some appear simply to have chosen a rate independent of the arguments. IIAs could resolve the inconsistency in rulings (and reduce time and money spent in arguing for one or the other approach) by specifying how interest is to be calculated.

5. Allow or require tribunals to consider the impact of awards on host countries and limit severely damaging awards. Many claims under IIAs and some awards might be considered to be so large that they would severely damage the general economy and thus the population of a poor country. One could argue that such large awards should not be made, regardless of the

outcomes of calculations such as FMV. Another way of looking at the issue is to accept that the harmful impact on the general population of a poor country due to government actions should be limited.

A claim that is as big as a large portion of a country's foreign exchange reserves or GDP might be considered so damaging to a poor country, if granted, that it would be unconscionable. IIAs could be designed to limit awards that are too destructive of economies in poor countries. Provision of some kind of limits on individual awards, however, does not solve the problem of multiple claims against a country that, in total, might be considered unconscionable. The existence of an international investment court might allow the consolidation of cases and enable the impact on the host country of multiple awards to be considered. In the absence of such a court, IIAs could state that general concern with the **total awards** against a host country might be excessively damaging and leave it up to tribunals to take into account the impact of awards on poor countries.

10.3 REBALANCING: IMPOSING DUTIES ON INVESTORS

Rebalancing international law with respect to investor duties means, following the principle of reciprocity, that additional legal obligations are required of investors to parallel the grant of rights they enjoy under IIAs.

What Would Be the Source of the Investor Obligations?

There are several different approaches that could be taken to impose obligations on foreign investors within the international investment regime. The obligations could be included within IIAs themselves, creating a rough symmetry with the investor rights provisions. Under the existing model, this option could be criticized on the grounds that it would entrust investment tribunals with the authority to determine whether investors had violated their obligations. However, another approach would be to use IIAs to require state parties to adopt legislation to ensure appropriate accountability. Similar provisions are included in international trade agreements on issues such as intellectual property law. Yet another approach would be to include investor obligations in some new legal instrument, a possibility we explore in Chapter 9.

Example: Investor Obligations in an IIA
Investor duties are included in the 2016 Draft PAIC. Chapter 4, "Investor Obligations," of the Draft PAIC requires the investor to, inter alia, (i) adhere to "socio-political obligations" including the "respect for national sovereignty and observance of domestic laws, regulations and administrative practices, respect for socio-cultural values, non-interference in internal political affairs, non interference in intergovernmental relations, and respect for labor rights"; (ii) refrain from bribery; (iii) observe corporate social responsibility obligations; (iv) use natural resources in a responsible manner; and (v) observe business ethics and human rights.

What Substantive Obligations Could Be Imposed on Investors?

Basic Obligations

Developing countries hope to attract foreign investment in order to promote sustainable economic development; the substantive obligations of investors' local operations should reflect this purpose. At the most rudimentary level, investors should conduct business activities in accordance with the laws of the host country. Local operations should be integrated organically into the national development plans of the host countries, and foreign investors should not abuse their market power in the host country.

Additional Obligations

Beyond normal business activities, subsidiaries in host countries should also be required to comply with existing relevant international standards. This could include meeting the anti-corruption obligations detailed by the OECD Convention, standards based on the UN Guiding Principles on Business and Human Rights, and other global human rights norms and standards.

Who Would Be Subject to the Obligations?

The subsidiaries of foreign investors should take on primary responsibility for obligations of foreign direct investment in host countries. However, the corporate parents and the home states should simultaneously take on joint responsibility. The subsidiaries are part of the global operations of the parent corporation and are subject to the parent corporation's global operation strategies.

Every multinational enterprise has a home base and is affected by the home country's policies. Accordingly, obligations facing the subsidiaries should be designed in coordination and conformity with requirements imposed on the parent and the home state. Host countries frequently view the business activities of foreign subsidiaries as a critical part of the national strategies of the home country. On the other hand, home countries consider the protections of the interest and investments of their foreign subsidiaries as part of their national strategies.

The notion of a corporate nationality is often obscured in an era where many western multinationals have footprints across the globe. Nonetheless, within a specific context, we can always identify a single home state for the concerned subsidiary operation on which to impose corresponding obligations. It can have nothing to do with where the corporation initially originated. For instance, in the previously discussed case, ExxonMobil was qualified as a Dutch enterprise despite being based in the United States.

How Would These Rights Be Enforced?

In order to effectively rebalance the foreign investment regime, a system of investor obligations would need to be enforceable. An initial issue that would need to be addressed would be the question of "standing": who would have the right to seek enforcement of investor obligations? Presumably the host state

government, at a minimum, would have the standing to enforce investor obligations, but standing could also be extended to cover adversely affected communities, workers, or other stakeholders.

It would also be necessary to determine the appropriate form of dispute settlement process. Options include the use of ad hoc arbitral tribunals (the current model for investor rights under IIAs), a standing international judicial body, domestic courts, and state-to-state dispute settlement.

A number of different remedies could be made available for violations of investor obligations. Within the current framework, a host state could be permitted to raise a violation of investor obligations as an affirmative defense that would preclude the investor's ability to bring a claim for alleged violations of its rights under an IIA (an application of the "clean hands" doctrine). Alternatively, violations of investor obligations could be a basis for reducing any damages awards to foreign investors. Other forms of remedies, such as injunctive relief, could be implemented through domestic legislation.

The above approaches, however, have limits. They rely on the investor bringing the claim and allow the investor to define the party who is bringing the action and the procedural rules and institution through which the claim will be heard. Interested and affected parties may not have a chance to have their voices heard or meaningfully participate in the dispute, even if their rights and interests are directly affected.

If investment agreements specified that governments (or even affected communities) could bring claims through domestic courts against investors who failed to live up to their obligations in the IIAs, this would potentially be much more effective in terms of creating widespread change in investor behavior. All investors would then have strong incentives to take notice of these obligations, rather than only those who were considering themselves bringing a claim.

10.4 CONCLUSION

Guided by procedural principles (in particular subsidiarity and accountability of states to their citizenry), this chapter has recommended reforms to allow states the policy space to pursue sustainable development goals. Reforms such as defining investment clearly, narrowing interpretation of key doctrines such as FET, removing restrictions on performance requirements, creating policy carve-outs for priorities including protection of public health and the environment, and including obligations for investors, all can potentially play a role in this endeavor.

11. REBALANCING INTERNATIONAL INVESTMENT LAW: DISPUTE SETTLEMENT

11.1 REBALANCING: DISPUTE SETTLEMENT

The reform of ISDS is motivated in part by the need to rebalance investor and state rights, and in part by the need to address numerous procedural and rule-of-law deficits that have plagued investment arbitration and have been criticized by parties on all parts of the spectrum.

Rebalancing investor-state rights in dispute settlement could involve, most ambitiously, eliminating ISDS altogether. Short of that, such rebalancing requires a number of reforms including modifying current exhaustion of remedies doctrine, strengthening transparency rules, regulating or prohibiting third-party funding, and restoring state-to-state arbitration as the primary non-domestic dispute settlement forum for investment claims.

Addressing rule-of-law deficits in the ISDS process could include other structural reforms such as creating an appellate body or bodies, or establishing stronger domestic review mechanisms; constructing a permanent arbitral court-style mechanism; and strengthening the independence and impartiality of adjudicators in other ways. While these steps would not resolve the more fundamental concerns regarding the ISDS, they could improve certain aspects of that mechanism.

After first laying out the case for ISDS reform, this section proceeds to the various options for rebalancing dispute resolution and addressing procedural and rule-of-law issues.

11.2 WHAT ARE THE PROBLEMS WITH ISDS?

The ISDS system is widely criticized as deficient on a number of grounds, including that it:

- privileges foreign investors over all other stakeholders,
- marginalizes domestic courts and institutions,
- expands interpretations of the IIA obligations,
- generates uncertainty in the law,
- lacks rule of law features, and
- enlists private arbitrators to adjudicate public concerns and interests.

Privileging Foreign Investors over All Other Stakeholders

First, there is the fundamental structural question as to why foreign investors, as a particular class of persons, should have access to a specialized form of international dispute settlement that is available only to them and not to other stakeholders.

The special dispute settlement rights granted to foreign investors were originally justified as a method of attracting more foreign investment to some countries, under the assumption that increased foreign investment plays a positive role in economic development. Yet, the empirical evidence about the impact of IIAs on FDI flows does not justify privileging foreign investors with a bespoke system of international arbitration.

Marginalizing Domestic Courts and Institutions

The ISDS system has led to the marginalization of domestic courts and legal institutions that can often be bypassed as a result of provisions in IIAs. This may have been justified at the genesis of the system with reference to concerns over the quality of legal justice in certain host country jurisdictions, a concern which has been widely addressed in many legal systems since decolonization.

Expanding Interpretations of the IIA Obligations

The ISDS system as constituted allows jurisdictional provisions (such as definitions of covered investors and investments) and investment law norms (such as the FET standard) to be interpreted broadly to create new rights. Indeed, some have argued that the current system of arbitrator compensation magnifies this trend: because arbitrators are compensated based on the number and duration of cases they hear, there is a financial incentive for them to adopt permissive approaches to the investor claims they entertain and accept. These expansive interpretations, in turn, reduce state regulatory prerogatives and can threaten decisions made for public interest purposes or through legitimate domestic processes.

Generating Uncertainty in the Law

There is no meaningful review mechanism to address incorrect decisions, nor to ensure like cases are decided in like manner. This has allowed for an incoherent and sometimes widely divergent set of rulings and legal theories. It is a compounding problem, in that ever more expansive interpretations of IIA norms are not checked by any higher legal authority. As a result, investors and states face significant difficulties in understanding their rights and obligations.

Lacking Rule-of-Law Features

The ISDS mechanism has been widely criticized for a range of rule-of-law deficits. It is cited as contradicting principles of inequality under the law; being insufficiently transparent; failing to protect the rights and interests of non-parties; lacking rules and tools for ensuring independence and impartiality of adjudicators; and being devoid of meaningful review mechanisms to ensure legal and factual correctness of awards and help promote consistent interpretations of the law. These issues, in turn, erode trust in the process and legitimacy of specific awards and the regime more broadly.

Appointing Private Arbitrators to Adjudicate Public Concerns and Interests

Private arbitrators reviewing domestic conduct raise legitimacy concerns. The system of party appointment and compensation, and the lack of strong ethical rules, raise questions about the independence and impartiality of adjudicators. Compounding those issues, decisions made by adjudicators are not subject to meaningful appellate or judicial review.

11.3 THE CASE FOR ABOLISHING ISDS

Given the problems with ISDS identified above, one option for reform would be to abolish ISDS as a form of dispute resolution altogether. In any case, it is unclear why foreign investors should be treated more favorably than other individuals bringing claims against governments. This is because foreign investors have other legal fora in which to bring claims and they have access to other means – beyond ISDS – to protect their interests. In addition, removing ISDS may, as a side effect, help build capacity in national courts.

The availability of other international legal fora. ISDS is not the only legal forum open to foreign investors concerned about their treatment from governments. They also have access to international and regional human rights dispute settlement processes where they can bring claims about violations of the most serious property rights issues. These dispute settlement processes are considered sufficient by the international community to deal with other equally egregious issues, although their focus is not on awarding large-scale compensation but rather offering redress for wrongs.

The availability of other forms of protection for investors. Beyond seeking legal redress, foreign investors can protect themselves in other ways. For instance, they can take out political risk insurance from private or public entities in order to obtain financial compensation for at least some of the same kinds of issues

that are covered under IIAs. Protection for many other issues that are crucial to human well-being are dealt with primarily through insurance systems (e.g. recompense for the destruction of a person's home). While in their current form, political risk policies are unlikely to provide the same level of coverage as a successful claim through the current ISDS process, increased reliance on such policies could support a case for expanding coverage that is offered.

Building capacity in the national court system. One common argument for retaining ISDS is that the national court systems of some host countries are incapable of fairly addressing claims by foreign investors. However, as UNCTAD has observed: "Rather than focusing exclusively on ISDS, domestic reforms aimed at fostering sound and well-working legal and judicial institutions in host states are important. This may ultimately help remedy some of the host-state institutional deficiencies which IIAs and the ISDS mechanism were designed to address." In other words, by abolishing ISDS, there may be a renewed effort to build capacity in national court systems. Moreover, a side effect of abolishing ISDS may be to add pressure from foreign investors to the push to build capacity in local courts, since investors would not have an alternative to support their claims. On the other hand, previous efforts to reform the judicial system of many developing countries have not made much progress. Added pressure from foreign investors is not likely to be sufficient to effect reforms that have thus far failed.

Utilizing state-to-state dispute settlement mechanisms. In the absence of ISDS, the investor's home state can challenge a host state's IIA breach through state-to-state dispute settlement. Most existing treaties already contain mechanisms for state-to-state dispute resolution alongside their ISDS provisions. Some IIAs, such as the treaty between Australia and the US, and the treaties concluded by Brazil with a number of countries in recent years, similarly opted not to include ISDS provisions. This option is discussed in more detail below.

Abolishing ISDS represents a clear case of rebalancing investor and state rights towards restoring state regulatory authority.

11.4 REFORM OF ISDS

In the event that ISDS remains a part of the regime, this section outlines some reforms that could improve ISDS, both from a rebalancing perspective and a rule-of-law perspective. The latter includes reforms to the institutional structure as well as procedural reforms.

1. ISDS Reforms that Help Rebalance Investor and State Rights

A. Exhaustion of Local Remedies

One idea for reforming the process of ISDS is to require foreign investors to resort to domestic courts in the host state to resolve their dispute before bringing an international claim. This requirement, known as "exhaustion of local remedies," is a fundamental principle of international law that is applied both when individuals ask their governments to bring claims on their behalf against other governments, and in human rights cases. Although some early investment treaties contained this requirement, most modern IIAs do not. Moreover, even those treaties that include an exhaustion clause generally impose a very short time limit (e.g., 18 months) during which the investor must pursue their claim in domestic courts.

An exhaustion of local remedies requirement offers numerous benefits, starting with respecting the legitimate jurisdiction of domestic judicial systems from unnecessary encroachment by international institutions. It would also help to rebalance some of the asymmetries in the ISDS system, reducing the procedural advantages that foreign investors enjoy over both host state governments and other constituencies (such as domestic investors, environmental and labor organizations) that lack comparable access to international dispute settlement processes.

The local remedies rule could further help to promote the rule of law by adding pressure for strengthening domestic legal systems and helping to integrate them with the international investment regime. For developing countries, encouraging the resolution of foreign investment disputes through the domestic courts would provide an opportunity to clarify the legal standards applicable to both foreign and domestic investment, such as the procedures and criteria for granting licenses or permits for resource extraction.

The rule could also improve the functioning of ISDS tribunals by clarifying both the factual record and the relevant principles of domestic law. Many investment disputes turn on the extent to which changes in regulatory policy interfere with an investor's "legitimate expectations" about the value of an investment. It is difficult to assess whether an investor's expectations are "legitimate" without a clear understanding of both the relevant facts involved and the legal framework in which the investment was made. These issues are presumably more within the competence of a domestic court than an international investment tribunal.

However, to be effective, the exhaustion of local remedies requirement would need to meet certain criteria. First, to avoid overly narrow interpretations by investment tribunals, the exhaustion requirement should be made an explicit condition of host states' consent to arbitration. Second, the investor should be required to pursue domestic remedies for a period of time that is reasonable to accommodate the procedures of a domestic legal system (ie five years). Third, any "futility" exception to the exhaustion requirement should be narrowly drafted to require evidence of corruption or some other specific lack of capacity on the part of the domestic courts.

Example: Exhaustion of Local Remedies Requirement in IIAs
India's new Model Bilateral Investment Treaty (2015) contains a limited exhaustion of local remedies requirement. It requires foreign investors to pursue their claims in domestic court for at least five years before bringing an international claim.

B. Transparency of Arbitral Awards and Decisions

In some, but not all, cases, arbitral awards, decisions and filings under IIAs are made public. If ISDS is to be retained, all documents associated with the arbitration, including the award, should be made public, irrespective of the forum for resolution of the dispute (subject to the protection of confidential information such as information related to national security). Transparency ensures public trust in the system as well as its legitimacy.

Without transparency, filings (including pleadings, expert reports, and briefs of parties and *amicus curiae*), decisions and awards are known only to the arbitrators and counsel in the individual dispute. As these individuals can be retained by parties in future disputes, this can have the effect of creating private law known only to insiders and can result in advantages for a limited group of individuals, enabling them to charge increased fees that in turn increase the costs of bringing disputes.

The lack of transparency also prevents those who are affected by the very nature of the issues at dispute in ISDS from following and participating in disputes and scrutinizing such awards. This is particularly cogent as ISDS evaluates government regulatory decisions, regulations that affect the public at large. Transparency is therefore essential to guarantee public confidence in the fairness of the dispute resolution process.

Example: UNCITRAL Transparency Rules
The following are excerpts from the UNCITRAL's Transparency Rules:
1. Subject to article 7 [covering confidential or protected information], the

following documents shall be made available to the public: the notice of arbitration, the response to the notice of arbitration, the statement of claim, the statement of defence and any further written statements or written submissions by any disputing party; a table listing all exhibits to the aforesaid documents and to expert reports and witness statements, if such table has been prepared for the proceedings, but not the exhibits themselves; any written submissions by the non-disputing Party (or Parties) to the treaty and by third persons, transcripts of hearings, where available; and orders, decisions and awards of the arbitral tribunal.
2. Subject to article 7, expert reports and witness statements, exclusive of the exhibits thereto, shall be made available to the public, upon request by any person to the arbitral tribunal.
3. Subject to article 7, the arbitral tribunal may decide, on its own initiative or upon request from any person, and after consultation with the disputing parties, whether and how to make available exhibits and any other documents provided to, or issued by, the arbitral tribunal not falling within paragraphs 1 or 2 above.

C. Restricting Third-Party Funding

A third procedural reform that would improve ISDS is restricting third-party funding (TPF). Generally speaking, TPF involves a speculative investor making an investment in a claim in dispute, in return for some degree of control over the case and a contingent stake in the recovery. The use of TPF is a relatively recent phenomenon, the practice having been banned earlier. The rationale for the acceptance of this formerly forbidden practice was the hope that it would increase access to justice for impecunious or poorly funded claimants.

TPF in investment arbitration (Investment TPF) began in the early 2000s and grew dramatically after the 2007-08 Global Financial Crisis, driven in part by speculative finance managers looking for new investment vehicles. TPF funders now routinely market TPF to traditional FDI investors as a tool for balance sheet management in the event of a dispute. The success of this effort has led to the dramatic increases in the number of TPF-funded claims (Pia Eberhardt & Cecilia Olivet 2012).

Allowing speculative finance into ISDS as it stands brings a highly-capitalized set of non-direct investors into a dispute mechanism with incentives that are unrelated to the goals of the system. This increases the number of claims filed, the number of weaker claims pursued (for either settlement or precedent value), and the number of cases not settled outside arbitration in the hopes of a larger recovery, driving host country costs upwards. TPF funders target claims against less developed and less well-resourced states. This threatens to transform the ISDS system into an extraction mechanism for wealth transfers from developing country citizens to well-funded financial speculators, instead of a system intended to protect development capital for the good of investors and host states. For these reasons, TPF in investment arbitration is at best a distortion of the investment system and at worst a deliberate exploitation of the weaknesses and deficits of the system for the benefit of speculative finance (Garcia 2018).

TPF should be banned from ISDS through revisions to current and future IIAs, changes to domestic laws, and changes to arbitral rules. However, if banning is not feasible, TPF should be regulated. First, IIAs, investment contracts and the rules of arbitral associations should require mandatory disclosure of the presence of TPF in a given case and, most importantly, mandatory disclosure of the terms of the funding agreement. Second, where TPF is found to be involved, the tribunal should order mandatory security for costs, so that in the event the TPF-funded claimant loses, the state has access to funds to reimburse it for its legal costs (Thrasher 2018).

Example: TPF Funding

A recent example of TPF funding is found in Teinver, S.A. et al. v. Argentina (2017). In that case, Burford Capital, a leading third-party funder, funded a claim against Argentina in a case involving a valuation dispute between Argentina and Teinver and two other Spanish investors. Argentina stepped in and expropriated two airlines, claiming that mismanagement had driven the airlines into insolvency. An arbitration tribunal returned an award in excess of $325 million. Burford Capital invested approximately $13 million in the matter and sold its interest on the secondary market for $107 million, a gain of $94.2 million and a 736% return on its investment.

D. State-to-State Arbitration

A final reform option would be to limit dispute resolution in IIAs to state-to-state arbitration. State-to-state arbitration involves states initiating claims against a treaty party arguing violations of the IIA, without the direct involvement of the investor. The practice is already commonly found in IIA provisions, although in many cases it is limited to resolving issues of interpretation or application of the treaty rather than directed at resolving substantive claims under the treaty.

The notion of state-to-state arbitration on the substance of IIA claims was a common provision found in Friendship, Commerce and Navigation treaties. Essentially, this was a type of diplomatic protection claim for violations suffered by a state's nationals. Such provisions can still be found in modern treaties (see Box below)

Limiting dispute resolution under IIAs to state-to-state arbitration offers several benefits, including enabling home states to protect a large class of similarly affected foreign investors through a class action or protecting individual investors who either cannot afford to initiate an action or fear retaliation or discrimination by the host state for initiating such an action. State-to-state arbitration would also necessarily limit the number of claims that could be initiated as it would be impractical for states to have to defend all investor claims. Moreover, the practice would limit the expansive interpretations given to IIA provisions as the state bringing the action would be conscious that expansive interpretations could be detrimental to its own interests when it becomes the defendant state in future claims initiated by the other treaty party.

At the same time, state-to-state arbitration re-politicizes dispute settlement in IIAs. States would be given the power to pick and choose which investor claims it wanted to pursue, which could be driven by the state's ideology. The practice could also subject capital-importing to abuses from diplomatic protection by capital-exporting states. Reisman has argued that ISDS is essential as it separates investor claims from "the caprice" of politics between states, a benefit which is lost in state-to-state arbitration. However, the benefits of the practice may outweigh this loss to investors.

Example: State-to-State Provisions in IIAs
The US Model BIT offers state-to-state arbitration both for the interpretation of IIA provisions as well as for its application. As article 37(1) notes: [A]ny dispute between the Parties concerning the interpretation or application of this Treaty, that is not resolved through consultations or other diplomatic channels, shall be submitted on the request of either Party to arbitration for a binding decision or award by a tribunal in accordance with applicable rules of international law

2. Institutional/Rule of Law Reforms

As an institution designed to promote justice in the area of international investment law, ISDS lacks some of the fundamental hallmarks of legitimacy that characterize a judicial system. For one, it does not allow for the correction of erroneous or conflicting awards, which could be addressed by establishing an appellate system. Secondly, it relies exclusively on ad hoc arbitration, which prevents reliance on procedural efficiencies, consistency in decision-making, and a permanent body of decision-makers that a specialized international investment court could provide. Finally, it uses ad hoc arbitrators whose independence may be compromised. This section looks at three alternatives to improving ISDS from an institutional perspective. These are creating an appellate system to review arbitral decisions, establish an international investment court, and improving the composition of arbitrators.

These reforms, while primarily motivated by rule of law and procedural fairness concerns, have a secondary rebalancing effect. Given that the current ISDS system produces inconsistent arbitral rulings and has over the past several years seen an increasingly expansive interpretation of fundamental treaty norms that favor investors, the implementation of these rule of law reforms could be expected to restore state policy space under the current status quo.

A. Expanding Review Mechanisms

International investment law allows only limited review of arbitral decisions. This is done in order to enable proceedings to be conducted with relative speed and to help ensure awards are final and easily enforceable. But these policy goals come with tradeoffs. One is that the limited scope of review means that countries may be bound to awards that violate fundamental principles of their domestic law. Another is that it binds countries to adverse awards even when those awards are legally or factually incorrect. And a third is that limited review has resulted in the same treaty provisions being interpreted in inconsistent ways.

In an effort to improve the legitimacy and consistency of the ISDS procedures, one reform approach is therefore to expand scope and opportunity for review of ISDS awards. This could be accomplished by expanding grounds for domestic court review. Another option is to create an avenue for substantive appeals vis-a-vis arbitral rules, which could enable arbitral awards to be appealed to either an existing institutional body or to a dedicated international investment appellate body, similar to the WTO Appellate Body.

Example: The WTO Appellate Body
The WTO Appellate Body is a standing body of seven persons that hears appeals from decisions issued by trade panels in disputes brought by WTO Members. The Appellate Body members are to be broadly representative of membership in the WTO. They are appointed for four-year terms, which may be renewed once. The Appellate Body can uphold, modify, or reverse the findings of a panel. Appellate Body Reports, once adopted by the Dispute Settlement Body, are final and made public.

B. An International Investment Court System

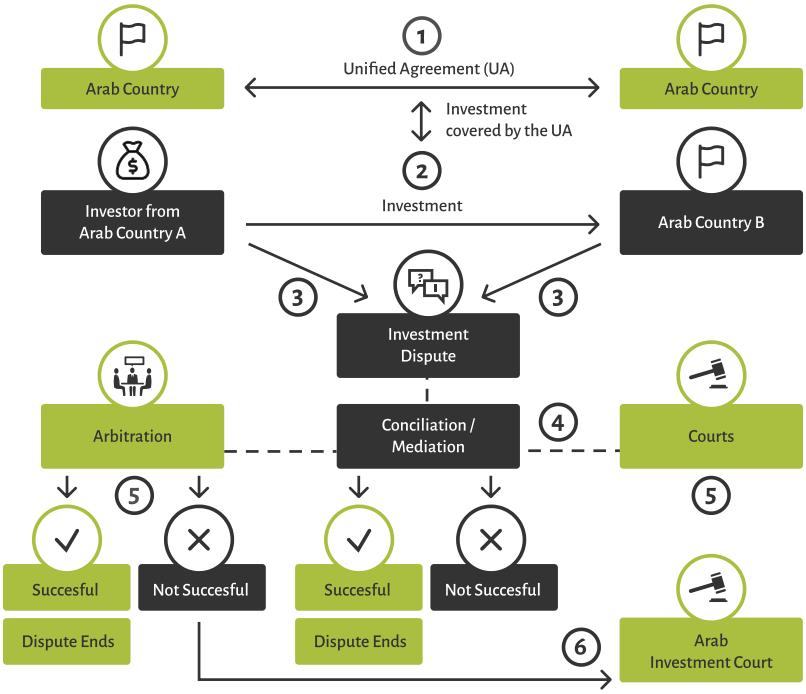
A second option for improving the legitimacy of ISDS is to replace it with an investment court system that would hear investor-state disputes in lieu of traditional *ad hoc* arbitration tribunals. The European Union has proposed such a system and is attempting to include it in all of its future IIAs. The EU Model

contemplates the establishment of a two-tiered standing court with a tribunal of first instance and an appeal tribunal. Both tribunals are designed to be staffed by a permanent roster of judges for a term of at least six years. Judges would be paid a monthly retainer fee to ensure their availability and independence.

Reliance on a court system, rather than *ad hoc* arbitration, is also advocated in the model of the Arab Investment Court (AIC), established under the Unified Agreement for the Investment of Arab Capital in the Arab States (Unified Agreement). Article 25 of the United Agreement requires disputes to be settled by way of conciliation or arbitration or by recourse to the Arab Investment Court.

The dispute settlement system of the Unified Agreement is described in the chart below.

DIAGRAM *Arab Unified Investment Agreement Dispute Settlement Model*



Under the Unified Agreement, investors have primary recourse to conciliation and/or arbitration. Only if conciliation and/or arbitration has not been conclusive, or if the disputing parties fail to agree to submit the dispute to conciliation or arbitration, can investors seek recourse to the AIC. However, the AIC is not an appeal organ.

The AIC model could inspire the design of a reform to ISDS where a court and ISDS simultaneously exist. Investors could thus be given the choice of either going directly to arbitration or proceeding to an investment court. The court could further provide guidance on investment matters by issuing interpretations of issues that are commonly at issue in arbitrations, as the AIC does.

One concern that has been raised about specialized courts established to hear a certain type of claims by a certain type of actors, however, is that it "may be prone to resolve disputes in ways that aggrandize its role, which is to say, to reach decisions that will induce investors to assert more claims" (Dreyfuss 2016: 889).

C. Independence of Arbitrators in Investment Dispute Settlement Bodies

Another important area for reform is the process for appointing and assuring the independence of members of investment tribunals. Under the current system, tribunals typically are comprised of three members: one appointed by the investor, one by the host state, and the third member – the "President" of the tribunal – by agreement of the Parties (or by an appointing authority if no agreement can be reached). This process provides investors with an unprecedented role in "choosing their own judges" in disputes that frequently involve important issues of public policy.

In addition, arbitrators frequently represent investors as counsel in other investment arbitration proceedings, creating a significant risk of conflicts of interest. Currently, a party to an arbitration can challenge an arbitrator on various grounds. The challenge may be reviewed by other members of the tribunal or by an *ad hoc* review panel. Critics of the system believe that reviewers are very hesitant to disqualify an arbitrator.

To increase the legitimacy of the system, arbitrators, members of an investment appellate body, or an investment court, should be appointed by the relevant governments establishing the system. In addition, to guarantee independence,

they should either be permanent members of the dispute resolution body with a regular salary, or their financial independence should otherwise be ensured. Arbitrators or judges should further be subject to appropriate conflict of interest standards that would, at a minimum, preclude them from acting as counsel for private parties in other disputes. Moreover, arbitrators should be appointed on the basis of holding demonstrable expertise relevant to the range of social and environmental as well as economic issues relevant to the case on which they are adjudicating.

Example: Arbitrator Independence

In AWG Group v. Argentina (2007), *Argentina attempted to disqualify the claimant-appointed arbitrator, Gabrielle Kaufmann-Kohler, on the grounds of conflict of interest. Kaufmann-Kohler had recently been appointed as a non-executive director at an international bank whose investment portfolio included an interest in one of the claimants. The challenge was heard and rejected by the two other members of the tribunal, which noted, first, that Kaufmann-Kohler had been unaware of the bank's investment and, in any event, that the investment did not compromise her independence or impartiality, among other things, because the size was not material. The decision was upheld by a U.S. court when Argentina filed to vacate the ultimate award.*

11.5 CONCLUSION

This chapter has set out a series of reforms that would support a more transparent, accountable, and participatory dispute settlement process. It also envisages national courts playing a much greater role in the system by demanding that investors exhaust domestic remedies. But more fundamentally, it has argued that abolishment of ISDS is justified by the fact that there is no compelling reason why foreign investors should be treated any more favorably than other individuals bringing claims against governments. No procedural principles demand such treatment, nor is it likely to produce increased investment that will significantly contribute to the kind of economic, social and environmental goals at the heart of sustainable development.

12. REALIGNING INTERNATIONAL INVESTMENT LAW WITH 21ST CENTURY GLOBAL PRIORITIES

12.1 A NEW INTERNATIONAL FRAMEWORK FOR INVESTMENT AND SUSTAINABLE DEVELOPMENT

Strategies to Realign Investment Law with 21st-Century Goals and Priorities

A paradigm shift is necessary to make international investment align with and support the goals of reducing host country poverty and inequality, maintaining and improving host country health and environmental needs, and assuring human dignity for all.

The available tools of multilateral and bilateral investment treaties, investor-state contracts, and mechanisms for resolving disputes, need to be restructured to address the effects of globalization while providing a supportive and secure basis for investment. The first step in this realignment is for home countries, their investors, and host countries to reassess their domestic laws and use of investment treaties and investor-host country agreements and to align them with the strategic principles developed in this book.

A second, more ambitious strategy involves the negotiation of a carefully calibrated **multilateral framework agreement on sustainable investment**.

12.2 THE NEED FOR MULTILATERAL ACTION ON INVESTMENT AND SUSTAINABLE DEVELOPMENT

In addition to reforming the existing IIA regime, there are certain issues related to foreign investment and sustainable development that, under the principle of subsidiarity discussed in chapter 6, are appropriate subjects of cooperation and governance at the multilateral level. The mobility of capital, the problem of fragmentation of international law, and the linkages between foreign investment and global challenges such as climate change, suggest that certain aspects of foreign investment governance would best be addressed in a new multilateral legal instrument. This chapter discusses areas of successful multilateral cooperation that could serve as models and identifies some specific areas that could be addressed in such an agreement.

DIAGRAM *The Need for Multilateral Solutions*

Examples of Successful Multilateral Action: Intellectual Property, Public Health, and Tax

As discussed below, although the adoption of a multilateral agreement addressing investment and sustainable development may seem unlikely in the current political climate, examples of successful multilateral action addressing global priorities can be found in a number of key economic and social sectors.

Intellectual Property

Rights holders achieved the globalization of intellectual property rights by defining them as trade issues and incorporating them into the trade regime with the WTO Agreement on Trade-Related Intellectual Property (TRIPs). This regime, like the current international investment regime, also faced a crisis. In the early 2000s, Brazil, South Africa, sub-Saharan Africa and Thailand faced a devastating HIV/AIDS pandemic. In 2000, in Africa alone, 20.66 million people were infected (Roser and Ritchie, 2018). Policymakers in these regions quickly recognized the connection between their intellectual property commitments and the high prices of patented antiretrovirals to treat HIV/AIDS. The price of pharmaceutical profits versus unnecessary deaths (due to unaffordability) mobilized civil society and brought pressure on governments to take action that would result in increased affordability and availability of the requisite antiretrovirals.

In November 2001, at the outset of the WTO Doha Round of trade negotiations, the African Group and Brazil announced that they would refuse to negotiate any trade issues until governments agreed to a declaration stating that nothing in TRIPs should prevent governments from addressing their public health needs. The result was the Doha Declaration on the TRIPs Agreement and Public Health that affirmed government policy space to prioritize health over patent protection. A number of countries have availed themselves of flexibilities in TRIPs, such as seizing patents through compulsory licensing with compensation to allow generic production and importing cheaper patented drugs from abroad

(parallel importing). Thus, both multilateral and domestic strategies (enabled by flexibilities in the treaty) have allowed states to reclaim *some* policy space to promote policies more aligned with sustainable development.

Public Health

In 2003, 168 states signed a landmark tobacco treaty, the WHO Framework Convention on Tobacco Control. The treaty came into force in 2005 and is legally binding in the 181 ratifying countries. In March 2006, Uruguay implemented new anti-smoking laws in line with the WHO treaty's provisions that included plain packaging requirements. Despite the fact that Uruguay's laws were compliant with the WHO treaty provisions, Philip Morris brought an ISDS claim against Uruguay. Uruguay won the case. This example suggests a strategy of exploiting differences between various treaty regimes (multilateral health vs. bilateral investment) to stake a claim for prioritizing health, or any other comparable non-economic goal.

Tax policies

Taxation is another realm in which countries compete to attract investment. Particularly in the area of corporate taxation, there has been a steady trend of reduced corporate tax rates. In the case of mobile economic activity, competition has gone beyond tax rates to include incentives, such as so-called "patent box" regimes, targeted at mobile assets.

Multinational taxpayers have been found to take full advantage of available leakage in tax systems by shifting profits from high to low-tax countries through the use of transfer pricing and other techniques to erode the tax base in high-tax countries. In some cases, taxpayers have avoided taxation by the host and the home country, achieving what is referrred to as "stateless income." In response to public outcry and resulting political pressures, the G20/OECD project to combat tax base erosion and profit shifting (BEPS) achieved broad agreement on new international standards to combat BEPS that are being implemented by countries to varying degrees.

One of the hurdles to implementing these changes was the international network of bilateral income tax treaties. The solution is an innovative multilateral legal instrument to amend bilateral income tax treaties necessary to implement BEPS standards under a unifying framework of a single instrument that offers flexibility to signing countries to: (i) identify the treaties it is willing to amend; and (ii) identify optional amendments that it agrees to adopt in those treaties it proposes to amend, in addition to the minimum standards required by the treaty. More than 75 countries have agreed to amend income tax treaties under this instrument (subject to individual country ratification procedures), which entered into force on 1 July 2018.

Example: A Multililateral Convention on Tax

In connection with the BEPS project relating to cross-border taxation, the G20 Finance Ministers and Central Bank Governors issued a mandate to the OECD to prepare a Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI"). The MLI was negotiated by 100 countries in November 2016, has been signed by over 75 countries, and entered into force on 1 July 2018, following final ratification by the requisite minimum number of countries.

As an innovative tool to achieve rapid alignment of existing treaties with modernized international standards, the MLI may be a particularly promising multilateral model for amendment of existing IIAs towards realignment with 21st-century global priorities. A similar model is the United Nations Convention on Transparency in Treaty-Based Investor-State Arbitration, adopted in 2014. That treaty, which is also known as the "Mauritius Convention," aims to provide states an efficient and effective means of modifying their existing IIAs to enable increased transparency of ISDS proceedings.

12.3 A FRAMEWORK CONVENTION ON INVESTMENT AND SUSTAINABLE DEVELOPMENT

At the 2016 Hangzhou G20 summit, trade ministers agreed on G20 Guiding Principles for Global Investment Policymaking that outlined nine general principles to promote inclusive economic growth and sustainable development, setting a path forward for global investment cooperation. The Guiding Principles were first drafted by UNCTAD, and were pushed forward at the summit by China as the hosting state. They were the result of cooperative deliberation among major capital importing and exporting states. The G20 accounts for 74 percent of global inward FDI stock and 81 percent of global outward FDI stock, as of 2015 (Zhan 2016).

Although the Guiding Principles are not legally enforceable, they could provide a foundation for governments to build upon by negotiating a "Framework Convention on Sustainable Investment." The Framework Convention could promote a more robust approach to reconciling the governance of international investment with sustainable development.

Potential elements of the Convention include the following:

1. The Framework Convention could help to reduce the fragmentation of international law by clarifying the Parties' intent that the provisions of investment treaties should be construed to avoid conflict with human rights and environmental treaties.
2. The Convention could provide a mechanism for modifying the terms of bilateral and regional investment treaties among the Parties to the Convention in order to implement some of the reforms discussed above in Sections 7.2 and 7.3**,** modeled on the Multilateral Legal Instrument on taxation discussed above.
3. The Convention could also establish broad principles for the regulation of foreign investors and investment. The Framework Convention approach would permit more detailed, enforceable investor obligations to be developed and enforced through the adoption of subsequent protocols and national legislation. For example, the Convention could require participating governments to:
    - coordinate policy on climate change,
    - refrain from tax and subsidy competition to attract foreign investment,
    - hold transnational corporations accountable for resultant harms in host countries, and
    - conduct sustainability impact assessments before approving significant foreign investments in sensitive sectors (such as extractive industries, infrastructure, and essential services).

Climate change

In order to tackle the challenge of climate change, global cooperation and coordination are necessary. There is a concern that while countries taking action to reduce emissions may be providing global benefits, the costs of their

mitigation efforts will be concentrated locally, creating a cost-benefit equation that can act as a powerful deterrent to unilateral action.

> *Country A adopts stringent emissions standards or a carbon tax that increases the costs of doing business in that country. As a result, energy-intensive manufacturing facilities and other associated operations may move to countries that have not adopted similar measures. FDI into Country A may drop, while outward, efficiency-seeking FDI from Country A will rise. Countries that fail to take similarly stringent measures would likely benefit from their climate inaction as companies move or establish their operations to the least costly jurisdictions. Emissions would not be reduced, and may even increase rapidly.*

Climate policy can thus impact FDI flows, and government policies on investment attraction and retention can similarly impact climate-related outcomes. Recognizing these links, it is important to assess whether and how international investment law and policy can be used to advance (and at least not undermine) global collaboration on climate change.

This could be done, for instance, by:

- specifying that states must adopt and not derogate from policies aiming to implement their nationally determined contributions under the Paris Agreement;
- including mechanisms enabling state parties and other citizens to use international investment treaties to raise and challenge states' failures to adhere to globally agreed climate mitigation commitments;
- establishing commitments to cooperate on promoting the transfer of climate-friendly technologies;
- imposing disciplines on fossil fuel subsidies; and
- encouraging investment for the production and distribution of renewable energy.

Incentives Competition

Governments around the world are competing for capital (Tavares-Lehman 2016). In order to attract and keep FDI, governments (and the cities, states, or provinces within them) often offer financial, fiscal, and regulatory incentives schemes. While the winning bidder may ultimately get or keep the project, its net gains are less than they would have been without the competitive incentives, and indeed may be less than the benefits generated by the project. Even the winner therefore loses, and countries with limited resources to engage in these competitions may find themselves consistently failing to attract or keep coveted investments.

Within and across countries, there have been few successful initiatives to limit such competition. But some exceptions exist. In the EU, for instance, where countries are required to let capital move freely across their borders, they are also significantly limited in terms of their ability to use locational incentives to outbid their fellow European member states for investment projects. As investment treaties enable, encourage and, in some cases, require easy movement of firms and capital, it similarly makes sense for them to include disciplines preventing costly and wasteful incentives schemes. Presently, however, such provisions (or related monitoring and enforcement mechanisms) are absent from international investment treaties, representing a missed opportunity for global cooperation on a crucial FDI-related issue.

Holding Transnational Corporations Accountable

One concern about the foreign investment activities of multinational enterprises is that it is extremely difficult to hold corporate actors liable for harms they cause in the host state. The cross-border and often extremely complex nature of their structures, combined with legal norms on separate legal personality, and the limited liability of shareholders, all contribute to this problem. This is a well-recognized problem and one that an international Convention on investment could be well-suited to address.

Sustainability Impact Assessments

Sustainability impact assessments (SIAs) offer an approach to explore the economic, environmental and social impacts of foreign investments. They involve a process by which foreign investors can assess the potential economic, social (including human rights) and environmental impacts of their investment *before* the investment is established. Their focus is on broadening the investor's view of the effects of the investment beyond simply a cost-benefit analysis to include non-market, non-monetised factors. Good SIAs generally involve stakeholder participation in assessing the impacts and the use of a range of quantitative and qualitative methods to transparently assess key impacts in relation to the assessment. Moreover, the depth and the scope of the impact assessment should align with the significance of the foreign investment, ensuring that the process is proportionate.

12.4 CONCLUSION

Despite the current skepticism about the prospects for implementing a new multilateral bargain for international investment and sustainable development, noteworthy multilateral successes have been achieved in equally contentious areas of global social and economic policy. A new multilateral framework to address a range of interconnected problems identified in this book could be transformative. Issues like the mobility of capital, climate change and the fragmentation of international law associated with international investment and sustainable development cannot be solved by states acting alone.

13. LOOKING AHEAD

13.1 LOOKING AHEAD – A PARADIGM SHIFT IN INTERNATIONAL INVESTMENT LAW

The individual reforms discussed in this book are driven by an overarching vision that the international investment regime is a form of governance that must contribute to key societal goals (Roberts 2013; Garcia et al. 2015). This is a departure from the way in which the regime is currently conceptualized by its proponents as a system to provide investor benefits in the hope that those benefits will spill over to others. The objective of this book is to change the terms of the whole debate so that the values and goals elaborated here are at the center of discussions about each individual reform process. To lay the groundwork for such fundamental change, this book advocates the following:

1. **A change to policy debates around international investment law**. International investment law has, in part, been justified by rationales (often connected to practitioners within the regime) that fail to engage with the broader justice and governance concerns set out in this book. Now is the time to genuinely and robustly address justice and governance concerns as central to policy debates throughout the international investment field.

2 **A change to the institutional actors who formulate, implement and enforce investment law.** National and international law on international investment is formulated and negotiated by government officials who reside in ministries of foreign affairs, trade, or commerce. Foreign affairs and trade ministries are institutionally charged with increasing integration (measured by trade and investment flows), as well as strengthening formal and informal ties to other nations. In addition, international investment law continues to be enforced by arbitrators whose background and experience are within a narrow investment law community. We need to encourage existing actors to engage with this paradigm shift, and to include institutional actors from a far broader range of backgrounds , in order to ensure that values such as sustainable development, human rights, and environmental justice are put at the heart of international investment law.

3 **A more consistent public engagement with the current international investment regime.** There have been high-profile moments when the international investment regime has permeated the broader public consciousness and led to moments of crisis for the enactment of new IIAs or cases brought through existing IIAs (e.g. *Philip Morris v. Uruguay*). In spite of this, countries continue to sign ever more treaties, and investors continue to file ever more cases, with minimal system reforms on the horizon. Promoting deeper forms of civic engagement to create a more globalized and persistent movement, making a compelling case to policymakers for more substantive and holistic reform, would be a worthwhile endeavor. Despite the current skepticism about the prospects for implementing a new multilateral bargain for international investment and sustainable development, noteworthy multilateral successes have been achieved in equally contentious areas of global social and economic policy.

In conclusion, this book has argued that the current widespread dissatisfaction with the international investment regime is no surprise in light of its lack of alignment with the global challenges of the 21st century. Even in purely economic terms, the case for the current international investment regime is

hardly robust. This is unfortunate, because well-governed international investment can be a powerful tool for sustainable development.

This book provides three conceptual tools that can help us move beyond the current impasse:

1. **Re-think** the international investment regime to see it as an incomplete and unbalanced system of governance,
2. **Re-balance** the existing system by reforming aspects that are incompatible with principles of good governance, and
3. **Re-align** the system away from a narrow focus on expanding investment flows towards a more inclusive set of objectives.

Perhaps the most important and first step in this reform process should be consideration by all actors of the **paradigm shift** that this book recommends with respect to understanding investment law in the 21st century. Individual substantive or procedural reforms may well be quite important and could be pursued for a number of overlapping reasons, but this book recommends something more fundamental: a completely new way of understanding investment law, which can, in turn, offer a framework for evaluating and executing the many substantive, procedural and strategic decisions ahead.

Towards that end, this book does not try to suggest a single recipe for how the governance system should look. Instead, it provides ingredients that can be combined effectively – now and in the future. It is hoped that by pursuing these strategies, a 21st-century investment law that has been rethought, rebalanced, and realigned can make a significant contribution towards a more sustainable development process and a more equitable future for all.

14. ANNEX

14.1 ANNEX: A PRIMER ON INTERNATIONAL INVESTMENT AND ITS GOVERNANCE

What is International Investment?

There are several different types of investment which may be broadly referred to as international investment (synonymously "foreign investment," or "cross-border investment"). The principal categories of these are:

Foreign direct investment (FDI) is one type of cross-border investment. FDI is defined as the result of an individual or enterprise of one country (Country A) investing in an entity in another country (Country B) with the aim of establishing a strategic, long-term interest in and management control or influence over that Country B entity. An FDI investor is commonly referred to as the parent company and the foreign entity may be referred to as a subsidiary, a branch, or more generally an affiliate. Given the difficulty in determining intent or fact of management control or influence, sufficient degree of control to qualify as FDI is generally assumed to exist when the foreign entity owns 10% or more of the foreign entity.

For example, a car company engages in foreign direct investment when it:

- establishes (and owns) a new manufacturing facility in another country;
- establishes and owns an affiliate in a tax haven country, even though it may not conduct much, if any business, in that affiliate;
- acquires 10% or more of an existing foreign firm.

FDI is different from other types of international investment such as portfolio investment and non-equity investment.

Portfolio investment is considered to be a more limited and liquid investment than FDI. The portfolio investor may own shares in a foreign company, but does not have a significant or lasting interest in that company, neither does it exercise control over that company. Similarly a foreigner may hold private or sovereign debt issued by a firm or the government of Country B. The portfolio investor can relatively easily sell its shares or bonds, especially if they are traded in a market, moving money out of the foreign company if, for instance, it loses faith in the company's management or the broader economic environment or simply sees better opportunities to profit from other investments. Flows of portfolio investment are generally considered to be more volatile than FDI, and can rather suddenly and dramatically reverse course, sometimes wreaking havoc on the host country in the process.

Contract-based business is sometimes considered as contract-based investment since it can create payment obligations similar to dividends from equity investment. Companies such as hotel chains and fast food companies may want to expand into foreign markets by franchising their operations: foreign-based individuals or enterprises will pay the hotel chain or fast food company for the right to use the company's established brand, access its networks, and employ its know-how, but not actually own those operations abroad. Similarly, a firm with a patent or other intellectual property may grant a license to a foreign company to use its know-how or name in exchange for future payments. These types of contractual relationships can be quite similar to FDI in a number of

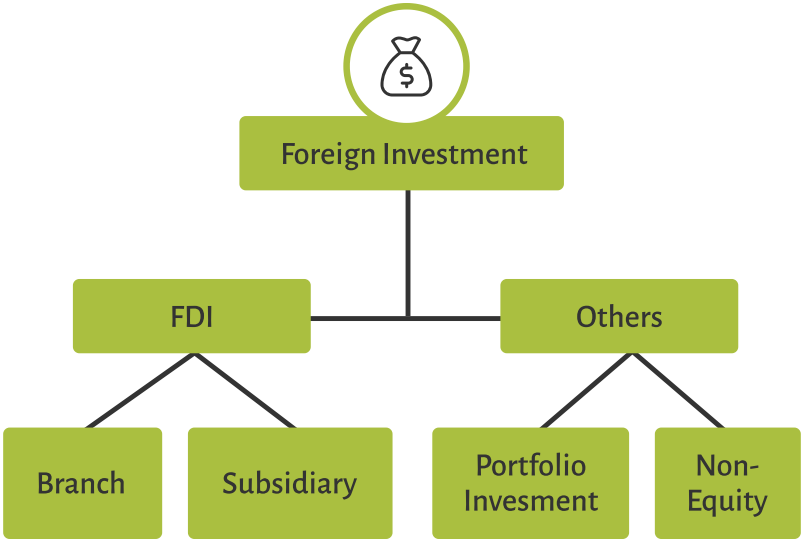
ways, for example by enabling cross-border economic engagement, transferring standards and technologies, creating or supporting jobs in the host country, and even enabling the Country A company to control aspects of the Country B company, but non-equity investments do not involve actual ownership of the Country B business by the Country A firm.

There are more questions about whether some other contractual arrangements should be considered as foreign investment. When a clothing company wants to reduce costs, it could move its existing manufacturing operations to a country with lower labor costs; this is clearly an example of FDI, or the company could find a garment manufacturer in the low-labor-cost country and contract to buy clothes from that manufacturer. Similarly, an agricultural company could establish its own farms in foreign countries to grow its crops (an example of FDI), or it could contract with local growers and agree to purchase their products, perhaps even providing technical assistance. Most observers would not consider these to be foreign investment since no capital crosses borders and no payment obligations similar to license fees or franchise fees result. Yet, they may nevertheless transfer technology and management skills similar to those expected of foreign direct investment.

Different forms of cross-border capital flows include, among others:

- trade credit (credit offered by suppliers, allowing purchasers to buy goods or services now, but pay later);
- loans (debt held by a bank to finance overseas companies, debt held by multilateral or regional financial institutions, corporate or sovereign bonds held by foreigners);
- and official government flows, such as development aid.

DIAGRAM *What distinguishes FDI from other types of foreign investment?*



Different countries send and receive different mixes of investment flows; different types of investment flows can have different impacts and warrant different policy treatment in the countries sending and receiving it.

The Current Investment Regime

The international investment regime comprises a number of parts. This book focuses on the most controversial pieces, the many international treaties that provide protection to investors, generally known as International Investment Agreements (IIAs) and the associated system of dispute settlement, referred to as International State Dispute Settlement mechanism (ISDS).

There are other arrangements which could be included, which set out additional or overlapping principles, norms, and rules for international investment, especially the investment rules associated with the World Trade Organization (WTO). Both the Agreement on Trade-Related Investment Measures (TRIMs), which restricts host countries' imposition of performance requirements on foreign investors, and national schedules under the General Agreement on Trade in Services (GATS), which ensure market access to certain investors, form part of the international investment regime as well.

What are IIAs and ISDS?

International Investment Agreements (IIAs)

IIAs come in various forms. There are now more than three thousand bilateral investment treaties (BITs) covering states in all parts of the world, and investment provisions are included in many regional and plurilateral trade agreements (RTAs).

Although the provisions differ somewhat in various treaties and agreements, in general, IIAs are treaties that provide standards of treatment that protect the interests of qualified foreign investors (who come from one country and invest in another country) against adverse State interference in their investments. There are several common standards of treatment typically found in most IIAs. These are: national treatment – the requirement that countries treat foreign investors no less favorably than domestic investors; fair and equitable treatment – the requirement that countries treat foreign investors fairly and equitably, or according to an international minimum standard of treatment; full protection and security; and prohibitions on expropriation without due process and adequate compensation.

Investor-State Dispute Settlement (ISDS)

The vast majority of IIAs provide investors access to an investor-state dispute settlement (ISDS) mechanism. This is a system through which individual investors can bring to an arbitral body claims against states for interference in their investments – without the need to convince their home government to bring a case on their behalf. This unique feature, whereby private firms can bring cases against foreign governments, has attracted significant public attention. The dispute is almost always judged by an international arbitration tribunal, where the investor is entitled to name one arbitrator, while the host country names a second. The two parties are to attempt to agree on a third arbitrator, who becomes chairman of the tribunal. If they fail to agree on the third arbitrator, an administering body, specified in the treaty, names the third arbitrator. In most cases, the administering body is the International Centre for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on Trade Law (UNCITRAL). The award rendered in these arbitrations is generally final and not subject to appeal.

An investor may also have recourse to ISDS without an IIA being in place. Many contracts for large projects, especially for mining and petroleum, have long included provisions that refer disputes to international arbitration, which is managed much like that of the general ISDS system and generates similar problems. On the other hand, the contractual provisions usually give rights to both the investor and the state to call on arbitration in a dispute. Further, some countries have inserted into their investment laws provisions that unilaterally give foreign investors access to ISDS even in the absence of an IIA.

15. ACRONYMS

15.1 ACRONYMS

ASEAN - Association of Southeast Asian Nations

BEPS - Base Erosion and Profit Shifting

BITS - Bilateral Investment Treaties

BRICS - Brazil, Russia, India, China, and South Africa

CPTPP - Comprehensive and Progressive Agreement for Trans-Pacific Partnership

DCF - Discounted Cashflow

ECOWAS - Economic Community of West African States

ECT - Energy Charter Treaty

FDI - foreign direct investment

FET - Fair and Equitable Treatment

FMV - Fair Market Value

FTA - Free Trade Agreement

GATS - General Agreement on Trade in Services

ICSID - International Centre for the Settlement of Investment Disputes

IIAs - International Investment Agreements

IMF - International Monetary Fund

ISDS - Investor-State Dispute Settlement

MERCOSUR - Mercado Común del Cono Sur (Southern Cone Common Market)

MLI - Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

NAFTA - North American Free Trade Agreement

OECD - Organisation for Economic Co-operation and Development

PACER - Pacific Agreement on Closer Economic Relations

PAIC - Pan African Investment Code

PCA - Permanent Court of Arbitration

RCEP - Regional Comprehensive Economic Partnership Agreement

RTAs - Regional and plurilateral trade agreements

SADC - Southern African Development Community

SDGs - Sustainable Development Goals

SIA - Sustainability Impact Analysis

TPF - Third-Party Funding

TPP - Trans-Pacific Partnership Agreement

TRIMs - Trade-Related Investment Measures

TRIPS - Trade-Related Intellectual Property Rights

UNCITRAL - United Nations Commission on Trade Law

UNCTAD - United Nations Conference on Trade and Development

WTO - World Trade Organization

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