



# A SOLUTION IN SEARCH OF A PROBLEM

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An Economic Perspective on Investment Treaties

Jonathan Bonnitcha, ANU

# Investment treaties: basic features

- Grant substantive rights to foreign investors
  - Examples: Compensation for expropriation; FET; National Treatment
- This package of substantive rights is *preferential*, both with respect to national and third country investors.
- Grant procedural rights to foreign investors
  - Specifically, the right to bring a claim that substantive rights have been violated to investor-state arbitration
- This procedural right is *preferential*
- A successful claim results in monetary compensation
- Some treaties also liberalise entry requirements. This presentation is focused on investment protection.

# The conventional justification for investment treaties I

- The most influential view is that:
  - investment treaties benefit source countries by protecting ‘their’ investments abroad.
  - Investment treaties benefit destination countries by encouraging greater foreign direct investment (FDI)
- For a pure capital exporting country, this makes sense:
  - but only in the very weak sense that *anything* that increases profitability of foreign investors abroad benefits a home state

# The conventional justification for investment treaties II

- For a pure capital importing, this does not make sense:
  - Not all FDI is equally valuable from a host state perspective.
    - Examples of externalities: technology transfer and pollution
  - No attempt to value the costs of investment treaties as tool to attract FDI.
- Further complications for countries that are both capital importing and exporting:
  - Increased two-way FDI resulting from preferential treatment for foreign investment – i.e. investment diversion – is not beneficial

# The Economic Approach

- Economics as a positive (descriptive) theory
  - The conduct of actors is influenced by incentives
  - These assumptions are implicit in existing debate; the economic approach allows the implications of these assumptions to be examined with greater rigour
- Economics as a normative theory
  - Hicks-Kaldor efficiency as a goal of public policy
- The starting point: private investment decisions of investors likely to maximise efficiency
  - But market failures: externalities, public goods.
  - Government as a source of inefficiency – e.g. discrimination, subsidies that do not redress externalities
- Important to be clear about the problem that an intervention is intended to solve.

# Framing The Economic Approach: Global Efficiency

- Do investment treaties create *net* benefits?
- Global efficiency corresponds to the perspective of a single state that is an importer and exporter of capital in roughly equal proportion

# Problem 1: Discrimination against foreign investors

- Discrimination reduces efficiency, as it means that the most productive firms will not necessarily undertake investment projects.
- Whether foreign investors suffer from discrimination is an empirical question - little supportive evidence.
- What sort of investment treaty provisions would be needed to redress discrimination?
  - National Treatment would be sufficient to redress substantive discrimination.
  - Access to investor-state dispute settlement would be sufficient to redress discrimination in domestic courts.

## Problem 2a: Fiscal Illusion

- One possibility is that governments may ignore the impact of their conduct on the value of foreign investment
  - Requiring a government to compensate for interference with a foreign investment could encourage the government to make more efficient decisions.
- However, an entitlement to compensation encourages an investor to ignore the risk that future government action poses to the profitability of an investment. (BRS)
  - The example of a factory-owner that knows she will be compensated for any new pollution control regulations
- There are a number of potential solutions that reconcile these two competing considerations in theory.
  - The most elegant of these is Miceli & Seggerson's – compensation should be paid when government conduct is inefficient.



# Investment treaties as a solution to fiscal illusion

- Even if governments do suffer from fiscal illusion, can investment treaties solve this problem?
  - Rules requiring compensation to be paid for losses caused by government conduct are likely to cause a government to be overly cautious, as government cannot always capture regulatory benefits.
  - The M&S solution requires arbitral tribunals to have perfect information
  - Investment treaties only force government to internalise foreign investors' losses, this distorts government evaluation of foreign investors' losses as compared to other private losses.
- Aside from these theoretical objections, there is little evidence that investment treaties are deeply internalised in a way that would change the *general* incentive structure within government decision making.

## Problem 2b: Hold-up problems

- Once an investment has been made, a government has an incentive to appropriate a greater share of the proceeds
- Investors are aware of this risk, so choose not to proceed with mutually beneficial projects.
  - As with fiscal illusion, hold-up problems result from a government's failure to fully internalise the impact of government conduct on an investment's value.
  - As with fiscal illusion, trying to solve hold-up problems with compensation rules risks inducing moral hazard on the part of investors
  - As with fiscal illusion, there are theoretical solutions that attempt to reconcile these considerations.

# Investment treaties as a solution to hold-up problems

- If hold-up problems exist, investment treaties may be able to help solve them:
  - Requiring compensation when a government *does* capture the benefits of regulatory change less likely to lead to under-regulation
  - Conduct that causes hold-ups is more likely to involve situations where costs and benefits are not spread among a wide range of actors
  - Restrictions on acquisition more likely to be internalised in government decision-making.
- Are hold-up problems really an issue in practice? ...
  - Repeat interactions
  - Reputation effects
  - Substitutes – host state law; internationalised contracts

## Problem 3: Risk aversion among foreign investors

- If investors are risk-averse, the possibility of efficient government regulation that interferes with the profitability of foreign investment can lead to under-investment.

But...

- It's not clear that foreign investors are risk averse in practice
- Even if foreign investors are risk averse, the appropriate solution is market-based insurance for which an investor must pay.

# Some implications

- In general:
  - An economic evaluation of investment treaties depends on the empirical conditions in the particular countries that are subject to them.
    - Assumptions about government decision-making are particularly important
  - Economic case for investment treaties is weaker than supposed.
  - Preferential rights for foreign investors should be included in investment treaties only if clearly justified
- Specific implications:
  - Compensation rules should focus on whether there is an acquisition of the investment by the state, not on magnitude of investor's loss.
  - Compensation rules should focus on the (in)efficiency of government conduct, not on an investor's expectations.

# Implications for future research

- Maximising FDI should not be an objective of government policy; at most, it is a proxy for other objectives
- Quantitative research should be more concerned with the impact of investment treaties on FDI disaggregated by sector.
- Research should be more concerned with the impact of investment treaties on government/investor decision-making