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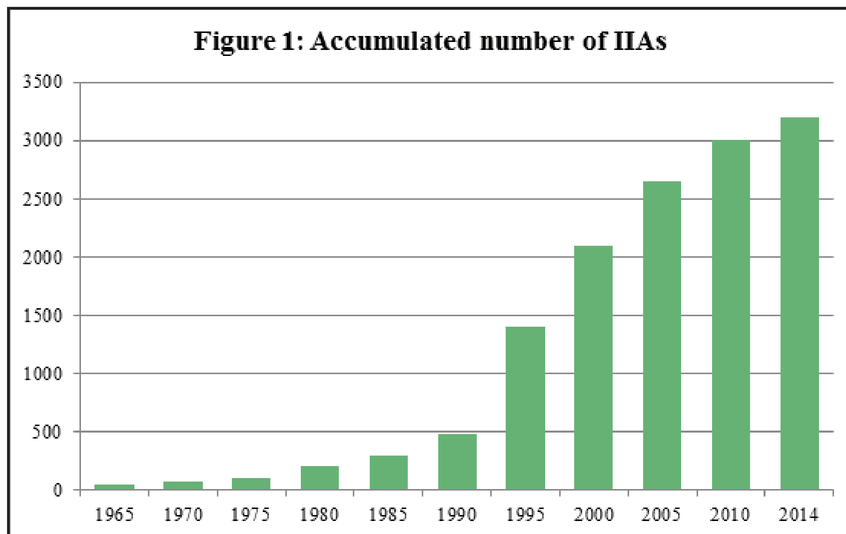
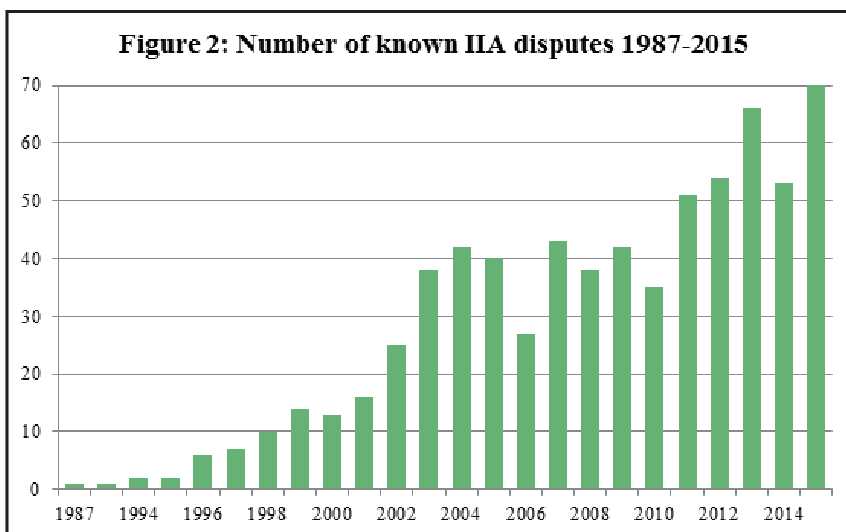
Virtues and Vices of International Investment Agreements

By Henrik Horn and Thomas Tangerås

State-to-state investment treaties such as TTIP and CETA have recently come under intense fire in the policy debate. Their vague formulations and highly potent compensation mechanisms are alleged to prevent host countries from pursuing legitimate public policy goals. An ongoing IFN project scrutinizes the economics and politics of investment agreements – and explains why some of the popular criticism seems to be warranted.

International investment agreements (IIAs) are state-to-state treaties that aim to promote foreign direct investment (FDI) by protecting foreign investors against adverse consequences from host country policy measures. Investment agreements were traditionally formed without much political opposition, but some agreements have recently come under intense fire. The debate has particularly concerned the role of investment protection in "mega-regional" preferential trade agreements – the Trans-Pacific Partnership (TPP), the Canada-EU Comprehensive Economic and Trade Agreement (CETA), and the EU-US Transatlantic Trade and Investment Partnership (TTIP).





The first IIAs appeared in late 1950s, but most agreements have been formed after 1990 (see Figure 1), and there are currently close to 2 700 agreement in force. Most IIAs exclusively address investment protection, but it has become increasingly common also for preferential trade agreements to encompass such protection. There are currently around 300 trade agreements containing investment protection stipulations. Investment protection can thus be part of multilateral trade agreements, but there is no multilateral investment agreement, despite the attempt by the OECD to launch such an agreement in the late 1990s. There has been a parallel increase in the number of known litigations under investment agreements since the late 1990s (see Figure 2).

IIAs should be distinguished from state-to-state tax treaties as well as standard commercial contracts between a host country and single investors. Importantly, the protection they offer is only available to foreign investors. Investment agreements differ in coverage, and the associated case law is highly fragmented, with the same type of provisions being interpreted very differently under different agreements. Nevertheless, the more prominent negotiated agreements share certain stylized features. For instance, agreements typically require host countries to compensate foreign investors in case of expropriation or measures with similar effects, and they contain a range of other provisions, including non-discrimination of foreign investment. The agreements also typically include compulsory dispute settlement mechanisms.

The critique

Two aspects of IIAs have been particularly criticized (see e.g. Stiglitz (2008)). The first concerns the substantive undertakings of the agreements. Typically, they cover both direct expropriation, meaning host country seizure of assets, and indirect (or regulatory) expropriations, meaning host country interventions that significantly reduce the value of the investment without any transfer of asset ownership. Critics argue that such provisions are so vaguely formulated that almost any regulatory policy with adverse consequences for foreign investors could be interpreted to require compensation payments, and that arbitration courts are therefore given far too much leeway to make their own interpretations of the agreements. For instance, there are cases where the regulatory expropriation rules have been interpreted to request compensation to investors for almost any change in policy that significantly reduces their profits.[1]

The second line of critique concerns the very potent dispute settlement mechanisms that are typically included in the agreements. So-called investor-state dispute settlement (ISDS) enables foreign investors to litigate against host countries through legal processes outside the domestic legal system. ISDS mechanisms are criticized in several regards, for instance for the lack of independence of arbitrators, the lack of transparency – indeed, it is not uncommon that litigation might be completely confidential – and the lack of appeal possibilities.

A core argument in the debate has been that the combination of vague substantive undertakings and very potent enforcement mechanisms, causes host countries to refrain from pursuing legitimate public policy goals to avoid litigation, what is sometimes referred to as "regulatory chill." This is said to lead to inefficient policies, and to constitute an infringement on the sovereignty of the host countries.

[1] IIAs also typically include vague requirements that foreign investment should be given at least a "minimum standard of treatment" and "fair and equitable treatment".

The scepticism toward IIAs has been fuelled by a number of cases to have made headlines: Phillip Morris' litigation against multiple countries over the tobacco plain packaging legislation; a large number of litigations against Spain for the withdrawal of renewable energy support schemes, with similar cases being brought against Italy and the Czech Republic; and the litigation against Germany by Swedish energy company Vattenfall for losses caused by the German decision to shut down nuclear power in the wake of the Fukushima disaster.

The critique against the investment protection in CETA has led the EU Commission to significantly change the dispute settlement mechanism in the agreement, and these new rules will most likely find their way into the other EU investment agreements. Similarly, several more advanced developing countries, including Brazil, India, and South Africa, are currently in the process of modifying their agreements. And the South American trade agreement Mercosur is in the process of completely abandoning the possibility for investors to litigate against member states.

This debate raises a number of important questions:

- Do appropriately designed agreements solve problems associated with regulation and investment?
- Do agreements cause regulatory chill?
- Who benefits and who loses from the formation of the agreements?

An ongoing project at the Research Institute of Industrial Economics (IFN) seeks to answer these and related questions.

The literature on investment agreements

The economic literature has for many years recognized that the irreversibility of foreign direct investment can create hold-up problems: once an investment is in place, and in particular when production is up and running, it might be tempting for the host country to take over the surplus from the operations, either through direct seizure of the assets, or through increased taxation. The informal economic literature on expropriation of foreign investment dates back at least to Keynes (1924), and a number of contributions in the 1950s and 1960s analysed the incentives and costs of expropriations. Several contributions focus on implicit mechanisms, such as reputational concerns, rather than international treaties for countering investor-state hold-up problems.

Markusen (2001) was among the first economists to formally analyze investment agreements. Until recently, the small literature has focused on three themes: a first strand examines whether the agreements in practice increase investment, and arrives at different conclusions; a second strand considers the role of a multilateral investment agreement; and a third strand analyse the determinants of the formation of investment agreements, including the relationship to preferential trade agreements. This literature does not provide answers to the core questions in the policy debate.

There is a small, and mostly very recent, literature that directly address the design and impact of specific obligations in investment agreements, however. Janeba (2016) considers how the combination of litigation costs and biased arbitration outcomes affects the incentive for a country to enter into an investment agreement. Kohler and Stähler (2016) examine consequences of a particular interpretation of the "legitimate expectations" notion that is sometimes employed by arbitration panels, and that holds that past regulatory policies can create legitimate investor expectations about subsequent regulations. Schjelderup and Stähler (2016) show how an arbitration mechanism might cause overinvestment, and potentially reduce welfare. Finally, Konrad (2016) considers the strategic incentives to invest to reduce the probability of environmental regulation.

A second strand of literature examines the optimal design of investment agreements. Aisbett et al (2010a) incorporate an imperfectly unobservable regulatory shock in a standard "regulatory takings" model, showing how full efficiency can be achieved also with distorted incentives to regulate if the host country can overcompensate the industry for its losses. Aisbett et al (2010b) examine the implications of National Treatment (NT) provisions that prevents a host country from requesting up-front payments from foreign firms prior to investing. Stähler (2016) shows how an investment agreement can implement a fully efficient outcome even if the regulatory shock is unobservable, if it is possible to use a third party to separate host country compensation payments from the payments that investors receive.

All these contributions yield interesting insights. But they also have shortcomings. For instance, they consider the impact of exogenously specified agreements, rather than allowing the parties to design the agreement in an optimal fashion. Or conversely, the studies give the parties freedom to use contractual constructions that are not used in practice. The work to be described below (Horn and Tangerås (2016)) differs from both the above-mentioned strands of literature in these and other regards. We build on compensation schemes of the form found in actual investment agreements; we highlight the optimal design of agreements with these features; and we study the incentives of the contracting parties to form such agreements, and their distributional implications.

Our analytical framework

Our modelling framework builds on a standard hold-up problem. In a first stage, foreign firms make irreversible investments. The investments create benefits to the host country in terms of e.g. employment, technology transfers, increased competition, etc. But the investments might also create negative externalities, which creates a potential role for host country regulation. The magnitude of these adverse effects is unknown at the time of the investment. But if sufficiently severe, these externalities can render production ex post undesirable from a domes-

tic, and possibly also from a joint welfare perspective. These "regulatory shocks" can represent a broad range of exogenous events, for instance the arrival of information concerning adverse environmental or heath consequences of production. Once the shocks are observed, host countries determine whether to regulate, effectively shutting down production, or to allow production.

There are two reasons why this interaction features undesirable outcomes. First, firms disregard both the positive and the negative external effects of their investment on the host country – what we denote the "investment distortion." Second, host countries ignore the loss inflicted on the foreign investors of the decision to regulate. All else equal, there will be too frequent regulation from a joint welfare point of view – we label this a "regulatory distortion."

The outcome in the market absent an agreement depends on the interaction between the investment and the regulatory distortions. We focus on situations where, absent investment protection, there would be more frequent regulation than is optimal from a joint welfare point of view, and where there is consequently underinvestment. There is thus a potential role to be played by an agreement that reduces regulation, and thus stimulates investment.

Formally depicting an investment agreement

A critical issue for analysing the impact of the compensation requirement for regulatory expropriations in IIAs, is obviously how to formalize core elements of the agreements and the case law. We focus on five salient features of IIAs.

1. IIAs do not contract directly on investment levels or regulation; which distinguishes IIAs from regular commercial contracts between host countries and foreign firms.
2. IIAs do not involve payments to and from outside parties.
3. IIAs only stipulate payments in case of regulation; they do not include commitments concerning subsidization of investment.
4. IIAs require that compensation in case of expropriation should equal the "fair market value" of the expropriated assets. To interpret this concept, arbitration panels normally seek guidance in a general principle concerning state responsibility in Customary International Law. This means that in case of illegal acts reparation should wipe out all consequences of the act.We thus assume that any compensation equals foregone operating profits.
5. IIAs contain exceptions from the compensation requirements for regulation that is undertaken to promote legitimate public welfare objectives – so called "carve-outs." For instance, an IIA might state that

   > "[n]othing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental, health or other regulatory objectives."

The problem facing the design of an agreement in our analysis (as in practice), is to determine the appropriate scope for carve-outs.

To capture the above listed features of IIAs, we consider agreements that request host countries to fully compensate foreign investors for their foregone operating profits, in case of regulation. But compensation is only required when the regulatory shocks are weaker than a benchmark value – denoted the level of investment protection in the agreement. But there cannot be any subsidization of individual investors.

Two distinct types of agreements

We distinguish between two archetypical forms of agreements. One is a "North-South agreement" between a developed and a developing country – the archetypical Bilateral Investment Treaty (BIT), which still constitutes the clear majority of investment agreements. Although formally often symmetric, such agreements serve to stimulate investment from North to South only. Their purpose is to enable South to make credible commitments regarding investment protection that South could not unilaterally take on.

The other archetypical treaty is a "North-North agreement." Such an agreement does not improve commitment possibilities, since the parties to these agreements have sufficient credibility in this regard. The gains instead stem from the bilateral internalization of the externalities from regulation that the agreement allows—the avoidance of the regulatory distortion mentioned above.

Findings

Our study establishes a large number of results regarding the investment agreements under scrutiny.

First, there is a robust set of circumstances in which North-North agreements fully resolve both the overregulation and underinvestment problems, despite the very rigid and simple form of compensation function that is we impose based on our understanding of actual agreements. Investment agreements thus work well in such situations. But there are also situations where North-North agreements do not achieve full efficiency.

Second, there is no reason to assume that North-South agreements will be fully efficient. The reason is that North and South have conflicting interests regarding investment protection: North wants the carve-outs for regulations that do not require compensation to be as small as possible. South might want more investment protection than it can commit to unilaterally. But it will not want to go as far as North, since South wants to retain its freedom to regulate without compensation for sufficiently severe shocks.

Third, a key policy question is whether investment agreements cause regulatory chill. Investment agreements do yield less regulation than would result without any agreement, but this is the whole idea of IIAs: to reduce some regulation to promote foreign investment. But we demonstrate that Pareto optimal investment agreements never yield under-regulation from a joint welfare perspective – there will be no "global regulatory chill" – provided host country decisions appropriately reflect national interests. When compensation is limited to at most each firm's operating profit, it is always optimal for the host country to regulate when doing so is ex post efficient. Hence, agreements induce either ex post efficient regulation or inefficient overregulation.

Matters are different if the host country government has a direct interest in the profits of foreign investors, for instance by capturing part of these profits as bribes. Such a government might negotiate an agreement that impose more investment protection than is optimal from a joint welfare perspective in order to capture rents for itself.

Finally, turning to winners and losers from the formation of an agreement, in a North-South agreement, both countries have a common interest in raising the level of protection to the level that maximizes the domestic welfare of South, so any negotiated level will exceed this level. If North can dictate the terms of the agreement (as often seem likely), it will set the level of investment protection so high that South barely finds the agreement acceptable.

Matters are quite different in the case of a North-North setting. Absent an agreement, each country will through its domestic laws and regulations impose a level of investment protection that maximizes its domestic welfare. This level does not factor in the benefits of the protection for the respective country's incoming foreign investors, however. A North-North agreement will therefore stipulate more protection than is desirable from a domestic welfare point of view. Hence, while there are gains in the aggregate, and foreign investors benefit from the increased investment protection, the rest of society will lose in each of the countries.

We believe our findings are informative regarding the politics of investment protection. The results suggest that symmetric agreements such as CETA and TTIP (and to some extent also the TPP) would benefit foreign investors, but reduce the aggregate welfare of the rest of society. This might explain why the industry in general favours these agreements, while at the same time there is considerable popular resistance to their formation. Our findings also predict that there should be less opposition to North-South agreements, since the benefits to a larger extent accrue to the broader public in the host country. Again, this seems broadly compatible with what is observed, in that there appears to be much less popular discontent with investment agreements in developing countries than with the mega-regional agreements.

Policy implications

One should not draw concrete policy implications from a single economic study, whether theoretical or empirical. But we believe that our analysis at least suggests that the criticism of investment agreements ought to be taken seriously:

- It seems quite clear that investment agreements can create aggregate benefits for the parties, at least to the extent they seek to remedy the types of problems that our study focus on.
- It is also clear that investment agreements can stimulate investment. But an agreement does not have to be beneficial just because it stimulates investment. An agreement that completely covers foreign investors against any type of risk would generate considerable investment, but there is little reason to believe that all this investment would be desirable from a national interest point of view. Indeed, it might even reduce the welfare of the parties.
- There might be pronounced distributional consequences of investment agreements between developed economies, such as CETA or TTIP.
- The potential benefits from an agreement depends on how severe the underinvestment/overregulation problem is absent an agreement. But we are not aware of any systematic analysis of the extent to which there is overregulation and consequent underinvestment between EU, on the one hand, and Canada and the US, on the other hand. Put differently, while it is possible to credibly point to the potential problems that CETA and TTIP might cause, there is very little empirical evidence concerning the magnitude of the problems they are meant to address. There is thus a need for more evidence on this.

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