UNCTAD/WEB/ITE/IIA/2007/2

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
Geneva

Development implications of international investment agreements

IIA MONITOR No. 2 (2007)
International investment agreements

UNITED NATIONS
New York and Geneva, 2007

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The universe of international investment agreements (IIAs) continues to expand and is becoming increasingly complex. As of the end of 2006, more than 2,500 bilateral investment treaties (BITs), 2,600 double taxation treaties and 240 other agreements with investment provisions – such as free trade agreements – existed. This impressive IIA network has several characteristics:

(a) Firstly, it is universal, in the sense that nearly every country has signed at least one IIA, and the great majority of countries are party to several, if not many, agreements relating to investment.

(b) Secondly, the structure of agreements is atomized, i.e. no single authority coordinates the overall structure or the content of the thousands of agreements that constitute the system.

(c) Thirdly, the IIA universe is multi-layered, i.e. IIAs exist at the bilateral, regional, interregional, sectoral, plurilateral and multilateral levels, often resulting in overlapping commitments of countries.

(d) Fourthly, the system is multi-faceted, meaning IIAs increasingly include not only provisions specific to investment, but also rules addressing other related matters, such as trade in goods, trade in services, intellectual property protection or movement of labour.

(e) Fifthly, the IIA universe can be characterized as having uniformity at the core, but increasing variation at the periphery. This means that on a number of core issues – such as national treatment and most favoured nation (MFN) treatment for established investment, fair and equitable treatment, guarantees of compensation for expropriation and of free transfers, and consent to investor-State and State-State dispute resolution – the agreements reflect a considerable degree of commonality in terms of the treaty language. Other provisions, however, such as non-discrimination with respect to the admission of foreign investors or prohibitions of certain performance requirements, show more variation in the way they are drafted or appear in only a minority of agreements.

(f) Sixthly, the IIA system is dynamic and innovative, meaning recent IIAs include new provisions or important amendments to existing rules (see below). To a considerable extent, this is a reaction to the substantial increase in investor-State disputes in the last couple of years, resulting in more than 250 known arbitration cases at the end of 2006.

These characteristics of the evolving IIA universe present opportunities and challenges for countries, in particular developing countries. This issue of the IIA Monitor sheds more light on them from a development perspective.

A. Opportunities and options for IIA negotiators

The greater variety of approaches with regard to IIAs offers countries with more options than ever before to conclude the “right” agreement, to draft provisions that best suit their development needs, and to ensure that foreign investment is not contrary to the public interest.

For example, the increasingly multifaceted nature of IIAs means countries no longer have to deal with investment protection within the narrow boundaries of “classical” investment agreements such as BITs. This not only provides them with the option of agreeing on broader and more intensive forms of economic cooperation, but also offers more bargaining space. This may be particularly advantageous for capital-importing developing countries. In exchange for providing ample protection to investors from capital-exporting States, they may demand concessions in other areas covered by the agreement, such as tariff reductions or other kinds of trade facilitation. As a result, the benefits deriving from a multifaceted IIA might be more equally felt than in the case of single-faceted BITs, where the principal beneficiaries of investment protection are companies from capital-exporting countries.

Furthermore, the trend towards higher sophistication in international investment rulemaking can be of advantage to countries, in particular developing countries. The alternatives in IIA negotiations are no longer limited to such basic options as whether to include liberalization commitments, to cover portfolio investment, to grant national treatment for established investors, or to give foreign investors access to international arbitration. Rather, a more differentiated approach is emerging that may better reflect advancing investment policies than the previous “black-and-white” schemes. As will be explained in more detail below, some countries have recently started to circumscribe the scope and content of individual IIA provisions with more precision, including rules on dispute settlement. A main objective behind these drafting efforts is to clarify the meaning of certain investor rights and avoid “bad surprises” for host countries concerning their interpretation by arbitration tribunals.

This evolution in treaty making offers an opportunity for developing countries to reassess their existing approaches and to explore whether further improvements in their IIA network are warranted, for instance with regard to the development contribution of foreign investment or in order to ensure more predictable and consistent arbitration awards. Finally, the dynamic process of international investment rulemaking is in itself an opportunity for developing countries to participate more actively in designing the IIA system, provided that they have sufficient capacity (see below).

B. Challenges of content

Recent trends and characteristics of the IIA system as described above have also generated several challenges relating to the content of IIAs. Once again, these challenges exist primarily for developing countries. Three challenges are particularly important:

(a) Firstly, there is the issue of how to establish and maintain policy coherence in a highly atomized and increasingly complex IIA universe with overlapping obligations.

(b) Secondly, there is the question of how to balance private and public interests within IIAs. The increasing breadth of the agreements raises new issues concerning the proper degree of regulatory discretion to reserve for countries concluding IIAs, and the ways and means of how to achieve this.

(c) Thirdly, there is the issue of what could be done to enhance the development dimension of IIAs. Since most existing investment agreements pursue the development aspect only indirectly by promoting foreign investment through the granting of investment protection, a more proactive approach towards making foreign investment beneficial for development purposes might be useful.

1. Promoting policy coherence

The issue of policy coherence has several facets. One aspect of policy coherence is that the IIAs of a country should be consistent with its domestic economic and development policies. The more the overall structure and content of an IIA reflects a host country's economic and development policies, the more it can contribute to achieving certain policy objectives. This entails creating a coherent national development approach that integrates investment, trade, competition, technology and industrial policies (UNCTAD, 2006a). As new IIAs are negotiated, there is a need to ensure that they are consistent with and in fact promote a country's economic development. With the emerging multitude of policy devices deriving from IIAs, it might become more difficult to use these agreements as a tool for achieving certain development goals. For instance, a policy of selected intervention vis-à-vis foreign investors might be undermined by the combined effect of granting establishment rights in individual IIAs and the application of the MFN clause, which could have the effect of opening the sector concerned to any foreign investor.

Furthermore, policy coherence is at stake with regard to the various IIAs that individual countries conclude with other countries. No country has such strong bargaining power that it can impose its IIA model on every one of its treaty partners. However, inconsistencies might appear with regard to almost any IIA provision. One area stands out as it represents a general divide in investment rulemaking – investment liberalization. New divergences are about to emerge with regard to the degree with which individual treaty provisions are specified and the need to include exceptions and reservations into an agreement (UNCTAD, 2006b).

Aside from inter-treaty incoherence, incoherence may also occur within the same agreement. This may be the case, for example, in free trade agreements or other economic cooperation treaties if the investment provisions are not fully consistent with other chapters on trade, services or intellectual property.

Policy coherence has yet another, broader dimension – namely, coherence of the entire IIA universe. Even more than in respect of the IIA network of individual countries, the global IIA system shows a high degree of diversity as well as different approaches. This patchwork of diverging treaties runs counter to some core principles that should apply to international investment relations – i.e. clarity, stability, transparency and the existence of a common set of ground rules.

Finally, the issue of policy coherence arises with regard to the interpretations that numerous arbitration awards have given to specific IIA provisions. In connection with the increase in investment disputes resulting in a number of inconsistent awards, there are new concerns on how one could improve coherence in this respect. For instance, arbitration tribunals came to diverging interpretations concerning some core IIA provisions such as the principle of national treatment, the MFN principle, the scope of dispute settlement, the so-called "umbrella clause" and the issue of regulatory takings.[1] Furthermore, international arbitration systems – such as the International Centre for Settlement of International Dispute (ICSID) Convention, the United Nations Commission on International Trade Law (UNCITRAL) arbitration rules or the International Chamber of Commerce (ICC) dispute settlement procedures – show significant differences.

While the issue of policy coherence is relevant for all countries, developing countries are more exposed to it than are others. Due to capacity constraints, lack of expertise, frequent policy changes and weak bargaining power, they might have serious difficulties in establishing coherent economic and development polices and reflecting them properly in their IIA network. They may also face considerable risk of concluding inconsistent IIAs or those that do not conform to national legislation. They may have to conduct negotiations based on divergent model agreements of their developed-country negotiating partner. In fact, many developing countries possess highly diverse IIA networks. In addition, the domestic regulatory framework in many developing countries is constantly evolving and subject to frequent changes. With more laws and regulations being adopted, there are also more occasions where such legislation or individual measure might be in conformity with some IIAs of that country, but in conflict with others, giving cause to claims for treaty violations. When it comes to investment arbitration, developing countries might have weaker means at hand than their developed country counterparts to defend themselves effectively.

On the other hand, the continuing trend towards more uniformity with regard to core principles of investment protection reduces the risk of inconsistency to some extent. The possible effects of inconsistency might also be mitigated by the MFN clause that is a standard feature in most IIAs. It prevents a host country from giving different treatment to investors of foreign nationality and could be used to transform originally inconsistent obligations into consistent ones. However, in the light of some recent contradictory awards, it is far from clear under what circumstances the MFN clause actually applies and how far-reaching its effects might be.[2] Thus, while international jurisprudence in principle can make an important contribution towards harmonizing the understanding of the interpretation of core principles of investment protection, it may also have the opposite effect.

This calls for a preventive strategy to avoid inconsistencies in the current IIA network, including through the possibility of renegotiating or – as *ultima ratio* – terminating inconsistent treaties. Nonetheless, it needs to be stressed that the process of harmonization through individual IIA negotiations has its limitations. In the end, moving towards substantially more policy coherence in treaty making would require finding ways and means to enhance multilateral consensus building on key IIA issues.

[1] See, e.g. Schreuer (2006), with further references to pertinent awards. See also UNCTAD (forthcoming a).

[2] In some cases, the interpretation of the MFN clause resulted in diverging arbitral decisions. See, e.g. the broad interpretation of the MFN clause in *Emilio Agustin Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction, 25 January 2000; Award, 13 November 2000; Rectification of Award, 31 January 2001; and *Siemens v. Argentina*, ICSID Case No. ARB/02/8, Decision on Jurisdiction (English), 3 August 2004; and the narrow interpretation in *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Jordan*, ICSID Case No. ARB/02/13, Decision on Jurisdiction, 9 November 2004 and *Plama Consortium Limited v. Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction, 8 February 2005.

2. Balancing private and public interests and the issue of regulatory flexibility

Another important challenge with international investment rulemaking is the question of how to balance the rights and interests of foreign investors with those of the host country, and how to ensure regulatory flexibility for host countries. An unbalanced IIA system would hardly be sustainable over the long run. Mostly because of the enormous increase in investment disputes in recent years, the discussion of what should be the counterweight to investors' rights has gained momentum. Thus far, three main approaches have emerged.

(a) Some countries have clarified individual IIA provisions, where there was concern that an expansive interpretation could diminish regulatory flexibility of host countries. This has happened with regard to provisions guaranteeing fair and equitable treatment of investment and the definition of an indirect expropriation.

(b) Numerous recent IIAs include stronger emphasis on public policy concerns in order to ensure that investment protection is not pursued at the expense of other legitimate public interests. For example, they include exceptions for host country measures to maintain national security, preserve the public order or to protect public health, safety or the environment. Exceptions have been met with the concern that they may undermine the purpose of the IIA by providing the host country with a potentially broad justification for derogating from IIA obligations. In addition, such provisions have been the subject of few arbitral awards and thus their scope is not yet widely understood. Other IIAs include provisions calling upon host countries not to depart from labour or environmental standards in attracting foreign investment, though often these provisions impose no binding obligation.

(c) A few IIAs have strengthened the public's role in investor-State dispute resolution by providing for greater transparency in proceedings, open hearings, publication of related legal documents, and allowing civil society representatives to submit amicus curiae briefs to tribunals.

In the same context, it is noteworthy that the ICSID rules were amended in April 2006 and provide now for preliminary procedures concerning provisional measures, expedited procedures for dismissal of unmeritorious claims, access of non-disputing parties to proceedings, publication of awards and additional disclosure requirements for arbitrators.[3] Efforts are also underway concerning a revision of the UNCITRAL arbitration rules to meet changes that had taken place over the past 30 years in arbitral practice.[4]

An alternative approach to balancing private and public interests, which to date has not been prominently explored in IIAs, would be to establish investor responsibilities directly in an IIA, rather than only leaving the host country with the right to impose them through its domestic laws. Such obligations may be merely passive, that is, an obligation to refrain from activity of a certain type, such as activity that would violate human or labour rights, damage the environment, or constitute corruption. The obligations, however, could also be active in nature, such as an obligation to make a development contribution. An instrument that imposed obligations on an investor might also grant to the host country recourse to the same arbitral mechanisms that currently only investors can invoke.

So far, the prevailing trend has been to deal with this issue in the context of voluntary guidelines for foreign investors. Thus, while not subjecting foreign investors to international

[3] See ICSID (2006).
[4] UNCITRAL (2006).

obligations in the IIA, their home countries and host countries nevertheless convey important political signals that foreign investors are expected to behave in a certain manner. However, most existing instruments in this area concern the "traditional" corporate social responsibility issues related to human rights, labour rights, environmental protection and prevention of corruption, and do not deal with economic development issues per se. Consideration could be given to developing guidelines on corporate economic development contributions to specifically address economic development concerns (UNCTAD, 2005a and 2003).

3. Enhancing the development dimension of IIAs

A final critical issue is how best to strengthen the development dimension of IIAs. The current mechanisms designed to address development concerns include reservations, exceptions, temporary derogations, transitional arrangements, and institutionalized monitoring and consultations mechanisms (UNCTAD, 2000). Thus, to the extent that the development dimension is addressed in international investment rulemaking, it is done in an indirect manner and in a primarily defensive mode, in order to shield contracting parties permanently or temporarily from assuming their full responsibilities under the agreement. The question is whether this protective approach is sufficient for development purposes.

Incorporating a proactive development dimension would require adding new kinds of provisions not often seen in IIAs, including home country measures. Such means could include a broad range of issues: (a) transparency and exchange of investment-related information; (b) fostering linkages between foreign investors and domestic companies; (c) capacity-building and technical assistance; (d) granting of investment insurance; (e) encouragement of transfer of technology; (f) easing informal investment obstacles; (g) joint investment promotion activities; (h) access to capital; (i) financial and fiscal incentives; and (j) the setting up of an institutional mechanism to coordinate the respective measures (UNCTAD, forthcoming b).

More recourse to investment promotion in IIAs could have several advantages. As investment promotion provisions usually establish a commitment of contracting parties to do something for the encouragement of foreign investment, their promotional effect might be felt more rapidly and strongly than in the case of passive obligations concerning investment protection. In addition, investment promotion could be used in the context of strategic investment policies of developing countries in order to steer foreign investment in particular sectors, activities or regions where these countries see a comparable advantage for them or where they see a promising potential for the future. Another potential benefit has to do with the relatively rare use of specific investment promotion provisions in current IIAs. Developing countries including such rules in their investment agreements might therefore have a competitive advantage in the global competition to attract foreign investment.

On the other hand, there is a certain risk that a stronger emphasis on investment promotion might result in more incentives-based investment distortion. In addition, political considerations in capital-exporting countries might be a potential impediment to giving investment promotion a more prominent role in IIAs.

Furthermore, any discussion on the development dimension of IIAs should take into account the difficult question of their anticipated impact. Recent empirical studies have argued that, in general, IIAs do have a positive impact on attracting foreign direct investment.[5] Most agree, however, that IIAs are only one factor in creating a favourable investment climate and that they may play a greater role in some developing countries than in others.

More generally, the issue of how best to incorporate a development dimension into an IIA raises the question of what kind of IIA best advances development objectives, a question that may not be answered in the same way for all countries. For example, a country may choose to enter into one of the following: (a) a traditional BIT focusing on investment protection; (b) a BIT with pre-establishment commitments; (c) a free trade agreement providing for comprehensive liberalization and covering issues other than investment, such as services, movement of labour, competition or intellectual property; or (d) an economic cooperation agreement merely laying the groundwork for future rulemaking through measures such as increased transparency.

Another consideration in this respect is giving a more prominent role to alternative methods of dispute resolution (ADR) in future IIAs. While arbitration is an important means of fostering the rule of law and increasing investor confidence, it can also have significant drawbacks, particularly for developing countries, in terms of high costs, long duration, and the damage that such proceedings may cause to the investor-State relationship. In other words, arbitration is not very development-friendly. ADR such as mediation and conciliation may – if applied at an early stage of the dispute – be cheaper, faster and better able to preserve the investor-State relationship. Presently, very few IIAs consider the use of ADR techniques to settle investor-State disputes. The significant rise in investor-State disputes in recent years could be an additional argument in favour of more ADR (UNCTAD, forthcoming c).

C. Challenges of capacity

Many developing countries lack the resources to participate fully and effectively in the evolution of the IIA universe. For example, a developing country may find that it lacks the resources to negotiate the agreements it wishes to negotiate. Alternatively, it may choose to participate in negotiations, but without having the knowledge needed to obtain concessions it otherwise could have obtained, or without fully understanding the consequences of the agreement it ultimately concludes, or without having the ability to honour the agreement once it is concluded. In the end, the challenges of capacity may fall most heavily on those developing countries least able to steer the international investment system in the direction necessary to address those challenges. Challenges of capacity are aggravated by many of the trends that are evident in the current international investment system. These include the growing number of IIAs, the increasing scope and complexity of IIAs, and the acceleration in the number of disputes submitted to investor-State arbitration.

The challenges of capacity need to be addressed for a number of reasons. Beyond the obvious difficulties arising from capacity constraints for individual countries, these limitations threaten the effectiveness of the entire IIA universe. This system assumes a community of countries knowingly assuming obligations resulting in a stable and transparent framework for investment within their respective territories. If countries are unable to appreciate the content

[5] See for example, Neumayer and Spess (2005); Tobin and Rose-Ackerman (2006); and Banga (2003). See, on the other hand, Gallagher and Birch (2006).

of the agreements to which they have agreed because of the complexity of the agreements, the risk arises that countries will enter into agreements that they are unprepared to honour fully. This in turn will undermine the value of the agreements. Even if challenges of capacity do not undermine the effectiveness of the system, they may skew its structure. Challenges of capacity may affect, for example, the content of IIAs. Countries lacking capacity may resist more complex, broader agreements, for instance with regard to liberalization commitments. Finally, challenges of capacity also threaten the justness of the international investment system. Countries that lack the capacity to participate fully risk being marginalized and left behind in the further evolution of international investment rulemaking.

Conclusion

International investment rulemaking in the new century offers fresh opportunities and poses new challenges for countries, in particular developing countries. They include challenges of capacity and challenges of content. The extent to which the further evolution of the IIA universe can contribute to economic and social development and to a better integration of developing countries into the system crucially depends on whether appropriate responses to these challenges will be found.

Establishing and maintaining a coherent IIA policy remains a difficult task for most developing countries as long as they have to negotiate investment treaties individually with stronger partners. As far as the balancing of private and public interests in IIAs is concerned, several options exist, although only a small group of countries so far has found it necessary to re-evaluate existing approaches and to strengthen the role of the State. Finally, while the development implications of IIAs have since long been recognized, more could be done to strengthen investment promotion in these treaties.

All this underlines the need for more policy research and technical assistance to help developing countries cope with the challenges in international investment rulemaking at the beginning of the 21st century. Also, the problems in managing a highly fragmented and not very transparent IIA universe demonstrate the importance of finding ways and means to enhance multilateral consensus building on IIA issues.

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