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The Brazilian Experience with Bilateral Investment Agreements: A Note

by

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THE BRAZILIAN EXPERIENCE WITH BILATERAL INVESTMENT AGREEMENTS: A NOTE

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Introduction

The Brazilian experience with Bilateral Investment Treaties (BITs) is very unusual. Investment flows to Brazil are among the largest in the developing world. According to the Economic Commission for Latin America and the Caribbean (ECLAC), between 2003 and 2005 the country accounted for 25% of the total foreign direct investment to Latin America (US$43.3bn of US$172.7bn). Despite its importance as a host country for foreign investments, however, Brazil is not party to any BIT whatsoever.

In the 1990s, the Brazilian Executive Branch signed 14 BITs but the Parliament approved none of them. The Brazilian Legislature gave several reasons for refusing to accept BITs but almost all of them concerned the limits that the agreements might impose on development policies. Therefore, studying the Brazilian case, especially Parliament's debate, might be useful for those who want to analyse the connections between BITs and development policy.

There is a growing perception in Brazil that BITs, depending on their specific negotiated provisions, may restrain the public sector's ability to implement economic, social, and environmental policies, as well as discriminate against domestic (i.e. national) capital. The debate that was stirred in Brazil may have been politically more contentious than elsewhere, but it summarises many of the concerns developing countries currently have about BITs

1. The essential role of foreign investment in Brazilian economic and social development

The essential role played by foreign investment in Brazil's social and economic development is undeniable. Historically, foreign capital has always been a significant component of the Brazilian economy and this influence was even more apparent during the import-substitution period, which took place between the 1930s and the 1980s.

The volume and strategic importance of foreign investment led scholars, when defining the political economy of Brazilian development, to use expressions such as "dependent capitalism" or "associated capitalism". Critical analyses tend to associate the insufficient level of technological research by national enterprises with the "excessive" amount of foreign direct investment in Brazil: subsidiaries of big companies, it is argued, brought capital goods and methods of production from home countries, in an effective "crowding out" that would be one of the obstacles to national development.

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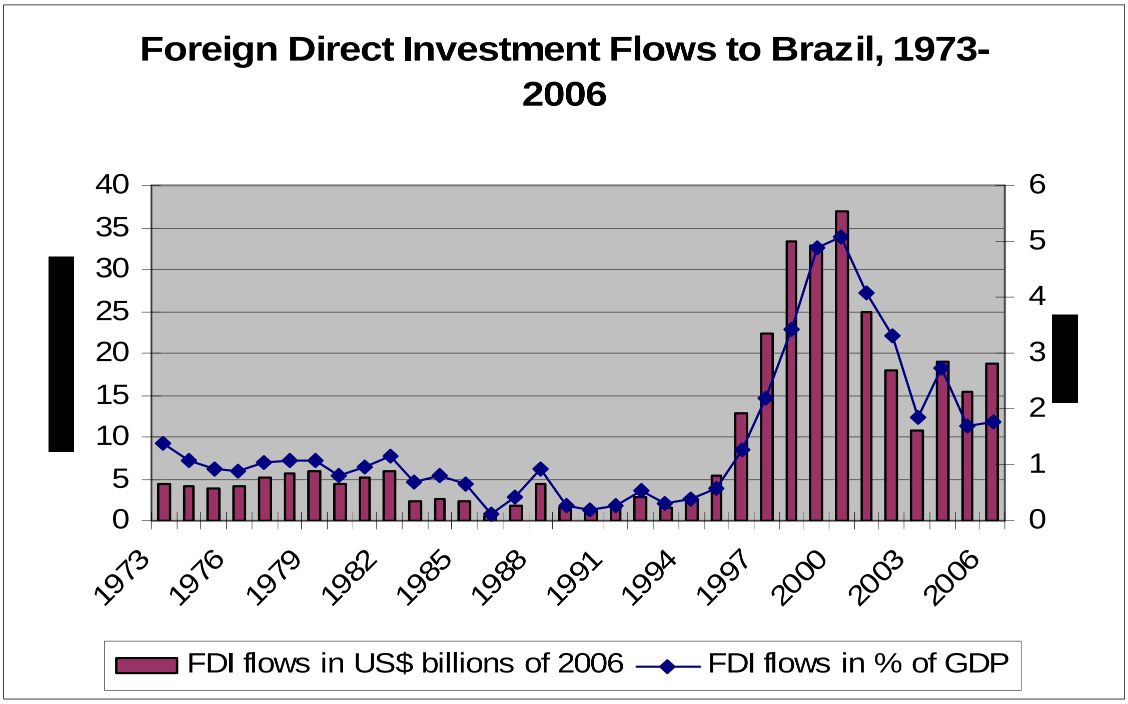
The importance of foreign investment is attested to by the data recorded for the current account of the balance of payments. Between 1950 and 1987, there were only three years (1964, 1965, and 1984) in which a surplus was recorded in current transactions. During most of this period, “foreign saving” accounted for more than 2% of the PIB. Furthermore, during the same period, the average rate of foreign direct investment accounted for 0.74% of GDP.



Source: Central Bank of Brazil

Looking at the data, it is difficult to argue that, in the post-war period, the Brazilian economy was “closed”. It is true that there were various tariff and non-tariff barriers designed to stimulate domestic production, so in that sense one could call it a “closed” economy. Yet, at the same time, the financial and industrial systems were closely connected with developed countries and the patterns of consumption by the wealthy closely followed those seen in America.

During the 1990s, quantitative restrictions over imports were abolished and the Government promoted linear tariff cuts in order to raise industrial efficiency and control inflation rates. In 1995, liberal politicians were also able to approve a Constitutional Amendment that banned any kind of discrimination against foreign investors.

The stable relationship between foreign capital and government was maintained after the leftist Workers’ Party, headed by Lula da Silva, won national elections and formed a new administration. After some hesitation, international enterprises and capital markets showed their trust in President Lula’s economic policies and Brazil's country risk fell to its lowest level ever recorded.

2. Signing BITs in Brazil

Between 1994 and 1999, Brazil signed 14 Bilateral Investment Treaties (BITs): with Belgium-Luxembourg, Chile, Cuba, Denmark, Finland, France, Germany, Italy, Korea, the Netherlands, Portugal, Switzerland, the United Kingdom, and Venezuela. There are two reasons why the Brazilian Executive Branch's signed these BITs.

Firstly, liberal ideology virtually dominated the political agenda during the period and one of its priorities was the stability of the juridical field in which business operated. Alongside foreign trade liberalization, the creation of regulation agencies for public services, and privatisation of state-owned companies, the negotiation of BITs was a component of a much larger strategy of liberal transformation. The main objective of this strategy was to reduce public sector interventionism in the economy.

Secondly, there was much concern at that time over the nature of foreign direct investment to Brazil. Between 1989 and 1994, FDI scarcely accounted for 0.5% of GDP (US$2bn per year). Other Latin American countries were performing much better and, since most of them had already signed BITs with developed countries, there was a perception that these instruments could help attract foreign capital.

The various BITs signed by the Brazilian Government were similar in their terms. They were basically post-establishment commitments to national treatment, most-favoured nation status, and the transfer of funds and indemnities for expropriation. In the case of disputes, there were provisions for investor-State arbitration, which would follow in most cases the rules adopted by the World Bank's International Centre for the Settlement of Investment Disputes (ICSID).

In spite of their relatively standard formulation, which did not differ substantially from the BITs signed by other countries, the agreements signed by the Brazilian Government would follow a very particular path. None was ever approved by the Brazilian Parliament and the process of ratification was brought to a halt. The criticisms raised by Congressmen were powerful enough to convince the Executive to withdraw them from Parliament. As a result, Brazil continues to be party to no BIT whatsoever.

3. Debates at the Brazilian Parliament

The decision of some Members of Parliament to express their concern with the BITs was influenced by both external and internal causes.

On the external front, politicians were advised to pay attention to the controversial lawsuits that emanated from the application of Chapter 11 of the North American Free Trade Agreement (NAFTA), as well as the political stalemate in the negotiations surrounding the Multilateral Agreement on Investment (MAI) in the Organisation for Economic Cooperation and Development (OECD). In the case of NAFTA, some Non-Governmental Organisations (NGOs) were particularly active in showing the potential loss of sovereignty that the Mexican authorities would suffer as a result of signing up to NAFTA. Experts were particularly worried about the flexible interpretation of some provisions of Chapter 11, such as "treatment in accordance with international law, including fair and equitable treatment and full protection and security" (Article 1105) and "measures tantamount to nationalization or expropriation" (article 1110). There were also fears that the ICSID and the United Nations Commission on International Trade Law (UNCITRAL) processes were not as transparent and accountable as had been previously thought.

The failure of the MAI negotiations had a still bigger impact on the Brazilian Parliament. People started to ask themselves about the political reasons that could have led the MAI negotiations to a stalemate, since OECD countries were precisely the ones that asked developing countries to sign BITs. Many Congressmen held the view that

OECD countries were much more interested in negotiating investment agreements as home countries but were hesitant about making commitments when faced with the possibility of being host countries. This ambiguity conveyed the message that there was something to fear about investment treaties.

On the domestic front, the economic stabilization brought about by the Real Plan and the huge process of privatising state-owned companies allowed the Brazilian economy to receive massive inflows of FDI. In 1999-2001, FDI flows to Brazil varied between 4% and 5% of GDP, helping to stabilize the balance of payments. FDI increased despite the fact that no BIT was in force, something that moved people to question whether they were necessary at all.

Be that as it may, nationalist and leftist groups in the Parliament started to analyse the juridical provisions of the BITs signed by the Executive. Congressmen raised a number of smaller, but far from insignificant, concerns about the consequences of the investment treaties. For instance, they wondered what the actual consequences of the Most-Favoured-Nation clause would be. Did it mean that Brazil was committed to the deepest provision, among all BITs signed, of each issue? There were also questions about the expression “in accordance with national laws”: to what period exactly did this refer? Did it mean the date the BIT was signed or the date the investment was made?

In the expropriation section of BITs, the reference to debt denominated in “convertible currencies” also raised debates. Brazilian legislation does not allow the public sector to have domestic debts denominated in foreign currencies. Dollars or euros may be used as means of payment for the transfer of funds, but not as a unit of account.

The most important concerns, however, tended to relate to three major issues: the free transfer of funds, the expropriation clause, and the dispute settlements mechanism.

Transfer of funds

Since 1999, Brazil has committed itself to eliminating practices that were incompatible with the Articles of the International Monetary Fund (IMF), which had previously been permitted under the “transitional arrangements” specified in Article XIV,2. The country decided to comply fully with Article VIII, 2(a), which prohibits members from imposing “restrictions on the making of payments and transfers for current international transactions”. In fact, the Fund may allow transitional restrictions, which are generally related to balance of payments crises and whose conditions have been debated for decades. Furthermore, Article VIII does not mention “capital transactions”, in relation to which Members are free to impose restrictions at any time.

The General Agreement on the Trade of Services (GATS) of the World Trade Organisation (WTO) also establishes commitments that may interfere with a Member’s ability to impose restrictions on the transfer of funds. Article XI of the GATS may be interpreted in an even more rigid way than the IMF’s Article VIII, since every transaction (in both the current and capital accounts of the balance of payments) would be covered. That said, the GATS also presents temporary exceptions related to the IMF decisions (Article XII, 2b).

The BITs would, therefore, have represented additional commitments to the free transfer of funds in two senses. Firstly, because they referred to both current and capital transactions, a fact that was particularly relevant when combined with their wide definition of “investment” (which included every form of capital inflow). Secondly, because the BITs did not include any balance-of-payments provisions.

The currency crises of the late 1990s (encompassing Asia, Turkey, Russia, Argentina and Brazil) changed minds about the efficiency and feasibility of capital controls. Far from being a “mortal sin”, temporary restrictions over capital inflows could, in specific circumstances, help to avoid the drastic economic consequences of misguided policies.

Expropriation

The BITs’ expropriation clause was another matter of deep concern for the Brazilian Parliament. On the one hand, there were restrictions on the way in which indemnity payments would be made. The BITs referred to “immediate payments, in convertible currency and freely transferable”. Domestic legislation, however, is quite different, insofar as it determines that, in some cases, payments should be made by public authorities in the form of long-term Treasury Bonds. The Federal Constitution itself establishes provisions of this kind. The divergence between BITs and domestic law would disadvantage national investors compared with their foreign counterparts.

On the other hand, there was much uncertainty about the expression “measures tantamount to expropriation”. The concept of indirect expropriation seemed overly flexible and vague and could be used by foreign investors, depending on the circumstances, to restrain the public sector's autonomy in setting economic, social, environmental, or urban policy.

Investor-to-State dispute settlements

International arbitration is a traditional practice in Brazilian law. Private enterprises normally go to international courts in order to settle disputes, especially those involving international commerce. Even the Government may sign agreements that provide for international arbitration but, in these cases, the object of the contract is always precise (an international loan, for instance).

The peculiarity of the BITs was that the State would be subject to international arbitration in a myriad of situations. At its most extreme, every investing party to a treaty might have the right to ask arbiters to interpret BIT provisions against national legislation. Some Members of Parliament expressed their worries that the principle of the “exhaustion of domestic recourses” would be overcome. Others pointed out that, insofar as domestic investors would not have recourse to international arbitration, there was discrimination in favour of foreigners.

Furthermore, some experts were not sure about the consequences of Brazil not being a Member of the ICSID. Did that mean that the “ICSID Additional Facility Rules” would be used? If so, which version would be applicable? There are often amendments to such rules, which constitute an evolving document, the provisions of which are not discussed by the Brazilian Government.

4. Criticisms on the BITs: a debate of political economy

Taking a broader view of the issues raised by the Brazilian Parliament in relation to the BITs, it could be argued that they actually constituted a debate of political economics. Behind the technical points there was a more general concern with possible restraints imposed on the State and its ability to pursue public policy. Furthermore, politicians hesitated to approve agreements that would discriminate against domestic investors, since many of the provisions of the BITs do not exist in internal legislation.

The relationship between BITs and development policies is an old and complex theme that has been studied by different institutions and experts. The United Nations Conference on Trade and Development (UNCTAD) 2003 World Investment Report, for instance, held that "such international agreements, like other legal texts, are specifications of legal obligations that limit the sovereign autonomy of the parties. Given that international legal obligations generally prevail over domestic rules, tension can arise between the will to cooperate at the international level through binding rules and the need for governments to discharge their domestic regulatory functions" (*WIR 2003*, p. 145).

The political debate that arose in Parliament led to a stalemate, because arguments against some provisions of the BITs were precisely those that foreign investors tried to overcome. Any investment treaty is a mechanism for protecting foreign investors from changes in national legislation or from the intervention of host countries in their business. To argue in favour of BITs insofar as they do not impose limits on host countries' public policy is a contradiction in terms.

Take, for instance, the debate on investor-to-State settlement mechanisms. Some Brazilian jurists have alleged that international arbitration rulings are legally binding if, and only if, they are submitted to the Superior Court of Justice (STJ), which will analyse whether the decision affects "public order" or "sovereignty". This kind of influence by national courts, however, is precisely what foreign investors are looking to eliminate with the signature of BITs. Concepts like "public order" and "sovereignty" are, in the eyes of foreign investors, so vague and broad that they could be used to any purpose.

Concluding remarks

Upon careful reflection, one could argue that Brazilian nationalist groups were not debating technical questions at all. Instead, they were resisting the very principle of restraints on the public sector's ability to pursue development policy. The entire argument of the legislators can be seen as a drive to preserve the policy space of the public sector.

In many developing countries, various concerns appear to have arisen about the limits imposed by BITs on the implementation of public policy. At the same time, their actual benefits remain unclear, as their capacity to attract investment flows are still unproven. Therefore, the relationship between BITs, on the one hand, and the preservation of the policy space, on the other, although an extremely broad issue (not to mention ultimately a political one), remains a matter of interest.