

Bellak, Christian

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## **Shift of the Use of Bilateral Investment Treaties as a Shield to Using Them as a Sword Against Government Activity?**

*Christian Bellak\**

According to many observers, one of the reasons why the Multilateral Agreement (MAI) failed was that it departed from conventional regulation, where the state sets the framework of rules and defines the obligations of companies. The MAI instead tried to define the rights of investors and the obligations of the state – and this fact applies largely to Bilateral Investment Treaties (BITs) as well.

In a nutshell, according to the United Nations Conference on Trade and Development (UNCTAD), BITs

»are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each other's territories by companies based in either country. Treaties typically cover the following areas: scope and definition of investment, admission and establishment, national treatment, most-favoured-nation treatment, fair and equitable treatment, compensation in the event of expropriation or damage to the investment, guarantees of free transfers of funds, and dispute settlement mechanisms, both state-state and investor-state.« (UNCTAD 2006a)

### *Current State of BITs*

At present, the situation with respect to BITs is characterised by three main features.

First, a strong increase in the *number of BITs* occurred recently.

\* Vienna University of Economics and Business Administration. This contribution builds on an earlier contribution to a panel discussion on »Towards a More Coherent International Policy Framework for MNEs«, chaired by Professor Rajneesh Narula, at the 30<sup>th</sup> European International Business Academy meeting in Fribourg, Switzerland.

»The number of BITs has increased significantly, especially during the 1990s. From a total of 386 BITs signed by the end of the 1980s, the number rose to 2,181 at the end of 2002.« (UNCTAD 2006b)

By 2006 approximately 1,700 BITs have come into force.<sup>1</sup> This plethora of BITs is due to a number of factors, among them the quantitative increase in foreign direct investment (FDI); the regional spread and diversification of FDI into formerly closed countries (e.g. in the Central and East European Countries, Vietnam, China); investments into riskier projects (e.g. in politically unstable countries).

The second trend is the sharp increase in the *number of disputes* (e.g. Gugler 2006, UNCTAD 2005). Disputes may arise from a number of factors, among them expropriation, discrimination against domestic firms, barriers to market entry. A particular feature of the disputes is that almost all were invoked by investors, i.e. almost none by states. This is indicative of a potential problem in the way BITs are designed (see below). The cumulative number of known treaty-based cases brought before ICSID or other arbitration facilities under IIAs in the last ten years was estimated at approximately 174 at the end of June 2005 and 219 only six months later (UNCTAD 2005, figure 1) – as compared to two at the end of 1994 (Houde 2006: 178). The large number of disputes and the problematic regulation of the dispute settlement procedures make BITs a nightmare for lawyers but on the other hand create an additional market for them as the average dispute settlement procedure costs are quite high.<sup>2</sup> It is well known that the rulings are costly, too:

»For example a World Bank arbitration panel ruled in May 2006 that Argentina must pay CMS Gas Transmission Company, a U.S. corporation with a roughly 30 per cent share in the country's gas utility, \$133 million to compensate the firm for lost revenues due to a utility rate freeze.« (Cibils 2005)

Another prominent case was the Lauder case (which is actually two cases),

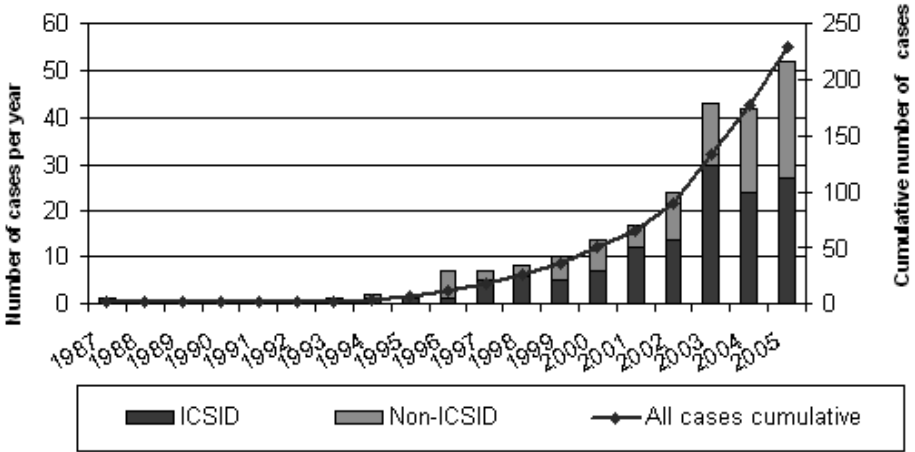
»where two different investors initiated arbitrations under different BITs in different forums against the Czech government [and where one of the investors, C. B.] won an award of over 300 mn USD from the Czech Republic.« (UNCTAD 2005: 17)

Third, a high degree of similarity of BITs is discernible, despite the increase in the number of model BITs. This fact is explained *inter alia* by the fact that all model BITs have been

1 The figures differ slightly between sources. One reason is that »a number of 2,500 BITs has been mooted. However, it includes a number of treaties that have been negotiated but not yet ratified.« (Houde 2006: 178)

2 For example: »Furthermore, even defending against claims that may not ultimately be successful costs money. A cursory review of cost decisions in recent awards suggests that the average legal costs incurred by governments are between \$1 million and \$2 million, including lawyers' fees, the costs for the tribunal of about \$400,000 or more, and the costs for the claimants, which are about the same as those for the defendant.« (UNCTAD 2005: 8)

Figure 1: Known Investment Treaty Arbitrations, 1987 to 2005<sup>1</sup>



1 Cumulative and newly instituted cases (end of year).

Source: UNCTAD 2006c

designed by developed countries.<sup>3</sup> In other words, the interests of investors from developed home countries are very similar across the developed world. For example, the fear of expropriation is relevant for any investor from developed countries in any industry in any developing host economy. In addition, since BITs are concluded bilaterally on the country level, while they may include sector-specific regulations, these are very rare *in praxi*.

The similarity of the model BITs cannot be argued to be a necessary country-specific differentiation or »tailored to the specific circumstances of the parties concerned« (as e.g. in Gugler 2006: 9). Rather, this fact can also be seen as an example of inefficient regulation, compared to a multilateral agreement in investment. Of course, a multilateral agreement would not automatically replace BITs. As the World Development Movement (WDM) (2003: 6) pointed out,

»any MAI to be negotiated at the WTO<sup>4</sup> would leave uncovered many aspects of investment currently included in BITs, and there would be a continuing demand for bilateral treaties to make up the shortfall.«

Rather, as Karl Sauvant (formerly UNCTAD) has pointed out at the EIBA meeting mentioned above, a multilateral agreement would most likely just set the minimum standard, whereas BITs would still be an important instrument of bilateral regulation of rights and

3 In this paper, I use the term »developed countries« for the member countries of the Organisation for Economic Cooperation and Development (OECD) and the term »developing countries« for the poor countries of the world.

4 World Trade Organisation.

obligations of foreign investors and governments. This scenario of parallel existence of BITs and a multilateral agreement would not alleviate the prisoner's dilemma of countries competing for FDI (see below), since BITs would still be used to differentiate a country's location factors from another competing country.

What has been said so far concerning BITs referred to developed countries' model BITs. Now, consider as a thought experiment the following question: How would a model BIT look like if it was designed by a developing country like, for example, Bangladesh? From any host country's view, the impact of FDI on the host economy will be relevant. This impact consists usually of three groups of items: first, the rents accruing to the host country (wages, profits, taxes) and the potential for profit shifting; second, the effects on competition in the host country (i.e. whether crowding out of domestic companies occurs due to the entry of a foreign transnational corporation [TNCs]); and third, the impact on domestic firms as positive externalities (spillovers). The latter item, spillovers, may take various forms like technological spillovers, technical spillovers, sourcing, etc.<sup>5</sup>

Thus, a model BIT drafted by developing host countries would most likely include provisions to maximise the benefit, including the right to expropriation without compensation in cases where labour standards or environmental standards are not met; or it would give the government the right to apply the competition law selectively in order to promote domestic firms, e.g. in public procurement or in privatisations of firms in natural resource extraction (competition policy); or it would exclude the possibility to use domestic courts for arbitration; or it would define not only rights, but also obligations of TNCs; or it would try to increase the sustainability of FDI like local content provisions; or it would require conducting an assessment of the (regional, environmental and social) effects of each specific investment prior to the application of the BIT (selective application, no automatic application), etc.

Overall, a model BIT developed by developing countries would include provisions on several issues that ultimately led to the failure of MAI. In this respect, it is useful to look at some of the lessons drawn from this process (e.g. Polk 1999, Drillisch/Sekler 2004).

*So: What's Wrong with BITs?*

The above discussed developments raise two immediate questions:

1. Why do countries conclude so many BITs if they run the risk of being dragged to court by multinational investors?
2. Why is the number of disputes increasing?

The remainder of this short note will briefly discuss a few aspects of both questions in turn.

*Ad 1. Why do countries conclude so many BITs if they run the risk of being dragged to court by multinational investors?* The strong growth in numbers of BITs is clearly due to a pris-

<sup>5</sup> The empirical evidence on the existence and magnitude of spillovers in the host economy is, however, mixed and does not point to substantial indirect effects from inward FDI on the host economy.

oner's dilemma scenario in which the individual states are caught in a race to the bottom. As they seek to attract FDI from TNCs, the situation is not much different from that of tax competition for FDI or similar policy interventions. This applies foremost to the position of the poorer developing countries like for example Cuba or Vietnam (e.g. Bellak/Küblböck 2004). WDM (2003: 7) quotes Toufiq Ali, Bangladesh's Ambassador to the WTO and at that time coordinator of the Less Developed Countries (LDC) group:

»When you go into a bilateral format of the negotiations, you are vulnerable. Why? Because against a major developed country, you simply cannot withstand the level of scrutiny. And you do not have the strength in numbers that you get in the multilateral process. This is exactly what happens bilaterally in the WTO. Within a multilateral context, in the WTO, sometimes developed countries are unable to get their way with us. But when you come to the bilateral mode, we find that where they are unable to persuade us to agree to something multilaterally, they apply pressure bilaterally and get it done.«

One interesting aspect is that – empirically – the amount of FDI flowing into a particular country seems to be unrelated to the existence of a BIT (e.g. Salacuse 1990):

»Brazil, for example, a major recipient of foreign investment flows [...], signed only 10 BITs during the 1990s, none of which were actually implemented.« (Cibils 2006: 2)

Brazil is therefore in a very different situation than, say, Argentina now. This should of course by no means imply that no BITs are better than having BITs – but probably it is better than having the wrong BITs (see above the example of a developing country model BIT). This leads to a first important imbalance of powers: As Young and Tavares (2004) conclude,

»this patchwork [of bilateral treaties, regional arrangements, and limited plurilateral or multilateral instruments, C. B.] creates a considerable problem of lack of coordination and consequent systemic failure, and in the end weakens the bargaining power of countries vis-à-vis TNCs, which have learned how to exploit the absence of a transparent and harmonized Foreign Direct Investment regulatory framework.«

From the perspective of the prisoner's dilemma, in many respects BITs are an inferior regulation to a multilateral agreement. Yet, a multilateral agreement does not automatically solve the problems of BITs. Some of the advantages of a multilateral agreement would be that the developing countries would have a greater incentive and a forum to join forces; the inclusion of more countries through international pressure (peer group); the introduction of minimum standards or ceilings, depending on the provision in question, etc. Besides, any multilateral agreement could include country-specific differentiations, if need be.

*Ad 2. Why is the number of disputes increasing?* In my view, two additional major imbalances are the main causes of the increase in the number of disputes.

On the one hand, there is an *imbalance of rights and obligations* of states and TNCs. As an example one might refer to the notion of *indirect expropriation* which can be found in several BITs and which refers to changes in government regulation once the investor is in place and which affect the investors' interests negatively. Indirect expropriation implies that the governments' hands are effectively tied if the government intends to change the existing regulatory environment. By the way, this fact explains the title of this paper. A good example are the two Lauder cases mentioned before, where one investor won its case »for alleged improper interference [of the government, C. B.] with their investments in the television business.« (UNCTAD 2005: 17)

On the other hand, there is an *imbalance of interests* between developing and developed countries. As a starting point, a general definition of a treaty is in place, which is »a written agreement between two states or sovereigns.«<sup>6</sup> Now, when a country is caught in a prisoner's dilemma, it might agree to a treaty even if it is not in its individual interest, but because it feels obliged to agree, since e.g. the neighbouring country, which is perceived as a competitor country with respect to FDI, has signed a treaty. As mentioned earlier, this is the situation of many developing countries right now.

The main source of this imbalance of interests is that the BIT *de jure* grants reciprocal protection of investments, yet *de facto* FDI flows from North to South. What, therefore, are the gains for the developing countries? It is, of course, the impact of FDI in the host countries – but there is nothing in BITs that addresses this issue. Therefore, BITs serve unilaterally the interests of investors from developed countries.<sup>7</sup>

This article has identified major imbalances between developing and developed countries on the one hand and between governments and TNCs on the other hand. Concluding, the current situation clearly serves the interests of investors from developed countries. Unless the developed countries are not prepared to address these concerns and apply *fairness* in the area of BITs, the described imbalances might turn the tide against them in the future. This may materialise in a parallel process where developing countries do not conclude further BITs and even cancel existing ones. Moreover, they may loose total interest in entering a MAI. This would be disadvantageous for developed countries' TNCs and their home countries alike, which would have to provide policy instruments to reduce or mitigate the political risk in host countries. The more positive view would be that developing countries draft their own model BIT and act as a group, forcing the developed countries to accept their rules. Yet, this latter movement is not in sight at present.

However, while the problems of BITs are pretty obvious – not least since the failure of the MAI –, the pendulum has not yet swung in the direction of addressing the main concerns of developing countries – let alone creating balance. There are ample suggestions on the international level on both, procedural and substantive issues, in order to improve

6 URL: [www.wordnet.princeton.edu/perl/webwn](http://www.wordnet.princeton.edu/perl/webwn).

7 One interesting idea to solve this imbalance that has been put forward by various authors was the re-introduction of performance requirements – similar to the earlier FDI policies to encourage technology transfer. This would, of course, have implications for the WTO agreements, etc.

the situation as recent publications by UNCTAD in 2005 and by the OECD in 2006 (e.g. Yannaca-Small 2006) show. This is also partly due to a lack of interest, knowledge and awareness among decision makers in parliaments on the national level in the developed countries who actually conclude the BITs.

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