

Drábek, Zdeněk

Article

Governance of FDI and the East Asian Economic Community

Asia and the Global Economy (AGE)

Provided in Cooperation with:

Asia Economic Community Foundation, Incheon

Suggested Citation: Drábek, Zdeněk (2021) : Governance of FDI and the East Asian Economic Community, Asia and the Global Economy (AGE), ISSN 2667-1115, Elsevier, Amsterdam, Vol. 1, Iss. 1, pp. 1-10,
<https://doi.org/10.1016/j.aglobe.2021.100001>

This Version is available at:

<https://hdl.handle.net/10419/340912>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



<https://creativecommons.org/licenses/by-nc-nd/4.0/>



Governance of FDI and the East Asian Economic Community[☆]

Zdenek Drabek

CERGE-EI, Charles University, Prague, Czech Republic

ARTICLE INFO

Keywords:

FDI governance
Regional economic agreements
International investment agreements
Trade and investment rules
Effects of international investment agreements
Investment disputes and international arbitration

ABSTRACT

Policy makers in the Asia Economic Community (AEC) engaged in the integration of the countries in the region have so far focused their attention on measures affecting commodity markets. Integration of investment activities should follow in the future. To achieve integration, the policy makers will have to harmonize investment rules. This paper discusses some of the major theoretical and empirical issues of investment governance. The theory is quite clear that, in most cases, cooperation and harmonization of investment rules should be beneficial for countries, a conclusion that is strongly supported by empirical evidence. However, the theory is less clear about specific rules. Though it is still evolving, the theory does provide useful guidance to policy makers in the AEC for negotiating more complete and efficient contracts involving foreign investment.

Introduction

The Asia Economic Community (AEC) has made impressive economic progress over recent decades largely by enhanced integration of commodity markets in the region. Existing integration in East Asia has primarily included measures to enlarge market access, to reduce trade costs, to create better business conditions for investment and to improve connectivity in transportation and other infrastructure networks. However, the AEC countries recognize that the overall goals are not static and that further and deeper integration will be needed to ensure a continuous reinvention of the region to maintain and enhance its relevance in an evolving global economy. Among other initiatives, this will call for closer integration of financial markets and for measures leading to the establishment of a more transparent, predictable and operationally effective system of investment promotion and investment security for foreign direct investment (FDI) across the region.

Cooperation and investment agreements with other countries in and outside the region should target three key issues of investment policy: (1) how to establish effective tools to attract FDI and facilitate FDI flows, (2) how to minimize investment disputes and, once disputes occur, (3) how to resolve disputes fairly and effectively. This paper has four objectives: (i) To identify and discuss the main issues stemming from criticisms of existing investment agreements – bilateral, regional and multilateral. (ii) To show how economists explain the desirability of investment agreements. (iii) To provide empirical evidence on the effects of international investment agreements (IIAs) on FDI flows and the per-

formance of international arbitration. And, finally, (iv) to derive policy implications for the Asian Economic Community.

Most of the criticism of investment agreements has come from the legal literature and from political scientists identifying litigation, reputational costs, reduced policy space and uncertainty of the law as the main costs of investment agreements. I take a different approach in this paper, based on economic analysis. I draw on economic theory to show the desirability of investment agreements. There has been a proliferation of economic literature discussing and empirically evaluating the importance of investment agreements for FDI flows, and I draw on the main conclusions from that empirical literature. Early empirical evidence on the performance of international arbitration also exists, and I provide a brief review of its most important findings and conclusions.

Unfortunately, the theoretical literature on investment agreements is relatively limited. However, the literature can, and has, drawn on the rich debate originating in the trade literature and the literature on regulations. I adopt the same approach and use what I consider to be the relevant elements of these two streams of economic literature. As I argue, findings from both streams can be very helpful in guiding policy makers to conclude investment agreements, but they are somewhat less helpful regarding the optimal design of specific rules.

The paper is organized as follows. Section 2 looks at the desirability of international investment agreements from the theoretical perspective. Section 3 briefly reviews the empirical evidence assessing the effect of IIA on FDI and the performance of international arbitration courts. The

[☆] This paper was presented at the Asia Economic Community Forum in Incheon, Korea on November 7–8, 2019. Dr. Z. Drabek is a Sr. Research Fellow at CERGE-EI and Visiting Professor at IES of Charles University, Prague. His research has been supported by a research grant from the Czech Science Foundation: GACR 18–04630S. The author is very grateful for useful comments to V. Benacek, J.C. Brada, H. Horn, J. Hancock, P. Mavroidis, I. Szekely, and has also benefited from comments of participants at the AECF. He also gratefully acknowledges the invitation from the AECF. The usual disclaimer applies.

E-mail address: zdenek.drabek1@gmail.com

<https://doi.org/10.1016/j.aglobe.2021.100001>

Received 1 February 2021; Accepted 1 February 2021

Available online 30 April 2021

2667-1115/© 2021 Published by Elsevier Ltd on behalf of The Asia Economic Community Foundation. This is an open access article under the CC BY-NC-ND license (<http://creativecommons.org/licenses/by-nc-nd/4.0/>)

policy implications of the theoretical arguments and of the empirical literature for the AEC region is discussed in section 4.

Do we need international investment agreements?

As is standard in economics, the economic theory of investment agreements begins by implicitly assuming that individuals, firms and governments have choices to make. This section aims to answer the following questions using existing economic literature: Should countries cooperate? If cooperation is chosen, what are the conditions for success? How realistic are those conditions? To answer these fundamental questions, I draw on the trade literature, which has provided a far richer theoretical discussion of agreements than has the literature on FDI.

The choice to be made by governments when conducting trade and investment policies is whether it will pursue discretionary policy or, alternatively, seek to cooperate with foreign countries. Trade theory has historically viewed the choice as being between free trade and protection. For most practical purposes, countries were seen as 'small' entities which faced world prices that they could not influence. It was, therefore, at the discretion of a country to decide whether it would protect its markets or pursue free trade. However, later literature emphasized a different aspect of trade – interdependence. The basic idea is that every trade policy measure also affects foreigners. This necessitates bargaining with foreign countries to cooperate and to agree on rules of trade.

Similar reasoning can be applied to capital movements, including FDI. In a perfect world with no restrictions on capital movements, current account imbalances are corrected for by price flexibility, and inflationary price effects are effectively neutralized by central banks, whose mandates are typically dedicated to price stability. In an imperfect world, however, (i) exchange rates are managed, (ii) domestic prices may not be perfectly flexible and/or may be distorted, (iii) various restrictions are imposed on foreign investment (e.g. 'strategic', promotion, agriculture, utilization of natural resources, intellectual property rights (IPR), etc., (iv) government decisions are subject to public policy considerations (e.g., environment, labor rights) and (v) take into account global competition including competition in rule-setting. The presence of imperfection means that rules to improve the decision-making process and to make optimal decisions are needed. In addition, it is important to decide whether the rules should be set at the sole discretion of national governments or through negotiations with other countries.

The choice between discretion and cooperation has been treated in economic theory in two different streams of literature. The first stream looks at the time-consistency of rules. The second stream is found in the framework of theory of trade agreements and seeks to identify conditions under which trade agreements are welfare enhancing, and to assess the properties of different trade rules under optimal arrangements of trade agreements.

Discretionary policy or cooperation? (Time consistency of rules)

An important part of the answer to this question involves deciding whether rules of trade are sustainable over time. Trade rules must be time consistent in order to ensure that cooperation works. The debates about time consistency of rules originated in the influential work of Kydland and Prescott (Kydland and Prescott, 1977), who argued that rules matter and that optimal rules must have certain desirable properties. They examined policy options not only at a particular point in time but also over time. Their pioneering contribution was to emphasize the importance of time consistency when choosing among different policy options. Governments need to set rules that are credible, and time-consistency provides in their view credibility to policies.

The practical task of establishing credible rules over time will be complicated if there are imperfections in rule setting. If the conditions under which policy rules were originally set change over time, govern-

ments may not be willing to commit to their own rules in the future¹. They may see it beneficial for the society that they break their own rule. However, their new policy must also be seen as beneficial by the society and must, therefore, be credible. In other words, the new policy will still require cooperation by the society.

Kydland and Prescott's ideas have been widely adopted in other branches of economics including, for example, macroeconomic policy, monetary policy, taxation, and public policy, among others.² Their main contribution to the debate on the rules vs. discretion was to show that discretionary policy can produce undesirable long-run outcomes even in a world with little uncertainty, good policy tools and public-spirited policy makers.³

The idea and the condition of time-consistency have been widely debated. Perhaps the most famous example of the debate is what is known as the Taylor rule (Taylor, 2017) in monetary policy. The rule sets guidelines for central banks to adjust interest rates in response to changes in economic conditions. While the rule has been widely received with a great deal of optimism and actually applied by several central banks, it has also been subject to criticism, and Taylor himself as well as Kydland and Prescott (2004) later called for some degree of caution in the use of the rule.

International trade and investment agreements? (Prisoner's dilemma)

The second theoretical approach guiding the choice between discretion and cooperation comes from the theory of optimal trade agreements. As noted above, trade theory has historically emphasized the role of free trade. Governments would adopt free trade policies and not seek international cooperation in the form of an international trade agreement, provided that trade takes place under specific conditions. The traditional theory assumes that (i) all markets are perfectly competitive; (ii) production occurs under constant or decreasing returns to scale; (iii) there are no externalities; (iv) the countries do not affect the prices at which they trade internationally; and (v) governments pursue the objective of maximizing national income and social welfare.

Once any of these assumptions is violated, however, the picture changes fundamentally, and economic theory takes a very different view on cooperation. There are, again, at least two different approaches taken by international trade economists to answer the question of whether countries should cooperate. One school of thought has been to approach these questions from the perspective of game theory and in the context of optimal trade agreements. This involves identification of gains for countries from coalitions with their foreign partners. The coalitions (agreements) must conform to certain rules in order to distribute the benefits of the coalitions. The game-theoretic approach has been adopted and developed, in particular, by Bagwell and Staiger (Bagwell and Staiger, 2001a), b, 2016, Markussen (Markussen, 1975), Maggi and Rodríguez-Clare (Maggi and Rodríguez-Clare, 2007) and Horn et al. (Horn et al., 2010b) in the theory of optimal trade agreements⁴ and by Aisbett et al. (Aisbett et al., 2010b, Aisbett et al., 2010a) and later by Horn and

¹ Note that rule imperfections may also originate in rules that not credible at the time of signing the agreement (e.g., the rules may be perfect, but their administration is carried out by corrupt politicians) but become credible later on once they are administered by different (honest in our example) politicians. This case is not considered here. The perfect rule should cover the possibility of changes in external conditions as is the case with the rule of flexible exchange rates.

² The literature on monetary policy is vast and goes back to Simons (1936), followed later by Friedman (1960). For the literature on time-consistency of monetary policy, see, for example, the original piece by Fischer (1988) which was followed by work by Taylor, Henderson and McKibbin, leading to what is known as the Taylor rule. For an assessment of the debate, see Taylor (Taylor, 2017).

³ See Buol and Vaughan (Buol and Vaughan, 2003).

⁴ Drawing on the work of Johnson [(Johnson, 1953)/4], Bhagwati and Ramaswami (Bhagwati and Ramaswami, 1963) and Markussen (Markussen, 1975),

Tangeras (Horn and Tangeras, 2018) in their work on optimal investment agreements.⁵ An alternative approach, drawing deeply from psychology, economic behavior, and organization, has been focused on the principles of adaptation, mitigation and risk taking by economic agents. (e.g. (Konrad, 2016)a).⁶ Since the debate about IIA is about rules, in this section discussion is limited to the first approach.

The game theoretic approach to cooperation is quite clear in claiming that countries can gain by cooperating (i.e., by signing trade agreements), and that those gains come from improvements in access to each other's markets through reciprocal tariff reductions. Since the terms must be established through negotiations between countries, trade theorists assume that countries will not undertake unilateral tariff reductions but will negotiate reciprocal reductions with trading partners. Countries face a 'prisoner's dilemma' in which the pursuit of one partner's individual interests will not make the countries better off, but the pursuit of joint interests and welfare will. While these ideas have been formulated for trade, similar logic is adopted in the case of cooperation in investments as discussed below.

Cooperation, but on what terms? (Incomplete rules and contracts)

An agreement (i.e. cooperation) *per se* does not necessarily imply that the agreement is efficient. On what terms should cooperation take place? Here the answers become far more complicated. A key condition of efficiency, defined in the literature in terms of Pareto conditions, is that countries' concessions have desirable properties of externalities. These externalities in trade occur in the foreign countries as a result of the home country's tariff reduction. In the investment area, these externalities can also reflect expanded investment due to improved market access. Externalities can be positive or negative, depending on each policy instrument, but, clearly, an efficient trade agreement can only be achieved if both countries believe that social welfare in both countries is enhanced by the agreement.⁷

The second reason agreements may not be efficient is incomplete-ness; these are actually the origins of the externalities. As pointed out by Grossman and Horn (Grossman and Horn, 2012), actual trade agreements are incomplete in various ways. First, contractual bindings are less responsive to changes in the underlying economic and political environment than they should ideally be. Second, agreements do not bind all policy instruments, but leave discretion over certain policies to the parties. Third, contractual provisions are expressed vaguely in order to save negotiators' time.⁸ The presence of asymmetric information as a possibility is another case in point. As Grossman and Horn (Grossman and Horn, 2012) themselves state, asymmetric information between contracting parties and the court can seriously affect the assessment of injuries in arbitrations and the extent to which they are verifiable. Stiglitz (Stiglitz, 2007) emphasized another element of incomplete

contracts – blaming imperfect markets and government preferences for income differences. Moreover, the role of arbitrations in Investor-State Dispute Settlement (ISDS) is not considered in their models, which is also a limitation since arbitrations can be seen as providing an important service for completing incomplete contracts.⁹

Externalities may vary from model to model. In the trade model of Horn et al. (Horn et al., 2010b), externalities are of three types – production externalities, consumption externalities, and externalities arising with regard to trade volumes. These are the sources of uncertainty when designing optimal trade agreements. Therefore, the parties must draft an agreement that resolves the problem of uncertainty and allows them to choose policies subject to the constraints set by the agreement. Finally, the theory recognizes that drafting, negotiating and policing agreements involve contracting costs which also influence the final design of optimal agreements. The more detailed the agreement, the higher the contracting costs are likely to be, both in terms of the costs of defining the constraints on the policies and the contingencies. For simplicity, Horn and his colleagues define the range of policy instruments only in terms of tariffs on imports and domestic subsidies, though they later extend the range to include consumption taxes. Given the basic structure of the model, they then work out the properties of an optimal trade agreement which improves on non-cooperative equilibrium.

The models of optimal trade agreements allow an interesting elaboration of various aspects to be considered in negotiations of international agreements. In particular, the models make it clearer to policy makers which issues need to be considered when weighing the option of not cooperating with trade partners. They also aid in considerations of the effectiveness of policy instruments.

The complexity of designing optimal trade agreements obviously requires agents to make a number of simplifying assumptions, some of which are quite strong. First, following the literature on optimal tariffs, Horn et al. (Horn et al., 2010b) assume that tariff changes will lead to changes in terms of trade. Clearly, this assumption may be suitable for large countries but its applicability to small countries may be questionable (e.g. (Broda et al., 2019)). Second, countries reach agreements via negotiation; hence both rules and discretionary policies must be negotiated. This, in turn, means that maximization of joint welfare negotiations is the single objective of the negotiations. Other negotiating games such as zero-sum- games are not considered here since the latter go in principle against the objectives cooperation. In addition, how countries respond to offers from trade partners depends on their response function. Reciprocity may not be a part of that strategy, or it may take different forms. The principle of reciprocity is a key factor of cooperation,¹⁰ but one that is not necessarily adopted as a necessary condition even by some economists.¹¹ Third, the logic of trade agreements is to allow governments to escape the 'terms-of-trade' (prisoner's) dilemma, i.e., trade liberalization under trade agreements may actually change terms of trade and hence offset gains of trade liberation. Trade agreements can also serve other purposes, including protecting the interests of domes-

the modelling work originated in Bagwell and Staiger [(Bagwell and Staiger, 1990), (Bagwell and Staiger, 2001a), b and (Bagwell and Staiger, 2002)] followed later by Maggi and Staiger (Maggi and Staiger, 2008).

⁵ The key element of this approach is an analysis in the framework of Nash equilibrium that may not be always seen as conforming strictly to game theory.

⁶ Other useful references include, for example, Janeba (Janeba, 2016), Kohler and Stohler (Kohler and Stohler, 2016), Konrad (Konrad, 2016), and Schjelderup and Stohler (Schjelderup and Stohler, 2016).

⁷ This is achieved in the modelling exercises by assuming that both parties are maximizing national welfare but recognizing that national welfare can be increased by cooperation, and in doing so, they also increase *joint welfare*.

⁸ These are all practical problems, which I later describe as a problem of implementation of agreements, i.e. contracts are not perfectly explicit and they are incomplete. Formally, incompleteness of contracts has been explained in the theoretical literature as related to four elements: (i) bounded rationality characterized by failure to know all the alternatives, uncertainty about relevant exogenous events, and the inability to calculate consequences; ii) transaction costs, (iii) non-verifiability and (iv) strategic ambiguity. See World Trade Report 2009, Appendix B-1, Geneva: (WTO 2009).

⁹ Note, however, that arbitrations can also act in exactly the opposite way.

¹⁰ Can countries cooperate and be better off even without reciprocity? As shown by Riolo, Cohen and Axelrod (Riolo et al., 2001), cooperation can take place without reciprocity. This case is not considered in this paper, as we assume that countries decide to cooperate in return for some benefits.

¹¹ Note that reciprocity does not necessarily imply direct benefits from cooperation. The benefits can be indirect, as we know from psychology. Countries may cooperate despite their lack of commitment to particular rules because by failing to do so, they would be punished by the market. To replicate Bowles and Gintis (Bowles and Gintis, 2013), who examine the reasons human beings maintain high levels of cooperation despite low levels of genetic relatedness among group members, countries cooperate because they (increasingly through globalization) have a predisposition to punish those countries that violate beneficial group norms. Thus, the fear of punishment may be another factor driving cooperation.

tic economic agents and lobbies.¹² The latter would obviously require a different modelling exercise. Moreover, the particular problem of whose interests are actually targeted in international agreements is quite critical. Well-behaved social welfare functions with all required properties must be assumed. Translating this into specific political and institutional arrangements, it must be assumed that governments truly represent the interests of society at large, that they act in response to transparent and institution-free social choices, and that changes in those social preferences are also constrained by the agreement. Finally, Horn et al. (Horn et al., 2010b) assume that international agreements impose limitations on the use of policy instruments, not on the outcomes of the agreements. This too, seems to be a serious limitation of their model since most trade and investment disputes arise from outcomes rather than from “mishandling” of policy instruments.¹³

In general, the existence of externalities is critical for justifying cooperation and international investment agreements (Lima, 2019). IIAs are immensely valuable to foreign investors because (1) they can improve market access, (2) they lessen the uncertainty of investors (reducing legal fragility and addressing poor legal protections, instability of market access and regulatory instability) and (3) they can lower costs of exogenous shocks by setting rules for crisis management. IIAs can be equally helpful to countries hosting foreign investment. IIAs can help by (1) making provisions to address domestic externalities of foreign investment (e.g. environmental damages), (2) performing as an instrument of domestic income distribution and, in particular, (3) as an instrument for poverty alleviation, economic growth, balance of payment management, and employment.

What about specific rules?

As suggested above, the guidance of economic theory on the role of IIA is relatively straightforward – negotiated arrangements can be the optimal choice for governments. The theory suggests, first of all, that a negotiated arrangement can be welfare-improving. For this to happen, it is important that the parties to the agreement (1) accept the principles of reciprocity and (2) transparency, and (3) they agree to binding commitments. In addition, (4) it is important that agreements improve on or mitigate the effects of distortions affecting mutual investment relations such as over- or under-regulation.”

However, as noted above, we cannot make a similarly straightforward recommendation when it comes to the design of specific rules. The most important of those rules in the current system of bilateral investment treaties (BITs) are (5) the treatment of (non) discrimination – national treatment (NT) and most favored nations treatment (MFN), (6) definition and treatment of exceptions to the agreement, (7) safeguards and (8) rules concerning dispute resolution. However, BITs have been criticized on the grounds of “bad rules” of other types, and for the absence of certain rules.¹⁴ The latter include rules on labor rights, environmental protection, employment of child labor, gender issues and others. I should also note that the problem about BIT is not also the controversial issue of some rules but also the implementation of both the agreed rules and of dispute settlement.

It is evident that many of these issues are of a practical nature, i.e., related to the coverage of IIAs, on which economic theory has very little to say. The theory obviously has a great deal to say about, for example, environmental policy and its efficiency, but the choice to include environmental objectives into IIAs may not be a matter of efficiency but

rather of political expediency, and thus of political economy. Similar objections can be made about the treatment of labor rights and many other considerations.

What remain the most frequently treated rules in the literature are the four areas (5)–(8) noted above. Economists are particularly interested in rules about discrimination. The literature dealing with theories of protection and discrimination goes back centuries, and while a majority of economists would emphasize the importance of free and competitive markets, there continue to be strong voices of dissent. It would be far beyond the scope of this paper to delve into the details of the debate. It may suffice to say that the national treatment (NT) has been defended as the most efficient policy instrument in the literature both on optimal trade agreements (Horn et al., 2010b) as well as optimal investment agreements (Horn and Tangeras, 2018).

Empirical evidence

Theory makes a strong case for cooperation and, specifically, for IIA. But what is the empirical evidence on the role of international investment agreements in promoting FDI? Do we have evidence of distortions or of serious problems originating in arbitration and compensations? In order to answer these questions, this section briefly reviews the empirical evidence on the effects of international investment agreements (IIA) and on the role of international arbitration.

Effects of international investment agreements on FDI

The literature on the effects of international investment agreements on FDI is quite large. Studies such as (Egger and Pfaffermayr, 2004); Neumayer and Spess (Neumayer and Spess, 2005) and Tobin and Rose-Ackerman (Tobin and Rose-Ackerman, 2011) have found a significant positive impact of bilateral investment treaties on FDI. Their influence has also been examined in Desbordes and Vicard (Desbordes and Vicard, 2009), Egger and Merlo (Egger and Merlo, 2007), Hallward-Driemeier (Hallward-Driemeier, 2003), Kerner (Kerner, 2009), Mina [(Mina, 2009), 2012], and several UNCTAD publications.¹⁵ There is a fairly large body of more recent literature, much of which reaches the same conclusions.

Even many critics of globalization have found significant positive impacts. For example, in their comprehensive review of studies covering 2005–2008, UNCTAD (UNCTAD 2009) found a positive relationship between IIAs and FDI. However, the evidence has not been entirely straightforward, which has led to debate and controversy. In one of the first studies on the effectiveness of IIAs, Sachs and Sauvant (Sachs and Sauvant, 2009) claimed that there was no “conclusive evidence” of a positive relationship between IIAs and FDI. Their study is undoubtedly influential and led to an explosion of empirical studies including those noted above and many more. The literature has been reviewed by Jacobs (Jacobs, 2017), Pohl (Pohl, 2018), and very recently by Brada et al. (2021). Sachs and Sauvant (Sachs and Sauvant, 2009b) themselves have somewhat modified their critical stand in their (2009b) study of IIA and double taxation treaties. Nevertheless, they, along with some other critics, remain cautious and strongly argue for significant changes in the formulations of rules agreed in the IIAs. In order to make further progress in the empirical literature, Brada et al. (2021) carried out a meta-analysis of more than 1000 estimates of the effects of IIAs on FDI. They confirmed that, even allowing for various differences in the modeling and estimating procedures, the effect of IIAs on FDI was not unambiguously positive. In sum, it is evident that the empirical evidence is controversial, and the rest of this section provides a brief summary of the main issues of the controversy.

Hypotheses. The fundamental challenge of the empirical work is setting the right hypotheses. In most cases, researchers have tested the key

¹² Note that protectionists’ governments can also run into a prisoner dilemma of their policy. I am grateful to Henrik Horn for reminding me this important point.

¹³ Horn et al. (Horn et al., 2010b) assume that trade agreements only constrain policies (i.e. tariffs) but not the volume of exports and imports, which is correct unless the agreements also limit the latter.

¹⁴ Perhaps the most impressive critic of trade and investment rules is Rodrik (Rodrik, 2018).

¹⁵ For a review, see UNCTAD (UNCTAD 2009).

hypothesis, whether IIA promotes FDI, so that IIA becomes a determinant of FDI. Clearly, FDI is influenced by many other factors, and IIA must be seen as only one of those factors. However, the model specifications have differed and could have, therefore, been among the causes of different outcomes.

It can be argued that the treatment of benefits to a host country defined solely in terms of changes in flows or stocks of FDI is too narrow. Consider a country that seeks FDI in order to augment its low savings and investment rates, to enhance the technological level of its industry, to improve its access to export markets, or to increase the level of its foreign currency reserves. Most, if not all, of these targets would be desirable for many developing countries and emerging markets. Therefore, it would be advisable to consider these benefits in designing the empirical work and in specifying the models. At the very least, researchers should make a distinction between developed and developing countries to account for their fundamental differences. *Pari passu*, countries may seek cooperation for political or strategic benefits including, for example, seeing IIA as an instrument for improving domestic governance in the host country. Similarly, countries may seek IIAs as a way to encourage the development of particular sectors or as an instrument for shaping a particular income distribution.

Methodological problems of evaluating the impact of IIAs on FDI

The impact of IIAs on FDI is clearly only one of many facets that can be considered in evaluating the effectiveness of IIA. We now have empirical evidence showing that the effects of IIAs on FDI depend on a range of political and social conditions, which are difficult to measure. A statistical analysis by Louie and Roussland (Louie and Roussland, 2009), for instance, suggests that if one does not take into account the quality of host-country governance, this results in the misleading conclusion that, for example, Double Taxation Treaties (DTTs) encourage outward US FDI. But, irrespective of recent advances in quantitative indexes measuring ambiguous concepts such as governance or institutions, it remains a challenge to carefully control for such intangible variables.

Another complicating factor concerns the sectoral distribution of FDI. Do sectors matter in the estimation of the effects of IIAs on FDI? Does the effectiveness of BITs in attracting FDI vary across economic sectors? Most IIA provide investment protection for after establishment operations and activities. However, it can be argued that investments in sectors with a high degree of sunk costs respond more strongly to IIA. The distinction between sectors with high sunk costs, such as extractive industries, and low sunk costs sectors could go a long way towards addressing one key concern of the critics who seek to maximize the benefits of FDI and thereby to maximize its contributions to the development of the host country.

Diversity of IIAs

The coverage and specification of rules in IIA is also important. Differences in IIAs create incentives for treaty hopping and can lead to biases in tests of the effectiveness of IIAs. As Poulsen (Poulsen, 2009) noted, "... while DTTs are more or less standardized documents, BITs can vary markedly in their substantive and procedural provisions." So it is possible that the differing results partially arise from not controlling for variations in the content of BITs. For instance, one would expect that BITs with market access provisions should have a greater impact on investment flows than BITs only covering the post-establishment phase. Similarly, BITs which incorporate a legally binding consent to arbitrate a wide range of investment disputes with private investors are likely to be valued more highly by investors than BITs in which such consent is limited or absent. While Yackee (Yackee, 2010) finds that BITs with strong arbitration provisions do not appear to have an impact on FDI, there is certainly much scope for further work in this area.

Results from research into the theory of trade disputes confirm the impact of various contractual distortions (e.g. (Bown, 2002), Butler and Hauser, 2000, (Grinols and Perrelli, 2003), and (Guzman, 2003)).

In trade, there are significant differences in the contractual treatment of, for example, dumping, sanitary and phytosanitary measures (SMS), technical barriers to trade (TBT), or compliance with WTO rules. This means that externalities of trade agreements are likely to be different, which leads to differing origins of trade disputes. The "spaghetti bowls" of investment rules are arguably even more pronounced than those of trade rules¹⁶ but, interestingly, a positive relationship between IIA and FDI has been established even in the presence of heterogeneous IIA (e.g. (Nguyen et al., 2014))¹⁷

Endogeneity

Another issue is that trade and investments may be tied together, and this also creates a problem in empirical assessment of the role of IIAs. For example, BITs are often concluded with countries with which investors already have other business relationships. In terms of the econometric estimations of functions, we face a problem of endogeneity. Similarly, signing BIT may be an element of a broader package of economic policies, and this simultaneous relationship is likely to lead to estimation biases. To the extent that free trade agreements or IIA reforms are parts of domestic investment and taxation regimes, the latter will have an impact on investment flows and should be taken into account. It is mainly for this reason that Hallward-Driemeier (Hallward-Driemeier, 2003) argued that BITs and IIAs should be a complement and not a substitute for good governance. A similar point is made by Desbordes and Wei (Desbordes and Wei, 2017). They find that BIT affects incentives in home countries and argue that governance and the sophistication of financial development in host countries also play a role.

The problem with endogeneity is that it makes it difficult to disentangle causation from correlation: do investors choose to invest in certain countries as a result of IIAs, or are treaties signed between countries which already exchange large investment flows? Do Chinese investments abroad, for example, reflect the presence of IIAs/BITs or, instead, are they an outcome of meetings between heads of states? No matter how many covariates quantitative studies try to include, they will have to address this difficult problem. In their study on the effects of US DTTs, for instance, Blonigen and Davis (Blonigen and Davis, 2004) focus on treaties entered into during the 1980s and 1990s, since the US did not pursue DTTs with investment partners which were already important during those decades. Some of the earlier contributions in the field, however, fail to confront the endogeneity problem. In their important analysis, Aisbett et al. (Aisbett et al., 2010b, Aisbett et al., 2010a, Aisbett et al., 2018) show that a widely quoted study fails to carefully control for the possibility of reversed causality, which in turn brings into question its conclusion that BITs have a strong impact on FDI.

Technical issues

Furthermore, the empirical work is subject to a number of technical challenges. (i) Should FDI be measured as stocks or flows? Researchers have used both. Perhaps the best-known protagonist of the approach based on stock data has been Egger (e.g., (Egger and Pfaffermayr, 2004)). On the other hand, many other studies focus on FDI flows, and these differences in the treatment of FDI data may themselves explain some of the differences in findings. (ii) Level of aggregation and sectoral treatment. It is sometimes argued that IIAs may be more important in certain sectors than others, as noted earlier.¹⁸ For example, natural resource investors may have more interest in BITs than investors

¹⁶ For more detail, see Drabek and Mavroidis (Drabek and Mavroidis, 2013), about problems arising from the absence of harmonized investment rules.

¹⁷ Nguyen (2014) also found that broadening the definition of investment by moving from "Admission" to "Establishment" and including National Treatment in BITs gives more impetus for investors to support FDI flows in Vietnam.

¹⁸ According to one survey, executives of foreign affiliates in manufacturing sectors found that DTTs are more important to their investments than they are to their counterparts in service sectors. With respect to BITs, resource extraction sectors have been particularly prone to various distortions brought about either

in less politicized sectors. (iii) Size of investment. It is believed by some researchers that the importance of IIAs in investors' decision-making processes is likely to depend on the size of the investment. The enforcement mechanism can lead to significant arbitration costs for the host country in disputes with large investors but may make the treaties more or less redundant for small investors. Furthermore, very large multinationals can often rely on diplomatic protection from their home state and may also be able to bargain for investor-state contracts with stronger legal guarantees than can small investors. Unfortunately, the investment data needed to capture the influence of the size of FDI on the provisions of IIA are not available, which makes the hypothesis difficult to test. (iv) Conceptual problems. Research on the effects of IIA on FDI is also subject to several conceptual problems. The definition of FDI can vary in different jurisdictions. For example, according to the World Bank definition, portfolio investment exceeding 10% of the value of a company counts as FDI. This means that the distinction between portfolio and direct investment is not entirely self-evident. Identification of the country origins of FDI may also be difficult in view of widespread practices by multinational corporations to move among different jurisdictions. (v) Single or cross-country data? Most studies of the links between IIAs and FDI have used cross-country data. Nevertheless, testing the relationship has become increasingly popular with researchers studying single countries. (e.g., (Nguyen et al., 2014)). (vi) Econometric techniques. Finally, different econometric approaches to testing the hypothesis have been taken. Each has its strengths and weaknesses. Most studies have relied on gravity equations, and the theoretical issues have been well researched in studies such as Anderson (Anderson, 1979) and Anderson and Wincoop (2003). More recent studies have sought to make improvements by, for example, employing panel data regressions on an augmented gravity model with the fixed effects and the two-step generalized method of moments (GMM) model specifications.

Role of international arbitration

Determination of FDI is clearly a process impacted by many factors. Investment disputes are of particular importance. Do investment disputes discourage foreign investment or are they neutral with respect to future investment decisions? As noted in the previous section, investment disputes can be expensive and generate strong disincentives in countries seeking FDI. Unfortunately, the empirical evidence on this is extremely weak and in need of work.

The existing empirical work covers three areas: (1) classification of disputes; (2) drivers of investment disputes and (3) assessment of Investor-State Dispute Settlements (ISDS). As this section argues, the empirical evidence is extremely limited and, where it exists, it is highly controversial. This is primarily due to an absence of data, the complexity of the drivers of investment disputes, lack of theory, and methodological difficulties in assessing the value of arbitrations to countries. Moreover, the role of disputes in investment markets is a relatively new field of research. Therefore, it may be useful to briefly outline the main issues.

What do we know about investment disputes?

The economic literature dealing with legal issues of FDI has focused almost entirely from the perspective of the impact of IIA on FDI rather than that of the impact of actual disputes and arbitrations. As noted in the previous section, the literature on the former, the impact of IIA on FDI, is quite large. In contrast, the literature on investment disputes has been covered almost exclusively by lawyers.

Critics saw the problem of investment disputes in the empirical pattern of litigations. They asked who litigates and why? What are the main legal reasons for litigation? Are the reasons legal or financial, strategic,

economic policy/regulations? Who benefits (awards/wins) from the disputes? To answer those questions, they needed data on investment disputes, which have been registered by several institutions, most notably UNCTAD and International Center for Settlement of Investment Disputes ICSID.¹⁹ Detailed descriptions of these data sources are provided in their regular publications. Unfortunately, there has been no systematic analysis of the data beyond the following general findings.

First, the claimants on the side of rich countries are typically large firms. Small and medium scale enterprises enter arbitration proceedings much less frequently. Second, the disputes tend to be spread over many sectors. Third, the role of claimants is also specific, it is typically a private firm, in contrast to disputes between states. The key difference between trade and investment agreements is that, in FDI disputes, it is a foreign investor who initiates the dispute. This has several implications. For example, one of the principal drivers of action may be firm characteristics including size, the sector in which the firm operates, etc. On the other hand, as in trade disputes, countries can choose to pursue disputes by themselves, or they can participate as co-complainants, or as third parties. They can also decide to free-ride in the disputes of others, and this complicates identification of the origins of disputes.

Fourth, it is interesting to note what the most frequently used legal instruments in investment disputes are. For some time, the majority of disputes were governed by BITs; Schultz and Dupont (Schultz and Dupont, 2015) estimate the share of BITs at around 67% for the period of 1972–2010.²⁰ Other legal instruments have also been used - other IIAs (12%), and investment laws of countries agreed by the parties to the contracts (13%). More recently, disputes have been handled under the disciplines of other agreements, such as the Energy Charter. Only rarely are disputes addressed using domestic law in conflicts involving investors from rich countries and poor countries as the defendant. Domestic courts are more likely to be employed in situations in which partners to the agreement are from countries with relatively strong legal systems (typically IIA between North and North). However, what is far less clear is how IIAs differ in their treatment of investor protection, regulatory regimes, anti-competitive practices, and, in particular, specific rules, as argued below.²¹

Are the rules biased against poor countries?

An area that has received much attention from scholars is the assessment of relative costs and benefits of arbitrations. The debate has its origins in a similar debate among trade economists and lawyers going back to the 1990s (Bhagwati and Hudec, 1996). Critics have argued that existing systems of arbitration are unfair, unfriendly to poor countries and biased against low income FDI-hosting countries. It is, therefore, not surprising that this issue has drawn attention from scholars, and it is evident that empirical evidence regarding those claims would be useful.²²

Attempts to evaluate the performance of investment arbitrations include, in particular, studies of dispute resolution provisions in IIAs (e.g., (Pohl et al., 2012)), costs of investment arbitrations (Franck, 2011) and studies of the fairness of arbitral awards (Franck, 2007, 2010, Franck, 2011). Those studies have typically been written by lawyers and have also been widely contested by other lawyers (e.g., (Van Harten, 2011), Schultz and Dupont 2014). As already noted, the findings from the literature remain highly controversial.

¹⁹ See UNCTAD, Investment Policy Hub, <https://investmentpolicyhub.unctad.org/ISDS>, and ICSID <https://icsid.worldbank.org/en/>.

²⁰ Schultz and Dupont (Schultz and Dupont, 2015), p.1150.

²¹ The work of Alschner and his colleagues is an exception. See, for example, Alschner and Skougarewskiy (Alschner and Skougarewskiy, 2016).

²² The issue at hand is very similar to that faced in the research on trade disputes – namely, ISDS is seen as detrimental “to the interests of developing countries”, and it is claimed that these countries do not have “a meaningful way of participating in that system”. See Horn and Mavroidis (Horn and Mavroidis, 2006).

by malpractice by private investors or by discriminatory, or even predatory, government interference.

A better understanding of the operational properties of rules supported by empirical evidence on rule breaches would go a long way towards addressing the main criticisms of IIA –that the rules discriminate against poor countries. In trade dispute resolutions, critics have observed that poor countries do not use the WTO Dispute Settlement Mechanism (DSM) to the same extent as rich countries (Horn et al., 2010a). In the investment area, critics have made similar claims, but these do not seem to be supported by evidence.

Distribution of claims

It is usually argued that the claimants in disputes are typically firms from rich countries, while the defendants are believed to be predominantly firms and states of low-income countries (both emerging and developing countries). However, a study by Schultz and Dupont (2014) found that over the period of 1972–2010, while rich countries did account for 88% of all claims, they were also the targets of litigation in the majority of legal cases (53%). Moreover, investors won fewer cases during the same period (87 cases) than host countries (112 cases).²³ A fairly large proportion of claims were settled without an arbitration award (ca 30%). Judging purely from the distribution of claims, and assuming host countries representing the South, it is difficult to assert that rich countries have been winning disputes. Nevertheless, more recent data would clearly be highly desirable.

Statistical techniques

Another major problem with the studies is that they have relied on simple statistical techniques and failed to apply social cost–benefit analysis or other tools of economic analysis in analyzing the impact of investment disputes. Descriptive statistics cannot capture the influence of different factors affecting dispute settlements.

However, the problem is not only technical. Take, for example, the case of the initiation of investment disputes or of their resolution. It is very likely that initiation of a dispute is influenced by a broader set of factors of political, economic, cultural and social origin, as we have observed in the trade literature and as has been noted in several sections of this paper. Simple cost-benefits assessments of arbitrations (e.g., (Franck 2010, Hodgson, 2014, Pohl et al., 2012), and (Shirlow, 2015)) failed to take into account broader economic issues and the social rate of discounting.

Another serious gap in the empirical literature is the evidence about rules that have been violated and which are at the origins of disputes. Even though there is data on the origins of disputes, there has been no detailed and systematic analysis of this data. Arguably, the most controversial are provisions for indirect expropriations, which constitute the bulk of disputes. It would be extremely useful to know whether the cases involving indirect expropriations arose from changes in taxation, from currency restrictions, revocation of permits or licenses, from changed price regulations, or other breaches.

Moreover, we know that rules other than those about indirect expropriations have also been breached, ranging from direct expropriations to violation of competitive or non-discrimination rules or of fair-and-equitable treatment (FET), and others. In the absence of analyses, we cannot determine what drives the propensity to complain, which is fundamental to understanding the drivers of disputes. Do complaints occur because respondents are unwilling to respect the legal standards agreed in the IIA? Is there any reason to believe that an agreed rule is ineffective, unfair or any combination thereof? Alternatively, are complaints

simply due to poor implementation capacity on the part of respondents to fully implement their commitments agreed in IIA? Studies of the effects of the violation of specific rules are only now emerging (e.g., Howse and Moore, 2019).

Compensation rules

The rule of extreme importance in arbitration concerns compensation for damages. The manner in which those compensations are decided by arbiters is clearly very important. The optimal investment agreement literature goes a long way towards designing and negotiating the level of investment protection and the regulatory interventions that imply a level of compensations that are acceptable to both parties to the IIA. But have they performed that function?

As described above, compensations have sometimes been seen as excessive by some, and inadequate by others. The level of compensations is obviously critical, not only as a matter of fairness, but also as an instrument affecting incentives and investment decisions. Excessive compensations can lead to highly risky investment and stimulate free riding, while inadequate compensations dampen investor interest.

Unfortunately, the empirical literature dealing with the impact of compensations on FDI and on the design of regulatory policies is extremely limited. The only exception to date has been Aisbett et al. (Aisbett et al., 2018). Their empirical work on compensations has mostly centered on the financial implications of compensation claims and on the question of who benefited from them. Aisbett and her colleagues defined distortions in the ISDS in terms of the level of compensations, and they tested two hypotheses. First, IIA can act as ‘deterrents’ – they either prevent treaty breaches or require hosts to pay compensation. As a result, investors believe that the host country is unlikely to act adversely in the presence of an IIA. Alternatively, investors may believe that adverse host actions will impair their profits less seriously because they will actually receive compensation (the ‘BITs as insurance’ hypothesis).²⁴ Using a large data set of ‘protected’ and ‘unprotected’ host countries, Aisbett et al. (Aisbett et al., 2018) find that BITs stimulate bilateral FDI flows from partner countries—but only as long as the developing host country has not had a claim brought against it to arbitration.

To the best of my knowledge, Aisbett et al. (Aisbett et al., 2018) is the only study to date that provides a systematic and rigorous assessment of the role of compensation in the global market for FDI. It is interesting because it shines a new light on a large number of studies that do not find any significant effect of IIAs on FDI. In other words, disputes seem to matter as well! On the other hand, Aisbett et al. (Aisbett et al., 2018) do not address the issue of the level of compensations, and compensations are taken in their study as a given. Yet, it is precisely the level of compensations that is seen by critics of IIAs as “distorted”. An assessment of the level of compensations would have obviously been beyond the scope of their study but would be highly desirable.

Beyond rules?

Rules matter but they are not the only factors impacting disputes and their resolutions. Incentives for firms and governments to comply with contracts may be determined by various legal, political and economic factors. Legal power such as a countries’ capacity to provide legal support to business, and political factors such as institutional setups for channeling and enforcing public interests may also matter.²⁵ Economic

²³ The numbers may be subject to some dispute due to ambiguities in different definitions, but they are very similar to Franck’s (Franck, 2011) estimates from a smaller sample. The problems of definitions include malleability of the definition of investor and host country, the problems of discontinued cases (17%) and those concerning the definition of “win” in arbitration. For more details, see Schultz and Dupont, (2014) op. cit. pp.1158/9. Franck’s findings were criticized as being themselves biased due to incorrect sampling and interpretation (Van Harten, 2011).

²⁴ Alternative hypotheses about how protected and unprotected investors react to BITs and disputes are reviewed in (Aisbett et al., 2018), pp. 3–6.

²⁵ For example, the more democratic a state is, the more likely it is that it will initiate indirect expropriation disputes, controlling for the countries’ relative size, and for one country’s dependence on FDI. The same point is made by Horn and Mavroidis (Horn and Mavroidis, 2006). Similarly, more democratic governments are more likely to address social issues such as income inequality, climate change, poverty, unemployment, minimum wages etc. in their internal negotiations.

factors such as level of income, size of markets or financial balances also play a role.

Unfortunately, we have no firm empirical evidence to support the claim that – as in the case of trade disputes – weak *legal capacity and negotiating power* of host countries could play a role as determinants of initiation of disputes. Both factors have been proposed as two key hypotheses and tested in the trade literature (Horn and Mavroidis, 2006), pp 16ff), and similar tests should be carried out in the work on investment disputes.

Concluding remarks on the empirical literature

There are several problems with the existing empirical literature on investment disputes. First, most of the literature to date is descriptive and provides very limited empirical evidence. Because the literature is descriptive, it does not provide strong evidence in support of various claims. The literature has so far been written by lawyers and involves legal analyses, often leading to contradictory results and policy prescriptions. Second, studies of the role of arbitration systems in the determination of disputes have not addressed other important determinants of investment disputes. Third, the structure of IIA may also play a role. Since BITs are not identical, the level of investment protection is likely to differ. Investment relations are governed in some countries by regional agreements or by GATS, and their investment protection may also differ. Fourth, it is possible that some countries may engage in litigation that originates in previous incidents and they may act in retaliation. Fifth, the only empirical evidence comes from assessments of arbitrations, case studies and one study of the impact of compensations.

The gaps in the literature are considerable. What is missing in particular is empirical evidence on the (1) drivers of disputes, (2) costs and benefits of ISDS, (3) and the broader economic effects of ISDS, including its effects on internal distribution of income. A subject on its own is the (4) complete absence of studies of the impact of disputes on investors.²⁶ It would be highly desirable to better understand the impact of investment disputes on the valuation of companies in the market and the ways in which major disputes between large companies influence global markets.

Policy implications for AEC

Our literature survey has at least four important policy implications. First, the literature is based on the fundamental condition that recognizes positive roles of FDI for economic development. The key step for policy makers is to ensure that investment agreements should be seen across the political spectrum as beneficial for economic growth and for a sustainable economic development. Ultimately, politicians will take the decision about the desirability of investment agreements with foreign countries. Second, as we have seen, the theory of trade and investment agreements makes a strong case for investment agreements. The theory, backed by empirical evidence, strongly favors the regulation of FDI flows through cooperation and, hence, through agreements.

The third important policy implication is that investment agreements with foreign countries must be credible. The credibility is partly secured by the broad agreement across the whole society about the desirability of FDI as noted above. However, the credibility of investment agreements is also dependent on the quality of those agreements. This primarily means the coverage and choices of activities and of specific rules, the choices between detailed and more general provisions of rules in the agreements and the choices between bilateral and regional agreements and rules.

The fourth, and arguably the most controversial part of the literature concerns the treatment of specific rules. As we have seen, here the guidance from economic literature is considerably more complicated. A

highly debated issue concerns rules about non-discrimination – NT and most favored nations treatment (MFN) – that form the basis of the multilateral trading system of GATT/WTO. Critics have periodically questioned the economic rationale of both NT and MFN.²⁷ Other policy interventions, originally designed to address distortions in global markets, have also been criticized as detrimental to the interests of developing countries. These interventions include anti-dumping duties, subsidies and other safeguard measures. As I have argued above, rules concerning dispute settlement in the form of international arbitration have become among the most sensitive rules to negotiate. In addition, the treatment of state-owned enterprises (SOEs) and firms remains perhaps the most poorly developed aspect of the regulatory framework of the international trade and investment system. Since SOEs constitute a large part of business activities in many countries, including some in the AEC, the rules concerning their operations would have to be negotiated by member states without much recourse to global rules. A decision will also have to be taken if investment agreements should be established bilaterally or with more partner countries. The major advantage of plurilateral or multilateral systems of governance is that they avoid “rules competition” that leads to lowering standards. Bilateral investment treaties impose additional costs on countries and firms and ultimately on consumers whenever rules differ.

It should be also noted that the economics literature has so far only addressed the question of optimality of investment agreements and avoided another important issue of concern to policy makers – the resilience to external and internal shocks. The current system of bilateral and plurilateral investment treaties typically makes no provision for protection against financial instability originating in foreign financial markets. It is also silent on matters such as adjustment measures needed to address financial instability or crisis. Thus, the decision about this aspect of the coverage of economic activities will also be important. Typically, bilateral investment treaties cover both goods and services but the coverage of financial services is only limited to FDI.

Now, turning to the specifics, the region of South East Asia has a long history of investment agreements. Most of those agreements were negotiated and signed bilaterally and the region now counts more than 80 IIAs only among the ASEAN member countries and their six “dialogue” partners such as New Zealand, Australia, Japan and China. These IIAs are either in the form of BITs, investment chapters of bilateral and plurilateral free trade agreements (FTAs) and regional investment agreements (UNCTAD 2013): 106–107). The existence of IIAs is a testimony to the realization by the countries in the region that investments are desirable and their markets need to be liberalized. However, both the number of these IIAs and their content present major challenges for the region.

First of all, the network of IIAs leads to a fragmentation of investment rules across the region. As noted, the fragmentation is costly and inefficient, and it reflects poor cooperation among the countries in the region with regard to FDI policies. Investors have to adapt to different rules, which is costly and the system generates incentives for “treaty shopping” or changes in “investor nationality”. Second, the content of IIAs is not the same. The coverage of sectors varies among the agreements. There are also differences in the adopted range and the specifics of investment rules, provisions to other agreements, especially agreements related to trade of goods and services, and there are different treatments of performance requirements and exceptions.²⁸ Third, the extent of investment liberalization remains limited. Most of the IIAs in the region do not provide for NT on pre-establishment, and NT is limited to post-establishment. This rule obviously restricts market access for foreign investors. Although MFN treatment is included in most agreements, the MFN provision excludes its applicability under the ISDS. Fourth, protection of foreign investors remains a controversial subject in the region

²⁶ First attempts are under way in the form of “impact studies”, but it is too early to assess their contributions.

²⁷ See, in particular, Rodrik (Rodrik, 2018).

²⁸ For more information see (Losari, 2014).

as much as elsewhere. The fair and equitable treatment (FET) clauses often lack a precise meaning and have raised numerous controversies and led to multiple interpretations by arbitral tribunals (Howse and Moore, 2019). In addition, the existing agreements have been criticized for not providing the right balance between the interests of investors and those of host countries and their right to regulate. It is the right to regulate that is today most frequently challenged in courts and is often perceived as “indirect expropriation”. According to some local observers, expropriation clauses in older IIAs tend to be very vague (Losari, 2014).

Finally, the most sensitive and arguably the most controversial issue of the existing agreements are the provisions for dispute settlements and their administration. Most IIAs contain both state-state dispute settlement and ISDS. It is the latter that has been subject to a considerable scrutiny as I have argued above. There are currently different approaches to improving the dispute settlement systems. One approach has been to abandon the ISDS based on independent international arbitrations and replace it by national jurisdictions. Another approach is to let BITs lapse or seek renegotiation of their content. There are also many proposals for improvements of the existing BITs. For example, the proposals of Sauvants and Ortino (Sauvants and Ortino, 2013) to create an independent appellate body to review decisions made by ad hoc tribunals or Losari’s proposals to include clauses for a joint interpretation mechanism for regulatory interventions and on the mechanism to select the members of a tribunal seem sensible.

The lesson for the AEC is, therefore, clear: negotiations to advance the debate and negotiations of investment rules will not be easy and straightforward and will obviously require patience. The most important issue will be to recognize the key role of the rule of law in the enforcement of contracts and the places and mechanisms for dispute resolution. It may be useful to keep in mind that the main reason for the existence of BIT was the protection of investors’ interests. It is true that investment treaties can, and sometimes do, include provisions for better market access, but the degree of protection of investor’s interests is, in my view, the most sensitive issue. Concerns about the rule of law and, consequently, about provisions for international arbitration in BIT have been, in my judgement, the critical motivations behind the BIT – even in the EAC region! The challenge for both host countries and for investors will, therefore, be to agree on a dispute resolution mechanism in which both parties have full trust and confidence.

Negotiators should keep in mind that generation of rules for AEC *sui generis* would not be advisable. ‘Regionalization’ of rules can be dangerous, inefficient and counterproductive. Even though global FDI rules are not complex, the case of trade and investment negotiations in GATT and the WTO provides at least one very powerful argument against fragmentation of rules – the elimination of discrimination in negotiations arising from differences in negotiating powers.

Declaration of Competing Interest

None.

References

Aisbett, E., Busse, M., Nunnenkamp, P., 2018. Bilateral investment treaties as deterrents of host country discretion: the impact of investor-state disputes on foreign direct investment in developing countries. *Kiel Working Paper No. 2021* | January 2016. *Rev. World Econ.* 154 (Issue 1), 119–155 February 2018.

Aisbett, E., Karp, L., McAusland, C., 2010a. Police powers, regulatory takings and the efficient compensation of domestic and foreign investors. *Econ Rec* 86 (274), 367–383 September.

Aisbett, E., Karp, L., McAusland, C., 2010b. Compensation for indirect expropriation in international investment agreements: implications of national treatment and rights to invest. *J. Global. Develop.* 1 (2) Article 6.

Alschnner, W., Skougarewskiy, D., 2016. Mapping the universe of international investment agreements. *J. Int. Econ. Law* 19 (3), 561–588 2016.

Anderson, J., van Wincoop, E., 2003. Gravity with Gravitas: a Solution to the Border Puzzle. *Am. Econ. Rev.* 93, 170–192 March 2003.

Anderson, J.E., 1979. A theoretical foundation for the gravity equation. *Am. Econ. Rev.* 69 (1), 106–116 1979.

Bagwell, K., Staiger, R.W., 1990. A theory of managed trade. *Am. Econ. Rev.* 80 (4), 779–795.

Bagwell, K., Staiger, R.W., 2001a. Domestic policies, national sovereignty, and international economic institutions. *Q. J. Econ.* 116 (2), 519–562.

Bagwell, K., Staiger, R.W., 2001b. The WTO as a mechanism for securing market access property rights: implications for global labor and environmental issues. *J. Econ. Perspect.* 15, 69–88.

Bagwell, K., Staiger, R.W., 2002. *The Economics of the World Trading System*. MIT Press, Cambridge, Mass. 2002.

Bagwell, K., Staiger, R.W., 2016. The design of trade agreements. *Handbook of Commercial Policy Chapter 8*. Elsevier 2016.

Bhagwati, J., Hudec, R., 1996. *Fair Trade and Legal Analysis*. The MIT Press, Cambridge Volume 2, 1996.

Bhagwati, J., Ramaswami, V.K., 1963. Domestic distortions, tariffs and the theory of optimum subsidy. *J. Polit. Econ.* 71 (1), 44–50.

Bloningen, B.A., Davis, R.B., 2004. Do Bilateral Tax Treaties Promote Foreign Direct Investment? NBER Working Papers, Cambridge, Mass, pp. 601–622 No. 8834, March 2002, and *International Tax and Public Finance*, Vol. 11, (September 2004), No. 5.

Bowles, S., Gintis, H., 2013. *A Cooperative Species: Human Reciprocity and Its Evolution*. Princeton University Press, Princeton 2013.

Bown, C.P., 2002. On the economic success of GATT/WTO dispute settlement. *Rev. Econ. Stat.* 37, 678–720.

Brada, J.C., Drabek, Z., Iwasaki, I., 2021. Does investor protection increase foreign direct investment? A meta-analysis. *J. Econ. Surv.* 35 (1), 34–70 2021.

Broda, C., Limao, N., Weinstein, D., 2019. Optimal tariffs and market power: the evidence. *Am. Econ. Rev.* 98 (5), 2032–2065 Reprinted in Limao (2019).

Buol, J.J., Vaughan, M.D., 2003. Rules vs. Discretion: The Wrong Choice Could Open Floodgates. *The Regional Economist*. Federal Reserve Bank of St. Louis January 2003.

Butler, M., Hauser, H., 2000. The WTO dispute settlement system: a first assessment from an economic perspective. *J. Law, Econ. Organ.* 16 (2).

Desbordes, R., Vicard, V., 2009. Foreign direct investment and bilateral investment treaties: an international political perspective. *J. Comparat. Econ.*, Elsevier 37 (3), 372–386. doi:10.1016/j.jce.2009.05.001, 2009.

Desbordes, R., Wei, S.J., 2017. The effects of financial development on foreign direct investment. *J. Dev. Econ.* doi:10.1016/j.jdeveco.2017.02.008.

Drabek, Z., Mavroidis, P., 2013. *Regulation of Foreign Investment: Challenges to International Harmonization*. World Scientific, New Jersey, London, Singapore 2013.

Egger, P., Merlo, V., 2007. The impact of bilateral investment treaties on FDI dynamics. *World Econ.* 30, 1536–1549 2007.

Egger, P., Pfaffermayr, M., 2004. The impact of bilateral investment treaties on foreign direct investment. *J. Comp. Econ.* 32, 788–804.

Franck, S.D., 2007. Empirically evaluating claims about investment treaty arbitration. *North Carol. Law Rev.* 86, 1 2007.

Franck, S.D., 2010. Empirical modalities: lessons for the future of international investment. 105 AM. SOC’Y INT’L L. PROC 33 2010.

Franck, S.D., 2011. The ICISD effect? Considering potential variations in arbitration awards. 51 VA. J. Int. Law 825 2011.

Grinols, E.L., Perrelli, R., 2003. The WTO impact on international trade disputes: an event history analysis. *Rev. Econ. Stat.* 88 (4), 613–624 Nov., 2003.

Grossman, G. and H. Horn (2012): “Why the WTO? An introduction to the economics of trade agreements,” research institute of industrial economics stockholm, Sweden-info@ifn.sewww.ifn.se, IFN Working Paper No. 916, 2012.

Guzman, A., 2003. *The Political Economy of Litigation and Settlement in the WTO*. University of California at Berkeley 8/1/2003.

Hallward-Driemeier, M. (2003): “Do bilateral investment treaties attract FDI? Only a bit...and they could bite,” *World Bank Policy Research Working Paper* 3121; 2003.

Hodgson, M., 2014. *Costs in investment treaty arbitration: the case for reform*. Transnational Dispute Management (TDM) 2014.

Horn, H., Maggi, G., Staiger, R.W., 2010b. Trade agreements as endogenously incomplete contracts. *Am. Econ. Rev.* March 2010.

Horn, H. and P. Mavroidis (2006): “The WTO dispute settlement data set: user’s guide”. Available at www.worldbank.org/trade.

Horn, H., Mavroidis, P.C., Sapir, A., 2010a. Beyond the WTO? An anatomy of EU and US preferential trade agreements. *World Econ.* 33 (Issue 11), 1339–1637 November 2010.

Horn, H., Tangeras, T., 2018. *Economics of International Investment Agreements*. The Research Institute of Industrial Economics, Stockholm mimeo, 2018.

Howse, R. and S. Moore (2019): “The right to regulate and the investor-state dispute settlement: renewable energy and the fair and equitable treatment norm,” “New York University, Paper prepared for ASSA Meetings, San Diego, 2020.

Jacobs, M.N., 2017. Do bilateral investment treaties attract foreign direct investment to developing countries? A review of the empirical literature. *Int. Relat. Diplomacy* 5 (10), 583–593. doi:10.17265/2328-2134/2017.10.001.

Janeba, E. (2016): “Regulatory chill and the effects of investor state dispute settlement.” *CESifo Working Paper No.* 6188.

Johnson, H., 1953. Optimum tariffs and retaliation. *Rev. Econ. Stud.* 21 (2), 142–153.

Kerner, A., 2009. Why should I believe you? The costs and consequences of bilateral investment treaties. *Int. Stud. Q.* 53 (1), 73–102.

Kohler, W., Stohler, F., 2016. *The Economics of Investor Protection: ISDS Versus National Treatment*. Mimeo April 22, 2016.

Konrad, Kai A. (2016): “Large investors and permissive regulation: why environmentalists may dislike investor-state dispute settlement,” *Max Planck Institute for Tax Law and Public Finance, Working Paper* 2016-10.

Kydland, F.E., Prescott, E.C., 1977. Rules rather than discretion: the inconsistency of optimal plans. *J. Polit. Econ.* 85, 473–491 1977.

Kydland, F.E., Prescott, E.C., 2004. Rules rather than discretion: the inconsistency of optimal plans: magma. *Econonas Tidskrift Ökonomi og Ledelse*, 572004.

- Lima, N., 2019. Policy Externalities and International Trade Agreements. World Scientific, Singapore 2019.
- Losari, J.J., 2014. Searching For an Ideal International Investment Protection Regime for ASEAN and Dialogue Partners (RCEP). Where Do We Begin?. National University of Singapore December 2014, ERIA Discussion Paper Series, download;jsessionid=A45FB93D7CBF63A06178E07F441A851B (psu.edu).
- Louie, H., Roussland, D.J., 2009. Host-country Governance, Tax Treaties, and U.S. Direct Investment Abroad in Sachs and Sauvant (2009a).
- Maggi, G., Rodríguez-Clare, A., 2007. A political-economy theory of trade agreements. *Am. Econ. Rev.* 97 (4), 1374–1406.
- Maggi, G. and R.W. Staiger (2008). “On the role and design of dispute settlement procedures in international trade agreements.” *National Bureau of Economic Research Working Paper* 14067, 2008.
- Markussen, J.R., 1975. International externalities and optimal tax structures. *J. Int. Econ.* 5 (1), 15–29.
- Mina, W. (2009, 2012): “Beyond FDI: the influence of bilateral investment treaties on debt,” *Georgia State University, Andrew Young School of Policy Studies, International Center for Public Policy, Working Paper* 13-25, December 2013.
- Neumayer, E., Spess, L., 2005. Do bilateral investment treaties increase foreign direct investment to developing countries? *World Dev.* 33, 1567–1585.
- Nguyen H.T.V., Cao T.H. Vinh, L.T.T. Trang (2014): “The impact of heterogeneous bilateral investment treaties (BIT) on foreign direct investment (FDI) inflows to Vietnam,” *SECO / WTI Academic Cooperation Project Working Paper Series* 2014/03.
- Pohl, J. (2018): “Societal benefits and costs of international investment agreements: a critical review of aspects and available empirical evidence,” *OECD Working Papers on International Investment*, No. 2018/01, OECD Publishing, Paris, <https://doi.org/10.1787/e5f85c3d-en>.
- Pohl, J., K., Mashigo and A. Nohen (2012): “Dispute settlement provisions in international investment agreements: a large sample survey”, *OECD Working Papers on International Investment*, 2012/02, OECD.
- Poulsen, L.S., 2009. The effect of treaties on foreign direct investment: bilateral investment treaties, double taxation treaties, and investment flows. *Eur. J. Int. Law* 20 (Issue 3), 935–938 1 August 2009.
- Riolo, R.L., Cohen, M.D., Axelrod, R., 2001. Evolution of cooperation without reciprocity, *NCBI. Nature* 414 (6862), 441–443 2001 Nov 22.
- Rodrik, D., 2018. Straight Talk on Trade – Ideas For a Sane World Economy. Princeton University Press, Princeton 2018.
- Sachs, L.E., Sauvant, K.P., 2009a. The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows. Oxford University Press, Oxford 2009.
- Sachs, L.E. and K.P. Sauvant (2009b): “Chapter on BITs, DTTs, and FDI Flows: an overview;” in Sachs, L. and K. Sauvant, K. (2009a).
- Sauvant, K.P., Ortino, F., 2013. Improving the International Investment Law and Policy Regime: Options for the Future. Ministry for Foreign Affairs of Finland Publication, Helsinki.
- Schjelderup, G, Stohler, F., 2016. Investor State Dispute Settlement and Multinational Firm Behavior. Mimeo November 3.
- Schultz, T., Dupont, C., 2015. Investment arbitration: promoting the rule of law or over-empowering investors? A quantitative empirical study. *Eur. J. Int. Law* 25, 2 2014.
- Shirlow, E. (2015): “Looking behind the statistics for investment arbitration”: Available at <http://kluwarbitrationblog.com/2015/02/24/looking-behind-the-statistics-for-investment-arbitration>.
- Stiglitz, J., 2007. Regulating multinational corporations: towards principles of cross-border legal frameworks in a globalized world – balancing rights and responsibilities. *Am. Univ. Int. Law Rev.*, (2007) 23 (3), 451.
- Taylor, J.B. (2017): “Rules vs. discretion: assessing the debate over the conduct of monetary policy;” Cambridge: *NBET Working Paper* No. 24149, December 2017, <http://www.nber.org/papers/w24149>.
- Tobin, J., Rose-Ackerman, S., 2011. When BITs have some bite: the political-economic environment for bilateral investment treaties. *Rev. Int. Org.* 6 (1), 1–32 Springer-papersMarch.
- UNCTAD (2009): “The role of international investment agreements in attracting foreign direct investment to developing countries;” *Series on International Investment Policies for Development*; Geneva: /DIAE/IA 2009/5.
- UNCTAD, 2013. Global Value Chains: Investment and Trade for Development *World Investment Report 2013*, (UN Publication 2013).
- Van Harten, G. (2011): “The use of quantitative methods to examine possible bias in investment arbitration,” in *Yearbook on International Investment Law & Policy* 859 (Karl P. Sauvant ed., 2011).
- WTO, 2009. World Trade Report 2009 – Flexibility in Trade Agreements. World Trade Organization, Geneva 2009.
- Yackee, J.W., 2010. Do bilateral investment treaties promote foreign direct investment? Some hints from alternative evidence. *VA J. Int. Law* 51, 397–441.