Submission to the Productivity Commission's Review of Bilateral and Regional Trade Agreements

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Executive Summary

This submission addresses the specific issue of post-establishment protection for foreign investment – that is, the inclusion of provisions within FTAs that require the parties to the treaty to afford certain standards of treatment to investments by nationals of another party. Currently such provisions are contained in the Investment Chapters of five of Australia's six FTAs. There is little economic justification for including these provisions in Australian FTAs. In our view, future FTAs should not include provisions providing post-establishment protection for foreign investment. If such provisions are to be retained, we recommended that they be drafted more narrowly.

1. Introduction

1.1 How this Submission relates to the PC's Study Brief

This submission relates most directly to the following issues identified for specific study in the Productivity Commission's brief for the Bilateral and Regional Trade Agreements project:

- contribution of bilateral and regional trade agreements to reducing trade and investment barriers and safeguarding against the introduction of new barriers;
- impact of trade agreements on Australia's trade and economic performance, in particular any impact on trade flows, unilateral reform, behind-the-border barriers, investment returns and productivity growth, and
- scope for Australia's trade agreements to reduce trade and investment barriers of trading partners or to promote structural reform and productivity growth in partner countries.

We also note that the list of issues to be considered was inclusive but non-exhaustive. The specified issues seem to focus only on the gains to Australia of liberalization on behalf of our partners, and neglect potential costs of our own commitments. This neglect is not a significant concern in regard to tariff and quota liberalization because the gains from unilateral trade liberalization of this sort are

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well established. However, as we will discuss below, the cost-benefit balance for states committing to extra protections for foreign investors is far less clear. For this reason, our submission also examines broader issues of welfare maximization.

1.2 Background and Scope

The most common post-establishment protections in FTAs require host states to accord foreign investment fair and equitable treatment, national treatment and compensation for expropriation. This submission considers the merits of including such provisions in Australian FTAs. We also consider the merits of allowing these protections to be enforced through investor-state dispute settlement.

Five of Australia's six current FTAs include post-establishment protections.[3] There is a high degree of similarity between the sections of these five treaties that deal with investment protection, although there are also some important points of contrast. Four of these treaties grant foreign investors the right to bring claims against a host state for treaty breaches to investor-state arbitration. Similar post-establishment protections are contained in Australia's twenty-one Investment Promotion and Protection Agreements (IPPAs). Accordingly, our analysis would also apply to any future (re)-negotiations of IPPAs.

It is true that each FTA raises issues that are specific to the particular negotiating parties involved. There may be particular concerns about the investment climate in a country that could justify including tailored post-establishment protections in specific FTAs. However, country-specific concerns of this sort do not seem to be driving either Australian or international practice in this area. Rather, the terms to which countries agree appear to be based on template negotiating positions that are offered equally to all countries. Because negotiating practice is driven by these generalised positions, we think it is useful to address the merits of post-establishment protection at a general, as opposed to a country-specific, level.

This submission does not discuss other issues relating to foreign investment in FTAs. We do not address questions relating to foreign investment liberalisation, market access, free transfers of capital or limits on the use of performance requirements. We aim to offer a targeted contribution on the question of post-establishment protection.

2. The Impacts of Treaty-Based, Post-establishment Protections for Foreign Investors

In this section we outline the costs and benefits of treaty-based, post-establishment protections for foreign investors principally from the perspective of Australia. Within Australia there are several broad groups likely to be affected: Australians making investments in treaty partner countries, the Australian government (as a representative of the Australian public), and Australian businesses competing with foreign investors from treaty partners. Since we are discussing rules to protect foreign investors from the actions of the Australian government (which are made in either social or

[3] Chapter 11 of the Australia-US FTA; Chapter 11 of the Australia-ASEAN-NZ FTA; Chapter 10 of the Australia-Chile FTA; Chapter 9 of the Thailand-Australia FTA; Chapter 8 of the Singapore-Australia FTA.

business interests), the rough division of winners and losers is not difficult to discern. However, we make use of detailed scholarly work to explain the subtleties of this conclusion below.

2.1 Impacts on Investors

2.1.1 Impact on investment returns for Australians investing in partner countries

Overall we might expect treaty protections for foreign investors to increase their risk-adjusted return. However, the impact on returns is likely to be smaller if:

- the investment faces little political risk (as in the case of investments into other OECD countries),[4]
- there are other equally cost-effective means of protecting against political risk (for example the purchase of political-risk insurance or negotiation of individual contracts with host states that detail a set of legal rights, specific to the project, that the investor is capable of enforcing through international arbitration outside the host state).

2.1.2 Impact on Investment Barriers (at and behind border) and Structural Reform in Partner Countries

In almost all cases, countries begin to sign treaties that provide protection to foreign investment after they have undertaken unilateral policy reforms, meaning that such treaties generally do not induce further liberalizations. In fact, some authors have raised concerns that foreign investment protection might inhibit ongoing, broader reform of the investment climate, namely:

- Protections provided by investment treaties decrease the political pressure from foreign interests on policy-makers for broader improvements in the investment climate in a country.[5]
- Protections offered to investors decrease the expected benefits to the host government of incoming investments. In some cases (such as sensitive sectors) the expected value might be negative, making the host more likely to reject investments within their power, or to raise barriers to investment in these sectors.[6]

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[4] Conversely the protections may be more valuable to investors when the investment faces high political risk, as in the case of investments in sensitive sectors such as natural resources and utilities.

[5] Ginsburg, T. "International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance", *International Review of Law and Economics* 25 (2005) 107–123.

[6] Aisbett, E., Karp, L. & McAusland, C. (2006). Regulatory Takings and Environmental Regulation in NAFTA's Chapter 11. UC Berkeley: Department of Agricultural and Resource Economics, UCB. CUDARE Working Paper No. 1014. Retrieved from: http://www.escholarship.org/uc/item/1qh5j6dv

2.2 *Impacts on Host Governments*

2.2.1 Impact on Investment Efficiency and Productivity Growth in Australia and Partner Countries

Investor protections can impact upon productivity in host states by affecting whether the most efficient firms invest there. In this regard investor protections may have a positive or negative impact, but on balance it seems likely that the impact for Australia as a host will be negative. The theoretical argument is as follows.

If foreign investors face greater political risk in the absence of a treaty than domestic investors, then there will be inefficiently low levels of foreign investment in the host. In other words, production will be undertaken by domestic firms which are less efficient than potential foreign entrants. To the extent that treaty protection reduces the excess risk faced by foreign investors, it is likely to improve resource allocation and productivity by encouraging more efficient foreign investors.[7]

If, on the other hand, foreign investors do not face greater political risk than domestic firms in the absence of a treaty, then the pre-treaty level of foreign investment is not inefficiently low c.f. domestic investment. In so far as treaty protection further reduces the political risk faced by foreign firms, it may do so inefficiently.[8] In this case, productivity may fall as a result of the investment agreement as efficient domestic producers are displaced by less efficient but better politically-insured foreign firms.[9]

The answer to which of the above efficiency arguments dominates depends on your beliefs about the political risk faced by domestic and foreign investors. Proponents of international investor protections tend to assert the excess risk faced by foreigners as a self evident truth.[10] However, there also exists a large literature on the lengths that governments will go to in order to attract

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[7] This is the basic argument in favor of participation in investment agreements by net capital importing countries. It is made in numerous academic articles including Markusen, J. R. “Commitment to Rules on Investment: The Developing Countries' Stake.” Review of International Economics 9, no. 2 (2001): 287-302.

[8] This point was made seminally in the context of domestic regulatory takings by L Blume, D Rubinfeld and P Shapiro, 'The Taking of Land: When Should Compensation Be Paid?' (1984) 99 (1) The Quarterly Journal of Economics 71.

[9] This point has been made by K Vandevelde, 'The Economics of Bilateral Investment Treaties' (2000) 41 *Harvard International Law Journal* 469, and Aisbett, E., Karp, L. & McAusland, C. (2006). Regulatory Takings and Environmental Regulation in NAFTA's Chapter 11. UC Berkeley: Department of Agricultural and Resource Economics, UCB. CUDARE Working Paper No. 1014. Retrieved from: http://www.escholarship.org/uc/item/1qh5j6dv 010)

[10] See, for example, S Ratner, 'Regulatory Takings in Institutional Context: beyond the Fear of Fragmented International Law' (2008) 102 American Journal of International Law 475 “[N]ational governments emphasize political participation of domestic actors, while foreign actors must rely on international law standards for protection.”

scarce, globally mobile capital.[11] Indeed, some commentators believe that the rapid spread of international investment agreements is actually evidence of the increasing power of multinational corporations relative to nation states since the late nineteen eighties.[12] There exists unfortunately little objective empirical evidence on the relative strength of foreign c.f. domestic investors in their interactions with governments.[13]

2.2.2 Impact on Foreign Direct Investment Flows between Partners

A number of studies have examined the link between bilateral investment treaties (BITs) and FDI. This scholarship is relevant to the question at hand because BITs are treaties almost exclusively concerned with post-establishment protection of foreign investment.

A basic survey of the BIT – FDI scholarship reveals eight studies that claim statistically significant findings to support the hypothesis that signing BITs increases FDI.[14] This count includes studies that

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[11] We refer here to the literatures on "regulatory chill", "race to the bottom" and "pollution havens" among others.

[12] Sornarajah, M.: 2006, "A law for need or a law for greed?: Restoring the lost law in the international law of foreign investment", *International Environmental Agreements: Politics, Law and Economics* 6(4), 329-357 and follow-up discussion by Mann, H.: 2006, From a law for greed to a law for need: the underlying importance of Prof. Sornorajahs paper, International Environmental Agreements: Politics, Law and Economics 6(4), 359-363.

[13] However work by one of the authors on this topic will be submitted to a journal next week. It shows that foreign firms are no less influential over governments than domestic firms (*except* in Europe, US and Canada) and that multinational firms are significantly more influential than other types of firms.

[14] J Salacuse and N Sullivan, 'Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); T Buthe and HV Milner, 'Bilateral Investment Treaties and Foreign Direct Investment: A Political Analysis' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); E Neumayer and L Spess, 'Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); D Swenson, 'Why do Developing Countries Sign BITs?' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); P Egger and M Pfaffermayr, 'The Impact of Bilateral Investment Treaties on Foreign Direct Investment' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); R Grosse and L Trevino, 'New Institutional Economics and FDI Location in Central and Eastern Europe' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); K Gallagher and M Birch, 'Do Investment Agreements Attract Investment? Evidence from Latin America' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); UNCTAD, 'The Impact on Foreign Direct Investment of BITs' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009)

find only some types of BITs increase FDI[15] and a study that makes a finding of a 'minor and secondary' relationship between BITs and FDI.[16] A further five studies reject the hypothesis that BITs increase FDI.[17] Not all these studies should be treated equally. Some studies draw on more comprehensive data sets and apply more appropriately specified statistical models to those data sets than others. The problem of controlling for policy shifts made concurrently with ratification of BITs and disentangling reverse-causality effects[18] with data for such a small population is endemic to them all. However, it is clear that those studies whose empirical approach better accounts for endogeneity concerns generally do not find a link between BITs and FDI.[19] Our appraisal of the current literature is that it does not provide any sound evidence that investor protections promote mutual direct investment.

2.2.3 Impact on Governance Quality, Efficiency, and Equity

The possibility that post-investment protections improve the efficiency of government decision-making is at the heart of the economic argument for international investment agreements. We have left it to the end of our discussion, however, as it is not listed as one of the issues for the Commission to consider. Nevertheless, we believe some comment on this important topic is worthwhile.

Firstly, the extent to which government decisions are likely to be influenced by the international legal protections owed to foreign investors is difficult to assess in general terms. A whole range of legislative and executive decisions, made by different tiers of government, could potentially become

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[15] Including a study that finds that only US BITs increase FDI and a study that reaches the apparently contradictory finding that most BITs increase FDI but US BITs do not increase FDI from the US.

[16] UNCTAD

[17] J Tobin and S Rose-Ackerman, 'Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties'Yale Law and Economics Research Paper No 293 M Hallward-Driemeier, 'Do Bilateral Investment Treaties Attract FDI? Only a Bit ... And They Could Bite' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); J Yackee, 'Do BITs Really Work? Revisiting the Empirical Link between Investment Treaties and Foreign Direct Investment' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); E Aisbett, 'Bilateral Investment Treaties and Foreign Direct Investment: Correlation versus Causation' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009); W Mina, 'External commitment mechanisms, institutions, and FDI in GCC countries' (2009) 19 International Financial Markets, Institutions and Money 371.

[18] That is, the effect of increasing inward FDI on the likelihood that a country will sign a BIT.

[19] The most comprehensive discussion of the endogeneity problems in this literature can be found in E Aisbett, 'Bilateral Investment Treaties and Foreign Direct Investment: Correlation versus Causation' in K Sauvant and L Sachs (eds) *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows* (Oxford University Press, Oxford 2009).

the subject of a claim made by a foreign investor. The associated processes of decision making, and their sensitivity to a national government's obligations to compensate foreign investors, can be expected to vary. In the remainder of this section, however, we will assume that investor protections do have some impact on government actions.

The basic theory of committing to compensate investors for government actions which are harmful to the value of their investments is that it forces governments to internalize the costs (and benefits) that their actions impose on foreign investors. To the extent that this theory is true in practice, investor protections can be expected to increase the efficiency of government actions *in so far as they relate to foreign investors* and *from a global perspective*. We consider each of the caveats in italics below, beginning with the latter.

The National Benefit of Global Efficiency Improvements

Global efficiency improvements which are associated with a net transfer from governments to foreign investors do not necessarily translate to welfare improvements for host states, unless:

- These commitments solve a substantial hold-up problem and substantially raise investment above an initially inefficiently low level,[20]
- Foreign investors can compensate hosts for the increased risk burden associated with their investments,[21] or
- Reciprocal investment flows between states are balanced such that the costs of providing protection to investors from partner states is balanced by the benefits of protections offered to home investors by partner states.

The final dot point above is of most potential relevance to Australia. It appears from the list of issues included in the brief for the PC's study that at least some policy-makers in Australia view Australia as principally an investment source country, and thus a country which need only consider the costs and benefits of treaties from a source perspective. In the context of current FTA negotiations there are two major flaws in this argument. Firstly, we are not a net source country in our relationship with the United States. Secondly, the balance of costs and benefits of investor protections is not simply proportional to investment flows. The costs from the perspective of a host are highest in risky sectors such as natural resources. Australia receives significant amounts of foreign investment in this sector.

Is the Shift in Stakeholder Weights in Government Decisions Efficient?

[20] Our discussion under previous sections in this submission suggests that this is not a likely scenario for Australia.

[21] There are a large number of reasons that we cannot expect foreign investors to compensate host government for accepting the greater risk which treaty provisions place on them. These include national treatment clauses which prevent governments from demanding extra payments from foreign investors. This issue is discussed in the papers by Aisbett, Karp & McAusland.

There exists a basic conceptual flaw in the argument that providing legal protection to foreign investment encourages more efficient regulatory decision making. On the arguments own premises, decision makers are more sensitive to the costs and benefits of a decision if the government is forced to bear the costs of the decision directly. This assumption implies that decision-makers are sensitive to only those private costs that the government is forced to bear. Any system of liability that requires government to compensate foreign investors for economic loss that is not coupled with an equivalent system of protection for all other economic actors will encourage decision-makers to over-value the interests of foreign investors. Moreover, the assumption of sensitivity implies that decision-makers under-estimate any economic benefits of a decision unless they are able to be captured by the government. On this basis, making decision makers bear the costs of a policy when they cannot capture its benefits would lead to inefficient reluctance to alter the status quo.[22]

A reluctance on behalf of policy-makers to alter the status quo on (otherwise known as regulatory chill) may also arise in the context of investment protection because of uncertainty about how a particular regulatory action will be viewed by the extra-national tribunals which arbitrate claims brought by investors against host states. The inconsistency of the findings of arbitral tribunals is an ongoing concern among legal scholars in this field.[23]

3. Recommendations

Recommendation 1: *Future Australian FTAs should not include provisions providing post-establishment protection for foreign investment.*

Given that there are few benefits and potentially significant costs to offering post-establishment protection to foreign investment, we recommend that these provisions be omitted in future Australian FTAs.

This policy has been successful elsewhere. For example, the European Union has achieved a high level of investment liberalisation within its membership. However, member countries do not provide protection to foreign investment originating from one another.[24] Brazil – a resource-rich capital-

[22] V Been and J Beauvais, 'The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine' (2003) 78 New York University Law Review 30

[23] LE Peterson and K Gray, *International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration* (2003); High Commissioner for Human Rights, *Economic, Social and Cultural Rights: Human rights, trade and investment* (2003); G Van Harten and M Loughlin, 'Investment Treaty Arbitration as a Species of Global Administrative Law' (2006) 17 (1) European Journal of International Law 121.

[24] With the exception of a small number of BITs agreed between 'old' European states and 'new' European states many years before the latter joined the EU.

importing country like Australia – has never ratified a treaty that includes post-establishment protection, yet has been successful in attracting foreign investment over the past two decades.

Recommendation 2: *If provisions providing post-establishment protection for foreign investment are included in future Australian FTAs, they should be drafted more narrowly.*

In general, post-establishment protections in Australia's FTAs are thoughtfully drafted. Investor-state arbitrations, to which Australia was not a party, have revealed a number of potential issues with similar wording contained in Australia's IPPAs. The Australian government has dealt with many of these issues through modifications to the most-favoured nation clause, by tying the fair and equitable treatment to the customary international law minimum standard, by adding an interpretative annex on expropriation and by setting out the procedure for investor-state arbitration in more detail. These changes have dealt with our most urgent concerns. Nevertheless, we recommend that if foreign investment protection is to be included in FTAs, further modifications be made to Australia's basic negotiating position.

Examining Australia's existing FTAs is difficult because four key issues are inter-related:

- The way in which the substantive protections – fair and equitable treatment, national treatment and compensation for expropriation – are drafted;
- The ability of foreign investors to enforce these rights through investor-state arbitration;
- The ability of foreign investors to rely on more favourable protections in other treaties via a most-favoured nation provision in the FTA in question
- The ability of investors from any country (including Australian investors) to incorporate in a country that is entitled to foreign investment protection in Australia and then claim that protection on the basis of corporate nationality.

To begin with the last issue, any investor is able to take advantage of the most generous protections of any FTA or IPPA by structuring their investment through an intermediary corporation in the country entitled to maximum protection. There is no drafting technique of which we are aware that would be able to eliminate this risk, short of dispensing with the doctrine of corporate nationality entirely. Accordingly, any protection offered to the investors of one country must be evaluated in light of the risk that it might be claimed by the investors of any country (including Australian investors). There are practical constraints on the ability of an investor to 'forum shop' for treaty protection, the most significant being the tax consequences of incorporating an intermediary, however the risk remains. We recommend that all drafting questions should be evaluated in light of this risk.

On a similar basis we advise against the inclusion of a most-favoured nation (MFN) clause. An MFN clause is only appropriate when a government is certain that future policy will be to offer protections that grow increasingly broad over time. The inclusion of such a clause means that Australia, as host government, can find its carefully drafted clauses bypassed through recourse to less considered language in other treaties. Even clauses that restrict MFN to future agreements limit the ability of Australia to tailor future agreements to the specific circumstances of an international relationship without finding that the terms of a past agreement have been inadvertently altered.

Third, we recommend that investor-state dispute settlement (ISDS) be removed from Australia's basic negotiating position. Any decision to include it in a particular FTA should be justified by a specific cost-benefit analysis examining the merits of its inclusion in the treaty in question. We make this recommendation because the majority of the costs of post-establishment protection flow from the ability of a foreign investor to enforce their rights under a treaty, whereas the benefits – to the extent they exist – are not necessarily tied to enforceability. It is true that Australia would be bound – as a matter of international law – by the obligations to which it agrees, even in the absence of investor-state dispute settlement. However, it is clear that enforceability is enormously important in practice. There are dozens of cases in which an investor has been awarded compensation through ISDS for a state's failure to provide fair and equitable treatment. We know of no cases in which a state has conceded that it has failed to provide fair and equitable treatment and offered compensation to an investor in the absence of ISDS.

Finally, we recommend redrafting of the provision that requires a state to offer an investor fair and equitable treatment. Arbitral decisions have interpreted this standard particularly broadly. For example, a number of decisions have required host states to compensate foreign investor for breaches of their 'legitimate expectations', even when these expectations have no legal basis.[25] An investor would not be able to gain compensation for a breach of their legitimate expectations under Australian administrative law.[26] Australia's treaty practice has responded to this concern by stating that fair and equitable treatment does not place obligations on a state that go beyond the minimum standard of treatment of aliens required by customary international law.[27] This is a welcome change in drafting practice, but it creates new confusion. In the past, the fair and equitable treatment standard has been interpreted as going beyond the customary minimum standard. Suggesting that fair and equitable treatment is the same thing as the minimum standard creates a risk that arbitral tribunals may conclude that states intend to imply that past decisions on fair and equitable treatment define a new, higher customary international law standard. We recommend that this provision omit any reference to fair and equitable treatment and, instead, refer only to the customary international law minimum standard of treatment for aliens.

[25] *International Thunderbird Gaming Corporation v. Mexico*, UNCITRAL (NAFTA), 26 January 2006, [147].

[26] *Re Minister for Immigration and Multicultural and Indigenous Affairs; Ex parte Lam* (2003) 214 CLR 1, [67] per McHugh, Gummow JJ.

[27] See, for example, Chapter 11 – Article 6 (2) c) of the Australia – ASEAN – NZ FTA.

4. Appendix – Why have countries agreed to investment protection?

Our analysis raises the question of why so many countries have agreed to protection of foreign investment in the past. This question does not relate to the Productivity Commission's study brief. Nevertheless, we think it is important to offer some basic comments on it, not least because the ubiquity of foreign investment protection through BITs might encourage the view that investment protection is a 'natural' component of any multi-issue FTA.

There is an existing social scientific literature that examines this question. One theory is that existing treaty practice is primarily driven by developing countries competing for scarce international capital.[28] According to this theory, capital-importing countries face a collective action problem – international rules protecting foreign investment are not in their interests as a group, yet each state individually has an incentive to commit to investment protection to attract a greater share of international capital flows.[29] An alternate view is that investment protection reflects a rational strategy on the part of newly independent developing states to expropriate foreign investors and then credibly commit to protect future investment through BITs.[30] A third explanation is that BITs reflect the ascendency of certain ideas about economic development among government negotiators, rather than a rational assessment of the costs and benefits of offering protection.[31]

We do not attempt to resolve this debate. However, we do wish to add two further observations that have repeatedly arisen in our private discussions with negotiators from a number of different countries. First, a recurring theme in private discussion is that governments are keen to sign international economic agreements so as to have a tangible outcome to show for diplomatic visits or to be seen to be 'active' on international economic issues. We feel that this factor alone plays a substantial role in driving international practice in the area. Second, it seems to us that negotiators systematically misjudge the benefits and the costs of offering post-establishment protection. Many conceive of the benefits of investment protection by drawing inappropriate analogies to trade liberalisation. It is possible for this misjudgement to persist because the costs of offering foreign investment protection are uncertain, diffuse and may not crystallise until well into the future.

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[28] Z Elkins, A Guzman and B Simmons, 'Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000' (2004) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=578961.

[29] A Guzman, 'Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties' (1998) 38 Virginia Journal of International Law 639

[30] R Bubb and S Rose-Ackerman, 'BITs and bargains: Strategic aspects of bilateral and multilateral regulation of foreign investment' (2007) 27 International Review of Law and Economics 291

[31] J Yackee, 'Are BITs Such a Bright Idea? Exploring the Ideational Basis of Investment Treaty Enthusiasm' (2005) 12 University of California Davis Journal of International Law and Policy 195