

March 2016

Why International Investment Agreements Matter

Investment is a leading source of economic growth, job creation, infrastructure, competition, international trade and innovation. Countries with a high level of investment systematically achieve higher levels of development in more sustainable ways. A central question among policy makers is therefore how to enhance investment. Investment is influenced by a multitude of factors. International investment agreements (IIAs) can be an important factor for host countries to incentivize foreign direct investments (FDI), both in quantity and quality. They are not a substitute for long-term and comprehensive improvements towards a transparent, rules-based pro-business policy environment, but they do play a fundamental role by providing an additional layer of security to foreign investors.

There are today around 3000 IIAs, including Bilateral Investment Treaties (BITs), in place as well as a growing number of investment chapters included in free trade agreements. Moreover, mega-regional agreements which also have investment chapters are a key priority on the global trade and investment agenda and have increasingly attracted public attention. At the same time, however, public opposition to and misconceptions of IIAs are persistent and widespread, and an increasing number of countries contest the merits of an open investment climate. It is therefore more important than ever to recall and highlight to policy makers, and the public at large, why international investment agreements matter, and how they contribute to economic prosperity worldwide.

❖ IIAs reduce risks for foreign investors and can contribute to increased FDI inflows

When making an investment decision, investors calculate the risk of any proposed investment or project. To encourage FDI inflows, policy makers seek to increase investors' confidence by decreasing risk. IIAs have a key role in achieving this. They act as an insurance policy¹ by protecting investment against political risk and offering investors legal protection under an efficient Investor-State Dispute Settlement (ISDS) mechanism.

While undertaking an investment operation, economic risk is unavoidable. This risk has to be borne by the company itself. In addition, investments abroad, but also domestic investments, are accompanied by political risks². The State is sovereign on its territory, and can in principle change

¹ UNCTAD, *World Investment Report 2015*, pp.125-126

² Suarez Anzorena, C. Ignacio and William K. Perry, "Protecting Foreign Investment and Arbitration", in *The Rise of Bilateral Investment Treaties*, 2010

legislation and policies that are relevant for investors at any point in time. This can substantially change the status and therefore the costs and risk of an investment project. One of the main risk factors when making an investment decision is therefore uncertainty vis-à-vis public policy, which raises the question whether the conditions that led an investor to make the investment or project in a given country remain the same after the investment has been realized. Similarly, investors can fear about the possibility of losing physical assets, intellectual property infringement, management resource exploitation and reputational damage. Such uncertainty can discourage foreign investors to invest their capital outside their home market. Investors working on public infrastructure and public service projects at sub-sovereign level face particular risks. In developing economies, it is often these kinds of projects that can make the biggest overall beneficial impact on the local economy and the lifestyle and wellbeing of the citizens.

Thus, the main objective of investment protection from a State point of view is to define a safe environment in order to promote and attract investments which are important ingredients for sustained economic growth. For enterprises, the main purpose is to ensure that their investments are protected through the respect of an engagement by the State. This balanced protection is a condition *sine qua non* in order to invest (e.g. constructions, intellectual property rights), and to subsequently preserve the jobs created as a result of foreign investment. IIAs are therefore crucial in providing a predictable and stable framework for investment through an officially recognized and binding agreement between the home and the host state. They reinforce the rule of law ensuring that States will respect their international commitments and take responsibility in case of violation of their obligations, e.g. by discriminatory treatment. This contributes to decreased uncertainty faced by investors, which in turn encourages FDI.

Indeed, empirical evidence shows that, as the number of IIAs increased dramatically in the 1980s and 1990s, outright expropriations of foreign investors sharply decreased³. This led to an increase in the predictability of the open international investment climate and international investment flows. This positive relationship between IIAs and FDI has been clearly supported by several studies⁴.

Expropriations remain possible even under the protection of an IIA. But IIAs call for minimum legal standards for expropriations. If an expropriation takes place, it must be for a public purpose and carried out in a non-discriminatory fashion, while investors must be provided with a timely, adequate and effective compensation. A special risk for investors is indirect expropriation, where abusive discriminatory treatment by a host government de facto amounts to expropriation.

❖ IIAs promote international competition

An important aspect of IIAs is the non-discrimination provision. This bans discriminatory treatment against foreign investors, guaranteeing both national treatment (foreign investors must not receive any worse treatment than national investors) and most-favoured nation treatment (privileges

³ Minor, M.S., "The Demise of Expropriation as an Instrument of LDC Policy", *Journal of International Business Studies*, 25, pp.177-188, 1994

⁴ See Kerner (2009), Guerin (2010), Oh and Fratianni (2010), Tortian (2012) and Berger (2013)

enjoyed by one foreign investor must be granted for all foreign investors)⁵. This enables a level playing field, in turn increasing international competition, benefitting consumers, innovation and overall economic efficiency of the host country.

IAs can also contribute to transparency by making all national provisions affecting investor rights and obligations publicly available. Examples include rights of entry, establishment and post-establishment operations, such as sectors or industries reserved for domestic investors, conditions applying to joint ventures, and taxation.

❖ IAs can help achieve higher levels of development

IAs are also important for achieving higher levels of development in developing countries. FDI is a major component of their net resource flows. However, foreign investors can be sceptical about investing scarce capital in countries in which they have concerns regarding the quality of the domestic institutions, the rule of law and, as a consequence, the stability of investment conditions.

The basic provisions of IAs address these concerns through the guarantee of investment protection and “due process” under binding treaties and legal mechanisms. IAs contribute to improving the countries’ regulatory and institutional framework, “by adding an international dimension to them and by promoting the rule of law and enhancing good governance”⁶. According to the OECD Policy Framework for Investment, “such agreements may also help countries to improve their own domestic legislation covering investment”⁷. Moreover, the simple fact of signing an IA sends out a signal to potential investors: the country is serious about the protection of foreign investments. Therefore, this can have positive spill-over effects, encouraging foreign investors from countries that are not part of the IA to make investments and bid for public projects in a developing country. Indeed, academic research⁸ has provided rigorous quantitative evidence that IAs increase FDI inflows to developing countries.

IAs are thus crucial for developing countries, both because of the importance of FDI for these economies and because of the quality of domestic institutions negatively affecting the country. The “insurance” aspect of IAs is even greater, reducing the risk for foreign investors, encouraging FDI inflows, in turn creating jobs, driving innovation and fuelling economic growth.

❖ There is no other adequate legal alternative to IAs

Critics against IAs also often claim that other mechanisms already exist to protect international investment. One other instrument could be private and public investment insurance and guarantees, which can help reduce political risk. However, they are not always available and IAs are often a pre-

⁵ Neumayer, Eric and Laura Spess, “[Do bilateral treaties increase FDI to developing countries?](#)” LSE Research Online, 2005.

⁶ UNCTAD, *World Investment Report 2015*, pp.125

⁷ OECD, *Policy Framework for Investment*, p.28, 2015

⁸ Neumayer, Eric and Laura Spess, “[Do bilateral treaties increase FDI to developing countries?](#)”, LSE Research Online, 2005

requisite for their availability. Public investment guarantees often depend on a country's development goals. In addition, private insurance generally entails high costs, which present particular challenges for smaller companies.

Finally, individual contracts cannot be an effective alternative to IIAs either. Although they might be useful in particular cases, they have a very limited area of applicability as they only protect against arbitrary infringement of these individually negotiated contracts. Hence, IIAs offer a fundamental framework for legal protection to investors for which there is currently no adequate alternative. They close an important gap and safeguard security in international investment.

❖ **IIAs limit unfair abusive use of state's power while also reaffirming its rights**

IIAs are a crucial tool to protect foreign investors' rights from unfair abuse of state's power. The key word here is abuse, not use. States are – and should be - sovereign on their territory and in the way they legislate. This is clearly recognized in recent IIAs and by business.

Any state has a right to adopt its own policy based on national security and other legitimate public purposes. For example, IIAs typically reaffirm the state's right for national security review of FDI. However, it should be emphasized that "security" provisions must not be used as a disguised form of protectionism or for confiscatory purposes. In that regard, IIAs are essential in supporting FDI reviews for legitimate security concerns while protecting foreign companies from abuses. IIAs do not aim to reduce the state's regulative powers, but to prevent its abuse, reaffirming its legitimate scope of action.

❖ **IIAs and ISDS are key for business**

The ISDS mechanism is a key component of IIAs, as it ensures effective enforcement of the substantive provisions provided in the agreements. It provides access to a neutral forum for resolution of a dispute involving a state and a foreign investor. This process takes an investment dispute out of the political arena and into a transparent, rules-based forum of independent and impartial arbitrators. It provides an effective protection for foreign investors against treatment such as nationalization, expropriation and related measures by stipulating duties of states to prevent its government from exercising state's power arbitrarily over foreign investors operating outside the legal protection of their home country. To access the BIAC paper on ISDS, please click [here](#).

Critics sometimes claim that other mechanisms already exist. For instance, investors could bring their case to domestic courts of host countries. However, there can be legitimate concerns in many countries about the degree of independence and impartiality or risk of inordinate delays these courts might have when dealing with a case between their government and foreign investors, particularly in countries where the institutional quality is relatively low.

Recently, a public debate has arisen again on the topic of IIAs. Critics claim for example that IIAs, and in particular ISDS, restrict the host state's ability to regulate in the public interest. Actually, past

cases of arbitration show that foreign investors are not always compensated for the damage caused when states adopt bona fide regulations in a non-discriminatory manner for legitimate public purposes which are enacted in accordance with due process.⁹ The claim that ISDS infringes states' right to regulate is not justified.¹⁰

The debate has been fuelled by internationally coordinated negative campaigning, making reference for example to several on-going arbitral proceedings, which however have not yet reached final conclusion. Further dialogue should be based on the final outcome of such proceedings. Meanwhile, several countries have unfortunately begun pulling back from their IIAs (e.g. South Africa, Indonesia, and Bolivia). The criticism regarding some of the existing IIAs and current practices within ISDS, such as transparency in ISDS proceedings or the code of conduct for arbitrators, should be objectively and rigorously analyzed - and not simply accepted - before certain careful and balanced modifications may be envisaged. Business is open for a fact-based dialogue on how the best functioning of the ISDS instrument can be ensured. At the same time, we must recognize and highlight that IIAs, and ISDS as an integral part of them, remain vital instruments for business and governments and must continue to provide effective protection of foreign investment.

Recent cases, such as the expropriation of YPF from Repsol in Argentina, remind us that arbitrary behavior of governments against foreign investors is not something of the past, but a very real possibility also today. In such situations, the impartiality of the judiciary is often deficient. IIAs are then the only instrument left to business to guarantee effective protection. It should also be taken into account that much of the criticism is based on early generations of IIAs and that recent IIAs such as the US Model BIT have introduced new provisions in response to these discussions.

❖ What role for the OECD

The OECD Declaration on International Investment and Multinational Enterprises, which balances the promotion by governments of an open international investment climate with a commitment from business to responsible business conduct, is a fundamental basis for OECD's work on investment policy and is an instrument which is of great importance to business. In 2015, the OECD updated its Policy Framework for Investment, which is the backbone for its work on investment and development. In addition, thanks to its convening power and its Freedom of Investment Roundtable, the OECD is ideally placed to highlight the importance of IIAs to both member and non-member countries.

In view of the importance of international investment flows, bilateral and regional investment agreements continue to play a key role and remain an essential tool for attracting and protecting

⁹ Methanex vs. United States (2005) and Saluka Investments B.V. vs. The Czech Republic (2006)

¹⁰ See Study prepared for the Minister for Foreign Trade and Development Cooperation, Ministry of Foreign Affairs, The Netherlands, "The Impact of Investor-State Dispute Settlement (ISDS) in the Transatlantic Trade and Investment Partnership", page 9, Reference: MINBUZA-2014.78850, 24.06.2014. Besides, the study highlights that "most investment claims do not challenge the government's ability to legislate or regulate as such, but are administrative in character, challenging a government's treatment of an individual investor in the context of a particular license, permit, or promise extended by government officials"

international investment. In particular as IIAs have been subject to emotional criticism, often based on misconceptions, and as some governments are now opposing them, the OECD has a key role to play in highlighting their fundamental importance.

In the current context it is highly unlikely that multilateral discussions on an investment framework would lead to a high-quality outcome that would have concrete impacts on the ground for business. At least for now, therefore, a practical way forward both for individual governments and groups of governments remains to engage in high-standard bilateral and regional investment agreements that can deliver concrete results by creating an open investment climate.

BIAC is convinced that there is a renewed urgency for the OECD to provide a factual-based analysis, to strongly communicate the benefits of foreign investment, and to explain the essential contribution international investment agreements can make in this context. As mentioned in [BIAC's Proactive Investment Agenda for 2016](#), we urge the OECD to embark on an ambitious pro-active investment program and confirm the Organization's leading role in the investment debate, with the ultimate objective to boost economic growth and development. As part of these efforts, it would be beneficial if the OECD could reassess the positive effects of investment treaties on the economies of host countries, thereby promoting investment treaties and contributing to global discussion on international investment rules.

ANNEX

Empirical Evidence of the importance of IIAs

The case below, provided by Repsol, is mentioned as an illustrative example to highlight the importance of the key messages in the BIAC paper. This issue was previously raised by BIAC in the context of OECD discussions.

❖ The YPF (until May 2012 Repsol YPF, S.A) Case

- On 16 April 2012, the government of the Republic of Argentina expropriated from the Spanish oil company Repsol 51% of the shares in YPF, without paying any compensation.
- The confiscation of YPF in 2012 entailed “disinvestment” and gave Argentina a virtual zero ranking in terms of regional Direct Foreign Investment for the first time in over 20 years.
- Since that date and in defense of its rights, Repsol started various legal proceeding in the competent jurisdictions of Spain, Argentina and the United States, as well as an arbitration procedure with the World Bank’s International Centre for Settlement of Investment Disputes (ICSID).
- The Spanish government denounced the Argentine government’s actions from the outset. The European Union, The United States and several multilateral bodies also expressed their clear condemnation of this decision, calling it an unacceptable breach of the rule of law.
- In this context, Brussels intensified the international pressure on Argentina, by bringing the case to the OECD, since the expropriation of YPF did not respect the Declaration of International Investment and Multinational Enterprises subscribed to by the Argentine government in 1997. The fact that the issue was addressed in the framework of the OECD Investment Committee, which reviews protectionist and discriminatory measures that restrict foreign investment, was an important step in the discussions.
- In relation to the ICSID, it is noteworthy that the tribunal accepted the arbitration complaint filed by Repsol against the Argentine Republic for the expropriation of YPF and the attendant breach of the Bilateral Investment Treaty between the Kingdom of Spain and the Argentine Republic of October 3, 1991.
- On 27 February 2014, the Republic of Argentina and Repsol signed an extrajudicial settlement in respect of the expropriation of YPF. This agreement recognized, amongst other things, the company’s right to receive US\$5 billion as compensation for the expropriation of 51% of the shares of YPF and stipulated guarantees for effective payment as well as the termination of all judicial and arbitration proceedings and the reciprocal waiver of future claims.

- The agreement provided a solution for Repsol's rightful claims, and may exemplify the importance of persevering in the efforts to uphold the international investment protection regulations.

Lessons learned and conclusions

- The Freedom of Investment Roundtable was the only multilateral space where Repsol could present, through BIAC, the case in an effective manner as we were suffering a breach of national treatment. Other interested parties, including BIAC and some Roundtable member governments were also able to register views on this very important case.
- The Declaration was a crucial instrument to maintain the principle of the rule of law regarding to investment protection.
- Dispute settlement procedures, as the ISDS, and enforcement measures are key elements to protect global investment and create a level playing field in which each player has an equal chance to benefit from investment.
- The pressure exerted by different governments and international institutions and organizations, such as BIAC, in support of the rule of law was essential to make the extrajudicial settlement possible. It is therefore needed to continue assuming a firm stand in order to promote efficient and expeditious solutions that will make it possible to strengthen the rule of law and international mechanisms to protect foreign investment.
- Foreign Direct Investment (FDI) is one of the emerging markets' major macroeconomic indicators, since it reflects a country's economic thrust and conditions its economic progress. Not for nothing is it one of the key drivers of modernisation of production systems and infrastructures and improved international competitiveness.
- Although the EU has made major inroads in implementing measures to protect the Investments of companies in third countries in recent years, events such as the seizure of Repsol's shares in YPF are a reminder to the international community that there is still work to be done. In any event, what is needed is for the parties involved to abide by written rules and the Bilateral Investment Treaties (BITs) reached.