Developing countries and the future of the international investment regime
The author, a Researcher at the German Development Institute/Deutsches Institut für Entwicklungspolitik (DIE), gratefully acknowledges the valuable comments on earlier drafts of this paper from Dominique Bruhn, Leonor von Limburg and Lauge Poulsen.
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# Abbreviations

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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>BIT</td>
<td>Bilateral investment treaty</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign direct investment</td>
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<td>ICSID</td>
<td>International Centre for Settlement of Investment Disputes</td>
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<td>IIAs</td>
<td>International investment agreements</td>
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<td>ISDS</td>
<td>Investor–state dispute settlement</td>
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<td>MAI</td>
<td>Multilateral agreement on investment</td>
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<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<td>PTIA</td>
<td>Preferential trade and investment agreement</td>
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<td>TTIP</td>
<td>Transatlantic Trade and Investment Partnership</td>
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<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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<td>US</td>
<td>United States of America</td>
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<td>USD</td>
<td>United States dollar</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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International investment agreements (IIAs)\(^1\) have recently been the focus of increased public attention in many developed countries. The public criticism of the Transatlantic Trade and Investment Partnership (TTIP), currently being negotiated between the United States (US) and the European Union (EU), is a case in point. Critics fear that TTIP, and especially the investor–state dispute settlement (ISDS) mechanism, may have detrimental effects on public policymaking in the US and the EU. To many stakeholders in developing countries this debate is not new. In fact, IIAs have come under increased scrutiny in countries like Bolivia, Ecuador and Venezuela, which have withdrawn from the International Centre for Settlement of Investment Disputes (ICSID), and Indonesia and South Africa, which have announced their decision to terminate many if not all of their IIAs. In light of this criticism, some observers argue that the international investment regime is facing a profound crisis of legitimacy.

Despite these prominent examples, however, many countries are continuing to negotiate investment rules — albeit at a much slower pace — in particular in the context of bilateral and regional trade agreements. Recent years have seen initiatives to make the international investment regime more development friendly. This has involved reformulating key IIA provisions to achieve a better balance between the protection of private property from outright unfair and discriminatory treatment by host state governments on the one hand, and the right and ability of host state governments to regulate foreign investments in the interest of public policy objectives on the other. In addition, the United Nations Commission on International Trade Law (UNCITRAL), the second most important investment arbitration forum after ICSID, has introduced new requirements to make ISDS proceedings more transparent to public scrutiny.

Against this background of divergent responses to the supposed crisis of legitimacy, it is becoming increasingly difficult for stakeholders in developing countries to navigate the international investment regime and decide whether to continue negotiating IIAs — and, more importantly, which kind of IIAs — or to ‘press the escape key’ and unilaterally terminate investment treaties. This study provides an introduction to the history and current state of international investment rule-making with a special focus on developing countries. The next section provides an overview of how the international investment regime has evolved and introduces the main provisions found in investment treaties. Section 3 reviews empirical evidence on the impact of IIAs on foreign direct investment (FDI) flows and Section 4 discusses to what extent IIAs’ protection standards and dispute settlement arrangements lead to a reduction of developing countries’ policy space. Section 5 reviews developing countries’ different reactions to the supposed legitimacy crisis of the international investment regime and argues that each reaction can be categorised as one of four distinct approaches: do nothing, ‘NAFTA-isation’, terminate to renegotiate, and terminate to exit. Section 6 concludes by highlighting the challenges developing countries face when attempting to reform their investment treaties and the ways in which development policy could contribute to supporting these efforts.

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\(^1\) In this study the term IIA will be used to refer to the overall group of bilateral and regional investment treaties, including bilateral investment treaties (BITs) and preferential trade and investment agreements (PTIAs), which establish rules for the protection, promotion and liberalization of foreign investment flows. The terms BIT and PTIA will only be used to address questions specific to these types of treaties.
While IIAs have only recently become the focus of broader public attention, these types of instruments have actually been negotiated since the late 1950s, with more than 3,000 concluded between then and now. IIAs establish the international legal standards that govern foreign investment flows and that host countries must adhere to. Importantly, most investment treaties include an arbitration mechanism that allows foreign investors to sue their respective host country governments in cases where the treaties’ substantive standards are alleged to have been breached. This section provides an overview of the spread of IIAs since 1959 when the first such treaty was signed between Germany and Pakistan. Focusing on the number of negotiated treaties and on their contents and signatory-country characteristics, the evolution of the international investment regime can be divided into three phases. This section also provides a brief and non-technical introduction to the key IIAs provisions that form the basis for the subsequent analysis of how IIAs impact on developing countries. In a nutshell, this section argues that IIAs represent a peculiar bilateral international treaty format that establishes wide-ranging rules for the protection and liberalisation of foreign investment flows.

The foundations of the modern international investment regime were laid in the aftermath of World War II (Figure 1). IIAs were thought to fill the legal gap left by the breakdown of colonial systems and in light of the expropriation policies adopted in many newly independent as well as communist states that often involved the denunciation of contracts between foreign investors and host countries (Maurer 2013). The first IIAs that were signed between capital-exporting and capital-importing countries from the late 1950s onwards were designed as a response to these specific legal challenges. Traditional investment treaties included a core of substantive provisions that ensure foreign investors are treated without discrimination and according to a general international minimum standard, are compensated in the case of expropriation and have the right to move investment-related capital freely in and out of the host country. Often, IIAs also included provisions that required host states to honour investment contracts between investors and host states (see Box 1).

Interestingly, this set of investment provisions designed in response to a historically unique problem — namely widespread expropriation, the discriminatory treatment of foreign investors and the denunciation of contracts — still constitutes the core of modern investment treaties. The open-ended and often vague drafting of these core protection standards seems increasingly outdated in today’s global economic governance system. IIAs signed since the late 1950s and that are still in force have not been sufficiently reformulated in response to changing policy priorities in host and home countries. Furthermore, in a number of high-profile ISDS cases, host countries have been sued by foreign investors on the basis of a seemingly outdated treaty signed decades previously. The evolution of the international investment regime can be divided into three distinct phases:

In the first phase of the international investment regime, from the late 1950s to the late 1980s, IIAs were predominantly signed between capital exporters from Western Europe and capital importers from Africa and Asia. As shown in Figure 1, only a small number of treaties were adopted annually during the first three decades of the modern international investment regime. These early treaties already included the core protection standards listed in Box 1, but often omitted the controversial ISDS mechanism.
In the second phase, from the late 1980s to the early 2000s, the global diffusion of IIAs gained momentum. During the heyday of the Washington Consensus, the number of newly concluded IIAs increased considerably. In 1996 alone, 211 IIAs were added to the expanding web of investment treaties. As a result of the 1980s debt crisis in Latin America, countries from the region began dropping their import substitution policies and joined in the global rush to sign IIAs. Developing countries mainly signed IIAs in order to attract FDI from multinational companies based in developed countries. In this phase, developing countries increasingly began negotiating IIAs among each other, which is noteworthy because these countries often did not manifest any bilateral FDI flows worth mentioning. It is possible therefore to deduce that the signing of IIAs had become an almost procedural measure during the 1990s and that they were not always signed for their instrumental value of promoting foreign investment, but also as tools to promote diplomatic relations between the signatories (Poulsen 2015). In the late 1980s, ISDS mechanisms became a standard feature of IIAs but, throughout the 1990s, despite the increasing spread of these mechanisms, foreign investors seldom made use of them until the turn of the millennium, as discussed in Section 4 below.

After the international investment regime’s boom period in the 1990s and early 2000s, the signing of new treaties abated considerably, heralding the start of the third phase of the international investment regime. This phase is characterised by an increasing dissatisfaction among developing and developed countries alike regarding the effects and content of traditional IIAs, which is manifest in the decreasing numbers of newly signed IIAs. During the first decade of this century, more than 100 IIAs were concluded each year; however, since 2010, fewer and fewer IIAs have been and are being negotiated. In 2014, only 31 new IIAs were negotiated, of which 13 were PTIAs with comprehensive investment chapters (UNCTAD 2015). This highlights the growing trend for investment rules to be increasingly negotiated in the context of regional and bilateral trade agreements that emulate the example of the North American Free Trade Agreement (NAFTA).
Another secular trend that characterises the third phase of the international investment regime is the sharp rise in ISDS cases (see Section 4). The first ISDS case was filed in 1987 against Sri Lanka, but the majority of cases have appeared since the start of the new millennium. The number of known ISDS cases currently stands at 608 and, in 2014 alone, 42 new cases were filed (UNCTAD 2015). The sudden rise of ISDS cases took most countries by surprise, as they underestimated the actual risks when signing IIAs (Poulsen 2015). Countries have responded differently to the challenges posed by ISDS cases. While developed countries have started to recalibrate the contents of their IIAs, developing countries have generally stopped signing new treaties or are even beginning to terminate existing ones (Manger and Peinhardt 2013). So far, only Indonesia and South Africa have gone as far as unilaterally terminating IIAs on a larger scale and it is questionable whether this exit option is available to poorer developing countries (see Section 5).

The trend towards more balanced IIAs was, incidentally, started by the US and its NAFTA partners, Canada and Mexico. In response to a number of high-profile ISDS cases, the three NAFTA countries introduced a number of pioneering provisions that aimed to recalibrate the relationship between investment protection and the regulatory policy space of host countries. A second trend, also initiated by the US, was the inclusion of market access clauses that require partner countries to negotiate on market access commitments and thus liberalise national regulatory systems for foreign investments (see Box 2).

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**Box 1**

**Core provisions of traditional IIAs**

The structure and content of the majority of IIAs signed since the late 1950s is remarkably similar. This similarity is the result of their common legal origin — namely the 1959 Draft Convention on Investment Abroad, prepared by Hermann Joseph Abs, then Director-General of Deutsche Bank, and Lord Shawcross, a former UK Attorney General — and the fact that these treaties are negotiated by most capital-exporting countries on the basis of coherent model texts. These traditional IIAs are roughly 10 pages long and include around 12 provisions.

The *preamble* of most traditional IIAs reaffirms that increased legal protection will stimulate foreign investment and thus lead to economic development. The *investment definition* is typically very broad covering ‘all kinds of assets’ including not only FDI, but also portfolio investments and intellectual property rights. The treatment standards of traditional IIAs only apply in the *post-establishment* phase, meaning that host states can regulate the admission and establishment of foreign investments. *Non-discrimination* standards are an integral part of IIAs. Once signed, the host state is committed to providing equal treatment for foreign and domestic investors (national treatment) and to treating all foreign investors alike (most-favoured nation treatment). In addition, IIAs include non-contingent absolute standards, such as the requirement to provide *fair and equitable treatment* as well as *full protection and security*. IIAs include the Hull Formula that demands ‘prompt, adequate and effective’ payment of compensation in the case of direct or indirect *expropriation*. IIAs include a *transfer clause* that allows investors to move their property freely in and out of the host country and a so-called *umbrella clause* that requires the host state to respect the investment contracts it has entered into with foreign investors. Last but not least, the large majority of IIAs signed since the late 1980s include *investor–state dispute settlement* mechanisms that, in cases of alleged breaches of IIA provisions, allow foreign investors to sue host states before an independent international tribunal without having to rely on the diplomatic protection of its home country.

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**Box 2**

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Recent changes in the international investment regime have been mainly influenced by the US. Compared to West European capital exporters, the US was a latecomer to the negotiation of IIAs. The first US IIA was signed in 1982 with Panama and, by the end of 2013, the US had signed 47 BITs and 20 PTIAs with comprehensive investment chapters. The US introduced two main innovations:

1. Since the beginning of its IIA programme, the US has included market access clauses in order to bring about the liberalisation of host countries’ investment regimes. According to this approach, foreign investments must be accorded national or most-favoured-nation treatment before they can be admitted by the host-country government. Furthermore, US IIAs prohibit performance requirements.

2. In response to a number of high-profile ISDS cases that were filed by foreign investors on the basis of Chapter 11 of NAFTA, the US, along with its partners Canada and Mexico, reformulated a number of key IIA provisions. This recalibration of IIAs sought to increase governmental policy space relating to the regulation of foreign investors. In contrast to previous IIAs, the new 2004 US model treaty featured a more restrictive definition of the investments covered, a fair and equitable treatment clause that does not require more beneficial treatment than is granted by customary international law, and a more constrained meaning of indirect expropriation. With regard to the ISDS mechanism, the US introduced transparency requirements for arbitral proceedings and provisions aimed at preventing the filing of ‘frivolous’ claims, and it also strengthened the role of non-disputing parties.

This innovation in US IIA policy has had a major impact on worldwide IIA practice, particularly since the conclusion of NAFTA and the subsequent changes to the US model IIA text. NAFTA served as a template for the subsequent wave of PTIAs that include comprehensive investment chapters. The latest and possibly most significant step towards the NAFTA-isation of international investment policymaking is the reformulation of the EU’s Common Commercial Policy and the transfer of powers to negotiate integrated trade and investment agreements from member states to the EU level.

Box 2
The ‘NAFTA-isation’ of international investment rule making

As a result, developing countries that wish to continue signing IIAs are now faced with an international investment system that is increasingly ‘NAFTA-ised’. This shift from the European template of wide-ranging and often vaguely drafted IIAs to the NAFTA approach combining more balanced post-establishment provisions with liberalisation commitments presents opportunities as well as challenges for developing countries, as discussed in Section 4 below.
Much of the criticism levelled against IIAs relates to the lack of evidence that these treaties actually promote FDI flows to developing countries. IIAs were invented after World War II to protect foreign investments in relatively unfavourable and unstable political environments. In other words, these treaties were created as a substitute for insufficient political and legal institutions in host countries. IIAs were thus primarily designed to tackle the political factors inhibiting FDI flows to developing countries. Only IIAs that include market access provisions and prohibit performance requirements also address, at least partly, the economic determinants of FDI inflows. While such market access provisions are a standard feature of bilateral or regional PTIAs, they have rarely been included in stand-alone investment treaties until recently. This section reviews the empirical evidence available on the role IIAs play as an effective policy tool that, by reducing the political risk of foreign investments, aims at promoting FDI inflows. It will consider whether more stringent IIAs — i.e. those treaties that include market access provisions and comprehensive ISDS clauses — have a stronger effect on FDI flows. It will also look at the differences arising from the context in which these rules are negotiated: either as stand-alone IIAs or as part of broader bilateral or regional trade agreements. The section concludes by asserting that the impact of IIAs on FDI flows remains ambiguous and that IIAs have proven to be only one of many determinants helping to attract foreign investors.

Despite the long history of the international investment treaty making, the first studies analysing how these treaties affect FDI flows did not emerge until the late 1990s and early 2000s (see, for example: UNCTAD 1998; Banga 2003; Hallward-Driemeier 2003). This dearth of research from the late 1950s to the late 1990s is striking given that many, if not all, developing countries that signed these treaties did so in the hope of attracting more FDI. Many of the more than 3,000 IIAs have therefore been signed on the basis of a hypothetical connection between IIAs and FDI and without any empirical support for this claim.

IIAs’ effects on FDI have been mainly assessed using econometric methods. These econometric studies are based on a mathematical equation that analyses the relationship between bilateral or aggregated FDI flows (the dependent variable of the model) and IIAs (the explanatory variable of interest), while taking into account the potential role of other explanatory variables (control variables) such as gross domestic product, inflation and the institutional quality of the host states. Econometric methods usually involve analysing a large sample of countries over a number of years in order to generate a large number of observations on how IIAs affect FDI flows. The results generated are not country specific, but reflect a more general relationship based on the explanatory variables included in the model.

The literature available on how IIAs affect FDI flows is inconclusive. Most of the more recent econometric studies tend to find a positive relationship between IIAs and FDI flows (see, for example: Egger and Pfaffermayr 2004; Neumayer and Spess 2005; Gallagher and Birch 2006; Büthe and Milner 2009; Busse, Könniger and Nunnenkamp 2010; Tobin and Rose-Ackerman 2011). However, other econometric studies find IIAs to have no — or even negative — effects on FDI flows (see, for example: Hallward-Driemeier 2003; Tobin and Rose-Ackermann 2005; Yackee 2009). One of the main deficiencies of these studies is the fact that they treated IIAs as ‘black boxes’, neither taking into account their specific contents nor distinguishing the type of treaty. One of the most important variations of IIA design is whether they include an ISDS clause — the very clause that makes the treaty enforceable. Interestingly, recent evidence suggests that strong ISDS clauses do not increase FDI flows any further (Yackee 2009; Berger et al. 2011; Berger et al. 2013). In addition to ISDS provisions, the effects of market access provisions have also been
When carrying out econometric studies, both the methodologies applied and the data that is fed into the statistical models present challenges:

**Methodological challenges**
Econometric methods are often sensitive to even slight changes in the estimation technique and, when studying how IIA affects FDI, such slight changes have generated very different results (Yackee 2009). Another methodological challenge relates to the so-called endogeneity problem that questions the role IIAs play in promoting FDI (Aisbett 2009). More specifically, it may be that high FDI flows lead to the signing of IIAs (‘reverse causality’) and that ‘omitted’ or unobservable variables are responsible for FDI increases and not IIAs. For instance, unobserved personal networks between the politicians and entrepreneurs of two countries can lead to both more FDI and a higher likelihood of bilateral agreements.

**Data-related challenges**
The data used to measure how IIAs affect FDI are often insufficient. The main challenge when seeking to econometrically estimate the effects of IIAs is inadequate or lacking bilateral FDI data. Where such data is available, it is not usually possible to distinguish between the different motives of the investors, modes of market entry and targeted sectors. IIAs’ effects may differ depending on the specific characteristics of investment projects but, given the FDI data available is highly aggregated, it is not possible to take account of this important factor.

While the problematic nature of FDI data is well known, much less attention has been paid to the inadequacy of available data on the existence and content of IIAs. Indeed, most studies simply use a binary variable for indicating the absence or presence of an IIA between two countries. Yet, IIAs can in actual fact be very different in nature and have very different characteristics. Comparing IIAs without taking a closer look at their content can be likened to comparing apples and oranges.

The above-mentioned challenges mean that the results of the econometric studies described in further detail below should be treated with caution, in particular when it comes to drawing policy conclusions on the merits of IIAs as instruments to promote FDI (UNCTAD 2014a).

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**Box 3**
**Methodological challenges of the econometric approach to analyse the effects of IIAs**

When carrying out econometric studies, both the methodologies applied and the data that is fed into the statistical models present challenges:

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making concerning the volume and location of foreign investments (European Commission 2000; Yackee 2010; European Commission 2013). Another source of alternative evidence is the analysis of the link between IIAs and political risk insurance. One standard justification for the conclusion of IIAs is that their presence is taken into account by insurers when assessing the political risk of investment projects. An IIA, accordingly, could help to lower the insurance costs and indirectly promote FDI. A survey of public as well as private risk insurers shows that — with some notable exceptions such as Germany — IIAs are not considered as a precondition for the issuing of a risk insurance thus calling into question the positive effect of IIAs on FDI flows (Poulsen 2010).

A last factor that lends credence to the argument that IIAs are not necessarily key in promoting FDI is that large bilateral FDI flows are established and operate without investment treaty protection (UNCTAD 2014a). The most striking example of this is Brazil, which is a main destination of global FDI flows, yet has not so much as a single IIA in force. Another example is the foreign investments made by US multinationals in China — and the rapidly growing Chinese investments in the US, for that matter — that thrive without the protection of an IIA.

The overview of the empirical literature shows that IIAs are no panacea for developing countries hoping to attract foreign investors. While this does not mean that IIAs are wholly ineffectual legal instruments, it should however be mentioned that they are only one among a host of different legal, economic and business-related determinants that can impact on the investment decisions of multinationals (UNCTAD 2009). Even among the legal determinants, IIAs are not the only instrument at the disposal of developing countries. The domestic regulatory framework is of the utmost importance for foreign investors and IIAs cannot serve as a perfect substitute in this respect (Hallward-Driemeier 2003; Tobin and Rose-Ackerman 2011). Furthermore, IIAs are only one legal instrument that developing countries can employ to complement their domestic regulatory framework and increase the confidence of foreign investors. Investment contracts signed between foreign investors and host-country governments for specific investment projects usually cover a range of provisions that are typically found in IIAs and arbitration mechanisms and are similar to the ISDS provisions of IIAs.

What the above tells us is that developing countries seeking to reform their model treaties and either to negotiate more balanced IIAs in future or renegotiate existing ones need not fear that foreign investors will pack their bags and leave (Bonnitcha 2014a).
In addition to the lack of convincing evidence that IIAs have a positive effect on FDI, IIAs are also coming under fire because of how they affect the ability of host-country governments to pursue public policies. Critics argue that IIAs can heavily constrain a host country’s ability to regulate foreign investments, and (b) enforcement mechanisms, namely ISDS. This section argues that the substantive provisions of IIAs do indeed provide wide-ranging levels of legal protection for foreign investors. IIAs following the traditional European approach often include vaguely drafted and open-ended provisions that allow arbitral tribunals to interpret them in an overly investor-friendly manner. IIAs also allow more favourable provisions from other IIAs to be ‘imported’, which raises the overall level of protection granted by the host country in question. Even though IIAs may appear to be particularly constraining on paper, their actual impact on developing countries’ ability to adopt certain public policy measures depends on the enforcement of their substantive provisions. The number of ISDS cases has increased substantially over the last 15 years. Interestingly, ISDS cases are not primarily directed against least- and less-developed countries, but increasingly against middle- and high-income countries.

The very purpose of IIAs adopted in the late 1950s and 1960s was to constrain the policy space of the governments of newly independent or socialist countries in relation to expropriation or discriminatory measures against foreign investment. This one-sided nature of IIAs is rooted in the specific historical context of the late 1950s and 1960s: their sole purpose was to protect investors from capital-exporting countries against arbitrary and discriminatory interventions from host-state governments. In actual fact, outright expropriations were a temporary phenomenon of the 1960s and 1970s and so, for foreign investors, the importance of provisions regulating direct expropriation has since diminished while other provisions have become more important. Two provisions — fair and equitable treatment and indirect expropriation — stand out in this respect, as both have been most often invoked in ISDS proceedings.

Despite the important role that fair and equitable treatment standards play in ISDS proceedings, their exact meaning and interpretation remains controversial. Fair and equitable treatment contains elements such as the provision of a stable and predictable legal framework, the protection of the legitimate expectations of foreign investors and protection against discriminatory and arbitrary government conduct. Fair and equitable treatment may thus be interpreted as the international pendant to the rule of law concept in domestic legal systems (Schill 2010) and is intended to fill the gaps left by more specific IIA provisions (Dolzer and Schreuer 2008). The fair and equitable treatment requirement impacts heavily on host countries’ policy space because a wide range of actions by domestic actors — including the courts, executive and legislators — may be affected (Dolzer 2005). However, it is not only its broad meaning that is problematic. From the perspective of policy space, the main problem with vaguely drafted and wide-ranging provisions like fair and equitable treatment and indirect expropriation is their inconsistent interpretation by arbitration tribunals that leaves host countries very unsure about how to comply with their international commitments (Spears 2010).

Rules for lawful direct or indirect expropriation have been an integral part of the IIAs concluded over the last six decades. As instances of outright expropriation of foreign property are the exception today, the importance of indirect expropriation has grown significantly. After fair and equitable treatment, indirect expropriation is the standard that has been invoked most often in ISDS cases. In the case of indirect expropriation, the
legal title of the foreign investor remains untouched, but government action or a legislative act has the effect that the investor is no longer able to utilise the investment (Dolzer and Schreuer 2008). Concerns have been raised about the indirect expropriation provision because it is vaguely defined, leaving arbitration tribunals with significant room for interpretation. As such, and similar to the effects of the fair and equitable treatment standard, it enables foreign investors to challenge host-country government measures that have little to do with purely economic considerations.

There are other IIA provisions that restrict the policy space of host countries, such as national treatment or the free transfer of capital requirement. However, the purpose of these provisions is more narrowly defined and their meaning and interpretation is more straightforward. In other words, these clauses restrict host countries policy space, but they do so in a comparatively predictable manner.

As mentioned above, more recent IIAs include market access provisions and prohibit the use of performance requirements. Market access commitments mean that developing countries agree to protect foreign investors in the pre-establishment phase thus granting them free entry subject only to previously defined sectorial exceptions. These treaties also include provisions that prohibit the use of performance requirements, such as local content policies and technology transfer obligations, that often go beyond the commitments of the World Trade Organization (WTO) and, in particular, of the Agreement on Trade-Related Investment Measures. This trend to include clauses on market access and performance requirements can have serious implications for the policy space of host countries, as they are

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**Box 4**

'Treaty shopping' for the best protection standards

Almost all IIAs contain two provisions that allow foreign investors to import more favourable provisions from other investment treaties: the most-favoured-nation treatment clause and the broad definition of covered investors (Schill 2009).

**Most-favoured-nation** treatment requires that contracting parties grant each other the best treatment they have agreed to in IIAs negotiated with third countries. The most-favoured-nation clause ensures that a foreign investor obtains the best treatment that the host country grants to investors from third states. The effects of the most-favoured-nation clause are wide-ranging. In practice, it means that a foreign investor that is protected by a relatively weak IIA signed between his home country and a host country can import more favourable provisions from other IIAs signed by the host country with third countries. Numerous arbitration tribunals have interpreted the most-favoured-nation clause in this sense and have allowed foreign investors to import more favourable substantive provisions from other IIAs.

**Investor definitions** specify which investors are covered by an IIA. Investment treaties modelled on the European approach typically include very broad investor definitions. These broad definitions mean that national investors with substantial business activities in a home country are not the only ones to be protected by an IIA signed by this home country and a host country. In addition to genuine national investors, other investors can also rely on the protection of an IIA signed between a country they have invested in to bring an ISDS case against a host country. Arbitration tribunals have confirmed that subsidiaries owned by foreign companies and even shell companies can rely on the protection of another home country’s IIA with a host country. An investor who wants to invest in a host country that does not have an IIA with their home country, or that has only a weak IIA in place, can structure the investment in such a way that the investor can have recourse to another home country’s IIA that does grant the required protection. There are even cases where ISDS tribunals have allowed national investors to bring claims against their own government through a foreign subsidiary.
in effect surrendering their flexibility to adopt certain industrial policies in the future.

Another specific feature of IIAs that has serious ramifications for host countries’ policy space are the systemic interlinkages that permit foreign investors to import stronger substantive protection standards from other treaties. These interlinkages mean that it is insufficient to analyse the impact of a single treaty, but absolutely essential to assess how different treaties signed by a host country may interact. These interlinkages are the result of two provisions that are included in almost all IIAs: most-favoured-nation treatment clauses and broad investor definitions (see Box 4). The policy space of a host country government is thus not only defined by the bilateral treaty relationships with another country, but also by the most beneficial IIA signed by this host country.

As a result, most-favoured-nation clauses and broad investor definitions lead to an upward harmonisation of the level of protection granted by a host country (Schill 2009). These systemic interlinkages built into almost all IIAs make the reform of a host countries’ IIA network difficult, as foreign investors are able to bypass more restrictive treaties by ‘importing’ (see Box 4) more beneficial rules from other IIAs. Reforms of substantive provisions need to include changes to the most-favoured-nation and investor definition clauses to restrict the possibility of more generous provisions being imported from IIAs that the host country signed in the past. Until the host country has reformed all of its IIAs, treaty shopping must be factored in.

The protection standards included in IIAs are only as constraining as the instruments foreign investors have recourse to when seeking to enforce those standards in a host state. ISDS is probably the most extensive arbitration mechanism in international law. In contrast to other areas of international law, states signing IIAs give their prior consent that investment-related disputes can be arbitrated internationally. More importantly, under ISDS, foreign companies or private persons invested in a host state can bring a claim against their

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**Figure 2**

Annually and cumulatively initiated ISDS cases, 1987–2014

host state independent of the diplomatic protection provided by their home states — for example, by using state-to-state arbitration mechanisms. The intended aim of the ISDS mechanisms initially promoted by ICSID was therefore to ‘depoliticise’ the resolution of investment-related disputes (Shihata 1986).

In addition, ISDS has been adopted to ‘delocalise’ dispute resolution (Newcombe and Paradell 2009) and allow foreign investors to bypass the local court system of host states. IIAs typically allow foreign investors to seek compensation for the alleged wrongdoings of host states without having to exhaust local remedies. Foreign investors can instead rely on the procedural rules of international dispute settlement institutions, such as ICSID and UNCITRAL, to enforce the substantive provisions laid down in IIAs. The tribunals tasked with adjudicating these disputes typically consist of three arbitrators: one appointed by the claimant, one by the respondent and one by the disputing parties by mutual agreement. These tribunals are established on an ad hoc basis and arbitrators are typically chosen from a small pool of public international law practitioners and scholars. What is more, the awards of these tribunals are final; no appeals mechanism exists and they are enforceable in almost all countries. The ISDS system is therefore more akin to the system of private commercial arbitration between companies, which is problematic as ISDS tribunals decide not only on the violation of private contracts, but also on matters of public policy (Van Harten 2007).

Foreign investors are increasingly using this powerful tool to challenge host states’ actions. While ISDS mechanisms were already a mainstream feature of IIAs by the end of the 1980s (Yackee 2008), investors did not start using them on a larger scale for another ten years. Statistics on publicly known cases indicate that ISDS was occasionally used by foreign investors in the 1990s (Figure 2). However, it was a number of high-profile lawsuits filed under Chapter 11 of NAFTA at the end of the 1990s that heralded the explosion of ISDS cases. By the end of 2014, 608 ISDS cases were publicly known (UNCTAD 2015), but there may also be a considerable number of additional unreported cases. The fact that the previous two years saw the highest numbers of known ISDS claims — 59 new cases in 2013 and 54 new cases in 2012 — highlights that more and more foreign investors are using the system to their advantage. However, references to the high number of new cases in recent years are, on their own, not enough to explain the supposed legitimacy crisis of the international investment regime. For example, the rising number of dispute settlement cases in the context of the WTO, which more or less corresponds with the number of ISDS cases, is seen as a sign that the multilateral trading system is working properly and not as a sign of crisis.

Contrary to their original purpose, ISDS claims are not predominantly directed against poor developing countries with insufficient domestic legal systems. This is hardly surprising as those countries receive comparatively small volumes of foreign investment. What is surprising, however, is the fact that middle-income countries with comparatively well-functioning legal and political systems top of list of countries being sued by foreign investors (Williams 2014). The most recent figures show that developed countries are not immune from being sued by foreign investors either: around 40% of ISDS cases initiated in 2014 were brought against developed countries and a quarter of new cases were filed by EU nationals against European countries (UNCTAD 2015). This highlights the fact that ISDS is scarcely used against poorer developing countries and, instead, is predominantly deployed against middle- and high-income countries.

In light of the present criticism levelled against investment treaties and ISDS, it is important to consider the outcomes of ISDS proceedings. UNCTAD regularly releases data on ISDS cases and shows that of the 405 cases concluded so far 36% were decided in favour of the respondent state and 27% in favour of the claimant. The remaining cases were either settled (26%), discontinued (9%) or the tribunals found a breach of the treaty but awarded no financial compensation to the investor (UNCTAD 2015). These figures have been used by some to indicate that the system does not necessarily produce outcomes that disproportionately favour foreign investors (Abbot et al. 2014). Others have criticized UNCTAD’s data as not reliable because it mixes the outcomes of two distinct phases of ISDS proceedings namely the award on jurisdiction and the
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Critical decision on the merits of a case. Furthermore, despite the fact that the details of the 26% settled cases are not known anecdotal knowledge indicates that at least some of them involved payments to the investor or revocation of regulations. This assessment shows that investors face rather low entry barriers to successfully initiate ISDS cases and that they have rather good chances to achieve favourable outcomes (see e.g. Mann 2015). At the same time it is important to highlight that in those cases that have been won by the investor the vast majority of them have not been able to recover the amount of compensation initially claimed. Despite the fact that recent figures are scarce, a previous study found that, while investors on average claimed close to USD 350 million per case, the average amount awarded by the tribunals was around USD 10 million (Franck 2007). Some awards have, of course, been substantially higher, such as the widely cited USD 269 million the Czech Republic was required to pay to CME Group Inc. or, more recently, the USD 50 billion awarded in the Yukos vs Russia case, but these seem to be the exception rather than the rule.

Furthermore, critics’ claims that ISDS can be used to challenge almost every government decision or even legislative decision are overstated. The overwhelming majority of ISDS claims have been triggered by measures targeted at a small number of investors, rather than whole industry sectors or even the general public. These measures are typically undertaken by the government, and legislative and judicial decisions make up only a small proportion of these (Williams 2014). Although ISDS per se may not therefore threaten public policymaking in host countries, especially with regard to the legislative branch, host countries nevertheless face the challenge of bringing their government conduct, from the central to the local level, in line with the international commitments they have signed up to in IIAs to avoid litigation. Efforts to enhance coordination between the various branches of central and local government to ensure their actions are consistent with their IIA commitments may indeed be a complex and arduous process (Knörich and Berger 2014).

Although arbitration tribunals do not always decide in favour of the investor the mere possibility of an ISDS proceeding combined with insecurity about how key IIA standards may be interpreted can lead to a ‘regulatory chill’. In such a situation, the fear of being sued by foreign investors means that host countries avoid introducing new legislation. This claim is, however, difficult to substantiate empirically and only a little anecdotal evidence exists to support it. A recent comprehensive study on how IIAs affect public policymaking in the areas of health, safety and the environment with a focus on Canada found no convincing empirical evidence for a ‘regulatory chill’ effect (Cote 2014).

It has been argued in this section that IIAs provide foreign investors with the means to challenge a wide range of host country actions, in particular due to vaguely drafted and wide-ranging substantive provisions such as fair and equitable treatment and indirect expropriation. The system to deal with breaches of these one-sided standards is borrowed from transnational commercial arbitration. In light of the fact that ISDS tribunals are brought in to decide on executive, legislative and judicial matters of host countries, the ad hoc nature of investment dispute resolution makes them vulnerable to criticism.

Howard Mann argues that it is important to separately analyse the decisions on jurisdiction and the merits. He shows that investors win 72% of the decisions on jurisdiction and 60% of the cases that got to the merits phase. See e.g. Mann (2015).
There is no doubt that the international investment regime is currently in a turbulent transitional phase, if not in a deep institutional crisis. This is most starkly evidenced by the sharp decline in newly signed IIAs, a trend that began around the turn of the millennium and has accelerated since 2010. The examples of Latin American countries denouncing the ICSID Convention or the Indonesian and South African announcements to terminate IIAs at present seem, despite the considerable public interest they have attracted, to be the exception rather than the rule. Developing countries are continuing to sign IIAs, albeit at a slower pace and with more heterogeneous contents than in the past. The challenges these countries must address are twofold: they must update the templates they use to sign new treaties, and they must reform the network of existing treaties that often grant foreign investors wide-ranging rights of legal protection. This section describes the four main pathways states can adopt when tackling these challenges — do nothing, 'NAFTA-isation', terminate to renegotiate, and terminate to exit — and discusses their advantages and disadvantages.

At present, an abundance of criticism is being levelled at IIAs in general and ISDS provisions in particular, with civil society organisations particularly vocal in opposition. The primary triggers for this movement were the failed negotiations of the Multilateral Agreement on Investment (MAI) among member states of the Organization for Economic Co-operation and Development at the end of the 1990s and the first high-profile ISDS cases that were filed on the basis of NAFTA’s Chapter 11. Most recently, the focus has been on discussions around the benefits and drawbacks of including an ISDS mechanism in the Transatlantic Trade and Investment Partnership (TTIP), which is currently being negotiated between the US and the EU. As previously discussed, there is also a growing body of academic literature from legal scholars, political scientists and economists that questions the basic premises of the international investment regime. However, the question as to whether the international investment regime is facing a legitimacy crisis must be answered not only by looking at public and academic discourses, but also by evaluating over time the actions of states signing — or refusing to sign — IIAs.

Countries retreating from key international investment regime institutions, such as IIAs or the ICSID Convention, would be the clearest sign of crisis. If we examine the behaviour of states, the supposed legitimacy crisis has not (yet) resulted in a widespread retreat from the international investment regime (Box 5). Highly visible policy actions, such as exiting ICSID or unilaterally terminating IIAs, seem to be the exception rather than the rule as, to date, only a handful of countries have gone down that road. With regard to ICSID membership, three Latin American countries have denounced the ICSID Convention since 2007. However, far more countries have, in fact, signed and ratified the ICSID Convention during the same period. Countries are still acceding to the ICSID Convention at a constant rate after a peak during the 1990s (Figure 3). The unilateral termination of IIAs also seems to be a rather limited phenomenon, despite the high level of public attention Indonesia and South Africa have received since announcing their intention to terminate their respective IIAs. However, while the number of IIAs that have been terminated unilaterally is actually rather small, the figures for 2013 show that 27 IIAs were unilaterally terminated in that year alone, which indicates a growing trend (UNCTAD 2014c). That said, in 2013, it would have been possible to terminate any one of more than
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1,300 treaties — and by 2018 this total number of treaties is expected to reach almost 1,600 (UNCTAD 2013) — meaning the current level of termination is a marginal phenomenon.

Another sign of crisis would be countries refusing to enter into new treaties. Interestingly, the number of newly signed IIAs started to decrease when the number of new ISDS cases started to rise. This relationship is not just correlative; there is also a causal relationship between the first ISDS claims made against a country and the subsequent drop in IIAs signed by this country (Poulsen 2013). However, while 180 countries have signed IIAs, 99 have experienced at least one ISDS claim so far (UNCTAD 2015). This means that a considerable number of countries remain unaffected by ISDS claims. Also, one should be cautious about reading too much into the fact that 82 countries have not signed an IIA since 2010, as most of these countries have traditionally signed few treaties (see Box 5).

The analysis of countries’ reactions to the supposed legitimacy crisis of the international investment regime presents a highly diverse picture (see also Schill and Jacob 2012). While a handful of countries have retreated altogether from the international investment regime, others have responded by reforming their treaty templates or by simply continuing with their traditional approaches. Given that almost all developing countries signed fairly similar IIAs in the 1980s and 1990s, the more diverse policy responses adopted since the late 2000s hint that the global investment regime is in a state of transition. The sections below cluster countries reactions into four different

Box 5
Facts about the supposed legitimacy crisis of the international investment regime


To date, relatively few states have unilaterally, i.e. without the consent of their treaty partners, terminated their IIAs. These include Bolivia that terminated its BITs with the Netherlands in 2008 and its BIT with the United States in 2011, Ecuador that terminated nine BITs, and South Africa that announced its intend to terminated 11 BITs with West European countries (Carim 2015). The Government of Indonesia announced its intention to terminate its 64 BITs (Jailani 2015). The 2014 World Investment Report published by UNCTAD states that, in 2013 alone, 27 IIAs were unilaterally terminated, indicating a growing trend (UNCTAD 2014d).

Another indication for the alleged legitimacy crisis would be the widespread refusal of countries to conclude new BITs. While 111 countries continued to conclude BITs after 2010, a total of 70 countries has not signed new BITs since 2010.* However, even if these countries discontinued their BIT practice, they continue to negotiate investment rules in the context of free trade agreements. In fact, 50 countries that have not signed a BIT since 2010 have signed at least one IIA since then. Also, many of the countries that have not signed a BITs since 2010 have traditionally signed few BITs. 35 of the 70 countries that have not signed a new BIT since 2010 had signed no more than 10 BITs each by then. See: http://investmentpolicyhub.unctad.org/IIA/IiasByCountry#iiaInnerMenu (accessed on 18 August 2015).

* These numbers do not include 51 countries that have not yet signed a single IIA.
approaches — do nothing, ‘NAFTA-isation’, terminate to renegotiate and terminate to exit — and discuss the advantages and disadvantages of each approach from the perspective of developing countries.3

The ‘do nothing’ approach

In recent years, a small number of countries have continued negotiating IIAs that are modelled on the traditional European treaty template and include vague and open-ended investment protection provisions. Examples of recent treaties of this nature include the Spain–Mozambique IIA signed in 2010 and the 2011 Bangladesh–United Arab Emirates IIA (Schill and Jacob 2012). While treaties that closely follow the traditional European model may nowadays be an endangered species, a number of newly negotiated treaties selectively include more balanced provisions. UNCTAD’s overview of recently negotiated IIAs published in its 2014 World Investment Report shows that, although balanced provisions are included in all treaties, it is in particular the bilateral investment treaties negotiated among developing and transition countries that continue to adhere fairly closely to the European approach. For example, a number of IIAs signed in 2013 include largely unconstrained fair and equitable treatment and indirect expropriation clauses (the two clauses that are most often used in ISDS proceedings) and often do not limit foreign investors’ access to ISDS (UNCTAD 2014c).

What is noteworthy about this continuation of the traditional European IIA model is that this approach is mainly being adopted by developing and transition countries in treaties signed with other developing and transition countries. While the traditional promoters of this wide-ranging IIA template — namely West European capital exporters — are no longer using them, mainly as a result of the new EU investment policy (see

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3 Comprehensive and system-wide reforms are not being contemplated in this study as, at present, they are politically unviable — an example of this is the futile debate about the establishment of a multilateral investment framework (Berger 2013). However, systemic reform proposals, such as UNCTAD’s Investment Policy Framework for Sustainable Development (UNCTAD 2012), are important reference points for developing countries that can inform their thinking about how to reform their international investment treaty networks.
developing and transition countries are continuing along these traditional lines. This is a puzzling fact, as one would assume that developing countries have sufficient leeway for making sure investment treaties are development-friendly when negotiating and drafting them with other developing or transition countries, and certainly much more leeway than they would have when negotiating with developed countries. By continuing their traditional treaty practice, many developing countries are subjecting their executive, legislative and judicial actions to the risk of being sued by foreign investors. Furthermore, when developing countries make these extensive commitments to foreign investors, they cannot be reversed in the short term. Typically, IIAs remain in force for more than ten years and, even when terminated, foreign investors can have recourse to the legal protections they contain for at least another ten years.

It is a well-established fact that developing countries have signed IIAs not only due to their instrumental value as tools to promote foreign investment, but also as means to establish and improve bilateral diplomatic relations (Poulsen 2013). Many of the investment treaties that include unconstrained protection clauses may indeed be driven by such policy objectives. Independent from the contracting parties’ intentions during the negotiations, these treaties can be used by a broad range of foreign investors to invoke ISDS proceedings. Developing countries following the traditional IIAs approach should therefore reconsider their policy. Given that criticism of IIAs is intensifying in most countries, that evidence regarding the impact of these treaties on FDI is unconvincing, and that we now have 15 years of experience in dealing with the ISDS, the ‘do nothing’ approach is no longer a viable option for developing countries.

The ‘NAFTA-isation’ approach

Probably the most common response to the supposed legitimacy crisis of international investment policymaking has been to reform investment treaty templates and to apply them in the negotiation of new IIAs. This reform approach has been pursued by a number of developed and middle-income countries and emulates the policy of the three NAFTA countries. As detailed in Section 2, in response to a number of high-profile ISDS cases filed on the basis of NAFTA’s Chapter 11, the US, Canada and Mexico started to reformulate their model IIA texts in the early 2000s in order to increase their policy space to regulate foreign investments in the public interest. This more balanced approach is now being emulated by a large number of countries, thus enabling them to reform their own IIA approaches. The second largest contracting party to investment treaties, China, has introduced balanced investment provisions in many of the treaties it has negotiated since 2008. During negotiation processes, China absorbed innovative treaty language from the policies of its partner countries and this eventually found its way into Chinese investment treaties. China has been learning from countries like Canada, Mexico, New Zealand and Peru that comprehensively follow the NAFTA approach (Berger 2013; Berger 2015). The last bastion of the traditional investment protection approach was West European capital exporters and they are also switching to a more balanced approach. This is the result of the EU’s Lisbon Treaty, which entered into force in 2009 and transferred powers relating to investment protection from member states to the EU level (Bungenberg 2011; Chaisse 2012). This meant that all subsequent investment treaties would henceforth be negotiated by the EU Commission, rather than by member states individually. As a result of this shift of competency, European investment treaties must now comply with Article 21 of the Lisbon Treaty which requires that the external actions of the EU should, among other things, encourage sustainable development in developing countries with the primary aim of eradicating poverty. The Member States’ BITs did not have a normative reference framework of this kind prior to Lisbon. In addition, the Treaty horizontally extends competencies, endowing the European Parliament with a more important legislative role. As such, it is expected that the European Parliament will have a greater influence over ongoing IIA negotiations and can therefore push for these agreements to be drafted in a more development-friendly manner, in accordance with Article 21 of the Lisbon Treaty. Recently negotiated investment treaties with Singapore and Canada show that a number of balanced provisions have already been incorporated in the EU’s new international investment policy. The new mode of
investment treaty making in the EU can have positive implications for developing countries, which benefit from the introduced reforms when negotiating with the EU in the future (Berger and Harten 2012).

At the same time, as more balanced post-establishment provisions are being introduced, the US and Canada, and also economies like Japan and the EU, are pressing their partner countries to include pre-establishment provisions aimed at expanding market access for their foreign investors. Often these market access provisions are included in PTIAs. The inclusion of market access commitments in the most recent investment and trade agreements represents a challenge for developing countries. As discussed in Section 3, empirical studies have shown that these types of clauses are particularly suited to encouraging investment flows into developing countries within the framework of free trade agreements. However, by agreeing to the inclusion of market access clauses host countries give up their rights to regulate foreign investments. The advantages of introducing more balanced post-establishment provisions must therefore be weighed up against the introduction of market access clauses that have commonly featured in recent investment treaties. It is important for host countries to consider their national development strategies and ascertain precisely which sectors should be opened up in response to these strategies.

From the perspective of developing countries, NAFTA-isation is the most practical way to reform their investment policies, as most capital-exporting countries have already switched to this approach. The inclusion of refined provisions and the introduction of general exception clauses potentially decrease host countries’ liability and the risk of being sued by foreign investors. However, the NAFTA-isation approach only allows developing countries to reform their international investment policies gradually by signing new – i.e. more balanced – investment treaties or by renegotiating old treaties. As discussed below, to be able to regulate foreign investments and increase their policy space, host countries must renegotiate old treaties that offer foreign investors wide-ranging levels of investment protection. Undertaking such renegotiations will, however, depend on the willingness of the partner country and is inevitably a time-consuming effort. Furthermore, these reforms only gradually decrease a country’s risk of being hit by ISDS claims based on vague and wide-ranging provisions. Until all the old and one-sided investment treaties have been replaced by new and more balanced ones, foreign investors, by virtue of corporate structuring, have the possibility of utilising the most beneficial treaty – and it is often the older treaties that offer more extensive rights of legal protection. The most practical way to reform is the regionalisation of investment treaty making, i.e. the negotiation of investment rules negotiated within the framework of regional trade agreements (Berger 2013). However, this approach can only be successful if new, more balanced trade and investment agreements actually replace the old investment treaties in force between the members of this new regional arrangement. The replacement of old treaties by new and more development-friendly treaties has the positive side effect that the complexity of the international investment system is reduced (UNCTAD 2015).

The decisions made by a handful of developing countries to terminate their IIAs have been the focus of considerable attention, particularly among the civil society advocates, academic experts and fellow developing countries looking for alternative approaches to international investment treaty making. Examined more closely, the unilateral termination of investment treaties can serve two specific purposes: old IIAs can be terminated in order to renegotiate their terms or IIAs can be terminated in order to exit the system altogether. These two approaches serve very different political purposes and so their potential as alternative approaches for developing countries are discussed separately below.

The ‘terminate to exit’ approach

This approach has been adopted by a small number of countries like Bolivia, Ecuador and South Africa. The South African Government’s decision to selectively terminate its IIAs with European capital exporters is the most prominent example of the unilateral termination of investment treaties. South Africa rushed into signing investment treaties in the early 1990s after the collapse of the Apartheid regime in the hope of attracting foreign investment. These treaties were modelled on the European approach with its typically vague and
wide-ranging protection standards, and they included provisions on, for example, national treatment and expropriation that provided foreign investors with much more generous treatment than was afforded by national law (Schneiderman 2009). The predictable result of this hasty treaty making was a significant ISDS case filed by an Italian investor against South Africa’s affirmative action measures included in its new mining laws and seeking compensation of USD 350 million. In response, the South African Government undertook a review of its investment treaties and stopped signing new investment treaties. It also halted South Africa’s accession to the ICSID Convention. The review was finalised in 2010 and suggested that South Africa’s investment treaties should be renegotiated and, if this was not possible due to the unwillingness of the respective treaty partner, the treaty should be terminated (see DTI 2009). The South African Government subsequently adopted these recommendations and terminated its investment treaties with Belgium and Luxembourg in 2012 and Germany, Switzerland and the Netherlands in 2013. Other IIAs with European countries will also be terminated when they expire. However, given the drastic nature of this measure, it is surprising that South Africa has yet to announce when it will terminate investment treaties with developing countries, such as its IIA with China signed in 1997.

This ‘terminate to exit’ approach effectively means that a country intends to reinstate national law as the sole legal basis for the governance of foreign investments. In the South African case, the government in Pretoria introduced a new investment law, which has been criticised as being less investor friendly. The South African example shows that a host country’s decision to unilaterally terminate a substantial number of IIAs signed with capital-exporting countries can create serious friction with those countries and may, at least in the short term, negatively affect its investment climate. While a relatively attractive investment destination like South Africa may be well placed to continue attracting foreign investment, smaller and less successful economies might be more negatively affected by the unilateral termination of investment treaties. Exiting from the international investment regime cannot be achieved quickly, however, as most IIAs include a so-called survival clause that continues to provide investors with the legal protection granted in a treaty for 10 to 20 years after its termination. As such, exiting countries run the risk of severely alienating foreign investors, particularly when national investment laws are more restrictive than the provisions included in IIAs.

The ‘terminate to renegotiate’ approach

The Indonesian Government is currently considering discontinuing the 64 BITs it has signed since the late 1960s (Jailani 2015). At first sight, Indonesia’s plans may appear to be the latest in a series of moves by developing countries to retreat from the international investment regime. Looking more closely, however, Indonesia’s announcement is distinct. First of all, the discontinuation potentially applies to all of its BITs and not only to those signed with capital-exporting countries (which differs from South Africa’s practice of focusing on the termination of treaties with European Union countries). Furthermore, Indonesia’s rationale for discontinuing its bilateral investment treaties also appears to be different. Although little reliable information is available to this regard, reported statements of the Chairman of the Indonesian Investment Coordinating Board suggest that the main objective is to ensure ‘consistency between local and international laws and regulations’; to ‘streamline provisions’ and to ‘take into account various changes in Indonesia’s legal system’. Last but not the least, although Indonesia wants to terminate its BITs, it remains committed to the investment rules negotiated in the context of the Association of Southeast Asian Nations (ASEAN).

Negotiated since the 1960s, Indonesia’s investment treaties vary considerably — a problem that affects many (particularly developing) countries. BITs made in earlier periods remain in force and it is particularly these older treaties that seem to have the most serious consequences for Indonesia, as evidenced by two

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5 EuroCham, ‘EU Delegation meets with Chairman of BKPM’, EuroCham News, 28 May 2014.
ongoing investor–state arbitration proceedings. One of Indonesia’s oldest BITs, the 1976 Indonesia–UK investment treaty, has now been used twice as a basis for bringing an action against the Indonesian Government at ICSID. Inconsistencies between these old and wide-ranging investment treaties and national laws are almost inevitable and potentially lead to ISDS cases (Knörich and Berger 2014).

Developing countries thus face a double challenge: ensuring consistency within the body of investment treaties and then between investment treaties and national laws and regulations. The negotiation of new, more balanced IIAs is an important and necessary step, but it is far from sufficient to deal with these challenges. For example, despite the Indonesian Government’s recent attempts to negotiate more balanced investment rules in the context of ASEAN and, in so doing, potentially enhance its policy space, considerable risks remain because the old bilateral investment treaties remain in force. This problem is shared by other developing countries, such as Myanmar, that are engaged in regional investment rule making and have a number of old and less-balanced BITs in place (Bonnitcha 2014b). As argued above, investment treaties create various systemic linkages that allow foreign investors, with a little bit of legal creativity, to bypass the less investor-friendly rules of recently concluded investment treaties. Developing countries therefore need to find ways to reduce the liability resulting from the old, less-balanced investment treaties that remain in force. In addition to the renegotiation of treaties, another possibility to hedge against unfavourably negotiated terms of older investment treaties that is being discussed at the moment is the issuing of interpretative notes by the contracting parties (Johnson and Razbaeva 2014). This approach is a comparatively cost-effective way of re-balancing as the contracting parties do not have to re-negotiate whole treaties. It is however up to the arbitrators whether they take these interpretative notes into account or not.

A necessary first step is therefore the contemplation of a new model treaty text that takes domestic laws and policy priorities into account. However, as most countries have negotiated a large body of their investment treaties within in a rather short time span — typically during the 1990s — a large number of treaties would have to be terminated and renegotiated en masse within only a few years. This is a formidable task, even for a country like Indonesia that has a relatively experienced and capable bureaucracy, and thus it may prove too difficult an endeavour for smaller and poorer developing countries. To do this requires a well-thought-out strategy that takes into account the government capacity required to renegotiate multiple treaties at the same time, the potentially adverse effects on the confidence of foreign investors and the preparedness of partner countries to renegotiate. Such an ambitious systemic approach most likely exceeds the capacities of most developing countries and thus often does not constitute a viable alternative.

Despite these well-founded reasons to attempt a systemic overhaul of a host country’s investment treaty network, the ‘terminate to renegotiate’ approach currently pursued by Indonesia is a costly and time-consuming effort, not only for the government requesting it, but also for its partner countries.
The way forward for developing countries and development policy

This study has argued that the international investment regime is in a phase of turbulent transition. Developing countries have responded differently to the supposed legitimacy crisis of international investment policymaking. Their responses range from doing (almost) nothing or emulating the NAFTA approach that combines balanced investment protection standards with market access clauses, to terminating investment treaties. As discussed in the previous section, each approach has its specific benefits and drawbacks. Developing countries signed a multitude of investment treaties from the late 1980s to the early 2000s following a ready-made and simple to implement template. Continuing this approach is no longer viable given the considerable liability risks these treaties potentially entail. Policymakers in developing countries should therefore no longer question whether to reform their international investment policy, but instead should examine which reforms to adopt and how these reforms can best be implemented. The evolving complexity of international investment rule making requires that international development cooperation pay closer attention to and more heavily engage in this changing field of global economic governance.

The first challenge policymakers in developing countries face is simply to get the contents of IIAs right. New treaty templates should be drafted in a way that takes into account international experience with ISDS cases. This is important as these cases reveal how investment treaties might be used by foreign investors — successfully or not — to challenge the executive, legislative or judicial actions of host states. Furthermore, treaty templates should reflect national policy priorities enshrined in the body of national investment-related laws and regulations. A number of developing countries and regional organisations, such as the Southern African Development Community, have already redrafted their treaty templates, which means that there is huge potential for South-South cooperation and mutual learning. This can be facilitated by bilateral donors in cooperation with multilateral organisations like UNCTAD that have built up considerable capacity-building expertise.

Once developing countries have drafted appropriate treaty templates that reflect their national policy priorities, they need to decide on the context in which to renegotiate investment rules. In other words, they must decide at which level the investment rules should be negotiated (bilateral, regional or multilateral) and which form of treaty (stand-alone IIA or an investment chapter in a free trade agreement) would best serve their interests. For example, the most recent research seems to suggest that market access provisions, particularly those included in free trade agreements, can have a significantly positive effect on FDI. More nuanced research, however, is needed to substantiate this finding and also to evaluate the effects of these provisions on the policy space of host countries.

No matter which approaches developing countries adopt (with the exception of the ‘do nothing’ approach), the reform of their international investment policies and treaties will most likely be a step-wise process, which means that these countries will not be able to instantly mitigate the risks of being sued by foreign investors through the ISDS. Alongside the need to increase the capacity of their bureaucracies, developing countries must develop strategies to avoid investor–state arbitration by implementing alternative methods of dispute resolution (UNCTAD 2010). Again, bilateral and multilateral donors should step up their activities to support developing countries in this area. Furthermore, the reform of multilateral arbitration forums and institutions should be high on the decision-makers’ agenda in developing countries. By introducing comprehensive transparency requirements, UNCITRAL has taken a first step in this direction. Other arbitration institutions should follow suit. In addition, much bolder steps should be considered and discussed, such as the establishment of appeals mechanisms or even an international arbitration court.
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