

Chapter 11 of NAFTA: Investor- to-State dispute settlement procedures

October 10-12 2006

Goals of investment agreements

- Basic goal is to promote foreign investment by:
 - i) Giving foreigners the right to invest in markets.
 - ii) Treating foreign investment as well as domestic investment (e.g. regarding taxes).
 - iii) Protecting foreign investment from government actions that decrease its values (expropriation).

Investment requires (large) *sunk* costs and tends to be more risky than trade in products, therefore requires special protection.

History of multinational international investment treaties

- (Non-ratified) International Trade Organization contained provisions promoting liberalization of both trade and investment.
- GATT incorporated trade provisions but not investment provisions
- Late 90's unsuccessful Multilateral Investment Agreement (Favored by EC and US, resisted by developing nations.)
- Early 2000's continued attempts to introduce Investment Agreement into WTO (and resistance to these attempts).

Facts about Bilateral Investment Treaties (BITs)

- Over 2000 BITs.
- These became important during post WW II period when many former colonies were nationalizing foreign investment.
- Dispute tribunals: United Nations Commission on International Law and the World Bank's International Settlement for Investor Disputes.
- Historically these were used to arbitrate disputes regarding narrow commercial interests, where strict confidentiality made sense.
- These *fora* are now used to arbitrate Chapter 11 complaints

Dispute tribunal and appeals

- Tribunal consists of three members, one chosen by each party and the third chosen by compromise
- Only appeals process is via the domestic court system in which the tribunal is legally located. (e.g. Mexico appealed Metalclad case in a British Columbia court. The dispute between Mexico and US firm was eventually decided in Canadian court.)

NAFTA and Chapter 11 (the “Investment Chapter”)

- Chapter 11 of NAFTA was used as model for the failed Multilateral Investment Agreement.
- Preamble of NAFTA agreement states that objectives include the preservation of public welfare, the promotion of sustainable development, strengthening and enforcing environmental regulations.
- Do the investment rights in Chapter 11 conflict with these goals?

Mexico's view of Chapter 11 of NAFTA

- By reducing risk, ITs (presumably) promote investment.
- Prior to NAFTA (ratified in 1994) Mexico had undertaken unilateral measures to create a more open economy.
- One view is that Mexico favored Chapter 11 of NAFTA a means of committing to this open policy (tying the hands of future governments), thereby encouraging investment.
- Another view is that Mexico was bullied in accepting Chapter 11, along with environmental side agreements, as the price of greater access to US markets.

Why does Host want to sign an IT? (The benign view)

(“Host” receives investment, “Source” provides investment.)

- IT helps to solve a “time-consistency problem”. Host would like to promise to treat investment well, in order to attract investment. Once the investment is *sunk*, Host has temptation to extract “rents” or expropriate. Anticipating this temptation, Source is reluctant to invest.
- Both Host and Source benefit from investment and both would be better off if Host could credibly commit to behave well.
- ITs punish Host for bad behavior, decreasing incentive to behave badly. ITs are a “commitment device”.

ITs do more than protect sunk investments (*ex post* restrictions)

- Some ITs (including Chapter 11) also restrict government actions taken *before* investment is made. (*ex ante* restrictions)
- “Right of establishment“ rules make it illegal for a county to insist on certain requirements, such as minimum export provisions, minimum re-investment of profits. (Those rules might apply even if domestic firms face these kinds of obligations.)

Distinction between *ex post* rules and *ex ante* rules

- Why should a Host want to tie its hands *before* investment (*ex ante*)? IT might reduce the bargaining chips that a host country has, making the bargain (vis a vis the Source, for a particular investment) less favorable to Host.
- Host might still benefit from this kind of *ex ante* restriction, e.g. (a) to rein in corrupt Host officials; (b) to commit future policymakers to a liberal policy; (c) to convince Source that future investments (possibly complementing current investment) will be attractive.

Asymmetry of ITs

- ITs restrict Host's behavior (possibly benefiting Host).
- ITs do not restrict Source behavior, e.g. Source can shop around leading to "tax competition" amongst Host nations. (Is there anything wrong with "shopping around"? Answer partly depends on whether equilibrium outcome is competitive, or the result of a bargaining game.)
- ITs protect "investor rights". They do not offer protection for rights of those who might be adversely affected by investment, e.g. environmental effects. Does it make sense to include those rights in an IT?

Empirical evidence of effects of ITs

- Do ITs actually increase FDI?
- (i) Regressions fail to find significant effect of ITs on bilateral trade.
- (ii) Other regressions find that ITs have statistically significant effect on multilateral (as distinct from bilateral) investment. (Possible explanation: Signing IT sends signal to all investors that Host will treat investment fairly.)
- Recent evidence finds that evidence in (ii) may be spurious due to use of inadequate statistical model

Empirical evidence, continued

- Measures of corruption and rule of law are statistically significant in explaining FDI.
- Detecting influence of IT on investment is a hard empirical problem, because IT may not have an immediate effect.
- The “lagged effect” of IT may differ across countries, and be hard to identify using panel data.
- There is stronger empirical evidence that larger bilateral FDI stocks increase chance that Host and Source sign BIT. In this sense, ITs are signed as a result of FDI. That is, “FDI causes ITs” rather than the reverse.

Why might FDI “cause” (i.e. precede) BITs?

- BITs protect existing stock of FDI, not just new FDI.
- Source has stronger incentive to push for BIT the larger is its stock of FDI in Host. Larger existing stock makes BIT less attractive for Host.
- Individual investors may be willing to undertake investment if they anticipate that future BIT will be triggered by large aggregate FDI stock.
- In this case, BIT follows FDI (consistent with data), but the (rational) anticipation of BITs promotes investment.
- (It is possible that the event x happens before the event y , but nevertheless y contributes to x .)

Investor-to-State vs. State-to-State disputes

- International trade disputes are “State-to-State”.
- US “Byrd Amendment” gave private parties a piece of the action by giving “harmed party” a portion of anti-dumping duties.
- This law creates dangerous incentive problem. WTO ruled that it was illegal.
- IT treaties, governing investment disputes, are Investor-to-State.

Pros and cons of investor-to-state (ITS) provision

- States may be willing to protect only the interests of powerful constituents. The ITS provision de-politicizes the decision.
- Investors need to consider only their own interests, whereas states need to consider competing interests. ITS provision increases likelihood of complaint.

Foreign investors and domestic investors

- A major point of ITs is to ensure that foreign investors are treated as well as domestic investors.
- Foreign investors have option to bypass domestic courts and take complaint to international tribunal.
- This option favors foreign over domestic investors. Should there be offsetting obligations for foreign investors?

A story

- A foreign firm and a domestic firm are considering undertaking a project that might cause environmental damage. IT requires host to treat two firms identically at pre-investment stage: “right of establishment”. Only one firm invests.
- The investment *might* cause environmental damage. (uncertainty)
- If damage occurs, and domestic firm had invested, policymaker can tax the firm to clean up.
- Domestic courts will decide whether tax is fair.

The story, continued

- If damage occurs and Foreign firm had invested, the Host knows that the firm could complain about the ex post environmental tax to international tribunal (or to domestic courts). The firm would choose the tribunal only if it thinks that the tribunal is more likely to render a favorable (to the firm) judgment.
- Host faces more risk when Foreign firm makes investment. (The risk is that Host will not have tax revenues to clean up damage.)

The story (end)

- The IT gives the Source investor (some) implicit insurance, not enjoyed by domestic investor.
- Should the Host be allowed to make Source investor pay for this “insurance”, e.g. by demanding stricter environmental standards when the investment is made?
- The “right of establishment” in ITs makes it difficult to extract this kind of “insurance premium”. Foreign and domestic investors must be treated equally.

Summary of story

- Domestic and foreign investors operate in different legal environments after investment has been made.
- The requirement that they operate in the same legal environment before the investment is made can create an imbalance that favors the foreign investor.
- Of course the point of ITs is to make a level playing field for foreign and domestic investors

Who is the “state”?

- The “state” is the national government that signed the treaty (e.g. Mexico or the US), not the level of local government that created the law that the investor objects to.
- National governments are thus responsible for local actions, but they might not have the same incentive to defend those actions (e.g. for a local environmental problem).

Who is an “investor”?

- An investor is anyone who makes an investment. Definition of investment is very broad.
- It includes shares in a business, loans to a business. In S.D. Meyers, tribunal ruled that "market share" is an asset that qualifies as an investment. That is, access to a market is considered an investment.
- Access to a market would typically be considered under trade rather than investment rules. Some people see Chapter 11 as providing a means for trade disputes to be treated as investor disputes.

Chapter 11: a way to shift trade disputes into investor-dispute arena?

- Chapter 11 has created the opportunity to transfer disputes from state-to-state arena to the investor-to-state arena.
- Some of the investment disputes can also be viewed as trade disputes.
- Investment and trade blend together, because a trade restriction is likely to affect the value of investment, particularly if "investment" is understood in very broad terms, e.g. as a property right to a market share.

Summary I

- Many BITs, and Chapter 11 of NAFTA, permit investor-to-state (as distinct from state-to-state) claims.
- Previous BITs dealt with narrow commercial disputes, whereas Chapter 11 disputes have involved questions of broad public policy.
- For Chapter 11, the "state" is the party of NAFTA, not a local government level. (The complaint may have arisen from actions taken at the local level.)

Summary II

- The cases are heard by a three panel board.
- The deliberations are confidential (A NAFTA tribunal said that a party is free to release information, but urged restraint so that process could take place outside the glare of publicity.)
- There is no requirement of public notification that a complaint has been initiated, so a relevant part of the government might not know about it.

Summary III

- Chapter 11 provides the possibility of importing a trade dispute into the investment arena. For example a prohibition against imports (apparently a trade issue) might result in decreased value of an investment.
- Chapter 11 restricts a government's ability to expropriate an investment. This restriction helps to solve a time-consistency problem. By making the investment climate safer, it can benefit both the host and investor.

Summary IV

- Chapter 11 also limits a government's ability to place conditions on investment, known as "performance requirements" (e.g. minimum content requirement, restrictions on repatriation of profits).
- These limitations remove bargaining chips from host country. They may be a guard against local corruption. They may encourage current investment because they create an attractive environment for future complementary investment.

Summary V

- Investors have choice of where to invest, and shop around for a good deal -- often in the form of tax breaks. There is no restriction on investors' ability to use this bargaining chip.
- Chapter 11 protects investors' rights. This protection is not balanced by a protection of other objectives, i.e. environmental objectives.