Regulatory Takings and Environmental Regulation in NAFTA's Chapter 11*

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Abstract

Expropriation clauses are ubiquitous in international investment treaties, and have prompted several compensation claims from investors hurt by new environmental regulations. An argument in favor of expropriation clauses is that they solve several post-investment moral hazard problems such as hold-ups. However, we show that expropriation clauses can also interact with co-existing National Treatment clauses in a manner that hinders investment. We show that a police powers carve-out for environmental regulation can recover some of these investment opportunities.

Keywords: foreign direct investment, regulatory takings, expropriation, NAFTA, National Treatment, environment

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1 Introduction

More than a decade after its passage, one of the most controversial elements of the North American Free Trade Agreement (NAFTA) is its chapter on investment: Chapter 11. The original aim of Chapter 11 was to promote investment, particularly in Mexico, by providing increased security and transparency to foreign investors. The "investor-to-state" provision of the chapter entitles investors to take expropriation claims against the host country directly to international courts. On paper, NAFTA's Chapter 11 defines expropriation broadly: it includes not only direct measures such as nationalizing industries, but also 'creeping' expropriation, or 'regulatory takings', that arise when governments impose new regulations and restrictions on firms' activities. This broad definition of expropriation has led to governments being sued for such actions as banning a polluting petrol additive (Methanex vs. US) and refusing to permit a hazardous waste facility (Metalclad vs. Mexico).

Not surprisingly, the expropriation clause has been contentious. Critics contend that it benefits large multinational corporations at the expense of states' sovereign rights, the environment, and the public good. Sensitive to the political implications of their decisions, many of the tribunals adjudicating the NAFTA cases have been reluctant to apply the broadest definition of expropriation. Some tribunals have accepted a 'police powers carve-out' from the definition of expropriation, which means that states do not have to compensate foreign investors for injury arising from bona fide, non-discriminatory regulation for the public good.

This paper examines the equity and efficiency implications of a police powers carve-out. Although we draw much of our motivation from NAFTA, there are currently over 2200 bilateral investment treaties (BITs) globally[1] and so we set our analysis in the institutional context of modern investment treaties. Almost without exception, these treaties contain clauses mandating equitable treatment, i.e. Most Favored Nation (MFN) and National Treatment clauses. These clauses can interact with expropriation clauses to create barriers to efficient bargaining between host and investor in the pre-investment stage. Inefficient bargaining can, in turn, prevent investors and host governments from undertaking and allowing, respectively, some mutually beneficial projects. We show that a police powers carve-out can recover some of these opportunities, and may promote welfare and be both Pareto welfare-improving.

[1] Almost all of these 2200 BITs contain expropriation clauses similar to that in NAFTA, as do the recently signed Central American - Dominican Republic Free Trade Agreement (CAFTA-DR) and the draft Free Trade Agreement of the Americas (FTAA)

The basis for this result is straightforward. U.S. courts (for example) have largely rejected the theory of regulatory takings. If international tribunes accept this doctrine by adopting a broad interpretation of expropriation, the investor-to-state provision of BITs would give foreign investors rights not enjoyed by domestic investors. Foreign investment would then create more risk for the host (relative to domestic investment), because the need to provide compensation makes regulating foreign investment more costly. The requirement of National Treatment makes it difficult for the host to require a side-payment in order to offset this additional risk. Thus, even though a strict definition of expropriation and a requirement of National Treatment both solve incentive problems when viewed individually, their combination can create inefficiencies.

The most familiar argument for including an expropriation clause in an investment treaty is that it solves the hold-up problem. The hold-up problem occurs when the host wants to expropriate the assets of foreign investors after they sink their up-front costs. Wary of hold-ups, investors may forego investment in the first place. Signing a treaty with an expropriation clause is one way a government can pre-commit not to expropriate foreigners' assets. Markusen (2001) discusses the costs and benefits of commitment for developing countries wishing to gain from Foreign Direct Investment (FDI).

The hold-up problem occurs where the host attempts to capture rent from a project. Even when the host's objective is to solve a legitimate public problem, and not to capture rent, it may behave inefficiently when the investor is a non-citizen. Consider environmental regulations that decrease a firm's profits, which investors may label *creeping expropriation* or *regulatory takings*. When a government weighs the benefits and costs of a new regulation, it may ignore the regulation's impact on profits repatriated by foreigners. Consequently, when viewed from a global welfare perspective, governments may regulate foreigners' activities with excessive zeal. By forcing governments to compensate investors for any costs arising from regulation, expropriation clauses can induce *cost-internalization*, eliminating excess regulation and thereby promoting investment. Cost-internalization is the leading justification among legal scholars for U.S. Fifth Amendment's compensation mandate (Been and Beauvais, 2003). The need to create incentives for cost-internalization is likely to be greater when dealing with foreign (relative to domestic) investment.

The hold-up and cost-internalization problems can be obstacles to governments credibly pre-committing to treat foreign-owned assets in a (globally) efficient manner *after* the investments have already been made. Expropriation clauses provide a remedy for these post-investment inefficiencies.

Compensation rules that are applied to regulatory actions have distribution as well as efficiency effects. Conditional on the investment already being made (i.e. ex post), the host bears all risks associated with the project and may even incur losses. For example, a particular project might be discovered to create environmental damages that require costly mitigation. If this occurs under a strict definition of expropriation, the host suffers environmental damage and/or costly cleanup, or it regulates and pays compensation to the foreign firm. The prospect that a host nation is left bearing all the risk from overseas investment is at the heart of public dissatisfaction with the expropriation clauses in modern investment agreements.

One solution is for the host to be exempted from paying compensation when its actions are a legitimate use of the host's police powers to protect the public good. That is, governments might be granted a police powers carve-out from the expropriation clause.

If the host and investor can bargain efficiently in the pre-investment period, a police powers carve-out is unnecessary. For example, if the host can make the right to invest conditional on a side-payment from the investor, then the host can assure itself non-negative expected value from the project, and will be no worse off (in expectation) from any project that it actually allows to take place within its borders. If the bargaining is unrestricted and there are no information asymmetries, the expropriation clause will also remain globally ex ante efficient.

In practice, however, there are numerous obstacles to hosts and investors efficiently bargaining over shares of a project's rents. Seemingly unrelated clauses ubiquitous in modern investment treaties may themselves be obstacles to bargaining. Perhaps the most important are the Most Favored Nation (MFN) and National Treatment clauses, which we discuss in greater detail in Section 2. Briefly, these clauses dictate that host governments may not treat investments from signatory nations any less favorably than they treat investment originating from non-signatory nations or the host nation itself, respectively. For example, the host nation cannot levy a higher tax rate on foreign investors than it applies to domestic investors. Such restrictions impair a host's ability to bargain with overseas investors. If a project is risky—for example the environmental risks associated with the project are substantial—the host may need sizeable up-front compensation in order to be willing to bear all the project's post-investment risk. (When domestic investors finance the project, the government's ability to regulate without compensating causes the investor to bear some of the environmental risk.) If the requisite compensation exceeds the taxes levied on domestic equivalents, the host cannot demand this compensation without violating the National Treatment principle. If the host accepts a smaller payment from the foreign investor, the host's expected payoff from the project may be negative. If the host raises the tax it levies on domestic investors, it suffers the deadweight loss associated with distortionary domestic taxation. Thus, equitable treatment clauses impose restrictions on efficient bargaining between the host and investor.

If the constraints on first stage bargaining are severe, then the host may not want the foreign investment to occur. Consequently, the impact of the expropriation clause on the level of investment permitted will depend on the host's ability to screen what it considers risky investments.

Some multilateral investment agreements, including NAFTA, provide concrete language guaranteeing strong 'rights to invest.' Such language prevents the host from cherry-picking amongst potential investment projects.[2] The result is that hosts may have to accept investments even if they expect to lose from these investments because of a high risk of environmental harm and a need for regulatory action. When there is little or no police powers carve-out, investment agreements such as NAFTA's Chapter 11 may mean that the host receives more foreign investment, but benefits less from it.

Other multilateral investment treaties with weaker rights to invest allow governments to cherry-pick by designing policies that screen risky projects. With such treaties, a police powers carve-out may recover opportunities that would be rejected in the presence of a broadly defined expropriation clause. Because the carve-out grants the host government an option to protect itself should a project turn out to be harmful, the carve-out eliminates the need to reject risky projects or exempt risky sectors (from the investment treaty) ex ante. Alternately, for NAFTA signatories who cannot arbitrarily reject proposed projects, a carve-out can ensure that the host's expected benefit from incoming projects is non-negative.

How generous should a carve-out be? Uncertainty as to the true size of environmental damages (and whether they are even positive) is unavoidable. Should investment treaties exempt host governments from paying compensation for regulatory takings any time there is a hint that the environment is being damaged? Or should a carve-out be granted only when there is

[2] Instead, NAFTA signatories may declare certain sectors exempt from National Treatment and Most Favored Nation Treatment; measures affecting these sectors are listed in NAFTA Annexes I and II. NAFTA signatories may also list sectors (in Annex III) in which a signatory reserves the right to ban investment outright. Only Mexico has exercised the right to reserve named activities for the state; amongst Mexico's named sectors are oil and gas refining and exploration, and electricity and nuclear power generation.

broad scientific consensus that damage is occurring? Our paper identifies the distributional and investment-promoting impacts of a narrow (versus generous) police powers carve-out. Perhaps surprisingly, we find that, over some range, narrowing the police powers carve-out has no impact on investment levels. In that circumstance, narrowing the carve-out does serve to transfer rents from the host to the investor. In such cases a narrow carve-out cannot be justified on the grounds of efficiency, but should be judged for its fairness.

The literature on the hold-up problem in investment includes Grossman and Hart (1986) and Noldeke and Schmidt (1995); see Schmitz (2001) for a recent survey. Cost-internalization (or lack thereof) is often a central ingredient in research on the race to the bottom in environmental regulation ((Markusen, Morey, and Olewiler 1995),(Levinson 1997)). Markusen (2001), discussed above, and Turrini and Urban (2000) are among the few theoretical analyzes of the economics of international investment agreements. The latter authors suggest that developing countries are reluctant to participate in a multilateral investment agreement (such as the one proposed at the Singapore Ministerial meeting of the World Trade Organization) because they reduce the amount of rent host states' capture from each investor. The empirical literature finds little conclusive evidence that bilateral investment treaties (BITs) promote FDI. See, for example, Hallward-Driemeier (2004), Neumayer and Spess (2004) and Tobin and Rose-Ackerman (2005).

We depart from prior research on international investment treaties by explicitly modeling the interaction between expropriation clauses and the bargaining constraints arising from equitable treatment clauses. We identify conditions under which a broad expropriation clause is efficient, but, for equity reasons, may be undesirable. We also identify conditions under which a police powers carve-out can be joint-welfare improving and investment-promoting.

The remainder of the paper is laid out as follows. The next section discusses important institutional details of investment agreements in order to justify the relevance of our model and results. Section 3 introduces a two-period model and examines the equilibrium level of regulation occurring post-investment. Section 4 presents the bargaining and investment stage, where we assess the efficiency and equity of a BIT with a narrow versus generous police powers carve-out. Section 5 concludes.

2 Background and Institutional Context

This section provides additional detail on the form of NAFTA's expropriation clause, on some investor-to-state cases that have been heard and judged by tribunals, and on the institutional details that, we argue, limit efficient first-stage bargaining between potential hosts and investors.

NAFTA's Article 1110 governs expropriation and compensation. This article states

> 1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:
>
> (a) for a public purpose;
>
> (b) on a non-discriminatory basis;
>
> (c) in accordance with due process of law and Article 1105(1) [fair and equitable treatment]; and
>
> (d) on payment of compensation in accordance with paragraphs 2 through 6 [detailing the size and currency of compensation payments].
>
> 2. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.

Thus according to Article 1110, even if the host's actions are for a public purpose, non-discriminatory, and in accordance with due process, they are still subject to compensation requirements. This article adopts a broad definition of 'regulatory takings' or indirect expropriation.

NAFTA's expropriation clause has prompted several investors claims for compensation; claims are arbitrated by either the International Centre for Settlement of Investment Disputes (ICSID) or United Nations Commission on International Trade Law (UNCITRAL). Below, we briefly describe the salient features of three of these claims. We focus on case features that guide our modeling choices in Section 3.

Ethyl Corporation v. Canada. (See Canada Department of Foreign Affairs (????), Environment Canada (????), Warner (????), and anonymous (????).) Ethyl Corporation claimed that the Canadian federal government's proposed ban on imports and interprovincial transport of the gasoline additive MMT (methylcyclopentadienyl manganese tricarbonyl) violated NAFTA articles 1102 - National Treatment, 1106 - Performance Requirements, and 1110 - Expropriation and Compensation. Ethyl Corp. emphasized that the ban would benefit producers of competing oxygenates (such as ethanol and MTBE), and that it was possible for MMT to be used throughout Canada if manufacturing plants were established in each province. On this basis Ethyl Corp. claimed that the ban was arbitrary and intentionally discriminatory toward Ethyl Corp., which was the sole supplier of MMT in Canada. In its defense, the Canadian government claimed that the ban was motivated by health risks associated with manganese emissions as well as air quality concerns due to damage MMT may cause to the catalytic converters in cars. Canada also noted that MMT use in unleaded petrol is banned in much of the U.S. as well as in parts of Europe. However, because Canada banned import and transport of MMT, rather than *use*, the government's position was weakened. Allegedly, Canada's own laws prevented it from banning MMT use because the responsible government agencies had found insufficient evidence of either the claimed environmental or health effects[3].

Ethyl Corp. submitted a claim for $251 million to an UNCITRAL panel on the basis that the Canadian government had contravened Chapter 11 of NAFTA. Anticipating that the panel was likely to find against it, in July 1998 the Canadian government reversed the ban on MMT import and transport, paid Ethyl corp. $13M in legal fees and damages, and signed a letter stating that MMT is not known to be hazardous and does not impair motor vehicle function.

Metalclad Corp. v. United Mexican States (See U.S State Department (????) and ICSID (????).) The Metalclad Corporation, a U.S. waste disposal company, claimed that Mexico breached NAFTA Articles relating to expropriation and standards of treatment. It asserted that a municipal government in Mexico wrongfully refused to permit Metalclad's subsidiary to open and operate a hazardous waste facility that Metalclad had built. Metalclad claimed the project was built in response to the invitation of certain Mexican officials and that the project met all Mexican legal requirements. Metalclad further claimed that an ecological decree, made by the State government after Metalclad filed its initial claim against Mexico, constituted expropriation. The ecological decree made the area around and including the landfill a preserve for cacti and effectively prevented the landfill from ever being able to operate. Metalclad sought damages of US$43,125,000 "plus damages for the value of the enterprise taken."

[3]The U.S. EPA had also initially banned the sale of MMT but was forced to allow it by a domestic court ruling.

In August 2000, the ICSID tribunal concluded that the Mexican government's actions constituted expropriation and awarded Metalclad $16.7 million. Although the British Columbia Supreme Court later set aside part of the award, it upheld the NAFTA tribunal's finding that the State government's ecological decree constituted an indirect expropriation.

Notably, the $16.7 award reflected Metalclad's assessment of its costs for developing the landfill, not the value of the operation. This award amount appears inconsistent with language in NAFTA article 1110, paragraph 2, which states that compensation shall include asset value (which incorporates the present value of the stream of expected future profits). Another notable feature of the Metalclad case is that the Mexican government was held liable for the actions of its political subdivisions: the municipal agency charged with granting use permits and the State governor who declared the ecological decree.

Methanex Corp. v. United States of America (See U.S. Department of State (????) and UNCITRAL Tribunal (????).) Methanex Corporation, a Canadian marketer and distributor of methanol, alleged injuries resulting from a California ban on the use or sale in California of the gasoline additive MTBE (Methyl Tertiary Butyl Ether), which uses Methanol as an ingredient. Methanex contended that a California Executive Order and regulations banning MTBE expropriated parts of its investments in the United States in violation of Article 1110, denied it fair and equitable treatment in accordance with international law in violation of Article 1105, and denied it national treatment in violation of Article 1102. California claims that the ban on MTBE was enacted in order to protect public health and prevent water pollution. Methanex assserted that the Californian action resulted from political lobbying by the U.S. domestic ethanol industry, a competitor in the gasoline additive market. Methanex further contended that the regulations were not justified on environmental grounds and that there existed less drastic means of addressing the environmental issues.

Methanex claimed damages of $970 million. On August 3, 2005, the Tribunal issued a Final Award, dismissing all of Methanex's claims. The Tribunal dismissed the expropriation claim on the grounds that the MTBE ban was the result of due process and for the public good: "...as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable..." (UNCITRAL Tribunal, p. 278). This language indicates that a police powers carve-out is consistent with NAFTA's Chapter 11, at least in the eyes of this particular tribunal.[4] The Tribunal also ordered Methanex to pay the United States' legal fees and arbitral expenses of approximately $4 million.

2.1 Institutional Barriers to Efficient Bargaining

This subsection provides additional detail on institutional features common to many multilateral investment treaties, including NAFTA's Chapter 11.

2.1.1 Most Favored Nation and National Treatment

Like many other investment agreements, Chapter 11 specifies explicit minimum treatment standards, areas in which this treatment must be afforded, and exceptions to the treatment standards. Compared to most BITs, NAFTA's National Treatment standard covers more aspects of investment. Article 1102: National Treatment states:

> 1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.
>
> 2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

Article 1103: Most-Favored-Nation Treatment is identical to these first two paragraphs of Article 1102 with the phrase "to its own investors" replaced by the phrase "to investors of any other Party or of a non-Party".

Noteworthy features of Articles 1102 and 1103 are that the host's equitable treatment obligations begin even before ground is broken for a new project: National and MFN Treatment rules apply during "establishment" and "acquisition". Thus, the principle of National Treatment precludes the host nation from demanding that foreigners pay up-front transfers in order to secure the right to invest.

[4] The UNCITRAL panel's need not, however, create a precedent by which all future expropriation claims will be judged. The practice of Stare Decisis (letting precedent decisions dictate future legal rulings), is not followed in international law to the same extent as in the courts of some countries, notably the United Sates. [[[Reference]]]

2.1.2 Political subdivisions

Investment treaties involving the US (unlike many treaties to which the US is not a signatory) extend the treaty conditions to political subdivisions of the signatory governments. NAFTA's Article 105: Extent of Obligations states:

> The Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments.

Chapter 11 contains some exceptions to this rule. Article 1108 exempts local governments from the requirements of Articles 1102 (National Treatment), 1103 (Most-Favored-Nation Treatment), 1106 (Performance Requirements) and 1107 (Senior Management and Boards of Directors). However, as the Metalclad case showed, local governments are not exempted from the expropriation conditions in Article 1110.

The extension of Chapter 11's requirements to political subdivisions is relevant to this paper because it means that the political entity (e.g. state or local government) whose regulatory actions may lead to claims of expropriation is not necessarily the same entity with the power to negotiate the conditions of entry for the foreign investment in question (e.g. federal government). This split makes it even more unlikely that the host will be effective in bargaining for an extra share of surplus to compensate for the environmental risk which it bears as a result of the expropriation conditions.

3 The model

We develop a two stage model of environmental regulation and investment in the presence of a pre-existing bilateral investment treaty (BIT). In the first stage the host and the investor bargain over the size of the tax payment the source will make to the host conditional on the host doing nothing later that decreases the value of the project for the investor. When bargaining in the first stage, the parties take as given the terms of the BIT, including the size of any police powers carve-out, and any other investment clauses such as National Treatment and 'rights to invest'. After bargaining is finished, the source and host simultaneously decide whether to undertake and allow, respectively, the project.