



Assessing the Impacts of Investment Treaties: Overview of the evidence

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Acronyms and Abbreviations

BIT	Bilateral investment treaty
CETA	Comprehensive Economic Agreement between Canada and the European Union
EU	European Union
FDI	Foreign direct investment
FTA	Free trade agreement
ICSID	International Centre for Settlement of Investment Disputes
ISDS	Investor–state dispute settlement
NAFTA	North America Free Trade Agreement
UNCITRAL	United Nations Commission on International Trade Law



1.0 Introduction

A network of over 3,000 partially overlapping treaties governs international investment. These investment treaties grant international legal protection to foreign investors from certain types of adverse action by the governments of the host states in which they invest. Crucially, it is normally possible for foreign investors to enforce these legal protections through international arbitration.

Investment treaties were originally negotiated bilaterally between developed and developing countries. More recently, developing countries have signed investment treaties with one another. Investment treaties between developed countries remain rare—though this may change, as seen for instance in the conclusion of the Comprehensive Economic Agreement between Canada and the European Union (CETA), which includes an investment chapter. Although there are relevant differences between investment treaties, they are remarkably uniform in their core provisions. Most provide a common suite of protections to foreign investors, including guarantees of compensation for expropriation, “fair and equitable treatment” and non-discriminatory treatment. Some more recent investment treaties also include binding investment liberalization provisions, which prevent a state from imposing restrictions or conditions on new foreign investment that are not applied equally to domestic investors.

Investment treaties are only one aspect of the legal regime governing foreign investment. The laws and policies of the host state in which an investment is made are also relevant, as are contracts negotiated directly between investors and host states. Recent high-profile arbitrations, however, have focused public attention on the investment treaty regime. Relying on investment treaties, foreign investors have demanded compensation for government decisions to introduce new environmental and public health measures. However, foreign investors have also brought claims for compensation following tax increases, changes to the regulatory regime governing utility pricing and alleged mistreatment by the judiciary in host states. Foreign investors’ claims under investment treaties are not always successful. Foreign investors’ ability to frame plausible multimillion-dollar claims against a wide range of host government actions—and the fact that these claims are adjudicated through a system of private arbitration—has made investment treaties controversial. With this background in mind, this scoping study seeks to provide an overview and assessment of existing evidence of investment treaties’ impacts.

1.1 Case Study Approach: Significance and limitations

In reviewing existing evidence of investment treaties’ impacts, one important cross-cutting issue is the significance, if any, to be given to case studies and anecdotes. Participants in policy debates about investment treaties sometimes refer to examples of countries that either have, or have not, entered into investment treaties. For example, in relation to the question of investment treaties’ impact on foreign direct investment (FDI) flows (see Section 2), some proponents of investment treaties observe that Eastern European countries experienced a significant increase in FDI in the 1990s, around the same time that they enthusiastically embraced investment treaties. Similarly, some critics of investment treaties note that Brazil experienced a significant increase in FDI during the 1990s and 2000s, despite being one of the few countries that has never ratified an investment treaty.

Correlation does not equal causation. In the absence of further information, neither of these examples is sufficient to support any inference about the impact of investment treaties on FDI. It may be that the increase in FDI to Eastern European countries in the 1990s was driven by political and legal changes at the national level associated with the transition from communism, and that the countries concerned would have experienced the same increases in investment regardless of whether they entered into investment treaties. Conversely, it may be that Brazil would have experienced even greater increases in FDI if it had entered into investment treaties. In the absence of greater methodological rigour, there is little insight to be gained from the trading of anecdotes.

In relation to the question of investment treaties’ impact on FDI flows, one way of dealing with the methodological problems of anecdotalism is through cross-country econometric study that seeks to control for relevant factors that are likely to have an independent causal impact on FDI flows. More rigorous application of case study methodologies can also address some of the problems of anecdotalism. For example, the observation



that Eastern European countries adopted a range of domestic legal reforms around the time they entered into investment treaties is not sufficient to show that the two trends are causally related. However, using a “process-tracing” methodology—involving interviews with government officials and review of relevant contemporaneous documents—it might be possible to show that the governments concerned entered into investment treaties as part of a conscious strategy to “lock in” domestic reforms. Conducting rigorous case study research of this sort is difficult and time-consuming. Aside from a handful of notable exceptions, which are reviewed below, little rigorous case study research on investment treaties’ impacts has been conducted to date.

1.2 Structure of This Paper

This paper is structured as follows. Section 2 provides a framework for categorizing investment treaties’ impacts and then reviews evidence of the nature and extent of these impacts. Using the same framework, Section 3 focuses specifically on investment treaties’ impacts on developing countries. Section 4 considers the advantages and disadvantages of negotiating investment chapters in free trade agreements (FTAs) as an alternative to free-standing investment treaties. Section 5 reviews qualitative evidence of whether investors value investment treaties, an issue that overlaps significantly with the review of quantitative evidence of investment treaties’ impact on investment flows in Section 2. Section 6 offers some concluding commentary.



2.0 Investment Treaties: Benefits and limitations

Following previous academic work (Bonnitcha, Poulsen, & Waibel 2017; Poulsen, Bonnitcha, & Yackee 2015) we can identify several potential costs and benefits of investment treaties. These include their impact on investment flows and on governance at the national level. In addition, investment treaties may have distributive effects. These categories of potential costs and benefits provide a framework for examining the impact of investment treaties in general. Much of the empirical scholarship, however, has focused specifically on whether investment treaties result in such costs and benefits for developing countries.

2.1 Attracting Foreign Investment

Empirical work on the benefits of investment treaties has focused primarily on their impact on FDI flows, using econometric techniques to measure this impact. The vast majority of this empirical work focuses on the impact of investment treaties on FDI inflows to developing countries. This body of research raises two central questions:

- i. Do investment treaties increase FDI inflows?
- ii. To what extent does any increase in FDI resulting from investment treaties constitute a “benefit”?

We examine each question in turn.

Impact of Investment Treaties on FDI

These studies face a range of methodological challenges, which have been discussed in detail elsewhere (e.g., Aisbett 2009; Bonnitcha, Poulsen, & Waibel, 2017; Hogan Lovells & BIICL 2015; UNCTAD, 2014). These methodological challenges include:

- The appropriate specification of econometric models; for example, whether to examine investment treaties’ impact on bilateral investment flows between treaty partners or their impact on a state’s total FDI inflows regardless of origin.
- The coding of investment treaties so as to distinguish between treaties that have theoretically relevant differences; for example, between treaties that do and do not provide for investment treaty arbitration.
- The inclusion of appropriate control variables, particularly variables that capture changes in a state’s institutional quality and investment climate, which have a strong independent impact on FDI flows.
- The appropriate focus of quantitative studies; the vast majority of quantitative studies estimate the impact of bilateral investment treaties on FDI inflows to developing countries, thereby overlooking the impact of investment treaties between developed countries and of investment chapters of FTAs (Bonnitcha, Poulsen, & Waibel 2017).
- Problems with the quality of FDI data, which are particularly serious if total FDI data is disaggregated to the bilateral (i.e., country-dyadic) level or by industry of investment.

Bearing these challenges in mind, the findings of quantitative studies of investment treaties’ impact on FDI are mixed. An UNCTAD (2014) review of 35 published and unpublished studies on the impact of investment treaties found that the majority suggest that investment treaties do have some positive impact of FDI inflows, while a significant minority reach the opposite conclusion. Focusing exclusively on published studies, Bonnitcha, Poulsen and Waibel (2017) reach essentially the same conclusion, while also emphasizing the significant differences in methodological quality between various studies. They also note that, among studies that do find a positive impact of investment treaties on FDI, different studies reach contradictory findings about the circumstances in which investment treaties are likely to have a positive impact on FDI. This raises questions about the reliability of the findings of the literature as a whole. We return to qualitative studies of investment treaties on foreign investors’ investment decisions in Section 5 below.



Extent to Which Increases in FDI Constitute a Benefit

One issue that has received less attention in the literature to date is the assumption that additional FDI inflows constitute a “benefit” from a host state perspective (Bonnitcha, 2016). Beyond scholarship on investment treaties, there is a vast literature on the benefits of FDI from a host state perspective. This literature suggests that, in general, additional FDI is beneficial from a host state perspective. It also suggests, however, that the benefits associated with FDI—including positive spillovers such as technology transfer—vary significantly by sector of investment and by host country characteristics (e.g., Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2010; Blomström & Kokko, 2003; Borensztein, de Gregorio & Lee, 1998; Javorcik & Spatareanu, 2009). In some circumstances—for example, foreign investment in extractive sectors in poorly governed countries—additional FDI may even have negative impacts on host country welfare (van der Ploeg, 2011).

The findings of studies of the differential impact of FDI are crucial to any review of the costs and benefits of investment treaties. Several recent studies suggest that investment treaties are most effective at attracting investment in the extractive sector (Busse, Königer, & Nunnenkamp, 2010; Colen & Guariso, 2013) and other sectors associated with high sunk costs (Colen, Persyn, & Guariso, 2016; Danzman, 2016; Kerner & Lawrence, 2014). Such studies suggest that investment treaties are more effective in attracting the types of FDI that are less beneficial from a host country perspective.

A related issue is the extent to which increased outflows of FDI constitute a “benefit” from a source country perspective. This question has received less attention in the literature on FDI. Some studies suggest that outward FDI leads to a reduction in domestic investment in the home state (e.g., Al Sadig, 2013; Desai, Foley, & Hines, 2005; Feldstein, 1995). Other studies reach the opposite conclusion (e.g., Herzer & Schrooten 2007; Lee, 2010). Even if investment treaties do lead to a reduction in domestic investment in “home” states, simplified theoretical models of the international economy, such as the Heckscher-Ohlin model, suggest that such a reallocation of capital would still result in net benefits for the home state. To date, however, these questions have received almost no attention in the academic literature on investment treaties.

Impact of Investment Treaties on Portfolio Investment

The range of “investments” covered by most investment treaties is exceedingly broad, including loans, cash, debentures, contractual rights and minority shareholdings. All these assets fall outside the definition of FDI. Moreover, several high-profile investment treaty arbitrations have arisen from portfolio investments. For example, the dispute in *Deutsche Bank v Sri Lanka* concerned a hedging contract between a foreign bank and a state-owned enterprise, and the dispute in *Ablacat v Argentina* concerned Argentina’s default on its sovereign bonds. Although portfolio investment clearly falls within the protection of most investment treaties, to date no academic studies have sought to assess investment treaties’ impact on portfolio investment flows.

Summary

The majority of quantitative empirical research on the impact of investment treaties has focused on the question of whether they increase FDI flows to developing countries. This body of literature faces several methodological challenges, including the challenge of disentangling the effect of investment treaties from the impact of the domestic investment climate more generally. Taken overall, the literature suggests that investment treaties probably do have some impact on FDI flows to developing countries, although these effects are not so large that they can be identified consistently across a range of studies that apply differently specified econometric models to different data sets. It is also unclear what elements of investment treaties are relevant when determining impact—is it the pre-establishment element, investor–state dispute settlement (ISDS), or the provisions on expropriation, etc.?

A further question is whether investment treaties attract the types of FDI that are most beneficial from a host state perspective. Investment treaties are most likely to be effective in attracting types of FDI that are, in fact, less beneficial from this perspective. For example, econometric studies suggest investment treaties are more effective in attracting inward FDI to the mining sector than inward FDI in high-tech manufacturing.



2.2 “Levelling the Playing Field”

One regularly cited policy justification for investment treaties is their ability to redress discrimination against foreign investors. Both the EU (European Commission, 2015) and the United States (USTR 2014) cite “levelling the playing field” between domestic and foreign investors as a core justification for the investment chapter of the proposed Transatlantic Trade and Investment Partnership (TTIP). This rationale is equally relevant to investment treaties involving developing countries. Insofar as investment treaties ensure equal legal and regulatory treatment of all investors, they are likely to encourage the most efficient investors to establish and expand investments, regardless of their nationality.

Investment treaties’ impact on the competitive relationship between firms investing or seeking to invest in a host state has important implications for the question, identified in the previous section, of whether an increase in FDI resulting from an investment treaty constitutes a benefit. For example, if an investment treaty redresses discrimination against foreign investors, it is likely to encourage new foreign investment by efficient firms. In this case, additional FDI is more likely to constitute a net benefit. On the other hand, if an investment treaty gives special rights and privileges to foreign investors, any additional FDI could be the result of privileged foreign investors who benefit from the protection of the treaty “crowding out” their more efficient domestic and third-country competitors.

Relatively little academic work has been done on the extent to which investment treaties redress problems of discrimination against foreign investors and/or institute a system of reverse discrimination in favour of foreign investors. The work that has been done focuses on two questions. First, some studies have used legal methodologies to determine the extent to which investment treaties grant preferential rights to foreign investors. It is undisputed that investment treaties grant substantive rights to foreign investors that go well beyond guarantees of non-discrimination. Examples include guarantees of “fair and equitable treatment” and the protection of the so-called “umbrella clause.” However, academics disagree about whether such guarantees are equivalent, or more generous, than the legal protections commonly provided to investors within the legal systems of more advanced economies (cf. Johnson & Volkov, 2013; Kleinheisterkamp, 2014; Parvanov & Kantor, 2012).

Second, some studies have used empirical methodologies to test the premise that, in the absence of investment treaties, foreign investors suffer from discrimination in host countries vis-à-vis their domestic competitors. This work is still in its infancy, but it suggests that foreign investors are not generally subject to regulatory or judicial treatment in host states that is inferior to the treatment of equivalent domestic competitors (Aisbett & McAusland, 2013; Aisbett & Poulsen, 2016). This line of research has important implications, as it casts doubt on one of the core policy arguments for investment treaties—namely the assumption that host governments treat foreign investors more poorly than they treat their domestic competitors.

In principle, a host state could institute a non-discriminatory system of investment protection through national law, thereby obviating the need for investment treaties to “level the playing field” for foreign investors. This appears to be the policy rationale behind South Africa’s Protection of Investment Act, which applies equally to domestic and foreign investors. While such a law grants the same formal protection to domestic and foreign investors, it does not necessarily ensure equal protection of foreign investors in practice if the state’s judicial and administrative institutions discriminate in the application and enforcement of that law. But whether foreign investors suffer from administrative and judicial discrimination in the absence of investment treaties is an empirical question—i.e., a question that can only be answered by considering relevant evidence—the answer to which may vary between states. The research cited in the previous paragraph suggests that foreign investors are not necessarily subject to administrative and judicial discrimination.



Summary

One regularly cited policy justification for investment treaties is their ability to promote a “level playing field.” Such claims sit uneasily with the legal content of investment treaties, which are fundamentally preferential instruments. Investment treaties grant rights to one particular class of investor. Most of these rights—such as the core guarantee of fair and equitable treatment—are also preferential in the sense they are not defined by reference to the way the host state treats comparable domestic or third-country investors. Investment treaties also provide preferential access to international arbitration as a mechanism for resolving disputes. In the absence of clear evidence of discrimination against foreign investors that could justify a grant of preferential treaty rights, claims that investment treaties create economic benefits by “levelling the playing field” should be treated with caution.

2.3 Facilitation of Domestic Reforms

Practitioners frequently cite investment treaties’ role in promoting “good governance” and “the rule of law” as a core benefit (e.g., Schill, 2010). In principle, investment treaties could affect domestic governance in countries bound by them in at least three ways:

First, by requiring compensation for the expropriation of foreign investments, they could help “lock in” a system of private property ownership following transition from communism (e.g., Poulsen, 2015, p. 86). Roberto Echandi, a former Costa Rican ambassador to the EU, asserts that investment treaties have helped lock in other types of market-oriented reforms in developing countries (Echandi, 2011). He does not, however, provide any examples of this impact or any other evidence to support it.

Second, many provisions of investment treaties—such as the guarantee of fair and equitable treatment—relate to the process of government decision making affecting foreign investors. By making a host state liable to foreign investors if government decision making fails to meet these procedural standards, investment treaties could encourage reform of administrative and judicial processes in the host state. There is relatively little evidence of whether investment treaties facilitate domestic reforms in this way. Peru, Colombia and South Korea have instituted different types of internal systems to manage disputes with foreign investors and to ensure compliance with investment treaties (UNCTAD, 2010). However, there is no direct evidence of the extent to which such institutions trigger wider administrative reforms in practice. It is possible that such institutions are important mechanisms via which investment treaties induce change in domestic administration, but it is also possible that such institutions primarily address investors’ grievances *ex post* and do not trigger significant administrative reform. These are important questions for further research. In their empirical work in Nigeria, Turkey and Uzbekistan, Mavluda Sattorova, Ohio Omiunu and Mustafa Erkan (in press) found that investment treaties had little impact on administrative decision making. Quantitative studies of investment treaties’ impact on rule of law metrics have found that they have no (Sasse, 2011), or a negative (Ginsburg, 2005), impact on the rule of law.

Third, some more recent investment treaties include specific provisions that deal directly with domestic reform. For example, Article 11(4) of the US Model Bilateral Investment Treaty (BIT) requires states to publish all regulations of general application. In principle, such treaty obligations should improve transparency at the domestic level. To date, there have been no studies of whether they achieve these benefits in practice.

Determining whether investment treaties’ impact on domestic governance constitutes a benefit or a cost raises further issues that remain largely unresolved in the academic literature. These questions will become especially relevant if future empirical work reveals that investment treaties do have significant impacts on domestic governance. For example, if a developing country spends millions of dollars creating and operating an agency to manage compliance and litigation risks arising from investment treaties, should this be seen as a positive contribution to the institutionalization of the rule of law in that state? Or should such expenditures be seen as a diversion of government resources from more pressing priorities?



Summary

In theory, investment treaties could facilitate domestic reforms in the countries that sign them. However, to date there is little evidence to support this supposed benefit. Insofar as investment treaties do have such effects, they are likely to vary considerably between countries based on the political dynamics within the state in question and on the way in which obligations arising under investment treaties are internalized within national and sub-national administration.

2.4 Loss of Government Policy Space

Many of the strongest criticisms of investment treaties also relate to their impact on national governance. Such criticisms focus primarily on the impact of threats of investment treaty arbitration, for example on the possibility that states will fail to institute new tobacco control measures or will relax environmental regulations if a foreign investor threatens investment treaty arbitration. Valuing the cost of investment treaties' impact on government policy space raises many of the same conceptual problems as valuing the benefit of facilitating domestic reforms. For example, if the threat of investment treaty arbitration discourages a state from adopting strict environmental regulations that lack a strong evidentiary basis, should this be seen as undue foreclosure of a state's discretion to decide whether the evidentiary record is sufficient to justify more stringent regulation? Or should such limitations be seen as a necessary constraint on arbitrary regulatory action?

For all the public debate, remarkably little research has examined the extent to which threats of investment treaty arbitration dissuade states from adopting regulatory measures. Insofar as evidence is available, its implications are unclear. In the first Vattenfall case, Germany relaxed environmental conditions attached to a coal power station in order to settle an investment treaty dispute (Miles, 2016). The settlement in that case, however, also ended ongoing domestic court proceedings. It is therefore unclear what role, if any, the investment treaty played in pressuring Germany to settle (Schill, 2016). Tobacco companies regularly threaten investment treaty arbitration when governments propose new tobacco control measures (Tavernise, 2013; *Philip Morris v Australia*; *Philip Morris v Uruguay*). Some countries have proceeded with stricter tobacco control measures in the face of such threats. In contrast, in 2013, New Zealand announced that it was delaying the introduction of tobacco plain packaging in light of Philip Morris's claim against Australia (Turia, 2013). Gross (2003) and Tienhaara (2009) identify other cases where they argue that Indonesia and Costa Rica, respectively, abandoned environmental measures in light of the threat of investment treaty arbitration. On the other hand, several governments have also proceeded with more stringent environmental regulation in the face of known risks of investment treaty arbitration (Williams, 2016).

Summary

Investment treaties clearly limit government policy space to some extent, but there has been surprisingly little research on the extent to which they dissuade governments from adopting regulatory measures in practice. Valuing the extent that such constraints constitute a cost remains a subject of heated disagreement in the academic and policy literature.

2.5 Depoliticization of Investment Disputes

One of the main justifications for investment treaty arbitration as a system of dispute resolution is the argument that it "depoliticizes" investment disputes (Vandeveldt, 1992). According to this view, in the absence of an investment treaty, investors' home states are drawn into investment disputes to advocate on behalf of their aggrieved investors. The elevation of investment disputes to the diplomatic level damages the relationship between host and home states, and interferes with other aspects of their diplomatic relationship. Investment treaties solve this problem in that they allow investors to resolve disputes with the host state through a legal mechanism in which the investor's home state plays no role.



Note that this is a very particular use of the term “depoliticization.” A dispute may be depoliticized, in the sense of being resolved through a legal mechanism rather than through diplomatic negotiations, but may still become the subject of public debate or political controversy. Philip Morris’s challenge to Australia’s plain tobacco packaging legislation and Vattenfall’s challenge to Germany’s decision to phase out the use of nuclear power are two examples of investment treaty arbitrations that have become the subject of public debate and political controversy. For a critique of the use of the term depoliticization in scholarship on investment treaties, see Paparinskis (2010).

The extent to which investment treaties successfully depoliticize investment disputes has only recently become a subject of academic study. Two studies have empirically examined this topic—and point to opposite conclusions. Maurer (2013) notes that the U.S. executive became involved in investment disputes in the developing world in the mid-20th century in a way that damaged U.S. foreign policy interests. In his view, the executive was unable to avoid being drawn into these disputes because, in the absence of investment treaties, U.S. foreign investors would lobby Congress, and Congress would then pressure the executive to defend the investors’ interests in the executive’s dealings with developing country governments. In contrast, Gertz, Jandhyala and Poulsen, in a forthcoming work, examine U.S. diplomatic cables made public by WikiLeaks. They conclude that the existence of an investment treaty did not appear to affect the extent to which the U.S. government raised the treatment of its investors in diplomatic exchanges with host country governments

Summary

Historically, one of the main justifications for investment treaties was their ability to depoliticize investment disputes. There is little evidence of the extent to which they achieve this benefit in practice.

2.6 System Costs and Benefits

Any complete evaluation of the costs and benefits of investment treaties must also take into account the costs associated with constructing and maintaining the network of investment treaties. Such costs include the cost to governments of drafting and negotiating the treaties, or maintaining an in-house legal team in case of a dispute. System benefits, on the other hand, could include the speed of a given dispute settlement system. For example, if investment arbitration were faster and cheaper than the process in national courts, that would be a system benefit.

There has been no systematic study of either the costs associated with constructing and maintaining investment treaties, or of the savings in transaction costs resulting from the existence of investment treaties. Bonnitca, Poulsen and Waibel (2017) compare the costs of investment treaty arbitration to the costs of litigating broadly similar disputes to finality in domestic courts. They suggest, however, that investment treaty arbitration is slower and significantly more costly than resolving similar disputes in courts in the United States or in the United Kingdom.

Summary

Investment treaties are likely to create both system costs and benefits. There is little direct evidence of the magnitude of such effects, but they are likely to be smaller in scale than the costs and benefits considered in previous sections.

2.7 Distributive Impacts

In addition to the net costs and benefits reviewed in the previous section, investment treaties may also have distributive impacts. To illustrate, consider a situation in which an investment treaty does not have any impact on the investment decisions of foreign investors or on governance in the host state. Such a treaty would still have significant *ex post* impacts, as aggrieved foreign investors would be able to use investment treaty arbitration to obtain compensation for mistreatment by the host state. In this hypothetical example, such impacts would be purely distributive in character—any benefit to foreign investors as a class would correspond to an equal



loss to host states (Bonnitcha, 2014). Such *ex post* effects are particularly relevant when considering the impact of investment treaties on foreign investments that were made prior to the existence of the relevant investment treaty.

Investment treaties could have further distributive impacts if they alter the way that host states and foreign investors bargain ‘in the shadow of law’ toward agreed settlements in investment disputes. In theory, investment treaties are likely to strengthen the bargaining position of foreign investors vis-à-vis host states in negotiations to settle any investment disputes (Koskenniemi 2017). Such effects are likely to be important in practice, because negotiated settlement is the most common method of resolving investment disputes (Merrills, 2011; Waibel, 2010). The distributive impacts of investment treaties, however, have not yet been subject to empirical investigation.

Summary

Investment treaties have at least some distributive effects. The direction of these effects is clear. Investment treaties allow foreign investors to obtain compensation from host states for breach of the treaties, and thereby strengthen the bargaining position of foreign investors vis-à-vis host states in negotiations to settle any investment disputes. Both effects benefit foreign investors as a class at the expense of host states as a class, but there is insufficient evidence to estimate the scale of such impacts relative to investment treaties’ other impacts.



3.0 Investment Treaties: Impacts on developing countries

The categorization of costs and benefits proposed in the previous section provides a framework to understand the impacts of investment treaties on countries, independent of their development status. The nature and extent of each of these impacts, however, will vary in different countries. Investment treaties' impacts in any particular country are likely to depend on whether it is a net capital importer or exporter. Moreover, investment treaties' impacts are likely to vary in light of other country characteristics, such as differences in systems of government, natural resource endowments and national income.

Most developing countries are net capital importers relative to their developed country investment treaty partners. This means that their interests lie in the potential ability of investment treaties to attract additional investment flows. It also means that developing countries are more exposed to the costs associated with investment treaties, including loss of policy space and adverse distributive effects.

3.1 Attraction of Foreign Investment

Section 2 provided an overview of quantitative evidence of the impact of investment treaties on foreign investment flows. The majority of this evidence relates to investment flows to developing countries. Section 3 has reviewed qualitative evidence of the impact of investment treaties on investment flows. The evidence is mixed and subject to significant methodological challenges. Taken together, these studies suggest that investment treaties probably do have some positive impact on investment inflows to developing countries in certain sectors.

Regardless of whether or not a country signs investment treaties, there is strong evidence that domestic institutional quality and other elements of the domestic investment climate have a significant independent positive impact on inward FDI (e.g., Bénassy-Quéré, Coupet & Mayer 2007). A different question is how the presence of investment treaties interacts with domestic institutional quality—i.e., are investment treaties more effective in attracting foreign investment to developing countries with better or poorer institutional quality? Experts have come to different conclusions in this respect.

UNCTAD (2014) implies that investment treaties complement other aspects of the investment climate—i.e., that they are more effective in increasing FDI in developing countries where foreign investment is perceived as less risky. The logic behind this argument is unclear. Investment treaties provide foreign investors with legal protection against certain types of government interference. If anything, one would expect investment treaties to be more valuable to foreign investors in circumstances in which otherwise viable investments are subject to high risks of such government interference, i.e., in situations where the investment climate is poor.

Evidence of whether investment treaties have a greater impact on investment flows to risky countries is, however, equivocal. Tobin and Rose-Ackerman (2011) find that investment treaties are more effective in attracting FDI to developing countries with relatively strong domestic institutions, whereas Neumayer and Spess (2005) provide some qualified evidence that they are more effective in developing countries with weak institutions.

Empirically testing interaction effects between institutional quality and the impact of investment treaties on investment flows poses serious methodological challenges. These include conceptual disagreement about what constitutes “good” institutional quality, empirical challenges in constructing metrics that measure (or are suitable proxies for) a specified conception of institutional quality and controlling for the strong independent causal impact of institutional quality on investment flows (Bonnitcha, Poulsen & Waibel, 2017). With regards to the first and second of these challenges, studies often use metrics for which time series data is easily available, such as the World Bank's Worldwide Governance Indicators (WGIs) or political risk metrics published by the International Country Risk Guide (ICRG). These metrics aggregate characteristics that are relevant to the study of investment treaties with characteristics that are not relevant. They also tend to reflect the perceptions of business people, as opposed to other actors, which may not be appropriate depending on the conception of institutional quality that the study incorporates. There are no easy solutions to these challenges.



3.2 Loss of Policy Space

Section 2 provided an overview of evidence of the extent to which investment treaties lead to a loss of policy space, covering both developing and developed countries. It is possible that investment treaties could lead to greater loss of policy space in developing countries than developed countries. This is because developing countries have:

- i. Lower levels of legal capacity to understand and evaluate the legal implications of treaty language under negotiation (see, e.g., Poulsen, 2015).
- ii. Lower levels of capacity to ensure implementation of treaty obligations and policy coordination across government.
- iii. Lower levels of capacity to assess and respond to threats of investment treaty arbitration made by foreign investors.

Through detailed empirical study, Williams (2016) suggests that government capacity constraints play a complex role in mediating investment treaties' impacts. Her research suggests that lack of government capacity is a partial explanation for the origin of investment treaty disputes. The balance of political interests within host states also plays a central role in governments' decisions about whether to risk investment treaty arbitration or settle such disputes by acceding to foreign investors' demands. Furthermore, in an investment dispute a host state may have to choose between two different costs—the cost of acceding to a foreign investor's demands and abandoning a preferred regulatory measure, or the cost of defending the measure in investment treaty arbitration with the associated risk of an adverse award.

3.3 Investment Treaty Arbitrations: Distributive effects

One impact that has been relatively well-documented is the incidence of investment treaty arbitration against developing countries. Arbitral awards ordering a state to compensate a foreign investor are a cost from the perspective of the state in question and a benefit from the perspective of the foreign investor in question. As discussed in Section 2, the risk of adverse arbitral awards is an important consideration in assessing investment treaties' distributive impacts.

In her review of known disputes, Williams (2016) finds that most investment treaty disputes are brought against middle-income countries. This result, however, is largely explained by the volume of investment covered by investment treaties. Middle-income countries have significantly larger stocks of inward FDI than low-income countries, leading to a larger number of investment treaty arbitrations. While developed countries are by far the largest destinations for FDI, most inward FDI to developed countries originates from other developed countries and is not covered by investment treaties. Insofar as investment treaties operate between developed countries—notably, North America Free Trade Agreement (NAFTA)—they have also led to a significant number of investment treaty disputes. In addition, low-income countries may be more open to accepting the demands of a large foreign investor to avoid arbitration, although there is no direct evidence on this point. Williams (2016) also finds that democracies are more frequently the subject of claims in investment treaty arbitration, even after controlling for factors such as national income.

As for the outcomes of investment treaty arbitrations, in her review of a smaller subset of disputes, Franck (2015) finds that foreign investors are more likely to be successful in investment treaty arbitrations against developing countries, but that this correlation is driven by the fact that developing countries are less likely to be democratic and that foreign investors are more likely to be successful in claims against non-democratic states. In the absence of data about the frequency with which states settle claims following the threat of arbitration, however, it is difficult to draw strong policy conclusions from empirical studies of the frequency or outcomes of investment treaty arbitration. Patterns in the frequency or outcome of arbitrations might be driven by the fact that states with different development status have different propensities to settle claims following threats of arbitration. Unfortunately, there is no reliable data on states' responses to threats of arbitration.



3.4 Treaty Shopping

A further issue is the problem of so-called “treaty shopping.” Investment treaties are formally preferential instruments: they protect only the investments of one treaty party in the territory of other treaty parties. It is often easy, however, for an investor from a home state to incorporate a subsidiary in a third state and then use that subsidiary as a corporate vehicle to make an investment in the host state. Such an investor could then claim the protection of either an investment treaty between the home state and the host state or an investment treaty between the third state and the host state. Arbitral tribunals have generally allowed this practice (e.g., *Mobil v Venezuela*), subject to narrowly defined exceptions (e.g., *Philip Morris v Australia*). This practice poses at least two related problems for developing countries. First, it is difficult—sometimes even impossible—for a host state’s authorities to determine which investors are entitled to the protection of which investment treaties in advance. Second, a single investor can bring multiple investment treaty arbitrations under different treaties in relation to a single dispute.

The impact of this legal complexity on national level investment governance within developing countries has not been subject to empirical research to date. However, the legal consequences are clear. Foreign investors’ ability to structure virtually any investment in a way that brings it within the coverage of a least one of the host state’s investment treaties significantly increases the exposure of that state to investment treaty claims.

3.5 Summary

Considered overall, evidence suggests that investment treaties probably do lead to a modest increase in some types of FDI in developing countries—for example, investment in sectors involving high sunk costs. However, this evidence should be interpreted in light of the methodological challenges noted in Section 2.1, and in view of evidence that FDI in different sectors and different conditions is associated with different patterns of costs and benefits. Investment treaties also create costs for developing countries, both in terms of loss of policy space, and in defending and paying adverse awards in investment treaty arbitrations. There is insufficient evidence to come to any overall conclusion about the net effect of investment treaties for developing countries. Moreover, it is highly likely that the net effect of investment treaties varies significantly between developing countries. For example, China is a net capital exporter relative to many of its investment treaty partners. Its bureaucracy has a high level of capacity to manage negotiations of, and compliance with, investment treaties. In contrast, its southern neighbour, Myanmar, is a least-developed country currently undergoing a transition to democracy and with low levels of bureaucratic capacity. These differences affect the pattern of potential costs and benefits associated with investment treaties.



4.0 Free-standing Investment Treaties vs. FTA Investment Chapters

NAFTA, which entered into force in 1994, was the first FTA to contain an investment chapter modelled on the content of a free-standing investment treaty. Since this time, the inclusion of investment chapters in FTAs has become increasingly common. The EU's assumption of competence for foreign investment under the Lisbon Treaty and the turn toward "mega-regionals" have emphasized the importance of this trend.

Academic work has begun to examine whether investment chapters of FTAs are more effective than free-standing investment treaties in attracting FDI. For example, Berger, Busse, Nunnenkamp and Roy (2013) find that investment chapters of FTAs that contain investment liberalization provisions are more effective in promoting FDI than free-standing BITs that contain equivalent liberalization provisions. This could be due to the public attention that FTA negotiations attract in comparison to BIT negotiations, meaning that investors are more likely to become aware of their provisions. It remains to be seen whether these results will be confirmed by further studies.

Manger's (2009) work on the political economy of investment liberalization provisions in FTAs provides another possible explanation for such results. He argues that the combination of preferential investment liberalization and tariff reductions in FTAs gave prospective investors seeking to use the host state as an export platform to supply the investor's home market advantages vis-à-vis third-country investors seeking to use the host state as an export platform for the same market. Note that this explanation suggests that investment chapters of FTAs impose significant costs on third states that are not party to such agreements.

A distinct issue relates to potential costs or benefits arising from the process of negotiating free-standing investment treaties versus investment chapters of FTAs. In principle, including investment chapters in FTAs should provide for greater opportunities for issue linkage across the agreement, whereby state parties can agree to concessions in one aspect of the agreement in return for benefits elsewhere. This issue has not yet been investigated empirically.

Summary

One study suggests that investment liberalization provisions contained in the investment chapters of FTAs are more effective in attracting FDI than equivalent provisions in BITs. Work on these questions is, however, at a very early stage, and there has been no empirical investigation of other benefits or disadvantages of negotiating investment chapters of FTAs as compared to investment treaties.



5.0 Investors' Views: Value of investment treaties

Section 2 examined quantitative studies of whether investment treaties increase foreign investment. This section considers two closely related issues. The first is qualitative evidence of investment treaties' impact on foreign investors' investment decisions. The second is whether foreign investors value investment treaties, regardless of whether investment treaties influence their investment decisions. While closely related, the latter issue is distinct from the former. Even if investment treaties do not encourage foreign investors to invest more, foreign investors may still value the ability to bring any future disputes to investment treaty arbitration—i.e., they may still value investment treaties for their distributive impacts. This is consistent with evidence that foreign investors have occasionally lobbied their home states to conclude investment treaties to protect existing investments that they have already made in a given host state (Bonnitcha, Poulsen, & Waibel 2017).

For the most part, surveys of investors suggest a low level of knowledge of investment treaties, and that the treaties rarely have a significant impact on investment decisions (Copenhagen Economics, 2012; Multilateral Investment Guarantee Agency [MIGA], 1991; Yackee, 2009). Two recent studies have focused specifically on the value of investment treaties for foreign investors in certain developing country contexts. Both studies reached only a very small number of interviewees/survey respondents and were also subject to other significant methodological limitations, notably, selection bias. Bearing these limitations in mind, the first study suggested that European investors would value a BIT between the EU and Myanmar (Development Solutions, 2016), while the second found that Chinese investors did not value BITs with sub-Saharan African states (Cotula et al., 2016).

A third recent study suggests that many investors do consider investment treaties when deciding where, and how much, to invest (Hogan Lovells & BIICL, 2015). The authors of that study caution that its results should be interpreted in light of a range of methodological constraints—including cases where survey responses were apparently inconsistent with the respondent company's behaviour. Nevertheless, the results of this study highlight the possibility that, in light of greater public awareness of investment treaties, investors may now be paying more attention to investment treaties than was previously the case.

To our knowledge, no study has sought to examine whether investors of different sizes value investment treaties differently. The high average costs of investment treaty arbitration—over USD 4 million per party per dispute (Hodgson, 2014)—may present a significant obstacle to small investors. In theory, one might expect medium-sized investors to value investment treaties more than large investors, due to the greater presumed political influence of large investors over host governments (Poulsen, Bonnitcha & Yackee, 2013). However, a recent study examined the size of successful claimants in investment treaty arbitration (van Harten & Malysheuski 2016). It found that the majority of successful claims were brought by large companies (i.e., annual revenues of over USD 1 billion) and very wealthy individuals (i.e., net wealth over USD 100 million).

Summary

The majority of investors do not appear to value investment treaties. On the other hand, some investors do appear to value investment treaties to some extent. As such, qualitative evidence suggests that investment treaties are likely to have a modest positive impact on investment flows, through their influence on the decisions of the minority of investors that do value them.

It is unclear whether medium-sized investors value investment treaties more than large investors. It is difficult to assess the significance of studies of claimant size in the absence of relevant baselines (i.e., data that provide a basis for comparing the distribution of claimant size with the distribution in size of all foreign investors in a relevant state). In any event, the high cost of investment treaty arbitration suggests that investment treaties are of limited value to small investors.



6.0 Conclusion

The majority of the academic literature has focused narrowly on one supposed benefit of investment treaties, namely the treaties' effect on FDI flows. Taking both the quantitative and qualitative evidence together, it seems that investment treaties probably do lead to a modest increase in some types of FDI to developing countries. This is because, although investment treaties do not appear to influence the investment decisions of the majority of foreign investors, there is some evidence that a minority of foreign investors do sometimes take investment treaties into account when deciding whether and where to invest. However, due to methodological challenges, considerable uncertainty remains about the existence and scale of this supposed benefit. It is difficult to consistently identify these impacts or to pinpoint the relevant elements of treaties causing these impacts.

Moreover, it is unclear whether investment treaties' impact on FDI flows constitutes a benefit to a host state. This is for two main reasons. First, insofar as investment treaties do increase FDI, evidence suggests that they do so in sectors that are least beneficial from a host state perspective (see Section 2.1). Second, insofar as investment treaties do increase FDI by some foreign investors, this may be the result of covered foreign investors displacing their domestic and foreign competitors that do not benefit from the protection of an investment treaty. In other words, investment treaties may increase FDI by investors of some nationalities, and decrease FDI by investors of other nationalities. This is because investment treaties are fundamentally preferential instruments that give foreign investors of some nationalities advantages over investors of other nationalities (see Section 2.2).

Studies to date have not been able to find conclusive evidence supporting other alleged benefits of investment treaties, such as facilitating domestic reforms or depoliticizing investment disputes. Also, although investment treaties clearly limit government policy space to some extent, the "cost" of such constraint remains a subject of heated disagreement in the academic and policy literature. There is evidence too that investment treaties do have significant distributive impacts, in the sense that states have been required to compensate foreign investors in circumstances where compensation would not have been paid in the absence of an investment treaty. However, it is difficult to assess the relative scale of these impacts, and there has been little research on investment treaties' other distributive impacts—notably, their impact on investor–state bargaining in negotiations to settle investment disputes.

When weighing all the benefits and costs of investment treaties against each other, there is insufficient evidence to come to any overall conclusion about the net effect of investment treaties for developing countries. Furthermore, it is highly likely that the net effect of investment treaties varies significantly between developing countries.

This scoping study highlights the need for further research on investment treaties' impacts. One priority should be research on investment treaties' impact on domestic governance and their potential chilling effect on policy-making. This scoping study shows that these potential effects are central considerations in any overall evaluation of the costs and benefits of investment treaties. However, in contrast to econometric studies of the impact of investment treaties on FDI flows, there has been little empirical study of these questions to date. Research of this sort requires access to the government decision makers who are actually involved in negotiating, implementing and ensuring compliance with investment treaties.

Further quantitative and qualitative research examining investment treaties' impact on investment decisions at a higher level of disaggregation—e.g., by sector and project structure—would also be useful. Empirical research on FDI highlights that different types of investments have different patterns of positive and negative spillovers from a host state perspective. As such, an important policy question for developing countries is whether investment treaties are effective in attracting "high-quality" investment. Further research should also consider the way that investment treaties influence bargaining and negotiations between foreign investors and host states.



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