THE MODERATING ROLE OF IIAs IN FDI: IMPLICATIONS FOR SUSTAINABLE DEVELOPMENT

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ABSTRACT

Despite a long belief in positive impact of Foreign Direct Investment (FDI) on host countries and in a positive role of international investment agreements (IIAs) in attracting FDI, empirical studies in neither of the areas have confirmed results. As Sustainable Development has become an important agenda for many developing and less developed countries, where FDI is considered as an important resource for their development. A clearer picture of the relationship between FDI, IIAs and sustainable development will have significant implications in both academic and policy terms. Thus, this study explores conceptual frameworks to re-shape these relationships.

Keywords: Impact of FDI; institutions; International investment agreements (IIAs); sustainable development

INTRODUCTION

Foreign direct investment (FDI) has long been considered as beneficial to the development of states. At the same time, international investment agreements (IIAs) have also been increasingly encouraged in international, regional and bilateral trade and investment agreements as a vehicle of 'investment protection' for foreign investors (mainly Multi-National Enterprises, MNEs) as they are expected to help signatories attract FDI to their countries. This is particularly so for developing and less developed countries where lack of transparent, efficient or effective institutional environment often deters FDI inflows to these countries.

Despite the apparent desirability of the negotiated investment treaties to contribute and promote sustainable development, the text of most old-type treaties (Bilateral Investment Treaties, BITs) does not expressly refer to it. Instead BITs in their Preambles refer to "prosperity" to be increased among all the signatories of the treaty (i.e. Australia/Hong Kong BIT, 1993; Nigeria/Germany BIT, 2000; or Nigeria/China BIT, 2001). This means that arbitrators that decide arbitration cases based on these treaties, under which a foreign investor is seeking damages against the host state, are under no obligation to take sustainable development into account when making their decision. In order to avoid any doubts as to the intended role of IIAs in promoting sustainable development, modern IIAs now expressly refer to the concept in their Preambles "REAFFIRMING their [contracting states] commitment to promote sustainable development and the development of international trade in such a way as to contribute to sustainable development in its economic, social and environmental dimensions" (CETA, 2016, Preamble, para. 9).

However, although there is significantly developed body of knowledge on both 1) the role of institutional development in impact of FDI; and 2) the role of IIA/other relevant legal instruments on FDI attraction, empirical results of these studies are still mixed and thus, the relationship between FDI, institutions and legal instrument are still ambiguous. Thus, this study aims to develop conceptual frameworks which bridge these two bodies of knowledge. The structure of the study is as follows: the next section presents the context of this study and the third section develops conceptual frameworks. The final section discusses policy implication and methodological suggestions for future studies.

CONTEXT

FDI Impact on Host State and Institutional Influence

Despite a common belief in benefits from FDI, the degree of 'benefits from FDI' on host countries can vary depending on host country condition. Whilst main motivations of FDI are usually derived from 'economic reason', some FDI might be attracted to a certain host country for political reasons or by lax regulatory structure in the host (Dunning and Lundan, 2008). A host country might attract inward FDI with lax regulatory structure to certain degree, but if so, there is also danger of long-term issues related to these types of FDI such as creating 'race-to-bottom' tax competition or 'pollution haven', which might surpass benefit from FDI. In many developing 'natural resource rich countries', the actual spill-over effect and/or benefits of inward FDI has been questioned (*e.g.* Cordes *et al*., 2016) with often raising concerns related to 'enclave economy', environmental issues, governance (*e.g*. corruption; political stability) and/or inequality (*e.g*. Basu and Guariglia, 2007; Hitam and Borhan, 2012).

Thus, recent studies on 'impact of FDI' have been moving towards to 'sustainability' issue particularly together with the launch of UN Sustainable Development Goals (SDGs) (*e.g.* UNCTAD, 2014; Biermann et al., 2016). However, there is still dearth of research on what factors make FDI more sustainable in host countries. Bridging point between FDI and sustainability might be institutions and governance. Studies and policy papers suggest importance of 'governance' or 'institutional development' at national level for 'sustainable development' (*e.g.* Acemoglu *et al.*, 2004). Institutions, "the humanly devised constraints" (North, 1990, p.3), are created and characterised depending on the "given lumpy indivisibilities" of each country. They in turn "shape the direction of long-run economic change" in a country (*ibid*, p.16). Thus, some FDI studies also discuss institutional influence on whether and to what extent a host country has positive impact from FDI (*e.g*. Bénassy-Quéré *et al*., 2007; Rottig, 2016; Biemann *et al*., 2017). In many developing/less-developed countries "[i]nstitutions are…(often)…created to serve the interests of those with the bargaining power to devise new rules" (North, 1990, p.16) rather than in a way to "facilitate the functioning of markets" (Khanna and Palepu, 2010, p.6). Although many developing and transition economies have carried out, institutional reform, "institutional development is a complex and lengthy process…(and therefore),…[d]ismantling government intervention and reducing barriers to international trade and investment…do not immediately produce well-functioning markets" (*ibid*, p.13). In these countries, where "inefficient forms of exchange" are common in markets, (North, 1990 p.11), institutional voids are "a prime source of the higher transaction costs and operating challenges" (Khanna and Palepu, 2010, p.6). Thus, this study proposes that IIAs or other similar legal instruments might play a certain role, particularly, in the context of filling the institutional voids in these countries.

The Role of Investment Treaties in Promoting and Protecting FDI: the Current Legal View

Legislative History of FDI Protection

At the turn of the 19th century and under the charge of the United States, states have entered into "Friendship, Navigation and Commerce Treaties" (FCN Treaties), which have served as the model for the true investment promotion and protection instruments: Bilateral Investment Treaties (BITs). BITs are signed between two states, who aim to attract FDI from each other's territories. More commonly, BITs were setup to protect the foreign investors from developed (home) states, investing into the developing (host) state. In order to offer protection, BITs have a number of substantive standards of protection, most commonly expropriation; fair and equitable treatment (FET); national treatment (NT); most-favoured-nation treatment (MFN) and full protection and security (FPS). The substantive standards are also accompanied by a unique instrument in international law: investment treaty arbitration (ITA)

BITs continue to be important legal instruments today. Despite their omnipresence, BITs have been criticised for their broad, "catch-all" and vague character and many states have aimed to redraft their investment protection policies, by entering into a new type of investment protection agreements. Most notably, states have pursued regional trade and investment policies in a coordinated manner, resulting in trade agreements, which also contain investment protection chapters, or attached agreements. In total, there are more than 3300 International Investment Agreements (IIAs) in force today, and out of these, most are still BITs (UNCTAD, 2018).

More recent examples of IIAs include the (1) EU-Canada Comprehensive Economic and Trade Agreement (CETA); (2) EU-Singapore Free Trade Agreement, with an Investment Protection Agreement; (3) EU-Japan Economic Partnership Agreement; (4) EU-Vietnam Trade Agreement, with an Investment Protection Agreement; (5) EU-Mexico Trade Agreement; and some, in which negotiations are still on their way: (6) EU-New Zealand Trade Agreement; (7) EU-Australia Trade Agreement; and (8) EU-MERCOSUR Trade Agreement. Unlike BITs, these new treaties (mega-regionals) are more comprehensive and states negotiate access to market, trade tariffs and other areas, together with investment protection and promotion. Likewise, IPAs attached to these mega-regionals are a clear attempt to remedy some of the poor treaty drafting as reflected in the BITs, in the hope to secure more sustainable development, preservation of the states' regulatory space and improvements to investment dispute settlement mechanism (UNCTAD, 2018).

Investment treaty arbitration (ITA) as the mechanism for settling investment disputes has traditionally been identified as the main advantage of IIAs for mainly two sets of reasons (Franck, 2007). On the one hand, ITA offers control to individual investors over their investment dispute and involved interests, severing their dependence from their home states. ITA gives independent legal standing to private parties (non-state) to enforce state's legal obligations under international law. This is a unique feature of ITA, which does not have a comparator in international law. ITA severs investor's dependency on its home state for the solution of its dispute with another sovereign (host) state. That is a distinct comparative advantage that foreign investors have over any domestic competitors, who can only enforce their legal rights within the parameters of the domestic legal (court) system. At the same time, ITA is seen to depoliticise complicated and strenuous disputes (Dugan *et al*, 2008).

Intellectual Property: an Unknown Constant

Intellectual property has been attributed with positive contributions to the development of host states (UNCTAD, 2007). Its protection has been safeguarded internationally since the 1880-s with multilateral treaties, and has been included in the trade agenda since the 1990-s. What was less known until recently, intellectual property is also protected via international investment agreements, because it is included in the definition of a qualifying "investment" under most investment treaties. It has been argued that the characterisation of intellectual property rights (IPRs) as foreign direct investment helps to achieve economically positive effects for the development of a country (Maskus, 2000; Corredor, 2014).

The origins of IP protection in investment treaties can already be traced to the FCN Treaties, which are the historical predecessors of BITs. BITs very clearly include IPRs into the definition of investments, particularly by listing IP in the "asset based" definition. This additional protection of IP has been however dormant and has only recently been brought to light by the *Philip Morris* arbitration cases. Despite an obvious backlash, it appears that states do not wish to exclude IP assets from investment protection. The mega-regional agreements, such as CETA, continue to list IPRs in the definition of a protected investment and further increase the protection of IPRs via separate chapters on IP.

Current ITA Legitimacy Crisis

Lack of empirical evidence to justify system

The vast literature and policy response focus their criticism on (1) the process of ITA; and (2) broad substantive protection in IIAs. More specifically, it has been argued that the ITA system is skewed in favour of the foreign investors. According to UNCTAD, there have been 904 ITA cases in total (Investment Policy Hub, 2018). Out of these, 580 cases have been concluded and 314 are still pending. The concluded cases show the following picture: 35.9% have been decided in favour of the state, and only 28.1% have been decided in favour of the investor. Moreover, 22.9% of cases have been settled; 10.9% have been discontinued; and 2.2% have not been decided in favour of either of the parties (liability under IIAs was found; but no damages were awarded). Although the numbers of the currently resolved ITA cases do not appear to confirm this impression of the system as biased in favour of the multinational enterprises (foreign investors), there are substantial transaction and litigation costs attached to complex ITA cases. Moreover, there is some evidence to support the argument that the existence of the ITA system can lead to regulatory chill (Van Harten and Scott, 2016), particularly with regulation, which aims to protect the public interest in the areas of health or the protection of the environment. If ITA and broad substantive protection do not contribute to the development of the host state through increased inward FDI, what is their benefit to the broader public interest and the state?

New cases stress-testing the system as a whole

There are several cases that have shed light on the inadequacies of the investment treaty system for FDI protection. The first string of cases is illustrated by arbitration in *Philip Morris v Australia* and *Philip Morris v Uruguay.* Here the tobacco companies opposed the new regulation in the area of public health. Another example of IP arbitration, which has been seen as a surprise development in expert communities is the arbitration in *Eli Lilly v Canada*. Here, the pharmaceutical company challenged the Supreme Court's interpretation of patent laws, arguing that its legal interpretation is in violation of the TRIPS Agreement and in violation of the NAFTA provisions protecting patents as qualifying investments. A different example is the arbitration in *Vattenfall v Germany*. After the 2011 Fukushima nuclear disaster in Japan, Germany made a regulatory decision to close down all nuclear power stations without any compensation. This prompted the foreign investors to file an arbitration claim under the Energy Charter Treaty in the hopes of acquiring some form of compensation for the closed facilities. When first filed, the actions by the foreign investors were broadly criticised and served by the critics of the ITA system as the prime example of the inadequacy of the system as a whole. The parties have reached a settlement in 2011 (Award, 2011), whereas the German Constitution Court found in favour of the investors.

CONCEPTUAL FRAMEWORK

Linking IIAs and FDI: IIAs as substitute for poor institutions?

IIAs included in global treaties have been believed to enhance trade and investment of MNEs and expected to work as substitute for poor institutional environment of many developing host countries. In this context, a substantial number of empirical studies have indeed found IIAs working as a positive determinant of FDI into developing countries and this seems to be particularly so when these countries have BITs with developed sourcing countries (*e.g.* Büthe and Milner, 2004; Neumayer and Spress, 2005; Salacuse and Sullivan, 2005; Yackee, 2011). In a similar context, some studies found only ratified BITs have significant positive effect as FDI determinants (*e.g.* Siegmann 2008; Büthe and Milner 2014), which implies that host countries' strong 'signal' to commitment to these 'substitute institutional arrangement' might be a pre-requisite condition to utilise legal instruments in attracting FDI.

However, overall, the results of these empirical studies vary with some studies finding no significant impact of IIA on FDI (*e.g.* Gallagher and Birch, 2006; Siegmann, 2008) and with others finding their results are not statistically significant (*e.g.* Hallward-Driemeir, 2003; Tortian, 2012). The results of studies which found IIA as a positive determinant of FDI are also complex depending on the contents of IIA (*e.g.* Neumayer and Spess, 2005; Salacuse and Sullivan, 2005; Siegmann, 2008), the nature of impact of IIA on FDI (*e.g.* Büthe and Milner, 2004; Yackee, 2011) or firm level decision (*e.g.* Egger and Merlo, 2012) (see pp.14-21 in UNCTAD, 2014). The implication from these studies is that IIAs certainly play a positive role in attracting FDI, but whether the role is as decisive as a determinant has not been agreed. Moreover, there is lack of attention on whether IIAs play any role in impact of FDI on the host country at the post-FDI stage (*ibid*). As IIAs exert additional costs to host countries, policy implication of IIAs in relation to FDI might need to be considered at an encompassing level incorporating issues regarding attracting, maintaining and utilising benefit from FDI (Büthe and Milner 2004; Neumayer and Spess 2005; Gallagher and Birch, 2006). Whilst there is dearth of study which explores whether and/or how legal instrument might help or hinder the process of a host country fully exploiting benefits from FDI, this issue is significant for 'sustainable development' of many countries. Legal instruments/treaties aiming at protecting MNEs' investment bring differing dynamism between MNEs and host country governments/societies.

'Moderating effect of IIA' in attracting and retaining FDI

The rationale behind this study's proposition is based on findings from previous studies that impact of IIA is minor or secondary rather than 'independent' determinant with limitations in influencing economic matters (UNCTAD, 2014). In addition, several studies found that IIAs seem to work as complementary with good institutions of host countries rather than substitute of poor institutions as expected (*e.g.* Hallward-Driemeier, 2003; Neumayer and Spess, 2005;

Tobin and Rose-Ackerman, 2011). Tortian (2012) similarly founds that financial development of a host country dilutes the BIT impact on FDI flows. These studies imply that the role of IIAs might be moderating 'institutions', which is one of key FDI determinants, rather than 'determining' FDI directly. Moreover, some studies suggest that the impact of IIA on FDI seems to be dynamic rather than static. For example, Egger and Merlo (2007), by including temporal dummies, found that the positive impact of IIA on attracting FDI seems to decrease as time goes by. In a similar context, Tobin and Rose-Ackerman (2006) argue that the marginal effect of extra BIT decreases. If the role of IIA in relation to FDI changes over time, the scope of cost vs. benefit consideration regarding IIA and FDI also needs to be extended to post-FDI stages, where host countries deal with actual impact of FDI, as well as pre-FDI stages.

Here, in its discussion on impact of FDI, this study focuses on 'sustainable FDI' coming from 'long-term' investment. Although 'long-term' FDI might not necessarily bring 'sustainable' FDI, longer-term FDI certainly brings more stability and certainty to a host country in its utilising benefit from FDI. In fact, studies found that long-term commitment of an MNE's business in a host country is positively linked to re- or expansionary investment (*e.g.* MacKinnon and Phelps, 2001; Nguyen, 2016). Criscuolo and Salter (2006) also suggest 'repeat investment' as one of indicators in measuring an MNE's embeddedness in the host country which can bring more sustainable FDI. In a similar context, Ernst and Young (2011, p.11) reported that "more than 50% of employment generated in the UK from FDI is from companies which have already established a base in the UK and are either expanding or co-locating further investment at an existing site". Thus, for a host country, it is important to understand what influences on retaining investments as well as attracting them.

In this context, this study also proposes that IIAs might play the moderating role in retaining FDI (*e.g.* re- or expansionary investment) as well as attracting it. For example, Egger and Merlo (2012), using firm-level data, found that BITs have a positive impact on the sample firms' FDI activity in their hosts by increasing the number of their plants, FDI stocks and fixed assets per firm (UNCTAD, 2014). Similarly, IIAs might play a role in "domestic institutional reform efforts" of a host country (*ibid*, p.10), which in turn will boost MNEs' confidence in the host country whilst potentially increasing their re-/expansionary investment or potentially deterring any "institutional arbitrage" of MNEs (Rottig, 2016, p.12), *i.e.* exploiting weak institutional structure of a host country, at their post-investment stage. Thus, the conceptual framework of this study on the relationship between IIA and FDI can be depicted as in Figure 1.

DISCUSSION AND CONCLUSION

Methodological suggestions for future study

On methodological suggestions for future studies, the most likely one might be statistical ones with 'moderator' variable included in an equation (e.g. $y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 (x_2 \hat{} x_3)$, where y represents either inward FDI or re-/expansionary investment as the dependent variable and x_2 denotes institutional factors whilst x_3 denotes legal instruments such as IIAs). Here, depending on the context of the study, selection of variables and proxies might be diversified. Particularly, considering the emphasis of this study's framework on institutional factors and investment-related legal agreements, hypotheses might be developed in more detailed levels such as comparing differences of effect of bilateral IIAs (BITs) as opposed to regional IIAs.

However, this study's framework does not exclude possibility of being developed into a qualitative study. If quantitative studies support moderating effect of IIAs, depending on data availability, a qualitative case study on implementation and/or negotiation of IIAs between MNEs and host country governments might bring great insight regarding details of '*how*' IIAs moderate institutional factors and impact of FDI in host countries.

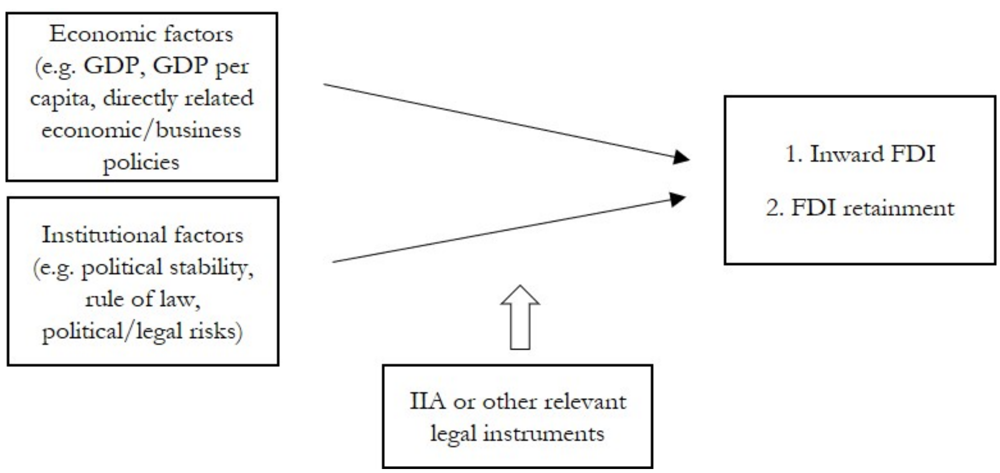
Policy implication and concluding remarks

This study provides conceptual frameworks by re-assigning the role of IIAs in relation to FDI as 'moderating institutional influence on FDI' in both attracting and retaining FDI. Thus, these frameworks might bring policy implications in two areas. Firstly, this study can re-enforce the importance of institutions. The argument that "institutions matter is hardly novel or controversial" but "what is interesting is *how* institutions matter" (Peng *et al.,* 2008 p.921). This study's frameworks, where IIAs play a moderating role in the relationship between institutions in host countries and FDI into the countries, can provide more specific assumptions regarding whether and/or how IIAs can be utilised for improving host country institutional development. Secondly, by extending the scope of research on IIAs and FDI to post-investment stage, this study's conceptual frameworks suggest 'long-term' effect of IIA through its potential moderating role in institutional development of a host country. Thus, they can provide policy implication of 'impact of FDI'. This is particularly relevant to 'sustainable development' of developing countries. In some cases IIAs might work against the host country when MNEs exploit institutional void in a host country. As the moderation can be done in either enhancing or deterring way, this framework also covers potential negative effect of IIAs on FDI, which can provide relevant policy implications to host countries' negotiating and signing future IIAs.

To achieve sustainable development goals, states not only need resources but also need to retain and develop the resources for longer term. Whilst FDI can provide valuable resources for many developing countries, the impact of FDI does not always seem to be positive. Similarly, the role of bilateral and regional IIAs in attracting and securing FDI is also ambiguous. This paper explores the role of IIAs in relation to FDI in broader context. It is argued here, that the IIAs have an important role in retaining, as well as attracting FDI by moderating influence of institutional factors in host countries and are resultantly essential in the pursuit of sustainable development goals. Thus, this study contributes to both the body of knowledge in several related academic areas including FDI and international law study by providing frameworks to be developed into future empirical studies whilst providing significant policy implications regarding sustainable development for developing and less developed countries.

FIGURES

Figure 1. Moderating effect of IIA on institutional factors in 1) attracting and 2) retaining FDI



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