The International Investment Law and Policy Regime: Challenges and Options

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E15 Task Force on Investment Policy

Overview Paper
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International investment—more specifically, foreign direct investment (FDI)—has become the most important vehicle to bring goods and services to foreign markets. In addition, FDI integrates the national production systems of individual countries and is in the process of creating an integrated international production system, the productive core of the globalising world economy. Against the background of the salient features of FDI and the emerging integrated international production system, this paper seeks to do three things—one, to discuss the evolution of national FDI policies; two, to review challenges for the international investment law and policy regime; and, three, to identify options on how some of these challenges can be met. The discussion is broader than focusing on priority issues only; rather, it covers a range of issues that may eventually need to be addressed. The emphasis is on the international governance of international investment in the globalising world economy, which so far has taken place through a myriad of mostly bilateral investment treaties (BITs). The resulting regime—which increasingly sets the parameters for domestic policy-making on international investment—has developed rapidly, remains in flux, and needs to be improved to maintain its effectiveness and legitimacy.

National (as well as international) policy-making regarding MNEs and their international investment takes place in the context of sets of tensions for governments seeking to attract FDI and benefit from it as much as possible, and minimise any negative effects. Hence, national policies regarding FDI, and the international regulatory framework within which national policies are formulated, are of key importance for host countries, and they can conflict with the goals of MNEs to maximise their international competitiveness and global profits. In the 1990s, countries began to establish investment promotion agencies with the specific brief to attract as much FDI as possible. Since the turn of this century, however, national approaches in both developed countries and emerging markets towards incoming FDI have become more nuanced. Achieving the right balance has become a key challenge for countries, and it is one that emerging markets, especially with regard to outward FDI by their firms, increasingly need to consider.

A defining characteristic of the investment regime is that investors have a private right to action when seeking redress, under the investor-state dispute-settlement (ISDS) mechanism enshrined in the majority of IIAs. From the perspective of international investors, this is a strong and positive feature of the investment regime, but it entails considerable risks for host country governments. A topical and urgent question is whether appeals mechanisms for current ad-hoc tribunals, a world investment court as a standing first-instance tribunal making the decision in any dispute settlement case, or a combination of both should be established. Institutionalising dispute settlement in this manner would be a major step towards improving the investment regime. Difficult as it is to improve the current dispute settlement mechanism, embarking on a process of examining how this could be done, with a view towards bringing a better mechanism into being, would send a strong signal that governments recognise that the ISDS mechanism would benefit from improvement.

An independent Advisory Centre on International Investment Law would help to establish a level playing field by providing administrative and legal assistance to respondents that face investor claims and are themselves not in a position to defend themselves adequately. The WTO experience provides useful inspiration. An Advisory Centre on International Investment Law—which would suitably complement a reform of the ISDS mechanism—could do the same thing for the international investment regime. Related questions could be pursued in a working group consisting of representatives from principal stakeholders. It could be serviced by an NGO with a track record of work on the international trading system. It could, hopefully, also draw on the experience of intergovernmental organisations with an interest in this subject.

The growing criticism of the investment regime suggests that a new balance is required. This begins with the objectives of IIAs, more and more of which recognise, in their preambles, objectives other than protection, as well as the right to regulate. It also includes the continuing demand that foreign investors, like domestic investors, have responsibilities too, and not only host countries. Unless the regime can be made more holistic, reflecting in a balanced manner the interests of all principal stakeholders and defining the relationships between foreign investors and governments in general, it risks losing its legitimacy in the longer run.

There is also the question whether the ideal approach would be to have one instrument that defined the relationships between governments and international investors—a universal framework on international investment that, in a coherent and transparent manner, would provide the predictability and stability that long-term investment needs. If a truly universal framework is considered out of reach at this time, one might want to consider whether a plurilateral framework on international investment could serve as a first step in that direction.
Concluding, the paper suggests that it would be desirable to launch an informal but inclusive confidence-, consensus- and bridge-building process on how the international investment law and policy regime can be improved. Such a process could seek to identify systematically the strengths and weaknesses of the current regime and discuss how to deal with them. It could also consider a number of the issues that were discussed as not being FDI/international investment proper, as many of them are intimately linked to it. It would have to be an inclusive process and hence involve the principal stakeholders to ensure that main interests are taken into account.
# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Salient Features of Foreign Direct Investment and Multinational Enterprises</td>
<td>1</td>
</tr>
<tr>
<td>Salient Features</td>
<td>1</td>
</tr>
<tr>
<td>Rise of an Integrated International Production System</td>
<td>3</td>
</tr>
<tr>
<td>The National Regulatory Framework for International Investment</td>
<td>5</td>
</tr>
<tr>
<td>Tensions</td>
<td>5</td>
</tr>
<tr>
<td>Trends</td>
<td>6</td>
</tr>
<tr>
<td>Two Challenges</td>
<td>7</td>
</tr>
<tr>
<td>International Regulatory Framework for International Investment</td>
<td>8</td>
</tr>
<tr>
<td>Objectives and Characteristics</td>
<td>8</td>
</tr>
<tr>
<td>Challenge of Preventing, Managing and Settling Disputes</td>
<td>9</td>
</tr>
<tr>
<td>An Advisory Centre on International Investment Law</td>
<td>12</td>
</tr>
<tr>
<td>Updating the Contents of International Investment Agreements:</td>
<td>13</td>
</tr>
<tr>
<td>Refining Key Concepts, Broadening the Purpose of the Regime, and Responsibilities of Investors</td>
<td>13</td>
</tr>
<tr>
<td>A Multilateral/Plurilateral Framework on International Investment</td>
<td>15</td>
</tr>
<tr>
<td>Emerging Issues Arising from an Integrated International Production System</td>
<td>16</td>
</tr>
<tr>
<td>An Informal, Inclusive Confidence-, Consensus-, and Bridge-Building Process</td>
<td>18</td>
</tr>
<tr>
<td>Conclusions</td>
<td>18</td>
</tr>
</tbody>
</table>
LIST OF ABBREVIATIONS

ASCM  Agreement on Subsidies and Countervailing Measures
BITs  bilateral investment treaties
CETA  Comprehensive Economic and Trade Agreement
EU   European Union
FDI  foreign direct investment
FTAs  free trade agreements
G7    Group of Seven
GATS  General Agreement on Trade in Services
GATT  General Agreement on Tariffs and Trade
ICSID International Centre for Settlement of Investment Disputes
IIAs  international investment agreements
IMF  International Monetary Fund
ISDS  investor-state dispute settlement
M&As  mergers and acquisitions
MFN  most-favoured nation
MNEs  multinational enterprises
NGOs  non-governmental organisations
OECD Organisation for Economic Co-operation and Development
SOEs  state-owned enterprises
TTIP  Transatlantic Trade and Investment Partnership
TTP  Trans-Pacific Partnership
TRIMs Trade-related Investment Measures
UK   United Kingdom
UNCTAD United Nations Conference on Trade and Development
US   United States
WTO  World Trade Organization

LIST OF TABLES

Table 1: Selected Indicators of Foreign Direct Investment and International Production, 2013 and Selected Years
Figure 1: Changes in National Investment Policies, 2000-2014 (Percentages)
Figure 2: Known Investor-State Dispute Settlement Cases, 1987–2014
International investment—more specifically, foreign direct investment (FDI)—has become the most important vehicle to bring goods and services to foreign markets—the sales of foreign affiliates in 2013 were estimated at US$35 trillion, while world exports were US$23 trillion. In addition, FDI integrates the national production systems of individual countries and is in the process of creating an integrated international production system, the productive core of the globalising world economy.

Against the background of the salient features of FDI and the emerging integrated international production system, this paper seeks to do three things—one, to discuss the evolution of national FDI policies; two, to review challenges for the international investment law and policy regime; and, three, to identify options on how some of these challenges can be met. The discussion is broader than focusing on priority issues only; rather, it covers a range of issues that may eventually need to be addressed. The emphasis is on the international governance of international investment in the globalising world economy, which so far has taken place through a myriad of mostly bilateral treaties. The resulting regime—which increasingly sets the parameters for domestic policy-making on international investment—has developed rapidly over the past few decades. It remains in flux and needs to be improved further to maintain its effectiveness and legitimacy.

SALIENT FEATURES
OF FOREIGN DIRECT INVESTMENT AND MULTINATIONAL ENTERPRISES

SALIENT FEATURES

The importance of international investment

Firms undertake the lion’s share of FDI, commonly defined as investment that involves control over foreign assets. According to the International Monetary Fund (IMF), control is assumed to exist if a foreign investor (among other things) owns at least 10 percent of the shares of a foreign company (“foreign affiliate”). However, there are also various forms of non-equity relationships (for example, management contracts, franchising arrangements) that also confer control over assets located abroad. In a broader definition of international investment, anything that involves a value controlled by foreign firms can be considered a foreign investment, in the sense that it can raise issues similar to those associated with FDI as traditionally defined. Unfortunately, though, systematic time-series data are available only for FDI. Thus, these data are an underestimation of international production, that is, assets that are under the common governance of parent firms (multinational enterprises—MNEs).

To return to the better-documented part of the phenomenon, at least 100,000 MNEs control at least 1 million foreign affiliates (even under the conventional definition of FDI, these figures underestimate the number of MNEs and their foreign affiliates considerably). Some 70,000 of these MNEs are headquartered in member countries of the Organisation for Economic Co-operation and Development (OECD; developed countries, for short), and some 30,000 in non-OECD countries (emerging markets, for short). They were responsible for US$1.3 trillion of FDI inflows in 2014, compared to about average annual inflows of US$50 billion during the first half on the 1980s. Much FDI takes the form of mergers and acquisitions (M&As), regardless of whether parent firms are headquartered in developed countries or emerging markets. The world stock of FDI at the end of 2013 stood at US$26 trillion. While the biggest MNEs might control some two-thirds of the world’s FDI stock, most MNEs are small or medium-size enterprises. These often have limited capabilities to access finance and information about investment opportunities, or staff international operations and deal with difficulties in host countries should they arise. As a result, they face special obstacles in their multinationalisation process.

Multinational enterprises, regardless of whether they hail from developed countries or emerging markets, have invested in all sectors and throughout the world. The services sector alone accounts for around two-thirds of the world’s investment flows and stock, and natural resources for almost one-tenth. Traditionally, the developed countries attracted most FDI flows, but now emerging markets receive more than half of these (US$745 billion in 2014). When it comes to the world’s accumulated inward FDI stock, however, the developed countries are still by far in the lead, hosting almost two-thirds of it.

Apart from the rising attractiveness of emerging markets for FDI flows, an important recent development has been the rise of firms from these countries as outward investors. From virtually negligible amounts a decade or two ago, outward FDI from emerging markets reached US$550 billion (or 41 percent of the world total) in 2014, more than ten times what world FDI flows had been during the first
half of the 1980s. Firms headquartered in 138 emerging markets on which data were available had, in 2013, an accumulated stock of outward FDI, and 75 of them reported FDI outflows for every year during the period 2009–2013. At the same time, though—and as in the case of the developed countries—a few countries dominate these outflows. Taking average FDI outflows during 2011–2013 as the basis (and excluding financial centres and tax havens), the top three outward investing emerging markets were China (US$88 billion), the Russian Federation (US$70 billion), and Singapore (US$21 billion).

China is by far the leader. It is not only the largest host country for FDI among emerging markets (attracting US$128 billion in 2014), but also the largest FDI home country—Chinese firms invested an estimated US$116 billion abroad in 2014, a good part of it channelled through Hong Kong and other financial centres and tax havens. China’s outward FDI flows will likely overtake the country’s inward flows in 2015 or 2016. A salient feature of China’s FDI abroad is that some four-fifths is undertaken by state-controlled entities, overwhelmingly state-owned enterprises (SOEs), especially the 115 centrally controlled ones. China’s outward investors are helped by the country’s regulatory framework for outward FDI. This framework has moved over time from restricting, to facilitating, supporting, and encouraging outward FDI (even if this framework still has strong elements of administrative control that make it cumbersome).

It is very likely that the growth of FDI, including from emerging markets, will continue, for various reasons. The basic one is that demand for investment will remain high, as investment is central to economic growth and development. In an increasingly digital world economy, further, knowledge-intensive investment—precisely the type that FDI often is—is at a premium. For example, delivering the United Nations’ Sustainable Development Goals over the period 2015–2030 alone requires that an annual investment gap of between US$2–3 trillion will need to be financed. Independently of these goals, global infrastructure needs by 2030 will require financing a gap of US$15–20 trillion. FDI would have to rise significantly to help fill these gaps, considering that bilateral financing a gap of US$ 15–20 trillion. FDI would have to rise significantly to help fill these gaps, considering that bilateral financing is likely to be intense, including by offering incentives and otherwise facilitating it.

Motives and determinants

Whether governments can successfully tap the reservoir for FDI depends on the motivations for firms to invest abroad, as well as the nature of the FDI determinants that characterise host countries.

Firms locate production abroad for essentially four sets of reasons—they seek to serve foreign markets better (market-seeking FDI), especially when trade is not an alternative (as for many services). They seek to increase the efficiency of their operations, especially by tapping into lower labour costs elsewhere (efficiency-seeking FDI). They seek to access natural resources (resource-seeking FDI). Or they seek to acquire such assets as technology or brand names (asset-seeking FDI). These motivations, in various combinations, are most likely to remain the driving forces for MNEs in the
future as well when they decide whether to invest abroad (as opposed to, say, export).

These motives, in turn, interact with the three principal sets of factors that determine where abroad MNEs decide to locate the production of goods and services—the economic determinants, the regulatory framework, and investment promotion.

The single most important among them are the economic determinants, in particular the size and growth of a market, the quality of the infrastructure and supplier base, and the cost and quality of skilled labour, other production factors, and science and technology resources. Natural resource-seeking investment apart, the availability of such assets determines to a large extent the locational choices of firms seeking to invest abroad. The economic determinants will remain the single most important factor in the future as well, as they govern whether or not a given investment location contributes to the international competitiveness of firms and, hence, ultimately their profitability.

At the same time, for any FDI to take place it is necessary that the regulatory framework is enabling: It needs to allow foreign firms to undertake FDI. This second set of FDI determinants has to be present. But the regulatory framework does not have to be perfect, as the governing set of determinants are economic ones.

The third set of FDI determinants consists of investment promotion. This set of determinants has become more important as the FDI regulatory framework has become more similar. Accordingly, virtually every country has established investment promotion agencies since the mid-1990s, increasingly also at the sub-national level. These are in fierce competition with each other to attract FDI, resulting in a highly competitive world FDI market. The effectiveness of such agencies can be important, at least for emerging markets, for attracting investment, assuming that the economic FDI determinants are in place and the regulatory framework is enabling.

The improvement of the economic determinants in emerging markets, combined with an enabling regulatory FDI framework and active efforts to attract FDI, explains to a large extent why emerging markets have become the leading destination of FDI flows in the past few years. Progress towards the Sustainable Development Goals—reduced poverty, improved education, health and nutrition, and an expanding middle class—will make the emerging markets even more attractive to FDI in the future.

**RISE OF AN INTEGRATED INTERNATIONAL PRODUCTION SYSTEM**

The growth of FDI and the way it is organised has led to the emergence of an integrated international production system. Firms locate specific activities wherever it is best for them to maintain or increase their international competitiveness—and, hence, ultimately their profitability. This concerns not only the production of "nuts and bolts," so to speak, but increasingly also various components of service activities and, indeed, various headquarters functions.

Locating manufacturing production abroad has traditionally been an approach taken by firms that engaged in market-seeking FDI. What is relatively new is that MNEs have moved to an international intra-firm division of labour by building corporate networks of foreign and domestic affiliates that specialise in the production of various parts and components that, eventually, are assembled in any location in the world best suited for this purpose. Moreover, firms that are not tied to particular parent firms through ownership arrangements are becoming part of the production networks of these parent firms through non-equity arrangements. The value chains that are the result are often regionally centred, especially in Asia (although they are typically referred to as "global" value chains). While parent firms remain the ultimate decision-makers in these value chains, the role of headquarters increasingly becomes that of deciding where various production activities take place, organising a highly complex network, providing key tangible and intangible assets (for example, finance, brand names, research and development), orchestrating information and knowledge flows within the network, and ensuring that profits are maximised globally for the enterprise as a whole. The emergence of such complex networks coordinated by headquarters makes it difficult at times to identify the boundaries of a particular firm or, for that matter, to determine liability in case of, for instance, gross negligence. It also means that the distinction between host and home countries is losing its sharpness. This, in turn, has implications, for example, for questions related to taxation, where to put legal titles for patents and trademarks, and for determining corporate nationality (important, among other things, for the question of standing in international investment disputes).

Another new aspect is that the splitting up of the value chain is being extended to the production of services, a process that roughly started around the turn of the century and is continuing to gather speed. Advances in information technology were key to this development.

Given that most services are intangible, they traditionally needed to be produced when and where they were consumed—they were not tradable. Hence services firms—be they in banking, insurance, accounting, health, architecture, research and development, legal services, or any other services sector—seeking to expand abroad had to establish themselves in the markets they planned to serve. (This is also reflected in that the bulk of FDI is in the services sector.) Advances in information technology, however, have made it possible for the information part of a range of services—and many services are information intensive—to be captured digitally, stored, and sent to any location when and where
that information is required. Services have become tradable. This “tradability revolution,” in turn, makes it possible for service firms to split up the production process and locate, as in the case of manufacturing, the production of various service components wherever it is best for them from the perspective of furthering their international competitiveness. In this manner, integrated international production and the global value chains associated with it are now being extended to the services sector.

The possibility of splitting up the production of services extends also to the various functions that are traditionally performed by corporate headquarters, ranging from communications to finance. They too can be located wherever it is best from the perspective of firms as a whole, disassembling what once were unified headquarters. It is a process that has begun, but still far from having run its course.

In aggregation, these value chains of integrated international production add up to the expanding integrated international production system that is the productive core of the globalising world economy.

The emergence of such a system and the global value chains that define it—which is taking place, as it does, within the framework of an enabling national and international investment law and policy framework (to be discussed below)—puts to rest the old question of whether FDI leads to trade or trade leads to FDI. Rather, the question becomes—where do firms locate their production facilities, be it to produce goods or services? If the location is at home, it is domestic investment; if the location is abroad, it is FDI. As production becomes more fragmented, the locational outcome may involve multiple facilities, and the resulting transactions may comprise domestic sales, sales by affiliates overseas, and intermediate trade of products, parts and components within corporate networks. FDI and trade are necessary complements for integrated international production.

The intertwinement of investment and trade has policy implications. This has been recognised in the Agreement on Trade-related Investment Measures (TRIMs) by addressing restrictive and distorting effects that certain investment measures may have for trade in goods. Additional measures are prohibited in other international investment agreements (IIAs), especially bilateral investment treaties (BITs). There is also the question of incentives used to attract FDI, an issue addressed briefly elsewhere in this text. On the other hand, there are investment-related trade measures that can distort investment flows. Particularly important here are rules of origin. Unlike trade-related investment measures, the latter have received little attention in multilateral disciplines.

TABLE 1: Selected Indicators of Foreign Direct Investment and International Production, 2013 and Selected Years

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<thead>
<tr>
<th>Item</th>
<th>Value at current prices (Billions of dollars)</th>
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<tbody>
<tr>
<td></td>
<td>1990</td>
</tr>
<tr>
<td>FDI inflows</td>
<td>208</td>
</tr>
<tr>
<td>FDI outflows</td>
<td>241</td>
</tr>
<tr>
<td>FDI inward stock</td>
<td>2 078</td>
</tr>
<tr>
<td>FDI outward stock</td>
<td>2 088</td>
</tr>
<tr>
<td>Income on inward FDI</td>
<td>79</td>
</tr>
<tr>
<td>Rate of return on inward FDI</td>
<td>3.8</td>
</tr>
<tr>
<td>Income on outward FDI</td>
<td>126</td>
</tr>
<tr>
<td>Rate of return on outward FDI</td>
<td>6.0</td>
</tr>
<tr>
<td>Cross-border M &amp; As</td>
<td>111</td>
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<tr>
<td>Sales of foreign affiliates</td>
<td>4 723</td>
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<tr>
<td>Value-added (product) of foreign affiliates</td>
<td>881</td>
</tr>
<tr>
<td>Total assets of foreign affiliates</td>
<td>3 893</td>
</tr>
<tr>
<td>Exports of foreign affiliates</td>
<td>1 498</td>
</tr>
<tr>
<td>Employment by foreign affiliates (thousands)</td>
<td>20 625</td>
</tr>
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</table>

Memorandum:

<table>
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<th>Item</th>
<th>Value at current prices (Billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>22 327</td>
</tr>
<tr>
<td>Gross fixed capital information</td>
<td>5 072</td>
</tr>
<tr>
<td>Royalties and license fee receipts</td>
<td>29</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>4 107</td>
</tr>
</tbody>
</table>


* Based on data from 179 countries for income on inward FDI and 145 countries for income on outward FDI in 2013, in both cases representing more than 90 per cent of global inward and outward stocks.
* Calculated only for countries with both FDI income and stock data.
* Data for 2012 and 2013 are estimated using a fixed effects panel regression of each variable against outward stock and lagged dependent variable for the period 1980-2010.
* Data for 1995-1997 are based on a linear regression of exports of foreign affiliates against inward FDI stock for the period 1982-1994. For 1998-2013, the share of exports of foreign affiliates in world exports in 1998 (33.3 percent) was applied to obtain values.
* Data from IMF, World Economic Outlook, April 2014.
The prevalence of the integrated international production system is reflected in that some one-third of world trade takes place as intra-firm trade, that is, among the various parts of the same MNEs. Beyond intra-firm trade, approximately 80 percent of global gross trade involves MNEs in one way or another. Of that, approximately 42 percent is intra-firm trade, approximately 16 percent happens through non-equity modes (which include contract manufacturing, licensing and franchising) and approximately 42 percent occurs through arm’s-length transactions involving at least one MNE. Similarly, a substantial share of international technology transfer—especially the transfer of tacit technology—takes place within this integrated international production system.

This new reality underscores the importance of the locational FDI determinants. While the economic determinants will remain paramount, an open investment and trade regime is the precondition for the further growth of global value chains under the common governance of parent firms that, in turn, make key corporate decisions.

But this new reality also entails risks. For MNEs, they are related to possible disruptions of their global value chains, especially when they work under just-in-time production conditions. Such risks can stem from natural disasters, such as the 2011 earthquake and tsunami in Japan—international supply chains involving Japanese suppliers were severely disrupted, at significant costs for the firms involved. But supply chain disruptions can also result from political risks, such as adverse regulatory changes, breach of contract, civil disturbances, expropriation, terrorism, and civil war. National and international investment insurance coverage has still to take into account that political risks no longer can have only implications for the operations of a firm in one particular country, but may have negative implication in other parts of a firm’s global value chain.

Be that as it may, FDI and non-equity forms of control by MNEs over foreign production facilities have become more important than trade in delivering goods and services to foreign markets—as already mentioned, the sales of foreign affiliates alone in 2013 amounted to about US$35 trillion, compared to world exports of about US$23 trillion (Table 1). Moreover, a substantial part of trade flows is through the global value chains governed by MNEs. FDI and non-equity forms of control, as the most important form of international economic transactions, integrate not just national markets through trade, but also national production systems. This raises questions about the governance of international investment and, in particular, the relations between investors and governments.

The National Regulatory Framework for International Investment

National (as well as international) policy-making regarding MNEs and their international investment takes place in the context of sets of tensions for governments seeking to attract FDI and benefit from it as much as possible—the global corporate interests of MNEs versus the national development interests of countries; foreign versus domestic ownership; policies to attract FDI versus policies to maximise its benefits; and a country’s interest as a host country versus its interests as a home country. And the constraints of the emerging integrated international production system, a globalising world economy and international investment law versus the need for policy space in the interest of pursuing legitimate public policy objectives. To illustrate two of these tensions—MNEs evaluate the benefit of each of their FDI projects in relation to maximising their competitiveness and profitability within the framework of their own global corporate networks, while governments seek to maximise the benefits of the same projects within their own territorial boundaries. Or, as host countries, governments seek to maintain policy space to pursue their own legitimate public policy objectives, while, as home countries, governments seek to protect the investment of their own firms abroad and to facilitate their operations by limiting the policy space of host countries.

These tensions create dilemmas for policy-makers, who typically need to consider various (often conflicting) objectives and need to do that in the context of conflicting pressures from various stakeholder groups. Among the latter, non-governmental organisations (NGOs) have become important actors in a number of countries, and their views need to be taken into account. These dilemmas and pressures impose limitations on the formulation of national laws and regulations and entering into IIAs, primarily BITs and free trade agreements (FTAs) containing investment chapters. (IIAs also include certain World Trade Organization [WTO] agreements, notably the General Agreement on Trade in Services [GATS] and the Agreement on TRIMs.) Underlying these tensions is that for governments FDI is but a tool to
advance their countries’ economic growth and development, while for firms FDI is a tool to further their corporate competitiveness and profitability. The task of policy-makers is to maximise the positive effects of FDI in their countries and minimise any negative ones. Hence, national policies regarding FDI, and the international regulatory framework within which national policies are formulated, are of key importance for host countries, and they can conflict with the goals of MNEs to maximise their international competitiveness and global profits.

TRENDS

The national regulatory framework for FDI defines whether and under what conditions such investment can enter a host country, operate in it, and exit it. It is therefore of central importance to both host countries seeking to attract FDI and benefit from it, and to MNEs seeking to establish a portfolio of locational assets that serves their international competitiveness best.

Over time, national FDI frameworks have changed considerably. After not being welcoming to foreign investors during the 1960s, 1970s, and early 1980s (frequently enforced through national screening agencies), they turned decisively welcoming during the 1990s. During that decade, some 95 percent of national FDI policy changes that the United Nations Conference on Trade and Development (UNCTAD) recorded worldwide went in the direction of making the investment climate more favourable for foreign investors. Governments opened formerly restricted sectors to FDI, removed caps on investments, or raised ceilings for such investment. They facilitated the operations of MNEs and their foreign affiliates in host countries, including by relaxing performance and approval requirements and simplifying business registration. They marketed their countries to investors. They offered incentives to attract FDI, with incentives competition becoming fiscal wars at the sub-national level in some countries. They assisted incoming investors in various ways, including by offering information, coordinating investor visits, and providing after-investment services. They liberalised the repatriation of earnings and other capital. And they codified various protections in national regulations, laws, or even constitutions. In the 1990s, countries also began to establish investment promotion agencies with the specific brief to attract as much FDI as possible. Red carpet had replaced red tape.

Since the turn of this century, however, national approaches in both developed countries and emerging markets towards incoming FDI have become more nuanced. While the majority of policy changes continue to go in the direction of making the investment climate more welcoming, the number of changes that do the opposite has risen considerably since 2000, reaching between 20 and 30 percent of total national investment policy changes during the past few years (Figure 1). Many of the latter measures related to the entry of foreign investors and many were concentrated in natural resources (including agriculture) and the services sector. A number of governments also have come to treat M&As differently from greenfield investments. While the latter are universally welcome (creating, as they do, new production capacity), M&As are at times regarded with suspicion, especially when they raise competition concerns, take place in sensitive industries (however defined), are being undertaken by state-controlled entities and, in particular, are seen as a threat to national security (however defined). This is reflected in the strengthening of the investment review mechanisms in such countries as Australia, Canada, China, Germany, and the United States (US).

![Figure 1](image-url)
The challenge for national FDI policy makers is to find the right balance among policies to attract FDI, seeking to increase its benefits to their economies, and regulating FDI inflows in pursuit of legitimate national public policy objectives (especially the protection of national security) without compromising the investment climate and deterring foreign investors; policy benchmarking can play a role here. Achieving this balance is made more difficult by pressures from various constituencies, including constituencies that may favour policies that could lead to FDI protectionism, and because national policy objectives can change over time. National FDI policy-making is a dynamic process.

The approach towards investment promotion has become more nuanced as well. To be sure, the overwhelming majority of governments still seek to attract as much FDI as possible by making their countries’ investment climate more welcoming. But a growing number of investment promotion agencies also pursue a more targeted approach, focussing on attracting the kind of FDI that is particularly important for their economies’ economic growth and development. There are even signs that countries seek sustainable FDI: commercially viable investment that makes a maximum contribution to the economic, social, and environmental development of host countries and takes place in the context of fair governance mechanisms, as concretised by host countries and reflected in the incentives they may offer—sustainable FDI for sustainable development. In this case, the focus is not on the quantity but the quality of FDI. Efforts to increase the contribution of FDI to host economies are in line with this type of approach, through, for instance, the promotion of backward and forward linkages with local companies and the encouragement of technology transfer.

However, the incentives competition to attract FDI has not abated, be it through financial, fiscal, regulatory, or other incentives. This is so despite mounting evidence that many incentives are icing on the cake, that is, they do not decisively influence the locational decisions of firms in most cases. But without a multilateral approach to such competition, it is not likely that the incentives competition for FDI (not even its transparency) can be contained—a future area for international action. Perhaps this could be done best in the context of an updated Agreement on Subsidies and Countervailing Measures (ASCM).

Moreover, there are signs that the incentives competition is being extended to outward FDI, as governments seek to help their firms strengthen their international competitiveness. All developed countries, in varying degrees, have put instruments (home country measures) in place to help their firms invest abroad. Governments provide information about investment opportunities and the FDI regulatory framework in host countries to their MNEs. They offer financial and fiscal incentives for outward FDI. They have established institutions to provide investment insurance against various political risks. They link official development assistance to particular FDI projects (for example, in natural resources). And they conclude international investment agreements and double taxation treaties to protect investors abroad and facilitate their operations. A few emerging markets, too, have begun to support their firms investing abroad (the best known example being China’s “going global” policy), but the great majority of them have not yet done so.

**TWO CHALLENGES**

This situation gives rise to two challenges—should there be a separate regime for SOEs? And what should countries do that do not have a policy on outward FDI?

The first challenge concerns that state-controlled entities (especially SOEs, but also sovereign wealth funds) are among the outward investors that benefit from home country measures when they invest abroad. SOEs have long been outward investors. The assets controlled by the largest SOEs that were MNEs and were headquartered in developed countries amounted (in 2010) to US$1,400 billion, and those controlled by the largest SOEs that were MNEs and were headquartered in emerging markets amounted to US$400 billion.

Still, the rise of emerging market MNEs that are SOEs investing abroad has raised a question, namely whether the help given to SOEs investing abroad infringes on “competitive neutrality,” that is, distorts the competitive outward FDI landscape in favour of these entities in the markets in which they invest. For instance, SOEs seeking to acquire firms in host countries may have a competitive advantage when receiving concessional financing by their home country governments. (There is also the question of whether such entities might be pursuing objectives other than commercial ones.) This issue is currently being negotiated in the context of the Trans-Pacific Partnership (TPP) agreement, and it is also on the agenda for the Transatlantic Trade and Investment Partnership (TTIP).

The result may be a special regime for a certain class of investors. This, in turn, raises the question of whether it is desirable to move away from a unified international investment law and policy regime and towards a regime that distinguishes types of investors and, for that matter, types of investments (for example, M&As versus greenfield investment). It also raises the question of whether the application of the principle of competitive neutrality should remain limited to state-controlled entities or should be extended to the support, through various incentives, of outward FDI in general, be it by state-controlled entities or private firms. (In this context, it needs to be recognised that state ownership does not necessarily always mean state control and, conversely, not having state ownership does not always mean that the government cannot influence corporate decision-making.) This question mirrors the discussion of whether incentives offered by countries to attract FDI need to be disciplined, an issue that had already been (unsuccessfully) raised in the context of the Uruguay
OBJECTIVES AND CHARACTERISTICS

The objectives that governments pursue when establishing national regulatory frameworks for FDI influence the objectives they pursue when concluding international investment agreements—the latter need to support national objectives, or, at least, not stymie them. The importance of the international law and policy regime as a parameter—and legal yardstick—for national law and policy-making has risen considerably, as this regime has “teeth,” in the form of an international dispute settlement mechanism that allows investors to seek redress in case they feel that host countries have violated their rights. Awards against governments can potentially be high, not counting the costs of arbitration and possible implications for the regulatory power of governments.

Thus, in the 1990s, when the predominant national objective of governments was to attract FDI during the heyday of liberalisation and make the investment climate more welcoming for foreign investors, the number of BITs concluded by governments exploded from 371 at the end of the 1980s to 1,862 at the end of the 1990s, to reach 2,923 at the end of 2014, to which 345 other IIAs need to be added. Protecting FDI through BITs was meant to encourage investment inflows.

Indeed, the principal purpose of these treaties was—and remains—to protect the assets of investors abroad and facilitate the operations of these investors in host countries. This did not happen by accident, but rather by design—when developed countries began to negotiate BITs with developing countries in 1959, the clear objective was to protect FDI in a world in which, on the one hand, foreign investors had little confidence in the judicial systems of developing countries, and, on the other hand, international investment law consisted largely of relatively vague customary international law which, moreover, was questioned by many developing countries. In later years, a growing number of countries added liberalisation provisions to their IIAs to make it easier for their firms to enter foreign markets and operate in them, especially by stipulating national treatment at the pre-establishment phase of an investment. Now, a sizable share of IIAs (and especially BITs) also exists between emerging markets.

During the 2000s, when the national regulatory frameworks for FDI in a number of countries became more nuanced, Governments are becoming increasingly interested in the type of an investment, the source of an investment, and the effects of an investment in their countries. Achieving the right balance has become a key challenge for countries, and it is one that emerging markets, especially with regard to outward FDI by their firms, increasingly need to consider.
in turn and as a rule, include (in an open-ended manner) everything that has a monetary value, ranging from equity in an enterprise, to intellectual property rights, to contracts, to expected profits. Similarly, key protection standards to be observed by host countries, such as fair and equitable treatment (which has become the basis of many claims by investors) and indirect expropriation, are not defined precisely. Protection, further, is expanded through most-favoured nation (MFN) commitments, umbrella clauses, and the possibility of treaty shopping. At the same time, IIAs do not impose obligations on foreign investors or, as a rule, on home countries. And they typically do not pay much attention to some other public policy objectives, such as economic development.

Matters are further complicated because the international investment law regime consists of a multiplicity of legal sources. These include the multitude of IIAs, customary international law, the decisions of tribunals, various voluntary governmental, intergovernmental, and non-governmental standards, as well as mixed voluntary/mandatory instruments. While there are many substantive similarities among many of these instruments, there are also substantial differences. The regime governing international investment is therefore highly fragmented, difficult to describe, and hard to navigate, and it exhibits instances of inconsistent law making and law application. Moreover, it is in constant flux. Its fragmented institutional infrastructure further exacerbates these challenges.

Finally, a defining and crucial characteristic of the investment regime is that investors have a private right to action when seeking redress, under the investor-state dispute settlement (ISDS) mechanism enshrined in the majority of IIAs. From the perspective of international investors, this is a strong and positive feature of the investment regime, because governments do at times infringe on treaty obligations, and investors can therefore have real and legitimate grievances about the behaviour of host country governments. In such cases, ISDS makes investors independent of their home country governments when they wish to bring a claim (unlike in the case of the WTO). It also makes them independent of the judicial systems of their host countries, a number of which, for various reasons, investors may not trust or favour fully. The ISDS mechanism makes the international investment regime one of the strongest international regimes in existence.

**CHALLENGE OF PREVENTING, MANAGING AND SETTLING DISPUTES**

**Rise of disputes and criticisms of their settlement**

While the current ISDS mechanism may work well from the perspective of international investors, it entails considerable risks for host country governments. These begin with that, under applicable IIAs, aggrieved investors have a choice between seeking remedy either under the domestic law of a host country or the applicable IIA (or both), while host countries do not have that choice, as only investors can initiate the ISDS mechanism when disputes between investors and host countries arise. (There is also the question of whether contractual claims can be pursued parallel to treaty claims.) And such disputes are unavoidable, considering the growth of FDI (now amounting to a stock of some US$26 trillion); the number of international investors; the number of their foreign affiliates and the number of investors in such affiliates (all of which, depending on the applicable IIA, may have a right to initiate arbitration proceedings); the intrusiveness of FDI, involving, as it does, the entire range of interactions related to the production process over the entire life span of a project; and the various tensions within which national policy-making in this area is situated. Add to that the number of IIAs; the broad definitions of “investor” and “investment;” the broad formulation of the various protections contained in these agreements; and that violations of investor rights can take place at any administrative level (that is, not only the national level). As a result, the potential for conflicts between host countries and MNEs and their foreign affiliates is considerable—it is not even possible to estimate the potential liabilities to which governments are exposed.

Not surprisingly, then, the number of treaty-based investment disputes has risen considerably, having reached at least 608 known cases by the end of 2014 (Figure 2), involving governments of 99 countries from across the world. (While this number of disputes may appear low, it should be compared to the number of disputes on which panel reports were issued during the existence of the General Agreement on Tariffs and Trade [GATT] from 1948 to the end of 1994—when the WTO came into existence—which was only 91.) As disputes are resolved in favour of investors (although many are not), more claims are likely to be brought, especially if third-party financing becomes more widely available. Moreover, awards against responding host countries can be high, as can be the costs of arbitration (the costs of the claimant’s defence alone can often be in the millions of US dollars).

As a result, no aspect of the international investment regime is more in the public’s eye than the regime’s dispute settlement mechanism. Critics submit, rightly or wrongly and among other things, that, de facto, big investors only have access to the dispute settlement mechanism, while governments do not (except in the case of counter-claims); that small and medium-size enterprises cannot afford the ISDS process; that private arbitral panels adjudicate over public policies; that conflicts of interests exist for arbitrators, including conflicts of interests that may compromise their independence; that inconsistent decisions are rendered; that there is no real possibility for the review of arbitral decisions taken; that poor countries are not in a position to defend themselves as respondents; that the decisions of tribunals may chill policy-making in such areas as the protection
of the environment, the observance of social standards, the protection of human rights, and the advancement of development; that investors engage in abusive treaty shopping to benefit from ISDS; that they bring frivolous suits; that governments can never win in arbitrations, but only not lose; and that the costs of the rising number of claims are high, both in terms of the costs of the arbitration process and the potential awards involved. Some of these criticisms are overstated, some are more serious than others, some are being addressed in more recent IIAs, but all of them bear—rightly or wrongly—on the legitimacy of the ISDS mechanism and, with that, on the legitimacy of the international investment regime.

Key questions therefore are—how can investment disputes be prevented in the first instance, that is, at the national level? And, in particular, how can the handling of disputes at the international level be improved?

Meeting the challenge at the national level

At the national level, the prevention, management, and resolution of disputes between foreign investors and host countries are imperative. In particular, it is imperative for countries to avoid such disputes reaching the international (arbitration) level. Institutions such as investment ombudspersons and inter-ministerial committees (as, for example, in Peru) that vet conflicts that arise, with a view towards settling them amicably at an early stage, are helpful here. So, too, are such alternative dispute resolution approaches such as mediation.

Moreover, possibilities to reduce the likelihood that large contracts between international investors and host countries become a source of disputes could be explored. Often, such contracts do not reflect the best possible deal a host country could obtain had it (like the negotiating international investor) a multi-disciplinary world-class team negotiating on its behalf. Contracts that are, or are seen to be, unbalanced are likely not to last. Rather, they are likely to give rise to conflicts that, ultimately, may go to international arbitration. Fair deals also benefit investors in that they create conditions of mutual trust and help the sustainability of commitments. (In the past, it might have been possible to improve bad deals over time; but with the advent of the increasing use of ISDS, countries need to get deals right from the beginning.)

One possible response to this situation is the creation of an investment negotiations support facility. Such a facility could help especially the 48 least developed countries negotiate fair large-scale investment contracts with foreign investors. It is promising that the Group of Seven (G7) (with the encouragement of the least developed countries) has begun to look into the possibility of establishing such a facility, as fair contracts would reduce at least one source of potential conflicts between international investors and host country governments.

Meeting the challenge at the international level

As to international dispute settlement, a number of options should be considered to improve the ISDS mechanism, at least going forward, and a number of them have already been addressed in, for instance, more recent treaties of the US. Some of these should be relatively straightforward. For instance, abusive treaty shopping to obtain the protection of an IIA and its ISDS mechanism could be limited sharply by requiring that a substantial presence test be met. Similarly, frivolous claims could be avoided through a screening mechanism that allows the dismissal of such claims. Transparency has been significantly strengthened. A code of

FIGURE 2: Known Investor-State Dispute Settlement Cases, 1987–2014

ethics for arbitrators could help to avoid conflicts of interest. Arbitral proceedings could be opened up to the submission of amicus briefs and the attendance of non-parties in arbitral hearings. The establishment of standing panels of arbitrators could help alleviate concerns about the selection of arbitrators, their independence, and their impartiality (although, given that two of the arbitrators are appointed by the parties to a dispute, it is difficult to see how they could be seen as being independent and impartial). Treaty parties could be given greater rights in the interpretation of their treaties, both in general and in the context of an ongoing dispute, which are binding for arbitrators. Treaties could make it explicit that governments have the right to regulate in the public interest, even if that imposes burdens on foreign investors. And so on.

There are also more fundamental improvements that could be envisaged. They need to be based on the recognition that the current approach to dispute settlement by arbitral tribunals involves a fundamental tension. On the one hand, it is a party-owned process undertaken in an ad-hoc manner by private individuals focused on solving individual disputes; on the other hand, these private individuals exercise quasi public law functions in that arbitrators review the legality of certain actions by governments and, broader, contribute to the further development of international investment law, but with weak democratic legitimisation, legislative control, and the ability to appeal decisions to correct judicial errors and ensure consistency.

In this context, a topical and urgent question is whether appeals mechanisms for the current ad-hoc tribunals, a world investment court as a standing first-instance tribunal making the decision in any dispute settlement case, or a combination of both should be established. Institutionalising dispute settlement in this manner would be a major step towards improving the investment regime, comparable to the move from the ad-hoc dispute settlement process in the GATT to the Dispute Settlement Understanding in the WTO. Such an institutional innovation could not insulate the full consistency of the application of IIAs, given that the underlying treaties are not uniform. However, it could, over time, make the dispute settlement process more accountable and develop a body of legal authoritative interpretations that would increase the coherence and predictability of the investment regime. More generally, creating an avenue for appeal would increase the legitimacy of a central component of that regime and enhance the rule of law.

Several configurations and arrangements are conceivable. For example, awards issued by the ad-hoc panels currently envisaged in IIAs could be appealed to ad-hoc appellate bodies. These could be constituted in the context of particular disputes and in a manner similar to the way in which the first-level ad-hoc panels were established, but with a broader mandate than that of the ad-hoc annulment committees of the International Centre for Settlement of Investment Disputes (ICSID) (which are empowered to annul only on the specific grounds of Article 52 of the ICSID Convention). In a variation, the members of the appellate bodies could be chosen from a predetermined list of persons, preferably not by the parties to a dispute but by an independent third party. In either case, appeals could proceed under whatever arbitration rules have been chosen. One advantage of such an approach would be that appeals mechanisms could relatively easily be added to the current ad-hoc regime. A disadvantage is that such an approach would not necessarily increase the consistency and predictability of arbitral decisions, although, if arbitrators were to be chosen from a relatively limited pool, consistency could increase.

On the other end of the spectrum, one could envisage a single permanent and independent world investment court, staffed by tenured impartial judges. It would serve as the first instance for any dispute, replacing the current decentralised dispute settlement regime. It could be supplemented, in due course, with a standing appellate body. Decisions rendered by any of these bodies would be precedential. One advantage of such an approach would be that it would increase the consistency and predictability of decisions and in this manner help consolidate international investment law. A disadvantage is that such an approach would establish a relatively elaborate—and ambitious—structure in a specialised field of international economic law. It would resemble a national court system.

There are of course variations between these two approaches. (And there are also options outside these two approaches, such as requiring the [time-limited?] exhaustion of local remedies and abandoning ISDS altogether [or at least in certain contexts], or expanding access to this mechanism to indigenous firms.) For instance, one could imagine an appellate mechanism for reviewing awards being established in the framework of the treaty negotiations between two or more parties, but other states would be invited to opt in to make use of that mechanism as well, multilateralising the appellate mechanism in this manner (this approach seems to be foreseen in the TPP Agreement). Other variations are conceivable. Any new arrangement could, in principle, be made applicable to the stock of IIAs by taking a Mauritius Convention-type approach—governments could negotiate a convention on the applicability of an appellate mechanism in existing IIAs, making the agreed-upon applicability binding for them and their treaty partners, provided the latter have signed and ratified the convention as well.

While ambitious, it is not inconceivable that institutional improvements in the investment regime’s dispute settlement system can be made. After all, the IIAs concluded by the US in the past decade or so foresee the possibility of an appellate body. The European Union (EU), in agreements with Canada and Singapore, is warming to this proposal, as reflected in the Comprehensive Economic and Trade Agreement and the EU-Singapore Free Trade Agreement. Moreover, the EU is under pressure to improve the ISDS mechanism substantially. Importantly, it has responded to this pressure by announcing in May 2015 that it seeks
to introduce an appeals mechanism in its IIAs, in a move towards a dispute settlement approach that would function similar to traditional court systems. Beyond that, the EU is also working towards the establishment of an international investment court and appellate mechanism that would apply to multiple agreements, and which would be a stepping stone towards a permanent multilateral system for investment disputes.

Any of these institutional improvements would of course involve significant challenges, requiring substantial research, multi-stakeholder consultations, and extensive negotiations. Issues that would need to be considered include the following. What can one learn from the experience of similar arrangements in other areas, especially trade? Would the benefits of such an institutional change outweigh its costs (including the possibility that unfortunate decisions might set bad precedents, or that the process might become too costly for smaller investors)? What would the architecture of such an institution look like and how would such an institution be organised? How would such an institution be created? How would appointments be made? How would it be financed? How would such an institutional innovation be made applicable to disputes arising under existing IIAs? And should such an institution be a standalone body or be associated with an existing institution (and, if so, which)? For example—and just to mention one possibility in relation to the last of these questions—since the ICSID is the single most prominent dispute settlement venue, one could think of a treaty updating the present Convention—an ICSID II, so to speak. It would preserve enforceability but update any features in the current rules that might require modernisation. (including, for example, expanding the possibility for counter-claims). Most importantly, such a new treaty would create a single world investment court (and appellate body) that would then be available to all governments that have signed and ratified such a treaty.

Difficult as it is to improve the current dispute settlement mechanism, embarking on a process of examining how this could be done, with a view towards bringing a better mechanism into being, would send a strong signal that governments recognise that the ISDS mechanism would benefit from improvement. This is not merely a technical question but (as public discussions of ISDS show) a matter of what is considered as fair by the public.

Detailed discussions of the range of issues related to this matter are already under way in a number of forums. These should make sure that all interested stakeholders are heard, including to ensure that all issues are being addressed. In-depth discussions in informal forums could helpfully make an input into governmental deliberations.

### An Advisory Centre on International Investment Law

A similar signal strengthening the legitimacy of the dispute settlement process would be sent if the ability of poor countries to defend themselves as respondents in investment disputes would be improved. (This matter is dealt with separately here, as it is not a matter of access to the dispute settlement mechanism, but a matter of being able to utilise it properly.) Conversely, a dispute settlement mechanism that does not provide a level playing field for the disputing parties can easily be seen as compromised, undermining its very legitimacy.

Claims against host country governments can range in the hundreds of millions of dollars, host country regulations may be challenged and the reputation of a country as an investment location can be at stake. And, as noted, the annual number of claims is substantial, and litigating them is expensive, especially as disputes are becoming more complex. There is also the risk that respondents may have to assume the litigation costs of the claimants if they lose a case. The advent of third-party funding further accentuates the imbalance for poor countries, as such funding provides an additional source of finance to potential claimants.

Poor countries typically do not have the in-house expertise to defend themselves adequately—in fact it may not be the best use of scarce resources to build such expertise as few countries need to defend themselves in more than one or two cases at a time. At the same time, they often do not know how to defend themselves properly and are not familiar with the specific requirements of the ISDS mechanism. And many simply may not have the financial resources to hire the required expertise, which also does not help the efficiency and quality of the arbitration process—an important consideration since the bulk of the litigation costs typically are for counsel and expert witnesses.

This puts poor countries into an unfavourable position whenever a dispute arises, beginning with perhaps having to settle a dispute in which they potentially could prevail, or knowing when to settle during an early stage of a dispute when they usefully could do so, simply because they do not have the required understanding of the process or the resources to defend themselves. Similar considerations apply to small and medium-sized enterprises, as these too typically do not have the expertise and resources to raise claims; a small claims settlement mechanism, with an expedited process, set deadlines, and sole arbitrators, could be of help here.

An independent Advisory Centre on International Investment Law would help to establish a level playing field by providing administrative and legal assistance to respondents that face investor claims and are themselves not in a position to defend themselves adequately. The WTO experience
In the end, however, there are limitations to what even an improved dispute settlement mechanism can do. The reason is that any such mechanism needs to operate on the basis of applicable IIAs. If these agreements contain language that refers to general principles and rules that are open textured, imprecise, and leave considerable room for interpretation, then the possibility that disputes arise is commensurately high, as is the unpredictability for governments as to what they can or cannot do. Legal certainty is required, even if it may be impossible—and perhaps not even desirable—to eliminate all room for interpretation.

Accordingly, an important aspect of improving the regime concerns refining the key concepts in IIAs, including their substantive protections, by providing tight wording that defines as clearly as possible the sort of injuries for which investors can seek compensation and the type of actions that governments can take. Given that the post-2015 international agenda is shaped by sustainable development considerations, it would also be desirable to develop actionable criteria for what constitutes sustainable FDI (as defined earlier), for example, by elaborating a list of attributes that could be used to evaluate the nature of an investment in a particular investor-state dispute (for example, paying taxes in host countries? Training? Fostering linkages?).

A related issue concerns the interrelationships of the international investment regime with other substantive areas of the law, including the international regimes dealing with the environment, human rights, labour, and development, as well as taxation and subsidies. After all, the investment regime is not a closed law system that stands in isolation from other international regimes. Guidance on how such linkages should be recognised could be built into IIAs, for instance, through a general provision referring to the relevance of other areas of international law.

In other words, governments need to take full responsibility for the drafting of IIAs by seeking to reach the highest level of clarity possible for concepts used by them and interrelationships that need to be taken into account.

While providing greater clarity and recognising interrelationships should, in principle, be possible going forward, there is also the challenge of how to deal with the stock of IIAs in this respect. The Mauritius Convention on Transparency (opened for signature in March 2015) provides one approach towards how that challenge could be addressed—governments could negotiate a convention on, say, the precise meaning of fair and equitable treatment,
and states could sign up to it, making the agreed-upon interpretation binding for them and their treaty partners, provided the latter have signed and ratified the convention as well. (It may be difficult to follow this approach for only one standard, as the scope of a given standard can be connected with the scope of other standards; where this is the case, several standards would have to be covered in such a convention—which would make such an effort more complicated.)

These challenges, in turn, are directly related to the principal purpose of the investment regime. Given the origin of IIAs, it is not surprising (as pointed out earlier) that the principal purpose of the regime has been, and remains, to protect foreign investors and, increasingly, facilitate their operations. The question is whether such a narrow focus, reflecting the interests of one stakeholder only, is sustainable. The growing criticism of the regime suggests otherwise, as does the fact that a number of governments have pulled out of the regime. In particular, the quest of governments to be able to pursue legitimate public policy objectives without risking that they might be seen to violate investors’ rights highlights that a new balance is required. The same applies to the continuing demand that foreign investors, like domestic investors, have responsibilities too, and not only host countries. Unless the regime can be made more holistic, reflecting in a balanced manner the interests of all principal stakeholders and defining the relationships between foreign investors and governments in general, it risks losing its legitimacy in the longer run.

Enhancing the legitimacy of the regime requires therefore that the regime’s purpose be broadened to reflect not only the desire of countries to protect the assets of international investors, but also the interest of countries in pursuing other legitimate public policy objectives. The latter include in particular the need to promote sustainable development (and, with it, the flow of investment for sustainable development). This, in turn, requires that governments have the right to regulate in the interest of legitimate public policy objectives, and this right needs to be acknowledged in a legal provision in IIAs. These objectives include not only the promotion of sustainable development, but also the protection of public welfare, including public health, labour standards, safety, and the environment. This, in turn, necessitates governments to have a certain amount of policy space and investors to commit themselves to responsible business conduct.

When it comes to substantive provisions flowing from the broadened objectives of IIAs, then, these would not only have to confer rights on investors and responsibilities on host countries. Rather, they would also have to recognise the rights of host countries to pursue legitimate public policy objectives and deal with the responsibilities of investors. In addition, the rights and responsibilities of home countries—and, for that matter, other stakeholders—would have to be considered.

"Policy space" is a flexible concept, and care needs to be taken that it is not interpreted too broadly. This is similar to the challenge (discussed earlier) of taking care that key concepts and protections contained in IIAs are not interpreted too broadly. In either case, the possibility that this may occur reduces predictability, be it for investors or governments, and it increases the likelihood that investor-state conflicts occur. Hence, clearer wording for key concepts and protections in IIAs needs to be sought.

It is encouraging to see that the investment regime is already moving in the direction of broadened objectives and updated contents of IIAs, even if not as fast as some would desire. But, then, reform has to be balanced with the need to maintain the predictability of the regime as a protection device, and it has to build on what is working.

As far as objectives are concerned, more and more IIAs recognise, in their preambles, objectives other than protection, as well as the right to regulate. Particular attention is being given to public health, labour standards, safety, and the environment.

As to the contents of IIAs, some governments have narrowed the definition of “investment” by clarifying its scope. They have also clarified certain protections and, in the process, narrowed them somewhat (for example, fair and equitable treatment, indirect expropriation). They have dropped some protections entirely (for example, the umbrella clause). They have provided for consultations between the parties about the promotion of investment and other issues. And they are giving a greater role to treaty partners regarding the joint interpretation of clauses they have negotiated, giving them in this manner more control over their agreements (including, conceivably, the power to suspend arbitral proceedings if they agree that there is no treaty violation).

There is also movement regarding the question of the responsibilities of investors, in the interest of promoting desirable corporate conduct and discourage undesirable one. To begin with, host country governments can of course impose obligations on investors (both, domestic and foreign), and have done so, and investors have to abide by them, making them liable for any infringements that might occur. But there is the question of the extent to which IIAs limit the ability of host countries to do so, or discourage them to do so, for fear of being accused of violating treaty provisions. The introduction of investor responsibilities in IIAs would remedy this situation. Moreover, for countries with limited capabilities to enact their own laws and regulations in this area—and, equally important, implement them—the inclusion of investor responsibilities in IIAs would compensate for this lack of capability.1 There is indeed some movement regarding including relevant responsibility clauses in IIAs and, separately and complementarily, strengthening

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1 Including investor responsibilities in IIAs can also serve another function, namely, depending on circumstances, as a shield against investor claims.
and developing various voluntary instruments that operate largely on the basis of naming and shaming.

For instance, the recent Netherlands–United Arab Emirates BIT, for instance, enjoins the parties to promote the OECD Guidelines for Multinational Enterprises. Technically, there are also stronger ways of addressing obligations of investors. For example, the availability of investor protections could be conditioned on compliance with the applicable laws when making an investment, including anti-corruption laws, as the recently concluded Comprehensive Economic and Trade Agreement (CETA) does. Compliance with domestic laws and the observation of responsible business conduct during the operations of the investment could become a prerequisite for access to dispute settlement. A doctrine of "reasonable expectations" on the part of governments vis-à-vis foreign investors could be developed, for instance in the context of interpreting any of the current substantive obligations (say whether the host country’s has indeed been fair and equitable) or in the context of obligations of investors, as a balance in determining fair and equitable treatment (based on the view that fair and equitable is a relational issue seeing fairness and equity as a two-way street). Investors could be held liable for the non-observance of certain domestic laws of their host countries through counterclaims in the ISDS process. They could also be held liable for complicity or direct acts connected to the non-observance of obligations contained in international treaties pertaining to, for example, human rights and labour issues, that IIA treaty partners have ratified; while such treaties normally do not impose obligations directly on investors, IIAs could make reference to such treaties through an "import clause" and establish a link to investors. Or investors could be held liable for the non-observance of certain voluntary international standards, subject to certain conditions and exceptions. Ensuring that investors can be subject to a proper hearing on the merits in their ultimate home country for damages caused by their investments in host countries could also improve investor conduct vis-à-vis their foreign operations. All these are avenues for addressing the responsibilities of investors in IIAs that, technically, could be pursued. It is another matter, however, to what extent any of them would be able to garner the support of treaty partners.

As to voluntary instruments, the 1976 OECD Guidelines for Multinational Enterprises are an example of how a voluntary set of guidelines can be strengthened. More specifically, by establishing an implementation mechanism, reviewing the guidelines from time to time (and adding provisions covering new subjects), empowering a committee to issue clarifications, and providing key constituencies with access to the implementation mechanism, the guidelines were strengthened over time and have become more effective. In 2011, the United Nations’ Human Rights Council adopted the Guiding Principles on Business and Human Rights, followed three years later by a voted decision to establish an open-ended intergovernmental working group to elaborate an international legally binding instrument to regulate the activities of MNEs and other business enterprises.

While the guiding principles are voluntary (relying on non-binding multi-stakeholder approach for its implementation), the evolution of the OECD Guidelines and the Netherlands–United Arab Emirates BIT show that voluntary instruments can be "hardened." Since many instruments providing guidance to MNEs and other business enterprises are voluntary, the question arises whether it would be worthwhile to explore how a hardening of voluntary instruments could be achieved over time to reach a certain balance in the rights and responsibilities of international investors and governments—if not in one instrument, then at least across several.

Either of these two paths towards the greater recognition of the responsibilities of investors—including responsibilities in IIAs and strengthening voluntary instruments—encounters a number of challenges. For one, some (or many) firms are likely to resist treaty-based responsibilities of investors; others, however, especially those that have already accepted various corporate social responsibility standards, may be more accommodating. Moreover, imposing direct obligations in IIAs on international investors is not without its own challenges, as international treaties normally bind states only. In addition, there is the question of not discriminating between foreign and domestic enterprises, with the former being subject to higher standards. (But, then, while foreign investors have access to ISDS, domestic ones do not.) At the same time, though, is it likely that, say ten years from now, it would be acceptable that the investment regime reflects primarily the interests of one group of stakeholders and that it imposes obligations only on host countries? Or that obligations are mandatory for governments and voluntary for firms? If this is not likely to be acceptable, it is necessary to explore how these issues can be addressed.

A working group consisting of leading international investment scholars could propose how the objectives and contents of IIAs could best be updated, in close consultation with principal stakeholders. Such a group could benefit from the support of a consortium of universities from all continents. The results could then be presented to governments, for their consideration in future investment rule-making.

A MULTILATERAL/PLURILATERAL FRAMEWORK ON INTERNATIONAL INVESTMENT

There is also the question whether the ideal approach would be to have one instrument that defined the relationships between governments and international investors—a universal framework on international investment that, in a coherent and transparent manner, would provide the predictability and stability that long-term investment needs. That is, global rules for a global economy, starting from the need to promote sustainable development. (See in this context UNCTAD’s Investment Policy Framework
and the Model International Agreement on Investment for Sustainable Development prepared by the International Institute on Sustainable Development.) Such a framework, be it multilateral or plurilateral, would establish a basic set of commitments observed by all signatories, be they small or big countries. It would avoid the difficulties that arise from a regime that consists of a multitude of IIAs, be it for international investors that operate in a multitude of jurisdictions (each with its own varying commitments in IIAs), or be it for governments that may see some of their objectives frustrated by treaty shopping on the part of some international investors. Such a framework could also reduce the need of negotiating separate agreements that, together with the existing agreements, would eventually amount to a holistic framework on international investment.

Naturally, negotiating a universal framework would face a range of difficulties, as reflected in the abortive past efforts to do so. These difficulties would include reaching, among a great number of governments, the right balance of rules that various stakeholder groups might wish to obtain, and determining where such a framework could be negotiated. At the same time, though, governments have shown great willingness to make rules on international investment, as reflected in the continued proliferation of IIAs. If a truly universal framework is considered out of reach at this time (including through the expansion of the GATS to cover other types of investment), one might want to consider whether a plurilateral framework on international investment could serve as a first step in that direction. In either case, the international investment court and appellate mechanism sought by the EU, as a stepping stone towards a permanent multilateral system for investment disputes, could become a nucleus around which a universal framework could be built.

Moreover, the mega-regionals (all of which are likely to contain investment chapters), as well as the BITs between important countries that are currently being negotiated, could well result in a more harmonised approach and, ultimately, facilitate a move towards a universal agreement. These negotiations represent significant opportunities to shape the investment regime by narrowing the substantive and procedural international investment law and policy differences between and among the principal FDI host and home countries and setting standards that considerably influence future investment rule-making in general. If this occurs, the result of these negotiations will become stepping stones towards a universal investment instrument.

Equally if not more importantly, the constellation of interests of countries has changed profoundly and in a manner that should help with pursuing a universal approach. When earlier efforts at the multilateral level were undertaken, there was a clear distinction between home and host countries, typically along North-South lines. Now, as documented earlier, firms in a rising number of emerging markets (and particularly the biggest among them) are becoming important and dynamic outward investors. The implication is that emerging markets define their policy interests no longer only defensively as host countries, but also offensively as home countries interested in protecting their investors abroad and facilitating their operations. This can be exemplified by China’s change in approach when, in the context of the US-China Strategic and Economic Dialogue, the country agreed in July 2013 to continue negotiating a BIT with the US on the basis of pre-establishment national treatment and the negative list approach to exceptions from such treatment—both approaches resisted by China before then.

Similarly, developed countries have “discovered” that they are also important host countries, including for investors headquartered in emerging markets, and that they are increasingly respondents to international arbitration claims. The implication is that they define their policy interest no longer only offensively as home countries, but also defensively as host countries interested in maintaining adequate policy space to be able to pursue legitimate public policy objectives. This can be exemplified by the change of approach by the US when, in revising its model BIT, it narrowed protections of foreign investors—and the US had been the country leading efforts to provide full protection to investors and facilitating their operations.

This convergence of policy interests between home and host countries as well as developed countries and emerging markets, should facilitate reaching a universal agreement—if there is the political will to pursue such an objective.

**EMERGING ISSUES ARISING FROM AN INTEGRATED INTERNATIONAL PRODUCTION SYSTEM**

The discussion so far has focussed relatively narrowly on issues directly related to FDI—or, more broadly, international investment. But the emergence of an integrated international production system poses challenges that go beyond this focus, although a number of them are intimately linked to FDI and international investment. They involve the governance of firms’ international activities in general, apart from the issues that have traditionally been addressed in IIAs. A number of instruments already exist that address these issues directly related to FDI—or, more broadly, international investment. But the emergence of an integrated international production system poses challenges that go beyond this focus, although a number of them are intimately linked to FDI and international investment. They involve the governance of firms’ international activities in general, apart from the issues that have traditionally been addressed in IIAs.
pricing arrangements, and anti-corruption agreements. The question is whether a systematic effort is needed to identify the range of such issues and develop responses to them.

For one, the advent of the digital economy and especially the increase in the tradability of services is bound to have profound implications. The services sector accounts for more than half of the total gross domestic product in most countries and for over two-thirds in virtually all developed countries. The tradability revolution therefore is likely to lead to a restructuring of a substantial part of the economies of many countries. This, in turn, is bound to cause serious adjustment difficulties in those countries whose production of the newly tradable services (or parts thereof) is being moved abroad. It may also lead to a restructuring of FDI flows and stocks. While services account for roughly two-thirds of FDI flows and stocks—precisely because services in the past needed to be produced when and where they were consumed—it may become less necessary for services firms to engage in FDI to be present in foreign markets. Rather, this can be done, as in manufacturing, through (electronic) trade, at least to a certain extent. On the other hand, countries now have the opportunity to attract FDI geared towards the production of entire services or service “components” (for example, entering data, analysing insurance bills, or doing certain legal research) destined for other parts of a global value chain or the world market. This, in turn, creates new opportunities for investment promotion agencies worldwide, not only by targeting services firms, but also the services functions (including research and development) of manufacturing and other firms.

Further, the emergence of an integrated international production system creates a host of more specific challenges going beyond the services sector and involving international production in general. Some were already dealt with in the past but may need to be revisited, some are in the process of being addressed (but perhaps not sufficiently), and some are only emerging.

For example, transfer pricing has since long been recognised as an issue. In a world of global value chains and integrated international production, it becomes increasingly difficult to determine the fair price of specialised goods and services being produced in one part of the value chain by a given affiliate and provided to other parts of the same corporate network or to the network as a whole, and for which there are no market prices. How to deal with such situations and, in particular, avoid abusive transfer pricing? The OECD has developed guidelines in this respect—but are they still sufficient for today’s sophisticated global value chains? Related to that, how can taxes be determined—and allocated—if a given foreign affiliate is not a standalone facility but only a part of a global value chain and hence not viable on its own? Will it be necessary to move towards some sort of unitary taxation system worldwide that allocates income across tax jurisdictions on the basis of established criteria (as happens among states in the US)? (Such an approach could conceivably be implemented by any country on its own, which might put pressure on other countries to do the same.)

Also related to the emergence of integrated international production is the question of the nationality of a firm. If a firm was originally established in one country, grew and ventured abroad through FDI, and now has the bulk of its assets in other countries, with various headquarters functions dispersed across various jurisdictions, what nationality does that firm have? A clear definition of “nationality” is important not only for tax purposes, but also to determine whether a firm is protected by a given bilateral investment or double taxation treaty.

Further, what do these developments mean for corporate liability, especially in cases of egregious gross negligence? Are there situations in which the corporate veil may need to be pierced? Conversely, MNEs could dedicate a certain (small) percentage of their earnings to corporate social responsibility activities in their host countries (or at least the poorest among them), to make such activities sustainable and more predictable—something that India requires from firms located in its territory.

Finally, in a world of integrated international production, is it still possible, let alone efficient, to deal with a number of corporate activities on a national basis? Two examples illustrate this point.

The first one concerns bankruptcy. If a large MNE goes bankrupt today, not only is its home country directly affected, but also the many host countries in which it has affiliates. However, most global bankruptcies are still administered on a territorial basis, with separate filings in each country. In the absence of an international approach to bankruptcies, each country seeks to “ring fence” the assets located on its territory, with little regard to the possible rescue of the enterprise as a whole. This presents a problem in a world of global value chains, as, to the extent that individual foreign affiliates are fully integrated into their corporate networks, they are typically not viable on their own. If no solution can be found for the corporate network as a whole, both the host and home countries involved are negatively affected. With more than 100,000 MNEs (a number that is increasing), more and more of them having a rising number of affiliates in a growing number of countries, and more and more of these affiliates being fully integrated into the global value chains of their parent firms, more and more complicated bankruptcy cases are likely to occur. No international rules for corporate bankruptcies exist (although the United Nations Commission on International Trade Law has developed a Model Law on Cross-border Insolvency).

Another example for the need of an international approach concerns M&As, the principal mechanism through which many firms enter foreign markets. If two large MNEs merge, the competition authorities in the countries in which each of the two have affiliates (not to count the countries that may be affected by the merger via trade) may need to vet
The growth of FDI and MNE activities, the emergence of an integrated international production system, and the state of the international investment law and policy regime have given rise to a number of challenges that will need to be addressed in future investment policy and rule making. As the public debate about the investment regime and the debate within the international investment law community suggest, this has become an urgent matter.

Accordingly, it would be desirable to launch an informal but inclusive confidence-, consensus- and bridge-building process on how the international investment law and policy regime can be improved. Such a process could seek to identify systematically the strengths and weaknesses of the current regime and discuss how to deal with them. It could also consider a number of the issues that were discussed as not being FDI/international investment proper, as many of them are intimately linked to it. It would have to be an inclusive process and hence involve the principal stakeholders to ensure that main interests are taken into account. It could be located in an international organisation or initiated by a small group of interested countries. If greater informality is desired, such a process could be organised by a credible NGO. A multi-stakeholder process would also have the advantage that all issues would be put on the table. The outcomes of such a process could be made available widely and, hopefully, help governments to improve the international investment law and policy regime.

CONCLUSIONS

The international investment law and policy regime is in flux. Like any regime, it can be improved. This presents challenges and opportunities. Thoughts need to be given to how the regime governing the relations between international investors and governments in an area that constitutes the most important form of international economic transactions in the globalising world economy can be updated. The regime needs to be more responsive to the requirements of today’s world. It also needs to be responsive to the requirements of the world as it is emerging in light of the further growth of FDI, the proliferation of MNEs and their foreign affiliates, the emergence of an integrated international production system, and the imperative to move to a sustainable development model of economic development. And it needs to be responsive to the expectations that its key stakeholders have regarding the regime. Further developing the regime is not only necessary for the regime to remain useful for its principal stakeholders, but also to warrant its legitimacy and, more generally, the rule of law.
Implemented jointly by ICTSD and the World Economic Forum, the E15 Initiative convenes world-class experts and institutions to generate strategic analysis and recommendations for government, business and civil society geared towards strengthening the global trade system.