

On Foreign Investor ‘Privilege’ and the Limits of the Law: A Reply to Ivar Alvik

Jürgen Kurtz*

Abstract

International investment treaties are structurally characterized by inherent asymmetry in the (non-relative) legal protections extended to foreign investors vis-à-vis domestic companies and nationals. For many lawyers, ‘foreign privilege’ is deeply problematic as it violates a foundational legal principle – namely, equality before the law. Yet law and law alone cannot always offer a definitive answer of this sort. At the very least, legal hypotheses should be rigorously tested against insights from other disciplines that can offer sharp analytical light on the complex contours of a given phenomenon. In this reply, I explore the political economy of host state policy as it is formed against three categories of foreign direct investment (FDI). Conceptually (and empirically), this political economy matrix reveals sharply varying levels of risk of hostile state action against distinct forms of FDI. To be sure, this analysis alone does not justify the traditional and expansive model of bilateral investment treaty protections. Yet, at least for some categories, this political economy case reveals an internal problem that is difficult (if not impossible) for the state itself to resolve, and, thus, it may well be rational for such a state to leverage international norms to extend qualified extra-domestic priority to foreign actors.

There is deep contestation surrounding the investment treaty regime. The immediate causes of both state and stakeholder concerns are related, to a very large degree, to the interpretation of the norms of investment treaty protection. Yet those hermeneutic choices are largely (though not entirely) controlled by the expansive scope, framing and orientation of the underlying treaties. Those treaties do indeed reflect what Ivar Alvik terms ‘foreign privilege’, both substantively and procedurally.¹

* Professor of International Economic Law, European University Institute, Florence, Italy; Professor (on leave), University of Melbourne Law School, Australia. Email: jurgen.kurtz@eui.eu.

¹ Alvik, ‘The Justification of Privilege in International Investment Law: Preferential Treatment of Foreign Investors as a Problem of Legitimacy’, in this issue, 289.

There is inherent asymmetry in the (non-relative) legal protections extended to foreign investors under a bilateral investment treaty (BIT) *vis-à-vis* domestic companies and nationals. Domestic actors, by design, are not provided treaty guarantees of fair and equitable treatment, umbrella clauses, expropriation protections and so on. More deeply, those substantive norms may well be positioned at a legal standard over and above what is extended to domestic actors under domestic law (including constitutional settings). Procedurally too, foreign investors have the remarkable possibility of bypassing the judicial system of the host state and prosecuting treaty claims directly against the state through a hybrid form of arbitration. For Alvik, these various facets of ‘foreign privilege’ are problematic as he argues that they are a threat to the legitimacy of the investment treaty regime. His principal critique is that ‘foreign privilege’ violates a foundational legal principle – namely, equality before the law. His normative anchor is also legal, being a call for greater engagement with domestic law and its standards. The specific normative reforms are substantive ‘deference’ to domestic law plus a procedural nod to the domestic sphere via a qualified precondition of the exhaustion of local remedies.

I am not unsympathetic to some of this critique and even to a few of the normative claims. I am, however, sceptical that law and law alone can offer a determinative answer to whether we can justify or condemn legal asymmetry of the sort described by Alvik as ‘foreign privilege’. International economic law, to a very large extent, relies on a functional justification to ensure continued state commitment to any given regime. Absent this functionality, there is usually no good case for international constraints on sovereign economic regulation. Of course, there are various benefits that can flow from such constraints. These traverse from levels of outcome (wealth and/or welfare gains), to the remedy of an internal (political economy) problem and/or the resolution of an entrenched coordination problem (between states parties). Many of these complex questions necessarily require non-legal disciplinary insights and powerfully complement legal analysis, especially on issues of system design. For current purposes, let us consider the political economy of host state policy towards different categories of foreign investment and identify where there is a problem that is difficult (if not impossible) for the state itself to resolve. If such a flaw is in play, it may well be perfectly rational for a given state to offer extra-domestic priority for select types of foreign investment because (i) it is a risk borne only by foreign investment in some economic sectors and (ii) the state cannot overcome the problem itself using domestic tools and promises.

Remarkably, even with the frenetic pace of contemporary recalibration of investment treaties, the scope of protection in investment law has remained relatively stable. Most investment treaties continue to define protected investment extremely broadly. Very often, that definition simply provides that protected ‘investment’ under the treaty engages every kind of asset invested by the foreign investor with limited interpretative guidance supplied by an illustrative list. This framing is sufficiently elastic to extend coverage far beyond foreign direct investment (FDI) (where the foreign investor achieves some ownership/managerial control over their investment in a host state) to

include short-term and less 'sticky' forms of capital such as debt or portfolio investment. The latter are prone to sudden reversals or herd behaviour that raise distinct regulatory challenges, especially for developing states confronting large-scale withdrawals that threaten their banking and financial systems. Yet, this powerful case for legal variegation aside, let us focus on the classic legal premise underpinning only the coverage of FDI in investment treaties. This assumes that it is a single category that engages a common political economy risk of adverse state action and thus can justify 'foreign privilege' to all forms of FDI.

We can immediately challenge the rationality of this premise by disaggregating FDI by motivation. There are at least three forms of FDI driven by specific motivations: first, resource-seeking foreign investment where the foreign investor's locational choice is driven by the desire to acquire and exploit natural resources; second, market-seeking foreign investment where the foreign investor seeks to invest in order to supply goods and services to consumers in the host state; and third, efficiency-seeking foreign investment where the foreign investor seeks to benefit from factors (such as low labour costs or other specialized inputs) that enable it to compete and flourish in international markets. Critically, there are varying political economy risks of adverse state action (whether by direct expropriation or incremental regulatory change designed to transfer rents to governments) across these different stylized models. The assessment of these different political economy risks to discrete categories of FDI challenges the legal logic and assumption of extending the same level of protection ('foreign privilege') to defined 'investment' in a given treaty.

Consider first resource-seeking FDI, shaped by the desire to acquire and exploit natural resources. Critically, locational choice here is constrained as firms must invest in territories that are rich in resources. The nature of the investment is also highly specific. Resource projects involve substantial investments in fixed and immobile plants and equipment. The enormous size of capital commitment required in these sectors often limits the possibility of domestic exploitation (particularly in developing states). Select host states therefore have significant incentives to attract foreign investment in the resource sector. *Ex ante*, then, foreign firms and host states have approximately equal bargaining power in negotiations that would shape any contractual arrangement governing foreign investment in a given resource project. Yet a fundamental political economy problem arises once that investment is made. As so memorably put by Raymond Vernon, 'almost from the moment that the signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eyes of the government'.² *Ex post*, once invested, firms are in a far weaker bargaining position given their inability to exit the state by withdrawing the sizeable fixed capital assets inherent in a resource project. Those sunk assets become both a hostage and a source of host country bargaining strength. The terms of the executed contract,

² Vernon, 'The Obsolescing Bargain: A Key Factor in Political Risk', in M. Winchester (ed.), *The International Essays for Business Decision Makers* (1980) 281; see also R. Vernon, *Sovereignty at Bay: The Multinational Spread of US Enterprise* (1971).

therefore, can rapidly obsolesce as governments are tempted to reshape the original contractual terms in their favour.³

There is a tendency among investment lawyers to give this political economy account a cursory nod in their (usually doctrinal) exploration of the field.⁴ More problematically, entrenched defenders of the system will claim it as being representative of vulnerability of all forms of FDI (which is plainly flawed, as I point out below), while critics argue that it is somehow confined or redundant in the contemporary period (which is equally mistaken). With respect to the latter point, it is important to note that the logic of the obsolescing bargain can extend beyond the focused category of resource investments. Consider also the firm- and industry-level characteristics of large-scale infrastructure projects. Just as in the resources sector, infrastructure providers require sustained access to location-specific resources and the sizeable scale of infrastructure investment translates to high exit costs. In addition, the oligopolistic structure of these markets means that there are few rival (domestic or foreign) firms to which those investors can easily sell their business operations.⁵ If citizens are the end users and payers for goods and services (underpinning a given infrastructure project), this too can heighten the risk of adverse state behaviour. Local political actors can gain political power from engaging in public battles with these firms because high consumer costs and perceptions of underinvestment in disadvantaged communities generate popular protests against private providers.⁶ The same point can be made inductively. To put it mildly, it is unsurprising that we see a majority of quantitative patterns of investment treaty activation in the resource and infrastructure sectors.⁷

In contrast to this conceptual and empirical evidence of select foreign investor vulnerability, Alvik offers the reader a straw man:

[A]rguing that foreign investors as a group are more vulnerable to the domestic political and legal process because they lack the right or the ability, to participate has little connection to reality. The typical foreign investor is not an individual outsider thrown into an alien political and social environment, but, rather, a multinational corporation likely to wield substantial influence in the host state by virtue of both its organizational capacity and its economic resources.⁸

³ This is, necessarily, a truncated account. For greater detail, see also Kobrin, 'Testing the Bargaining Hypothesis in the Manufacturing Sector in Developing Countries', 57(3) *International Organization* (IO) (1987) 609; Frieden, 'International Investment and Colonial Control: A New Interpretation', 48(4) *IO* (1994) 559; Cai and Treisman, 'Does Competition for Capital Discipline Governments? Decentralization, Globalization and Public Policy', 95(3) *American Economic Review* (2005) 817.

⁴ E.g. Alvik, *supra* note 1, at 309, n. 109.

⁵ Bauerle Danzman, 'Contracting with Whom? The Differential Effects of Investment Treaties on FDI', 42(3) *International Interactions* (2016) 452, at 461.

⁶ *Ibid.*

⁷ Bauerle Danzman, 'The Political Economy of Bilateral Investment Treaties', in M. Krajewski (ed.), *Research Handbook on Foreign Direct Investment* (2019) 36 (finding that, after scaling investor-state dispute settlement claims by the percentage of FDI stock across industries, 'manufacturing is grossly under-represented in claims, relative to manufacturing's share of FDI stock' and, '[i]n contrast, agriculture, extraction and utilities are substantially over-represented'). See also International Centre for Settlement of Investment Disputes, *The ICSID Caseload: Statistics* (2019), at 11.

⁸ Alvik, *supra* note 1, at 306 (footnote omitted).

I have repeatedly encountered similar sentiments by students when teaching investment treaty law, many of whom are instinctively opposed to extending extra-domestic legal protections to multinational corporations. Of course, there is a grain of truth in the broad proposition that economic size can translate into political influence. But scholarship requires a more rigorous inquiry – conceptually, doctrinally and empirically. Ironically, in fact, there is a targeted political economy case for some of Alvik's critique when we consider the remaining broad categories of FDI.

Market-seeking FDI, for instance, puts foreign investors in a somewhat stronger bargaining position *vis-à-vis* host states (depending on the size and characteristics of the market in question). *Prima facie*, these firms have greater geographic options as to where to locate their production facilities. Market size here is the critical determinant, and it can vary over time and, in general terms, is non-exclusive. Critically, firms' relative sunk costs to overall costs of production are likely to be far lower compared to resource and infrastructure investment.⁹ For manufacturing firms, this translates into greater mobility, flexibility and control than extractive investors in the face of hostile state action (such as expropriation) that would destroy the underlying value of the investment capital.¹⁰ Yet, while this might act as a constraint against extreme takings, the host state may still be tempted to engage in less radical forms of rent seeking. By definition, market-seeking foreign investment can disrupt the market share of competing domestic firms. Domestic industry that competes with foreign investors has exactly 'the same incentive to lobby for barriers to investment as it has to lobby for impediments to trade', given the displacement of market share through foreign competition (whether in the form of FDI or imports of goods/services).¹¹ Tax and/or regulatory outcomes in the formation of particular investment policy may, just as with trade policy, systematically prioritize the welfare of the few (domestic competing industry) over the welfare of the many (consumers and other stakeholders in the receiving state). In coming to a view on how this conflict might be resolved, we should bear in mind that the receptivity of the host state to lobbying for protection by domestic firms may vary greatly depending on the stage or maturity of the investment project under consideration. Some have argued, for instance, that FDI through merger and acquisition (M&A) attracts greater political risk than FDI via joint venture (with domestic firms) or greenfield investment. Among other considerations, M&A investments require foreign firms to fully invest in a host country, make exit options costly and give those firms little bargaining power with the state regarding tax incentives, regulatory changes and contract negotiations.¹²

⁹ Jonathan Bonnitcha, Lauge Poulsen and Michael Waibel offer the example that 'relative sunk costs are much lower in, for example, garment manufacturing than in offshore oil production or large-scale infrastructure projects'. They go on to point out, correctly in my view, that 'the prevalence of hold-up problems varies across industries'. J. Bonnitcha, L. Poulsen and M. Waibel, *The Political Economy of the Investment Treaty Regime* (2017), at 132 (emphasis in original).

¹⁰ See generally Kobrin, *supra* note 3.

¹¹ Grossman and Helpman, 'Foreign Investment with Endogenous Protection', in R. Feenstra, G. Grossman and D. Irwin (eds), *The Political Economy of Trade Policy: Papers in Honor of Jagdish Bhagwati* (1996) 216.

¹² Lee, Biglaiser and Staats, 'The Effects of Political Risk on Different Entry Modes of Foreign Direct Investment', 78(2) *Review of Economics and Statistics* (1996) 181.

Lastly, efficiency-seeking foreign investment is structured across a different platform than these other models of FDI (with even lower risk of adverse state action). It will often comprise a supply chain in which intermediate goods and services are traded in an internationally dispersed production process. Foreign investors here are adopting complex integration strategies to acquire efficiency gains where production processes are split and carried out in locations to minimize overall production cost. In this model, global investment and trade are inextricably linked. In fact, approximately 80 per cent of global trade takes place between affiliates of multinational enterprises trading intermediate goods and services.¹³ For developing countries, in particular, the value-added gains from global value chains can be very significant relative to the size of local economies.¹⁴ The raw numbers mask more nuanced pathways of development benefit that can flow from participation in global value chains – in particular, positive spill overs, such as the manner in which lead foreign firms within a network engage with domestic suppliers to improve the quality and technological sophistication of their products. Of course, these forms of value enhancement will depend significantly on the overall policy and institutional influences to which foreign companies are subject, including their interactions with governmental agencies, trade unions and employer associations.

This economic structure, on first principles, has the lowest risk of adverse state action. For one thing, foreign investors that invest in new factories for, as an example, labour-intensive textile manufacturing do not normally contract with governments. To that extent, then, there is no bargain (or hard expectation) that can obsolesce in the manner of resource contracts or close equivalents like infrastructure. Their invested capital is also, in general terms, far less substantial than large-scale resource projects, thereby lowering redeployment costs in the face of potentially adverse host state action. It is also important to bear in mind the direction and spatial quality of economic activity in efficiency-seeking FDI. A supply chain in which intermediate goods and services are traded in an internationally dispersed production process is often export orientated. By definition, then, this limits the potential for displacement of domestic market share by domestic firms in contradistinction to the risk of protectionism thrown up by market-seeking FDI. More uniquely, however, we should consider the political effects that flow from the fact that domestic and foreign firms in a supply chain are partners. When an individual (foreign) firm in a supply chain is targeted by hostile state action, other firms – including domestic companies that may have political influence in the host state – have strong incentives to exert effort to protect the foreign target.¹⁵

¹³ United Nations Conference on Trade and Development, *Global Value Chains and Development: Investment and Value-Added Trade in the Global Economy* (2013), at iii.

¹⁴ In developing countries, value-added trade contributes some 28 per cent to average gross domestic product (GDP) as compared with 18 per cent for developed countries. There also appears to be a positive correlation between participation in global value chains and GDP per capita growth rates. *Ibid.*

¹⁵ Johns and Wellhausen, 'Under One Roof: Supply Chains and the Protection of Foreign Investment', 110 (1) *American Political Science Review* (2016) 31, at 34; see also Milner, 'Resisting the Protectionist Temptation: Industry and the Making of Trade Policy in France and the United States During the 1970s', 41 *IO* (1987) 62 (arguing that growth in exports and patterns of global intra-firm trade in the 1970s raised the costs of protection for internationally orientated firms that therefore resisted protectionism even in that period of serious import competition).

The political economy literature suggests therefore that 'a host government is most likely to honor its commitments to foreign firms that are economically linked to other firms in the host economy and to break its commitments with foreign firms that operate in isolation'.¹⁶ We have then the startling possibility of simple redundancy in the extension (extra-domestic) investment treaty protections to foreign investment deeply embedded with domestic actors in a given host state. To be sure, there may be problematic strategies (from the perspective of the host state) employed by domestic actors when using their domestic influence to project a common 'roof' over a given supply chain, not least the distortive political contributions and even bribes. Investment treaties, as normally framed, offer no realistic response to governance concerns of this sort. For our purposes, the normative lesson inherent in the political economy account surrounding efficiency-seeking foreign investment points in a very different direction than the usual constraints on state sovereignty in an investment treaty. Clearly, the depth of linkage with domestic firms is crucial in shaping the likely roof of protection in any given supply chain and, by extension, positive spillovers into the domestic economy. Targeted policies to facilitate this level of integration matter greatly, especially a set of coherent and mutually reinforcing trade and investment strategies.

Summing up, the genesis of international investment law is one of political and legal contestation. For developed states, overly expansive BIT protections were designed to substitute, and, at the margins, contest, sharp downward shifts in the customary standard of property protection articulated by newly independent states in the post-colonial period. For much of its history, investment treaty scholarship has historically been dominated by lawyers employing traditional doctrinal legal analysis to understand, defend and/or critique these norms. Path dependence runs deep here. A sharp feedback loop is often in play where the very legal outcomes of investor-state arbitration shape and constrain the prospective legal reform strategy of some states (and this further incentivizes the deployment of doctrinal legal techniques). Yet law alone seems poorly equipped to uncover the complexity and nuance implicit in many of the hard questions of investment treaty law, not least the contemporary justification or otherwise of 'foreign privilege'. Scholars should be careful in employing legal claims and tools that generate simple binary outcomes. At the very least, legal hypotheses should be rigorously tested against insights from other disciplines that can deliver sharp analytical light on the complex contours of a given phenomenon. Political economy here especially offers scholars and policy-makers alike important clues as to how and why particular treaty norms are more likely to be activated against particular categories of foreign investment. Properly employed, interdisciplinary examination of this sort allows a more accurate and theoretically justified framing of those legal norms to challenge adverse state action *vis-à-vis* FDI.

¹⁶ Johns and Wellhausen, *supra* note 15, at 48.