The Impact of Foreign Investor Protections on Domestic Inequality

By Manuel F Montes

1. Introduction

A prominent element of international economic governance is the provision of legal protections to foreign investors as codified in international investment agreements (IIAs). This essay will explore how these investment protections undermine the capabilities of host governments, particularly developing countries, to reduce essential aspects of domestic inequality.

Bilateral investment treaties (BITs) and investment chapters in free trade agreements between developed and developing countries are the two forms of IIAs. In these agreements, states make the promise that foreign investors will be protected from arbitrary and unfair treatment–both in terms of process and policy actions–by the host government. The current dominant form of these BITs[1] exposes host countries to litigation costs and monetary penalties should their policies and actions be judged to be in violation of their investor protection obligations.

These treaties between sovereign states have been promoted by Western governments based on the argument that providing strong commercial protections to foreign investors will increase the flow of investment in developing countries (Montes 2015). The rationale for investor protection is the view that courts in developing and non-Western countries are relatively underdeveloped and "too biased, too slow and sometimes too corrupt" (CEO/TNI 2012, 11) to provide foreign investors a fair and independent dispute settlement system in case of conflicts with the host state. These treaties provide that these disputes would be decided by a "neutral" body of legal experts meant to act independently in arbitration panels. The most prominent convenor of arbitration panels for these treaties is the International Center for Settlement of Investment Dispute (ICSID), hosted by the World Bank.

2. Key Governance Features of Investment Treaties

According to UNCTAD (2016, 101), there are 3,304 known IIAs in existence. Many treaties are, by their own provisions, secret; this is why it is only possible to approximate the number of treaties in existence.

The BITS system framework is imported from the commercial contractual and dispute resolution system among private parties. Because the system involves on one side the public sector of a

[1] From hereon, for convenience and given that their provisions are highly comparable, we will use the term "BITs" also to refer to both bilateral investment treaties and investment chapters in free trade agreements. The important difference between BITs and investment chapters is that while a BIT can be terminated as a stand-alone treaty, abrogating the obligations in an investment chapter in a free trade agreement will require withdrawal from the whole agreement, including, for example, any mutual trade concessions in the other parts of the treaty.

host country, it is especially open to being associated with a violation the governance principle of transparency. In most BITs, the contractual obligations are all on the side of the host country and the liable party is a state–not a private entity–which has built-in accountability to its own citizens. The secrecy provisions of almost all treaties can prevent government officials from publicly disclosing the country's obligations to foreign investors.

These treaties also have provisions that require that disputes arising between investors and the state, including the process of dispute resolution and the any awards granted, to be subject to strict secrecy. Such secrecy is a standard feature of commercial contracts and their dispute resolution. Currently only 608 Investor State Dispute Settlement (ISDS) cases are known (UNCTAD 2015). UNCTAD notes that since most IIAs allow for fully confidential arbitration, the actual number is likely to be higher (UNCTAD 2015, 112).

The international system of dispute resolution, called the "investor-state dispute settlement" (ISDS) in the BITs system is extremely powerful and unique in the existing (Westphalian) system of states. Unlike other international mechanisms, it allows private parties to sue states directly and obtain compensation. In the World Trade Organization (WTO), for example, only states can sue states (though, often, the dispute involves some aggrieved private company). Under BITs, ISDS expose states to enormous monetary penalties to be paid to the aggrieved investor. It is estimated that the number of cases being processed in 2011 was 450. "In 2009/2010, 151 investment arbitration cases involved corporations demanding at least US$100 million from states" (CEO/TNI 2012, 7).

Four interrelated features of the BITs system are particularly problematical from a governance point of view:

1**. Severe imbalances in rights and responsibilities** in the provisions of the investment treaties (including broad definitions of what is investment and who is an investor, free transfer of capital, right to establishment, national treatment and most-favoured-nation clauses, fair and equitable treatment, protection from direct and indirect expropriation and prohibition of performance requirements) (Bernasconi-Osterwalder 2011). These provisions characterize investors' rights and ignore investors' responsibilities. A short list of the kind of obligations governments have under BITs would include (Bernasconi-Osterwalder et al 2011, 11):

- Fair and equitable treatment (FET);
- Compensation in the case of direct or indirect expropriation;
- National treatment, or treatment no less favourable than that given to domestic investors;
- Most-favoured nation (MFN) treatment, or treatment no less favourable than that given to investors from third countries;
- Freedom from so-called "performance requirements" as a condition of entry or operation. These are requirements, for example, to transfer technology, to export a certain percentage of production, to purchase inputs domestically, or to undertake research and development;
- Free transfer of capital. This provides a guarantee to investors that they can freely move assets in and out of the country.

- A blanket obligation, known as an “umbrella clause,” which obliges the host state to respect any legal or contractual obligations it may have to the investor; and
- The right to bring arbitration claims against host governments.

Not all BITs have these obligations, but the list is consistent with the existing U.S. model treaty. In the prevailing models of these treaties and in overwhelming majority of actual treaties, provisions recognizing the need to uphold host states’ regulatory authority are not present.

Khor (2014) briefly summarizes the most problematical imbalances in the BITs provisions:

- The definition and scope of “investment” is very broad; it covers all kinds of assets including portfolio investment, credit, derivatives, contracts, intellectual property rights (IPRs), and expectations of future gains and profits. Thus legal cases can arise if an investor feels aggrieved about how any of these “investments” are affected.
- National treatment, i.e. the foreign investor has the right to be treated similar to or better than local investors. The foreign investor can claim to be discriminated against if the local is given preference or other advantage.
- Fair and equitable treatment. This has been interpreted by some tribunals as the investor having a stable legal and business framework or predictable investment environment for the life of the investment. Investors have sued on the grounds of non-renewal or change in terms of license or contract, and changes in policies or regulations (including economic, health, or environment measures) that the investor claims will reduce its future profits. The claims for unfair treatment can be “practically limitless” in scope, according to a study by the UN Conference on Trade and Development (UNCTAD 2014). Most ISDS cases are brought up under this clause.
- Expropriation. This includes direct expropriation (e.g. government takeover of a property) and indirect expropriation (in which tribunals have ruled in favour of investors that claimed losses due to changes to existing or introduction of new government policies or regulations).
- “Survival Clause.” It is difficult to withdraw from state obligations in a BIT. Most BITs have a default renewal feature; if no party to a BIT gives notice of withdrawal upon expiry, the BIT is deemed to roll over and continue, usually for another similar period. If a country wishes to withdraw from a BIT, or to not renew the BIT upon expiry, the survival clause requires the host government to provide the investor protections for a period of years after termination. Most BITS have a provision that the rules will still be in force for an extended period (in many cases 10 or 15 years) after withdrawal or expiry. The import of this legal provision is extremely important because it is the key obstacle to global reform of the system. A multilateral treaty on investment will not extinguish existing BITs obligation and terminate the survival clauses.

2**. Vague treaty provisions** create enormous grounds for disputes, especially compared to the more rule-based regimes like international trade law (Roberts 2014) and allow for the expansive interpretation of provisions by arbitrators. The rise of a systemic bias in favour of the investors in the resolution of disputes under investment treaty law[2] is consistent with the increase in the volume of these disputes, creating the opportunity for the expansion of this kind of practice among the network of arbitrators involved. Interpreted or created obligations from arbitral rulings are often in conflict with the original intent of the States that negotiated the treaty. Arbitrators have asserted jurisdiction over a wide scope of issues, including regulatory policies on which national constitutional courts have already ruled, which means that the international investor protection system can override the highest judicial authorities in a national system. The way the arbitration system has operated, so far, generates deep concerns in regard to democratic governance and accountability.

3. **Conflicts-of-interest** stems from the monopolization by a cabal, and impertinent expertise among the professionals involved in the investor-state dispute settlement mechanism. The network of arbitrators is dominated by private lawyers, with a shared background and expertise most often from commercial law (CEO/TNI 2012) and who participate in the revolving door among the roles of arbitrators, counsellors, and expert witnesses for parties involved in disputes. Up to 2011, fifteen arbitrators decided 55 per cent of the known disputes, 64 per cent of the disputes involving claims higher than $100 million, and 75 per cent of the cases involving claims higher than $4 billion (CEO/TNI 2012, 38). There have been cases of arbitrators sitting in judgment over cases involving companies in which they have a conflict of interest because membership on the board of a holding company.[3]

4. **Chilling effect on public policy**: Both the cost of litigation and monetary penalties in the event of an adverse arbitral judgement have a direct chilling effect on a sitting government which must draw on the general public budget for these expenses. Claims or threats by investors to bring forward a claim against a particular state are increasingly being used to object to new legislation from being adopted or applied, thus creating an ex-ante chilling effect on the regulatory policy-making.[4] The built-in lack of transparency and disclosure over ISDS procedures limit the space for public participation and accountability, and the possibility of shaming private companies for their predatory or anti-regulatory actions.

3. The Statistics of Defective Governance

What is the impact of the deeply flawed investor protection system? In theory, the costs of such a system would be borne anywhere where foreign investment occurs. Since developing countries

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[2] The problems of expansive interpretations of vague treaty provisions by arbitral panels are well-known. For an example of the kind of "highly malleable" constraints put on governments by these vague provisions see van Harten (2011).

[3] In 2004, one of the 15 privileged arbitrators, Gabrielle Kaufmann-Kohler of Switzerland, "was appointed as arbitrator by water company Vivendi and energy and gas supplier EDF in two different claims against Argentina. Two years later, in 2006, Kaufmann-Kohler was appointed to the Board of the Swiss bank UBS, which was the single largest shareholder in Vivendi and which has stakes in EDF. Kauffman-Kohler claimed she was unaware of the connections. Argentina challenged her impartiality on the case. A committee deciding on the challenge denied Argentina's claim, but lambasted her for failing to disclose her role as a corporate board member" (CEO/TNI 2012, 40).

[4] In fact, investment lawyers Wiśniewski and Górskaon (2015) suggest that the threat of sparking a dispute is a legitimate company tactic to prevent any changes in the regulatory regime in which they operate.

now absorb about half of foreign investment flows, one would expect that the costs of the system would be equally borne in developed and developing countries. However, the costs are borne in much greater proportion in developing countries because most foreign investors still come from developed countries and their investments in other developed countries occur without the protection of a BIT. This is changing, in light of the EU-Canada Comprehensive Economic and Trade Agreement (CETA), which was signed[5] on October 30, 2016 and the proposed EU-US Transatlantic Trade and Investment Partnership (TTIP) agreement. Both will have "NAFTA[6]-style" investor protections enforceable through arbitral procedures. In CETA, an investment treaty among developed countries, Canada and the European Union introduced an International Court System (ICS) with extensive changes in arbitral procedures. The EU has proposed that such a system include: (1) a two-tier arbitration system: a first instance tribunal and an appellate tribunal, the latter being authorized to set aside awards based not only on grounds for annulment outlined in the ICSID Convention, but also additional grounds such as errors of law and manifest errors of fact; (2) the first instance tribunal would be composed of judges randomly selected from a roster of 15 members who are prohibited from acting as counsel, party-appointed expert, or witness in an investment dispute during their terms; (3) full transparency with proceedings and key documents publicly available, in line with (and, in some respects, going beyond) the UN Commission on International Trade Law (UNCITRAL) Transparency Rules; (4) a "loser pays" system under which the losing party will bear the costs of arbitration, and the authority of the tribunal to reject frivolous claims on a summary application; (5) tribunals' responsibility to control the length of proceedings by requiring it to render an award within 24 months of the claim being submitted and explain any delay to this time (Squire 2017). These proposed changes in the ISDS procedures are meant to reduce issues of arbitrary and inconsistent interpretation, conflicts-of-interest, and enormity of litigation costs in the current practice of ISDS. However, these procedural changes, applicable possibly in CETA if[7] implemented and future treaties if they incorporate some form of ICS, do not alter the fact that the matter being adjudicated is one in which only one party, the state, has obligations to the other party.

The private sector and many practitioners of international law expressed criticisms to these governance changes on multiple grounds. These changes have been criticized on the grounds that these do not necessarily improve the legitimacy and efficiency of the system (Koeth 2016, 12). For example, the number of arbitrators with expertise in the issues under judgment to be put into a pool from which to draw arbitrators is too small to make meaningful change. Another criticism is that the addition of an appeal process will only increase the cost of the dispute settlement process.

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[5] The EU Parliament and national parliaments of EU member states must approve CETA before it can take full effect.

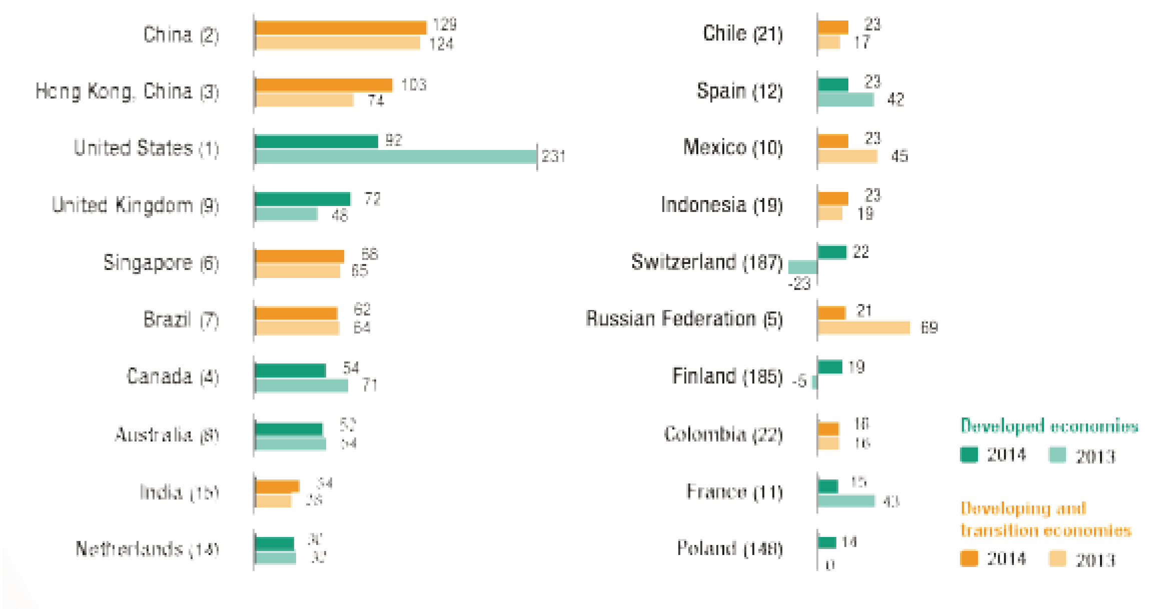
[6] Even though the first dispute against a state was lodged in 1987, NAFTA (North American Free Trade Agreement) of 1994 is the true grandfather of the system, in which an investor can seek damages against a state as set out in its Chapter 11. NAFTA happens to include two developed countries–the US and Canada. (The third NAFTA country was/is a developing country, Mexico.) At this writing, only Canada, which arguably is the less developed between the US and Canada, has endured payments for damage claims brought by US investors, while Canadian investors have not won a single case against the US government.

[7] CETA must still be ratified by each EU member state and as the result of a last minute concession to the objections to CETA by the Wallonian region of Belgium, the EU is seeking an opinion on the compatibility of ICS to European treaties.

Given that, at present, the bulk of treaty-protected foreign investment occurs in developing countries, most of the data presented in this section will be about the costs borne by developing countries from this governance system. Developing countries now are the destination for 55 per cent of the foreign investment inflows (UNCTAD 2016, 1). It also shows that in 2014, the year with latest available full year data, total foreign investment flows declined, due to a sharp decline foreign investment into developed economies in the midst of the continuing global economic crisis. (All the data used in this section, unless as otherwise noted, is as of the end of 2014, when the most complete ICSID data is available.)

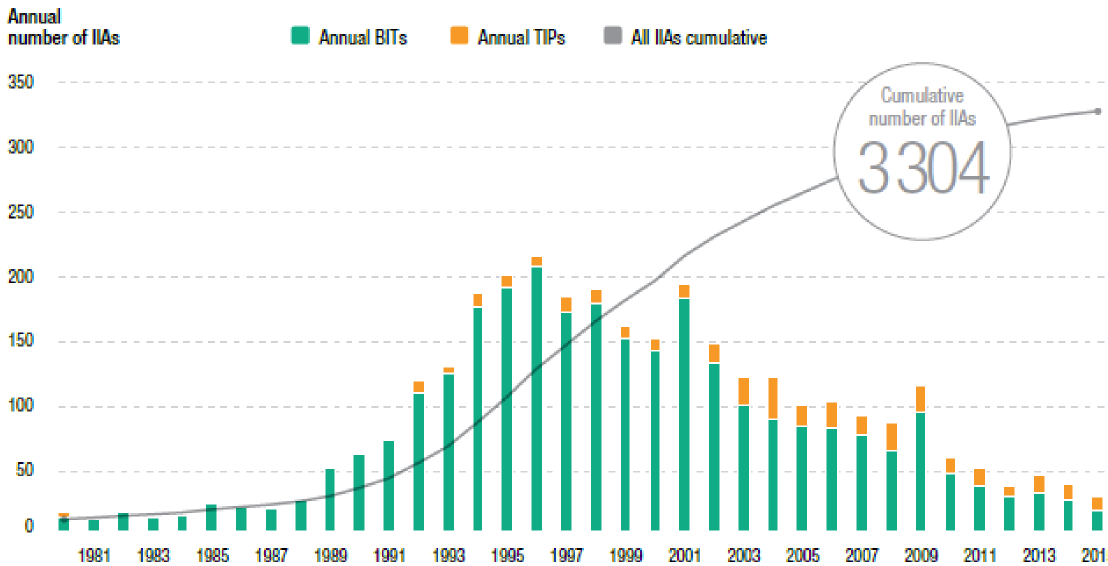
Among the top ten hosts of foreign investment, five are developing countries (figure 1.1).

Figure 1.1: Top FDI Hosts: Ranking and Amount of FDI, 2013-14



Source: UNCTAD (2015), Figure I.3, p. 5.

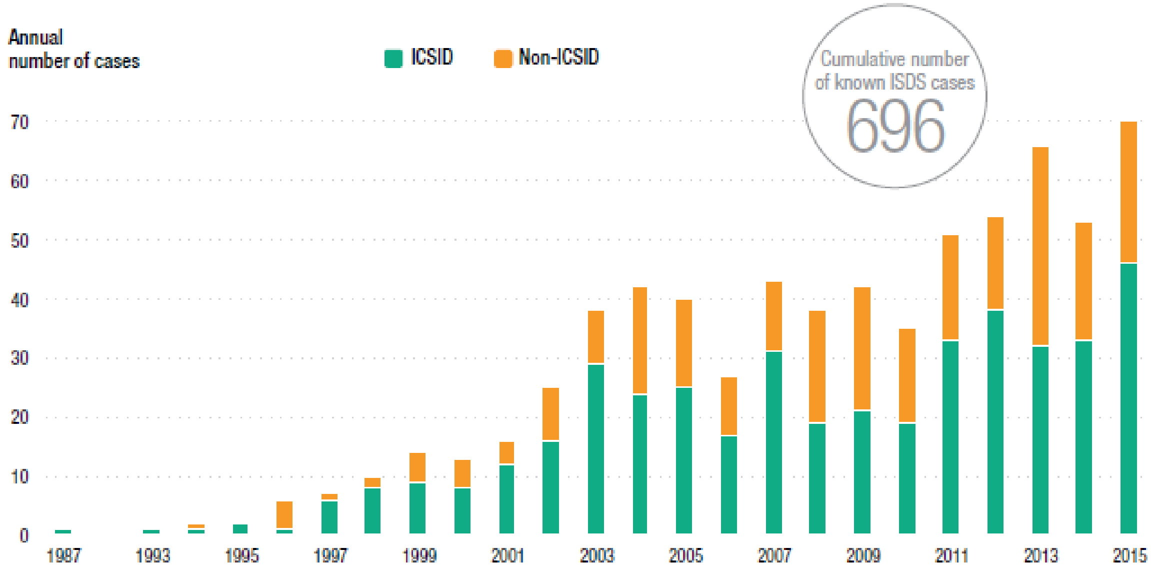
Figure 1.2: Annual additions of IIAs and Cumulative Number



Source: UNCTAD 2016, Figure III.3, p. 101.

Figure 1.2 summarizes the long-term trends in IIAs. There is a noticeable tapering off in the number of new BITs so that the cumulative pattern in figure 1.2 exhibits a negative first derivative. Part of this is driven by the loss of "targets"–many countries that could accede to BITs already have them–and part because of the declining interest and changes in developing country approaches to investor protection, as will be discussed in the last section. Figure 1.2 reflects only the number of cases, not the size of populations or economies subject to BITs. If the proposed "mega-regional" arrangements, such as the TransPacific Partnership (TPP) and TTIP agreements, both with NAFTA-style investor protections comes to pass, millions of people will be introduced to the disciplines and rigors of BITs. However, the new U.S. administration inaugurated in January 2017 has withdrawn from the TPP and could withdraw from further negotiations in TTIP. There is a discussion among delegations in Geneva about the possibility of commencing discussions on investment facilitation which could import investor protections into WTO disciplines.

Figure 1.3: Known ISDS Cases, Annual and Cumulative



Source: UNCTAD 2016, Figure III.4, p. 104.

In contrast to the clear tapering off new BITs, the number of (known) ISDS cases continues to escalate (figure 1.3). ICSID is the dominant arena for known[8] cases and is the forum that is most frequently mentioned in known IIAs. Parties can choose other venues to settle their disputes, including private arbitration services or facilities provided by the International Chamber of Commerce and other international bodies. In 2014, "[O]f the 42 new known disputes, 33 were filed with the International Centre for Settlement of Investment Disputes (ICSID) . . ., 6 under the arbitration rules of UNCITRAL, 2 under the arbitration rules of the Stockholm Chamber of Commerce (SCC) and 1 under those of the International Chamber of Commerce" (UNCTAD 2015, 114). The ICSID Convention, which established ICSID in 1966, is a multilateral "treaty formulated by the Executive Directors of the World Bank to further the Bank's objective of promoting international investment" by providing "for settlement of disputes by conciliation, arbitration or fact-finding" (ICSID 2016). ICSID does not conduct arbitration or conciliation proceedings itself, but offers institutional and procedural support to conciliation commissions, tribunals, and other committees which conduct such matters.

Settlements are mainly monetary penalties payable to (mostly private) enterprises. Not only have the number of cases been increasing; arbitral awards decided by ISDS tribunals have been increasing in size. In 2014, three awards amounting to US$ 50 billion were decided against Russia in the cases brought by Yukos oil company majority shareholders. In the same year, an ICSID tribunal ordered Venezuela to pay US$ 1.6 billion, which includes compounded interest at the rate of 3.5 per cent, as compensation to Exxon Mobil. In October 2012, Ecuador was ordered to pay to the U.S.-based Occidental Petroleum Corporation US$ 1.7 billion plus interest for

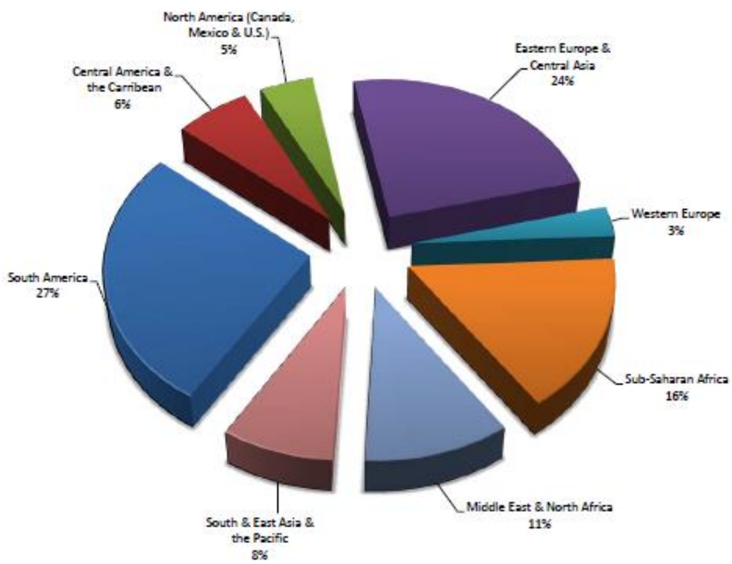
[8] ICSID's dominance is partly due to the ICSID requirement to report the existence of cases it accepts. The number of actual cases is unknown.

having canceled its operating contract in 2006. In March 2010, Ecuador had lost another oil-related case–this one brought by Chevron for approximately US$ 700 million. These two awards combined are the equivalent to approximately 3.3 per cent of that nation's Gross Domestic Product (GDP) (Anderson and Rocha 2013). In 2014, an ICSID tribunal awarded the mining company Gold Reserve US$ 713 million plus arbitration costs against Venezuela (Mohamadieh and Uribe 2016).

The incidence of disputes in the extractive sectors is noteworthy. In the matter of poverty, inequality, environmental degradation, impact on health, and the treatment of indigenous populations, extractive industries are particularly pertinent.

Figure 1.4 indicates that Sub-Saharan Africa, South America, and Eastern Europe and Central Asia, where foreign investment in extractive industries are prominent, have the largest proportion of ICSID disputes.

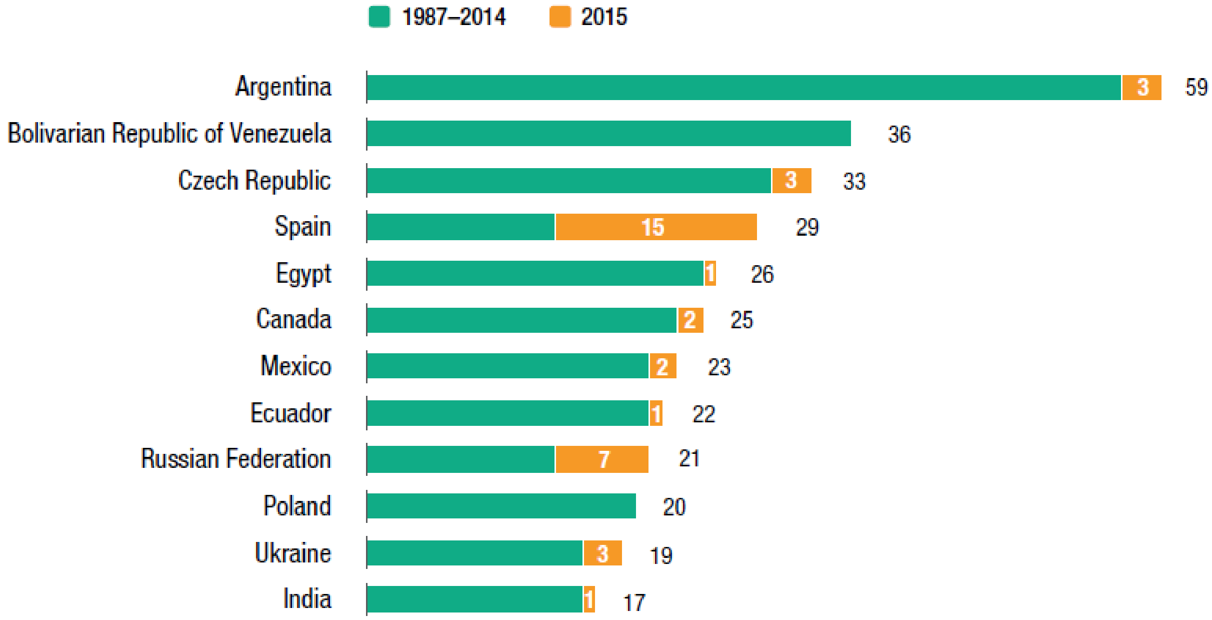
Figure 1.4: Geographic distribution of all ISDS cases registered under the ICSID Convention and Additional Facility Rules, by location of State Party



Source: Mohamadieh and Uribe (2016), Graph 1, p. 7.

The states that have subject to the greatest number of suits are given in figure 1.5. Argentina has fielded the most number of suits, 20 of which under the Argentina-United States BIT (UNCTAD 2015, 114). Four of the 11 respondent states are in Latin America.

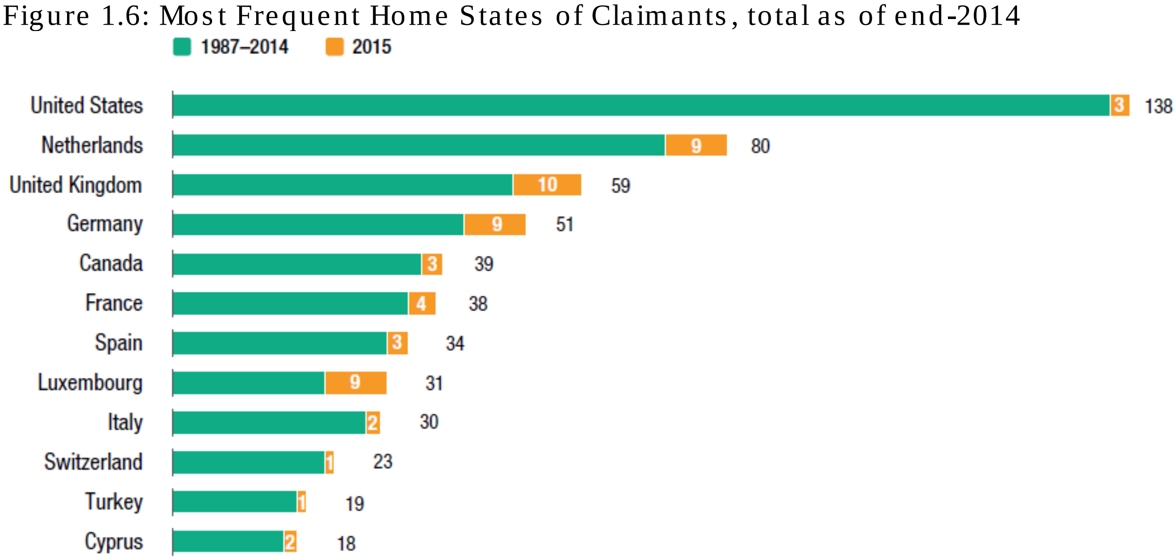
Figure 1.5: Most Frequent Respondent States, total as of the end of 2014



Source: UNCTAD (2016), Figure III.5, p. 105.

The most frequent home state of claimants is the United States (figure 1.6), followed by three large European economies. Overall, U.S. and E.U. investors together account for 75 per cent of the global number of ISDS claims (UNCTAD 2014).

Figure 1.6: Most Frequent Home States of Claimants, total as of end-2014



Source: UNCTAD (2016), Table III.6, p. 106.

An overall characterization of the outcomes of arbitral judgements is stymied by the secrecy obligations of parties to the system. Many compilations rely only on ICSID reports, which do not include all disputes, and, even here, documentation about the nature of the case *and* of the awards is often a matter of guesswork or indirect reference from some government documents or academic paper (UNCTAD 2016, 107) reports that as of the end of 2015, the number of "concluded cases" was 444. Of these, 36 per cent were decided in favor of respondent states; this means that in these cases all claims were either dismissed on jurisdictional grounds or on their merits. In two percent of the cases, tribunals found that there was a breach of treaty obligations but no monetary compensation was awarded to the investor. Nine per cent were discontinued for reasons other than settlement. Twenty-six per cent were "settled," most likely, because the terms of the settlement often remain confidential, generating a monetary award in favour of the investor. Twenty-seven per cent of the cases were decided in favor of the investor. If one were to interpret a settlement as an outcome in favor of the investor, since the state is the bearer of all the obligations in a standard BIT, and sum up those decided in favor of the investor with those settled, then in 55 per cent of cases, investors prevailed in ISDS-impelled proceedings. Another way to break down the number is to look only in the list of concluded cases which were decided by tribunals on their merit; in this case, 60 percent of the cases were decided in favor of the investor and 40 per cent in favor of the state.

A specific uncertainty about the category of "settled" cases is the extent to which these would have involved monetary payments by respondent states to investors, since in this context, states are the only party with contractual obligations and investors have none. Information on the nature of the settlements is not readily available, and settled cases could include withdrawals on the part of the investor, perhaps because of the high cost of the legal process. This is unlikely; on the contrary, it is more likely that respondent states have settled cases because of the prohibitive cost[9] of the process in order to minimize their losses. Among the known BITs cases, the Organization for Co-operation and Development (OECD) found that legal and arbitration costs averaged over US$ 8 million, with some exceeding US$ 30 million (OECD 2012); this compares unfavorably with the average cost of the anti-trust litigation process in the U.S. of US$ 194,000. CEO/TNI (2012, 15) reports that the Philippine government "spent US$ 58 million to defend two cases against German airport operator Fraport–the equivalent of the salaries of 12,500 teachers for 1 year, vaccination for 3.8 million children against diseases such as TB, diphtheria, tetanus, polio; or the building of 2 new airports."

The BITs regime provides an alternative path to financial profits for internationally active private actors by through settlements and awards from states in millions of dollars. This distorts the business of model of foreign investors, to the disadvantage of hosting countries which seek their investments for developmental objectives.

Of the 144 cases with outcomes in favor the state, almost half (71 cases) were dismissed by tribunals for lack of jurisdiction (UNCTAD 2015, 116). The stage in which tribunals decide that

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[9] The cost of the process include the cost of the services and travel for members of the arbitral panel, the cost of services for counsel of the opposing sides, and other costs with respect to information gathering, travel of witnesses, and so on.

they have jurisdiction is thus a critical stage from the point of view of host countries. Even in this stage, litigation and process costs are already being incurred by countries.

UNCTAD (2015) provides a breakdown of the outcomes of cases decided only on merit; this could give an indication on possible biases in the arbitral process. UNCTAD (2015) finds that 60 percent of the cases were decided in favor of the investor, while 40 per cent in favor the state. Because in BITs all the obligations are to the account of the state, ISDS already has a built-in bias towards awards for investors. The fact that an enormous proportion of judgements end in favour of the state suggests many things, including (1) an inadequacy in the quality and impartiality in the ISDS process despite its cost, (2) the encouragement of an alternative business model oriented toward obtaining profits from the "deep pockets" of government bodies, and (3) the use of the dispute system as a tool for influencing state policy, a tool not available to indigenous investors. Which of these possibilities, if any, apply to specific cases would require more detailed information about the concluded cases than is available publicly.

In understanding the kinds of outcomes from the ISDS system, it is also important to recognize the differences among host countries in their susceptibility to dispute actions. The United States is an important host country which also has a greater capacity to absorb the fiscal cost of investment disputes compared to developing countries. It is an important destination of outward investment from developing countries (though in absolute amounts the scale of investments is tiny) and contracting businesses. It can be argued that these investors and contractors in the United States would take greater care in initiating a dispute action against the U.S., even if federal, state, and city policies continually change and have an impact on the expected profits of foreign investors.[10]

The outcomes of the arbitral system suggest that there could be two kinds of costs generated by the system: (1) the fiscal costs cost of the process and (2) the perverse governance impact on regulatory policy and the business model for enterprises operating internationally. The first kind of cost, on fiscal resources, derives from the cost of the process and the possibility that states are paying damages at the scale beyond the actual costs actually borne by investors. The chilling effect on public regulatory policy, the encouragement to international business toward a model based on exploiting the public finances of developing countries, and the corruption of the arbitration process are part of the second kind of cost.

Under a different worldview, and remembering that ICSID's own *raison d'etre* is the *promotion* of foreign investment, the costly outcomes of the foreign investor protection system can be justified. This *Weltanschauung*[11] would look upon the system as a necessary evil to elicit foreign

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[10] There are also differences in the kinds of investors tumbling out of the U.S. and other countries whose incentive structures are based on maximizing managerial incomes and shareholder values. (See Lazonick (2011) for a window into this literature, which also argues that in the long-term, the U.S. could be at a competitive disadvantage because these "financialized" management approaches privileges short-term returns and penalizes innovations that create new products and markets.) Coming from underdeveloped financial markets, it can be argued that investors from developing countries experience relatively less pressure toward maximizing financial returns than those from the U.S.

[11] Schreuer (2002, 5) expresses this worldview in a paper about the ICSID Convention thus: "The role of FDI for development is practically uncontested today and has been recognized by nearly all developing countries. Therefore, the Convention's original idea, the promotion of economic development through FDI, has turned out to be a clear success."

investment flows into developing countries, investments which would otherwise not occur at the levels observed.

Unfortunately, only a tiny number of studies confirm this supposition. In these studies, it takes heroic efforts by researchers sympathetic to BITs to find weak positive effects (See Sauvant and Sachs (2009) for an example of such a study). Most of the research indicates that the necessary evil of BITs does not have any positive impact on scale of foreign investment flows into developing countries.

Detailed research, based on firm-level surveys, indicate that the existence of BITs is not important in corporate investment decisions. In fact, there are surveys that indicate that legal departments of U.S. companies might not be aware of their existence or the kinds of provisions available in BITs (Skovgaard Poulsen 2011, 163). In a survey of general counsels of the top 200 of the Fortune 500 firms, Yackee (2010, 429) finds a "a low level of familiarity with BITs, a pessimistic view of their ability to protect against adverse host state actions, and a low level of influence over FDI decisions." Yackee's (2010, 430) survey records that about 20 percent of higher than "medium" (on a scale of no to high) familiarity with BITs and all respondents indicate that non-lawyer chief executives were very familiar with BITs. Only about five percent of the general counsels considered BITs to be "very important" to a "typical FDI decision."

There is no evidence that the existence of BITs reduces the cost of political risk insurance and interviews with officials of Multilateral Investment Guarantee Agency (MIGA) and executives in private insurers suggest that BITs are not a factor in setting these rates (Skovgaard Poulsen 2010).

Casual evidence can also be cited here. Brazil has no bilateral investment treaties in force and has been a favored destination of foreign investment (according to Figure 1.1, the seventh ranking national destination globally). South Africa's publicly announced decision to withdraw from a BITs-enforced investor protection system in 2011 has not had noticeable impact on the scale of investment inflows and investor interest (though existing investors, supported by diplomatic pressure from their home countries, have publicly expressed objections to the new policy). After the end of apartheid in 1994, South Africa, just like the former communist countries in that era, rapidly agreed to numerous BITs with OECD countries to attract foreign investment. China enjoyed large foreign investment inflows before it began signing on to BITs, offering investors only domestic protection under a communist judicial system.

4. Constraining Social Policy against Inequality

Inequality has many dimensions beyond income, including access to productive assets, to secure livelihoods and family incomes, to a healthy environment, to affordable social services including water and health care, and so on. Investors have successfully made it costly for states to undertake social policy against various dimensions of inequality. This section will review some of these cases.

Hindering Black Economic Empowerment Policies in South Africa

Upon taking office in 1994, the African National Congress (ANC)-led government instituted a set of measures toward the redistribution of assets and opportunities, which it proposed was needed to resolve the economic disparities created by apartheid policies which had favoured white business owners. This objective was to be implemented across government departments.

South Africa's Department of Mining and Energy implemented a set of policies and targets requiring progress by companies in the sector in meeting social, labor, and development objectives as set out in a broad-based socio-economic empowerment mining charter. The legislation also required mining companies to divest themselves of a portion of their assets in order to increase indigenous ownership. In a case that is listed as *Foresti v. South Africa* (2010), a group of investors sued South Africa claiming that its Black Economic Empowerment legislation violates the terms of investment protection treaties concluded by South Africa with Italy and Luxembourg. The individual investors, all Italian nationals, sued for violations of protections contained in the Italy-South Africa investment treaty; in addition, their Luxembourg-based holding company, Finstone (PTY) Ltd SA, claimed breach of obligations in a separate investment treaty concluded by South Africa with Belgium and Luxembourg.

The case was settled on terms that were favorable to the claimants. South Africa agreed to reduce substantially the ownership share that was required for divestment by the claimants.

The case illustrates that an investment treaty lawsuit can impact the implementation of affirmative action and other human rights measures. It raises the prospect that the governments will be deterred from adopting such measures due to the risk of investor claims. Some analysts also questioned whether the case could lead other investors in South Africa, who previously accepted the requirements for divestment, to demand a watering-down of the requirements to match the treatment received by the claimants in this case (van Harten 2011).

Undercutting National Minimum Wage Policies

After the downfall of the Mubarak regime, the new Morsi government, which took office in June 2012, raised national minimum wages. In a case registered as Veolia v. Egypt (Veolia v. Egypt 2015), the French company Veolia sued the national government for breach of protections under the France-Egypt bilateral investment treaty because changes in domestic labour laws, including the higher minimum wage, would affect its expected profit. This case is still pending.[12]

The investor had a concession with the city of Alexandria for waste management since 2001. The 15 year contract was terminated in 2011. The investor claims that the France-Egypt BIT shields the concessionaire from the financial implications of any such legal changes (Peterson 2012).The dates associated with the case are quite interesting. The Morsi government took office on June 30, 2012, while the case was registered on June 25, 2012. No doubt the termination of the existing contract in 2011 was a consideration in the complaint. The termination of an existing contract has been a ground for many other cases. If the trigger for the complaint was the contract termination, the case also illustrates the fact that national governments are liable for compensation from the damages potentially stemming from the actions of local governments.

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[12] The Tribunal issued Procedural Order No. 4 concerning production of documents on December 21, 2015. See https://icsid.worldbank.org/apps/icsidweb/cases/Pages/casedetail.aspx?CaseNo=ARB/12/15

Undermining Land Reform

Land reform had been part of the revolutionary program in Zimbabwe, but the process had been allowed a longer transition. When it was implemented, the policy collided with the country's obligations under some investment treaties. *The Border Timbers Limited and others v. Zimbabwe* (2010) and *the Bernhard von Pezold and others v. Zimbabw*e (2015) are cases against the country's land reform policies.

In the first case, investors sought compensation on the grounds that Zimbabwe expropriated the claimants' large agricultural estates. Investors claimed that they had been targeted as part of the state's well-known land reform process (Bastin 2013).

This case also illustrates the question of representation in arbitration procedures which are not codified and over which sitting arbitral panels have practically absolute control. Subsequent to the start of the case, an NGO and several Zimbabwean indigenous communities sought permission jointly to participate as *amici curiae* in the proceedings. In particular, they sought to file a joint written submission, to access key case materials, and to attend the oral hearings and reply to questions posed by the tribunal. The tribunal rejected applications by non-disputing parties to participate as amici curiae (Border Timbers Limited and others v. Zimbabwe 2010).

ICSID Convention Rule 37(2) permits participation of non-disputing parties. The Tribunal expressed doubts over whether the communities seeking representation were in-fact indigenous people. It also maintained that the would-be *amici curiae* had not demonstrated that their submission would assist the tribunal in determining a factual or legal issue related to the proceedings, would address a matter within the scope of the dispute, or would be related to any significant interest they had in the proceedings. The tribunal also held that the *amici curiae* were not "independent" from the respondent state and thus, for that reason alone, did not satisfy Convention Rule 37(2).

The judgment on the *Bernhard von Pezold and others v. Zimbabwe* was rendered by the Tribunal on July 28, 2015, but the Republic of Zimbabwe requested annulment procedures, which are still pending. In the *Border Timbers Limited v. Zimbabwe*, the award was rendered by the Tribunal on July 28, 2015, and currently annulment proceedings, requested by the respondent, are pending. We have no information on what the judgments were, but given the request for annulment by the respondent government, the judgements were most likely in favour of the investors. In the standard practice of business in this area, there is an indirect indication that investors obtained a judgement of "restitution and damages" against Zimbabwe; this is trumpeted by one partner, named Matthew Coleman, of the counsel of the investors in the partnership's website (Steptoe 2016).

Destabilizing the Public Provision of Essential Services (Water)

In this justly famous case, the Bolivian city of Cochabamba was forced to reverse in April 2000, within a year of the award, the privatization of water services to a consortium which included the foreign company Bechtel in response to consumer complaints and mass actions about high prices and loss of access. The aggrieved consortium initiated a US$ 50 million case against Bolivia at ICSID on the argument that not only would the cancellation of the contract result in write-off of about US$ 1 million in costs so-far incurred by the consortium, but also in lost future profits. The case is registered as *Bechtel v. Bolivia* (2002).

In August 2003, more than 300 organizations from 43 countries, including Bolivia, sent an International Citizens Petition demanding that the case be transparent and open to citizen participation. The ICSID Tribunal rejected the petition. However, the case proved extremely controversial in public and destructive to the image of the claimants. In 2006, one year after an ICSID panel accepted jurisdiction of the case, the main shareholders of the consortium agreed to settle the case for a symbolic sum of 2 bolivianos ($0.30). The Bolivian government saved further litigation costs but had to concede that plaintiffs were on the right side of the law.

Regulatory chill on environmental policy

On January 6, 2016, TransCanada announced that it was filing an investor-state suit against the U.S. government under NAFTA, seeking US$15 billion in damages, for its decision to cancel the company's Keystone XL project. While the case is at an early stage, there are many other examples of regulatory chill. In the *MetalClad v. Mexico* (2000) case, brought under NAFTA Chapter 11, the city of Guadalcázar decided to convert the area of operation of the investor (a U.S. waste disposal company) to an ecological reserve. The ICSID award against Mexico of US$16.7 million payable within 45 days from the date of the award (following which, interest would "accrue on the unpaid award or any unpaid part thereof at the rate of 6% compounded monthly" (2000, para. 131) addressed two issues (Mohamadieh and Montes 2014, 11):

1) The set of events that cumulatively denied the company a permit to operate a hazardous waste disposal. The Tribunal stated in this regard "expropriation under NAFTA includes not only open, deliberate, and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state" (Metalclad v. Mexico 2000, para. 103).

2) A subnational (state) level act that converted the area of operation of the investor to an ecological reserve. In this regard, the tribunal stated that the "tribunal need not decide or consider the motivation of intent of the adoption of the Ecological Decree" (2000, para 111). Thus, <u>the Tribunal explicitly decided that the purpose of the measure was not important</u>.

The phrase "reasonably-to-be-expected benefit" has since featured in many subsequent cases. The power of arbitrary interpretation by arbitral tribunals under BITs appears to include the authority to weigh government actions against the "legitimate expectations" of the investor. In the *Bilcon of Delaware et. al v. Canada* (2015) case, a tribunal accepted jurisdiction and determined liability on the part of Canada on the grounds that the rejection of the investor's project by the province of Nova Scotia because it failed the standard environmental impact assessment violated the investor's legitimate expectations created by the investment promotion activities and promises of the Canadian province publicly broadcast in television advertisements.

5. Reforming the System

As illustrated in the previous section, the enforcement of state obligations under BITs has been used by investors to obstruct social and environmental policies. In the case of the South Africa particularly, the settlement with investors in the black empowerment case proved unpalatable to the government and was the occasion for the rethinking of its approach to investor protection. The government has embarked on a publicly announced program of withdrawing from its BITs and relocating its investor protection system in domestic law.

In truth, other undesirable features–not just their obstruction of social policy–of BITs as the approach to investor protection have provoked reform efforts. In the case of India, for example, recent dispute settlement defeats which subvert or circumvent the country's judicial system have been a key motivation (Dar 2015). For example, in February 2012, India's Supreme Court invalidated 122 grants of licenses on the 2G telecommunications spectrum on the grounds that the awards had not followed the correct procedures and were tainted by corruption. Domestic adjudication of this case went all way to the supreme court which ruled the allocation "unconstitutional and arbitrary" on public interest grounds and resulted in a prison sentence for the Minister of Communications and Information Technology. Nevertheless, the cancellation of the spectrum awards has triggered investor disputes on based on claims of indirect appropriation and the violation of fair and equitable treatment.

Brazil, which has signed 14 treaties, none of which have not been ratified by the legislature, has embarked on designing its own model treaty (under the preferred title of "Agreement on Cooperation and Facilitation of Investments"), which is based explicitly on investment promotion, *instead of* investor protection. While the specific elements of the Brazilian approach continue to evolve as it negotiates treaties sequentially with other developing[13] countries, the new approach eliminates investor-state dispute resolution. The Brazilian approach involves constant state-to-state involvement over investment projects from the early states to the settlement of disputes, if this cannot be avoided. There is no guarantee that social objectives on reducing inequality will be well incorporated in the resulting treaties. However, to the extent that this approach requires active state involvement and that policies against inequality are a responsibility of the state, the Brazilian approach is a step in the right direction.

In the developed world, there have been recent efforts at reform, which can apply to future treaties, but not to existing treaties. The European-Canadian CETA of October 2016 provides (1) expanded definitions of the concepts of greatest contention in ISDS including "indirect expropriation" and "fair and equal treatment;" (2) explicit general exceptions recognizing the right of the state to regulate on the grounds of public health, the environment public order and morality; and (3) a preamble that explains that the purpose of the agreement is not just the protection of the rights of investors but also the achievement of social objectives such as the respect for human rights and realizing sustainable development (Koeth 2016). These changes go some way into reducing the imbalance in rights which tie the hands of a state interested in reducing domestic inequality.

That investment treaties currently being negotiated even have to take the trouble to recognize the right of the state to regulate, reflecting the intolerable imbalance in the current practice of investment treaties. The right to regulate is a basic element of sovereignty under international law, reflecting both the power and the responsibility of the state in discharging *"Salus populi suprema lex esto"* (the wellbeing of the people is the highest law). This right is not granted by

[13] Treaty negotiations with Mozambique, Angola, and Mexico have been concluded. A treaty with Chile is being negotiated.

investment agreements. On the justification that the main purpose of investment treaties is the attraction of foreign investment and that actions that foreign investors consider injurious to themselves violate this purpose, arbitral tribunals have ruled that states have lost this general right.

In the meantime, as mentioned earlier, there have been strong diplomatic trends in incorporating NAFTA-style investor protections in proposed mega-regional agreements and possibly lodging such a regime in a multilateral manner in the WTO. The United States has been active in initiating free trade negotiations, notably the TransPacific Partnership (TPP) among 12 economies in the Pacific Rim and Trans-Atlantic Trade and Investment Partnership (TTIP) between the U.S. and the European Union. With the new U.S. administration that took office in January 2017, it is likely that the United States will end its assertive leadership in mega-regional agreements which can be highly advantageous to its international corporations. With some relatively minor adjustments, investor-state dispute enforcement of investor protection is part of the TPP. However, on January 23, 2017, the United States withdrew from the TPP with an executive order from the president to the U.S. Trade Representative to "withdraw the United States as a signatory to the Trans-Pacific Partnership (TPP)" and "to permanently withdraw the United States from TPP negotiations" (Whitehouse.gov 2017).

A NAFTA-style ISDS is also an important feature of the proposed trans-Atlantic TTIP negotiations. Since the contents and underlying philosophy of both TPP and TTIP are comparable, in principle, the United States would soon be withdrawing from TTIP negotiations. While the possibility is less likely now, should the TTIP become reality, European governments will find themselves newly subject to the disciplines over their social and environmental policies coming from investor protections for U.S. investors. Because of the greater volume of investments into Europe from the U.S., compared to those from developing countries, and the more litigious character of U.S. investors, TTIP has the potential to increase the global populations whose governments will confront obstacles in policies to reduce inequality.

The precedent presented by CETA as discussed earlier in this section suggests that should the E.U. be involved in future investment treaty negotiations, it will seek to incorporate the international court system for investment disputes, which is an attempt to improve the process without eliminating the imbalance of obligations in investment treaties.

6. International Governance and Domestic Inequality

There are multiple channels, some overlapping, through which BITs have an impact on domestic inequality. There are many dimensions of domestic inequality, not just the differentiated impact on incomes within the resident population. These dimensions would include gender, racial and other ascriptive inequities, differential skills, and regional imbalances.

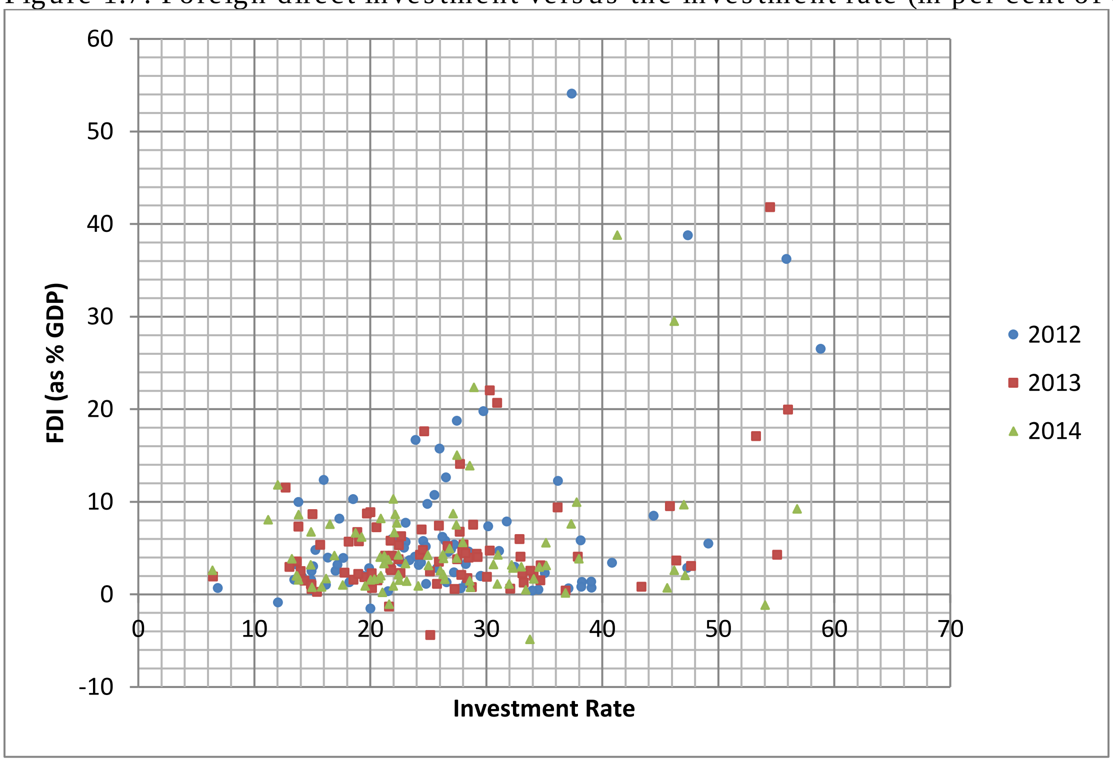
In the case of channels of impact, one set is possibly through the impact of foreign investment on domestic inequality through its effect on domestic growth, employment, and incomes. Another set of channels is through the impact of BITs on fiscal actions–both public policy and public resources for social programs.

Impact of BITs through foreign investment

To varying degrees of generality, existing studies on the foreign investment suggest that its impact is to worsen domestic inequality. There are many well-rehearsed conduits of effect. For example, foreign investment projects tend to use more advanced technology and rely on skilled workers in the domestic economy. Basu and Guariglia (2007) find that foreign investment increases inequality in a dual economy model, even if it increases growth since foreign investments tend to reduce the weight of agriculture (where incomes and productivity are lower) in the economy.

However, as discussed above, there is only weak evidence that BITs have a positive impact on foreign investment. Thus, BITs cannot be strongly implicated for an impact on inequality through the level of investment. One channel could be on whether foreign investment is associated with higher levels of total investment. Figure 1.7, based on 92 developing country annual data points, suggests that could be a positive relationship between Foreign Direct Investment (FDI) and the investment rate, but this could be a weak one. (Figure 1.7 is based on data in the most recent three years, but the graph is representative of the pattern from the 1970s). If higher FDI is associated with more domestic inequality, a negative relationship would suggest that if more IIA protections stimulate investment, then IIAs do not necessarily increase domestic inequality.

Figure 1.7: Foreign direct investment versus the investment rate (in per cent of GDP)



cBITs reduce the cost of political insurance for foreign investors. Once again, the existing evidence indicates that the cost of the political insurance is quite independent of the existence of BITs (Skovgaard Poulsen 2010).

The evidence that BITs have a negative impact on domestic inequality in developing countries through its impact on investment is weak and, possibly, non-existent.

The enormous compensation awards that have been observed could serve as a direct channel between BITs and domestic inequality. However, this requires a more strenuous data effort beyond the scope of this paper, including overcoming the secrecy surrounding these awards. Awards will exacerbate domestic inequality, even as most can be seen as one-time bonanzas for already wealthy investors. For developing countries, one channel is that their own citizens and residents have benefited as awardees as foreign investors, entering as owners in incoming investment from treaty country partners. The overwhelming majority of BITs awardees are enterprises resident in developed countries. These awards would exacerbate domestic inequality in *developed* countries. These enterprises have a more diffuse ownership structure–including pension funds, in which arbitral awards could benefit labor. For large U.S. corporations, however, a big proportion of these awards can be captured by management, given the nature of compensation practices that have become standard in these corporations (Lazonick 2014).

Impact of BITs through public policy and resources

One important channel is the impact of BITs on domestic inequality through the public sector. As demonstrated earlier, BITs affect public policy, and the practice of BITs also has an effect on fiscal resources (through the cost of arbitral awards). It must be recognized that this impact is mediated by the stance of public policy. If public policy is indifferent or tolerant of increasing inequality as the price of greater investment and faster growth, the costs of investor protection cannot be easily implicated in increasing domestic inequality.

The case studies presented in section 4 represent a growing incidence of the many ways BITs have a direct impact on domestic inequality, particularly the dimensions of inequality that go beyond income and wages. Ownership requirements, environmental and health protections, and access to land have been adversely affected by the domestic policy straitjackets introduced through investor protection obligations. The impact of the integrity of the domestic judicial system as exemplified by the awarding of 2G licenses in India in the late 2000s speaks to the unequal access to redress for damages introduced by the BITs network. While the United States has managed to carve out many policies by its states from BITs disciplines (including minimum wage requirements and local content), under BITs, most developing country national governments are liable for the adverse impact on investors of the policies of their subnational governments.

The other channel of impact by BITs is through public resources–through its claims on public revenues from cost of arbitral litigation and awards, constraints on reductions in investment incentives, and tax policy in general. The Philippine Fraport case example earlier discussed throws light the substantial costs–on alternative spending on teacher salaries and immunization programs, among others–of investor-state arbitration on poor countries, who often have been inclined to settle to avoid these costs. However, there is no guarantee that such fiscal savings will be directed to social programs that reduce inequality.

7. Final Comments

This paper does not present direct evidence that the BITs international governance mechanism has a strong effect on domestic inequality. The case examples in Section 4 suggest that BITs obligations obstruct public interventions oriented toward reducing inequality and can impose severe fiscal costs, draining resources that could be applied to combat domestic inequality. However, there are a host of intervening variables, not the least of which is the policy stance of host governments subject to BITs disciplines.

As discussed in Section 2, under the prevailing regime of investor protection, obligations are to the account only of host states. These obligations have tended to be denoted in ambiguous terms and interpreted expansively in arbitral proceedings. With very few exceptions, corresponding responsibilities on the part of investors are not defined in the regime. The feasibility of a global, multilateral path toward reforming the system is extremely limited; a multilateral approach action cannot overturn the obligations codified in the 3,304 treaties in place. Nonetheless, as discussed in Section 5, developing countries are introducing initiatives to sidestep the problematic system.

New efforts on the part of BOTH developed and developing countries to reform the "classic" form of investor protections suggest that it is possible to see this form as a remnant of the high tide of the globalization era from the 1980s. Inequality is the most prominent motive force behind the burgeoning rethinking of the current form of globalization. In a piece provocatively entitled "Neoliberalism: Oversold?," Ostry *et al.* (2016, 38-39) of the IMF suggests that a policy considered part of an ideal standard set–"removing restrictions on the movement of capital across a country's borders (so-called capital account liberalization)" –cannot be associated with increased growth and is associated with increased inequality, which "in turn hurts the level and sustainability of growth."

Developing country authorities "practice" this neoliberal standard not only in structural adjustment programs, but in accepting investor protection obligations in treaties that have an expansive definition of what kind of investments are covered, to include, quoting from the final TPP text, "shares, stock and other forms of participation in an enterprise," "futures, options and other derivatives," and "bonds, debentures, other debt instruments and loans" (U.S. Trade Representative 2016, 3) and to commit to "permit all transfers relating to a covered investment to be made freely and without delay into and out of its its territory" (U.S. Trade Representative 2016, 9). Earlier, an IMF legal counsel opinion on the U.S.-Singapore Free Trade Agreement in 2003 stated that, in complying with the blanket prohibitions against capital restrictions of the free trade agreement, a member could become ineligible to access to the International Monetary Fund's (IMF) resources in the event of a balance of payments crisis (Montes 2012), since the Articles of Agreement authorize the staff to request the imposition of capital controls in such a situation.

The new investment treaty models from Brazil and India seek to exclude portfolio flows from investor protection. However, these proposals have not been tested in agreements which include G7 countries, whose financial centers are a key element of their international competitiveness. In the case of the United States particularly, it is difficult to find an instance when the investment coverage and "freely and without delay" provisions have strayed from the U.S. model in investment treaties with the U.S. The quotations in the preceding paragraph are from the final TPP text. However, the covered investment text in TPP's Chapter 9 is word-for-word from the

U.S. 2012 model bit (U.S. State Department 2012), including with regard to where the listing of covered investments breaks from the initial page to a second page in the U.S. Trade Representative's website.

Going by the CETA example, it appears that Canada and the E.U. are prepared to move toward a clearer definition of fair and equitable treatment and to restore the state's regulatory power for public purposes. A related development is the pattern in the new developing country model BITs to introduce responsibilities of investors. These proposals have not been tested with regard to treaties with developed countries.

Still, another trend in the international sphere is the growing effort in specifying the human rights responsibilities of business activities. In 2011, the United Nations Human Rights Council endorsed the Guiding Principles for Business and Human Rights, which elaborates the existence of voluntary human rights standards over the activities of private companies. On June 26th, 2014, the Human Rights Council in its 26th Ordinary Session adopted Resolution A/HRC/26/9 "Elaboration of an International Legally Binding Instrument on Transnational Corporations and other Business Enterprises with respect to Human Rights." The resolution provides for the establishment of an open-ended intergovernmental working group with the mandate to elaborate a legally binding international instrument to regulate, in international human rights law, the activities of transnational corporations and other business enterprises. Should this line of work prosper over the resistance of developed countries in the Council, it will create a set of obligations and responsibilities on the part of investors and international business.

These developments point to a retreat on the guarantees over an inhibited space for private profit-making which had been considered a fundamental ingredient of globalization and which the provisions of classic investment treaties have upheld. The Brazilian and Indian innovations and the drastic actions by Bolivia, Ecuador, and South Africa to revoke existing treaties are more in line with pressing for thoroughgoing and more rapid reform. The real test is whether this divide will leave other countries, that are not as prominent internationally in the foreign investment game, behind. As presented above, the evidence suggests that the classic treaties have insignificant impact on investment flows, but these smaller countries feel compelled to accede to investment treaties to achieve a minimum qualification to be considered as investment destinations. Will they take the leap to go with the alternative approaches being experimented on in the developing world?

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