



Large investors, regulatory taking and investor-state dispute settlement[☆]



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ARTICLE INFO

Article history:

Received 13 September 2016

Accepted 3 July 2017

Available online 15 July 2017

JEL classification:

Q68

K11

F21

F55

Keywords:

Investment arbitration

Settlement courts

Time-consistent regulation

Strategic investment

ABSTRACT

This paper offers an economic analysis of an international investor-state dispute settlement regime (ISDS) in markets with large investors. It identifies a reason for strategic overinvestment by the domestic industry, leading to permissive regulation in the absence of ISDS. An “ideal” investor-state dispute settlement arrangement (efficiency- oriented, transaction-cost free, with untouchable, fully reliable, and unbiased judges) has positive and negative effects in this framework. It generates an equal level playing field for domestic and foreign investors, but it magnifies an existing overinvestment problem and may reduce world welfare. The results explain anecdotal evidence according to which ISDS that protects foreign investors is liked by the domestic industry and disliked by other interest groups in the host country.

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1. Introduction

This paper studies the nexus between strategic investors, risks and other spillovers from industrial production, government regulation, and a regime with international investor-state dispute settlement courts (ISDS). It identifies an existing regulatory policy failure that is caused by large domestic investors and time-consistent regulatory policy in the absence of ISDS and shows that ISDS can magnify this problem.

Investor-state arbitration has generated considerable interest in the legal sciences. [Franck and Wylie \(2015\)](#) review the role of, and the previous discussion about, investor-state dispute settlement arrangements such as investment treaty arbitration courts. There is agreement on their economic relevance and importance. The establishment and design of ISDS is, for instance, a key aspect of many free-trade agreements. But ISDS is even more widespread. Almost 700 disputes were initiated between 1987 and 2015. Governments were most frequently challenged not only for regulatory takings in the sector of renewable energy, but also for direct expropriations, discriminatory treatment, revocation and denial of licenses or permits (see the [UNCTAD, 2016](#), pp. 104–106).

Conceptually, ISDS addresses a fundamental policy problem in the international context: Foreign investors who install major physical capital in a sovereign host country suffer from the threat that the host country may use its sovereignty

[☆] This is a revised version of a draft entitled “Large investors and permissive regulation: Why environmentalists may dislike investor-state dispute settlement”. Research assistance by Niklas Gebhard and very helpful comments by Alexander Wu, Harald Lang, Tim Stolper, Thomas Tangerås and two anonymous reviewers are gratefully acknowledged. The usual caveat applies.

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to appropriate from the foreign investor. Means to do this are manifold: discriminatory regulation, confiscatory taxation, arbitrary fines, extortionary threats, and blunt expropriation or nationalization. The seminal contributions by [Eaton and Gersovitz \(1983\)](#), followed by [Cole and English \(1991\)](#), [Thomas and Worrall \(1994\)](#) and others, have alluded to this problem and its implications. Foreign investors shy away from making investments in a particular country if they anticipate opportunistic time-consistent confiscatory policy by the government in the host country of their investment. A punch line from this literature is that it would be in the mutual interest of foreign investors and of the host country, but difficult, to tie the hands of the sovereign host government.¹ The design of a regime with ISDS is meant to solve this problem by protecting foreign investors and by enforcing their property rights. It allows them to take the host-state to a court that is outside the control of the host-state government, but makes rulings which are binding for the parties in the dispute.

Some dark sides of ISDS have also been identified. [von Bogdandy and Venzke \(2014\)](#) allude to the lack of democratic legitimacy. The courts, while meant to tie the hands of sovereign governments, would need to be controlled and supervised as well – but by whom? In the absence of benevolence, interest policy and corruption might flourish. The court rulings may become arbitrary, their judgments may lack precision and predictability, and the sovereign states themselves may become the victims of extortion. [Franck and Wylie \(2015\)](#) provide an excellent collection of negative views – according to which these courts are pro-investor biased, unpredictable or illegitimate – and how states reacted to this.²

The positive effects of ISDS that have been identified rely on a well-functioning ISDS mechanism, whereas criticism mostly relies on possible deficiencies or the malfunctioning of the regime with ISDS, some of which could be remedied.³ So, is the desirability of ISDS only a question of the quality of its design? This question is studied here in a system that, by design, is transaction-cost free, makes fully well-thought-out and benevolent decisions, is free of outcome uncertainty or problems of incomplete information and perfectly and precisely follows a decision rule and compensation rule that is efficiency-guided. Still a “dark side” can be identified: ISDS magnifies incentives for strategic overinvestment and excessively permissive regulation that can emerge in industries with major set-up costs and large strategic investors.

In a nutshell, regulatory policy decides whether or not production in a given industry may take place. This policy, if chosen by a benevolent government, may aim at efficiency at the point of time of decision-making. Information about consumer risks, environmental risks, and other spillovers may arrive between the time of private investment (“ex ante”) and the time when the regulatory decision must be made (“ex post”). A government will base its regulatory decisions on the costs and benefits of production that apply and are available at the point of time when the regulatory decision is being made. If large investors have installed huge productive capacities that allow for large-scale, cost-efficient production, then a restrictive regulatory policy sacrifices the huge producer rents that could otherwise emerge from this investment. This high opportunity cost will make the government's regulatory policy more permissive than otherwise. The amount of investment influences future regulatory policy. This, in turn makes the industry's investment choice a strategic variable: domestic investors may have an additional, strategic incentive to make a high investment.

In the absence of ISDS the government regards the loss of producer rents for the domestically-owned industry, but it disregards the loss of producer rents of the foreign investors. If ISDS is in place and operating, it may force the government to compensate the foreign investors for these lost producer rents. The host government internalizes these costs and, as a result, becomes more permissive. Hence, the foreign investor becomes strategic as well. Moreover, the investments undertaken by several investors are complements to each other: high investment by one investor makes regulatory policy more permissive, and this benefits the other investor and makes this other player's investment more worthwhile.

The analysis makes several predictions. First, large domestic investors have a strategic effect on the government's regulatory choice. This strategic effect leads to excessive investment in the absence of ISDS. Second, ISDS will also install this strategic incentive for large foreign investors. This leads to more investment. Third, strategic complementarity of the investment amounts leads to even more investment. Fourth, in turn, the high investment ultimately contributes to regulation that is, from an ex-ante point of view, overly permissive. Fifth, ([Quick, 2015](#), pp. 199–200), reports that “political groups, in particular the social democrats, trade unions, customer organizations and other NGOs oppose the inclusion of ISDS in TTIP for various reasons,” but that “only the business community supports ISDS.” The theory predictions here are in line with this empirical observation.

The findings contribute to the economic literature on international arbitration courts. Some early contributions focus on the courts' role in the settlement of disputes between players from the private sector (see, for instance, [Casella, 1996](#); [Dixit, 2011](#); [Mattli, 2001](#)). Pioneering work by [Aisbett et al. \(2010a\)](#) provides a contract theory study of regulatory takings when the government is exempt from paying compensation if and only if the court perceives that the social benefits from regulation are sufficiently high. Their analysis relates to the institutional context of the North American Free Trade

¹ [Dixit \(2011\)](#) offers a survey about results on the quantitative importance of incomplete investor protection and discusses protection mechanisms. A few mechanisms have been identified. Repeated play is important, as noted by [Eaton and Gersovitz \(1983\)](#). Also incomplete information about the cost of production and relocation may protect some investor rent ([Konrad and Lommerud, 2001](#); [Olsen and Osmundsen, 2003](#)). The same applies for strategic capacity overinvestment across multiple locations ([Janeba, 2000](#)). Whether the type of political regime is important for limiting opportunism has also been discussed ([Huck and Konrad, 2005](#)).

² [Sappideen and He \(2015\)](#) discuss several countries' shifting position and a number of cases that were triggered by governmental consumer- and environmental protection regulation.

³ [Rivkin et al. \(2015\)](#) discuss many of the conceptual issues that had to be solved for a well-functioning ISDS. “Ideal” ISDS procedures, reliably predictable, accurate, uncorrupted, and transaction-cost free ISDS that is fair and equitable and strikes a balance between investor protection and legitimate regulatory takings would not be affected by most of the criticism mentioned.

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