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Citation: 38 Va. J. Int'l L. 639 1997-1998



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Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties

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I. INTRODUCTION

A serious analysis of Bilateral Investment Treaties (BITs) and their implications for both investment levels and the distribution of the gains from investment is timely. BITs have become the dominant international vehicle through which investment is regulated. As of July 1996, there were 1010 BITs in existence around the globe,¹ more than half of which have been signed or brought into force since the start of 1990.² The number of countries who have signed at least one BIT has reached 149 (including some countries which have ceased to exist, such as the USSR), leaving very few countries without any such treaties.³ Although a substantial academic literature related to these treaties exists, there has been surprisingly little analysis of the impact of BITs on the welfare of the countries that have signed them. This Article seeks to address this large gap in the literature and contribute to a more coherent understanding of BITs, their impact on foreign investment, and their effect on the welfare of nations.

In recent years, foreign direct investment (FDI) has grown at an unprecedented rate.⁴ Between 1986 and 1990, total world FDI flows increased from \$88 billion dollars to \$234 billion, representing an average rate of increase of twenty-six percent in nominal terms and eighteen percent in real terms.⁵ From 1980 to 1993, the stock of foreign investment increased at an average annual rate of

1. *Recent Actions Regarding Treaties to Which the United States Is Not a Party*, 35 I.L.M. 1130, 1130 (1996).

2. *See id.*

3. *See id.* The countries without any BITs include Botswana, Guatemala, Ireland, Mozambique, Myanmar, and Surinam. *Id.*

4. The simultaneous growth in FDI and the popularity of BITs should not be assumed to imply causation. Although BITs and FDI are obviously related, the sensitivity of FDI to the presence of BITs is an empirical question that must be left for future research.

5. *See* Thomas L. Brewer, *International Investment Dispute Settlement Procedures: The Evolving Regime for Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 633, 634-35 (1995).

eleven percent in real terms, reaching a total of \$2.1 trillion in 1993.⁶ A significant proportion of FDI flows has been directed at developing countries: FDI flows to these countries grew from \$13 billion in 1987 to \$22.5 billion in 1989 to \$90.3 billion in 1995.⁷

BITs have risen to prominence during a period in which the international regulation of foreign investment was the subject of great change, uncertainty, and controversy.⁸ Not long ago, when a host state expropriated a foreign investor's property, the relevant rule of customary international law, known as the "Hull Rule," required "prompt, adequate and effective" compensation.⁹ In the years that followed World War II, however, developing countries questioned the Hull Rule, claiming the right to determine how they would treat investors and the standard of compensation that should apply if that treatment was sufficiently harmful. This challenge to the Hull Rule proved successful and, by the mid 1970s (and perhaps sooner), the Hull Rule had ceased to be a rule of customary international law.¹⁰

Countries began to establish BITs even before the demise of the Hull Rule.¹¹ These treaties, typically signed between developed

6. See ERNEST H. PREEG, *TRADERS IN A BRAVE NEW WORLD: THE URUGUAY ROUND AND THE FUTURE OF THE INTERNATIONAL SYSTEM* 13 (1995). In the United States alone, it is estimated that the stock of foreign investment reached \$504 billion in 1994. See Michael H. Gottesman, *Chickens Come Home to Roost: Have American Treaties Fenced Off Some of Our Best Jobs from Americans?*, 27 LAW & POL'Y INT'L BUS. 601, 601 n.2 (1996).

7. See Malcolm D. Rowat, *Multilateral Approaches to Improving the Investment Climate of Developing Countries: The Cases of ICSID and MIGA*, 33 HARV. INT'L L.J. 103, 103-04 (1992); Anthony M. Vernava, *Latin American Finance: A Financial, Economic and Legal Synopsis of Debt Swaps, Privatizations, Foreign Direct Investment Law Revisions and International Securities Issues*, 15 WIS. INT'L L.J. 89, 145 n.199 (1996).

8. One commentator has observed that "[a]part from the use of force, no subject of international law seems to have aroused as much debate—and often strong feelings—as the question of the standard for payment of compensation when foreign property is expropriated." Oscar Schachter, *Compensation for Expropriation*, 78 AM. J. INT'L L. 121, 121 (1984).

9. See *infra* Part II.A.

10. See *infra* Part II.B.

11. There have been some efforts to establish multilateral agreements, but these have met with considerably less success than BIT efforts. As of 1996, there were eight multilateral investment treaties in place. See *Recent Actions Regarding Treaties to Which the United States Is Not a Party*, *supra* note 1. These include the Arab Magreb Union Treaty on Promotion and Protection of Investments; the North American Free Trade Agreement; the Energy Charter Treaty; the Arab League's Treaty for the Investment of Arab Capital in Arab States; the Agreement for the Promotion, Protection, and Guarantee of Investments Among Member States of the Organisation of the Islamic Conference; the Agreement Among the Governments of Brunei Darussalam, the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore, and the Kingdom of

and developing nations,¹² are binding international agreements that govern the treatment of foreign investment. Despite the fact that developing countries as a group objected vociferously and repeatedly to the Hull Rule, these same countries have signed over a thousand BITs that incorporate obligations similar to the Hull Rule. Indeed, most BITs offer investors even greater protection, at the expense of host countries, than the Hull Rule ever did. Most importantly, BITs typically include terms that protect the foreign investor against a "contractual breach" by the host.¹³ Thus, when a BIT is in force between a host and a home state, an agreement made between the home state investor and the host is binding on both. A breach of the agreement by the host is a violation of the BIT and, therefore, a violation of international law. BITs also give the aggrieved investor access to binding arbitration, thereby creating an enforcement mechanism that is much more effective, and thus better able to ensure compliance by the host, than was the Hull Rule.

This Article looks at why BITs have become the preferred method of governing the relationship between foreign investors and host governments in developing countries. Because BITs impose obligations that are similar—and, indeed, that exceed—the obligations imposed by the Hull Rule, and because the legal position advocated by developing states has always been for fewer such legal requirements, the simultaneous opposition to the Hull Rule and embracing of BITs is a paradox.¹⁴ This Article offers a

Thailand for the Promotion and Protection of Investments. See *id.*; see also Todd S. Shenkin, *Trade-Related Investment Measures in Bilateral Investment Treaties and the GATT: Moving Toward a Multilateral Investment Treaty*, 55 U. PITT. L. REV. 541, 588 n.267 (1994).

An effort has also begun at the OECD, where member states have been attempting to draft a Multilateral Agreement on Investment (MAI). This effort, however, recently stalled after negotiators pushed back an April 1998 deadline for the MAI indefinitely. See Lorraine Woellert, *U.S. Laws Hurt Trade Talks*, NAT'L L.J., Mar. 2, 1998, at A12. There have been proposals for similar multilateral efforts at the World Trade Organization. See Kenneth J. Vandeveld, *Rudolf Dolzer and Margrete Stevens' Bilateral Investment Treaties*, 90 AM. J. INT'L L. 545, 546–47 (1995) (book review).

12. The vast majority of BITs are executed by one developed and one developing state. Treaties between developing states have also been signed. See *Recent Actions Regarding Treaties to Which the United States Is Not a Party*, *supra* note 1.

13. To facilitate the discussion, the term "breach" is used throughout this Article to describe situations in which the host fails to honor promises made to an investor, regardless of whether or not there is a legal remedy available to the investor. Thus, a breach is any action that is contrary to the promises made to the investor at the time of the investment.

14. I am not the first to note this paradox. See, e.g., M. SORNARAJAH, *THE INTERNATIONAL LAW OF FOREIGN INVESTMENT* 259 (1994) ("This duplicity can be ex-

novel explanation of why developing states fought aggressively against the former rule of "prompt, adequate, and effective" compensation for expropriation and in favor of a more lenient standard, and yet contemporaneously flocked to sign treaties that offer investors much greater protection than did the old rule of customary international law. It is demonstrated that although an *individual* country has a strong incentive to negotiate with and offer concessions to potential investors—thereby making itself a more attractive location relative to other potential hosts—developing countries *as a group* are likely to benefit from forcing investors to enter contracts with host countries that cannot be enforced in an international forum, thereby giving the host a much greater ability to extract value from the investment. Put another way, developing countries as a group have sufficient market power in the "sale" of their resources that they stand to gain more when they act collectively than when they compete against one another. The analysis in this Article offers a better explanation for the behavior of developing countries than what is currently in the literature and allows an assessment of the desirability of BITs.

In addition, this Article discusses the welfare implications of BITs as compared to the "appropriate compensation" standard that developing countries have advocated at the United Nations. The Article demonstrates that although BITs increase global efficiency, they likely reduce the overall welfare of developing states.

Finally, the Article discusses the impact of BITs on customary international law. The Article argues that because BITs are signed by developing countries in pursuit of their economic self-interest

plained on the basis that while these states subscribe to a particular norm of international law at the global level, they are yet prepared to accord a higher standard of protection to the nationals of states with which they conclude bilateral investment treaties in the hope of attracting investment."); Rudolf Dolzer, *New Foundations of the Law of Expropriation of Alien Property*, 75 AM. J. INT'L L. 553, 567 (1981) ("This apparent contradiction can be easily explained in light of the special benefits that developing countries enjoy under such treaties."); M. Sornarajah, *State Responsibility and Bilateral Investment Treaties*, 20 J. WORLD TRADE L. 79, 90 (1986) ("At first glance, there appears to be some duplicity in the stance taken by many developing states in international fora as these states have shown no reluctance to subscribe to entirely different standards in bilateral investment treaties" as compared to the relevant General Assembly resolutions.). This Article, however, is the first to point out that developing countries face different incentives when they behave as a group than when they behave individually. It is also the first to identify the distributional consequences of BITs. See also Andrew Guzman, *M. Sornarajah's The International Law of Foreign Investment*, 6 EUR. J. INT'L L. 612 (1995) (book review) (suggesting that LDCs may be better off under customary international law than under BITs).

rather than out of a sense of legal obligation, these treaties do not support a rule of customary international law that incorporates the Hull Rule.

Before proceeding, a note of clarification is in order. The bulk of the literature on BITs and foreign investment protection has focused on expropriation, devoting much less attention to other types of disputes between investors and hosts. The analysis here, however, encompasses all potential disputes between investors and hosts. Indeed, disputes that do not involve a direct taking are more interesting and important today because outright takings are now quite rare.¹⁵ The most common source of tension between an investor and a host state is not expropriation but rather conflicts that fall short of a taking. Customary international law—even under the Hull rule—provides little protection for the investor against these less extreme actions by the host. BITs, on the other hand, allow potential investors to negotiate for whatever protections and safeguards they feel are needed. In other words, BITs provide the investor with protections that are superior, in all forms of investor-host conflicts, to those of customary international law.

II. THE FALL OF THE HULL RULE

A. “Prompt, Adequate, and Effective”

Early in this century, the world’s principal nations shared the view that investors were entitled to have their property protected by international law and that the taking of an alien’s property by a host nation required compensation that was “prompt and adequate.”¹⁶ The modern terminology used to describe the customary

15. See Michael S. Minor, *The Demise of Expropriation As an Instrument of LDC Policy*, 25 J. INT’L BUS. STUD. 177 (1994). Minor states:

[E]xpropriations of foreign affiliates generally rose through the 1960s. A sharp increase occurred through the early 1970s, which peaked in 1974 and 1975. This was followed by a marked decline during the latter 1970s. . . . [T]he declining trend extended through the 1980s. Expropriations maintained a fairly constant, but very low, level through 1986, but appear to have disappeared afterwards.

Id. at 178.

16. See *Concerning the Factory at Chorzów (Ger. v. Pol.)*, 1926–29 P.C.I.J. (ser. A), Nos. 7, 9, 17, 19, excerpted in HENRY J. STEINER ET AL., *TRANSNATIONAL LEGAL PROBLEMS* 451–54 (1994). The Permanent Court of International Justice stated that “there can be no doubt that the expropriation . . . is a derogation from the rules generally applied in regard to the treatment of foreigners and the principle of respect for vested rights.” *Id.* at 452. The Court also stated that “reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.” *Id.* at 453. For other early

international law against expropriation arose in the 1930s in a dispute between Mexico and the United States.

Between 1915 and 1940, the Mexican government confiscated various agrarian and oil properties, including some owned by Americans. The United States considered these expropriations to be illegal acts and sought compensation for its affected citizens. A diplomatic exchange of notes took place between the American Secretary of State, Cordell Hull, and the Mexican Minister of Foreign Affairs.¹⁷ In one of his notes, Hull put forth what has become the leading formulation of the full compensation standard:

The Government of the United States merely adverts to a self-evident fact when it notes that the applicable precedents and recognized authorities on international law support its declaration that, under every rule of law and equity, no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefor.¹⁸

The requirement of "prompt, adequate, and effective" compensation has become known as the "Hull Rule," in reference to this statement.¹⁹

international cases articulating the rules governing expropriation, see *Norwegian Shipowners Claims Arbitration* (U.S. v. Nor.) 1 Rep. Int'l Arb. Awards 307 (1922) and *Spanish-Moroccan Claims Arbitration* (U.K. v. Spain), 2 Rep. Int'l Arb. Awards 615 (1925).

17. Notes exchanged between the United States and Mexico during the 1938 dispute are reprinted in 3 GREEN H. HACKWORTH, *DIGEST OF INTERNATIONAL LAW* § 228, at 655-65 (1942).

18. *Id.* at 658-59.

19. The protection of foreign investments is typically considered a matter of international law, but domestic law makers have, from time to time, sought to influence the treatment of investors abroad through domestic legislation. In the early 1960s, for example, the United States Congress passed what would become known as the "First Hickenlooper Amendment." Foreign Assistance Act of 1963, Pub. L. No. 88-205, 77 Stat. 386 (1963) (codified as amended at 22 U.S.C. § 2370(e)(1) (1994)). This law requires that the President terminate aid to any country that has seized American-controlled property, repudiated or nullified contracts with Americans, or "imposed or enforced discriminatory taxes or other exactions, or restrictive maintenance or operational conditions," and that has failed to "discharge its obligation under international law . . . including speedy compensation for such property in convertible foreign exchange, equivalent to the full value thereof . . ." 22 U.S.C. § 2370(e)(1). This statute represents an attempt on the part of the United States to provide an enforcement mechanism, through domestic law, that carries out the American interpretation of international law. Since its adoption, however, the First Hickenlooper Amendment has been applied only twice, once against Ceylon in 1963 and once against Ethiopia in 1979. See Patricia M. Robin, *The BIT Won't Bite: The American Bilateral Investment Treaty Program*, 33 AM. U. L. REV. 931, 938-39 (1984).

B. *The Decline and Fall of the Hull Rule*

Consensus surrounding the Hull Rule was possible during the first half of this century because many of the countries that later opposed the rule were then colonies rather than sovereign states. Before decolonization, the official views of these states were controlled by their colonial masters, who supported a regime of full compensation. Furthermore, colonies were not recognized as independent states, suggesting that even if they had an independent, publicly stated view of how international law should protect investors, that view would not have affected customary international law.

As former colonies became sovereign states, however, these newly minted countries were able to voice their own views, and those views became relevant to the formulation of customary international law. As their numbers grew, these states carried greater weight in the international arena, and as they questioned existing international norms, including the Hull Rule, the status of those norms was threatened.²⁰

Arguably the strongest early objection to the Hull Rule was voiced by Mexico during discussions with the United States regarding Mexican expropriations of property in the first half of this century. For example, in a note dated August 3, 1938, the Mexican Minister of Foreign Affairs stated that "[m]y Government maintains . . . that there is in international law no rule universally accepted in theory nor carried out in practice, which makes obligatory the payment of immediate compensation nor even of deferred compensation, for expropriations of a general and impersonal character"²¹

It was not until after the World War II, however, that expropriation and conflict over expropriation became commonplace.²² Na-

20. A rule of customary international law requires two elements: (1) the general practice of states, and (2) state adherence to the rule based on a belief that such adherence is legally required (*opinio juris*). See Statute of the International Court of Justice, June 26, 1945, art. 38, 59 Stat. 1055, 3 Bevans 1179, reprinted in INTERNATIONAL LAW: SELECTED DOCUMENTS 27 (Barry E. Carter & Phillip R. Trimble eds., 1991) ("The Court . . . shall apply . . . international custom, as evidence of a general practice accepted as law."); Concerning the Continental Shelf (Libya v. Malta) 1985 I.C.J. 13, 29 (June 3) ("It is of course axiomatic that the material of customary international law is to be looked for primarily in the actual practice and *opinio juris* of States . . .").

21. HACKWORTH, *supra* note 17, at 657.

22. See CHARLES LIPSON, *STANDING GUARD, PROTECTING FOREIGN CAPITAL IN THE NINETEENTH AND TWENTIETH CENTURIES* (1985); Detlev F. Vagts, *Foreign Investment Risk Reconsidered: The View from the 1980s*, 2 FOR. INV. L.J. 1 (1987).

tionalizations and expropriations in the form of direct takings increased for at least two reasons. First, as mentioned above, former colonies became newly independent states and sought to flex their newfound sovereignty—sometimes by seizing assets from foreigners who had been granted rights by a colonial power. Second, newly formed communist countries in Eastern Europe and, later, the People's Republic of China and Cuba, began to seize property. The period of simple takings, however, turned out to be relatively short lived. By the early 1980s, acts of direct and explicit taking of property had become rare.²³ In fact, from 1984 to 1992, one observer counted only three such expropriations.²⁴

Throughout this period, the majority of the developing world supported a less stringent compensation requirement for expropriations than the Hull Rule's "prompt, adequate, and effective" standard. The inevitable disputes that arose following expropriations proved difficult to resolve. Without an existing procedure to deal with such disputes, and without a mechanism to resolve the conflicts between LDCs and developed countries, the international community appeared to be at an impasse. The lines of disagreement were clear: capital importers supported a less stringent rule and capital exporters supported the Hull Rule.

In the battle for international legitimacy, both sides of the debate claimed that customary international law was on their side.

23. The reasons for the rise and fall of the use of outright seizures as a policy tool are beyond the scope of this Article, as is the question of whether we can expect expropriations to return. Commonly cited reasons for the rapid fall in the rate of seizures include the success of LDCs in removing control of property from the hands of former colonial powers and their citizens, a fall in the popularity of state ownership, a desire to attract new investment, a belief among LDCs that they can benefit from investment as long as it is regulated, improvement in the managerial and administrative expertise of LDC governments, changed international economic conditions, and changed behavior on the part of investors who have adopted investment strategies that are less vulnerable (e.g., joint ventures, structures that leave certain important operations outside of the host country, strategically placed management from the home country without whom the value of assets fall substantially, and so on.). See, e.g., Stephen J. Kobrin, *Testing the Bargaining Hypothesis in the Manufacturing Sector in Developing Countries*, 41 INT'L ORG. 609 (1987); Minor, *supra* note 15; Michael S. Minor, *LDCs, TNCs and Expropriation in the 1980s*, CENTRE ON TRANSNAT'L CORP. REP., Spring 1988, at 53–55.

24. See Minor, *supra* note 15, at 181 tbl. 2. Note that the definition of "expropriation" is critical. Minor does not actually count expropriations, but rather counts "acts" of expropriation. "An act is applicable to all of those firms taken in the same industry in the same country in the same year." *Id.* at 178. He defines expropriation as "the forced divestment of equity ownership of a foreign direct investor." *Id.* (citations omitted). Unlike this narrow definition of expropriation, this Article focuses not only on direct takings, but also on all forms of conflicts arising out of or relating to investment agreements between host countries and investors.

The developed world pointed to the history of the Hull Rule and to the support it had received both in practice and in writings by commentators. In response, LDCs pointed out that practice had not always accorded with the Hull Rule and that, in any event, the rule simply lacked the broad international support that customary international law requires.²⁵ Although the developed world denied the point, it seemed that the debate itself was undermining the claim that the rule retained its status as customary international law.

Beginning in the early 1960s, LDCs found a forum in the United Nations from which to announce their views and, in doing so, further undermined the position of developed states. From 1962 through the mid 1970s, the United Nations General Assembly—dominated by LDCs—passed a series of resolutions intended to emphasize the sovereignty of nations with respect to foreign investment. Although General Assembly resolutions do not represent authoritative statements of international law, they are probative of the state of international law.²⁶ In particular, it is difficult to claim customary international law status for norms that are repeatedly contradicted by General Assembly resolutions.

The 1962 Resolution on Permanent Sovereignty over Natural Resources (Resolution 1803)²⁷ provided that in cases of expropriation, “appropriate compensation, in accordance with the rules in

25. See *Ebrahimi v. Islamic Republic of Iran*, Iran Award 560-44/46/47-3, at *51-52 (Iran-U.S. Cl. Trib. Oct. 12, 1994) (WESTLAW, INT-IRAN Database) (“[W]hile international law undoubtedly sets forth an obligation to provide compensation for property taken, international law theory and practice do not support the conclusion that the ‘prompt, adequate and effective’ standard represents the prevailing standard of compensation. . . . Rather, customary international law favors an ‘appropriate’ compensation standard.”); SORNARAJAH, *THE INTERNATIONAL LAW OF FOREIGN INVESTMENT*, *supra* note 14, at 365-65 (“It is safe to conclude that there is no customary practice supporting the norm of full compensation for nationalisation.”); Dolzer, *supra* note 14, at 561 (“[Although] compensation must be paid for expropriated alien property as a matter of international law . . . the evidence for the Hull rule’s continuing validity falls short of the mark”); Schachter, *supra* note 8, at 123 (“[T]he ‘prompt, adequate and effective’ formula has not won general acceptance in cases or state practice.”).

26. See, e.g., *Texaco Overseas Petroleum Co. v. Libyan Arab Republic*, 17 I.L.M. 1, 30 (1978) (“Resolution 1803 (XVII) seems to this Tribunal to reflect the state of customary law existing in this field.”); see also COMMITTEE ON INT’L TRADE AND INVESTMENT OF THE ABA SECTION OF INTERNATIONAL AND COMPARATIVE LAW, *THE PROTECTION OF PRIVATE PROPERTY INVESTED ABROAD* 18 n.57 (1963) (“The General Assembly is not an international legislature, and its pronouncements are not law, although they may constitute evidence of customary or generally recognized law in the absence of vocal protests by disapproving members.”).

27. G.A. Res. 1803, U.N. GAOR, 17th Sess., Supp. No. 17, at 15, U.N. Doc. A/5217 (1962), *reprinted in* 2 I.L.M. 223 (1963).

force in the State taking such measures in the exercise of its sovereignty" must be paid.²⁸ At the time, the United States argued that "appropriate compensation" meant precisely the "prompt, adequate and effective" compensation that the American government, among others, preferred.²⁹ This position, however, was thoroughly undercut by the 1973 Resolution on Permanent Sovereignty over Natural Resources (Resolution 3171),³⁰ which removed any doubt about the meaning of "appropriate compensation." The resolution stated, among other things, that:

[T]he application of the principle of nationalization carried out by States, as an expression of their sovereignty in order to safeguard their natural resources, implies that each State is entitled to determine the amount of possible compensation and the mode of payment, and that any dispute which might arise should be settled in accordance with the national legislation of each State carrying out such measures.³¹

One hundred and eight countries voted in favor of the resolution, with only one voting against and sixteen abstentions.³²

In May of 1974, the General Assembly went a step further, declaring a New International Economic Order in Resolution 3201.³³ This resolution stated that every state enjoys:

Full permanent sovereignty . . . over its natural resources and all economic activities. . . . [E]ach State is entitled to exercise effective control over them and their exploitation with means suitable to its own situation, including the right to nationalization or transfer of ownership to its nationals No State may be subjected to economic,

28. 2 I.L.M. at 225.

29. See Stephen M. Schwebel, *The Story of the U.N.'s Declaration on Permanent Sovereignty over Natural Resources*, 49 A.B.A.J 463 (1963).

30. G.A. Res. 3171, U.N. GAOR, 28th Sess., Supp. No. 30, at 52, U.N. Doc. A/9030 (1974), reprinted in 13 I.L.M. 238 (1974).

31. 13 I.L.M. at 239.

32. See *id.* at 240. The United Kingdom voted against the resolution; most developed countries abstained. *Id.* The result of the vote made it impossible to argue that "appropriate compensation" meant "prompt, adequate, and effective" compensation. See, e.g., Dolzer, *supra* note 14, at 561-665 ("[T]he continued validity of a rule of customary law requires that a clear majority of states view this rule as legally binding.").

33. G.A. Res. 3201, U.N. GAOR, 6th Special Sess., Supp. No. 1, at 3, U.N. Doc. A/9559 (1974), reprinted in 13 I.L.M. 715 (1974).

political or any other type of coercion to prevent the free and full exercise of this inalienable right.³⁴

Resolution 3201 considers unacceptable any form of sanction on a country that has expropriated the assets of an investor. This resolution, therefore, undermines one of the few mechanisms that might enforce a rule against expropriation, whether it be the Hull Rule or the standard of "appropriate compensation" favored by many LDCs. In addition, this resolution, like the earlier United Nations General Assembly resolutions, does not recognize an international obligation of repayment.

Finally, in December of 1974, the General Assembly adopted Resolution 3281, the Charter of Economic Rights and Duties of States (CERDS).³⁵ According to CERDS, each state has the right:

(a) To regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. . . .

....

(c) To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any cases where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means.³⁶

CERDS serves to further emphasize the sovereignty of LDCs with respect to their treatment of foreign investors and their control over the dispute resolution process. Essentially, CERDS puts the

34. 13 I.L.M. at 717.

35. G.A. Res. 3281, U.N. GAOR, 29th Sess., Supp. No. 31, at 50-55, U.N. Doc. A/9631 (1974), reprinted in 14 I.L.M. 251 (1975).

36. *Id.* ch. II, art. 2. The vote on Chapter II, Article 2, Paragraph (c) of CERDS was 104 in favor and 16 against, with 6 abstentions. See 14 I.L.M. at 264.

host country government in full control and places the investor at the mercy of that government.³⁷

The relevance of these resolutions is not that they themselves announced or created a rule of customary international law. Rather, because a large majority of countries made it clear that they felt no legal obligation to follow the Hull Rule, the resolutions demonstrated that "prompt, adequate, and effective" was no longer a rule of customary international law.³⁸ Moreover, the U.N. resolutions demonstrate that developing countries, acting as a group, prefer a regime under which they are able to expropriate property when they feel it is justified and under which they need only pay what they determine to be appropriate compensation.

Once it became clear that the Hull Rule was no longer a rule of customary international law, which certainly occurred in the wake of Resolution 3171 and may have occurred much sooner, neither the traditional "prompt, adequate, and effective" standard nor the "appropriate compensation" standard had enough international support to be considered a rule of customary international law. In the absence of BITs, therefore, developing countries had won a clear victory. The international rules governing North-South investment were entirely uncertain and individual states were in a position to determine what constituted appropriate compensation.³⁹

III. THE RISE OF THE BILATERAL INVESTMENT TREATY

In light of the considerable and long term efforts by LDCs to defeat the Hull Rule, one might conclude that developing countries oppose any form of investment protection at the international

37. One should not view this position as more radical than it is. The host country is constrained by at least two principles. First, the notion of "appropriate compensation," although vague, has some significance. There is little evidence that anybody seriously advocates a requirement of zero compensation. See SORNARAJAH, *THE INTERNATIONAL LAW OF FOREIGN INVESTMENT*, *supra* note 14, at 209 (stating that the positions of developing countries have ranged from zero compensation, for which there is now no support, to "the generally accepted view that 'appropriate' compensation must be paid"). Second, and probably more importantly, even without any legal limitations on the actions of host countries, reputational concerns offer investors some protection. A host wants to be seen as a favorable place in which to invest and so, to encourage future investment, may refrain from extracting value from existing investors.

38. Put differently, the U.N. resolutions provide evidence of the demise of the Hull Rule, not of the rise of an alternative rule of customary international law.

39. See Dolzer, *supra* note 14, at 553 ("[T]he present state of customary international law regarding expropriation of alien property has remained obscure in its basic aspects.").

level. That conclusion, however, is contradicted by widespread and enthusiastic LDC support for BITs. Before turning to a discussion of this paradoxical behavior of LDCs in Part V below, this part of the Article reviews the history of BITs and considers their most important terms.

In a remarkably short period of time, BITs have become an important part of the foreign investment landscape. Between 1959, the year the first BIT was signed,⁴⁰ and 1991, over 400 BITs were signed worldwide.⁴¹ More than ninety developing states and "virtually every developed state" were parties to at least one such treaty during this period.⁴² In the 1990s, the pace of BIT signings increased dramatically and by mid 1996, over one thousand BITs had been signed, with almost every country on the globe a party to at least one such treaty.⁴³ Whatever impact these treaties may have on customary international law,⁴⁴ they represent an important part of the international investment landscape in their own right.

A. *Description and History of BITs*⁴⁵

The U.S. BIT program has existed for slightly more than twenty years,⁴⁶ and it has been sixteen years since the United States signed its first BIT.⁴⁷ BITs have been part of the international landscape for a considerably longer period, however, as have American treaties that include investment protections. The

40. See Jeswald W. Salacuse, *Bit by Bit: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries*, 24 INT'L LAW. 655, 655 (1990).

41. Michael A. Geist, *Toward a General Agreement on the Regulation of Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 673, 684 (1995); see also U.N. CENTRE ON TRANSNAT'L CORPS. & INT'L CHAMBER OF COMMERCE, *BILATERAL INVESTMENT TREATIES: 1959-1991, Annex* (1992) [hereinafter *BILATERAL INVESTMENT TREATIES*] (listing BITs concluded up to mid-1991).

42. See Mohamed I. Khalil, *Treatment of Foreign Investment in Bilateral Investment Treaties*, 7 IC SID REV.-FOREIGN INV. L.J. 339 (1992); Geist, *supra* note 41, at 684.

43. See *Recent Actions Regarding Treaties to Which the United States Is Not a Party*, *supra* note 1; see also RUDOLF DOLZER & MARGRETE STEVENS, *BILATERAL INVESTMENT TREATIES* (1995).

44. See *infra* Part VI.C.

45. For a current and comprehensive discussion of BITs and their content, see DOLZER & STEVENS, *supra* note 43.

46. See Kenneth J. Vandeveld, *U.S. Bilateral Investment Treaties: The Second Wave*, 14 MICH. J. INT'L L. 621, 624 (1993) ("The BIT program was launched in 1977.").

47. See Jose Luis Siqueiros, *Bilateral Treaties on the Reciprocal Protection of Foreign Investment*, 24 CAL. W. INT'L L.J. 255, 274-75 (1994); *BILATERAL INVESTMENT TREATIES*, *supra* note 41, Annex at 36.

United States began to sign treaties of "Friendship, Commerce and Navigation" (FCNs), the precursor to the BIT, soon after the birth of the country.⁴⁸ FCNs were a common part of U.S. policy toward outward foreign investment until after World War II.⁴⁹ As the name of these treaties suggests, and contrary to the BIT, FCN treaties were not exclusively, or even primarily, vehicles to protect investments abroad. Nevertheless, the treaties included some protections for American investors in foreign countries, including a prohibition on expropriation without compensation. The primary purpose of these agreements, however, was the promotion of international trade and the improvement of international relations. With the rise of the General Agreement on Tariffs and Trade (GATT) after World War II, the role of FCNs in the regulation of international trade diminished and the American FCN program wound down by the mid 1960s.⁵⁰

At about the same time, other countries were discovering and implementing a new instrument for the protection of foreign investment—the BIT. By the time the American FCN program had completely shut down, several European countries were busy negotiating and signing BITs with developing countries. Unlike the FCNs, these treaties focused exclusively on the protection of investment—a topic not covered by GATT. The first such treaty, signed in 1959, was between West Germany and Pakistan.⁵¹ Switzerland was also an early participant in BITs⁵² and other European countries began to sign BITs in the late 60s.⁵³ Eventually, Japan and the United States joined the growing number of developed states with BIT programs.⁵⁴

48. See Kenneth J. Vandeveld, *The BIT Program: A Fifteen-Year Appraisal*, in *The Development and Expansion of Bilateral Investment Treaties*, 86 AM. SOC'Y INT'L L. PROC. 532, 533 (1992).

49. *Id.*

50. *Id.* at 533-34.

51. See Salacuse, *supra* note 40, at 655; see also BILATERAL INVESTMENT TREATIES, *supra* note 41, Annex at 21; see generally Vandeveld, *supra* note 48, at 534 ("[B]etween 1962 and 1972, Germany concluded forty-six of these agreements.").

52. Switzerland signed 21 BITs before 1972. See U.N. CENTRE ON TRANSNAT'L CORPS., BILATERAL INVESTMENT TREATIES, Annex I at 98-99 (1988).

53. See Robin, *supra* note 19, at 941 (stating that France, the United Kingdom, the Belgo-Luxembourg Economic Union, the Netherlands, and Norway began BIT programs in the late 1960's and early 1970's).

54. Japan did not sign a BIT until 1977 and the United States did not sign one until 1982. Both signed their initial treaties with Egypt. See BILATERAL INVESTMENT TREATIES, *supra* note 41, Annex at 25, 36.

The United States established its BIT program in 1977.⁵⁵ The program began with the development of a prototype BIT that incorporated a number of specific objectives regarding the protection of foreign investment overseas, including: (1) bolstering the claim that the Hull Rule remained customary international law by establishing a network of treaties that included this principle; (2) protecting current and future foreign investment from host government behavior; and (3) providing a mechanism for resolving investment disputes that did not rely on either local courts or direct involvement by the United States Government.⁵⁶ The original model text was completed in 1981⁵⁷ and has since been modified several times.⁵⁸

Although the U.S. treaty is, in principle, open to negotiation, BITs signed by the United States are usually very similar to the model treaty. (In fact, looking beyond United States treaties, BITs in place around the world are quite similar to one another.⁵⁹) Although some negotiation is possible on some issues, the United States is committed to the basic structure of the model treaty and will only accept small changes. Typical provisions include terms governing compensation for expropriation, the repatriation of profits, dispute settlement procedures (usually through some neutral forum), national treatment requirements, and "most favored nation" requirements.⁶⁰

B. *The Contents of a BIT*

The model United States Bilateral Investment Treaty consists of a preamble and thirteen articles.⁶¹ Article I defines certain key

55. See Vandevelde, *supra* note 46, at 624.

56. For a more detailed discussion of these goals, see Vandevelde, *supra* note 48, at 534-35.

57. See Vandevelde, *supra* note 46, at 642.

58. The basic model text was in place by 1984 and has undergone few significant changes since then. See *id.* at 627 (stating that the original model text was revised in 1982, 1983, 1984, 1987, 1991, and 1992 but the changes since 1984 have been relatively minor). For the draft treaties of several countries, see DOLZER & STEVENS, *supra* note 43, at 167 (Austria), 176 (Denmark), 187 (Germany), 200 (Hong Kong), 218 (Switzerland), 228 (United Kingdom), 240 (United States); U.N. CENTRE ON TRANSNAT'L CORPS., BILATERAL INVESTMENT TREATIES, *supra* note 52, Annex IV (Netherlands), Annex V (United States), Annex VI (Asian-African).

59. See DOLZER & STEVENS, *supra* note 43, at v.

60. See February 1992 Draft Treaty, *reprinted in id.* at 240 [hereinafter Model U.S. BIT].

61. *Id.*

terms. Of greatest interest for present purposes is the definition of investment:

- (a) "investment" means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts; and includes:
 - (i) tangible and intangible property, including rights, such as mortgages, liens and pledges;
 - (ii) a company or shares of stock or other interests in a company or interests in the assets thereof;
 - (iii) a claim to money or a claim to performance having economic value, and associated with an investment;
 - (iv) intellectual property . . . and
 - (v) any right conferred by law or contract, and any licenses and permits pursuant to law.⁶²

This definition covers not only hard investments such as real estate and equipment, but also financial assets (stocks, bonds, etc.) and, critically, contractual rights and rights conferred by law. The definition of investment is critical because, as mentioned above, "hard-core" expropriation that involves the outright seizure of assets has become quite rare.⁶³ The definition of investment in the Model U.S. BIT, however, protects not only against these seizures, but also against the "breach" of agreements between the host and the investor, and the withdrawal of licenses and other such rights. By defining investment in this way, the treaty ensures that any agreement between the host and the investor is itself part of the "investment" and, therefore, protected.

By making any breach of an agreement between the host country and the investor a violation of an international treaty, BITs allow such agreements to be treated like contracts between private parties within a single country. As discussed below, the protection of contractual rights is one of the most interesting and potentially influential aspects of the BIT. Virtually any dispute between host

62. *Id.* art. I(1)(a).

63. See *supra* notes 23-24 and accompanying text.

and investor—at least any dispute arising out of a negotiated agreement between the two—is a matter of international law.⁶⁴

Article II of the Model U.S. BIT establishes the minimum standards of treatment required from the host country: national treatment or most favored nation treatment, whichever is more favorable to the investment.⁶⁵ Article II also provides that “[i]nvestment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law,”⁶⁶ and prohibits unreasonable or discriminatory measures that impair the management, conduct, operation, and sale or other disposition of investments.⁶⁷ Of particular importance is Article II(5), which prohibits performance requirements such as export quotas, local content requirements, technology transfer requirements, and so on.⁶⁸ Finally, Article II requires that the host country “provide effective means of asserting claims and enforcing rights with respect to investment, investment agreements, and investment authorizations.”⁶⁹

Article III deals with the expropriation of investments and, because investment is defined broadly in Article I, applies to any number of possible contract violations by a host. Section 1 prohibits direct or indirect expropriation or nationalization, “except: for a public purpose; in a nondiscriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law”⁷⁰ This clause is, of course, a restatement of the Hull Rule, but because of the context in which the rule applies, it imposes obligations on host governments

64. See Model U.S. BIT, *supra* note 60, art. I(1)(a)(v); K. Scott Gudgeon, *United States Bilateral Investment Treaties: Comments on Their Origin, Purposes, and General Treatment Standards*, 4 INT'L TAX & BUS. LAW. 105, 129 (1986) (“[M]any of the BITs ‘internationalize’ enforcement of investment contracts and agreements.”).

65. See Model U.S. BIT, *supra* note 60, art. II(1) (“Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable”). Exceptions to this requirement are permitted for certain sectors that are subject to negotiation and inclusion in the Annex to the treaty. *Id.* (“The treatment accorded pursuant to any exceptions shall not be less favorable than that accorded in like situations to investments and associated activities of nationals or companies of any third country, except with respect to ownership of real property.”).

66. *Id.* art. II(2)(a).

67. *Id.* art. II(2)(b).

68. *Id.* art. II(5).

69. *Id.* art. II(6).

70. *Id.* art. III(1).

that exceed the traditional Hull Rule. The prohibition on expropriation without prompt, adequate, and effective compensation applies not only to the expropriation of assets, but also to any "breach" of an agreement. Thus, a host may be required to make "prompt, adequate, and effective" compensation for actions that, under the traditional Hull Rule, would not have been considered expropriations. Moreover, the BIT's dispute resolution mechanisms (discussed below) provide for a neutral forum to establish the amount of required compensation.

Article IV governs the transfer of assets to and from the host country. It requires that the host allow free transfer both into and out of the country as long as such transfers relate to covered investments.⁷¹ For example, the host is not permitted to restrict the repatriation of profits.⁷²

Article VI establishes a dispute settlement mechanism to govern relations between the host and the investor. Under this article, the host and the investor, upon entering into their investment agreement, may agree on any means to settle their disputes, including binding arbitration.⁷³ The Model U.S. BIT allows the investor and the host to select the forum in which they wish to arbitrate their disputes. These include the International Centre for the Settlement of Disputes (ICSID), *ad hoc* tribunals operating under the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL), and "any other arbitration institution . . . as may be mutually agreed between the parties to the dispute."⁷⁴ Arbitration effectively solves the dynamic inconsistency problem discussed in Part IV below because it allows disputes to be settled in a binding fashion and in a neutral forum. It is thus possible for a country to commit itself to an enforceable

71. *Id.* art. IV(1) ("Each party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory.").

72. Article IV(3) allows the host to "maintain laws and regulations (a) requiring reports of currency transfer; and (b) imposing income taxes by such means as a withholding tax applicable to dividends or other transfers." *Id.* art. IV(3). In addition, the host "may protect the rights of creditors, or ensure the satisfaction of judgments in adjudicatory proceedings, through the equitable, nondiscriminatory and good faith application of its law." *Id.*

73. *Id.* art. VI(2)-(3). The Model U.S. BIT also establishes arbitration as the means to settle disputes between the United States and the host country over the interpretation and application of the BIT itself. See *id.* art. VII.

74. *Id.* art. VI(3). Similar clauses exist in the BITs of other countries, although some offer the parties less choice. The most prominent arbitration center is ICSID, which is referenced in a majority of BITs. See DOLZER & STEVENS, *supra* note 43, at 129. It is beyond the scope of this Article to conduct a detailed discussion of the arbitration process.

contract, something that is not possible under customary international law.

The above discussion demonstrates that BITs offer foreign investors greater protection than the Hull Rule ever did. They do so primarily by providing a mechanism through which a potential investor and a potential host can establish a contract that is binding under international law. In addition, the provision of dispute settlement procedures offers investors a disinterested forum in which they can be heard and whose decisions bind the host. The other provisions of BITs offer substantive protections such as national treatment, most favored nation treatment, free transfer of assets, and a prohibition on performance requirements. Finally, BITs reproduce the Hull Rule's requirement of prompt, adequate, and effective compensation for expropriation, including "expropriations" that fall short of a direct taking.

IV. THE DYNAMIC INCONSISTENCY PROBLEM

A. *Dynamic Inconsistency and Foreign Direct Investment*

Before turning to an explanation of the behavior of developing countries, it is helpful to introduce a phenomenon known as the "dynamic inconsistency problem."⁷⁵ Dynamic inconsistency exists when a preferred course of action, once undertaken, cannot be adhered to without the establishment of some commitment mechanism.⁷⁶ The problem is akin to wanting to "tie oneself to the mast" but being unable to do so. More formally, dynamic inconsistency, also sometimes referred to as time inconsistency, describes situations in which a "future policy decision that forms part of an optimal plan formulated at an initial date is no longer optimal from the viewpoint of a later date, even though no new information has appeared in the meantime."⁷⁷

In the domestic setting, the dynamic inconsistency problem is avoided in most private transactions through contract. Parties are able to commit to a certain behavior because private contracts are

75. See OLIVIER J. BLANCHARD & STANLEY FISCHER, LECTURES ON MACROECONOMICS 70-75, 592-615 (1989); Finn E. Kydland & Edward C. Prescott, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, 85 J. POL. ECON. 473 (1977) (presenting a model of dynamic inconsistency in the optimal taxation of domestically owned capital).

76. Game theorists refer to dynamic consistency as a sub-game perfect equilibrium. See ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 268-282 (1995).

77. BLANCHARD & FISCHER, *supra* note 75, at 592.

enforceable under domestic law. This ability to contract, in turn, allows parties to negotiate, subject to transaction costs, the most efficient possible agreement. In the international setting, however, the dynamic inconsistency problem is a significant barrier to efficient foreign direct investment. The central problem is that a sovereign state is not able, absent a BIT, to credibly bind itself to a particular set of legal rules when it negotiates with a potential investor. Regardless of the assurances given by the host before the investment and regardless of the intentions of the host at the time, the host can later change those rules if it feels that the existing rules are less favorable to its interests than they could be. Domestic legal structures, critical to the credibility of contractual promises among private parties under domestic law, are no longer adequate to ensure compliance with the initial agreement.⁷⁸ These risks are particular to the foreign direct investment setting because the host government is a direct participant and has interests and objectives of its own that may conflict with those of the investor.

As a result of the dynamic inconsistency problem, when an investor enters into an agreement with a host nation, the two typically will not be able reach the optimal agreement. Notice that there need not be an intent to deceive on the part of the host. Even if the host wants to reach an efficient agreement and is willing to commit itself to a certain treatment of the foreign investment, it is unable to do so credibly because the host has the ability to later change its domestic laws to suit its own purposes.

Because the foreign investor cannot rely on domestic laws to protect its interests, the only alternative legal structure is international law.⁷⁹ International law, however, does not provide a way for a host country to make credible and binding commitments to an investor. The mechanisms for the enforcement of a contract between a state and a private firm is at best extremely weak and at worst altogether non-existent.⁸⁰ The precise status of such contracts is the subject of ongoing debate in the field of public international law and is far from being settled. For the present pur-

78. The host, of course, may be constrained to some degree by reputational concerns. See *supra* note 37 and *infra* p. 665–665 (discussing the role of reputation).

79. I ignore, for present purposes, the possibility of extraterritorial application of the domestic law of a country other than the host.

80. See, e.g., Thomas W. Waelde & George Ndi, *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation*, 31 TEX. INT'L L.J. 215, 243 (1996) (“[T]he question of the precise status and effect of the stabilization clause under international law is by no means clearly settled.”).

poses, it is sufficient to note that there is no consensus that a contract with a host, by itself, offers a firm any additional protections under international law. Furthermore, even if protections exist in theory, the investor cannot be sure that they will be enforced by an arbitral tribunal or that the host will accept the decision of a tribunal if the firm obtains a favorable ruling. The fact that such agreements cannot be relied upon with any confidence implies that it is not possible for a state, even if it enters into an agreement, to make its commitment fully credible.

The protections afforded to contract rights are so uncertain under international law that it is reasonable to model investor behavior under the assumption that these rights are of little or no value to the investor. More importantly, because these protections are unreliable, international law does not allow the host to make *credible* contractual commitments. This inability to make credible contractual commitments under international law explains why the debate over the protections afforded by customary international law was so important. Until the rise of BITs, there were few legal constraints, beyond those provided by customary law, on the behavior of host countries toward foreign investors. Thus, if the international community concluded that customary law did not require prompt, adequate, and effective compensation upon the taking of property, there would be no way for investors to achieve these protections. On the other hand, if the international community accepted the Hull Rule as international law, there would be no way for developing countries to except their own behavior from the rule.⁸¹

B. *The Behavior of Host Countries and Investors*

To understand foreign investment in developing countries, one must consider how the lack of a credible contracting mechanism affects the incentives of a government in its dealings with a particular foreign investor. During negotiations, the government of a potential host country wishes to encourage the investor to invest. The firm, on the other hand, wants to achieve the greatest possible return and will invest in the host country only if that country offers the greatest anticipated profit.⁸²

81. A country can be a "persistent objector" to a rule of customary international law, but it cannot choose to have the law apply to it in some contexts and not in others.

82. Imagine, for example, a firm choosing to build a new production facility and seeking the lowest cost location for that facility.

If investor and host had the ability to credibly bind themselves to a particular set of conditions governing the investment, we would expect, subject only to transaction costs, the investor to select the most efficient location for its investment and to write a binding contract with that country. The agreement would spell out the conditions on which the investment would take place and would provide for some division of the "surplus" (i.e., profit) from the investment between the investor and the host. This division of surplus need not be stated explicitly, but could take the form of concessions and commitments on the part of each party. For example, the host might agree to offer certain tax advantages to the investor, agree to allow the repatriation of profits, and waive certain import restrictions. The firm, on the other hand, might bind itself to providing a certain level of employment, certain transfers of technology, and so on.

The absence of a credible contractual mechanism, however, makes the investment problem much more difficult. Even if an investment is valuable enough to make it worthwhile for the country to commit to certain concessions that benefit the investor—favorable tax treatment, for example—it cannot do so in a credible fashion. Once the investment is made, the host country no longer needs to offer benefits sufficient to *attract* the investment, it only has to treat the investor well enough to *keep* the investment. The difference between the two time periods (before and after investment) comes about because both the host and the investor know that once the firm has made its investment, it typically cannot disinvest fully.⁸³ In other words, once it has invested, withdrawal would impose a cost on the firm. The host country can take advantage of this situation, and extract additional value from the firm by, for example, increasing the tax rate beyond the level that was agreed upon when the investment took place. Had the firm known that the tax rate would be higher than the agreed upon level, it may have chosen to invest elsewhere, or not to invest at all. Once the investment is made, however, it may be cheaper for

83. By this I mean that if the firm chooses to leave the country immediately after investing, it will not be able to recoup all of its investment. Indeed, it may be able to recoup only a very small fraction of its investment. This is, in part, because some portion of the investment (and perhaps a very large portion) is made in capital that can only be used in this one project. This can include specialized machinery, training of employees, and so on. For an empirical examination of the effect of irreversible investment on foreign direct investment, see Andrew Guzman & Aart Kraay, *Uncertainty, Irreversibility, and Foreign Direct Investment* (1996) (ch. 2 of unpublished Ph.D. dissertation, Harvard University) (on file with author).

the firm simply to pay the higher tax rather than to disinvest and reinvest elsewhere.

To illustrate this point, consider the following simple numerical example. Suppose that a firm is considering investing in one of two potential host countries. Assume that it will cost \$60 million for the initial investment and \$10 million after that to pay for salaries, upkeep, and so on, regardless of which country is chosen.⁸⁴ Assume further that the firm eventually decides to invest in one of the two countries and that it has succeeded in extracting from that country a promise of a complete exemption from corporate taxes and preferential access to power and water in the region in which it intends to build its facility. Suppose that, with these concessions, the investment is expected to yield revenues of \$100 million. The host has agreed to these terms because, even without any tax revenues and despite the disruption the investment may cause to the power and water supply, the gains in terms of employment, technology transfer, and so on make the investment beneficial to the host. Without these concessions, however, the firm would have invested in the other country. The host, therefore, is better off with the investment, including the concessions, than it would be without the investment. Under these assumptions, the host and the investor would both be willing to sign a binding agreement committing themselves to the terms stated above, as long as that agreement was credible and enforceable.

Because the agreement is not credible, however, the investor will be concerned that the host might change the conditions after the investment is made. Moreover, the host has positive incentives to change the conditions after the firm invests because it knows that the investor cannot easily recoup its initial capital expenditures. For example, at the outset of the investment contemplated above, the firm plans to invest at total of \$70 million (\$60 million to build its facility and \$10 million in additional ongoing expenses). This investment is worthwhile because the firm anticipates a return of \$100 million. Now suppose that after the firm builds its facility at a cost of \$60 million, the host withdraws the preferential access to water and power and imposes a tax of 40% on revenues. Rather than making \$100 million in revenues, the firm may only make, say, \$85 million because of the loss of access to power and

84. To keep the example simple, all figures are stated as lump sums. They can be viewed as the expected present discounted value of the stream of costs and revenues that the investment faces.

water. Furthermore, 40% of this amount will be claimed by the tax authority, making the after-tax revenue only \$51 million. Obviously, had the firm known beforehand that the host would behave in this way it never would have invested because the total cost of the investment (\$70 million) is more than it will earn from the investment (\$51 million). Because the firm has already spent \$60 million (and assuming that it cannot recoup its investment by tearing down or selling its facility), however, it must choose between continued operation of the facility and a total loss of \$19 million, or closing down the operation altogether and losing the \$60 million that it has already invested. Clearly, the firm will choose to operate the facility.

The problem may even be worse than the above example suggests because the host can impose any level of tax (or other policy to take value from the firm) it chooses. In the above example, the host can levy taxes of up to \$75 million in addition to withdrawing water and power concessions.⁸⁵ Any tax of less than this amount will make it worthwhile for the firm to remain in operation in the country rather than closing down the facility. Most importantly, the host can assess the firm's situation and select the maximum possible transfer of value that the government can demand without driving the firm out of the country altogether.

Extracting value from the firm by increasing the tax rate or otherwise changing the conditions under which the firm will operate represents only one of the options available to the host once the investment is made. The other two options are to abide by its original promises to the investor and outright expropriation.

There are two categories of costs facing a country that chooses to expropriate outright. The first is that the government (or the private parties to whom the government gives or sells the enterprise) may be far less competent to run the facility than the original firm. After expropriation, the firm's managers are likely to leave the country, taking a substantial amount of human capital with them and making it difficult for the host government to run the business as well as the investors who built the facility. This will impact both the profits that the enterprise will generate (if any) and the level of spillover benefits provided (employment, technology transfer, etc.). A second cost is to the country's reputation. The firm whose assets have been taken will undoubtedly complain

85. This example continues to assume that the investment earns \$85 million in revenues once the power and water concessions are withdrawn, and that it has costs of \$10 million.

to its home country, and that country may take action. Indeed, if the expropriation is severe enough, even countries whose nationals have not been affected may sanction the host country. In addition, the expropriation will be noticed by other firms which, as a result, may be hesitant to invest in the future.

Because the costs of outright expropriation are likely to be high, the more moderate course of extracting value from the firm without forcing divestment, as discussed above, may be attractive. This can be done in a wide variety of ways, including changing the tax rate, restricting the repatriation of profits, imposing new labor or local content requirements, and so on. This approach, which is sometimes called "creeping expropriation,"⁸⁶ allows the country to take advantage of the existing management and their skills, thus avoiding the major costs of an outright expropriation, while still extracting value from the enterprise. Creeping expropriation may also be preferred because it is less likely to provoke significant sanctions by the home country of the investor. After all, the firm's assets have not been seized and it is often difficult to identify where the right of a government to set policy crosses over into unreasonable conduct.⁸⁷

For any irreversible investment,⁸⁸ then, the host country will be able to demand a higher payment after the investment takes place than it could have demanded before investment of the capital. This is so because the investor will invest only if it expects to receive revenues that are greater in present value than its total costs. Before the investment, total costs include all expected costs of the investment, including irretrievable capital costs. Once the original investment has been made, however, the investor will not include the sunk (irretrievable) costs in its calculation because those funds are lost regardless of its actions. Once the investment is made,

86. The term "creeping expropriation" is somewhat misleading. The government may take only a single action and may not be interested in increasing the amount of expropriation as time goes on.

87. The "intermediate" option of extracting value without direct expropriation is the most relevant for the study of current foreign investment. As noted above, outright expropriations are now rare, but disputes between foreign investors and host countries involving alleged acts of creeping expropriation are common. Any allegation of wrongdoing made by the investor raises the possibility that the host has breached some part of the implicit or explicit agreement under which the firm made its initial investment. The attractiveness of creeping expropriation to developing countries may offer a partial explanation for why outright expropriations are now so uncommon and why dispute settlement between host countries and foreign investors is a more lively and controversial topic.

88. An investment is irreversible for our purposes if withdrawal from the investment yields less than the full value that was invested.

therefore, hosts may extract at least up to the value of the sunk costs without making it profitable for the firm to withdraw.

Of course, the firm understands the impact of the dynamic inconsistency problem before it invests. It may, as a result, choose not to invest. The potential host, on the other hand, wants the investment to take place and would, to get the investment, be willing to bind itself to a set of conditions on which the investment would take place. Because there is no credible commitment mechanism available, however, the host cannot make a credible commitment and the investment—desired by both parties—may not take place.

In light of the above discussion, one might ask why there is any direct foreign investment at all and why the investment that does takes place is often treated well. The reason is that the above description is based on a single investment decision. In actual fact, countries want to maximize their returns over longer horizons. Thus, they may resist the temptation to seize assets today to create or maintain a reputation that will attract future investment. Countries may also resist the temptation to extract value from foreign firms if they fear that sanctions will be imposed by the home country of the investor.⁸⁹ The long-term effects of individual investment decisions, in other words, change the incentives of the host country.⁹⁰

These effects, however, do not completely remove the dynamic inconsistency problem. When the host country considers the reputational effect of its actions, it will weigh the gains from breaching its agreement with the firm against any lost benefits caused by reduced efficiency within the firm, sanctions imposed by other countries, and the effect of the action on its reputation. *A priori*, there is no reason to think that this balancing establishes an efficient set of incentives for the host. Indeed, the fact that host countries sign agreements with investors, even when those agreements are not enforceable, indicates that the parties do not believe that reputation, by itself, is sufficient to give the host the proper incentives. The contracts represent an attempt to increase the cost to the host of violating the terms under which investment takes place.

89. Note that if Resolution 3201, *supra* note 33 (stating that no sanctions can be applied against a country that has carried out an expropriation), was applied to actions taken by a state against a foreign investor, the costs of such actions would be reduced and the actions themselves made more attractive to host countries.

90. These incentives also explain why many countries provide significant protection for foreign investment under their domestic legal regime.

The foregoing discussion has considered the impact of the dynamic inconsistency problem on the host country. The effect of the dynamic inconsistency problem must also be considered from a global perspective. In global terms, the most efficient outcome is achieved if investment takes place where it will earn the greatest total return. Absent transaction costs, this outcome is achieved when the parties are able to contract with one another and when a breach of contract is accompanied by expectation damages.⁹¹ The dynamic inconsistency problem, however, undermines efficiency because it discourages investment that would be desirable. Firms realize that host countries have incentives to squeeze additional value from their operations after the investment is made and this causes firms to avoid some investments altogether. Rather than facing expectation damages if it breaches, the host faces a penalty in the form of lost future investment and sanctions from foreign countries. It would be mere coincidence if these sanctions were equivalent to expectation damages, implying that the decision to breach the contract with the investor will not be based on appropriate incentives.

V. EXPLAINING THE PARADOXICAL BEHAVIOR OF LDCs

As discussed in Part III, the behavior of developing states presents an apparent inconsistency. On the one hand, they have repeatedly sought to establish a norm that leaves significant power in the hands of the sovereign state in its relations with investors, makes it difficult for states to enter into binding contracts with foreign investors and, therefore, leaves the dynamic inconsistency problem unresolved. On the other hand, developing countries have willingly and, indeed, enthusiastically, signed BITs with developed countries. These bilateral treaties undermine precisely the independence and control that the countries have fought so hard to protect.

This part of the Article considers and rejects the possibility that developing countries have simply changed their views on the subject or that, in exchange for signing BITs, LDCs have received concessions that they did not receive under the traditional standard of full compensation. Another explanation is then advanced, namely, that LDCs face a prisoner's dilemma in which it is optimal for them, as a group, to reject the Hull Rule, but in which each in-

91. See, e.g., A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 31-34 (2d ed. 1989).

dividual LDC is better off "defecting" from the group by signing a BIT that gives it an advantage over other LDCs in the competition to attract foreign investors.

A. *Existing Explanations of LDC Behavior*

One possible explanation of the behavior of LDCs is that the developing countries themselves have come to conclude that they are better off if they allow themselves to be bound through a contractual mechanism with investors. This might be termed the "LDC enlightenment theory." For a period of time after World War II, the argument would go, developing countries fought to defeat the Hull Rule and reduce the protections provided to international investment. More recently, however, these same countries have come to realize that it is in their interest to encourage foreign investment in their country and that one way to do this is to provide strong protections for foreign investment. Developing countries may also have developed a better understanding of the dynamic inconsistency problem and its importance in the foreign investment realm. As a result, they are now prepared to accept BITs because they appreciate the need to overcome this problem.

This theory is unsatisfactory for at least two reasons. First, the period in which BITs have been signed has overlapped considerably with the period in which LDCs sought to discredit the Hull Rule. The first BIT was signed in 1959, when West Germany established a treaty with Pakistan,⁹² and by the mid-1970s, West Germany had concluded over forty BITs with other countries.⁹³ The major efforts to undermine the Hull Rule at the multilateral level took place during the 1960s and 1970s.⁹⁴ In other words, during the very period when the General Assembly was denouncing the Hull Rule, large numbers of developing countries were signing bilateral treaties. If developing countries truly had changed their views on the value of commitment mechanisms and binding agreements, we would not expect to see a significant number of BITs in force and more being negotiated at the same time that the General Assembly voted 108 to one in favor of the 1973 Resolution on Permanent Sovereignty over Natural Resources and

92. See Salacuse, *supra* note 40, at 655.

93. All of those treaties, like most BITs signed to date, have included at least one developing country. No two developed countries have chosen to sign a BIT between themselves. See *Recent Actions Regarding Treaties to Which the United States Is Not a Party*, *supra* note 1.

94. See *supra* Part II.B.

adopted the New International Economic Order.⁹⁵ Nor can it be argued that the countries signing BITs and those fighting against the Hull Rule are different subsets of countries because both the BIT movement and the movement against the Hull Rule have included a majority of developing countries.

Furthermore, had developing countries decided, as a group, that providing greater protections for foreign investors served their interest, one would expect them to express that view at the General Assembly. The choice of the General Assembly as the forum for previous resolutions concerning investment demonstrates that developing countries have found it to be a useful and accessible forum. Moreover, if LDCs had truly changed their minds, the best way to demonstrate that they no longer held the views on investment expressed in the General Assembly resolutions would be to announce their new views in the same forum. One would also expect developing countries to have signed multilateral investment treaties rather than bilateral treaties.

An alternative theory is presented by Professor Sornarajah, who argues that developing countries, after successfully tearing down the Hull Rule, adopted BITs in reaction to the confused status of foreign investment and the uncertain protections afforded to it by international law: "knowing the confused state of the law, [countries] entered into such treaties so that they could clarify the rules that they would apply in case of any disputes which may arise between them."⁹⁶ If the goal of BITs were to clarify existing rules, however, there is no reason for them to provide so much protection to investors. If LDCs believed that international law offered relatively weak protections for foreign investment—as they indicated in the General Assembly resolutions—they could "clarify" such a rule. BITs, however, offer much more protection for investment than any rule to which developing countries have publicly subscribed. Furthermore, it is difficult to understand why LDCs would undermine the Hull Rule—which provided a clear rule regarding the protection of foreign investment—only to adopt BITs to avoid the legal ambiguity generated by the demise of the Hull Rule.

Rudolf Dolzer advances yet a different explanation. He claims that developing countries are prepared to accept the Hull Rule in

95. See *supra* notes 30–34 and accompanying text.

96. SORNARAJAH, THE INTERNATIONAL LAW OF FOREIGN INVESTMENT, *supra* note 14, at 233.

the context of BITs because of the "special benefits that developing countries enjoy under such treaties."⁹⁷ Sornarajah appears to hold this view as well, arguing that although a developing "state subscribes to a particular norm of international law, it is prepared to treat the nationals of a state with which it has entered into a bilateral treaty in accordance with the norm which has been agreed to in the treaty."⁹⁸ This view is difficult to reconcile with the content of most bilateral treaties. There is little in such treaties that inures to the benefit of the host countries apart from the benefits that those countries enjoy from a regime of investor protection. If the benefits of investor protection are sufficient to make these treaties desirable to LDCs, of course, it becomes impossible to explain why these countries sought to undermine investor protection when they dismantled the Hull Rule.

B. *A Strategic Analysis of LDC Behavior*

To understand the apparent paradox of the LDC struggle against the Hull Rule as customary international law and the simultaneous embracing of BITs that mandate even stricter investment protections, one must realize that developing countries have different interests when they behave as a group than they do when they behave individually. In other words, the decision of individual countries to sign bilateral agreements is not a sign that these agreements are in the interest of LDCs as a group, and the efforts of LDCs as a group to defeat the Hull Rule do not imply that an individual country would not want to embrace the rule for its own purposes.

1. *The Interests of an Individual LDC*

Consider first the incentives facing an individual developing country. In its negotiations with investors, the country would like to have the ability to make binding commitments to potential investors.⁹⁹ If it is able to make credible commitments, it will be able to attract more investors. Specifically, the country may be able to attract investors who, absent a commitment to lower taxes for example, would choose a different country for their investment. Fur-

97. Dolzer, *supra* note 14, at 567.

98. Sornarajah, *State Responsibility and Bilateral Investment Treaties*, *supra* note 14, at 90.

99. I assume that the ability or inability of this one country to make such commitments does not affect the ability of other developing countries to make binding promises.

thermore, for those investors who would invest in the country even in the absence of a commitment mechanism, the country can simply decline to offer more favorable conditions—thus getting those investors to invest on the same terms as would exist without the ability to commit.

The developing country, therefore, has a strong incentive to enter into BITs to increase the investment it receives and, thereby, increase the benefits enjoyed by the country. Put simply, by entering into a BIT, a country is better able to compete for investment. In practical terms, this implies that if a single LDC is offered the opportunity to enter into a treaty that will allow it to make binding commitments to investors without affecting the ability of other LDCs to do so, it will have a strong incentive to sign such a treaty.

The amount of extra investment that can be attracted to a country that is able to enter binding contracts depends on the sensitivity of the demand for the resources of that country (raw material, labor, government regulations, location, etc.). If the market for those resources of the country is highly competitive (i.e., characterized by many buyers and many sellers), even a relatively small improvement in the conditions offered to potential investors will lead to a large increase in investment. As in any competitive market, a small change in the price of the goods being sold will lead to a large increase in demand. In the foreign investment context, the goods being sold are the resources of the LDC and the "price" at which investors can get access to those resources will fall as investors are offered more attractive conditions by the potential host.¹⁰⁰

If the market is competitive, therefore, the ability to commit to a binding contract allows a country to increase dramatically the amount of investment it receives. It is important to note, however, that much of this increase in investment will come at the expense of other developing countries.¹⁰¹ If other LDCs have not signed such treaties, a country that does sign one will gain an important advantage, and if other countries have already signed BITs, a country that signs one will eliminate the advantage those other countries had in the competition for foreign investment. Thus, re-

100. Put another way, the "price" at which investors invest will be lower if the investor is able to earn a higher return.

101. As discussed below, efforts to attract investment from other LDCs in this way may lead to a reduction in the benefits enjoyed by LDCs as a group. See *infra* Part V.B.2.

ardless of what other countries are doing, a developing country has a strong incentive to be enthusiastic about signing a BIT.

Based on the above discussion, one might conclude that a regime that allows developing countries to contract with investors is preferred to the regime advocated by developing countries in their United Nations resolutions. A contracting regime is preferred, the argument would go, because it increases the number of efficient investments, which in turn leads to greater global wealth. Furthermore, a contracting regime is in the interest of developing states because it allows them to offer incentives that will increase investment and well-being in their countries. The contention is that because an individual country is able to attract investment more successfully when it can make binding commitments, the ability to make such commitments must be good for LDCs as a group.¹⁰² As argued below, however, the conclusion that LDCs are better off as a group simply does not follow from the fact that individual LDCs benefit from a contracting regime.

2. *The Interests of LDCs as a Group*

To understand the incentives and interests of LDCs when they act as a group, imagine a scenario in which two countries are competing against each other to attract a potential investor. Assume that both countries have signed a BIT with the home state of the investor. To attract the investment, each country is willing to make concessions to the potential investor. A country whose initial offer is insufficient to attract the investment has an incentive to increase the concessions it offers as long as the benefits of the investment to the country exceed the costs of the concessions. The result, therefore, is a bidding up of the concessions made to the investor. Ultimately, if the market for the resources of the developing countries is competitive, the potential hosts will continue to bid against one another until the benefit enjoyed by the host from the investment is zero. Only then will the country that stands to "lose" the investment find it impossible to offer the firm a more attractive package. Once the offers to the firm have been bid up to the point where the winning country stands to make no net gain

102. One version of this argument would suggest that under a regime of binding contractual agreements between hosts and investors, a developing country that does not want to be bound by a negotiated agreement can simply choose not to make such a commitment. The requirement of consent, the argument goes, ensures that LDCs will be better off.

from the investment, the firm does not have to share any of the surplus with the host and can, therefore, simply choose the location that offers the highest overall return. This is the efficient result because all investments that offer a positive expected net present value can be made and all investments will be made in the country where they offer the highest return.¹⁰³

The impact of this bidding contest on the distribution of the gains from an investment project is dramatic. The country that receives the investment will have won the competition to attract the capital, but will gain little or nothing from its victory. The benefits to the country generated by the investment (in the form of employment, technology transfers, tax revenues, and so on) will be offset by the incentives and concessions that were needed to attract the firm (tax breaks, reduced pollution controls, relaxed employment regulations, and so on). In other words, as in any competitive market, the seller—here the host country—will receive no economic profit. The entire profit will be enjoyed by the investor.¹⁰⁴

In the presence of BITs, then, potential host countries will bid down the conditions on which they allow investment in an attempt to attract as much investment as possible. Ultimately, the concessions extended to investors may be so great that countries will be indifferent between having and not having the investment. The competitive nature of the market means that the benefits of investment will all go to the investor, leaving no surplus for the host.

Contrast this result with the result under the CERDS regime. Imagine two countries competing for a potential investor, but without any way for either country to make a binding commitment. In this situation, the investor cannot obtain any credible guarantees regarding the treatment of its investment. The investor may still decide to invest, however, because the countries in question have reputational concerns that encourage them to treat in-

103. If the countries are not identical, it will not be necessary for the winner to bid the benefits from the investment down to zero. To win the bidding contest, it will only be necessary to bid the benefits down to the point where the other bidder stands to earn zero benefits from the investment. At that point, the other bidder will withdraw from the bidding and the remaining country will receive the investment. Nevertheless, the bidding contest reduces the ultimate benefits enjoyed by the winner of the bidding contest.

104. This situation is referred to as a "Bertrand equilibrium." Under a Bertrand equilibrium, two or more sellers compete with one another by lowering prices. The result is that prices are driven down to the point at which they are equal to cost. Sellers receive no profit from the sale because all surplus goes to the consumers. See MAS-COLELL ET AL., *supra* note 76, at 388-89.

vestment well. Moreover, the investor can also take steps to protect itself by, for example, entering into a joint partnership with the host (so that the host has a strong incentive to let the investor maximize profits), placing a few critical operations abroad (so that the host will gain little by expropriation), or demanding a signed agreement which, although not binding under international law, may cause the host international embarrassment if it treats the investment poorly. Most importantly, the investor may choose to invest without any binding commitments from the host country because LDCs offer advantages that are unavailable in the investor's home country (e.g., low labor costs, favorable environmental or labor laws, locational advantages, natural resources, and so on). Even though the investor lacks the protections of a BIT, it may still be worthwhile to invest.

If the investment takes place in the absence of a BIT, the country that receives the investment will be able to extract value from the investor because the host has the power to unilaterally change the conditions under which the firm operates. The firm's only defenses are the ability to pull its operations out of the country¹⁰⁵ and the reputational concerns of the host. The value extracted will depend on the reputational concerns of the country, the value that is available, and the success of the investor's efforts to make such value extraction difficult. In any event, the host will gain more from each dollar invested than it would in a world of BITs because once the investment is made, the host can extract value without losing the investment.

Thus, under the CERDS regime, hosts get more value from each investment. The disadvantage of CERDS, however, is that there will be fewer investments because the inefficiencies of the regime make it more costly to invest. Some investments that would be profitable under a BIT regime, in other words, will no longer be profitable under CERDS. These investments will never be made and developing countries will lose the benefits associated with them.

Obviously, if the level of investment dropped below a certain point, LDCs would be worse off as a group under the CERDS re-

105. The firm may also have the ability to simply scale down operations without pulling out completely. On the other hand, if the firm decides to leave the country altogether, the host may impose limits on what the firm can take with it, including whatever funds are in the host country.

gime than they would be under a BIT regime.¹⁰⁶ On the other hand, if there is only a small reduction in the overall level of investment, LDCs may be better off under CERDS because they can receive a larger share of the return from investments. In determining whether a country is better off under the CERDS regime or the BIT regime, therefore, it is crucial to determine how much investment will be lost under CERDS. The critical issue is the sensitivity of investment to the cost of investing. If the investment into LDCs taken as a group is sufficiently insensitive to the cost of investment, then LDCs as a group would be better off under the CERDS regime than under a BIT regime.

This analysis explains the efforts of LDCs, acting as a group in the General Assembly and elsewhere, to undermine the Hull Rule. In the debate over the status of the Hull Rule as customary international law, developing countries were working to change a rule that applied to them all. Attempts to undermine the Hull Rule, therefore, were attempts to change the rules that applied to LDCs *as a group*. Despite the fact that individual countries have been eager to sign BITs, LDCs as a group may be better off in a regime that leaves them unable to enter binding contracts with investors. Thus, the incentives for an individual country and for LDCs as a group are different. This difference arises because developing countries compete among themselves for a limited pool of investment. As they compete, they bid away some of the surplus they would otherwise enjoy and this lost surplus may in fact exceed the gains from new investment (i.e., from investment that would not otherwise have been made in any developing country). The net result is that whereas individual LDCs may be better off vis-à-vis other LDCs in a BIT regime, LDCs as a group may suffer an overall welfare loss.¹⁰⁷

C. *The Outstanding Empirical Question*

The above discussion offers a novel explanation of LDC conduct. For the theoretical explanation to be correct, however, an empirical claim about foreign investment must be made. Specifically, the above theoretical claims are true only if the flow of investment into LDCs as a group is relatively insensitive to the terms on which that investment is made as compared to the flow of in-

106. At the very least, LDCs would be better off under a BIT regime if a CERDS regime led to a complete halt in foreign investment.

107. See *infra* Part VI.B.

vestment into a single developing country. In economic terms, the demand for the resources of LDCs as a group must be relatively inelastic while the demand for the resources of a single country must be relatively elastic.¹⁰⁸ Ultimately, this is an empirical question that cannot be answered without further research. Although it is not possible to demonstrate that the empirical conditions assumed by this theory exist without a formal empirical study, it is possible to show that it is reasonable to assume the existence of these conditions.

For investment flows into developing countries as a group to be less sensitive than flows into a single developing country, it must be that a developing country is more likely than a developed country to be a substitute for another developing country. In other words, at the margin, more investors will switch from one developing country to another in response to a change in costs in one developing country than will switch from developing countries to developed countries in response to a change in cost in all developing countries. Although developing countries and developed countries do share certain characteristics, there are enough distinct traits of developing countries to support this assumption. For example, labor in developing countries is often extremely inexpensive relative to developed countries. Thus, the threat of an increase in the wage rate in an LDC may not deter an investor because even if there were a substantial increase in the cost of labor, it is likely to remain below that of the developed world.¹⁰⁹ Similarly, developing countries have natural resources that do not exist in developed countries, or that are not as abundant and inexpensive. In addition, the legal and regulatory climate of many developing countries may be more advantageous for investors.

For a single country, it is reasonable to assume that the foreign investment decisions regarding investment in that country are relatively sensitive to the cost of investing (i.e., the elasticity of demand for the resources of the LDC is high). This is so because developing countries must compete against one another for investment and, as the cost of investing changes, so may the choices of investors. If the cost of investing increases, for example,

108. Absolute elasticities are also a factor. If investment into LDCs as a group is highly elastic or if investment into a single country is highly inelastic, in absolute terms, the theoretical explanation given here might break down.

109. This discussion is, of course, extremely crude. A more complete discussion would look at all relevant factors for investment rather than simply one factor such as wages, and would take into account productivity levels as well as wages.

the potential investor can simply invest in a different developing country. Similarly, if the cost of investing is reduced, investment that would have gone to a different country may be attracted. For a single country, therefore, the increased cost of investing prompted by the dynamic inconsistency problem (as compared to a BIT regime)—holding conditions in other LDCs constant—will cause a relatively large reduction in the total amount of foreign investment. The investment that would otherwise have been made in the country will simply move to a developing country that can make a binding agreement.

For developing countries as a group, however, the sensitivity of investment demand is likely to be much lower. If the cost of investment rises in all developing countries, an investor must either invest despite the increased cost or abandon its intention to invest in a developing country. The advantages offered by one developing country are much more likely to be found in another developing country than in a developed country. Put differently, it is reasonable to assume that, in the eyes of investors, developing countries are more like one another than they are like developed countries.¹¹⁰ Thus, investment will be much less sensitive to the cost of investing (i.e., the elasticity of investment will be lower) when we consider LDCs as a group rather than individually.

In addition to the fact that the empirical assumptions necessary to support the theory advanced in this Article are plausible, those assumptions are also supported by the observed behavior of developing countries. No other theory has been advanced that is capable of explaining why developing countries simultaneously opposed the Hull Rule and embraced BITs. If the empirical assumptions underlying the theory of this Article are incorrect, these actions by LDCs are irreconcilable.

D. *An Economic Interpretation*¹¹¹

A fundamental insight that drives the results of this Article is the recognition that the presence or absence of a credible mechanism for contracting changes the competitiveness of the market for foreign investment. If it is possible to make credible commitments

110. That is, we can assume that the resources offered in one LDC are more likely to be substitutes for those of another LDC than those of a developing country.

111. The intent of this section is to present the analysis developed above in more conventional economic terms. It is my hope that this will help clarify the forces at work in the theory.

through contracts, every potential host country must compete for the investment—leading to a competitive market for the resources of those countries and, therefore, zero economic profit (or, at least, low profits) for the “seller” (i.e., the host). As in any competitive market, the seller must compete for business, and the buyer—here the investor—receives the entire surplus from the transaction.

If LDCs can act as a group, however, there is less competition. Imagine, for example, explicit collusion among all developing countries aimed at increasing the rents those countries earned from the “sale” of their resources to investors. If that collusion was successful, one would expect LDCs as a group to have some market power and, therefore, to be able to increase the “price” at which investment takes place and to extract some of the surplus of the transaction. The fact that the hosts are colluding, of course, will cause a reduction of the overall level of investment, but the gains from colluding would outweigh the losses to LDCs.

The host is able to extract rents because once the investment is made, the host is in the position of a monopolist. It can choose to set the “price” for its resources at the level that maximizes its own return. The basic theory of monopoly pricing teaches that a monopolist will set a price that is above the competitive price in order to extract monopoly rents. The result, of course, is a reduction in the demand for the resources, a loss to the buyer (here, the investor), and increased profits. Overall, there is a net loss, referred to as a “deadweight loss.”¹¹² In the context here, the host will demand more value from the investor than it would in a competitive environment. Thus, to the extent potential hosts compete against one another for investment, and to the extent that this leads to a competitive market for the resources offered by potential hosts, it should be expected that hosts will seek to extract value from the firm after the investment takes place. Because the investor has made an irreversible investment, it cannot easily withdraw from the country—making its demand for those resources very inelastic indeed.

Collusion among LDCs would still leave LDCs as a group in competition with developed countries. Developing countries would only be able to extract rents from investors if they were able to obtain some market power despite the presence of developed

112. See JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 65–79 (1988).

countries. Whether or not they are able to do so is the empirical question discussed in Part V.C. above, where it is suggested that such market power is in fact plausible.

All that remains, then, is to explain the relationship between explicit collusion and the demise of the Hull Rule. By tearing down the Hull Rule, developing countries eliminated the rule of customary international law that required them to pay full compensation for "takings." In the absence of any other international law or treaty, no mechanism existed for a host to commit to an investor in a credible fashion. Thus, the legal regime ensured that no country could bind itself to a certain standard of treatment before investment—only reputational constraints controlled the behavior of LDCs.

Without the ability to obtain a credible commitment from host countries and without a rule of customary international law protecting investment, investors faced a higher expected cost of investment because of the dynamic inconsistency problem. The effect, therefore, was the same as an explicit agreement among all developing countries that they would not bid against one another for investment. In fact, without BITs, the regime was even better for LDCs than a collusive agreement because it was impossible for any single country to "defect" from the agreement—thus, the "cartel" of LDCs was extremely stable.

The above explains, in economic terms, why developing countries fought to undermine the Hull Rule. Their willingness to sign BITs, as explained above in Part V.B, was caused by the fact that BITs introduced a mechanism through which developing countries could compete for investment. Just as members of a cartel may seek to defect from the cartel to increase their sales, individual LDCs embraced BITs as a way to compete for foreign investment.

E. *Summary*

The above discussion offers considerable insight into the behavior of developing countries with respect to the United Nations resolutions and BITs. Within the United Nations, developing countries have been able to cooperate and pursue an international legal structure that prevents credible contracting between firms and states and that provides only minimal protection to investment. Cooperation in this forum has been easy because the General Assembly acts as a single body and there is nothing to be gained by refusing to cooperate. The General Assembly, there-

fore, has provided capital-importing countries with an excellent forum to advocate for the dismantling of the Hull Rule and the "adoption" of much more lenient rules of investor protection.

If such a regime were to be accepted as international law, it would force investors to invest without the benefit of clearly specified and reliable terms. Although individual countries would like to provide such terms by signing contracts with investors before the investment occurs, such contracts would be unenforceable under international law and, therefore, would offer investors little security. LDCs would thus be free to raise the "price" of access to their resources.

BITs, however, provide a mechanism through which individual countries can easily "cheat" on this "cartel" of capital importers. By signing a BIT, the potential host country agrees, in a binding treaty under international law, to refrain from expropriation and to respect any contracts that it signs with investors. Derogation from such a contract is a violation of the treaty and, thus, a violation of international law that can be remedied through international commercial arbitration. Any single capital-importing country has an incentive to sign a BIT because such a treaty helps that country attract foreign investment. On the other hand, the treaties are harmful to capital importers as a group because they lead to a world in which contracts between firms and host states are binding.

The history of BITs, and of opinions on the protection of foreign investment generally, are consistent with the analysis presented in this Article. For example, the analysis here explains why investment treaties are almost exclusively bilateral rather than multilateral. The incentive to sign a BIT comes from the ability to get an advantage over one's rival host countries. If an investment treaty binds all LDCs, no single country gains that advantage. Moreover, a multilateral treaty eliminates the benefits LDCs enjoy as a group in a regime where there are few protections for investment. It is not surprising, therefore, that in a multilateral context, where LDCs are acting as a group, LDCs generally refuse to sign such investment treaties.¹¹³

113. One caveat should be made here. LDCs would reject a multilateral treaty if the alternative were no treaty. Once a web of BITs is in existence, however, the choice facing LDCs is not between a multilateral treaty and no treaty, but rather between the multilateral treaty and the BITs. If the multilateral treaty offers other advantages to developing countries, they may prefer the multilateral approach.

Also noteworthy is that no two developed countries have entered into a BIT with one another. Although it may be true that investors are usually less concerned about expropriation by developed states, these investors may, nevertheless, have legitimate concerns about the contractual arrangements and the conditions under which they make their investment. One explanation for the North-South nature of BITs is the bargaining power of the two sides. Without a BIT, a particular developing country will have a much lower level of investment than otherwise. Investment in a developed country, on the other hand, is much less likely to be sensitive to the presence of such treaties.¹¹⁴ Developing countries, therefore, are more eager than developed countries to reach an agreement on investment with a major capital-exporting country and the capital-exporting countries can, in turn, demand strong protections for their foreign investors.¹¹⁵

VI. EFFICIENCY, WELFARE, AND INTERNATIONAL LAW

A. *Efficiency Implications*

Under most BIT arrangements, contracts between investors and host countries are binding at the international level. This binding contractual mechanism of BITs is made possible by the dispute settlement procedures. Failure to respect the terms of a contract with a foreign investor is a violation of the BIT and gives the investor the right to pursue a remedy through a dispute settlement procedure, which in most circumstances is binding arbitration.¹¹⁶ To the extent that the damage scheme under a BIT is interpreted as expectation damages (as opposed to, say, restitution damages), the efficient outcome is achieved.¹¹⁷ Moreover, even if the meas-

114. This lessened sensitivity may be attributed to two factors. First, the home country of the investor is much more likely to be able to retaliate by taking actions against the foreign investors from the offending state that are operating in the home country. Second, the reasons for locating the investment in a developed country are less likely to be tied to production costs, such as labor and regulatory conditions, and much more likely to be related to other factors such as the presence of a large market, human capital, and so on.

115. Although BITs nominally impose symmetric obligations, North-South BITs are typically between countries with such different levels of outward foreign investment that only one side's behavior toward investors is significantly affected.

116. See, e.g., Model U.S. BIT, *supra* note 60, art. VI(1) (broadly defining an investment dispute); art. VI(3) (authorizing binding arbitration before ICSID and any other arbitral institution that the parties agree upon); art. VI(6) (stipulating that arbitral awards shall be binding and enforceable).

117. See *supra* note 91 and accompanying text. The efficient result will generally not be achieved where the BIT or contract does not specify the form of damages for violations of

ure of damages is not expectation damages, the BIT regime is more efficient than either CERDS or the Hull Rule because it governs a wider range of potential host-investor disputes (i.e., it applies to more than direct expropriation).¹¹⁸

More important than the measurement of damages, however, is the fact that the BIT framework, by providing a binding and credible contractual mechanism, allows the parties to avoid the dynamic inconsistency problem. The presence of an impartial dispute settlement mechanism that is capable of ensuring compliance by the host helps ensure that host governments will honor their agreements.¹¹⁹ Subject only to transaction costs, a BIT regime will cause capital to be invested where it stands to earn the greatest return. Thus, the cost of investing is reduced, more investment will take place, and the investment that does occur will be allocated in an efficient manner. BITs, therefore, yield an efficient allocation of capital.

In contrast to a BIT regime, the rules of CERDS introduce a significant degree of inefficiency. Under CERDS, the security of an investment is dependent on the goodwill of the host state. Outside the discipline provided by the market for foreign investment,

a prohibited action. For example, Article II of the Model U.S. BIT prohibits performance requirements, but does not specify a remedy should a country implement such requirements. See Model U.S. BIT, *supra* note 60, art. II(5). Thus, if the investor can quickly and easily prevent these requirements from being put in place (perhaps because the dispute settlement mechanism operates quickly and its rulings are followed by the host), then performance requirements will never be put in place. This result creates inefficiencies in situations where the benefit of a performance requirement outweighs the loss to the firm. If the country could, instead, simply pay the firm's expectation damages, the result would be more efficient. Moreover, it may be possible for the country and the firm to negotiate an agreement whereby the firm accepts performance requirements in exchange for some payment. In this situation, the outcome will be efficient, although there will always be the concern that the requirement is forbidden by the treaty such that the host will be in violation of international law.

118. Although rarely clear on the question, most commentators appear to view the "prompt, adequate, and effective" standard—present in both BITs and the Hull Rule—as a form of expectation damages. See, e.g., Brice M. Clagett, *Protection of Foreign Investment Under the Revised Restatement*, 25 VA. J. INT'L L. 73 n.8 (1984) ("The standard method of establishing [adequate compensation] is called discounted-cash-flow analysis."); Schachter, *supra* note 8, at 124–25 (stating that the Hull standard was "full value," i.e., fair market value); *World Bank Guidelines on the Treatment of Foreign Direct Investment*, reprinted in IBRAHIM F.I. SHIHATA, *LEGAL TREATMENT OF FOREIGN INVESTMENT: THE WORLD BANK GUIDELINES* 155, 161, 163 (1993) (defining "adequate" to mean fair market value, and "effective" to mean in a convertible currency).

119. More precisely, the agreement will be honored or the investor will be able to recover its losses.

investors enjoy little protection against actions by the host.¹²⁰ Although these reputational concerns may provide non-trivial protection, investors still have cause to be concerned about expropriation and other, less dramatic actions by the host state because there is no reason to think that reputational concerns are enough to cause hosts to honor all commitments.¹²¹ The lack of a credible commitment mechanism, in turn, drives up the cost of investment and causes profitable investments, which both the host and the investor desire, to be foregone because they are rendered unprofitable by the dynamic inconsistency problem.

In addition to reducing the amount of investment, the CERDS regime may distort decisions regarding where to invest. Imagine, for example, that two countries wish to attract a particular investment. Country A may be the better location for the investment because of, say, its geographic location and the available social infrastructure. Nevertheless, the investor may decide to invest in country B because country B is considered more likely to honor the agreement under which the investment takes place. This is an inefficient result because the investment would be, by assumption, more valuable in country A. If it were possible for country A to write a binding contract with the investor, the distortionary effect of reputation would be eliminated and the investment could be made efficiently. There is, therefore, no serious doubt that BITs are better on efficiency grounds than a regime based on CERDS.

B. *Welfare Implications*

The efficiency of BITs, however, is not the whole story. As compared to CERDS, BITs sharpen the competition for investment among potential hosts. This forces LDCs to offer greater and greater concessions to potential investors, bidding away the gains the host would otherwise enjoy. In effect, BITs make the market for foreign investment much more competitive by allowing

120. The market provides discipline primarily through reputational effects. If a country takes actions that are harmful to foreign investment, other firms will observe the actions and may choose not to invest in the future. *See supra* note 37 and p. 665-665 (discussing the role of reputation).

121. Indeed, the fact that investors and hosts choose to make binding commitments when they are able to do so indicates that the ability to make those commitments have value. Reputational constraints, by themselves, are not enough to ensure the level of investment protection provided by a binding contract. Most notably, reputational effects do not eliminate the dynamic inconsistency problem.

competition in the "price" of investment, that is, the terms under which investment takes place.

In the absence of BITs, international law currently yields the same economic result as would an agreement among developing countries to never negotiate with potential investors before the investment. Such collusion would force investors to either invest without knowing the final terms under which they have to operate or refrain from investing. The practical effect is to increase the "price" at which the resources of developing countries are sold. This in turn reduces the amount sold and, assuming investment into LDCs as a group is not overly sensitive to changes in the terms of investment, results in monopolistic gains to developing countries. The CERDS regime, in other words, makes the market for foreign investment and LDC resources imperfectly competitive, allowing developing countries (the sellers) to capture a larger share of the rents. Capital importers, therefore, are better off as a group under the CERDS regime than under the BIT regime. Just as a monopolist (or an oligopolist) enjoys an increase in welfare when it is able to reduce the competitiveness in a market, so LDCs enjoy greater returns under CERDS because this regime makes the market for foreign investment less competitive.

From the point of view of the welfare of developing countries as a group, the best of the three possible regimes is CERDS, followed by the Hull Rule (which only covers direct expropriation), followed by the BIT regime. The BIT regime is the least beneficial to LDCs because it includes the most expansive definition of investment and thereby allows greater competition among developing countries.¹²²

The purpose of this Article is not to advocate one of these regimes over another. Rather, it seeks simply to show the relevance of the distributional issues. Without a mechanism to redistribute wealth between countries, the distributional consequences of a particular policy should be considered. The rise of BITs has reduced the market power held by developing countries, which, in turn, has reduced the benefit these countries can capture from any particular investment. For this reason, the BIT regime may actually reduce the overall welfare of developing countries and there-

122. Of course, the increased welfare that developing countries enjoy under CERDS comes at the expense of investors. Like any monopolistic behavior, the behavior of host countries under a regime that does not allow binding contracts leads to a deadweight loss because the benefits to the host are smaller than the loss to investors.

fore should not be uncritically embraced by those who seek the interests of LDCs. On the other hand, there can be no serious doubt that, from a global efficiency perspective, a regime that allows for contracting between host governments and investors is more efficient than a regime in which potential hosts cannot effectively commit to any particular behavior or agreement.

C. *The Impact of BITs on Customary International Law*

This Article has sought to explain the paradox of LDC objections to the Hull Rule and the widespread adoption of BITs. In addition, the Article has pointed out the ambiguous effect of these treaties on the welfare of LDCs. The explanation of BITs presented here also allows the analysis of another issue that is attracting some attention, namely, the role of BITs in the establishment of customary international law. Do these treaties codify an agreed upon set of principles that applies to all or do they merely represent *lex specialis* as between the parties?¹²³ The debate is of some importance because if the BITs establish a rule of customary law, that law will apply to all countries even in situations where the host has not signed a BIT with the home country of the investor.¹²⁴

Those who argue that the BITs represent the codification and entrenchment of customary principles of international law point to the large number of such treaties and the fact that many of the na-

123. For a detailed argument that BITs do not contribute to the formation of customary law, see Bernard Kishoiyian, *The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law*, 14 NW. J. INT'L L. & BUS. 327, 329 (1994) ("[E]ach BIT is nothing but a *lex specialis* between parties designed to create a mutual regime of investment protection."). For the opposing view, see Asoka de Z. Gunawardana, *The Inception and Growth of Bilateral Investment Promotion and Protection Treaties*, 86 AM. SOC'Y INT'L L. PROC. 544, 550 (1992) ("Although the provisions of the bilateral investment promotion and protection treaties may not have attained the status of customary international law, they have an undoubted part to play in that regard."); David R. Robinson, *Expropriation in the Restatement (Revised)*, 78 AM. J. INT'L L. 176, 177 (1984) ("[M]any of the same developing nations that supported these [United Nations] declarations as political statements have, in their actual practice, signed bilateral investment treaties reaffirming their support for the traditional standard as a legal rule.").

124. The discussion here represents only one application of a more general ongoing debate regarding the relationship between treaties and customary international law. In that debate, Anthony D'Amato is the most prominent proponent of the view that treaties should be considered to create customary law. See ANTHONY D'AMATO, *THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW* (1971); Anthony D'Amato, *Treaty-Based Rules of Custom*, in *INTERNATIONAL LAW ANTHOLOGY* 95-101 (Anthony D'Amato ed., 1994). Arthur Weisburd is a prominent critic of D'Amato's position, arguing that treaties represent merely another piece of evidence of state practice or *opinio juris*, and are, therefore, no more compelling than other pieces of evidence. See Arthur M. Weisburd, *Customary International Law: The Problem of Treaties*, 21 VAND. J. TRANSNAT'L L. 1 (1988).

tions that rejected the traditional Hull Rule standard of compensation have signed BITs.¹²⁵ The prevalence of BITs, the argument goes, demonstrates that both developed and developing countries now consider the traditional compensation standard to be the relevant standard of international law. As one commentator has put it: "Is it possible for a State to reject the rule according to which alien property may be expropriated only on certain terms long believed to be required by customary international law, yet to accept it for the purpose of these treaties?"¹²⁶

The analysis of this Article shows that this question can and must be answered in the affirmative. The arguments of those who view BITs as evidence of customary law are flawed for two reasons. First, as the above quote illustrates, these arguments overlook the fact that the Hull Rule ceased to be a rule of customary law sometime before 1975.¹²⁷ Second, the arguments fail to take into account that customary law requires not only practice, but also a sense of legal obligation.¹²⁸ As the International Court of Justice has made clear:

Not only must the acts concerned amount to a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it. . . . The States concerned must therefore feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the acts is not in itself enough.¹²⁹

Therefore, in the words of another scholar, "the repetition of common clauses in bilateral treaties does not create or support an inference that those clauses express customary law. . . . To sustain such a claim of custom one would have to show that apart from

125. See F.A. Mann, *British Treaties for the Promotion and Protection of Investments*, 52 BRIT. Y.B. INT'L L. 241, 249 (1982); Clagett, *supra* note 118, at 81-85.

126. Mann, *supra* note 125, at 249.

127. See *supra* Part II.B.

128. A rule of customary international law requires both the general practice of states and state adherence to the rule based on a belief that such adherence is legally required (*opinio juris*). RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102(2) (1987). For a brief discussion of the general practice requirement, see Weisburd, *supra* note 124, at 6-7.

129. North Sea Continental Shelf (F.R.G. v. Den.; F.R.G. v. Neth.), 1969 I.C.J. 3, 44 (Feb. 20).

the treaty itself, the rules in the clauses are considered obligatory."¹³⁰

The relevant inquiry concerning whether BITs establish a rule of customary international law, therefore, is whether the presence of BITs establishes a sense of legal obligation or at least serve as evidence of such an obligation.¹³¹ Clearly, the BITs' effect on international law would be simplified if these treaties included an explicit acknowledgment that the treaty merely codified rules of customary law;¹³² unfortunately, BITs do not contain such language. Similarly, if the treaties explicitly stated that they did not represent a codification of a legal obligation, it would be clear that BITs should not be taken as evidence of customary law.¹³³ Again, the treaties themselves are silent on this point.

To determine whether BITs evidence a sense of legal obligation on the part of signatories, therefore, requires an inquiry into the reasons countries sign BITs. If BITs are signed out of a sense of obligation or to clarify a legal obligation, they must be considered evidence of customary international law. On the other hand, if BITs are signed for reasons unrelated, or even contrary, to a country's sense of legal obligation, BITs are not evidence of customary international law.

This Article has provided an explanation for the popularity of BITs among developing nations that is based on the economic interests of those nations. As discussed earlier, signing a BIT offers an LDC an advantage in the competition for foreign investment. That BITs have been signed in large numbers merely demonstrates the magnitude of the perceived benefits associated with the ability to avoid the dynamic inconsistency problem. Thus, if countries have signed BITs out of economic motives, the treaties should not be interpreted as evidence of customary international law. It is equally plausible that BITs represent a permissible derogation from the existing rules of customary law and that countries

130. Schachter, *supra* note 8, at 126.

131. We need not tarry over the details of the general practice requirement of customary international law because virtually every country has signed at least one BIT. Although one might ask if a single BIT is enough to demonstrate the practice of a state and argue that one must look to the actual practice of states rather than their obligations under treaties, for our purposes it is sufficient to simply assume that the general practice requirement is met. I make this assumption because the analysis developed in this part of the Article provides insights into the *opinion juris* requirement rather than the general practice requirement.

132. See Weisburd, *supra* note 124, at 23.

133. *Id.* at 24-25.

have pursued the treaties because it is in their economic interest to do so. This means that BITs offer no evidence concerning the rules of customary international law that govern compensation for appropriations.

The absence of a sense of legal obligation is further demonstrated by the vigorous opposition of developing countries to the Hull Rule. By the mid-1970s, the LDCs' consistent objections to the Hull Rule successfully undermined its status as customary law, and there is no evidence that LDCs have since developed a greater sense of legal obligation toward the protection of foreign investment. It is simply not possible to explain the paradoxical behavior of LDCs toward foreign investment based on a view that BITs reflect *opinio juris*.

The demise of the Hull Rule and the rise of BITs represent a struggle between developed and developing countries over the international protections to be provided for foreign investment. In the first round of this fight, developing countries successfully dismantled the Hull Rule. In the second round, developed countries responded with treaties that offered each individual LDC an opportunity to improve its position in the competition for investment. Although it appears that the developing world has lost the battle over investment protection, it must be recognized that the international legal structures were changed along the way. Developing countries have demonstrated that they do not feel an international legal obligation to provide full compensation for expropriation or to honor their contractual commitments to investors. On the other hand, they have, in pursuit of their economic self-interest, committed themselves to such behavior through BITs. BITs, therefore, do not reflect a sense of legal obligation but are rather the result of countries using the international tools at their disposal to pursue their economic interests.

VII. CONCLUSION

Bilateral investment treaties have become the dominant international vehicle through which North-South investment is protected from host country behavior. Because these treaties allow investors and hosts to establish binding and enforceable contracts, there is little doubt that BITs increase the efficiency and reduce the cost of foreign investment. In particular, the treaties solve the dynamic inconsistency problem by permitting the host state to bind itself to a particular course of action before the investment takes place.

This Article has shown, however, that there is more to the story. Although BITs improve the efficiency of foreign investment, they may not increase the welfare of developing countries. BITs give an individual country the ability to make credible promises to potential foreign investors. As a result, the country is more attractive to foreign investors and will receive a larger volume of investment than it would without the ability to make such promises. The increase in investment, however, is likely to come in large part at the expense of other developing countries. Developing countries as a group, therefore, will enjoy gains from an increase in total investment that is relatively modest. It is probable that this gain will be outweighed by the loss those countries will suffer as they bid against one another to attract investment.

Developing countries would be better off if, rather than competing against one another to attract investment, they could require potential investors to commit their investments to a particular country without a binding investor-host agreement. In this situation, which exists if neither the Hull Rule nor a BIT governs the investment, the host state can extract rents from a foreign investor because it can wait until an investment is made before increasing the costs to the investor. Just as a monopolist increases the price and reduces the quantity of goods sold to maximize profits, host countries under CERDS can increase the costs to investors and maximize the gains to the host country.

This strategic analysis of the behavior of developing countries explains why developing countries support CERDS—a collective action that allows LDCs to maximize their profits as a group—and, contemporaneously, sign BITs—an individual action that gives a signatory an advantage relative to other developing countries. It also makes it possible to assess the welfare implications of BITs. There is little doubt that BITs increase the overall efficiency of foreign investment, but they appear to do so at the cost of reducing the gains to developing countries. Whether this is a desirable trade off is, perhaps, a matter of debate. Finally, the analysis herein argues against viewing BITs as evidence of customary law. Developing countries sign these treaties to gain an advantage in the competition for investment rather than from a sense of legal obligation, as is required to establish a rule of customary international law.