THE NATIONAL INTEREST

Do We Need An Investment Treaty with China?

By: Simon Lester - December 3, 2012

After 18 years of talks, Canada and China recently completed negotiations on an investment treaty. There has been a spirited debate in Canada over whether the treaty was a good idea. The controversy foreshadows a similar discussion in the United States, as business groups and some politicians push for a U.S.-China investment treaty.
One thing missing from the Canadian debate was an effort to squarely address some fundamental questions about such treaties: Are investment treaties the right way to liberalize foreign investment? More specifically, do investment treaties remove barriers to foreign investment, or do they, instead, mainly encourage litigation?

Before examining these questions, let's start with a basic assumption: foreign investment, both inward and outward, is good. Investment is a fundamental driver of economic growth. The source of the investment is irrelevant, and there are few legitimate concerns with the "foreign" nature of an investment. Furthermore, when companies locate in the most efficient production area, consumers benefit and the companies becomemore viable over the long-term. Concerns about job losses from shifting production abroad ("outsourcing") are understandable for those affected, but putting up barriers to prevent such market-based outcomes is extremely costly and cannot be sustained in the long run.

Those who disagree will certainly oppose investment treaties, as they oppose foreign investment in general. But that is a different debate. The question here is: For those who believe foreign investment is beneficial, are investment treaties a good policy tool?

In this regard, investment treaty experts have examined whetherthese treaties "promote" foreign investment. Academic studies of this issue are mixed, with conclusions ranging from a large positive impact on foreign investment to a negative impact.

Moreover, it is not clear whether they are asking the right question. If the goal is to "promote" foreign investment by increasing its amount, governments could offer subsidies to foreign investors. But this is not optimal because government subsidies distort markets, which leads to a reconsideration of the question. The goal should not be for governments to "promote" foreign investment through international treaties. Rather, it should be for governments to remove barriers to foreign investment, so that investors can decide on their own where to invest.

This leads to the question ofwhich barriers should be removed, bringing us to actual legal obligations. Consider three provisions that are found in most investment treaties.

First, these treaties usually include a provision that allows foreign investors to sue governments for alleged violations, commonly referred to as investor-state dispute settlement (investors can sue states directly). For most international legal obligations, only governments can bring a complaint, providing a filter on legal claims. With investment treaties, by contrast, foreign investors pursue litigation on their own.

In terms of the substantive obligations, there are a number of these, but consider two in particular. First, there is the "National Treatment" provision, which says, in essence, that governments should treat foreign and domestic investors equally. This obligation is consistent with the general principle that "foreign" investment is just as good as "domestic" investment, and that the nationality of the investor does not matter (aside from legitimate national-security concerns). Arguably, this provision reflects the idea that investors should be able to decide on their own where to invest, with no encouragement or discouragement from government.

If National Treatment were the only obligation, concerns about excessive litigation would be lessened. But there are broader obligations as well. Forexample, there isanother provision included in most investment treaties entitled "Minimum Standard of Treatment": "Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security." (This language is from the U.S. model bilateral investment treaty). Experts in the field do notseem to agree on the meaning of this provision, and this vagueness opens the door for a wide range of claims that a government has mistreated a foreign investor. As noted, discrimination against foreign investors is already prohibited. Thus, the "Minimum Standard" provision means that there are some actions by governments which are not discriminatory, but nevertheless violate the treaty. Unfortunately, it is not very clear what these actions are, or why they should be prohibited by an international investment treaty. Trying to design a treaty that prevents governments from acting badly, in some general way, is perhaps overly ambitious.

When an investor-state dispute mechanism is combined with vague obligations such as "Minimum Standard of Treatment," opportunities for legal claims grow considerably. This can and has led to an explosion of litigation. It is possible that, rather than facilitating new foreign investment, these treaties might just be an additional avenue for foreign investors—who would have made their investment anyway—to sue host governments.

Experience with the Canada-China treaty as it takes effect will be informative for the U.S. policy debate. Chinese investment has already proved controversial in the United States, with the U.S. government sometimes wary of Chinese ownership of particular U.S. assets. It seems clear that the issue would be even more contentious if Chinese companies—especially state-owned ones—were able to sue the U.S. government directly for perceived bad treatment.

U.S.-China talks on foreign investment should address the actual content of the treaty, in particular whether certain provisions are necessary to provide a framework for liberalized investment. The specific legal obligations in these treaties will have an impact on how the treaty works in practice, and as a result on how a liberalized foreign-investment policy is judged in the court of public opinion. A key question: do "Minimum Standard of Treatment" rules, combined with investor-state dispute settlement, go too far?

This is not the first time such issues have been raised, as they have been controversial in other U.S. treaties as well. But the U.S.-China economic relationship is particularly contentious, and as a result these issues might face scrutiny beyond that seen in past treaties. By opening the door for a flood of sometimes questionable lawsuits by foreign companies, a U.S.-China investment treaty could actually undermine an open foreign-investment policy both in China and the United States. For those who support liberalized foreign investment, it might finally be time for a serious discussion of how international agreements should best handle these issues.