Bounded Rationality and Economic Diplomacy

Modern investment treaties give private arbitrators power to determine whether governments should pay compensation to foreign investors for a wide range of sovereign acts. In recent years, particularly developing countries have incurred significant liabilities from investment treaty arbitration, which begs the question why they signed the treaties in the first place. Through a comprehensive and timely analysis, this book shows that governments in developing countries typically overestimated the economic benefits of investment treaties and practically ignored their risks. Rooted in insights on bounded rationality from behavioural psychology and economics, the analysis highlights how policy-makers often relied on inferential shortcuts when assessing the implications of the treaties, which resulted in systematic deviations from fully rational behaviour. This not only sheds new light on one of the most controversial legal regimes underwriting economic globalization but also provides a novel theoretical account of the often irrational, yet predictable, nature of economic diplomacy.

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The Politics of Investment Treaties in Developing Countries

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To Misha

Contents

Figures

Tables

Selected abbreviations

BIT	bilateral investment treaty
FCN treaty	friendship, commerce, and navigation treaty
FCO	Foreign and Commonwealth Office, London
FDI	foreign direct investment
FIAS	Foreign Investment Advisory Services
FTA	free trade agreement
ICSID	International Centre for the Settlement of Investment Disputes
MAI	Multilateral Agreement on Investment
MFN	most favoured nation
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North American Free Trade Agreement
OPIC	Overseas Private Investment Corporation
PRI	political risk insurance
PTA	preferential trade agreement
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations

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The book is dedicated with love to my wife, Misha, who generously listened to my monologues on the intricacies of bounded rationality and economic diplomacy for much too long.

Preface

The curious case of Pakistan

In October 2001 Pakistan's Secretary of Law received a letter. It related to a dispute between the Pakistani government and a Swiss company, Société Générale de Surveillance (SGS). The dispute had begun in 1996 after the Sharif government terminated a contract with SGS due to suspicions that it had been obtained through bribes. SGS objected and began a series of legal proceedings in both Switzerland and Pakistan. All failed. The letter received five years after the dispute had begun was not from Switzerland or the Pakistani courts. This time it was from Washington DC. It came from a World Bank institution called the International Centre for the Settlement of Investment Disputes. ICSID said SGS was claiming more than US $110 million in compensation based on a so-called bilateral investment treaty (BIT). This puzzled the Secretary, as neither ICSID nor the BIT had been mentioned by SGS while the contractual dispute had lasted.[1] He therefore called up his Attorney General to ask what he knew about ICSID, and how SGS could possibly use a BIT to file such a claim. Although one of the most notable experts on international public and commercial law in Pakistan, the attorney general couldn't give him an answer. 'To be perfectly honest,' he later said to me, 'I did not have a clue.'[2] After hanging up, the attorney general therefore went on to Google. Here he typed in two questions: 'What is ICSID?' and 'What is a BIT?' And that is how he learned of these instruments for the first time.

It didn't take long before the attorney general realized that the letter from ICSID was serious indeed. Unlike the contract with SGS, which involved specific commercial rights, the six-page BIT provided SGS a right to compensation for a wide range of regulatory conduct based on

[1] ICSID Case No. ARB/01/13, Decision on Jurisdiction, 6 August 2003, par. 63.
[2] Interview, Karachi, January 2009.

very vague treaty language. Pakistan was obliged to fully compensate Swiss investors for expropriation, indirect expropriation, or any other measures having the same nature or effect. What that meant remained unspecified. Swiss investors could also claim damages owing to war, revolts, states of emergency or other armed conflicts, none of which were strangers in a Pakistani context. They were promised free repatriation of their profits and other capital out of Pakistan, which again was a very significant obligation for a country facing serious foreign exchange shortages at the time. The treaty also obliged Pakistan to treat Swiss investors in the same way as Pakistani investors (national treatment) or investors from other third countries (most-favoured-nation treatment), whichever was more favourable. Finally, it included a vague – but potentially far-reaching – clause providing for fair and equitable treatment, which again remained unspecified. In essence, the BIT provided SGS something akin to an 'economic constitution' while operating in Pakistan that was independent of Pakistan's own laws and regulations.

As important, it gave Swiss investors the right to settle disputes with the Pakistani government outside Pakistan's own legal system, for instance by using ICSID as the arbitration forum. This was in contrast to the usual procedure of international arbitrations, where foreign investors traditionally needed to go through domestic courts before international proceedings could be initiated. The tribunal had the authority to admit SGS's claim, rule on its own jurisdiction, as well as award damages binding upon Pakistan and with no real options for appeal.

Some corners of the Pakistani bureaucracy proposed to stay away from the proceedings and not comply with any potential arbitral awards, but the attorney general realized this was a bad idea. Like the vast majority of investment arbitration claims, SGS had asked for monetary compensation as a remedy. In case of non-compliance, the award would be enforceable against Pakistan's commercial assets around the world. Courts in enforcing states would have only limited options to refuse execution. Even more important, Pakistan was crucially dependent on financial assistance from the International Financial Institutions, so reneging on international legal obligations within a World Bank forum like ICSID would be imprudent.

Clearly, this was not a claim to be taken lightly, so the attorney general wanted more information on the BIT and why it had been signed in 1995. But when inquiring with the relevant ministries, he was unable to trace any records of negotiations ever taking place with Switzerland. There were no files or documentation and no indication that the treaty had ever been discussed in Parliament. In fact, no one could find the treaty itself, so Pakistan had to ask Switzerland for a copy through formal channels. For a treaty with such a considerable scope, this was somewhat

of a mystery. Yet, the attorney general later learned that this was no exception, as hardly any records existed of Pakistan's past BIT negotiations.

This was peculiar. For although Pakistan was no stranger to allowing *individual* investors a right to international arbitration based on specific contracts, its BITs had provided a 'standing offer' to international arbitration to foreign investors *as a group*. When signing BITs Pakistan had given all existing *and* future investors covered by the treaties the option of taking their disputes to international arbitration. Combined with their vague and broad treaty language, this not only gave investors a second chance at adjudicating contract disputes, as in the SGS case, but also implied a potentially infinite number of claims involving Pakistan's regulatory conduct. But even though Pakistan had actually been the first country to ever sign a BIT in 1959 with West Germany, and had concluded a total of 40 similar treaties since then, no one could seem to find any documentation that they had been carefully negotiated.

This was not because the negotiations were considered too sensitive to document in written form. On the contrary, when foreign delegations had come to the country, or the Pakistani leadership went abroad, BITs had merely been considered a diplomatic token of goodwill. There was an expectation that the treaties would lead to increased inflows of foreign investment, something Pakistan desperately needed, but they were not thought to have any potential liabilities or regulatory constraints. The claim by SGS made it obvious to the attorney general that this view was mistaken.

For many, however, this probably sounds a little too convenient: now that Pakistan had to adhere to her international legal obligations, it appears opportunistic of a bureaucrat to claim ignorance on behalf of his former colleagues. So to corroborate the story, I contacted a considerable number of officials involved in Pakistan's BIT program in the past. All confirmed more or less the same narrative, and today even government files admit to this view: 'BITs were initially instruments that were signed during visits of high level delegations to provide for photo opportunities'.[3] It was thereby not until Pakistan was hit by a multimillion-dollar arbitration claim that officials realized the implications of treaties signed by shifting governments since 1959.

This book will show that Pakistan's experiences have not been unique. During the 1990s and early 2000s, only few developing country governments realized that by consenting to investment treaty arbitration, they

[3] Communication between Pakistan's Board of Investment and Ministry of Law concerning re-negotiation of German-Pakistan BIT, 23 November 2009. On file with author.

agreed to offer international investors enforceable protections with the potential for costly and far-reaching implications. The majority of developing countries thereby signed up to one of the most potent international legal regimes underwriting economic globalization without even realizing it at the time.

This not only means that the history of the international investment regime has to be rewritten; it also provides more general lessons for our understanding of economic diplomacy. For even if policy-makers try to pursue their own preferences when designing the rules that shape global economic governance, they are not always as careful and sophisticated as much international relations literature would have us believe. Instead, economic diplomats are no different from the rest of us by often struggling to make sense of their surroundings due to limited problem-solving capabilities. It is only through studying the nature and role of these cognitive constraints that we will understand the often irrational, yet predictable, nature of international economic relations.