Michigan Journal of International Law

Volume 19 | Issue 2

1998

Sustainable Liberalism and the International Investment Regime

Kenneth J. Vandevelde
Thomas Jefferson School of Law

SUSTAINABLE LIBERALISM AND THE INTERNATIONAL INVESTMENT REGIME

*Kenneth J. Vandevelde**

INTRODUCTION

During the past decade, developed and developing states alike have constructed an increasingly liberal international investment regime[1] through conclusion of an enormous network of bilateral investment treaties (BITs).[2] As of early 1997, more than 1300 BITs had been signed

---

* Dean and Professor of Law, Thomas Jefferson School of Law. J.D., Harvard Law School (1979); B.A., University of Louisville (1975).

1. A liberal international investment regime is one in which States permit the market to determine allocations of capital, ensure the proper functioning of the market, and provide legal protection for investment against wrongful injury by public or private agents. I have argued elsewhere that the existing legal regime is effective principally at providing protection for investment. *See* Kenneth J. Vandevelde, *The Political Economy of a Bilateral Investment Treaty* (forthcoming).

2. The typical BIT guarantees that covered investment will receive national and most favored nation treatment, prohibits exchange controls and uncompensated expropriation, and obligates host states to submit investment disputes with private investors and treaty disputes with the home state to binding, third-party arbitration. Regarding the BITs, see generally RUDOLP DOLZER AND MARGRETE STEVENS, BILATERAL INVESTMENT TREATIES (1995); KENNETH J. VANDEVELDE, UNITED STATES INVESTMENT TREATIES: POLICY AND PRACTICE (1992); Adeoye Akinsanya, *International Protection of Direct Foreign Investment in the Third World*, 36 INT'L & COMP. L.Q. 58 (1987); Eileen Denza & Shelagh Brooks, *Investment Protection Treaties: United Kingdom Experience*, 36 INT'L & COMP. L.Q. 908 (1987); Pamela B. Gann, *The U.S. Bilateral Investment Treaty Program*, 21 STAN. J. INT'L L. 373 (1985); Mohamed I. Khalil, *Treatment of Foreign Investment in Bilateral Investment Treaties*, 8 ICSID REV.: FOREIGN INVESTMENT L.J. 339 (1992); Palitha T.B. Kohona, *Investment Protection Agreements: An Australian Perspective*, 21 J. WORLD TRADE L. 79 (April 1987); T. Modibo

involving over 160 States.[3] Further, since 1995, the Organization for Economic Cooperation and Development has been sponsoring negotiation of a multilateral agreement on investment.[4] Several multilateral agreements protecting foreign investment already exist, although these are limited in their applicability to certain regions or sectors of the economy.[5]

This consensus about the desirability of liberalization is a very recent phenomenon. More than two-thirds of the 1300 BITs, for example, have been concluded since 1990.[6] By contrast, as little as two decades ago, there were scarcely twenty countries in the world committed to liberal investment principles.[7]

This article explores the events that have given rise to this sudden and astonishing consensus. It argues that the consensus is not necessarily permanent, but reflects the momentary confluence of several political and economic trends. It concludes that, if the consensus is to be maintained, then States must use this moment to ensure the success of liberalism, rather than to seize temporary economic advantage. In essence, if a liberal investment regime is to be effective,[8] then States must develop a sustainable liberalism.

Ocran, *Bilateral Investment Protection Treaties: A Comparative Study*, 8 N.Y. L. SCH. J. INT'L & COMP. L. 401 (1987); Robert K. Paterson, *Canadian Investment Promotion and Protection Treaties*, 29 CANADIAN Y.B. INT'L L. 373 (1991); Jeswald Salacuse, *BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries*, 24 INT'L L. 655 (1990); M. Sornarajah, *State Responsibility and Bilateral Investment Treaties*, 20 J. WORLD TRADE L. 79 (1986); Kenneth J. Vandevelde, *The Bilateral Investment Treaty Program of the United States*, 21 CORN. INT'L L.J. 201 (1988); Kenneth J. Vandevelde, *U.S. Bilateral Investment Treaties: The Second Wave*, 14 MICH. J. INT'L L. 621 (1993).

3. The UN Centre for Transnational Corporations counted 1306 BITs as of the end of 1996. For a listing of the treaties, see UNITED NATIONS CENTRE FOR TRANSNATIONAL CORPORATIONS (UNCTC), BILATERAL INVESTMENT TREATIES IN THE MID 1990S (forthcoming). The International Centre for Settlement of Investment Disputes separately compiled a list of more than 1100 treaties involving 155 countries through the end of 1996. *See* INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES (ICSID) INVESTMENT TREATIES (1997).

4. *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TOWARDS MULTILATERAL INVESTMENT RULES (1996).

5. *See, e.g.*, North American Free Trade Agreement, Dec. 17, 1992, Chapter Eleven, 32 I.L.M. 605, 639 (1993); The Energy Charter Treaty, Dec. 17, 1994, Part II, 34 I.L.M. 360, 385 (1995).

6. *See* UNCTC, *supra* note 3.

7. In the early 1970s, several resolutions intended to challenge liberal investment principles were introduced in the United Nations General Assembly. The most important of these resolutions was opposed by only six States and the most controversial provision of that resolution, one that was the very antithesis of a liberal international investment regime, was opposed by only sixteen States. *See infra* text accompanying notes 81–88.

8. The effectiveness of a liberal investment regime in particular is directly linked to its longevity. Liberalism requires protection for investment, which by its nature is long term, and requires deference to the market, which is self-correcting only over the long term. *See* JOHN

I. THE TRADITIONAL DIVISION

A. *Theories of Political Economy*

In the modern era, three different theories concerning the proper relationship between the State and the market[9] have competed for the allegiance of the international community. The emergence of the modern nation state in sixteenth and seventeenth century Europe was accompanied by the development of the theory of mercantilism, which held among its tenets that economic activity should serve the political policy of the State.[10] Mercantilism advocated extensive state regulation of economic activity in furtherance of the national interest.[11] Mercantilists equated national wealth with the quantity of gold held by the State and sought to restrict imports while increasing exports in order to increase the gold supply.[12] In the period of its ascendancy, the sixteenth through the eighteenth centuries, mercantilism dominated European political economy.[13]

To the extent that a State needed resources not available in its territory, mercantilism held that these resources should be acquired from colonial possessions. At the same time, colonial possessions would produce a market for the State's exports. Thus, mercantilism and colonialism were mutually reinforcing.[14]

Mercantilism was challenged in the eighteenth century by the liberal economic theory of Adam Smith and David Ricardo. Liberals argued that national wealth was best measured by the productivity of the people, not the amount of gold in the treasury, and that productivity was best achieved by an unregulated market.[15] Liberals thus opposed restrictions on

---

RAPLEY, UNDERSTANDING DEVELOPMENT: THEORY AND PRACTICE IN THE THIRD WORLD 8 (1996).

9. *See generally* GEORGE T. CRANE AND ABLA AMAWI, THE THEORETICAL EVOLUTION OF INTERNATIONAL POLITICAL ECONOMY (1997); ROBERT GILPIN, THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS (1987); TORBJÖRN L. KNUTSEN, A HISTORY OF INTERNATIONAL RELATIONS THEORY 237–39 (1992); INTERNATIONAL POLITICAL ECONOMY (C. Roe Goddard et al. eds., 1996) [hereinafter Goddard et al.]; INTERNATIONAL POLITICAL ECONOMY: PERSPECTIVES ON GLOBAL POWER AND WEALTH (Jeffry A. Frieden & David A. Lake eds., 3d ed. 1995) [hereinafter Frieden & Lake]; INTERNATIONAL RELATIONS THEORY (Paul R. Viotti & Mark V. Kauppi eds., 2d ed. 1993).

10. *See* CRANE & AMAWI, *supra* note 9, at 5; Frieden & Lake, *supra* note 9, at 69; GILPIN, *supra* note 9, at 31–32.

11. *See* DOMINICK SALVATORE, INTERNATIONAL ECONOMICS 27–28 (5th ed. 1995); CRANE & AMAWI, *supra* note 9, at 5.

12. *See* SALVATORE, *supra* note 11, at 26–28.

13. *See* David A. Lake, *British and American Hegemony Compared: Lessons for the Current Era of Decline, in* Frieden & Lake, *supra* note 9, at 121.

14. *See generally* RONDO CAMERON, A CONCISE ECONOMIC HISTORY OF THE WORLD 130–62 (3d ed. 1997); Lake, *supra* note 13, at 122.

15. *See* CRANE & AMAWI, *supra* note 9, at 6–7, 55–58; Jeffry A. Frieden & David A. Lake, *International Politics and International Economics, in* Goddard et al., *supra* note 9, at 25.

international trade. By the early nineteenth century, liberalism had been embraced by Great Britain, the dominant economic power in the world, triggering a general movement toward free trade throughout Europe in the mid-nineteenth century.[16]

Political economy in the seventeenth and eighteenth centuries was not greatly concerned with international investment. The difficulties of travel and communication over large distances deterred the establishment of foreign direct investment.[17] The principal exception involved the Dutch, who made direct investments in various commercial projects throughout Europe as early as the seventeenth century,[18] although such investments tended to be of relatively short duration.[19] More typically, transfrontier investment flows prior to the mid-nineteenth century took the form of lending by European investors to borrowers in other European states.[20]

Nineteenth century industrialization, however, both produced large capital surpluses that were available for investment and entailed the development of large manufacturing and transportation enterprises that required major capital investments.[21] The early nineteenth century also saw the beginning of the widespread use of the corporate form of business organization[22] and the emergence of securities markets.[23] These developments provided the economic and legal conditions for a substantial increase in foreign direct as well as portfolio investment.[24] British foreign investment, for example, grew from $500 million in 1825 to $12.1 billion in 1900.[25] French foreign investment grew from $100 million in 1825 to $5.2 billion in 1900.[26]

Most foreign investment throughout the nineteenth century was portfolio investment, and the largest share of this was investment made by English banks in Europe and North America. As late as 1914, 43 percent of all foreign investment was British investment. Europe and North

16. *See* Charles P. Kindleberger, *The Rise of Free Trade in Western Europe*, *in* Frieden & Lake, *supra* note 9, at 73–88; Stephen D, Krasner, *State Power and the Structure of International Trade*, *in* Frieden & Lake, *supra* note 9, at 25, 28, 30–31; CAMERON, *supra* note 14, at 296–98.

17. *See* CHARLES P. KINDLEBERGER, A FINANCIAL HISTORY OF WESTERN EUROPE 258 (2d ed. 1993).

18. *See id.* at 209.

19. *See id.* at 258.

20. *See id.* at 208–24.

21. *See* CAMERON, *supra* note 14, at 308.

22. *See id.* at 213–14.

23. *See id.* at 308.

24. Direct investment is distinguished from portfolio investment in that a direct investor seeks to control the investment, while the portfolio investor seeks only a return on capital.

25. *See* KINDLEBERGER, *supra* note 17, at 220.

26. *Id.*

America received 27 percent and 24 percent of all foreign investment, respectively.[27]

Coincident with this explosion in foreign investment came the emergence of Marxist economics, which placed much importance on the flow of international investment. Marxist theory contended that the accumulation of large quantities of capital in industrialized states would lead to an oversupply and thus reduce the return earned by investors.[28] In order to increase their returns, capitalists would invest in nonindustrialized states, where the relative scarcity of capital would ensure a greater return on investment.[29] The result would be the development of a capitalist economy in these developing states, a necessary step on the way to the eventual establishment of socialism.

Although early Marxism focused on the positive effects of transfrontier investment flows on developing states in bringing feudalism to an end and promoting economic development, later Marxist theorists had a different perspective.[30] More recent Marxist theorists have focused on the potential adverse effects of foreign investment on developing states, arguing that foreign investment locks developing states into a pattern of underdevelopment[31] and dependency.[32]

Marxist theory found practical application in the Soviet Union after 1917 and in China, Eastern Europe and other States after World War II. These States abolished private property and the market, and created planned economies in which all aspects of economic activity were regulated by the State.[33]

---

27. *See* CAMERON, *supra* note 14, at 311.

28. *See* GILPIN, *supra* note 9, at 36–37.

29. *See* CAMERON, *supra* note 14, at 321; Frieden & Lake, *supra* note 15, at 29-30; CRANE & AMAWI, *supra* note 9, at 10, 83–85.

30. *See, e.g.*, CRANE & AMAWI, *supra* note 9, at 85; GILPIN, *supra* note 9, at 38–40, 270–73 (discussing how the development of capitalism between 1870 and 1914 affected Lenin's view of Marxism); Rhys Jenkins, *Theoretical Perspectives on the Transnational Corporation, in* Goddard et al., *supra* note 9, at 439, 450–52.

31. *See* SUBRATA GHATAK, INTRODUCTION TO DEVELOPMENT ECONOMICS 65 (3d. ed. 1995); E. WAYNE NAFZIGER, THE ECONOMICS OF DEVELOPING COUNTRIES 106–07 (3d ed. 1997); MICHAEL P. TODARO, ECONOMIC DEVELOPMENT 81–82 (5th ed. 1994); Jenkins, *supra* note 30, at 448–50.

32. *See* NAFZIGER, *supra* note 31, at 106–08; RAPLEY, *supra* note 8, at 18–20. *See generally* Theotonio dos Santos, *The Structure of Dependence, in* Goddard et al., *supra* note 9, at 165; Immanuel Wallerstein, *Dependence in an Inter-Dependent World, in* Goddard et al., *supra* note 9, at 176. Earlier important statements of dependency theory included CELSO FURTADO, ECONOMIC DEVELOPMENT OF LATIN AMERICA: A SURVEY FROM COLONIAL TIMES TO THE CUBAN REVOLUTION (Suzette Macedo trans., Cambridge Univ. Press 1970), and ANDRE GINDER FRANK, LATIN AMERICAN: UNDER DEVELOPMENT OR REVOLUTION (1969).

33. *See* MICHAEL BARRATT BROWN, MODELS IN POLITICAL ECONOMY 193-267 (Penguin Books 2d ed. 1995); RAPLEY, *supra* note 8, at 44.

Liberalism also was challenged in the nineteenth century by the emergence of economic nationalism, a successor to mercantile theory. Economic nationalism stressed the primacy of *raison d'etat* and favored state regulation of the economy, including international trade, in the name of the national interest. Economic nationalism was compatible with the wave of nationalist fervor that swept through Europe in the latter half of the nineteenth century,[34] and in fact European trade policy became more protectionist after the 1870s.[35]

Protectionism peaked during the interwar period with successive rounds of retaliatory tariff increases and currency devaluations intended to curtail imports and to improve each State's economic position at the expenses of other States.[36] One consequence of these protectionist policies was to reduce world trade sharply, which in turn contracted demand, decreased production, raised unemployment and worsened the Great Depression of the 1930s.[37]

B. *Pre-War International Investment Policy*

The growth in foreign investment during the nineteenth century led inevitably to investment disputes. Because so much foreign investment in the nineteenth century was portfolio investment, many of the earliest investment disputes involved the repudiation of debts, particularly debts owed by developing states to European investors.[38] Economic nationalist states, who linked the protection of their citizens' property with the national interest, proved all too willing to use military force to collect unpaid private loans.[39] Consistent with its own nationalist policy, the United States announced the Roosevelt Corollary to the Monroe Doctrine, which reserved to the United States the exclusive prerogative to use military force to collect private debts in the Americas.[40] Thus, the most salient feature of international investment policy in the period just prior to World

---

34. *See* CAMERON, *supra* note 14, at 222; PETER B. KENEN, THE INTERNATIONAL ECONOMY 225 (3d ed. 1994).

35. *See* CAMERON, *supra* note 14, at 301–03; Stephen D. Krasner, *State Power and the Structure of International Trade*, *in* Frieden & Lake, *supra* note 9, at 28–32. There nevertheless were significant efforts at trade liberalization through bilateral agreements, particularly by France. *See* BERNARD HOEKMAN AND MICHAEL KOSTECKI, THE POLITICAL ECONOMY OF THE WORLD TRADING SYSTEM 2 (1995).

36. *See* CAMERON, *supra* note 14, at 351; HOEKMAN & KOSTECKI, *supra* note 35, at 2–3; KENEN, *supra* note 34, at 227.

37. *See* CAMERON, *supra* note 14, at 351–58.

38. *See* M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 7 (1994).

39. *See* Kenneth J. Vandevelde, *Reassessing the Hickenlooper Amendment*, 29 VA. J. INT'L L. 115, 119 (1988).

40. *See id.*

War I was the claim by economic nationalist capital exporting states of the right to use military force to protect foreign investment.[41]

A second category of investment disputes involved damage to or confiscation of foreign direct investment. The security of property in foreign territory had been a longstanding concern of governments. Until the development of large scale foreign direct investment in the mid-nineteenth century, however, the concern had focused principally on the protection of merchandise for trade and the security of property during time of war.[42] As foreign investment increased in quantity, the seizure of foreign investment became a more common phenomenon.[43] Capital exporting states demanded compensation for the loss of their investments and, in a number of cases where these demands were submitted to international arbitration or adjudication, won awards or judgments holding that host states have a duty to pay compensation for the expropriation of foreign property.[44]

In reaching these decisions, international tribunals were not writing on an entirely clean slate. Since the Middle Ages, there had been in international law a doctrine that a State had the right to exercise diplomatic protection of its aliens abroad, that is, to seek redress for injuries to its citizens caused by the action of foreign states.[45] Over time, this principle had been applied to protect foreign investment,[46] a development reflected in the international judicial and arbitral decisions.

At the same time the right of diplomatic protection was being applied to foreign investment, the principle itself was under attack. In the late nineteenth century, Carlos Calvo, an Argentine jurist, propounded the Calvo Doctrine, which asserted that foreign nationals were not entitled to treatment in the host state more favorable than that received by host state

41. *See* Edward M. Borchard, *Limitations on Coercive Protection*, 21 AM. J. INT'L L. 303 (1927); Luis M. Drago, *State Loans in Their Relation to International Policy*, 1 AM. J. INT'L L. 692 (1907).

42. *See* VANDEVELDE 1992, *supra* note 2, at 16.

43. Brownlie notes that, in the century after 1840, some sixty claims commissions were established to deal with disputes arising from injuries to the interests of aliens. IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 521 (4th ed. 1990).

44. *See* Case Concerning the Factory at Chorzów (Ger. v. Pol.), 1928 P.C.I.J. (ser. A) No. 13, at 63–64 (Sept. 13); Case Concerning Certain German Interests in Polish Upper Silesia (Ger. v. Pol.), 1926 P.C.I.J. (ser. A) No. 7, at 81–82 (May 25); Lena Goldfields, Ltd. (1930) (unpublished opinion), *discussed in* 36 CORNELL L.Q. 42 (1950); Shufeldt Claim (U.S. v. Guat.), 2 REP. INT'L ARB. AWARDS 1080 (1930); Norwegian Shipowners Claims (Nor. v. U.S.), 1 REP. INT'L ARB. AWARDS 308 (1922); Affaire des Navires *Cape Horn Pigeon, James Hamilton Lewis, C.H. White* et *Kate and Anna* (U.S. v. Russ.), 9 REP. INT'L ARB. AWARDS 51, 63–66 (1902).

45. *See* BROWNLIE, *supra* note 43, at 521.

46. *See* SORNARAJAH, *supra* note 38, at 8–9.

nationals.[47] The Calvo Doctrine had a substantive and a procedural dimension. The substantive dimension rejected the idea that special international law norms apply to the treatment of foreign nationals by a host state.[48] The procedural dimension rejected the right of home states to exercise diplomatic protection of their nationals abroad.[49]

The Calvo Doctrine was an expression of the economic nationalist theory that was of growing importance in international political economy in the late nineteenth century. Special protection for foreign nationals under international law was inconsistent with the prerogative of the host state to subordinate economic activity to the national interest. The Calvo Doctrine was quickly embraced throughout Latin America.[50] Despite its consistency with economic nationalism, the Calvo Doctrine won little support in Europe, however.[51] Rather, the European states continued to perceive their interests as best served by a doctrine that protected their nationals and property abroad.[52]

The disagreement between the capital exporting states and the Calvo states became explicit in the famous exchange of notes between U.S. Secretary of State Cordell Hull and the Mexican Foreign Minister in 1938 with respect to Mexico's nationalization of agrarian and oil property owned by U.S. nationals.[53] On the strength of the arbitral and judicial decisions concerning the right to compensation,[54] Secretary Hull asserted in his note that host states have a duty under international law to pay "prompt, adequate and effective" compensation for expropriated foreign investment.[55] Consistent with the Calvo Doctrine, the Mexican minister contended that Mexico was obligated to compensate foreign investors only to the extent required by its own law,[56] since giving preference to foreigners would violate the principle of equality.[57]

A second challenge to the principle of diplomatic protection of foreign investment came from the socialist states that rejected the concept of private property entirely. Following its seizure of power in 1917, the Bolshevik government in the Soviet Union took the position that an alien

47. *See* DONALD R. SHEA, THE CALVO CLAUSE: A PROBLEM OF INTER-AMERICAN AND INTERNATIONAL LAW AND DIPLOMACY 17–20 (1955).

48. *See id.*

49. *See id.*

50. *See id.* at 21.

51. *See id.* at 20.

52. *See* SORNARAJAH, *supra* note 38, at 9–10.

53. The exchange of notes may be found at GREEN H. HACKWORTH, U.S. DEP'T OF STATE, PUB. NO. 1708, 3 DIGEST OF INTERNATIONAL LAW 655–61 (1942).

54. *See* cases and arbitral decisions cited in *supra* note 44.

55. *See* HACKWORTH, *supra* note 53, at 658–59.

56. *See id.* at 658.

57. *See id.* at 659.

who acquires property in another state does so subject to the national laws of the host state and thus international law imposes no requirement of compensation on a host state for the expropriation of foreign investment.[58]

As this suggests, by the mid-twentieth century, there were three views concerning the protection of foreign investment against expropriation. The developed states, consistent with either a liberal investment policy or an economic nationalist policy favorable to them, argued that international law required the payment of prompt, adequate and effective compensation. The Calvo states, consistent with their own economic nationalist views, contended that international law required only national treatment. The socialist states, avowing Marxist theory, denied that international law protected foreign investment.

C. *Post-War Investment Policy*

The end of the Second World War brought four important changes that would affect the political economy of international investment. First, there emerged a consensus that much of the economic havoc of the inter-war period had been aggravated by economic nationalist policies in the arena of international trade.[59] As the war drew to a close, the victorious allies resolved to create a liberal international economic order that would prevent the recurrence of the protectionist wars that preceded the military conflict.[60] In 1947, twenty-three States concluded the General Agreement on Tariffs and Trade (GATT),[61] intended as a temporary measure to begin the process of building a liberal regime for international trade. A second, more elaborate treaty, the Havana Charter, was expected to create a liberal regime for both trade and investment, but never entered into force because the United States withdrew its support.[62] Thus, the GATT signalled the beginning of a liberal international economic regime, although it did not involve investment.

Second, the quantity of foreign direct investment exploded, with the United States continuing in the role it had assumed in the 1920s as the leading source of foreign direct investment.[63] Improved communication

58. *See* S. FRIEDMAN, EXPROPRIATION IN INTERNATIONAL LAW 19 (1953); ALAN C. SWAN & JOHN F. MURPHY, CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS 774 (1991).

59. *See generally* HOECKMAN & KOSTECKI, *supra* note 35, at 2–3.

60. *See* CAMERON, *supra* note 14, at 370–71.

61. General Agreement on Tariffs and Trade, Oct. 20, 1947, 61 Stat. 3689, 55 U.N.T.S. 188.

62. *See* HOEKMAN & KOSTECKI, *supra* note 35, at 12–13.

63. *See* DEAN M. HANINK, THE INTERNATIONAL ECONOMY: A GEOGRAPHICAL PERSPECTIVE 223–24 (1994). In the 1950s, two-thirds of foreign investment came from the United States. *See* BO SÖDERSTEN & GEOFFREY REED, INTERNATIONAL ECONOMICS 468 (3d ed. 1994).

and transportation made it possible to control foreign investment around the world and thus by the 1950s direct investment had emerged as the dominant form of international investment flow.[64] Particularly in the 1950s and 1960s, economic nationalist developing states sought foreign direct investment that would contribute to the development of industries to manufacture goods to displace imports, a strategy known as import substitution industrialization.[65] The importance of capital movements has continued to grow, with the result that by the mid-1990s the quantity of capital movements was quintuple the quantity of international trade.[66]

Third, as foreign direct investment increased in quantity with an attendant increase in risk to capital exporting states, an international investment regime began to emerge. Unlike the regime for international trade, however, the regime for international investment was constructed of a network of bilateral treaties. Two different factors may have influenced the emergence of international investment agreements in the post-war era. First, the United Nations Charter now prohibited the use of force to protect property abroad.[67] Thus, capital exporting states began to search for alternatives to gunboat diplomacy, principally economic sanctions and international legal process.[68] The United States was the most visible proponent of economic sanctions, enacting legislation such as the Hickenlooper Amendment that imposed economic sanctions on host states that expropriated U.S. property without payment of prompt, adequate and effective compensation.[69] Economic sanctions, however, were rarely applied and they largely failed.[70] Second, liberal economic theory assumes the protection of property through an autonomous legal system.[71] Thus, a liberal international investment regime necessarily would require a body of international investment law.

The United States took the lead in developing such a regime. Immediately following the war, the United States began to negotiate a series of Friendship, Commerce and Navigation (FCN) treaties, a major purpose of

64. *See* HANINK, *supra* note 63, at 224; SÖDERSTEN & REED, *supra* note 63, at 462.

65. *See* RAPELY, *supra* note 8, at 22–25.

66. *See* HANINK, *supra* note 63, at 140.

67. Article 2(4) prohibits the "threat or use of force against the territorial integrity or political independence of any state, or in any other manner inconsistent with the Purposes of the United Nations." U.N. CHARTER art. 2, para. 4. Article 51 creates an exception for measures taken in the exercise of the right of self-defense. *Id.* art. 51. *See generally* ANTHONY CLARK AREND & ROBERT J. BECK, INTERNATIONAL LAW AND THE USE OF FORCE: BEYOND THE U.N. CHARTER PARADIGM (1993).

68. *See* SORNARAJAH, *supra* note 38, at 55–56.

69. *See* Vandevelde, *supra* note 39, at 125–44.

70. *See id.* at 144–48, 156–60, 166–67.

71. *See generally* Tamar Frankel, Essay, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389 (1993); Paul H. Rubin, *Growing a Legal System in the Post-Communist Economies*, 27 CORNELL INT'L. L.J. 1 (1994).

which was to protect U.S. investment abroad.[72] As Europe recovered from the war and began to invest abroad, the European states similarly began to negotiate treaties to protect foreign investment. Germany negotiated the first bilateral investment treaty in 1959,[73] with several other European states following suit in the 1960s.[74]

Fourth, at the very moment when liberal economic theory, with its emphasis on the rule of law in international economic relations, was being embraced by the dominant world powers, there was a dramatic increase in the number of countries that questioned the basic premises of liberalism. The socialist countries, which soon after the war included the Soviet Union, China, and Central and Eastern Europe, rejected the concept of private property and the free market entirely and thus could not participate in a liberal economic regime.[75] The end of colonialism yielded a large number of newly independent states in Africa and Asia that were fiercely nationalistic,[76] skeptical of the liberal economic order being advocated by the former colonial powers of Europe, and resistant to being bound by an international legal regime that had been created without their involvement.[77] Many newly independent states were drawn to Marxist economics, with its emphasis on the role of foreign investment in promoting underdevelopment, and to economic nationalism, which seemed highly congenial to the task of nation building that lay before

72. For a discussion of the FCNs, see HENRY C. HAWKINS, COMMERCIAL TREATIES AND AGREEMENTS: PRINCIPLES AND PRACTICE (1951); ROBERT REUBERT WILSON, THE INTERNATIONAL LAW STANDARD IN TREATIES OF THE UNITED STATES (1953); ROBERT REUBERT WILSON, UNITED STATES COMMERCIAL TREATIES AND INTERNATIONAL LAW (1960); Herman Walker, Jr., *Modern Treaties of Friendship, Commerce and Navigation*, 42 MINN. L. REV. 805 (1958); Herman Walker, Jr., *Provisions on Companies in United States Commercial Treaties*, 50 AM. J. INT'L L. 373 (1956); Herman Walker, Jr., *Treaties for the Encouragement and Protection of Foreign Investment: Present United States Practice*, 5 AM. J. COMP. L. 229 (1956); Robert R. Wilson, *A Decade of New Commercial Treaties*, 50 AM. J. INT'L L. 927 (1956); Robert R. Wilson, *Postwar Commercial Treaties of the United States*, 43 AM. J. INT'L L. 262 (1949); Robert R. Wilson, *Property-Protection Provisions in United States Commercial Treaties*, 45 AM. J. INT'L L. 83 (1951).

73. The first BIT was that between Germany and Pakistan, which was signed November 25, 1959 and entered into force on April 28, 1962. The first BIT to enter into force was that between Germany and the Dominican Republic, signed December 16, 1959 and entered into force June 3, 1960. *See* DOLZER & STEVENS, *supra* note 2, at 267 (chronological list of BITs).

74. Among the European states that signed their first BIT in the 1960s are Switzerland (1961), the Netherlands (1963), the Belgium-Luxembourg Economic Union (1964), Italy (1964), Sweden (1965), Norway (1966) and Denmark (1968). *See id.* at 267–69.

75. *See* RAPLY, *supra* note 8, at 44–45.

76. *See* SORNARAJAH, *supra* note 38, at 12.

77. *See* MALCOLM N. SHAW, INTERNATIONAL LAW 36–39 (3d ed. 1991); R.P. Anand, ATTITUDE OF THE AFRO-ASIAN STATES TOWARDS CERTAIN PROBLEMS OF INTERNATIONAL LAW, 15 INT'L & COMP. L.Q. 55 (1966).

them.[78] Because both Marxist economics and economic nationalism supported extensive state regulation of economic activity and a redistribution of wealth from developed to developing states, the two theories were often indistinguishable in practice.[79] Some states adopted policies that blended the two, as in the case of African socialism.[80]

By the late 1960s, the group of developed states, the so-called first world, which sought to create a liberal international economic regime, constituted only a small minority of states.[81] The socialist states of the second world and the developing states of the third world became increasingly vocal in calling for a restructuring of the international economic order along Marxist or nationalist lines in order to promote their political influence and their economic development. The opposition to a liberal international investment regime was particularly evident in the United Nations General Assembly, where the developed states were at their greatest numerical disadvantage. On May 1, 1974, the General Assembly adopted without vote Resolution 3201, containing a Declaration on the Establishment of a New International Economic Order (NIEO).[82] The Declaration stated that the international economic order should be founded on principles that included "[f]ull permanent sovereignty of every state over its natural resources and all economic activities."[83] Such sovereignty included "the right to nationalization or transfer of ownership to its nationals."[84] The Declaration did not specify whether compensation must be paid or the amount of any such compensation.

The issue of compensation was addressed by the General Assembly a few months later, on December 12, 1974, when it adopted the Charter of Economic Rights and Duties of States by a vote of 120–6, with ten abstentions.[85] Article 2.2(c), which was adopted separately by a vote of

---

78. Political independence and economic development were national priorities of the newly independent states. *See* RAPLEY, *supra* note 8, at 12.

79. *See* CRANE & AMAWI, *supra* note 9, at 21; GILPIN, *supra* note 9, at 282–88.

80. *See* BROWN, *supra* note 33, at 269–85; RAPLEY, *supra* note 8, at 31–32.

81. *See* THOMAS R. VAN DERVORT, INTERNATIONAL LAW AND ORGANIZATION: AN INTRODUCTION 52–55 (1998).

82. *Declaration on the Establishment of a New International Economic Order*, G.A. Res. 3201(S-VI), U.N. GAOR, 6th Special Sess., 229th mtg., Agenda Item 7, U.N. Doc. A/RES/3201(S-VI) (1974), *reprinted in* 13 I.L.M. 715 (1974).

83. *Id.* para. 4(e).

84. *Id.*

85. *Charter of Economic Rights and Duties of States*, G.A. Res. 3281 (XXIX), U.N. GAOR, 29th Sess., 2315th mtg., Agenda Item 48, U.N. Doc. A/RES/3281(XXIX) (1975) [hereinafter Resolution 3281], *reprinted in* 14 I.L.M. 251 (1975). The six states that voted in opposition were Belgium, Denmark, Federal Republic of Germany, Luxembourg, the United Kingdom and the United States. The ten states that abstained were Austria, Canada, France, Ireland, Israel, Italy, Japan, the Netherlands, Norway and Spain. *See id.* at 265.

104–16, with six abstentions,[86] stated that each state has the right "[t]o 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."[87] The Charter thus stated not that compensation must be paid, but only that it *should* be paid, and that the relevant standard for compensation should be based on the national law of the host state, not international law.[88]

The attack on liberal economic principles was not merely rhetorical. Although some developing states had sought to attract foreign investment in the first decades of the post war period,[89] by the 1970s, many developing states were more skeptical about the value of foreign investment and, in the name of Marxism or nationalism or both, expropriated major foreign investments in their territories.[90]

At the end of the 1970s, the world remained sharply divided in its view of international investment policy, particularly the issue of compensation for expropriation.[91] The developed states asserted that expropriation required payment of prompt, adequate and effective compensation. The socialist states contended that no compensation was required, although they frequently did agree to pay compensation in settlement of claims by expropriated foreign investors.[92] The developing states also rejected the prompt, adequate and effective standard, generally taking the position that the calculation of compensation should depend upon a variety of factors,

86. The sixteen negative votes were cast by Austria, Belgium, Canada, Denmark, Federal Republic of Germany, France, Ireland, Italy, Luxembourg, Japan, the Netherlands, Norway, Spain, Sweden, the United Kingdom and the United States. The six abstentions were by Australia, Barbados, Finland, Israel, New Zealand and Portugal. *See id.* at 264.

87. Resolution 3281, *supra* note 85, art. 2, para. 2(c), *reprinted in* 14 I.L.M. at 255.

88. *See generally* Charles N. Brower & John B. Tepe, Jr., *The Charter of Economic Rights and Duties of States: A Reflection or Rejection of International Law?* 9 INT'L LAW. 295 (1975); Burns H. Weston, *The Charter of Economic Rights and Duties of States and the Deprivation of Foreign Owned Wealth,* 75 AM. J. INT'L L. 437 (1981).

89. *See supra* text accompanying note 65.

90. *See* VANDEVELDE 1992, *supra* note 2, at 20. *See also* David A. Gantz, *The Maricona Settlement: New Forms of Negotiation and Compensation for Nationalized Property,* 71 AM. J. INT'L. L. 474 n.2 (1977); William Rogers, *Of Missionaries, Fanatics and Lawyers: Same Thoughts on Investment Disputes in the Americas,* 72 AM. J. INT'L. L. 1 (1978); United Nations Centre on Transnational Corporations (UNCTC), Work on the Formation of the United Nations Code of Conduct on Transnational Corporations, U.N. Doc. E/C.10/1985/S/2, *reprinted in* LOUIS HENKIN ET AL., INTERNATIONAL LAW: CASES AND MATERIALS 686 (3d ed. 1993).

91. *See* UNCTC, *supra* note 90, at 684–86.

92. *See id.* at 685–86. On lump sum agreements, see RICHARD B. LILLICH & BURNS H. WESTON, INTERNATIONAL CLAIMS: THEIR SETTLEMENT BY LUMP SUM AGREEMENT (1975); Richard B. Lillich & Burns H Weston, *Lump Sum Agreements: Their Continuing Contribution to the Law of International Claims,* 82 AM. J. INT'L L. 69 (1988).

such as the return that the investor already had received prior to the expropriation and the content of local law on the subject.[93]

With the amount of foreign direct investment in developing states continuing to grow and the support for the prompt, adequate and effective standard as an element of customary international law continuing to erode,[94] the developed states placed increased emphasis on securing protection for their investment abroad through the negotiation of bilateral investment treaties. Several developed states had begun negotiating BITs in the 1960s,[95] and the practice became more widespread in the 1970s,[96] as developed states sought ways to counter an increasingly hostile international investment climate.[97]

II. THE EMERGENCE OF CONSENSUS

No single event accounts for the sudden reversal in investment policy and the emergence of the contemporary consensus. Ironically, the apparent demise of economic nationalism with respect to capital movements in the 1990s may have resulted from the very ascendancy of nationalism in the 1970s, in much the same way that economic nationalism in international trade was discredited after the Second World War by the effects of economic nationalist competition prior to the war. In 1973, the year before the General Assembly reaffirmed the right of permanent sovereignty over natural resources in the NIEO Declaration, the members of the Organization of Petroleum Exporting Countries (OPEC) exercised their sovereignty over their natural resources by quadrupling the price of oil on the world market.[98]

One consequence was that many developing states suddenly were forced to borrow money to purchase oil and other imports.[99] Another

93. This was essentially the position taken in Article 2, Paragraph 2(c) of the Charter of Economic Rights and Duties of States. Resolution 3281, *supra* note 85, art. 2, para. 2(c). *See also* UNCTC, *supra* note 90, at 684–86.

94. *See supra* text accompanying notes 47–58, 74–90.

95. *See supra* note 74.

96. Developed states that signed their first BIT in the 1970s include France (1972), the United Kingdom (1975), Austria (1976), and Japan (1977). *See* ICSID, *supra* note 3, at 3–6. The United States started its BIT program in 1977, but did not sign its first one until 1982. *See* VANDEVELDE 1992, *supra* note 2, at 29, 35.

97. The United States in particular saw BIT negotiations as a means of responding to the attack on the principle of compensation for expropriation. *See* VANDEVELDE 1992, *supra* note 2, at 20–22.

98. *See* NAFZIGER, *supra* note 31, at 464. The proponents of the NIEO Declaration specifically applauded OPEC's action. *See* Ibrahim F.I. Shihata, *Arab Oil Policies and the New International Economic Order*, 16 VA. J. INT'L. L. 261, 271–75 (1976).

99. *See* TODARO, *supra* note 31, at 459–62.

consequence was that the OPEC states rapidly acquired from the sale of oil very large quantities of dollars that they deposited in banks around the world.[100] The banks were only too willing to lend these dollars to developing states,[101] with the result that in the early 1970s many developing states began to accumulate substantial external debts. For example, the external debt of all developing states grew from $68.4 billion in 1970 to $635.8 billion in 1980, an almost tenfold increase in just ten years.[102] Meanwhile, the Islamic Revolution in Iran in 1979 triggered a second oil shock that doubled energy prices, setting off the most severe worldwide recession in five decades.[103] The recession in turn reduced demand for developing state exports, thereby curtailing the ability of these states to earn foreign currency to service the debt incurred during the 1970s.[104]

A second crucial factor in creating the current consensus was the economic policy of the Reagan administration, which combined deficit spending with a restrictive monetary policy.[105] The resulting surge in the United States budget deficit converted the United States from the world's largest creditor in the early 1980s to the world's largest debtor by the mid-1980s.[106] The United States financed its budget deficits by selling bonds to foreign investors. The United States thus was competing with developing states for debt financing, with the result that developing states increasingly found themselves unable to borrow additional funds from private lenders to refinance their debts.[107] The restrictive monetary policy and competition for capital pushed up interest rates and thereby heightened the burden of the accumulated debt on developing states.[108] U.S. budget deficits also impaired the economic recovery in Europe,[109] which defeated the efforts of developing states to bolster their exports to developed states

100. The OPEC surplus increased nearly tenfold in a single year, from $7 billion in 1973 to $68 billion in 1974 and reached $115 billion in 1980. *See id.*

101. The amount of petrodollars lent to the third world between 1976 and 1982 totalled more than $350 billion. *See id.*

102. *See id.* at 460.

103. *See* GHATAK, *supra* note 31, at 435.

104. *See* RAPLEY, *supra* note 8, at 37–38; Jahangier Amuzegar, *Dealing with Debt*, 68 FOREIGN POL'Y 140, 141–42 (1987); Samuel Britain, *A Very Painful World Adjustment*, 61 FOREIGN AFF. 541, 541–48 (1982); Pedro-Pablo Kuczynski, *Latin American Debt*, 61 FOREIGN AFF. 344, 350–51 (1982).

105. *See* Jeffrey E. Garten, *Gunboat Economics*, 63 FOREIGN AFF. 538, 545 (1984).

106. The United States went from being the world's largest creditor in 1982 to its largest debtor by 1985. *See* STEVEN HUSTED & MICHAEL MELVIN, INTERNATIONAL ECONOMICS 314 (3d ed. 1995). *See generally* Lester C. Thurow & Laura D'Andrea Tyson, *The Economic Black Hole*, 67 FOREIGN POL'Y 3 (1987).

107. *See* Garten, *supra* note 105, at 546.

108. *See* GHATAK, *supra* note 31, at 435.

109. *See* Martin Feldstein, *American Economic Policy and the World Economy*, 63 FOREIGN AFF. 995 (1985).

and earn foreign currency to pay off their external debt. Capital shortages in developing states were exacerbated by massive capital flight,[110] as the deteriorating economic situation in developing states prompted wealthy nationals to invest their money abroad.[111]

These events converged in the early 1980s to trigger the third world debt crisis. The crisis began in August 1982 when Mexico announced that it could not make its payments on its $80 billion debt.[112] Banks that had lent extensively to developing states suddenly were threatened with collapse.[113] Ultimately, the collapse was averted by a combination of refinancing with funds borrowed from the World Bank and the International Monetary Fund and debt forgiveness under the Brady Plan in 1989 and the early 1990s.[114] One result, however, was that commercial banks thereafter were far less willing to lend money to developing states.[115]

Under other circumstances, developing states might have replaced commercial loans with loans from multilateral development agencies, such as the World Bank. The early 1980s, however, coincided with a reduction in lending by international financial institutions, largely at the behest of the Reagan administration.[116] In 1984, for example, the United States insisted on a 40 percent reduction in lending by the International Development Agency, the World Bank entity that lends to the poorest nations.[117] Between 1980 and 1987, United States contributions to multilateral development banks dropped from $2.3 billion annually to $1.1 billion.[118]

Further, such loans as were available through the World Bank and other public lenders were conditioned on the adoption by the loan recipi-

---

110. For example, it is estimated that capital flight accounted for all but $12 billion of Mexico's $96 billion foreign debt in 1985. *See* TODARO, *supra* note 31, 463–64.

111. Currencies in developing states became overvalued (partially as a result of falling exports). This in turn gave rise to fears that the currency would be devalued in the future, leading to efforts to invest funds in more stable currencies abroad. *See* HUSTED & MELVIN, *supra* note 106, at 407.

112. *See* Britain, *supra* note 104, at 548.

113. *See id.*

114. The Brady Plan, named for U.S. Secretary of the Treasury Nicholas F. Brady, called for reducing developing states' debt to commercial banks by 20 percent, combined with increased lending from the World Bank and International Monetary Fund. *See* GHATAK, *supra* note 31, at 443–49; SALVATORE, *supra* note 11, at 355.

115. For example, U.S. banks reduced their loans to oil importing developing states from $121 billion in 1982, when the debt crisis began, to $100 billion in 1986. *See* NAFZIGER, *supra* note 31, at 470. *See also* Amuzegar, supra note 104, at 142.

116. *See* Garten, *supra* note 105, at 552–54.

117. *See id.* at 553. The 40 percent reduction figure is adjusted for inflation.

118. *See* John W. Sewell & Christine E. Contee, *Foreign Aid and Gramm-Rudman*, 65 FOREIGN AFF. 1015, 1022 (1987). It should be noted that total U.S. foreign assistance actually increased during this period, but only because of the sharp increase in military assistance, which more than offset the decrease in economic development assistance. *See id.*

ents of strict macroeconomic structural adjustment policies that required painful reductions of budget deficits and currency devaluations.[119] Developing states that in the past might have equated foreign direct investment with external control of their economy or neocolonialism[120] found that foreign lending institutions could exercise far more control over their economies than foreign direct investors.[121]

These reductions in lending combined with capital flight sharply diminished the capital available to developing states to finance economic development.[122] Unable to borrow sufficient funds and with their domestic savings fleeing abroad, developing states found foreign direct investment one of the few remaining sources of capital available.

The wisdom of turning to private direct investment to fuel economic development seemed to be confirmed by yet another independent set of events: the performance of several East Asian economies, specifically Japan, the "Four Tigers" (Hong Kong, Republic of Korea, Singapore and Taiwan) and three newly industrializing economies in Southeast Asia (Indonesia, Malaysia and Thailand).[123] During the period from 1965 to 1990, these eight Asian economies grew at a rate that was three times the rate in Latin America and twenty-five times the rate in sub-Saharan Africa.[124] These eight economies were characterized by a number of common features, prominently among them high rates of private investment and an emphasis on production for export.[125] The so-called East Asian miracle amply demonstrated the role that private investment could have in fueling rapid economic growth and seemed to indicate the benefits of export led growth relative to import substitution industrialization.[126]

---

119. *See* NAFZIGER, *supra* note 31, at 562–74. *See also* Jahangir Amuzegar, *The IMF Under Fire*, 64 FOREIGN POL'Y 98 (1986).

120. On the critique of foreign investment as a form of neocolonialism, see GHATAK, *supra* note 31, at 65; NAFZIGER, *supra* note 31, at 106–07; RAPLEY, *supra* note 8, at 18–20; SORNARAJAH, *supra* note 38, at 43–45; TODARO, *supra* note 31, at 81–82; Viotti & Kauppi, *supra* note 9, at 455–58; Jenkins, *supra* note 30, at 440–50.

121. *See* UNITED NATIONS TRANSNATIONAL COMPARATIONE AND MANAGEMENT DIVISION, FORMULATION AND IMPLEMENTATION OF FOREIGN INVESTMENT POLICIES 15 (1992).

122. Thus, the net inflow of private capital into developing countries in the 1980s was only about 60 percent of what it had been in the late 1970s. *See* Eduardo Fernandez-Arias & Peter J. Montiel, *The Surge in Capital Inflows to Developing Countries: An Analytical Overview*, 10 WORLD BANK ECON. REV. 51, 51 (1996).

123. *See* Alex E. Fernández Jilberto & André Mommen, *Setting the Neoliberal Development Agenda*, *in* LIBERALIZATION IN THE DEVELOPING WORLD 1, 3–4 (Alex E. Fernández Jilberto & André Mommen eds., 1996) [hereinafter Jilberto & Mommen].

124. *See* WORLD BANK, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY 2 (1993).

125. *See id.* at 40–42; Jilberto & Mommen, *supra* note 123, at 15.

126. *See* Jilberto & Mommen, *supra* note 123, at 14; WORLD BANK, *supra* note 124, at 22–23, 37–38, 40–43.

The final step in the emergence of the contemporary consensus was the collapse of the Soviet bloc at the beginning of the current decade. Socialism with its planned economy had been the principal ideological alternative to free market capitalism during the post-war era.[127] The decision by virtually the entire socialist world to abandon planned economies in favor of free markets delegitimated central planning and left free market capitalism as seemingly the only effective model for economic growth.[128]

The combined effect of these events was the emergence of a consensus in the developing world about the desirability of attracting foreign investment through free market policies.[129] Developing states also realized that attracting foreign investment would require them to compete for it.[130] Even where developing states remained skeptical of the free market, the structural adjustment policies required of them by international financial institutions left many of them with no alternative but to liberalize their economies.[131]

III. SUSTAINING THE LIBERAL CONSENSUS

As the foregoing suggests, the phenomenal shift toward liberalization was largely driven by a perception that private investment would promote economic development. Few if any developing states have embraced liberalization as an end in itself. They are adherents to the liberal faith only to the extent that the practice of their faith leads to economic salvation.

Economic development, of course, involves at least two elements: increased productivity and an equitable distribution of wealth.[132] Unless liberalization delivers on both counts, then skepticism and ultimately apostasy may not be far behind. Sustainable liberalism thus requires that a liberal investment regime provide some measure of both growth and equality.

---

127. *See* NAFZIGER, *supra* note 31, at 540–49; RAPLEY, *supra* note 8, at 70.

128. *See* RAPLEY, *supra* note 8, at 70; Mark Kramer, *Eastern Europe Goes to Market*, 86 FOREIGN POL'Y 134 (1992).

129. *See* RICHARD CAVES, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS 249(2d ed. 1996); HANINK, *supra* note 63, at 234; Jilberto & Mommen, *supra* note 123, at 19–20.

130. A 1985 study found intense competition among developing states to attract foreign investment, with some states offering as many as thirty different incentives to attract a particular investment. *See* CAVES, *supra* note 129, at 220.

131. *See* Jilberto & Mommen, *supra* note 123, at 5–8, 24.

132. *See* GHATAK, *supra* note 31, at 34, 242–43; TODARO, *supra* note 31, at 132.

A. *Maximizing Productivity*

Liberal economic theory is based on the premise that free markets will yield maximum productivity.[133] The underlying assumption, however, is that markets are properly functioning. Unfortunately, developing states are often characterized by extensive market failures.[134]

First, a developing state may lack the political and legal framework necessary for the operation of the market.[135] Portions of the economy may be nonmonetized, meaning that the price mechanism that is crucial to a market allocation of resources will not even exist.[136] Poor communication may prevent potential investors from obtaining the information needed to enter the market.[137] Small markets such as those found in many developing states may be especially susceptible to restrictive business practices or monopoly concentration.[138] The State may not have the resources to provide public goods, such as physical infrastructure,[139] that the market will not produce adequately.

If the market is to function properly, it may be necessary for the State to intervene to correct potentially serious market failures. Sustainable liberalism, then, first and foremost involves careful attention to market failures.

---

133. Classical international trade theory holds that a State can maximize its productivity by producing those goods in which it enjoys a comparative advantage and then trading with other states to obtain goods in which those other states have a comparative advantage. A State enjoys a comparative advantage in a good if the opportunity cost of producing that good is lower than in another state. *See* SÖDERSTEN & REED, *supra* note 63, at 5–6. The theory of comparative advantage is the cornerstone of international economics. *See generally id.* at 3–71; KENEN, *supra* note 34, at 46–85.

134. *See* TODARO, *supra* note 31, at 87, 588–91. The discussion in the text is not exhaustive. It is meant only to illustrate the range of potential problems that developing states face in creating properly functioning markets.

135. This includes clearly established property and contract rights, as well as courts to enforce these rights. *See id.* at 587.

136. Some areas of many developing countries still use a barter economy. *See* GHATAK, *supra* note 31, at 33.

137. *See* TODARO, *supra* note 31, at 588–89.

138. *See* UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD) & WORLD BANK, LIBERALIZING INTERNATIONAL TRANSACTIONS IN SERVICES: A HANDBOOK 47 (1994).

139. A public good is a benefit enjoyed by all persons simultaneously and the enjoyment of which by one person is not diminished by that of another. Public goods represent a form of market failure, since the general tendency is to refuse to contribute to production of the good in the hope that one can take advantage of production by others. The result is that the market will not provide an adequate quantity of the good. On the importance of infrastructure to development, see HANINK, *supra* note 63, at 84; Jilberto & Mommen, *supra* note 123, at 11; TODARO, *supra* note 31, at 589. On the importance of infrastructure to attracting foreign investment, see UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT: A SURVEY OF THE EVIDENCE 24 (1992).

The State, however, may lack the will necessary to facilitate the proper functioning of the market. For example, politically motivated state actors may pursue the goal of redistributing wealth, rather than facilitating the operation of the market.[140] Even where a political commitment to liberalism exists, the public authorities may lack the information, skill or resources needed to address deficiencies in the market.[141]

If developed states wish to sustain the liberal consensus, they should be prepared to assist developing states in creating the conditions necessary for a properly functioning market. This may entail, for example, technical assistance with respect to the development of legal institutions, economic assistance in building physical infrastructure and providing other public goods, and assistance in kind with respect to the creation of an information network. An international community that wishes to sustain the liberal consensus may have little alternative but to ensure the existence of the economic, legal and physical conditions necessary for the success of a market based economy.

B. *Producing an Appropriate Distribution*

An even more vexing problem is the appropriate distribution of wealth. The lesson of history is that prior attempts at liberalization often have been undermined by popular resentment over the distributional consequences of that liberalization.[142] Sustainable liberalism thus requires that a liberal investment regime produce a politically acceptable distribution of wealth.

Liberal economics has relatively little to say on this issue: it is addressed principally to maximizing productivity rather than prescribing the appropriate distribution of wealth.[143] As it happens, the empirical evidence shows that increased productivity in developing states in many cases has been associated with a more equal distribution of wealth.[144] Thus, a liberal

---

140. *See* RICHARD GRABOWSKI & MICHAEL P. SHIELDS, DEVELOPMENT ECONOMICS 267, 273–76 (1996).

141. The Chicago school of economics in particular has developed a critique of government intervention to cure market failures. *See* Warren J. Samuels, *The Chicago School of Political Economy: A Constructive Critique*, *in* THE CHICAGO SCHOOL OF POLITICAL ECONOMY 13 (Warren J. Samuels ed., 1993).

142. *See* Amy L. Chua, *The Privatization—Nationalization Cycle: The Link Between Markets and Ethnicity in Developing Countries*, 95 COLUM. L. REV. 223 (1995). *See generally* JACOB VINER, *The Intellectual History of Laissez Faire*, *in* ESSAYS ON THE INTELLECTUAL HISTORY OF ECONOMICS 200, 222–25 (Douglas A. Irwin ed., 1991).

143. *See* RAPLEY, *supra* note 8, at 8; VINER, *supra* note 142, at 223–24.

144. The Kuznets curve hypothesizes that economic growth in developing states tends initially to aggravate inequality, but in later stages will diminish it. There are, however, a number of examples, including Taiwan, South Korea, China, Costa Rica, Sri Lanka, and Hong Kong, where rising income levels initially reduced inequality. *See* TODARO, *supra* note 31, at 154–55.

investment regime that is successful in improving productivity may do much to ensure its long term sustainability by enhancing equality as well.

C. *The Inevitability of State Redistribution*

At the same time, it would be naive in the extreme to expect developing states to adopt a pure liberal model. First, even those developed states that most fervently espouse liberalism fall prey to political interest groups that insist upon illiberal state interventions for the benefit of the interest groups.[145] It is unrealistic to expect developing states, where corruption and clientism may be even greater problems than in developed states,[146] to escape similar pressures. Second, pressure to intervene will be especially great if liberalization does not yield a politically acceptable distribution of wealth.[147] Third, the East Asian states that have inspired the third world with the possibility of economic development fueled by private investment often utilized market regulation as part of their development strategies,[148] a fact that is certain to be noted by developing states seeking to emulate the East Asian success. Fourth, the extensive state activity needed in some developing states to facilitate the operation of the market will itself have distributional consequences that cannot be ignored. State efforts to build physical infrastructure, for example, will

---

Indeed, East Asia generally has seen economic growth correlated with reductions in inequality. *See* WORLD BANK, *supra* note 124, at 2–5, 29–32; Jilberto & Mommen, *supra* note 123, at 14; Batara Simatupang, *Economic Transformation and Liberalization in Indonesia*, *in* Jilberto & Mommen, *supra* note 123, at 51, 68–69. The evidence nevertheless remains mixed, with some countries in fact experiencing the initial increase in inequality predicted by the Kuznets curve. *See* TODARO, *supra* note 31, at 156–57. *See also* Alex E. Fernández Jilberto & Barbara Hogenboom, *Mexico's Integration in NAFTA: Neoliberal Restructuring and Changing Political Alliances*, *in* Jilberto & Mommen, *supra* note 123, at 138, 152; Carlos F. Toranzo Roca, *Bolivia: Crisis, Structural Adjustment and Democracy*, *in* Jilberto & Mommen, *supra* note 123, at 161, 175. On balance, however, it appears that there is a positive correlation between the rate of growth and the share of the bottom 40 percent. *See* GHATAK, *supra* note 31, at 248. It is likely to be the case, of course, that growth will benefit some sectors of the poor more than others. *See id.* at 249–50.

145. *See, e.g.*, Jose E. Alvarez, *Political Protectionism and United States International Investment Obligations in Conflict: The Hazards of Exon-Florio*, 30 VA. J. INT'L. L. 1 (1989).

146. *See* RAPLEY, *supra* note 8, at 43–44, 136–39; Ana Maria Fernandes, *Neoliberalism and Economic Uncertainty in Brazil*, *in* Jilberto and Mommen, *supra* note 123, at 96, 118; Jilberto & Mommen, *supra* note 123, at 5, 25; Piet Konings, *The Post-Colonial State and Economic and Political Reforms in Cameroon*, *in* Jilberto & Mommen, *supra* note 123, at 244, 245–49; André Mommen, *Zaire's Economic Decline and Ill-Fated Liberalization Policies*, *in* Jilberto & Mommen, *supra* note 123, at 285, 298–300.

147. *See supra* text accompanying note 142.

148. *See* WORLD BANK, *supra* note 124, at 353–60; Stephen Haggard & Chung-in Moon, *The South Korean State in the International Economy: Liberal, Dependent or Mercantile?*, *in* Frieden & Lake, *supra* note 9, at 47–60; Jilberto & Mommen, *supra* note 123, at 24; André Mommen, *The Asian Miracle: A Critical Reassessment*, *in* Jilberto & Mommen, *supra* note 123, at 28, 42–47.

benefit some regions more than others,[149] some sectors of the economy more than others[150] and perhaps some racial or ethnic groups more than others.[151] Once the State is implicated in these redistributive activities, even if they are intended only to promote efficiency, it will be difficult to resist demands that the State engage in more overtly redistributive activities to benefit other regions, other sectors or other groups.

Each state intervention, however, with the exception of those that are effective in curing market failures, potentially corrodes the efficiency promised by liberalism.[152] The danger is that overregulation will stifle productivity and destroy the effectiveness and the credibility of an ostensibly liberal but overregulated economy.

Developing a sustainable liberalism thus requires efforts to steer state intervention in directions that will cause minimal distortion in the operation of the market. For example, states should avoid prohibitions on foreign investment that merely protect inefficient domestic enterprises. They should rely instead on subsidies or incentives if it is politically necessary to assist local producers, since such an approach still permits competition, albeit at a price disadvantage.[153] It also may be preferable to direct subsidies or incentives toward industries that will produce for export, thereby expanding trade, rather than those that produce import substitutes, which diminish trade and sacrifice economies of scale and specialization.[154] And because subsidies and incentives may encourage inefficient behavior, redistribution of income may be better achieved through a progressive tax system.[155] The tax system, in turn, should be calibrated so as not to discourage economic activity or undermine capital formation through domestic saving.[156]

Further, state intervention intended to create the conditions for an effective market, such as the construction of physical infrastructure, a communications network and public schools,[157] should be designed to en-

149. *See* Jilberto & Hogenboom, *supra* note 144, at 155.

150. *See id.* at 150–51.

151. *See* Chua, *supra* note 142.

152. *See* WORLD BANK, *supra* note 124, at 11.

153. *See* UNCTAD & WORLD BANK, *supra* note 138, at 54–58. Further, unlike prohibitions on entry, subsidies makes the cost of assistance explicit.

154. *See* WORLD BANK, *supra* note 124, at 358–60.

155. *See* GHATAK, *supra* note 31, at 250–52; WORLD BANK, *supra* note 124, at 231.

156. *See* GHATAK, *supra* note 31, at 143.

157. In East Asia, for example, state investment in education was concentrated in primary and secondary education, thus reaching a broad share of the population and reducing inequality. *See* WORLD BANK, *supra* note 124, at 15–16, 160, 203.

sure that the benefits are widely shared and do not exacerbate already existing inequalities.[158]

D. *The Role of International Law*

Although the BIT network is the principal legal manifestation of the emerging liberal consensus,[159] BITs as currently formulated can play only a modest role in the creation of a sustainable liberalism. BITs create a set of legal rules for the protection of foreign investment that is essential to the development of a liberal investment regime. Further, because the BITs typically remain in force for a minimum period of ten years and then continue indefinitely unless terminated by a party, they confer a limited stability on those rules.[160] BITs, however, do virtually nothing to address market failures.[161]

BITs could be modified to make a greater contribution to the sustainability of a liberal investment regime. First, they could assist in creating the conditions for a properly functioning market. For example, they could impose on host states obligations to protect investment more fully against private infringement by requiring such states to provide certain minimum

---

158. *See* GHATAK, *supra* note 31, at 249–50. Development strategies in the past because of their emphasis on industrialization too often have concentrated wealth creation in one or two urban areas, neglecting rural development almost entirely. *See* TODARO, *supra* note 31, at 287.

159. *See* Vandevelde, *supra* note 1.

160. For example, the BIT between Moldova and the United States provides, in Article XII, Paragraph 1, that the treaty "shall remain in force for a period of ten years and shall continue in force unless terminated in accordance with paragraph 2 of this Article." Treaty Between the United States of America and the Republic of Moldova Concerning the Encouragement and Reciprocal Protection of Investment, art. XII, para. 1, *reprinted in* Investment Treaty with the Republic of Moldova, Treaty Doc. 103-14, 103d Cong. 1st Sess., at 25 (1993). Article XII, Paragraph 3 goes on to provide that "[w]ith respect to investments made or acquired prior to the date of termination of this Treaty and to which this Treaty otherwise applies, the provisions of all of the other Articles of this Treaty shall thereafter continue to be effective for a further period of ten years from such date of termination." *Id.* art. XII, para. 3, at 26.

161. A few BITs have transparency provisions, i.e. provisions intended to facilitate the flow of information to investors about the investment climate in the host state. The most common provision requires each party to make public its laws concerning investment. For example, the Moldova-United States BIT provides in Article II, Paragraph 8, that "[e]ach Party shall make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments. *Id.* art. II, para. 8, at 10.

Another type of provision requires the host state to provide information directly to investors. For example, the BIT between the United States and the Ukraine was accompanied by an exchange of letters in which the Ukraine agreed to designate an office to serve as "the coordinator and problem solver for investors experiencing difficulties with registration, licensing, access to utilities, regulatory and other matters." Exchange of Letters dated March 4, 1994, *reprinted in* Treaty Between the United States of America and the Ukraine Concerning the Encouragement and Reciprocal Protection of Investment, with Annex, and Related Exchange of Letters, Treaty Doc. 103-37, 103d Cong. 2d Sess., at 15 (1994). Services to be provided by the office include information on investment regulations and dissemination of information on investment projects and their sources of finance. *Id.*

protections for intellectual property[162] and to afford investors with effective means of resolving investment related private disputes in local courts.[163] Because of the number of BITs being negotiated by developed states, it seems unlikely that developed states would be willing to agree to the addition of many provisions obligating them to furnish significant amounts of economic assistance for the purpose of creating a functioning market. BITs nevertheless could include provisions calling for assistance in kind. For example, they could include commitments by capital exporting states to assist capital importing states in disseminating information about investment opportunities in the latter states or to provide technical assistance to capital importing states in developing a more favorable investment climate.

Second, they could broaden support for a liberal investment regime by extending their protections to domestic as well as foreign investment.[164] Domestic investors thus would enjoy the same right of access to foreign currency and the same protection against state interference that foreign investors enjoy, while having the same right to take investment disputes with the host state government to international arbitration. Such a step would assist in creating a domestic constituency in support of the liberal regime created by the BITs.

A multilateral agreement on investment structured along similar lines could make a far greater contribution to promoting a sustainable liberalism. Such an agreement could serve to universalize the legal framework for a liberal investment regime in much the same way that the GATT has universalized liberal trade policy, thereby deepening the rhetorical and legal commitment to liberal principles.

A multilateral agreement also could provide the most effective mechanism for addressing market failures and for curbing excessive redistribution. State interventions to facilitate the market or to redistribute wealth may be less subject to capture by domestic interests if performed

---

162. In general, stronger intellectual property protection attracts foreign investment. *See* CAVES, *supra* note 129, at 50. The importance of intellectual property protection to attracting foreign investment varies by the type of investment. It plays the greatest role in investments involving research and development and the smallest role in investments involving sales and distribution. *See* EDWIN MANSFIELD, INTERNATIONAL FINANCE CORP., DISCUSSION PAPER NO. 27, INTELLECTUAL PROPERTY PROTECTION, FOREIGN DIRECT INVESTMENT, AND TECHNOLOGY TRANSFER 17 (1994). The strength of intellectual property protection may be more important to the decision whether to transfer technology than to the decision whether to invest. *See id.* at 19–20. Thus, intellectual property protection is particularly important to a host state that seeks not simply capital investment, but new technology.

163. *See* GRABOWSKI & SHIELDS, *supra* note 140, at 269–70. *See generally* Frankel, *supra* note 71, at 389; Rubin, *supra* note 71, at 1.

164. *See* Vandevelde, *supra* note 1.

in accordance with international standards.[165] A multilateral agreement could be accompanied by a set of codes addressing a range of problems, such as environmental protection,[166] restrictive business practices,[167] and tax policy.[168]

Standards that are the result of a multilateral negotiation may have a greater political legitimacy than those proposed by a bilateral negotiating partner. They may win more rapid acceptance on the ground that they represent the international consensus, are the product of complex global negotiation that cannot be reopened and thus are the only alternative to no standards at all. Local political and economic interests would have less influence over a multilateral standard setting process than a bilateral treaty negotiation. Indeed, standards addressing market failures are unlikely to emerge from bilateral agreements because of the desire to avoid a patchwork of conflicting standards and because many states may be unwilling to accept obligations that are not widely shared and thus would place them at a competitive disadvantage within their region.[169]

A multilateral agreement on investment nevertheless can play only a limited role in promoting a sustainable liberalism. Many of the most serious forms of market failure, such as inadequacies in physical infrastructure[170] and education,[171] can be remedied only through the application of substantial financial resources. Developing a sustainable liberalism thus will entail a continuing role for international financial institutions in funding the development of the physical and human resources necessary for the operation of the market.

165. *See* UNCTAD & WORLD BANK, *supra* note 138, at 42–44, 47.

166. Environmental pollution is an example of a negative externality, which is a cost borne by a person other than the one who produced it. Markets will oversupply a good that produces negative externalities because the producer does not bear the full costs of the good and thus does not have a sufficient disincentive to produce only the socially optimal amount. *See* NAFZIGER, *supra* note 31, at 338–39.

167. *See supra* note 138 and accompanying text.

168. Issues of tax policy include subsidies and incentives, which can distort the market by encouraging producers to engage in inefficient behavior, but in some cases may be preferable to the alternatives. *See supra* note 153 and accompanying text. In addition, because markets are segmented along national boundaries, it may be necessary to harmonize tax policies to eliminate market distortions caused by different national tax policies. *See* CAVES, *supra* note 129, at 245–46.

169. For example, environmental pollution constitutes an important type of market failure, but a state may fear that environmental standards not adhered to by other states in the region will deflect foreign investors to states that have less stringent standards.

170. *See supra* text accompanying note 138.

171. Education is an example of a positive externality, or benefit that is enjoyed by a person who did not produce it. *See* GRABOWSKI & SHIELDS, *supra* note 140, at 195–200, 268. Because the producers do not enjoy the full benefits of their activity, they have insufficient incentive to produce the socially optimal amount.

CONCLUSION

The liberal consensus that exists at the moment is unprecedented in international political economy. The economic nationalist consensus that dominated the international community in the early twentieth century was destroyed by the protectionist trade wars of the 1930s.[172] The reemergence of a new nationalist consensus in the post-war era has been prevented by the failure of import substitution industrialization policies to keep pace with the results of export led growth policies.[173] The attempt by the socialist and developing states to forge a new international economic order was undermined by the economic stagnation of those states that most unambiguously embraced socialism.[174] The failures of nationalism and Marxism coupled with the evident success of liberalism have created for the first time in history an opening for the emergence of a liberal international investment regime.

The liberal consensus, however, is a historically contingent one. Liberalism is no less vulnerable than competing ideologies to the adverse consequences of its failures. The past year, for example, has seen an economic downturn in Southeast Asia, coupled with continuing economic stagnation in Japan, leading already to claims that the East Asian miracle is ending or that it never really existed.[175] Efforts to debunk this particular miracle may well lead to a crisis of faith among recent converts to liberalism. States that favor a liberal investment regime thus must ensure that the regime they build is sustainable—that it can endure beyond the unique historical circumstances that gave birth to it.

Liberalism emerged at a particular moment in history in states that could provide the necessary ingredients for the operation of free markets. Many developing states, however, lack the conditions that permit markets to function. If liberalism is to be sustainable, it must succeed. If it is to succeed, then developed states must be prepared to assist developing states to create the economic, legal and physical conditions required by a properly functioning market.

---

172. *See* HOEKMAN & KOSTECKI, *supra* note 35, at 2–3.

173. *See* Jilberto & Hogenboom, *supra* note 144, at 142–43; Jilberto & Mommen, *supra* note 123, at 3–4, 19–20, 23.

174. *See* RAPLEY, *supra* note 8, at 45–46, 70.

175. *See* Harvey Stockwin, *Miracle myth, political failures send some Asian economies reeling*, SAN DIEGO UNION-TRIB., Nov. 2, 1997, at G1; Ho Kwon Ping, *Picking up the East Asian Pieces*, INT'L HERALD TRIB., Oct. 23, 1997, at 8; Stephen H. Dunphy, *Economic Memo*, SEATTLE TIMES, Oct. 12, 1997, at D1; Darren McDermott, *Southeast Asian Banks Contribute to a Bust in the Economic Boom*, WALL ST. J., Oct. 6, 1997, at 1; Merrill Goozner, *Uncertain Asian Economics Turn Inward, But Exports Say Long-Term Prospects Remain Sound*, CHICAGO TRIB., Sept. 22, 1997.

The existing network of BITs has contributed to the development of a liberal investment regime, but its inattention to the problem of market failures and its disregard of the need to develop a domestic political constituency for liberalism have minimized the network's role in promoting the long term sustainability of liberal investment policies. A multilateral agreement that deepened the global consensus on liberalization of investment flows, that promoted a commitment to liberalism among domestic investors in host states, and that provided a multilateral framework for addressing market failures and curbing excessive redistributive programs, although only part of the solution, would do much to ensure the long term sustainability of a liberal investment regime.