A Welfare Economic View of International Investment Agreements

Emma Aisbett

University of Hamburg

OECD Freedom of Investment Roundtable
Paris, Wednesday 14^{th} of October 2015

Outline

- Motivation for the welfare-economic approach to policy making
- Introduction to the welfare-economic approach
- Application of the economic approach to investment agreements
    - Are there market failures that IIAs might fix?
    - Are IIAs targeted at fixing the identified market failures?
    - Do IIAs exacerbate secondary distortions?
    - Summary

Why use the Welfare-Economic approach?

- It is an important component of the OECD *Recommendation of the Council on Regulatory Policy and Governance*.
- The welfare-economic approach is a standard component of best-practice policy-making,
- provides structure and analytical clarity to complex policy questions,
- facilitates objective assessment and transparent debate, and
- answers the question: *Does this policy have the potential to improve social welfare?*

How do we define Social Welfare?

- Welfare economic approach assumes policy-makers wish to improve social welfare.
- Define the society whose welfare you are interested in maximizing:
  - We will mostly consider global welfare, but also that of a host country where appropriate.
- Define the welfare function.
  - Economists typically use a utilitarian approach.
  - This means welfare is said to improve if winners could potentially compensate losers.
  - With these assumptions, improving welfare is synonymous with improving (Hicks-Kaldor) efficiency.

What about distributional and non-economic policy objectives?

- The economic approach is not only about money
    - A common misconception is that 'economic efficiency' is only concerned with money.
    - Actually welfare can be defined over anything that people care about.
    - Welfare economics is the cornerstone of environmental economics.
- Distributional questions
    - Economists recognise that government policy may legitimately be motivated by distributional concerns.
    - While neoclassical welfare economics does not make normative judgments about distributional impacts of a policy,
    - it can help identify winners and losers.

A necessary condition for a policy to be welfare-improving

- The First Welfare Theorem says
  - In the absence of ‘market failures’, the free market will maximize efficiency.
- The First Welfare Theorem implies
  - A government intervention *cannot* improve efficiency (and thus Utilitarian welfare) if it is not fixing a market failure.
  - Starting point for policy should always be: *What market failure are we trying to address?*
- Thus for FDI policy the starting question should be:
  - *Are there market failures which prevent us from attaining efficient levels of FDI?*
- Contrast to the common approach of:
  - *How can we increase FDI?*

What is a Market Failure?

- A market failure is anything which violates the assumptions of the First Welfare Theorem.
- The assumptions of the first welfare theorem are many, and include:
    - complete and perfectly competitive markets,
    - perfect information,
    - goods which are rival and excludable.
- Basic principle is that a market failure is anything which prevents the private returns to an action from aligning with its social benefit.

Sufficient conditions for a policy to be welfare-improving

- Identification of a relevant market failure is a *necessary* condition for policy to be welfare improving, but it is not *sufficient*.
- A sufficient condition is that the policy's benefits outweigh its costs.
  - Hence we often use cost-benefit analysis.
  - OECD is a leader here, but rarely applied to IIAs as regulation.
- Benefits depend on how bad the original market failure was, and how good the policy is at fixing it.
- Costs are of two broad forms:
  - Implementation costs (e.g. policy development, monitoring and enforcement costs),
  - Costs of secondary distortions which are caused or exacerbated by the policy.

Theory of the Second Best and Principle of Targeting

- The Theory of the Second Best says:
    - When there are two or more market failures, fixing one may increase or decrease welfare.
- The Principle of Targeting says:
    - Policy interventions should always be directly targeted at the identified market failure.
    - Imperfectly targeted interventions will induce other market distortions.
- Together these imply:
    - Fixing one market failure may actually lower welfare if it causes or exacerbates others.

The Hold-up Problem and International Investment

Hold-up story for international investment is typically envisaged as:

- An investor is considering making an investment.
- Host offers good conditions (including regulations and taxes).
- After costs are sunk the host adjusts taxes, regulations, etc to maximise its welfare function.
- The investor may be left unable to recoup sunk costs of investment.
- Knowing this, the firm will not invest in the first place and both firm and host are left worse off.
- There is a problem of 'under-investment' relative to the efficient level of investment.

Hold-up problem lowers global, investor, and host welfare.

Why hold-up may not be a problem

- Two conditions are necessary for hold-up problems to arise:
  - One agent (e.g. investor) chooses whether to make an investment involving sunk costs.
  - Optimal strategy (e.g. policy) for one agent (e.g. government) is different before and after the costs of the other agent are sunk.
- Optimal policy for government may, however, not change after the investment due to:
  - Reputation effects: hosts do not want to scare away other potential investors.
  - Repeated interactions: hosts want to encourage further investment by same investor.
- Governments compete for FDI through tax incentives, participation in IIAs,
- thus they have strong incentives not to jeopardize future FDI flows by intentionally treating current investors unfairly.

Undervaluation of foreign investors' welfare

- Some commentators claim that foreign investor's welfare is undervalued by host governments because they are politically disenfranchized.
- The exact problem this poses depends on whom the investor is undervalued relative to.
- Excessive taxation, licensing fees etc:
    - if investor undervalued relative to govt. revenues,
- Discrimination (e.g. in license distribution):
    - if investor undervalued relative to domestic firms,
- Over-regulation:
    - if investor undervalued relative environment, consumer or health and safety concerns,
    - note this may look similar to hold-up.

Undervaluation of foreign investors' welfare lowers global and investor welfare, but not host.

IIAs as a tool to address the hold-up problem

- Where hold-up is a problem, it is one which investors and hosts share.
    - Investor-state dispute settlement may be appropriate.
- Fixing the hold-up problem requires protecting existing investments.
    - Post-investment protections are relevant,
    - Investment liberalization (i.e. pre-investment) provisions are not.

IIAs as a tool to address under-valuation of foreign investor welfare

- Both investment liberalization and post-investment protections are needed to address problems of under-valuation.
- Host countries do not directly benefit from ‘fixing’ the under-valuation ‘problem’.
- Analogous to trade agreements, reciprocity is required to leave all parties better off.
- Also similar to trade agreements, state-state dispute mechanisms may be more appropriate than investor-state.

Undervaluation of domestic investors' welfare

- It is possible that the welfare of domestic investors is no more valued by governments than that of foreign firms.
  - Mistreatment of foreign firms is more likely to international attention.
  - Many host governments actively seek to encourage FDI due to perceived positive spillovers.
  - Foreign firms are much larger on average than domestic firms.
  - Foreign investment generally more elastic (mobile) than domestic investment.
- If there is no systemic bias against foreign investors, then correcting the government's distortion only in regard to foreign investors is a poorly-targeted intervention. It could reduce welfare since:
  - more efficient domestic firms may be squeezed out by foreign firms who are enjoying advantage from IIAs, and
  - it may lessen pressure for the necessary, broad-based, institutional reform.

Undervaluation of the welfare of other groups

- Governments may also under-value the welfare of other domestic groups, including:
  - consumers, indigenous groups, ethnic minorities, and citizens generally.
- If the welfare of these groups is undervalued more than that of foreign firms, then using IIAs to make hosts to fully internalize the welfare of foreign investors is likely to worsen national and global welfare.
- Suggests a need to better target IIAs to only protect against hold-up.
- For example, plain packaging legislation could not be challenged if protections were better targeted at fixing hold-up problems.

Induced distortions on the investor side

- Market-value compensation for costs of regulation provides insurance to investors against the possibility that their investment is found to cause social harm.
- This is effectively a subsidy and leads to over-investment (Blume, Rubinfeld and Shapiro, QJE, 1994).
- The costs of this distortion may outweigh the benefits of removing the distortion on the government side.
    - This is more likely when the government is acting close to optimally originally.
- Since regulatory intervention across industries is roughly proportional to the risks they pose:
    - The effective subsidy is greatest for the most socially risky industries, and
    - and conversely least for the most socially beneficial industries.

Summary: IIAs and the hold-up problem

- If a host has a hold-up problem, carefully crafted, post-investment treaty protections supported by ISDS may provide a well-targeted solution which enhances both investor and host welfare.
  - But costs of IIAs may outweigh benefits if poor targeting of provisions means that secondary distortions are created or exacerbated.
  - And not all hosts would appear to have hold-up problems due to reputation effects etc.

Summary: IIAs and undervaluation of foreign investor welfare

- If a host under-values the welfare of foreign investors relative to all domestic constituencies, provisions which force the host to treat foreign investors more fairly both pre- and post-investment will increase investor and home state welfare, but not host state welfare.
- Analogous to trade agreements, states may find mutual benefits through reciprocity or linkage to other issues.
    - State-state dispute mechanisms are probably more appropriate as well as more consistent with trade provisions.
- Welfare benefits will be maximized if provisions target areas where foreign investors are at a genuine disadvantage c.f. domestic constituents.
    - Welfare losses are possible if existing advantages of foreign investors are re-enforced.