BHUTAN'S INTEGRATION WITH THE GLOBAL ECONOMY:

INTERNATIONAL INVESTMENT TREATIES AND CONVENTIONS

June 27, 2019

EXECUTIVE SUMMARY

● Over the past five years, Bhutan's economic performance in terms of real Gross Domestic Product (GDP) growth has been respectable, averaging more than 5 percent per annum, driven by hydropower as well as services and agriculture.

● Despite a new 2010 FDI policy (amended in 2012) that sought to jumpstart FDI flows, inflows remain small and the lowest in South Asia, averaging less than US$20 million a year and $25 per person in per capita terms.

● Bhutan has been partially shielded from the global financial and investment system due to its historical and geographic isolation as well as high transit costs, but as a small country, there are significant advantages to leveraging its unique geography.

● Bhutan's FDI policy is based on a principle of openness and selected engagement with the international system. More specifically, there are certain rules: a negative list; no equity restrictions in priority sectors; minimum investment levels; certain prohibited sectors; easy capital flows with convertible currency; land ownership of FDI allowed; easy licensing; limits on visas of skilled workers.

● Globally, there has been a proliferation of investment treaties in recent years, mostly signed between developing economies and developed ones to attract capital to the former countries by protecting foreign investors from the latter countries. More than 5000 bilateral investment treaties were signed in last two decades, while Investment Chapters in Regional Trade Agreements (RTA's) are also gaining traction.

● Investment dispute settlement issues are the biggest source of controversy in the international investment regime, but more acceptable designs are emerging to capture investment in a way that is beneficial to both state and investor.

● There are both domestic and external reasons to negotiate IIA's. Three potential benefits are: stimulus to domestic reform and enhancement of credibility; improved access to foreign markets; and positive signal to foreign investors. The empirical evidence on the link between BIT membership and FDI inflows is inconclusive.

● The costs of acceding these treaties, some of which are linked to issues beyond IIA's, are: the possible constraints on policy choice; legal and administrative capacity constraints, and the costs of arbitration.

● Bhutan should negotiate treaties as part of a clearer strategy based on its value proposition and to relate Bhutan with the external world, in terms of investment and trade. First, it should formulate a clear FDI policy and based on that, sign bilateral investment treaties and FTA's in a careful way according to a roadmap. Second, it should build its legal capacity to negotiate, especially before joining ICSID. Third, it must make sure its GNH mindset is reflected in all IIAs and treaties that it signs, while at the same time, courting FDI in services and manufacturing.

MAP OF BHUTAN

This note has been prepared by Ali Zafar (Senior Economist, FCI and TTL) with inputs from Roberto Echandi (Global Investment Lead, FCI), and Aaditya Mattoo (Manager, DEC). It was done under the overall guidance of Esperanza Lasagabaster (Practice Manager, Finance, Competitiveness, and Innovation). The work benefited from guidance by Sanjay Kathuria (Lead Economist) and Yutaka Yoshino (Program Leader). The work benefited from the strong data contribution from the global investment team. The team wishes to thank the close collaboration of the Bhutanese authorities, especially Dasho Phuntso Norbu (Director General, Ministry of Economic Affairs) and Sonam Lhamo (Policy Officer, Ministry of Economic Affairs). The work was done under the broader TA for Bhutan Private Sector Competitiveness.

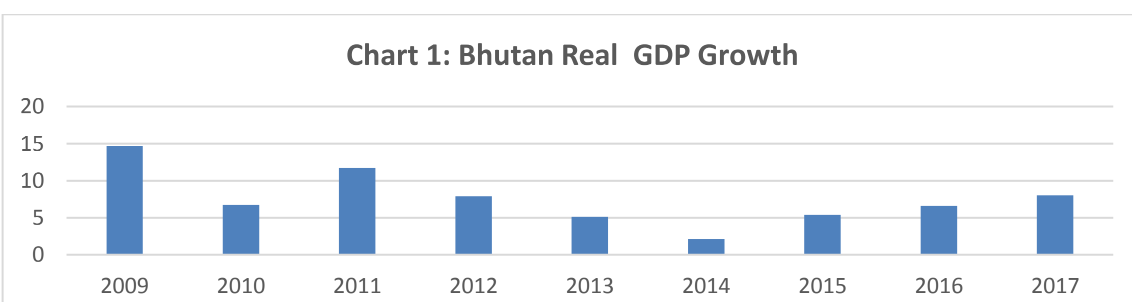
TABLE OF CONTENTS

I. Introduction: Bhutan Macroeconomic Context

In recent years, Bhutan has been successful in achieving macroeconomic stability through prudent management and sound fundamentals. A small landlocked economy, Bhutan has been one of the faster paced economies in recent years, with growth averaging more than 5 percent annually. A combination of accelerated investments in hydropower, good agricultural harvests, and supportive fiscal and monetary policy to boost implementation of the FYP has sustained the recovery (World Bank, 2016). Its fiscal management has been prudent, although domestic revenues have exhibited volatility due to the fluctuations in the hydropower sector and ranged between 16–30 percent of GDP over the past 10 years.

However, in the medium-term, significant challenges loom. The current account deficit has been widening, leading to an increase in debt as a share of GDP. Hydropower exports contribute around 40 percent of Bhutan's revenue and 25 percent of its GDP, but are having an environmental impact, and the sector's ability to generate employment is limited. In parallel, the public sector can absorb only 1,000 graduates per year. To understand the dynamics for the private sector, the 2017 Investment Climate Assessment (ICA) surveys 130 hundred Bhutanese firms, and reveals that employment remains concentrated in agriculture and the public sector. Many firms are facing obstacles that hinder investment, productivity, and international trade.

In this context, Bhutan can become wealthier through accelerating both domestic and foreign investment, as well as signing investment treaties. These investments could provide not just capital but also bring necessary skills, knowledge and ideas, and help the country move beyond hydropower. Today FDI inflows are small and constrained, on the one hand, by regulatory barriers and insufficient investment promotion, and, on the other, by inadequacies in skills and infrastructure. Bhutan can benefit from the experience of East Asia and other countries on how to break out of this low investment trap. FDI can help the macroeconomic balance by increasing exports and reducing the current account deficit, although it is not clear the future impact on growth, since it will depend on the quality and type of FDI inflows. FDI can also help create trade. Theoretically, firms invest abroad to expand their sales markets when trade costs are too high, therefore FDI is a substitute for trade. FDI in non-tradable sectors (services, etc) has this feature. However, in practice, FDI goes to export-oriented sectors including extractives but also manufacturing. Given the landlocked nature of geographic setting of Bhutan (with higher trade cost than countries such as India or Bangladesh), FDI could go primarily to non-tradable (at least as shown in the recent trend in the greenfield FDI). In this context, it will be important to use FDI to tap into regional value chains.



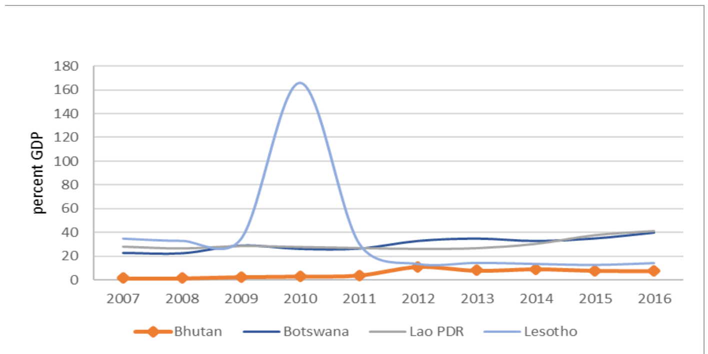
Source: IMF (2017)

II. State of FDI in Bhutan

A. Trends and Flows

As part of its 2010 Economic Development Policy and the 2010 Foreign Direct Investment Policy, Bhutan has articulated its desire to attract FDI and catalyze private sector development. The country seeks to deepen its integration in the regional and global economy. However, the GNH mindset is based on "high value, low impact" investments and targeting FDI flows to priority sectors. Overall, despite gradual liberalization since 2010, entry barriers remain significant for foreign investors. The consensus is FDIC can increase consistent with the Government's vision.

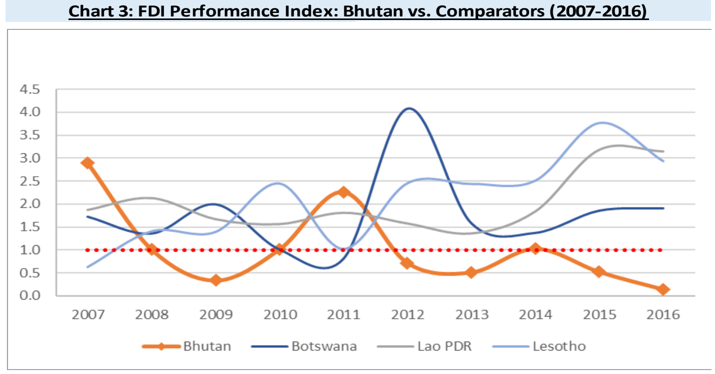
Chart 2: Total FDI Inflows: Bhutan vs. Comparators (2007-2016)



Source: UNCTAD.
Note: FDI flows are on a net basis (capital transactions' credits less debits between direct investors and their foreign affiliates).

There are several important general trends to note in relation to FDI flows in Bhutan. [1]First, overall FDI inflows have been quite limited and have averaged less than US$20 million annually since 2010 (Chart 2). [2] It is even low as percent of gross capital formation (GCF) in 2017. Bhutan FDI/GCF was 0.7 percent, India was 5.7 percent, Bangladesh was 3 percent, and South Asia average was 5.5 percent. Relative to its comparators, Bhutan has experienced the lowest FDI inflows per GDP, alongside Nepal and Lesotho (since 2012). Similarly, with respect to number of greenfield investments, Bhutan falls in the low end of its comparator group. Along with Lesotho, Bhutan received the lowest number of greenfield projects between 2007 to 2016, which is less than five percent of the projects Laos received and a fraction (11 percent) of Botswana's experience. Regarding dependency on FDI source countries, Bhutan demonstrated lower concentrations of source countries in 2012 than its comparators, indicating that Bhutan has received FDI from a more diverse group of source countries than e.g. Botswana or Laos.

Chart 3: FDI Performance Index: Bhutan vs. Comparators (2007-2016)



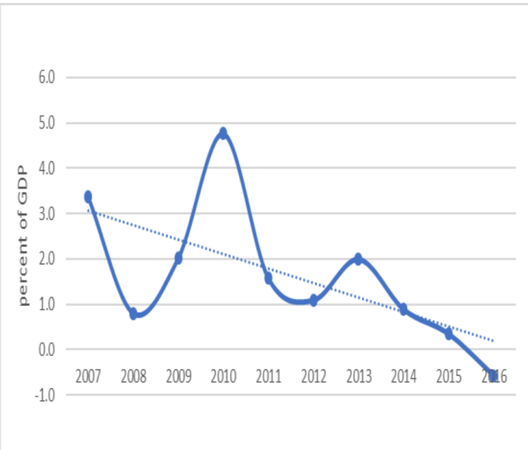
Source: Computations based on UNCTAD data.
Note: The FDI performance index provides a comparative insights into a country's FDI attraction with respect to its relative economic size, dividing its share of Global FDI by its share of Global GDP. This provides a measure of a country's "fair share of global FDI".

[1] The analysis excludes Indian hydropower projects since they are inter-Government agreements involving Indian loans and grants used by Bhutan to produce hydro and export back to India.
[2] This study employs global FDI data, as made publicly available through UNCTAD and the IMF's Balance of Payments, as well as proprietary project-level data from the Financial Times' FDI Markets database.

Bhutan's FDI performance has been volatile across years and its current performance indicates that it is not receiving its 'fair share' of global FDI. Since 2012, Bhutan's FDI performance has fallen below parity. In other words, Bhutan appears to have attracted lower shares of global FDI inflows than is expected of an economy of its size (Chart 3). Furthermore, it is striking that in 2011 Bhutan has among average FDI performance relative to its comparators, but since 2012, Bhutan has demonstrated the worst FDI performance compared to its peers. In terms of inward FDI flows, it reached a peak of approximately 5 percent of GDP in 2010. Since 2013, Bhutan has seen a downward decline its FDI inflows (Chart 4). As the hydropower projects with India near completion, there is a hope that there can be FDI in hydro, together with FDI in hotels and manufacturing.

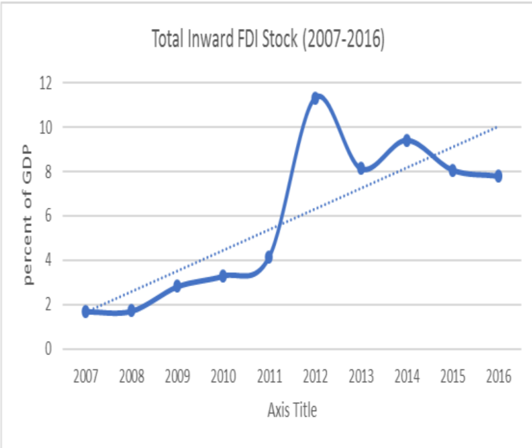
With regards to FDI composition (Chart 6), Bhutan has seen its FDI shift from largely dominated by intra-company loans to increasingly composed of equity other than reinvested earnings.[3] Over the last decade, Bhutan has at times received some FDI in the form of reinvested earnings. In more recent years, 2015 and 2016, Bhutan's FDI composition was split between equity and reinvested earnings. Bhutan's GDP growth was correlated with the rise in FDI stock between 2010 to 2012. However, in recent years (2014 to 2016), the country has seen its growth become increasingly domestical driven.

Chart 4: Bhutan's Inward FDI Flows Over Time (2007-2016)



Source: UNCTAD.
Note: FDI flows are on a net basis (capital transactions' credits less debits between direct investors and their foreign affiliates).

Chart 5: Bhutan's Inward FDI Stock Over Time (2007-2016)



Source: UNCTAD.
Note: FDI stocks are presented at book value or historical cost. For many economies, FDI stocks are estimated by cumulating FDI flows over a period of time or adding flows to an FDI stock that has been obtained for a particular year.

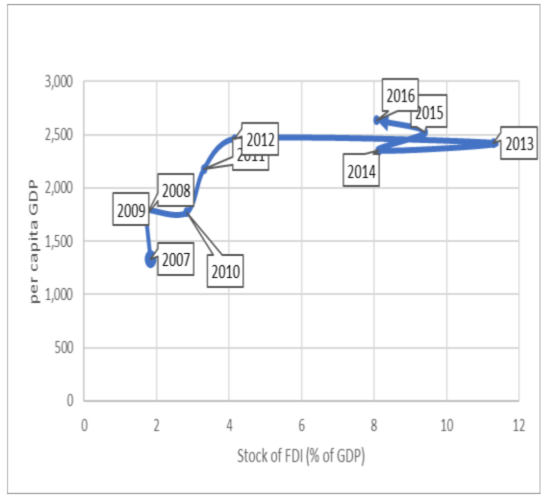
---

[3] A threshold of 10 percent or more of the ordinary shares of voting stock is applied to determine the ownership of a foreign direct investment.

Chart 6: Bhutan's Composition of Inward FDI Flows Over Time (2007-2016)

Source: IMF BoP.
Note: Not all economies report FDI flows disaggregated by component for all years.

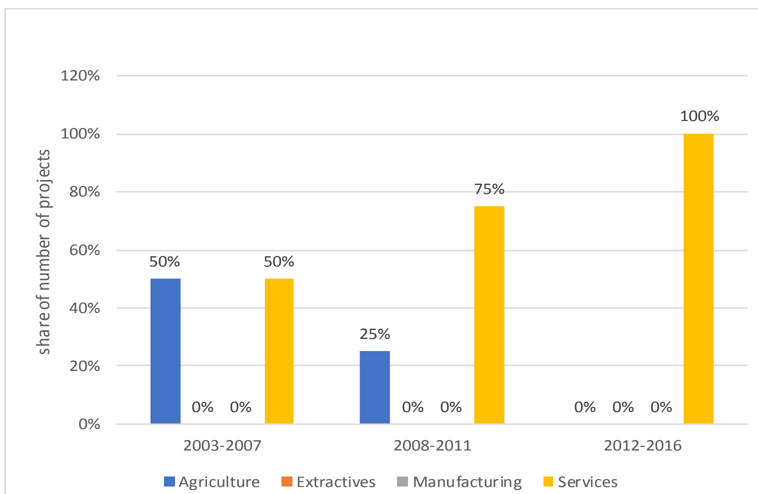
Chart 7: Bhutan's FDI/GDP Growth Path (2007-2016)



Source: UNCTAD.
Note: This graph shows the extent to which Bhutan's GDP growth path has been domestically driven or driven by FDI.

FDI inflows in Bhutan have not been equally spread between sectors and the services sector has been on rising trend. Bhutan's greenfield investments in agriculture have declined over time. Over the last fourteen years, Bhutan shifted from receiving half of its greenfield investments in agriculture (from 2003 to 2007) to one-quarter of projects from 2008 to 2011, before dropping to zero projects by 2012 to 2016. Over the same period, Bhutan received an increasing share of FDI in the services sectors (from half of greenfield projects from 2003 to 2007 to 100 percent from 2012 to 2016). As of December 2016, there were a total of 54 projects approved of which 32 projects were in the service industry and the remaining 22 in manufacturing (Government of Bhutan, 2017). Currently, FDI is concentrated in the hospitality and tourism industry with a 40 percent share, while there is some FDI in hydroelectricity and manufacturing, including power intensive industries (silicon, ferro alloys, etc), pharmaceuticals, and furniture production. There is a conspicuous absence of agribusiness investment. In terms of geographic dispersion, the Western part of the country, especially Thimphu, Paro and Chukha dzongkhags are the regions with the highest number of FDI projects, accounting for more than two-thirds of total FDI projects. Bhutan has not attracted greenfield FDI to its manufacturing sectors. Notably, across time, Bhutan's financial services has received the bulk of greenfield FDI

Chart 8: Greenfield FDI Announcements by Sector for Bhutan (2003-2007)



Source: Financial Times fDi Markets.
Note: Data is based on the sum of announced greenfield projects over the time period.

(Chart 8). A quick analysis of Bhutan's greenfield investments in recent years reveals that about two-thirds of foreign investors in the country have been market-seeking (67 percent), followed by roughly one-third investing in tourism. Specifically, Bhutan has seen market-seeking investments in its financial services and electricity. Markedly, during this same period, important efficiency-seeking FDI to Bhutan has been non-existent.

In terms of geographical sources of FDI, government data show a preponderance of investment from Asia. As of 31st December 2016, about 57 percent of the total investments in terms of projects approved were received from Asia followed by 30 percent from Europe and 10 percent from North America (Government of Bhutan, 2017). The largest investor from Asia is India (mostly in manufacturing - metallurgy, cement, chemicals, and garments), followed by Thailand and Singapore (mostly in hospitality in tourism).

There is an increasing interest in investment in the IT sector as well as in other sectors, with the entry of new players, and there is clear evidence of "sparks" in new emerging sectors. With the support of the World Bank, the Thimpu IT Tech Park project was built in 2014 in proximity to the country's capital. It currently employs close to 400 people. The public-private partnership Project was implemented jointly by Assetz Property Group from Singapore and the DHI, although the Singapore company recently sold their stake in 2015 because of too much vacant commercial space. Druk Holding and Investment (DHI) assumed full ownership of the company after Assetz withdrew and transferred its shares to DHI. DHI now holds 51% of the share and Bhutan Telecom Limited holds the remaining 49%. Other sources of FDI include Germany's SKW Stahl-Metallurgie in the metals industry, Bangladesh software company Southtech, and Vietnam's AA Corp who have created a joint-venture furniture factory.

B. FDI Policy Regime

The policy regime governing FDI inflows is spelt out in the 2010 FDI Policy (amended in 2014). This policy reflects dual objectives of the Government and has evolved from the first FDI policy of 2002, which came into effect in 2005. On the one hand, there is a growing liberalization and facilitation of conditions for entry of foreign investors, and, on the other, there is a desire to monitor the inflows and ensure FDI is used for sustainable development. Given the importance of GNH and environmental considerations, FDI inflows are meant to be governed by the country's domestic objectives. One important pillar of the government's approach is to use joint venture arrangements enabling domestic investors to have an equity stake in the FDI project. To avoid discrimination against foreign investors, the Government provides the same set of incentives and exemptions for FDI as for domestic investments (although international evidence suggests that incentives are not the drivers for FDI).

The Government of Bhutan has a policy that allows FDI in both manufacturing and service sectors. This investment regime is governed by project-specific agreements and sectoral policies subject to several restrictions. First, the approach enshrined in FDI law is the "negative list" approach, which provides the possibility for foreigners to invest mostly in joint ventures in all except for 16 areas. The negative list includes media and broadcasting, hotels rated three stars, arms, and tobacco. Second, FDI inflows into priority sectors have no ownership restrictions and can reach 100 percent foreign ownership and are fast tracked in terms of approvals. These priority areas are education, health, five-star hotels and resorts, infrastructure, research and development. Third, the Government of Bhutan places both an upper limit and a floor on FDI in some sectors: with the maximum foreign investors' equity at 74 percent and minimum project costs of Nu 50 million and Nu 25 million for manufacturing and services, respectively.[4] As opposed to earlier policies, minimum investment levels have been reduced in most sectors. Fourth, there is 51 percent equity cap in the financial sector. Fifth, foreign equity ownership of less than 10 percent is not permitted to get sufficient capital. Fifth, all FDI businesses need to be incorporated under the Companies Act of the Kingdom of Bhutan (2000) and be approved by the Government of Bhutan.

In terms of currency, the Royal Monetary Authority (RMA) stipulates that FDI will be made in convertible currency, unless provided otherwise by bilateral arrangement. There is an exception for India, with investments in Indian rupees acceptable in all sectors. In parallel, foreign investors have the right to repatriate dividends in the currency of earnings on the basis of self-sufficiency, namely that the net currency earnings of the company are sufficient to cover the amount of these transactions. Foreign investors shall have the right to repatriate their invested capital and any capital gains secured, in the currency of investment. The FDI company may borrow from financial institutions in the country and the debt-equity ratio shall be as per the provisions of the Royal Monetary Authority's prudential regulations.

The Government of Bhutan has rules on FDI, which are currently being clarified and revised. As part of its policy, the government has ensured flexibility in dealing with FDI inflows. First, according to FDI Policy 2010 (amended 2014), nationalization and expropriation can be used in situations of national interest, but it will be done in a non-discriminatory manner with adequate and fair compensation.[5] In the absence of bilateral investment treaties and ICSID adherence, investors are to rely on the Royal Court of Justice and local authorities using mediation and arbitration. National law allows domestic investor-state arbitration provided domestic courts are used. In addition, the Government reserves the right to permit FDI under terms and conditions that may be different from those specified, but the rule has a degree of ambiguity.

Land ownership by foreign companies is now allowed. According to the FDI policy, land for establishing FDI business shall be available either on lease or ownership, based on the provisions of the Land Act of Bhutan, 2007. Moreover, local partners shall be allowed to capitalize land as their equity contribution. However, the is a need to clarify the exact modalities of land ownership.

There are rules that govern visas and professional flows. FDI businesses do not face restrictions on visas and are entitled to work permits for their staff, but beyond a certain limit, they require approval of the Ministry of Labor and Human Resources to ensure that the skills required are not available on the domestic market. The other important clause is that the work permits shall

---

[4]The FDI policy sets minimum project costs for priority areas in both manufacturing and services ranging from Nu. 20 million in agro- and forest-based sectors to Nu. 50 million in other priority manufacturing sectors and Nu. 200 million in health, education, and infrastructure sectors.

[5] According to Bhutanese law, payment shall be made by the government promptly after the asset is nationalized or expropriated and a commercial rate of interest will be paid for the period between reflecting the market value of the investment nationalized or expropriated and with transferable currency.

be allocated to the business rather than to the individuals concerned and shall be issued with validity depending upon the terms of their assignment in the country.

The government conducted another wave of FDI reforms in 2014. First, it has become easier to convert Bhutanese ngultrum into foreign currencies and repatriate up to US$5 million in dividends per year. Second, the government cut minimum capital commitments for investments in the information technology sector. Third, the government is now more actively courting foreign investment in pharmaceutical companies.

III. FDI Treaties

One potential way for Bhutan to improve FDI inflows is by signing international treaties. Bhutan is a signatory only to a few international conventions. In terms of the United Nations, it signed the New York Convention in 2014.[6] In terms of **bilateral investment treaties**, it has not signed a major bilateral investment treaty and is not a member of ICSID. It is currently negotiating a Memorandum of Understanding with the European Investment Bank. In terms of **intellectual property**, Bhutan is a signatory to the WIPO (World Intellectual Property Organization) Convention and a signatory to the following international conventions and protocols: Paris Convention; Madrid Agreement; and Berne Convention. In terms of **trade agreements**, the country has signed some regional trade agreements (Bangladesh, Bhutan, India and Nepal (BBIN) and submitted its application for accession to the World Trade Organization (WTO) in 1999 but with no progress since then. While it adheres to trade agreements, it has not signed any that have a strong investment component, including SAFTA. In terms of **Double Taxation Treaties**, it has reached an agreement with India on the avoidance of double taxation and prevention of fiscal evasion.

A. Bilateral Investment Treaties

One of the major developments in the global architecture governing trade and investment has been the proliferation of bilateral investment treaties (BITs). Essentially, these are agreements between two countries that define the rules and conditions for investors in a host country. Since it is hard to have multilateral investment agreements, given the complexities involved and the challenges in reaching a consensus, bilateral investment treaties have been very much in vogue. Increasing from 500 in 1980 to nearly 5000 by 2017 and frequently between capital exporting richer countries and capital-importing poorer countries, these treaties provide for international arbitration of disputes between investors and governments. Many developed countries, including China, Germany, and Switzerland, and developing countries, including India and Bangladesh, have been signing multiple treaties in the hope of attracting foreign direct investment.

The key advantage of a BIT is that it provides an assurance of non-discriminatory treatment and legal security to foreign investors and helps countries bring in overseas investors;

[6] On 26 September 2014, Bhutan signed the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, becoming the 151st party to the Convention. Bhutan signed with two reservations: the "commerciality reservation", which means that the Convention will only apply to disputes characterized as commercial under municipal law, and the "reciprocity reservation", which means that the State party may choose to recognize and enforce only arbitral awards that are made in other States party (the Convention provides otherwise that all arbitral awards should be recognized and enforced wherever they are made).

however, there are many different types of BITs with different implications. Differences concern national treatment, protection from expropriation and performance requirements for investments, and access to relatively neutral dispute settlement mechanisms, such as the World Bank's International Center for Dispute Settlements (ICSID).[7] As opposed to a system where investors are not sure of the "rules of the game" and have to sue a government in its own courts, the BITs provide a stronger and more consistent framework, especially in relation to dispute settlement. Some BITs apply to investments established in accordance to domestic laws and regulations, and others apply to the establishment, operation and expansion of investments.

However, not all countries have signed BITs and acceded to ICSID. In recent years, there have been some concerns that the existing system was too favorable to investors and the existing legal architecture did not reflect public policy concerns, especially regarding public health, security, and environmental protection. Some academics have challenged the existence of BITs, some governments and academics have challenged ISDS and the private right of action. Some countries like Brazil have not signed BITs, while close to 40 others, including many in Latin America and sub-Saharan Africa, are revising agreements to include sustainable development clauses. South Africa terminated its treaties with the Netherlands, Switzerland and Germany in 2014, and Tanzania is in the process of revising some treaties to help develop its natural resource wealth. In Tanzania, the objective of the Government reviewing BITs is to make them consistent with the 2017 legislative changes to mining-related laws, for which the Government introduced a set of more restrictive measures against FDI in extractives to promote more domestic ownership (sovereignty) of natural resources.

Considering these growing national concerns, there has been a significant evolution of international investment agreements (IIAs) in the last two decades. Most IIAs were negotiated when there had not been any ISDS case. As the case law started to develop, countries opted to "modernize" their IIA models, leading to "old generation" and "new generation" IIAs. Echandi (2010) notes that, due to a significant increase in the number of ISDS claims over the last decade, a new generation of IIAs has emerged that include five major changes in the process of investment rulemaking. First, some recent IIAs have deviated from the traditional open-ended, asset-based definition of investment. Second, the wording of various substantive treaty obligations has been revised, and new IIAs clarify the meaning of provisions dealing with absolute standards of protection, including the international minimum standard of treatment in accordance with international law and indirect expropriation. Third, these IIAs address a broader scope of issues, including protection of health, safety, the environment, and the promotion of internationally recognized labor rights. Fourth, they include transparency provisions, which represent an important qualitative innovation compared to previous IIAs. Fifth, new IIAs contain significant innovations regarding investor-state dispute settlement (ISDS) procedures, especially in relation to greater transparency in arbitral proceedings, including open hearings, publication of related legal documents, and the possibility for representatives of civil society to submit briefs to arbitral tribunals. Echandi (2010) argues that the new generation of IIA's is geared to providing more certainty on the scope and extent of the IIA obligations and a more transparent

[7] The International Centre for Settlement of Investment Disputes (ICSID) is considered to be the world's leading international arbitration institution devoted to resolving disputes between states and foreign investors. Based in Washington DC, linked to the World Bank and signed by more than 150 country members, it was established in 1965 by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (known as the ICSID Convention or Washington Convention).

and predictable execution of the ISDS process. All this must be understood in the context of Bhutan's FDI policy and its approach.

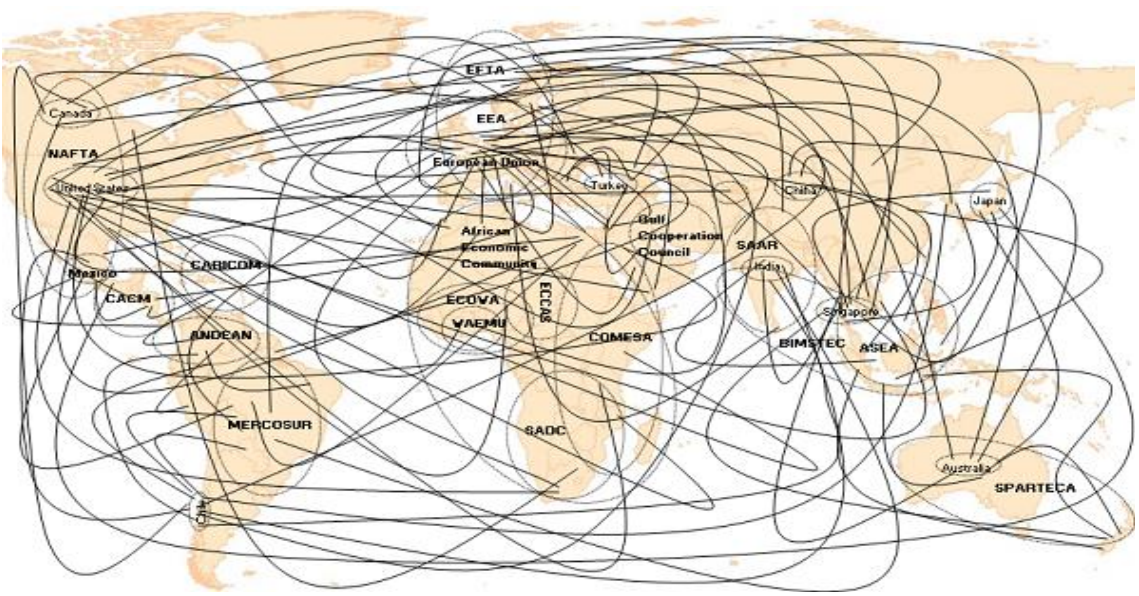
B. Trade and Integration Agreements

Another way for countries to regulate investment is to have an investment component in Regional or Preferential Trade Agreements. Many Regional Trade Agreements (RTAs) now regulate not just trade flows but also include a standalone investment chapter and/or cover investment under rules governing services trade through commercial presence ("mode 3" in the WTO's General Agreement on Trade in Services). A new World Bank database on RTAs reveals that, 55 percent of the 279 agreements signed by 189 countries between 1958 and 2015 include rules on investment; these and are legally binding in 39 percent. Under these arrangements, as part of a trade deal, countries pledge not to discriminate against foreign investors compared to national investors. Prominent among trade agreements with investment chapters are NAFTA in North America and ASEAN in Asia. Countries like the United States, Canada, and Korea are concluding deals with an increasing number of countries like Chile, Singapore, and Australia. The investment chapters included in Preferential Trade Agreements regulate the same issues of bilateral investment treaty (BIT) and include some additional topics. They tend to be BIT plus, in the sense that tend to apply to investment in the pre and post establishment phase and tend to be now new generation agreements.

C. Investment Promotion Agreements

A third set of arrangements that govern investment is the Investment Promotion Agreement (IPA). Numerically fewer than BITs and less detailed, these deals are agreements between the governments of two countries for the reciprocal protection of investments in territories by companies situated in either state. An IPA is a legal agreement between governments for the promotion and protection of investments made by investors of one contracting state in the other contracting state and provides treaty-based protection to foreign investment. Together with BITs, IPAs have proliferated as governments have sought more opportunities to attract investors.

Graph 1: Existing "Spaghetti Bowl" of IIAs



Source: UNCTAD (2017)

IV. Benefits of Treaties

Adhering to BIT and investment treaties in general can be advantageous to a country. IIAs have many functions. Some are external functions (i.e., beyond the territory of the signatory states) and others are more domestic (within the jurisdictions). The following four are linked to the Bhutanese context.

A. Stimulus to domestic reform and enhancement of credibility

One important but understated benefit of certain investment treaties is that they can help stimulate domestic reform and lend credibility to the policy regime in a country. Many countries find it difficult to attract FDI because of an excessively restrictive or burdensome regulatory environment that deters business, as documented for example in the World Bank's Doing Business indicators. Certain types of treaties exert pressure on countries to reform national policies and lock in reforms. They also help alter the domestic political economy by favoring reformers over vested interests. Signing an agreement may also help stimulate mutual reform and reduce restrictions and unnecessary regulation. Hallward–Dreimer (2003) notes that if a country signs a BIT while undertaking domestic regulatory reforms that facilitate FDI, it would be the institutional reforms and liberalization that may affect investors' locational decisions rather than simply the BIT itself. Bhutan can benefit by using FDI and other to help open up the dominant state sector of the economy.

B. Improved access to foreign markets

A potential benefit of trade and investment treaties is to provide increased access to foreign markets.[8] The reciprocal nature of trade agreements and BITs provides a framework for two-way flows, although BITs do not have a direct impact on market access. Agreements allow reciprocal market access that is legally binding. As part of their development strategies, countries like China and Vietnam have signed ambitious trade agreements and BITs, with China at more than 100 and Vietnam at close to 50. The benefits of trade and investment agreements for these two countries have been increased market access for Chinese and Vietnamese investment and exports in Western and Asian markets – which has also led to increased FDI inflows. It would be hard to argue that China and Vietnam would be better off without signing the BITs. Bhutan can benefit by having more export markets for its products.

C. Positive signal to foreign investors

Treaties covering investment can send a positive signal to foreign investors, although the empirical literature is ambiguous in relation to their direct impact on FDI inflows. Capital-importing countries can benefit from investment agreements because the security and protection afforded to foreign investors can be an added incentive for foreign investment in their respective countries. However, some recent studies indicate that treaties merely affect the

[8] Dolzer and Schreuer (200) find that market access is based on two concepts: admission and establishment of foreign investment. While admission covers the issues such as the "definition of relevant economic sectors, geographic regions, the requirement of registration or of a license and the legal structure of an admissible investment," the notion of establishment comprises the issues of "expansion of an investment, payment of taxes or transfer of funds."

direction of investment inflows, not the quantity, and others find it is linked to the type of FDI and agreement concluded. Bhutan can benefit from more quality international investors.

Bhutan membership of ICSID could send a signal to investors. By joining ICSID, an investor from any of the 153 ICSID contracting states could be assured that they would have access to conciliation or arbitration in the event of a dispute with the Kingdom of Bhutan, and that only the annulment proceedings under the ICSID Convention would apply. National courts in states that are party to the Convention must recognize such an award as if it were a final judgment of a court in that state and may not refuse recognition. The only grounds for annulment under the ICSID Convention are that: the tribunal (i) was not properly constituted; (ii) manifestly exceeded its powers; (iii) a member of the tribunal was corrupt; (iv) there was a serious departure from a fundamental rule of procedure; or (v) the tribunal failed to state the reasons for its decision in the award (ICSID Convention Article 52). Thus, unlike Bhutan's current dispute settlement framework, the Kingdom of Bhutan could not set aside an ICSID award even if it were (i) outside the permitted subject-matter of arbitration or (ii) manifestly contrary to the public policy of the Kingdom of Bhutan.

Overall, the literature is positive on the impact of IIAs. In their comprehensive survey of international investment agreements, Echandi, Krajcovicova, and Qiang (2015) have a generally positive assessment of IIAs and make five key observations. First, ratified international investment agreements may increase FDI to participating countries. Second, certain investment provisions, particularly those ensuring market access for investors, are crucial for success. Third, the effects seem to vary by sector. Fourth, including investment provisions in trade agreements can magnify the effects of such treaties. Fifth, the effectiveness of certain provisions—such as the investor-state dispute settlement provision—requires further research as the empirical evidence is not clear. Signing a BIT may increase the costs on domestic policymakers of bad policies. In a similar vein, Salacuse and Sullivan (2005), analyzing the impact of BITs with OECD countries on aggregate FDI inflows to 100 developing countries, found that, when developing countries concluded BITs with OECD countries, FDI inflows were likely to increase. Swenson (2008) finds that BIT signing has a considerable effect on capital goods imports and on imports of differentiated goods, suggesting that BITs foster trade that is mediated by multinational firms, especially for low income economies.

However, there is a range of perspectives. Hallward-Driemeier (2003) concludes that BIT treaty have had a role in increasing the foreign direct investment (FDI) flows to signatory countries, but have exposed policymakers to potentially large-scale liabilities and curtail the feasibility of different reform options. In a summary of the empirical and analytical literature, Sachs and Sauvant (2009) find that investment treaties can strengthen the rule of law in the sphere of international investment and hence contribute to the emergence of international investment law. They argue that:

> "It is clear, then, that no individual factor, such as an investment treaty, could move FDI flows by itself, and it is equally clear that it is very difficult to isolate the importance of any factor. To put it differently: if BITs and DTTs affect FDI flows, they do so in the context of a host of other determinants, with several them considerably more important than individual aspects of the regulatory framework. In general, the regulatory framework of a host country is at best enabling; once it is permissive, the economic determinants become key, especially market size and growth, skills, resources, and costs. While the economic determinants are not everything, everything is nothing when it comes to attracting FDI … BITs and DTTs can help improve the regulatory framework by complementing host-country policies related to FDI, guaranteeing certain investor

rights, making the legal and tax frameworks more transparent and stable for investors, and mitigating the potential impacts of political or economic instability by establishing certain enforcement procedures."

V. Costs of treaties

A. Potential constraints on policy choice

One of the challenges of investment agreements is that they can impose some constraints on policy-makers in developing countries—an issue that has received a lot of prominence in the media and civil society. This can be true when there is a conflict between national policy objectives and international investor goals. While IIAs can prevent discrimination or arbitrary behavior, they can constrain freedom for policymakers. One line of research argues that BITs impose restrictions on developing countries' regulatory flexibility, even if new policies would be consistent with the country's development objectives, or the furtherance of human rights goals (Peterson and Gray, 2003). Others have argued that BITs prevent countries from responding to macroeconomic crises (Argentina and Ecuador) and protecting nascent industries. Prominent cases include conflicts between black empowerment goals and mining investors in South Africa, land reform issues in Zimbabwe, and environmental policy in Mexico, although there have been recent shifts in these countries. IIAs may affect a host country's environmental regulations and public policy objectives. Moreover, the benefits for foreign investors, in terms of capital protection, may be greater than those for domestic investors.

Signing bilateral investment treaties also has a disadvantage in terms of shrinking the policy space of the Kingdom. Bhutan will have to carefully negotiate a treaty and ensure that it does not compromise on environmental or natural resource issues. Moreover, if Bhutan were to join ICSID, Bhutan would potentially be subject to potential arbitration of disputes on taxation policy.[9] The recognition or enforcement of the award could be contrary to the public policy of that country. As currently designed, with the 2013 ADRA and the 2014 signing of the New York Convention, Bhutan maintains a measure of autonomy regarding the appropriate subject matter of arbitration and the grounds for refusal of enforcement, while opening itself up to international arbitration of commercial disputes, including by foreign investors.

B. Legal and institutional capacity

A second cost is the legal and institutional capacity to negotiate treaties. A good negotiating team requires lawyers and in-house awareness of the minutiae of international treaties and a strong background and negotiating capacity. Emerging economies like India and Mexico have that capacity more than small countries like Guinea, Bhutan, or Nepal. The good news is that small countries like Costa Rica, El Salvador, Antigua have successfully used IIAs to defend their interests, so Bhutan will be able to do so also.

C. Fiscal costs of arbitration

A final cost is the fiscal cost of arbitration and possible sanctions, with the average cost amounting to US$3 million. Arbitration can be costly, and often, fiscally constrained economies do not have the budget to incur such costs. In the expensive battle with Chevron, which led

[9] As the investment dispute policy is currently designed, the New York Convention, which Bhutan acceded to in 2014, compliments the ADRA, as Article V (2) (b) of the New York Convention provides: Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that the subject matter of the difference is not capable of settlement by arbitration under the law of that country.

Ecuador to walk away from bilateral investment treaties, the combined costs for Ecuador were close to 3.3 percent of GDP, a non-trivial sum that was close to the combined health and education budgets of the country. In Philippines, two cases cost the government close to US$60 million. It can be argued that the large arbitral awards granted to investors can lead to a decline in the desire to sign BITs. However, most costs are reasonable.

VI. Road map for Bhutan

The road map for Bhutan will need to be based on its FDI policy, and the role IIAs can play for the country. For Bhutan, there are many advantages and a few disadvantages of joining the international investment system, but the advantages clearly outweigh the disadvantages. Bhutan can negotiate in a manner that is congruent with its national interests. In general, the key advantage of joining a Bilateral Investment Treaty with a trading partner is to encourage FDI inflows from the trading partner.

Based on its FDI policy objectives and political economy, Bhutan will have to make four key decisions. These are: 1) whether to negotiate IIAs; 2) the type of IIA; 3) the type of ISDS to have; and 4) if ISDS was there whether ICSID would be a means for dispute resolution. The answer to these will impact the nature of the IIAs Bhutan signs.

For Bhutan, accession to the ICSID Convention allows it to join 150 other nations who are party to it and to provide a strong signal to investors that it is ready to attract foreign investment. The country would have a platform and forum to redress grievances with investors and access specialized proceedings, an enforcement mechanism and wide-ranging support. The ICSID process was specifically designed to complement the unique characteristics of international investment disputes, with detailed regulations and rules that apply to each type of case to ensure independence, procedural fairness and to enhance efficiency. In the past, disputes between states and private parties relating to investments were mostly settled either before national courts or through ad hoc arbitration, both of which have serious disadvantages. For such disputes, no appropriate forum seemed to be generally available.[10]

In the case of Bhutan, an advantage of signing a BIT and joining the ICSID could be to send a signal to foreign investors, strengthen the domestic reform agenda, and fill in the legal vacuum. Currently, the country has zero bilateral or multilateral investment treaties to protect foreign investors and relies on its own national laws and policy frameworks. Given the low costs and comparative advantage of Bhutan in services, FDI inflows can be catalyzed in tourism and financial services. Also, the emerging light manufacturing cluster in the new industrial parks in the southern part of the country presents opportunities. Together with regulatory reforms, BITs can help Bhutan move forward and gain more visibility, like Sri Lanka and Cambodia have done in recent years.

The domestic legislation is clear. Currently the dispute settlement is done through the Bhutan Alternative Dispute Resolution Centre, which is a national body with the Chief Administrator as a Bhutan national appointed by and subject to the approval of the National Judicial Commission. On top of that, the 2013 Alternative Dispute Resolution Act (ADRA) of Bhutan has limited the

[10] Within the ICSID process, an independent conciliation commission or arbitral tribunal, composed from a roster of the world's most experienced conciliators and arbitrators, considers each case. In addition, an award rendered under the ICSID Convention is enforceable as a final judgment in the courts of every ICSID Member State.

scope of the subject matter of international commercial arbitration in the country, prohibiting arbitration on matters of insolvency and winding up, the subject of taxation and other matters which are against public policy, morality or any other existing provisions of the law in force in Bhutan (Article 47). [11]

The country will need to be opportunistic and strategic in signing IIAs according to the following principles.

- Consider how the IIAs best suit its development objectives and FDI policy goals;
- Start negotiating balanced BITs and/or FTAs with important trading partners; however, the Government will have to ensure that the marginal benefit exceed the marginal cost of negotiating and signing BITs and also to see how to deploy scarce administrative capacity (which is also being used to reform FDI).
- Build administrative and legal capacity to negotiate future investment treaties; and
- Continue to undertake the key regulatory reforms and marketing push to attract FDI inflows and bring in foreign ideas, talent, and competition.

[11] The ADRA also allows the High Court of Bhutan to set aside an arbitral award if the court finds that the award is manifestly contrary to the public policy of the Kingdom of Bhutan (Article 150(2)(b)).