Countries are competing for capital. Bilateral Investment Treaties are a tool in this competition. The use of laws and regulations to attract foreign investment has been termed institutional competition. Bilateral Investment Treaties have so far not been directly discussed in light of the different theories of institutional competition. However, the famous prisoner’s dilemma thesis as put forward by Guzman (1998) and the literature based on this article can be subsumed under the theory of institutional competition. The literature on institutional competition suggests that this competition can be either beneficial or harmful for the involved countries. The important question asked here is therefore: are BITs better understood as part of a ruinous competition for capital or, to the contrary, can BITs help overcome domestic inefficiencies and foster the positive effects of institutional competition? This question will be addressed with a focus on developing countries.

The chapter proceeds as follows: section 5.1 describes the notion of efficiency in the context of international investment law to provide a useful frame of reference. Section 5.2 describes the prisoner’s dilemma hypothesis and subsumes this hypothesis under the theory of institutional competition. The examples of tax competition and environmental competition will be discussed to highlight the potential benefits and costs of institutional competition. Section 5.3 illustrates to what extent international investment law may interact with the concept of institutional competition. This implies the consideration of political economy elements. As international investment law has thus far rarely been analysed from a political economy point of view, this paper takes recourse to the well-established political economy of international trade law. This approach entails a deviation from the unitary actor assumptions as employed in the previous chapters. It will be argued that BITs can help overcome domestic inefficiencies, but may at the same time pose a threat of an underprovision of domestic regulation. Taking this into consideration, section 5.4 analyses the relevant provision of BITs and reviews the case law focusing on the specific example of environmental regulation. Section 5.5 discusses the main results and provides a conclusion.

5.1 Efficiency and BITs

The economic analysis of law employs the notion of efficiency as a normative criterion. Two concepts of efficiency are usually applied: Pareto efficiency and Kaldor-Hicks efficiency. A situation can be called Pareto-efficient when no one can
be made better off without making somebody else worse off. Similarly, the notion of a *Pareto*-improvement is employed if the relevant transaction or reform is beneficial to the parties involved. The *Kaldor-Hicks* criterion, on the other hand, does not require that there are only winners to a reform: it suffices that the winners *could* compensate the losers (which does not necessitate that the winners actually do). Even without compensation, the use of the *Kaldor-Hicks* criterion can be justified on the grounds that in the long run, everyone in society will be better off as compared to a society that only employs the *Pareto* criterion. This section argues that the *Kaldor-Hicks* criterium is not well-suited to analyse international investment law. Further, the application of the *Pareto* principle also raises a number of concerns that forces us to limit our attention to *Pareto* improvements within a subgroup of countries, namely the developing countries.

When applying the concept of efficiency to the area of international investment law, one crucial question relates to the level of consideration, namely: what parties will be included in the efficiency considerations? To start with, Bilateral Investment Treaties are treaties between two states. Assuming that states act in the best interests of their citizens and that no party threatens to use (military) force, the treaty, similar to a contract, should be *Pareto*-efficient for the two states concerned. If a capital-importing and a capital-exporting state are assumed, the former must weigh the benefits and costs of higher investment protection. Idealy, the BIT will help overcome the commitment problem and therefore attract additional FDI. The additional investment will increase taxes, create spillover-effects and therefore contribute to the development of the country. The capital-importing state should consequently offer a level of investment protection where the marginal benefits equal the marginal costs. The capital-exporting state should accept the offer when the treaty implies higher investment protection to its MNEs as compared to a situation without the treaty. In sum, both parties are better off. The issue is then to find the right balance between commitment and flexibility (in the presence of contracting imperfections). This approach is taken by Van Aaken (2009) who argues, with regard to BITs, that "(t)he point of optimality between commitment and flexibility still needs to be found." Possible reasons are that the treaties lack adequate mechanisms that ensure flexibility or that tribunals interpret the terms of the treaty too strictly.

Therefore, it appears that a BIT is virtually by definition *Pareto*-optimal as long as only the welfare of the two contracting parties is concerned. However, this argument

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355 Schäfer and Ott (2005), p.32.
357 See Van Aaken (2009), p.16.