

Host States' Police Power and the Proportionality Test in International Investment Law

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Abstract

Capital exporting countries have effectively maintained the imbalance inherent in international investment law as they have better bargaining power in negotiating investment treaties. On the other hand, developing countries race to the bottom and undertake demanding investment related obligations to attract foreign direct investment. These countries are compromising their regulatory power as the terms they enter into would not allow them to take the necessary measures against foreign investors. The imbalance between the protection of investment and host states' regulatory power has called for the development of balancing tools which aim at enabling host states to exercise their inherent regulatory power to achieve domestic policy objectives. One of such balancing tools is the proportionality test. The central question of this essay is: how far does the proportionality test counterbalance the imbalance inherent in international investment law. It has analyzed the proportionality test in investor-state arbitration procedures in light of the imbalance inherent in international investment law, the fragmented nature of international investment law and its institutions, and the host states' regulatory power. This study shows that the proportionality test developed by the international investment dispute settlement system has manifested some positive developments but failed to effectively play a balancing role.

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1. Introduction

The proliferation of bilateral investment treaties (BITs) and the increasing use of investor-state dispute settlement procedures have made interest-balancing tools indispensable in international investment law (IIL)¹. Among these balancing tools is the proportionality test. The growing importance of the proportionality test is evident in international investment dispute settlement (IIDS). Given the fact that IIL is highly criticized for being uneven, the balancing role of the proportionality test will continue to advance. However, the legal and institutional fragmentation in international investment governance has inhibited consistent development of the principle of proportionality. Thus, the balancing role this principle would play in such a fragmented system is worth considering.

A number of scholarly works have depicted an imbalance in IIL between foreign investor's investment protection interest and the police power (legitimate regulatory power) of a host state. Kate Miles has explained the widely shared view about such imbalance and asserted that the main reason that caused the imbalance is the capital exporting countries' continuous determination to ensure their 'political and commercial' control in international investment.² Related to this, what is less explored is the extent to which the principle of proportionality in IIL, as it stands today, counterbalances such imbalance imposed by the capital exporting countries and allows legitimate exercise of host states' police power.

This essay analyses the proportionality test employed in IIDS procedures in light of the imbalance inherent in IIL, the fragmented nature of IIL and its institutions, and the host states' police power. Such analysis would require an integrated investigation approach involving multilevel and multidimensional aspects of IIL which influence the use of

¹ C. Sieber, 'The Principle of Proportionality in International Law' (Swiss National Centre of Competence in Research, Working Paper No 2012/38 December 2012), p.23.

² K. Miles, 'International Investment Law: Origins, Imperialism and Conceptualizing the Environment' *Colorado Journal of International Environmental Law & Policy*, 21 (2010), 1-48.

proportionality test in IIDS. To this effect, this essay has used relevant cases and secondary sources. The next section presents the development of the proportionality test in IIL. Section three provides the balancing role of the proportionality test in IIDS. Section four considers the bottlenecks in the advancement of the proportionality test. Lastly, section five provides concluding remarks which show that the proportionality test adopted by the IIDS system has failed to effectively play a balancing role.

2. The development of the proportionality test in IIL

The early and narrow purpose of IIL which did not go beyond protecting foreign investment from the risk of abuse of power has faced a series of criticisms. The recent socio-legal studies have shown the imbalance in IIL between the host states' police power and the protection of the interests of foreign investors. Kate Miles has, for example, called for a balancing approach describing the current IIL system as an instrument established to serve political and commercial interests of capital exporting countries.³ Others including Charlotte Sieber have explained how the tension between the host states' regulatory power and foreign investor protection guarantees under international investment agreements (IIAs) make the application of the principle of proportionality relevant in IIDS.⁴ Guiguo Wang has also concurred with the aforementioned works citing the continuous dynamics between the two conflicting interests and the relevance of the proportionality test to address this issue.⁵

Recently concluded BITs have witnessed how the two conflicting interests manifest themselves in contemporary IIL. Capital importing countries are striving to maintain regulatory flexibility while capital exporting countries aim at maximizing investment opportunities and

³ *ibid*, pp.3-5.

⁴ Sieber, pp.23-26.

⁵ G. Wang, *International Investment Law: A Chinese Perspective*, (Routledge Research in International Economic Law, 2015), p.425.

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guarantees.⁶ This tension continues to resonate itself in the application of IIAs' provisions in IIDS procedures and it is in this context that the proportionality test became practically relevant in IIL.⁷ International arbitration tribunals have, thus, recognized this battle and started applying the proportionality test to bring about the right balance. Host states have raised a serious concern that the notion of indirect-expropriation which is developed to protect foreign investment from invasive regulatory measures would be applied broadly in many domestic regulatory and legitimate measures regarding protection of environment, human rights and public safety and health.⁸ Such states claimed that 'this would mean that a state could not regulate these areas without incurring an obligation to compensate'.⁹

It is in response to this concern that the International Centre for Settlement of Investment Disputes (ICSID) tribunal introduced the proportionality test in IIDS system for the purpose of determining indirect expropriation in *Tecmed v. Mexico*¹⁰ as will be discussed in the next section. It should, however, be noted that the development of the proportionality test is not consistent due to the fragmented nature of international investment governance and lack of a single appellate body.¹¹

⁶ H. Shin and J. Kim, 'Balancing the Domestic Regulatory Need to Control the Inflow of Foreign Direct Investment Against International Treaty Commitments', *Asia Pacific Law Review*, 19 (2011), 177-194.

⁷ Sieber, p.23-25.

⁸ U. Kriebaum, 'Regulatory takings: Balancing the interests of the investor and the state', *The Journal of World Trade and Investment*, 8 (2007), 717-744.

⁹ *ibid.*

¹⁰ N. Osterwalder and L. Johnson, *International Investment Law and Sustainable Development*, (International Institute for Sustainable Development, 2011), p.141.

¹¹ C. Schreuer 'Investments, International Protection', (Max Planck Foundation for International Peace and the Rule of Law, 2013), p.4. <http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e1533?prd=EPIL> [last accessed 11-12-2015].

3. The balancing role of the proportionality test in IIDS

International investment arbitration tribunals faced criticism in several occasions for giving priority for foreign investment protection over host states' police power. Such criticism revolves around broad interpretation of indirect expropriation which has made it easy for foreign investors to claim compensation even when host states exercise their police power to pursue legitimate national public policies. *Tecmed* has introduced the proportionality test for the first time in determining indirect expropriation in investor-state dispute with a view to ensure the right balance between investment protection and exercise of police power.¹² At this juncture, it is apt to see if *Tecmed* and the subsequent investor-state arbitration awards have fought back the imbalance discussed above. In *Tecmed*, the tribunal declared the 'sole effects' test – the sole test which has been used to determine indirect-expropriation before *Tecmed* – insufficient and added the proportionality test to supplement it.¹³ The tribunal stated in its judgment that:

After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments.¹⁴

In determining indirect-expropriation, the tribunals were applying the 'sole effects' test and, thus, their role was limited to considering if a regulatory measure has caused serious damage to investment without any concern whatsoever about the regulatory power of the host state. In this regard, *Tecmed* has brought about a radical change by establishing a balancing approach through the proportionality test.

¹² P. Ranjan, 'Using the public law concept of proportionality to balance investment protection with regulation in international investment law: A critical appraisal', *Cambridge Journal of International and Comparative Law*, 3 (2014), 853–883.

¹³ ICSID: *Tecmed v. Mexico*, ARB (AF)/00/2, Judgement of 29 May 2003, paras 117-122.

¹⁴ *ibid*, para 122.

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However, the tribunal considered the public policy concerns raised by Mexico minor¹⁵ and didn't show a real commitment to the proportionality test it adopted to ensure the balance between investment interests and police powers of the host state (Mexico). Mexico claimed that its actions do not amount to expropriation of whatsoever form within the meaning of Art 5 of the BIT concluded between Spain and Mexico¹⁶ stating that it was exercising its legitimate regulatory power to protect the environment and public health.¹⁷ Though the tribunal considered the previous 'sole effects' test inadequate stating that the harm caused by regulatory action is not sufficient to establish indirect-expropriation, it has failed to apply the proportionality test in a manner it could serve the purpose for which it was introduced.

The tribunal considered the environmental, public health and social concerns raised by the concerned community and Mexican state as insignificant and not 'serious and urgent' enough.¹⁸ It has also impliedly approved some favor that should be done to a foreign investor in arbitration proceeding stating that 'investors are not entitled to exercise political rights such as voting for the authorities that will issue the decisions that affect such investors.'¹⁹ *Tecmed* has not, therefore, shown genuine commitment to the proportionality test and failed to effectively counterbalance the imbalance inherent in IIL. It has not also applied all the elements of the proportionality test as it has proceeded to 'a strict proportionality review' setting aside the other two stages of review.²⁰ What is more, its assessment has emphasized on the effects of the measures on the investment without giving matching due attention to legitimate exercise of regulatory power.

¹⁵ *Tecmed v. Mexico*, paras 147-149.

¹⁶ Agreement on the Reciprocal Promotion and Protection of Investments signed by the Kingdom of Spain and the United Mexican States, 18 December 1996, Art 5 (1).

¹⁷ *Tecmed v. Mexico*, paras 103-108.

¹⁸ *ibid*, para 147.

¹⁹ *ibid*, 122.

²⁰ Ranjan, p.864.

Due to the increasing relevance of ICSID tribunals in IIDS and because over 150 countries have signed the ICSID convention²¹, it is appropriate to examine the cases recently resolved by ICSID tribunals involving the principle of proportionality to see if this principle is really playing a balancing role. In *LG&E v. Argentina*, the tribunal employed the proportionality test referring to *Tecmed* stating that ‘the Tribunal must balance two competing interests: the degree of the measure’s interference with the right of ownership and the power of the State to adopt its policies.’²² The tribunal considered both the economic impact of the measures and the legitimate regulatory powers.²³ This judgement considered deprivation of the right to enjoy investment as an important factor to establish indirect-expropriation without, however, going further to test the proportionality of regulatory measures taken.²⁴ This approach is very close to the ‘sole effects test’ which emphasizes on economic implications of a measure on investment i.e. the approach *Tecmed* was meant to change.

The *El Paso v Argentina* tribunal has also applied the proportionality test citing *Tecmed*. Like *Tecmed*, it has failed to employ the first two elements of the proportionality test – suitability and necessity – and it has not shown in a clear manner how it applied the ‘strict proportionality assessment’.²⁵ In 2015, the *Tidewater v. Venezuela* tribunal limited itself to the effect of regulatory measure on investment in determining an issue related to indirect expropriation. The tribunal stated that ‘it is well accepted in international law that expropriation need not involve a taking of legal title to property; it is sufficient if the State’s measures have an

²¹ <http://www.internationalarbitrationlaw.com/arbitral-institutions/icsid/> [last accessed 11-12-2015].

²² ICSID: *LG&E v. Argentina*, ARB/02/1, Judgement of 26 September 2006, para 189.

²³ *ibid*, paras 190-197.

²⁴ *ibid*, para 198.

²⁵ ICSID: *El Paso v Argentina*, ARB/03/15, Judgement of 31 October 2011, paras 243-248.

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equivalent effect.'²⁶ This clearly defeats the balancing approach introduced by *Tecmed* and would bring the 'sole effects test' back.

4. The bottlenecks in the advancement of the proportionality test in IIL

Most of the challenges in the advancement of the proportionality test in IIL are related to the nature of this discipline. The initial purpose of IIL was just to provide protection for foreign investment. The impacts of foreign investment on host states were not subjects covered by earlier BITs.²⁷ Capital-exporting countries have also strengthened investor protection aiming at ensuring their political and commercial control in international investment on one hand and addressing the possibility of host states' systematic interference in investment on the other. This shaped the understanding on IIL and the protection purpose became dominant posing a challenge to attempts to adopt a balancing approach through the proportionality test in IIDS.

The legal and institutional fragmentation in international investment governance has also become a serious challenge to the advancement of the principle of proportionality in IIL. Establishment of different tribunals for every dispute led to varying interpretations and this made uniform application of this principle far-fetched and the losers are host states as effective implementation of this principle would have been in their favor. The lack of an appellate body which can ensure reliable application of the proportionality principle has, thus, significantly impacted the consistent advancement of the principle.²⁸ The Legal fragmentation has also inhibited coherent development of the principle as tribunals constituted for each dispute have to apply the provisions of IIAs considering their unique nature. All these factors have become challenges to the proportionality test and the current investor-state arbitrations tend to give

²⁶ ICSID: *Tidewater v. Venezuela*, ARB/10/5, Judgement of 13 March 2015, para 104.

²⁷ Shin and Kim, 179.

²⁸ Schreuer, p.4.

investment protection a priority over regulation in the public interest.²⁹ What is more, though the principle of proportionality has been used in IIDS since *Tecmed*, the tribunals have failed to follow the ‘analytical three-step structure’³⁰ as discussed in section three and this has posed another challenge in the advancement of the principle in IIL.

5. Conclusion

While the proportionality test has been introduced in IIDS with a view to bring about the right balance between protection of foreign investment on one hand and legitimate exercise of police power by a host state on the other, it has failed to effectively serve the purpose for which it was introduced. The tribunals have not gone through the rigorous proportionality review steps which have been necessary to ensure the right balance between the two conflicting interests. The lack of consistency in the development of the proportionality test in IIDS is also evident and this weakens the effectiveness of the proportionality test in investor-state dispute settlement.

²⁹ J. Cosmas, ‘Can Tanzania Adequately Fulfill Its Public Health Regulatory Obligations Alongside Bilateral Investment Treaties Obligations?’ *Journal of Politics and Law*, 8 (2015), 126-136.

³⁰ Ranjan, p.864-866.