1. Introduction to Incomplete International Investment Agreements

The China–Australia Free Trade Agreement (FTA) entered into force on December 20, 2015. A perusal of the agreement reveals that its investment chapter has a serious problem given that it is missing several articles addressing investment protection, such as expropriation and the minimum standard of treatment. Although this may impair their ability to attract foreign investment, both parties decided not to insert investment protection terms. Instead, they included a renegotiation clause.

China and Australia are not the only countries that have failed to complete their International Investment Agreements (IIAs). India and Japan have concluded an incomplete IIA. Various Latin American countries have also failed

---

1 Many countries insert renegotiation clauses to supplement missing articles. See, for example, the text of the China–Australia FTA, Investment Chapter, Article 9.9 (Future Work Program):

1. With a view to progressively liberalising investment conditions, the Parties shall regularly review the legal framework relating to investment and the investment environment, consistent with their commitments in international agreements […]

2. Unless the Parties otherwise agree, the Parties shall commence negotiations on a comprehensive Investment Chapter, reflecting outcomes of the review referred to in paragraphs 1 and 2, immediately after such review is completed. The negotiations shall include, but are not limited to, the following:
   (a) amendments to Articles included in this Chapter;
   (b) the inclusion of additional Articles in this Chapter, including Articles addressing:
      (i) Minimum Standard of Treatment;
      (ii) Expropriation;
      (iii) Transfers;
      (iv) Performance Requirements;
      (v) Senior Management and Board of Directors;
      (vi) Investment-specific State to State Dispute Settlement; and
      (vii) The application of investment protections and ISDS to services supplied through commercial presence […].

2 Chapter 2 defines IIAs. We focus mainly on the chapter on investment under the Preferential Trade Agreements (PTAs) ratified by developing countries in Asia.

to complete their IIAs. New Zealand recently concluded an incomplete IIA with China.

These incomplete IIAs exist due to high transaction costs that arise between states and within states. Various factors such as strong protectionism, a lack of institutional capacity, both failures in intra-government coordination and cooperation as well as a concomitant lack of legal and technical expertise, impede the parties’ ability to reach consensus.

In fact, the presence of an incomplete IIA is not necessarily indicative of failure, inefficiency, or error. Rather, leaving things undecided and renegotiating later is rational if today’s transaction costs are high or if tomorrow’s transaction costs are expected to be low.

To what extent, then, should the parties leave provisions incomplete? Simply put, what is the optimum level of incompleteness in an IIA? The optimum level would maximize the benefits to the parties, given the transaction costs that arise between states and within states. Given limited resources and capacity, the optimum level would maximize the parties’ economic gains by optimizing

---

6 Robert Cooter and Thomas Ulen, Law and Economics, 91 (2008). (The concept of transaction costs encompasses all of the impediments to bargaining such as search costs, bargaining costs and enforcement costs. Search costs are required for determining whether one’s preferred goods or negotiating partners are available in the market. Bargaining costs are the costs that require one to complete an acceptable agreement with the other negotiating partners to the transaction. The negotiation and legal skills for drafting an agreement could be an example of bargaining costs. Enforcement costs are the costs of making sure that the other negotiating partners stick to the terms of the agreement.)
7 Steven Shavell, Foundation of Economic Analysis, 299 (2004). See also, Cooter and Ulen, supra note 6 at 218. (In particular, parties tend not to specify terms and leave a gap in relation to low probability events because the expected loss from the gap will be minimal, whereas the cost of including the terms would be significant. For instance, it may take only a minute to discuss and agree upon terms regarding what to do if hiring a lawyer is required in the event of a car accident on the way to signing a deal, but if such an event is unlikely to happen, it will not be worthwhile to include a provision for such an outcome in the contract. To express this as an equation, suppose the costs of including a term for an (anticipated) contingency is C, that the likelihood of the contingency is P, and that the loss the parties would jointly suffer by failing to include a term for the contingency is L. The following equation would apply: Leave a gap → Expected loss of PL < C, Fill the gap → Expected loss of PL > C.)
the level of investment liberalization in the main text and carving out a reservation list to best attract foreign investments.

The optimum level can be achieved when the parties negotiate until the expected marginal benefit of adding the provisions equals the marginal transaction cost of reaching agreement on them. The benefit and cost of inserting one additional provision (e.g., an investment protection article) are marginal. The parties will perceive themselves as improving so long as the marginal benefit of the additional provision is greater than the marginal cost of the change. Thus, the parties will continue to make these small, or marginal, adjustments as long as the marginal benefit exceeds the marginal cost and will stop when the marginal cost of the last change equals the marginal benefit. This level maximizes the parties’ economic gain from the IIA and reflects the optimum level of incompleteness in an IIA.

In this sense, four types of incomplete IIAs (i.e., missing text, missing articles, missing reservation lists, missing domestic law), which will be illustrated in Chapter 4 (‘Unnecessarily incomplete provisions in IIAs’), are sub-optimal, that is, less than the optimum level of incompleteness. Because of high transaction costs, which will be discussed later, the parties’ economic gains from the agreed IIA are much less than expected. For instance, the parties may negotiate for years and conclude with no article, which adds no value to the text (i.e., missing text). Sometimes, the parties conclude the text without any exceptions that liberalize their entire economies (i.e., missing reservation lists). The parties may place domestic law in a reservation list that carves out entire economic sectors, which adds no value to the text (i.e., missing domestic law). Frequently, the parties fail to agree upon critical liberalization articles such as MFN or NT (i.e., missing articles).

How can the parties reduce transaction costs and move toward the optimum level of incompleteness? In other words, how can the parties achieve greater completeness by lowering the transaction costs of negotiation to increase the economic gains from the IIA? The rest of the book answers this. After Chapter 2 presents the overview of the provisions in IIAs, and Chapter 3 reconciles IIAs with foreign direct investment (FDI) and trade liberalization, Chapter 4 (‘Unnecessarily incomplete provisions in IIAs’) illustrates the four types of incomplete IIAs that are at the sub-optimal level. Chapter 5 (‘Incomplete contract theory and the optimum level of IIAs’) provides a background on contract theory and shows the optimum level of incomplete IIAs by employing marginal analysis. Chapter 6 (‘The cost of incomplete provisions’) illustrates the negative consequences associated with incomplete IIAs. Chapter 7 (‘Reasons for incomplete provisions’) addresses various factors that contribute to high

8 Cooter and Ulen, supra note 6 at 26.
transaction costs that cause incomplete IIAs. Chapter 8 (‘Solutions to incomplete provisions’) explains various legal and institutional remedies to reduce transaction costs and achieve greater completeness. Chapter 9 concludes the book. The following explains each chapter in detail.

OVERVIEW OF THE PROVISIONS IN IIAS

Chapter 2 reviews the structure of IIAs, that is, the main provisions and a reservation list, in detail. While the main provisions determine the overall obligations (and rights) to which both parties must conform, the reservation list identifies either the conforming measures under a positive list approach\(^9\) (General Agreement on Trade in Services [GATS]-type) or the non-conforming measures under a negative list approach.\(^10\) Both approaches will be analyzed in detail.

IIAS AND FDI, AND TRADE LIBERALIZATION

Chapter 3 reconciles IIAs with FDI, and trade liberalization. The chapter begins by explaining the two roles of an IIA: the protection and promotion of investments. The principles of security, reasonableness, non-discrimination, transparency, due process, and establishment of dispute settlement mechanisms in IIAs ensure the presence of a favorable and stable climate for foreign investments.

The chapter explains that IIAs are generally positively related to attracting FDI and that FDI tends to have a positive technology spillover, which enhances the flow of trade and growth of host countries. The magnitude and type of spillovers vary according to the technology or education level, the characteristics of its industries, or local market competition of host countries.

UNNECESSARILY INCOMPLETE PROVISIONS IN IIAS

Chapter 4 defines the concept of an ‘incomplete IIA’ as an investment chapter of a preferential trade agreement (PTA)\(^11\) in Asian developing nations with an

---

\(^9\) A positive approach is reflected in a number of IIAs. See e.g., Korea–EU FTA, Korea–ASEAN FTA.

\(^10\) The negative approach is reflected in many bilateral and multilateral investment agreements. Some examples include Korea–US FTA, US–Singapore FTA, and Australia–Japan FTA.

\(^11\) PTAs are agreements between a set of countries involving the preferential treatment of bilateral trade between any two parties to the agreement relative to their trade with the rest of the world. Customs unions and FTAs are common forms of PTAs.
explicit renegotiation clause. The chapter further identifies four different types of incomplete provisions and exceptions to each.

The four types of incompletion in IIAs are: (1) missing text (an IIA with a single renegotiation clause and no articles), (2) missing articles (an IIA with only a few articles that have been agreed upon and a renegotiation clause to complete the remaining articles in the future), (3) missing reservations list (main text without a reservation list), and (4) missing or unspecified measures (a reservation list with ambiguous, unspecified, or missing domestic laws). This chapter describes incomplete IIAs in recently ratified PTAs between developing countries in Asia, such as India, China, and the 10 countries that make up the Association of Southeast Asian Nations (ASEAN). It also examines PTAs between Australia and New Zealand, which have few or no incomplete provisions.

INCOMPLETE CONTRACT THEORY AND THE OPTIMUM LEVEL OF IIAS

Chapter 5 defines the ‘optimum level of incomplete IIAs’ and shows how an incomplete IIA only reflects sub-optimality due to high transaction costs. After explaining incomplete contract theory, this chapter applies a marginal cost–benefit analysis to find the optimum level of incompleteness in an IIA. The optimum level can be achieved when the parties negotiate until the expected marginal benefit of adding the provisions equals the marginal transaction cost of agreeing on them. The benefit of inserting one additional provision (e.g., an investment protection article) is marginal, and the cost of inserting one additional provision is marginal. The parties will perceive themselves as doing better so long as the marginal benefit of the additional provision is greater than the marginal cost of the change. The parties will continue to make these small, or marginal, adjustments as long as the marginal benefit exceeds the marginal cost, and will stop adding new terms when the marginal cost of the last change made equals the marginal benefit. This level

---

12 Chapter 2 explains the definition of the term ‘reservation list’ as referring to non-conforming measures under the negative list approach.

13 Cooter and Ulen, supra note 6 at 91. (Transaction costs are the costs of negotiating a contract ex ante and monitoring it ex post as opposed to production costs, which are the costs of enacting the contract. To be specific, ex post costs include: (1) the mala-adaption costs incurred when transactions drift out of alignment … (2) the haggling costs incurred if bilateral efforts are made to correct ex post misalignments, (3) the setup and running costs associated with the governance structures (often not the courts) to which disputes are referred, and (4) the bonding costs of effecting secure commitments.)

14 Cooter and Ulen, supra note 6 at 26.
maximizes the parties’ economic gain from the IIA and reflects the optimum level of incompleteness in an IIA. An optimal level maximizes the benefit of the parties, given the high transaction costs that arise between states and within states. Lastly, the chapter shows how incomplete IIAs are sub-optimal.

**COSTS OF INCOMPLETE IIAS (UNDESIRABLE EFFECTS)**

Chapter 6 identifies three negative consequences associated with incomplete provisions, namely: (1) missed opportunities in attracting FDI and achieving trade liberalization; (2) missed opportunities in establishing ‘appropriate economic and legal policies’ (AELP); and (3) opportunistic behaviors associated with incomplete IIAs.

This chapter first examines the literature on the process of ‘investment targeting.’ It investigates ways in which such targeting can be reconciled with IIAs to attract FDI. In practice, many countries establish investment promotion agencies (IPAs) to sort out the protection and liberalization sectors and to encourage FDI in those sectors. Then, this chapter shows how different types of incomplete IIAs may harm both host and home countries’ efforts to protect and attract foreign investors. Missing or ambiguous provisions may impede investors’ abilities to predict the levels of investment protection and the host countries’ regulatory powers.

The chapter also examines how incomplete provisions may prevent parties from establishing AELP to foster growth. IIAs aimed at increasing foreign investment flows traditionally were considered an instrument for Washington Consensus policies and neo-liberalist ideas. This view, however, is criticized

---


17 Neo-liberalism refers to the revival of market fundamentalism in the post-Cold War period which took place as a result of the failure of the Communist system in the Soviet Union. See generally, M. Sornarajah, Mutations of Neo-Liberalism in International Investment Law, 3 TRADE L. & DEV. 203, 210–215 (2011).
by many scholars because many countries have signed IIAs but failed to achieve economic growth.\textsuperscript{18} Many argue that IIAs should now reflect development concerns in host developing countries and introduce various carve-out methods to secure extra policy space.\textsuperscript{19}

This chapter argues that the literature is silent about AELP and growth and further argues that, depending on the insertion or modification of the articles or a reservation list, one could secure AELP for growth. Then, it illustrates specific examples of treaties in which missing articles or reservation lists may frustrate the parties’ efforts to protect their AELP.

Lastly, this chapter explains how parties could opportunistically utilize incomplete IIAs for their benefit. For instance, in the case of missing text or missing articles, parties could opportunistically stick to the articles in the previously concluded IIA and postpone further liberalization by enjoying greater policy space. Moreover, missing or ambiguous domestic law in reservation lists may allow host nations to opportunistically enjoy a larger policy space by not inserting or specifying the measure.

**REASONS FOR INCOMPLETE IIAS**

Chapter 7 identifies two reasons for incomplete IIAs: strong protectionism and lack of institutional capacity. Both substantially increase transaction costs and result in incompleteness far below the optimum level.

First, protectionist motives, lobbying, and host countries’ ongoing legal reforms are arguably the main reasons for incomplete IIAs. A strong preference for gradual, rather than rapid, market openings by host countries’ legislative bodies can induce negotiation teams to leave their IIAs incomplete. Arguably, even though the international pressure of globalization encourages host countries to execute more IIAs, a legislative body would remain opposed to ratifying an IIA that may reduce its popularity among protectionist groups and citizens. If the general public or lobbying interest groups want gradual market openings or specific sectors carved out, the legislative body can block ratification of the IIA and ask for it to be renegotiated. These burdensome requests hinder the negotiation team’s ability to produce a final, agreed-upon form. Therefore, the team leaves IIAs incomplete to avoid the administrative burden of domestic implementation.

\textsuperscript{18} Schill et al. (eds), International Investment Law and Development, 46 (2018).
\textsuperscript{19} Freya Baetens (ed.), Investment Law within International Law, 330 (2013).
Lobbying activities by protected industries in host nations make it difficult for a negotiation team to conclude a complete version of an IIA. For instance, if a negotiation team requests a ministry of land to review a draft IIA and send a reservation list for the land sector, the ministry may reflect the voice of protected interest groups. In turn, the ministry could ask for a huge exception in the IIA or add another page for the reservation list to protect interest groups. Practically, it is difficult for the team to argue against the line ministries’ rationale. In turn, the team generally develops a large carve-out with very broad exceptions, which accommodate and reflect the line ministries’ tastes and preferences. Large carve-outs are generally not acceptable to home states, which results in an incomplete IIA.

Moreover, complications arising from ongoing legal reforms in host countries, such as examining and sorting out unsettled domestic measures, further challenge the completion of IIAs. Following the Washington Consensus, many developing countries reformed their domestic measures to determine AELP. When host countries implement legal reform, they often leave their IIAs incomplete due to difficulties in identifying which domestic laws should interact with IIAs and which should be carved out.

In addition to protectionism, a lack of institutional capacity, both failures in intra-government coordination and cooperation as well as a concomitant lack of legal and technical expertise, causes incomplete IIAs. First, limited coordination and cooperation between a negotiation team and line ministries result in incomplete IIAs. The negotiation team may leave agreements incomplete

---


21 Narcis Serra and Joseph E. Stiglitz, *The Washington Consensus Reconsidered*, 3 (2008) (defines the Washington Consensus as a set of policies governing effective development strategies that have come to be involved with Washington-based institutions such as the IMF, the World Bank, and the US Treasury. The book notes, ‘The Washington Consensus is based on three underlying principles: a market economy, openness to the world market, and macroeconomic discipline. Generally, the Washington Consensus has a view toward “market fundamentalism,” where one looks to the market as the best solution to most economic problems.’)

22 For more information on line ministries’ coordination failure in trade policy in general, see Raymond Senar, *Trade Policy Governance through Inter-Ministerial Coordination: A Source Book for the Trade Officials and Development Experts* (2010). For more on line ministries’ coordination failure in terms of trade negotiation perspec-
because the ministries do not (or cannot) comply in a timely manner with a team’s requests for information. Many ongoing bilateral and multilateral negotiations have deadlines, and line ministries have difficulties completing all requested tasks on time.

Another problem is the lack of legal and technical expertise. Many host countries, particularly developing countries, lack sufficient legal expertise and have trouble understanding the legal consequences of modifying the terms of an IIA. This chapter analyzes the reasons for the absence of legal expertise, including staff turnover, a lack of human resources, and an inability to hire legal counsel.
SOLUTIONS TO REDUCE INCOMPLETENESS IN IIAS

Chapter 8 proposes both legal and institutional remedies to address incomplete IIAs. The suggested remedies could substantially reduce transaction costs and achieve greater completeness, moving toward the optimum level of incompleteness. The two legal remedies are: (1) reliance on the exchange of ‘side letters’ in the domestic implementation phase (i.e., after the conclusion of but before officially signing an IIA);\(^{25}\) and (2) formal renegotiation after ratification through a renegotiation clause.

The chapter first examines the determinants of choosing between a renegotiation clause and a side letter and examines each device in detail. It then highlights the cost-efficient, flexible, and transparent nature of side letters. Unlike expensive domestic procedures (e.g., public hearing requirements from the media and legislative bodies) required by formal renegotiations, exchanging side letters has no substantial administrative requirement. Moreover, because the domestic implementation process is the last opportunity to complete the treaty before its signing, a flexible letter accurately reflects any last-minute deal. This letter could modify the effective date of a completed article or even include a renegotiation clause to avoid incomplete provisions. Moreover, side letters could reflect delayed feedback from the line ministries and flesh out a domestic law or a scheduled reform of domestic legislation to enhance the transparency of domestic law. The letter could even request that the party responsible for the incomplete provisions complete the provisions after ratification of the treaty.

In addition to a side letter, different requirements in the renegotiation clause may encourage parties to complete the IIA. Comprehensive renegotiation schedules (i.e., schedules with agendas and deadlines) may help parties avoid unnecessary debates and from postponing renegotiation. Moreover, the renegotiation clause may condition the entry into force of previously completed articles on renegotiation, which may facilitate renegotiation. In addition, there is a spillover of expertise in the renegotiation phase. The negotiating party

\(^{25}\) The Plot, ‘Legal scrubbing or renegotiation? A text-as-data analysis of how the EU smuggled an investment court into its trade agreement with Canada’. (The news article argues that the negotiators negotiate the concluded treaties in the domestic implementation phase. In the case of the CETA investment chapter, the article found that the text released at the end of negotiations in 2014 and the version that came out of legal scrubbing in February 2016 diverged by 19 percent. The vast majority of changes consisted of material alterations of the treaty text – a de facto renegotiation.) Available at http://www.the-plot.org/2016/03/24/legal-scrubbing-or-renegotiation/ (last visited June 30, 2021).
could hold a workshop, for instance, to deliver their legal and technical expertise to the negotiating partners to complete the treaty.

Thus, the institutional remedies are: (1) improvements to the coordination and cooperation of line ministries, and (2) upgrades in legal and technical expertise. First, a stronger negotiation team with greater political power and easier access to line ministries may be a solution. To ensure that the negotiation team is strong, it is necessary to establish the team as a separate entity with strong political power and priority, housed within the executive office, like the United States Trade Representative (USTR), which is housed within the Office of the President, rather than in an established ministry.

Second, enhancing the legal expertise of the negotiation teams is another solution. Countries could hire more experts, reduce staff turnover, and provide better training for their negotiating officers. Moreover, during the course of negotiations, negotiators should ask the home state questions to acquire expertise in negotiation. In practice, when negotiators from home states become temporary lecturers in the ‘Question and Answer (Q&A) Sessions’ that are held in conjunction with primary negotiations, they use the ‘learning-by-doing’ approach.

The next chapter provides background information on IIAs.