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The Experience of Sri Lanka with International Investment Treaties

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I. Introduction

Today, most developing countries increasingly recognize foreign direct investment (FDI) as a potential source of economic development and modernization, income growth and employment. Sri Lanka is not an exception. Sri Lanka liberalised its economy in 1977 and pursued other investment policies to attract FDI. With these reforms, Sri Lanka made a shift from its original status of an agriculture-based economy to a more market-oriented industrial and services economy. The Board of Investment (BOI) of Sri Lanka, the government arm whose mandate focuses on attracting and facilitating FDI inflow, was established in 1978. Its mandate includes encouraging FDI inflows into Sri Lanka by creating a conducive environment for investment, and negotiating Bilateral Investment Treaties (BITs) with economies that have favourable economic and investment ties jointly with the Ministry of Foreign Affairs.

Since entering into the first BIT with the Government of Germany on 8th of November 1963, to-date, Sri Lanka has signed 28 BITs, of which 24 are in force. The high number of BITs, which was signed during the 1980s, can be explained by the changes in Sri Lanka's economy that took place after 1977. Sri Lanka's trend in entering into BITs during the last 50 years is shown in Figure 1 (next page). Out of 16 BITs signed during the 1980s and 5 BITs signed during the 1990s, all have been ratified within 1 to 3 years of signature. However, out of the 5 BITs signed during the 2000s only one BIT has been ratified and is in force.

This policy brief gives an overview of Sri Lanka's experience with investment treaties, including highlights from a study undertaken by the authors in regard to the interface between BITs and FDI inflows. The brief also reviews international trends in relation to re-negotiating BITs and discusses the elements driving these trends, offering insights into the factors shaping this discussion in developing countries.

II. Sri Lanka's experience in relation to the application of BITs provisions

The main goals of BITs are promotion and protection of foreign investment. This section presents an overview of Sri Lanka's policy approach to BITs and its experiences with investor-state dispute settlement (ISDS) cases.

Sri Lanka liberalized its economy in 1977, with the introduction of open economic policy. The BOI was mandated with a key role in the country's economic development in regard to mobilizing external finance. Sri Lanka's policy towards FDI considers it an essential element in attaining new technologies that may not be available in Sri Lanka, generating much needed direct and indirect employment opportunities among Sri Lankans, and enhancing overall competitiveness of Sri Lankan exports. In order to attract foreign investments, Sri Lanka made use of BITs as a promotional tool for investment, through the protection given therein.

Like most of the other countries, Sri Lanka has undertaken little prior analysis on the legal implications of the BITs and the economic costs and benefits associated with such

This brief is part of the South Centre's policy brief series focusing on international investment agreements and experiences of developing countries.

While the reform process of international investment protection treaties is evolving, it is still at a nascent stage. Systemic reforms that would safeguard the sovereign right to regulate and balance the rights and responsibilities of investors would require more concerted efforts on behalf of home and host states of investment in terms of reforming treaties and rethinking the system of dispute settlement.

Experiences of developing countries reveal that without such systemic reforms, developing countries' ability to use foreign direct investment for industrialization and development will be impaired.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

***** The views contained in the policy brief are personal to the author and do not represent the institutional views of the South Centre or its Member States.**

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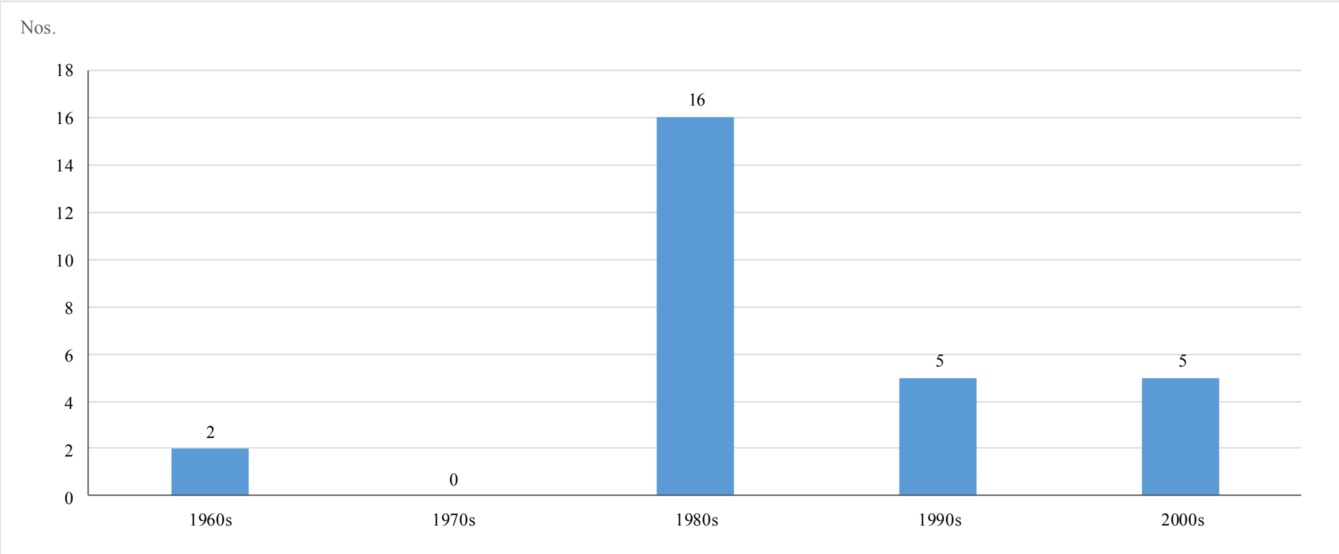
Figure 1: Sri Lanka's Trend in Entering into BITs



Source : UNCTAD International Investment Agreement Navigator, Board of Investment of Sri Lanka

agreements. Even in recent years, when a head of State visits Sri Lanka, there is a tendency to enter into BIT agreement with that particular country as a way of extending diplomatic cooperation between the two states. Sri Lanka had not given in-depth consideration on how the investment treaty language is interpreted, and could only realize the challenges that might emerge as a result of the bitter lessons learned from international arbitration cases filed by investors against Sri Lanka.

Sri Lanka faced its first investor-state arbitration case in 1987 (Asian Agricultural Products Ltd. v. Democratic Socialist Republic of Sri Lanka), which was brought under the United Kingdom-Sri Lanka BIT. This case is reported to be the first arbitration case in the International Centre for Settlement on Investment Disputes (ICSID). This was followed by two ICSID cases in 2000 and in 2010 bringing the total amount of ICSID cases against Sri Lanka to three. The three investor-state dispute settlement cases faced by Sri Lanka are: Asian Agricultural Products Ltd. V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO. ARB/87/3), Mihaly International Corporation V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO. ARB/00/2) and Deutsche Bank AG V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO. ARB/09/02). The summary of the three cases are given in Table 1.

III. Interface of BITs with FDI inflows to Sri Lanka

A study was carried out by the authors in 2015, to assess the impact of BITs in attracting foreign direct investment inflows into Sri Lanka, to identify the scope and coverage of Sri Lankan bilateral investment treaties (BITs) and to evaluate the reasons driving recent trends in BITs' reforms within the global and Sri Lankan context. The study was undertaken with a view towards making suggestions for improvements in existing and future BITs that Sri Lanka is, or would be, party to.

The study applied two approaches; a regression analysis and a scenario analysis to assess the objectives stated above. The regression analysis assessed the impact of BITs on FDI inflows to Sri Lanka. The scenario analysis reviewed the BITs' regime and assessed the scope and coverage of Sri Lankan BITs, reasons for revising BITs and areas to be considered for renegotiation.

The regression analysis was done using panel data regression based on secondary data pertaining to a sample of 30 FDI source countries to Sri Lanka[1]. The study looked at a 10-year period extending between 2005 and 2014 (data on country–wide FDI inflow to Sri Lanka is available from 2005 onwards). The independent variable in the study was natural log of annual FDI inflows to Sri Lanka. Several explanatory variables were used including home gross domestic product, trade openness of home country, natural log of the distance between home and host country, and host country parameters such as inflation, real wage of workers, labour force, trade openness of host country, presence of bilateral investment treaties (BITs), presence of double taxation agreement, control of corruption, and annual ship arrivals[2].

The scenario analysis was done using primary and secondary data pertaining to global and Sri Lankan scenarios in this regard.

In addition to the above, a descriptive analysis was undertaken to assess the general FDI performances of BIT and non-BIT partner countries of Sri Lanka. The descriptive analysis also covered the FDI inflows to Sri Lanka during the period extending between 2005 and 2014.

The total FDI inflows to Sri Lanka during 2005 – 2014 amounted to USD 9,044 million of which 74% of FDI inflows i.e. USD 6,725 million has been received from BIT partner countries (countries with which Sri Lanka has a

Table 1: Summary of Arbitration Cases of Sri Lanka

Case	Provision of the BIT used as basis for the claim	Award
Asian Agricultural Products Ltd. V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO. ARB/87/3) *Case filed in 1987*	Full Protection and Security	Sri Lanka had to pay US$ 460,000 in compensation plus simple interest at the rate of 10% from the date of the arbitration request up to the date of the actual payment.
Mihaly International Corporation V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO. ARB/00/2) *Case filed in 2000*	Pre-establishment National Treatment	The case was dismissed on a jurisdiction issue
Deutsche Bank AG V. Democratic Socialist Republic of Sri Lanka (ICSID CASE NO.ARB/09/02) *Case filed in 2010*	Definition of "Investment"	Sri Lanka had to pay a compensation to Deutsche Bank the sum of USD 60,368,993 plus interest based on a nine-month Libor rate as of 9 December 2008 together with a sum of USD 7,995,127.36, considered as the reasonable legal fees and expenses of Claimant, while the costs of the arbitration was borne equally by the parties.

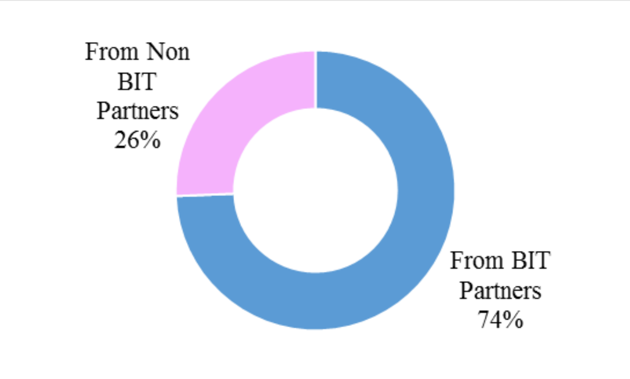
Source: ICSID, https://icsid.worldbank.org/apps/icsidweb/cases/Pages/AdvancedSearch.aspx

BIT in force) and 26% i.e. USD 2,320 million has been received from non-BIT partner countries (countries with which Sri Lanka doesn't have a BIT in force (Figure 2). Out of the BIT partner countries, Malaysia, UK, China, India and the Netherlands have stood among the top five FDI source countries of Sri Lanka while among non-BIT partner countries, Hong Kong, United Arab Emirates, Mauritius, British Virgin Islands and Canada secured first five places of FDI source countries of Sri Lanka.

Out of the over 2,000 of BOI projects approved under section 16 and section 17 of the BOI Law[3] during the study period (which are in different status of project approval process), 80% have been invested by investors from BIT partner countries, while the remaining 20% have been invested by investors from non-BIT partner countries (Figure 4). The descriptive analysis has also shown that compared to non-BIT partner countries, the BIT partner countries of Sri Lanka contribute more in terms of establishing project ventures in Sri Lanka.

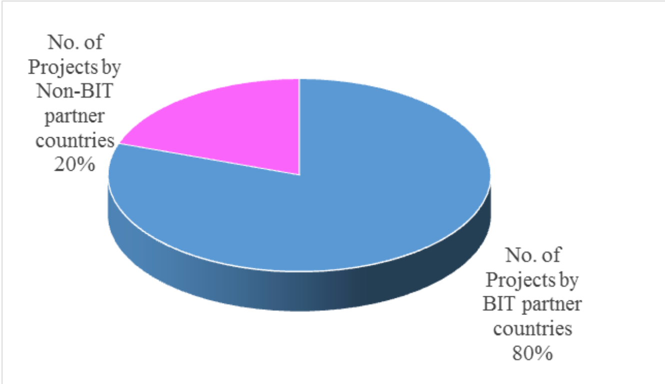
The trend in FDI inflows into Sri Lanka from BIT and non-BIT partner countries shows that FDI inflows from BIT partner countries have been high throughout the years[4]. However, FDI inflows from non-BIT partner countries have also become significant during last few years (Figure 3).

Figure 2: Composition of Total FDI Inflows to Sri Lanka: 2005-2014



Source: Compiled using data available at Board of Investment/ MIS

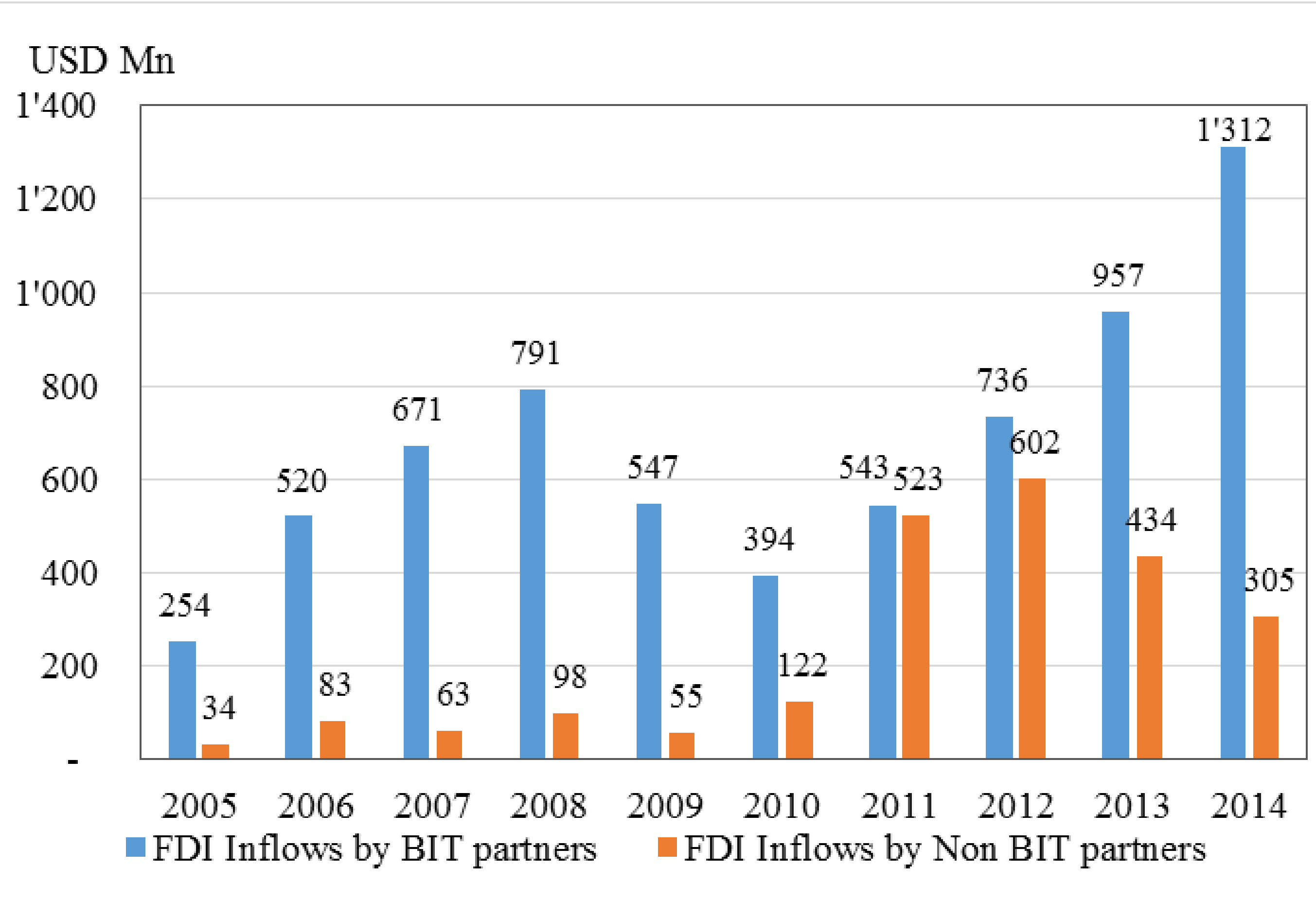
Figure 4: Share of BIT and Non-BIT Partner Countries in Number of BOI Approved Projects



Source: Compiled using data available at BOI/ MIS

Overall, while the findings reveal that FDI flows from Sri Lanka's BIT partner countries have been significant, the FDI from other non-BIT countries have also shown upward trends during the period covered by the study. The evidence does not allow for establishing a conclusion of causality between the presence of the BIT and the increase in FDI flows. For example, the conclusion of a BIT could be the result of a long history of cooperation and FDI flows between two countries that culminate in the negotiation and signature of a BIT. The data of FDI inflows into Sri Lanka reveal inconclusive evidence that FDI flows increased after the entry into force of a BIT with the partner country (See Annex). Australia and Pakistan have entered into BITs in Sri Lanka in 2007 and 2000 respectively. Although Australia shows a significant improvement in FDI inflows after executing the BIT, Pakistan has not shown any improvement while having a Free Trade Agreement in addition to BIT.

Figure 3: Trends in FDI Inflows to Sri Lanka 2005 - 2014: BIT vs. Non BIT Partner Countries



Source: Compiled using data available at BOI/ MIS

Even though 80% of the cumulative FDI inflow to Sri Lanka has been received from BITpartner countries,annual country wide inward FDI data for Sri Lanka is available only from the year 2005. Therefore, comparing FDI inflows to entry into force of BITs is not possible for the treaties signed by Sri Lanka.

This falls in line with the global trend of empirical studies on the impact of international investment agreements (IIAs) on FDI, which provide heterogeneous results and have limitations because of, among others, data and methodological challenges[5]. UNCTAD points out that empirical studies show mixed results; while the majority of the studies conclude that IIAs have a positive impact on FDI, UNCTAD points out that an empirical correlation does not necessarily imply causation[6].

The scenario analysis assessed the reasons behind the trends of BITs' reform, with special focus on the implications of bilateral investment treaties on host economies. Furthermore, it reviewed the strategies adopted by other countries reforming BITs, with a view towards identifying the areas for improvement in Sri Lanka's BITs negotiation process. These elements are discussed in the following section.

IV. International trends in relation to renegotiating BITs

A significant number of countries are in the process of reviewing their model BITs in line with recent developments in international investment law. For instance, at least 50 countries have recently revised or are in the process of revising their model BITs. This includes 12 African countries, 10 European and North American countries, 8 Latin American Countries, 7 Asian Countries and 6 transition economies[7].

While there is a trend in reforming BITs by some countries, there are also many countries that follow a "wait and see" approach in regard to BITs. These countries hesitate to undertake holistic reforms to their model BITs with the fear that it might adversely affect the country's attractiveness of FDI. Moreover, some countries fear a negative impact on political relationships with partner countries. As such, rather than engaging in reforming their BITs, they prefer to observe the repercussions and impact of BITs' reforms on first movers in this area[8]. These trends require assessing the underlying reasons driving the need for reform.

Reasons for BITs' reforms

(i) Structural changes in the economies of the developing host countries

Developing host countries have witnessed structural changes in their economies over time. Several moved from being capital importing countries only (seeking to attract more FDI inflows), to being capital exporting[9] (interested both in FDI inflows as well as promoting and protecting FDI outflows). However, some of the BITs were signed by these economies over three to five decades ago and have become outdated. Since many of the BIT signatory countries have become both capital importing and capital exporting countries, it has become essential for these countries to revisit their existing BITs as well as model investment treaties to ensure they realize their set objectives.

(ii) Little awareness of the legal implications of BITs

Originally, when countries entered into BITs, they had no or limited knowledge on the impact of such agreements. For example, the former Attorney General of Pakistan had stated that although Pakistan inked the first ever bilateral investment treaty with the government of West Germany 50 years ago, when the first investor-state dispute settlement case was brought against Pakistan, he was not aware of the BIT and its impact on the country[10].

He stated that "[*t*]*he Secretary of Law called me up in 2001 and asked what I knew about the International Centre for Settlement of Investment Disputes (ICSID) and this thing called a bilateral investment treaty (BIT). He informed me that Pakistan was being sued by SGS at ICSID and asked how SGS could do that. To be perfectly honest, I did not have a clue, so I had to look it up on Google. I typed in 'ICSID' and 'BIT', and that's how I learned about these instruments for the first time*"[11]. "*The secretariat of the Chief Executive [former President Pervez Musharraf] issued a directive which provided that no more BITs were to be signed by Pakistan until the Attorney General's office was consulted and all other government stakeholders were onboard. This was a first for Pakistan. Previously, I don't think any ministry—except that in charge—even knew that the BITs had been signed, and I couldn't find files on record demonstrating that meaningful negotiations had actually taken place*"[12]. This statement is very relevant and still valid for most developing countries, although often not admitted in public.

(iii) Increasing interest in sustainable development objectives

It is observed that there is a new trend to re-negotiate provisions of BITs to suit the national requirements and sustainable development objectives of the countries. Given the growing concerns with sustainable development obligations, the host economies seek to have provisions in their BITs that limit investors' access to investor-state dispute settlement in cases where the investor fails to comply with its obligations in regard to sustainable development goals. Designing future BITs requires balancing traditional State commitments against new investor's commitments introduced in connection with the achievement of sustainable development objectives[13]. Unlike earlier days, countries are now more concerned with the ability to use BITs for achieving economic development targets.

(iv) Trends in investor-state arbitration cases

Most of the countries have taken different approaches when negotiating BITs in recent years, especially due to the investor-state dispute settlement (ISDS) cases that have cropped up based on different provisions of the BITs. These ISDS cases may have pushed countries to revisit and rethink their BIT provisions, especially those that have been interpreted by arbitral tribunals in a way that restricted flexibility of the governments in changing their policies. It is also noted that the interpretation of BITs' provisions by the arbitrators have raised serious concern among host countries. Often, these provisions have been interpreted entirely different from the intent of State Parties to these agreements at the time of negotiations. For instance, expropriation and the most-favoured nation (MFN) provisions are two main provisions that investors invoke in arbitration cases against States. Therefore, governments have been considering how to improve the domestic courts systems as an alternative to ISDS, as well as carving out some of the provisions from the BITs.

V. Concluding observations: A "wait and see" approach

Given its experience with the three ICSID cases, Sri Lanka considered to "move away from BITs" and to "establish appropriate domestic legislation to protect inward FDI"[14]. However, the government of Sri Lanka followed a "wait and see" approach. Its position is the result of concerns that substantive changes could damage the investment environment of the country and could also create a politically complicated situation with partner countries. Sri Lanka avoided finalizing or ratifying any new BIT since 2009, although few BITs have been in the process of negotiation. Sri Lanka seems to be very careful on entering into new BITs in the future, except in cases of "compelling economic and political circumstances"[15].

Sri Lanka introduced selective adjustments in its BIT reform process. For example, it re-visited the Model BIT in line with global trends, to clarify the legal text, seeking to avoid unanticipated interpretations by arbitrators of future agreements reflecting the Model BIT. Sri Lanka also pays attention to defensive as well as offensive interests when negotiating BITs, covering both inward and outward investments. Capacity development of BIT negotiators and establishing close coordination between negotiators and legal officers defending claims against Sri Lanka is also considered a key to successful BITs negotiations.

BITs could be used as a promotional tool in attracting FDI to Sri Lanka. However, future BIT negotiations must be undertaken based on a clear in advance analysis of the potential impact, since achieving a "win- win" situation for both parties would ensure sustainable development in Sri Lanka.

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End notes:

[1] The analysis was done using random effects model in panel regression with STATA 12 statistical package.

[2] Data Sources : MIS/Board of Investment Sri Lanka, Central Bank of Sri Lanka, UNCTAD, World Governance Indicators, JETRO Survey on Industrial Factor Cost - various series, World Bank, http://data.worldbank.org, www.distancefromto.net. The empirical model is provided in the following equation as:

ln FDI = $\beta 0 + \beta 1$ln Home GDP + $\beta 2$Home Trade Openness + ln Distance + $\beta 4$Inflation$_{SL}$ + $\beta 5$Real wage rate of workers$_{SL}$ + $\beta 6$Trade Openness$_{SL}$ + $\beta 7$Labour Force in Mn$_{SL}$ + $\beta 8$Presence of BIT-Dummy + $\beta 9$Control of Corruption$_{SL}$ + $\beta 10$Annual Ship arrivals$_{SL}$ + $\beta 11$Presence of DTA-Dummy + εi. All explanatory variables have shown a positive relationship with FDI, and were significant at the levels of either 5% or 10%, except for three variables (real wage rate of workers, control of corruption index and presence of DTA).

[3] Projects approved under the Section 16 of BOI Law operate under the normal law of the country with no special incentives and the projects approved under section 17 of BOI Law enjoy BOI Concessions

[4] Out of 24 BITs ratified, all except Australia (new BIT) & Germany (terminated & signed) have been signed prior to study period (i.e. 2005-2014)

[5] See: UNCTAD Issues Note (September 2014) "The Impact of International Investment Agreements on Foreign Direct Investment: An Overview of Empirical Studies 1998-2014".

[6] Ibid.

[7] UNCTAD, World Investment Report 2015

[8] UNCTAD, World Investment Report 2004

[9] Gordon, Kathryn and Phol, Jaochim, "Investment Treaties over Time - Treaty Practice and Interpretation in a Changing World", OECD Working Papers on International Investment (2015/02): 1-49.

[10] See: International Institute for Sustainable Development, Investment Treaty News of 16 March 2009.

[11] Lauge Skovgaard Poulsen and Damon Vis-Dunbar (16 March 2009) "Reflections on Pakistan's investment-treaty program after 50 years: an interview with the former Attorney General of Pakistan, Makhdoom Ali Khan", IISD, Investment Treaty News, available from https://www.iisd.org/itn/2009/03/16/pakistans-standstill-in-investment-treaty-making-an-interview-with-the-former-attorney-general-of-pakistan-makhdoom-ali-khan/ (visited 4.7.2016).

[12] Ibid.

[13] John Gaffney, "Achieving sustainable development objectives in international investment". Available from http://www.tamimi.com/en/magazine/law-update/section-8/march-7/achieving-sustainable-development-objectives-in-international-investment.html.

[14] Intervention by Ms. Champika Malalgoda, Director, Research & Policy Advocacy Department, Board of Investment of Sri Lanka, delivered at UNCTAD IIA Conference - 16 October 2014, available at: http://unctad-worldinvestmentforum.org/wp-content/uploads/2014/10/Malalgoda.pdf (visited 4.7.2016).

[15] Ibid.

Annex: Foreign Direct Investment Inflows to Sri Lanka by BIT Partner Countries - 2005-2015 (figures in million USD)

No.	Country	Entry into Force (Year)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1	Australia	2007	3.32	4.47	1.51	8.79	5.97	8.65	6.29	14.75	18.18	37.40	18.60
2	Belgium	1984	8.38	8.07	13.88	13.35	2.87	2.89	15.77	3.38	8.15	3.90	7.48
3	China	1987	0.94	4.43	10.73	27.36	19.72	4.08	10.45	184.96	239.94	403.50	150.78
4	Denmark	1985	0.28	4.22	3.09	3.69	1.28	0.88	1.04	2.36	1.32	1.80	0.91
5	France	1982		3.16	1.60	0.18	1.08	1.72	3.38	1.10	11.91	10.17	2.32
6	Germany	2004	2.12	5.12	8.38	4.43	11.04	8.56	9.19	9.10	14.82	7.29	14.51
7	India	1998	17.86	27.05	42.88	125.93	77.71	110.24	146.80	160.17	50.52	51.84	67.84
8	Indonesia	1997		0.27	0.24	0.05	0.27	0.15	0.19	0.13	0.00	0.06	0.07
9	Italy	1990	10.56	19.45	18.24	7.02	7.11	1.88	1.82	1.23	1.29	1.89	1.00
10	Japan	1982	4.10	38.61	48.78	16.73	19.36	13.52	27.22	25.81	37.62	14.91	8.42
11	Korea	1980	4.99	10.52	10.64	9.29	1.77	2.38	3.19	18.06	1.04	1.01	0.84
12	Luxemburg	1984	17.31	54.05	5.98	82.25	23.87	5.16	25.61	37.25	21.40	13.52	26.91
13	Malaysia	1995	99.56	164.67	296.40	150.41	164.52	72.68	89.53	47.36	176.20	37.18	65.08
14	Netherlands	1985	0.61	12.61	28.63	117.22	43.98	27.68	51.35	55.70	118.24	98.60	90.16
15	Norway	1985	1.95	2.70	4.99	4.40	5.30	1.52	1.22	1.21	1.13	1.50	1.55
16	Pakistan	2000	0.15	1.12	0.53	1.29	0.47	0.45	3.08	0.32	0.33	1.52	
17	Singapore	1980	30.63	29.56	19.99	20.61	21.60	42.37	53.02	88.05	111.67	102.53	30.46
18	Sweden	1982	10.13	49.85	31.45	37.78	19.79	11.64	7.65	6.07	3.68	4.22	0.53
19	Switzerland	1982	1.51	4.34	1.02	3.22	5.25	0.72	20.86	14.46	17.68	4.84	3.25
20	Thailand	1996				12.17	1.66		0.21	0.04	16.01	3.34	
21	U.K	1980	26.37	40.39	95.84	87.44	89.04	61.81	52.05	37.79	70.23	382.54	29.04
22	U.S.A	1993	12.76	35.54	26.38	56.82	21.52	14.88	11.92	26.83	35.44	127.91	16.77
	Total		**253.52**	**520.19**	**671.18**	**790.41**	**545.18**	**393.87**	**541.86**	**736.11**	**956.78**	**1,311.45**	**536.48**

Source: Board of Investment of Sri Lanka

Note: 2005 is the year starting in which figures for FDI inflow by country are available