Regulatory Takings: A real globalization of property rights?

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Abstract
This text analyzes basic aspects of the doctrine called “Regulatory Takings”, its relationship with Bilateral Investment Treaties, and how both factors have encouraged a global acceptance of this thesis. Property rights and expropriations really imply an analysis of many other issues related to political economy, public policy and how a particular interpretation of property rights affects many countries, especially in Latin America, Middle East, and other developing regions in the world. The current scenario in Latin America is such that there is inequality in the understanding of property rights and the efficiency of its protection. Therefore, countries without a clear acceptance of the free market have a very weak basis for the protection of property rights. On the other hand, countries with a clear and strong acceptance and implementation of the free market have a solid basis for knowledge and protection of property rights. The change in the acceptance of free market system and the increasing criticism of it in developing countries could affect the real application of the notion of “regulatory takings”.

Keywords: Regulatory Takings, Foreign Direct Investment, Bilateral Investment Treaties, Property Rights,

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1. Introduction

In a context of legal and economic globalization, it is interesting to analyze the relationship between foreign direct investment (FDI), property rights and the legal doctrine called “regulatory takings.” This breakdown implies both an economic and legalistic perspective, because expropriations imply an analysis of many other issues related to political economy, public policy, and how a particular interpretation of property rights affects many countries, especially in Latin America, the Middle East, and other developing regions in the world. The current discussion on the basis and outcomes of globalization has generated a tremendous challenge to many states, its regulators, and regulations; there have been many difficulties incorporating practices, related to commerce and investment.

There are several elements related to the application of the doctrine of regulatory takings in the global economic order. An order ruled by the law of international economic organizations, treaties, systems to resolve conflicts and controversies, international jurisdiction, liabilities of the state, and others. Nevertheless, the most relevant approach is the division between trade and investment.

The first assumption is the existence of a special global regulation of FDI in which there can be found an interesting dialectic relationship between three aspects in the current scenario: (1) Aspects of Public economy such as freedom to invest, taxation, protection of property rights, and the prohibition of direct and indirect expropriations (2) Private legal issues related to the organization of companies abroad, basically upon the structure of
Transnational Corporations (TNC) or Multinational Corporations (MNC)² (3) The increasing number of Bilateral Investment Treaties (BIT).

Therefore, these three elements appear as the most important pieces of the international system of FDI which regulates duties and rights of the investors, mechanisms to solve controversies, the guarantee of the national treaty and the just treaty, and other issues.

The doctrine of “regulatory takings” has its origin in the Fifth Amendment of the Constitution of the United States of America which establishes the basic principle of expropriations, that is: “nor shall private property be taken for public use without just compensation”. There is interesting historical information about the topic from 1922. In “Pennsylvania Coal vs. Mahon. 260 US.393 (1922)”³ a significant sentence was given by the famous judge Oliver Wendell Holmes when a mining made a claim against the constitutionality of a state law that prohibited extraction of coal from the subsurface of urban sites for public safety reasons. (Fischel, 1995) This case established the following doctrine, source of several studies: “While property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking”.

This doctrine was very controversial, and the courts decided to reject this interpretation for almost fifty years, until its resurgence in the 1970s and 1980s in the context of economic reforms adopted during the government of President Ronald Reagan.

These ideas were supported by the contribution of the 1982 Nobel Prize winner, George Stigler.

As mentioned earlier, one of the most noted scholars in this field, William Fischel (1995) states that “the most controversial aspect of expropriations is presented when the government establishes or alters a regulation, generating a decline or reduction in value of certain properties.”

The current context of international contracts is seen as important instrument in the development of these theoretical and practical frameworks. This context is integrated by international regulations, international jurisdiction and international panels such as ICSID. Because the context of FDI, contracts and property rights is extremely relevant for developing countries, it is necessary to analyze the current scenario.

2. A dialectic context

A dialectic analysis can be applied to some aspects of the current context of FDI. First, there is a dialectic relationship between two concepts: “property rights” and “economic regulation.” These concepts have been incorporated into international agreements that rule the framework between states and private foreign investors. There is also a permanent inclination to restrict the regulatory power of the states through Bilateral Investment Treaties (BIT) or International Contracts, and an inclination that could result in a gradual attrition of the sovereignty of states. This circumstance can restrict the legal power of the state because MNC and TNC argue that restricting regulatory power of the state is a requirement to protect the property rights of foreign investors. Second, there is another dialectic relationship between the

rules directing FDI and the real level of development in every country. This relationship implies that FDI must be an efficient instrument to increase social welfare and real development.

Bilateral Investment Treaties (BIT), an important instrument for FDI, had diffused and been applied for the last twenty years, although its creation was forty years ago. This activity has created a wide network of international regulation of FDI. Nevertheless, there has been an interesting movement supporting a very harsh analysis of parts of these treaties. A typical clause in these treaties refers to the controversial “regulatory takings” or “indirect expropriations.” Therefore, most of the opposition to these treaties is really an opposition to these clauses. Professor Andrew Guzman of University of California, Berkeley states:

“It is widely recognized that economic globalization requires market – supporting institutions to flourish. Direct Investments in developing countries are overwhelmingly governed by bilateral investment treaties. BITs are agreements establishing the terms and conditions for private investment by national and companies of one country in the jurisdiction of another. Virtually all BITs cover four substantive areas: FDI admission, treatment, expropriation and the settlement of disputes.”

In the same way, Chilean Foreign Investment Committee website gives a good description of these treaties.


6 “In these agreements, each Contracting State commits itself to provide fair and equitable treatment to investments legally materialized in its territory by investors of the other Contracting State. They also guarantee the principles of National Treatment and Most Favored Nation status. Moreover, BITs protect private property rights through the establishment of basic principles and minimum standards in case of expropriations. Likewise, they guarantee that any expropriation or measure with similar effect will be adopted in accordance with a law based on public good or national interest, in a non-discriminatory manner. They state that expropriatory measures must be accompanied by the provisions of prompt, adequate and effective compensation. Additionally, these agreements establish a dispute settlement mechanism in case of controversies that might
Concerning the issue of how the current rules of FDI influence development, there is a critical approach stated by Davarnejad (2008):

“Imbalance serves as a keyword to describe the emphasis on the economic dimension of international investment regulations in comparison to the social dimension which has rarely been considered until now. In particular there is an imbalance in international investment law between regarding the interests and rights of investors on the one hand and the interests and rights of all the other parties affected by FDI in the other hand. With reference to the main providers of investment – multinational enterprises MNEs- the question is whether an imbalance exists between allowing rights without imposing obligations”

This paper assumes: (a) There is a clear influence of the intellectual school of thought called “Law and Economics” in the development and dissemination of BITs and especially the doctrine of “regulatory takings” (b) There is a level of inequality in the knowledge and real understanding of the regulatory takings doctrine in many developing countries, which creates increasing chances of expropriations, especially in an environment critical of globalization and its legal structures (c) Governments that decrease their trust in the development of market or increase their criticism of free market institutions are more likely to generate controversies related to regulatory takings. Many cases of direct expropriations and regulatory takings usually occur because of an unaccountable administrative power.

3. **Concepts**

According to a legal dictionary, expropriation means “the compulsory purchase of property by the state under its power of eminent domain.” Taking could be defined as “the act of laying hold upon an object.”

There are two classical kinds of expropriation: (a) **Direct or physical expropriation** (b) **Indirect or regulatory expropriations or regulatory takings.** Direct or physical expropriation means that the agency or the government materially eliminates the property rights of the owner, an act that implies a deprivation of the material ownership and legal control of the owner with respect to the thing. **Indirect or regulatory expropriation** implies any law, regulation, procedure, requirement, or practice that generates the same effects or is tantamount to a direct expropriation, which means, the loss of all or some part of the value of the property.

**Timothy Brenan and James Boyd** (2005) Professors of University of Maryland gives a clear explanation about the issue in a paper called **“Political Economy and the efficiency of compensation of takings”**:

“Over the last decade or so, a number of Supreme Court decisions have brought to the forefront of policy debates a long standing legal controversy over when and whether the government should compensate property owners when regulation reduces the value of their property. This “takings” jurisprudence begins with the last clause of the Fifth Amendment in the Bill of Rights to the US. Constitution, which among other limits on the power of government include …nor shall property be taken for public use without just compensation”

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9 Id. footnote 7

Thus, Brenan and Boyd state that, “much less clear in Supreme Court jurisprudence is whether a “taking” has occurred when a property owner suffers a loss not from the government owning the property, but as a consequence of regulations that create losses.”\footnote{Brennan, Tim and Boyd, James William, "Political Economy and the Efficiency of Compensation for Takings". Contemporary Economic Policy, Vol. 24, 2005 Available at SSRN, \url{http://ssrn.com/abstract=867108}, pp. 2}

An example of this taking clause is found in the website of the US. Bureau of Economic, Energy and Business Affairs' International Finance and Development unit:

“Neither party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization, except : (a) for a public purpose; (b) in a non discriminatory manner; (c) on payment of prompt, adequate, and effective compensation, and ; (d) in accordance with due process of law”.\footnote{\url{http://www.state.gov/e/ehb/rls/othr/38602.htm}}

This is the typical taking clause in every BIT, according to the American model.

In a hypothetical situation, any government can approve a regulation (especially in topics such as taxation, environmental law or land zones) that implies a large expenditure for a company, a reduction in the value of its assets, or variation of the present value of future cash flows. For instance, a regulatory adjustment in the tax structure of a foreign investment contract can generate a decrease in the value of an asset, thereby generating and indirect expropriation.
With respect to the elements and factors to determine a regulatory taking, Wise (2004) says that “the Supreme Court's quiescence began to change in the late 1970s. In the 1978 case Penn Central Transportation v. New York City, the Court specified three factors as having particular significance in determining a regulatory taking: (1) the economic impact of the regulation on the property owners (2) the extent to which the regulation interfered with distinct investment-backed expectations; and (3) the character of the governmental action.”

A very simple grammatical analysis of the expression “regulatory expropriation” or “regulatory taking” shows two parts: regulatory and takings

1. **Regulatory** is about economic regulation, and its theoretical framework is based on the theory of economic regulation developed by George Stigler, Nobel Prize winner of 1982.

2. **Expropriation**, according to a legal dictionary, means “the compulsory purchase of property by the state under its power of eminent domain”. Taking can be defined as “the act of laying hold upon an object.” 15 Therefore, the two concepts of the expression are related to “economic regulation” and “property rights.”

On one hand, one of the most highlighted theories about property rights was developed by Ronald Coase, University of Chicago professor and 1991 Nobel Prize Winner. This work is best known as “Coase’s theorem”. On the other hand, one of the most highlighted theories about economic regulation was developed by the George Stigler, 1982 Nobel Prize Winner and University of Chicago Professor.

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15 Id. footnote 7
Coase and Stigler share some similarities: both were professors at the University of Chicago; both obtained the Nobel Prize. Stigler even named the Coase’s main contribution about efficient allocation of property rights, as “Coase’s Theorem.” Additionally, both are great contributors to the intellectual movement called Law and Economics. This expression, “regulatory takings”, like many of the most important theoretical microeconomic approaches to property rights, reveals that “ownership” can be analyzed from the perspective of law, economics or both perspectives. This kind of analysis or approach has been slowly increasing in Latin America since the 1980s, where the consolidation of the free market economy was supported by the Structural Adjustment Policies (SAPs). This consolidation generated liberalization and increased levels of capital flows, essentially for the incrementing rates of FDI.

4. Problems with BITs and Regulatory Takings

4.1. Inequality

It is pertinent to insist that this is not only a legal problem, although the argument of this paper is the existence of an “inequality of legal knowledge” for the countries that accepted this system and do not understand the doctrine. Nevertheless, the application of the doctrine is much more of a public policy problem for the governments that subscribed these treaties.

Foreign Direct Investment (FDI) is affected by many factors such as risk control (political or economic risk), the level of profits, and the tax structure of every state. Taxation

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16 This situation is complicated in countries with plurality of concepts of property rights, such as in the Middle East, in which there is a division between Hanafi and non Hanafi jurists. For instance, in the case of an expropriation, which involves the deprivation of the property rights, the quality of owner or the outcomes that a government regulation could affect to a specific collection of rights, tantamount to an expropriation. This situation was the case of Wena Hotels Ltd. v Arab Republic of Egypt (Case N. ARB/98/4 – October 31, 2005) in which the government of Egypt deprived Wena Hotels of the rights to make use of its investments in accordance with a lease contract subscribed to by both parties. Also, “benefit” is a key word to understand the real content of the property rights because property gives to the owner the abilities to take advantage of the thing not only in case of necessity but in any time. However, this idea appears very strongly in the assumptions of Shafi’i and Hanbali schools, “Islam banned the use of interest in loan contracts” (Timur Kuran, 2004).
is one of the areas in which the doctrine of “regulatory takings” can be applied, and some scholars have called this concept “regulatory taxings.” 17 This notion incorporates the economic outcomes of taxes in property rights; it also considers the tax as an expropriation.

4.2. **Has this system been helpful and efficient to attract FDI to these developing regions?**

During the 1990s, FDI increased in Chile, but this process was supported by the economic and political stability of the country.

“Chile has achieved widespread recognition for its strong track record in attracting foreign direct investment (FDI). Indeed, according to the 2007 *World Investment Report*, published by the United Nations Conference on Trade and Development (UNCTAD), the stock of FDI in Chile reached 55.4% of GDP in 2006, up from just 30.0% in 1990. By comparison, in 2006, the average world figure reached 24.8% and that for developing countries was running at 26.7%.”18

Therefore, in the Chilean case, the elements of BIT and stability have worked. These were deciding factors, in contrast to other countries, such as Bolivia which have begun a process of critical approach to the BITs and the international jurisdiction of ICSID.

4.3. **Incentives to apply the doctrine of regulatory takings.**

In most developing countries, environmental issues, taxation and land zone regulations, are areas susceptible to the application of the regulatory takings doctrine. For example, one of the concepts that Latin America lacks is the political nature of environmental agencies; most of

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18 [http://www.foreigninvestment.cl/index/plantilla2.asp?id_seccion=1&id_subsecciones=94](http://www.foreigninvestment.cl/index/plantilla2.asp?id_seccion=1&id_subsecciones=94)
them are politically and not technically generated. Therefore, many decisions are subject to the pressures of corporate groups, interest groups, and lobbies.

This situation has an historical precedent as shown by the famous case Metalclad in which, “under the dispute resolutions provisions of North American Free Trade Agreement NAFTA, ordered Mexico to pay a compensation of almost $ 17 million of dollars to a US. Corporation, Metalclad, because Mexico’s land use and environmental laws prevented Metalclad’s Mexican subsidiary from operating a hazardous waste facility in Guadalcazar, Mexico” 19 20

**Been and Beauvais** (2003) wrote an interesting article about this situation and said that “provisions nearly identical to NAFTA article 1110 are contained in many of the 1500 bilateral investment treaties in effect around the world.”21 Also, many environmentalists have said that this is a really aggressive approach to the article 1110 of NAFTA with worldwide effects.22

Therefore, countries with wide unregulated or de-regulated areas in environmental issues are more attractive to FDI, and sometimes, these sectors of de-regulation have been supported by the BIT. It is important to remember that during the 1980s, one of the requirements imposed by the system of SAP (Structural Adjustment Policies) created by the IMF was related to privatization and de-regulation of many markets. With regard to SAP there were, two kinds of countries: (1) those countries that made structural reforms directly by the influence of the SAP (2) those countries, such as Chile, that implemented reforms that allowed

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21 Been, p.3
the liberalization, privatization, and incentives to FDI, which were supported by the liberal economists during the government of 1973 – 1990.

The current acceptance by most American, European, Asian, and African countries of the taking clause in the BITs is the first glimpse of a real globalization of this theory of property rights. This is the reason that it is possible to stay that the United States is exporting this doctrine to the International Law in many cases successfully.

According to the information of ICSID (International Centre for Settlement in International Dispute)\textsuperscript{23}, there are 178 countries that have subscribed to BITs, and have accepted the taking clauses. Thus, there is a huge network of BITs and a kind of global acceptance of the doctrine. Professor Andrew Guzman (2006) of University of California, Berkeley, states that “BITs are a part of a larger process of globalization that has been furthered by the dynamics of competition. This competition is driven by the desire of developing countries to participate in the global capitalist system”\textsuperscript{24}

4.4. **How the regulatory takings doctrine limits local regulation**

As stated earlier, the leading case in the topic in the United States is the famous decision Pennsylvania Coal vs. Mahon (1922) by Judge Oliver Wendell Holmes, who said: “While property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.” This is the same reasoning used by lawyers litigating in ICSID during arbitration about Foreign Investment. Currently, from a public policy focus, the question continues:

\textsuperscript{23} See \url{www.worldbank.org/icsid}

\textsuperscript{24} Guzman, pp. 46.
When does the regulation go too far? What is the limit of regulation? There are two answers given by two American scholars:

(a) Professor Thomas Eger states that “if the regulatory act causes a considerable reduction in value of the asset, “regulation” becomes “regulatory taking” and compensation had to be paid.”  
   Eger, Thomas , accessible in www.igidr.ac.in/~babu/law/slides/eger5.doc pp.9

(b) The explanation of Robert Cooter, Professor of University of California, Berkeley, states:
   “If the courts decide that restricting permitted uses is a mere regulation, then the restriction costs government nothing. On the other hand, if the court decides that this restriction is a taking, so that compensation must be paid, then the restriction is very costly to the government. Obviously, the non compensability of regulations gives government officials an incentive to over regulate, whereas the compensability of takings makes government officials internalize the full cost of expropriating private property.”

Therefore, a better standard of protection for the foreign investors implies the expansion of the treatment of the regulation as a taking.

4.5. Another question about the effects of the doctrine is related to the knowledge and understanding of the doctrine. Do the regulators in developing countries really know what this doctrine implies?

A first answer could be that the poorest countries in Latin America, the Middle East, or Africa perhaps still do not understand the full content of the doctrine of regulatory takings.
Although there is a great flow of lawyers and economists from developing countries studying in United States, it is not certain that these regulators have fully studied the impact of each situation regarding regulatory takings. Due to the fact that understanding regulatory takings involves a very sophisticated analysis, it is clear that a real tension exists between local regulation and this international concept of property rights crucial to BITs.

6. Final ideas.

6.1. The doctrine of regulatory takings implies an application of an American legal approach to property rights. Most of the developing countries – especially in South America, such as Bolivia, Ecuador or some in the Middle East do not have the same concept of property rights. This means that countries such as Bolivia and Venezuela, especially with their current ideological context, have announced direct and indirect expropriations, although their governments have subscribed to many BITs. Therefore, this situation increases the chance of conflicts in ICSID.27

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6.2. As a summary of the evolution of the doctrine of Regulatory Takings, there are 4 phases in the history of this topic:

1. The starting point of the application of the doctrine and its landmark foundational stage is the famous case Penn. Coal vs. Mahon 260 US.393 by Judge Oliver Wendell Holmes.

2. A second phase consisting of the abandonment of the doctrine (disused) from 1940 to 1960 - over 20 years of rejection of these principles.

3. A third phase which began in 1960 with the appearance of the paper by Ronald Coase called "The Problem of Social Cost" began the departure of the economic theory of "property rights." This phase was completed around 1980 with plans for deregulation and privatization started in the United States, mainly during the Reagan administration. These plans also coincided with the rise of the theory of economic regulation. This was publicly recognized by the delivery of the Nobel Prize in Economics in 1982 to Chicago professor George Stigler. This era is represented by the writings of scholars such as Siegan (1980), Epstein (1985), and the doctrine originated in the Contract with America (1994) and subsequently Fischel (1996).

mining project; 19. Motorola Credit Corporation, Inc. v. Republic of Turkey (Case No. ARB/04/21) Subject Matter: Cellular telecommunications network
4. A fourth phase, which could be called the "internationalization of the doctrine of regulatory takings", has been expressed through BITs.

6.3 The doctrine of “regulatory takings” had an urban origin, related to the land zone regulations. The increasing expansion of FDI and Bilateral Investment Treaties found in the regulatory takings doctrine, a useful instrument to strengthen the property rights of foreign investment against the risk of expropriations. This took place during the 1970s when there were many processes of direct expropriations in Latin America, such as the case of Chile with the American copper investment. This experience of expropriation encouraged the writers of the Chilean Constitution of 1980 to include three articles specifically devoted to the protection of property rights. At the same time, during the 1980s the decade of the boom of property rights and de regulation, many scholars, especially at the University of Chicago, revitalized the theories of judge Wendell Holmes and supplemented these doctrines with the theoretical framework of the de - regulatory movement.

6.4 With the end of the authoritarian governments and dictatorships in Latin America, the 1990's was a decade of consolidation of democracy and the free market, supported by foreign investment. In this context, the risk of direct expropriation was decreasing and it was a very good opportunity to strengthen the doctrine of the “indirect expropriations.”
6.5 This doctrine of “indirect” or “regulatory” expropriations is a really interesting American creation, which implies an accurate and elaborate knowledge of the American legal system. The question is if the regulators of many agencies in developing countries know it clearly.

6.6 The current scenario about the topic in Latin America could be described as “inequality in the concept of property rights” and as “inequality in the efficiency of their protection.”  

6.7 Countries without a clear acceptance of the free market have a very weak basis for the protection of property rights. On the contrary, countries with a clear and strong acceptance and implementation of the free market have a strong basis for knowledge and protection of property rights. In Chile, for example, this knowledge is increasing among the regulators, but there is still a great lack in the judicial power and judges.

6.8 Furthermore, countries or governments that have begun processes of reformation of their economic systems, supported by a criticism of the free market, have decreased their levels of protection of property rights. Currently those countries and governments, such as Bolivia and Venezuela, are more able to analyze the chance of direct expropriations. Therefore, a decreased level of protection of property rights normally implies an increased political risk.

28 It seems that many legal orders in Latin America do not reveal a strong support of the roles or effects of property rights, which according to De Soto are: (1) Fixing the economic potential of assets (2) Integrating dispersed information into one system (3) Making people accountable (4) Making assets fungible (5) Networking people (6) protecting transactions. De Soto, Hernando “ The Mystery of Capital”, Basic Books, New York, 2000, pp.49-62
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Cases:


Models:
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Agencies and Institutions

www.worldbank.org/icsid

http://www.foreigninvestment.cl/index/plantilla2.asp?id_seccion=1&id_subsecciones=94