

**United Nations Conference on Trade and Development**

# **World Investment Report**

**2003** **FDI Policies for Development:  
National and International  
Perspectives**



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## PART TWO

# ENHANCING THE DEVELOPMENT DIMENSION OF INTERNATIONAL INVESTMENT AGREEMENTS

*UNCTAD has been working on issues related to bilateral and regional investment agreements for some time, focusing on policy analysis and technical cooperation,<sup>a</sup> and involving a wide range of countries. WIR03 draws on this experience.*

*With the number of treaties that address FDI proliferating, issues relating to international investment agreements (IIAs)—agreements that, in their entirety or in part, address investment issues—have come to the forefront of international economic debate.*

*Part Two of WIR03 seeks to throw light, from the development perspective, on certain issues that arise in IIAs—irrespective of the ongoing multilateral investment discussions. Whether governments negotiate IIAs—and, if so, at what level and for what purpose—is their sovereign decision. And whatever the outcome of the investment discussions in the WTO, the issues raised here remain important, precisely because of bilateral and regional treaty-making.*

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<sup>a</sup> The results of this work are contained in various UNCTAD publications listed in the references. For the coverage of technical cooperation, see UNCTAD 2003e.



# INTRODUCTION

Countries seek FDI to help them to grow and develop—and their national policies are key to attracting FDI and increasing benefits from it.

Many countries have also concluded international investment agreements (IIAs)—especially agreements at the bilateral, subregional or regional levels that address investment issues, at least in part. In doing so, they seek to make the regulatory framework for FDI more transparent, stable, predictable and secure—and thus more attractive for foreign investors. If frameworks liberalize FDI entry and operations, they reduce obstacles to FDI. At the same time IIAs limit the “policy space”—and thus flexibility—governments, especially of developing countries, need to pursue policies to attract FDI and increase benefits from it to further their development. The challenge for developing countries entering IIAs is to find the right balance between the attractiveness provided by IIAs and the loss of policy autonomy that they entail. This year’s *WIR* seeks to identify the main issues.<sup>1</sup>

There has been significant liberalization of FDI policies over the past decade (table I.8). FDI flows have risen rapidly, partly in response. Still, FDI is only a complement to domestic investment, the main driver of growth. But since FDI is becoming more important in total investment, most developing countries and economies in transition are following the developed countries in removing restrictions to FDI entry and operations and improving standards of treatment of foreign affiliates. The results have been mixed. Opening has not, in many cases, led to the magnitude of FDI inflows that many developing countries expected. And even when inflows rose, the development benefits of FDI were often below expectations.

Why? Once an enabling framework has been established, economic factors—the main determinants of FDI flows—assert themselves. Host countries may not have the size of markets, growth rates, skills, capabilities or infrastructure that would make investment in productive capacity attractive—either for the domestic market or as export bases. Foreign investors may not have been well informed of the opportunities available—perhaps because host countries did not promote themselves effectively in an intensely competitive world market for FDI or were ambiguous about how much FDI they really wanted and on what terms. Prospective investors, in turn, may have found the investment environment deficient, difficult or risky—despite the liberalization.

More serious, the investment may not have had a substantial developmental impact on the host economy—expanding the export base, adding technology value to exports, contributing to easing balance of payment constraints, increasing local linkages, transferring technology and upgrading skills and management capabilities. Particularly for large TNCs, there might have been conflicts between the interests and needs of the host economy and the global corporate strategies of the investing firms, largely independent of concerns associated with specific locations.

Most countries—including developed ones—have tended to combine liberalization with more proactive measures to attract the right kind of FDI, including by setting up IPAs. They also have policies to draw greater benefits from FDI and reduce its negative effects.<sup>2</sup>

IIAs are put forward as an additional means to attract investment. They send a clearer signal to international investors, especially when they lock in the regulatory status quo, and they indicate a stronger commitment to the stability of rules. The number of IIAs has grown apace, and at all levels: bilateral (the most popular), regional (such as NAFTA and ASEAN) and multilateral (such as GATS and TRIMs). Many more IIAs are in the making.

But what about the loss of national policy space implicit in the rules that IIAs set? For a host country, finding the right balance in negotiating IIAs involves understanding two things:

- Host country policies and measures that are particularly important for attracting FDI and increasing benefits from it.
- Ways in which international agreements affect national policies.

Part Two of *WIR03* seeks to advance such understanding. Chapter III identifies key national policies and measures in inward FDI. It also reviews the rise, impact and features of IIAs. Chapter IV discusses eight issues that have passed a double filter: they are particularly important for national FDI policies and international investment negotiations, and they are particularly sensitive in the context of such negotiations. Chapter V focuses on one particular important issue: national policy space. Part Two also examines in chapter VI what else can be done in future IIAs to enhance the effectiveness of key national policies in promoting development. Concluding this Part is a summary of key messages.



## CHAPTER III

## KEY NATIONAL FDI POLICIES AND INTERNATIONAL INVESTMENT AGREEMENTS

National policies are key for attracting FDI, increasing benefits from it and assuaging the concerns about it. Those policies have to be seen in the broader context of the determinants of FDI, among which economic factors predominate (table III.1). Policies are decisive in preventing FDI from entering a country. But once an enabling FDI regulatory framework is in place, the economic factors become dominant. Even then, the regulatory regime can make a location more or less attractive for foreign investors and for maximizing the positive development effects of FDI, while minimizing negative ones.

Many policies affect FDI. This chapter deals only with those directly related to it, such as setting entry conditions for foreign investors, improving standards of treatment, enhancing benefits from FDI and coping with its less desirable effects.

Countries seek FDI to promote their growth and development. With its package of tangible and intangible assets, FDI can contribute directly and indirectly to building national capabilities. The growing appreciation of the benefits of FDI reflects several factors. Concessional aid is declining, and various financial crises have created a preference for long-term and more stable capital inflows. Access to innovative technologies is more important. And some of the earlier fears about FDI may have been exaggerated, given the economic benefits that many developing countries have drawn from FDI (*WIR99*). Many governments are now more confident in dealing with TNCs. And TNCs have learned to be more responsive to the concerns and priorities of host countries.

The best way of attracting and drawing benefits from FDI is not always passive liberalization (an

Table III.1. Host country determinants of FDI

Host country determinants	Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
I. Policy framework for FDI <ul style="list-style-type: none"> <li>• economic, political and social stability</li> <li>• rules regarding entry and operations</li> <li>• standards of treatment of foreign affiliates</li> <li>• policies on functioning and structure of markets (especially competition and M&amp;A policies)</li> <li>• international trade and investment agreements</li> <li>• privatization policy</li> <li>• trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies</li> <li>• tax policy</li> </ul> II. Economic determinants III. Business facilitation <ul style="list-style-type: none"> <li>• investment promotion (including image-building and investment-generating activities and investment-facilitation services)</li> <li>• investment incentives</li> <li>• hassle costs (related to corruption, administrative efficiency, etc.)</li> <li>• social amenities (bilingual schools, quality of life, etc.)</li> <li>• after-investment services</li> </ul>	<b>A. Market-seeking</b>	<ul style="list-style-type: none"> <li>• market size and per capita income</li> <li>• market growth</li> <li>• access to regional and global markets</li> <li>• country-specific consumer preferences</li> <li>• structure of markets</li> </ul>
	<b>B. Resource/asset-seeking</b>	<ul style="list-style-type: none"> <li>• raw materials</li> <li>• low-cost unskilled labour</li> <li>• skilled labour</li> <li>• technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters</li> <li>• physical infrastructure (ports, roads, power, telecommunication)</li> </ul>
	<b>C. Efficiency-seeking</b>	<ul style="list-style-type: none"> <li>• cost of resources and assets listed under B, adjusted for productivity for labour resources</li> <li>• other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products</li> <li>• membership of a regional integration agreement conducive to the establishment of regional corporate networks</li> </ul>

Source: *WIR98*, p. 91.

“open door” policy). Liberalization can help get more FDI, but alone it is not enough. Attracting FDI in a highly competitive market for investment now requires stronger locational advantages and more focused efforts at promotion. Getting FDI in technologically advanced or export-oriented activities is even more demanding.

Having attracted foreign investors into a country, policies are crucial to ensure that FDI brings more benefits. Policies can induce faster upgrading of technologies and skills, raise local procurement, secure more reinvestment of profits, protect the environment and consumers and so on. They can also help counter the potential dangers of FDI—say, by containing anticompetitive practices and preventing foreign affiliates from crowding out viable local firms or acting in ways that upset local sensitivities.

## A. Key national FDI policies

Developed countries have moved towards “market-friendly” policies—pursuing sound macro management, having stable and non-discriminatory rules on business entry and exit, promoting competition, building human capital, supporting innovation and so on. But even the most market-friendly countries have not given up promotional measures to attract foreign investors. Several use sophisticated promotion techniques as well as large grants and subsidies to target particularly valuable investments.

Developing countries are also trying to attract FDI and increase the benefits from it. And they, too, are moving towards market-friendly policies. But they have to be careful doing so, since their market structures are weaker and their development needs more pressing. That is why they are more concerned about preserving their national policy space for investment, to be able to use the policy instruments that can address their special needs.

The discussion here focuses on three objectives—attracting FDI, benefiting more from it and addressing concerns about TNCs. Some objectives and measures overlap, but they are considered separately for convenience.

### 1. Attracting investment

Countries can attract FDI in many ways. They can simply liberalize the conditions for the admission and establishment of foreign investors without doing much more. They can promote FDI inflows in general, without trying to attract particular kinds of investment—say, according to

Free markets do not always ensure efficient and equitable outcomes, particularly in developing countries with weak markets and institutions. Hence, the need for policy intervention. The groundwork for making markets work well—sound legal systems, clear and enforceable rules of the game, responsive market institutions, a vibrant domestic enterprise sector and the like—has to be laid down by the host country government. But even then, the strategic objectives of TNCs may not match the development goals of host governments. Policies need to bring them more in line with those goals.

The list of market failures and policy responses is long. The basic point here is that, in the real world of imperfect markets, governments have a major role. They can influence FDI in many ways with varying degrees of intervention, control and direction.

their technology content. Or they can promote FDI more selectively, focusing on activities, technologies or investors. Measures are often used together—by leaving most activities open to foreign investors, creating a better investment climate generally and putting special effort into bringing in particularly desirable investment.

The economic attractiveness of a country for FDI depends primarily on its advantages as a location for investors of various types. Market-seeking investors look for large and growing markets. Resource-seeking ones look for ample natural resources. And efficiency-seeking ones look for a competitive and efficient base for export production.<sup>3</sup>

More general factors affect all prospective host economies: political stability, a sound macroeconomic framework, welcoming attitudes to foreign investment, adequate skills, low business transaction costs, good infrastructure and the like (table III.1).

Given these factors it is still useful to use promotional policies to attract investors, particularly as competition for FDI mounts and investors become choosier. The information for basing investment decisions is not perfect, and subjective perceptions matter. Good marketing can make a difference (of course, only if other conditions are in place). And it is possible for host countries to create conditions that make investments more viable (rather than simply marketing what they already have). This may simply involve removing constraints to foreign affiliate operations. But it may also involve creating new skills, infrastructure or support institutions.

How much promotion is needed depends on the kind of FDI and the basic attractions of a host economy. A large and dynamic economy needs to promote itself less than a small and less dynamic one. The bulk of the massive inflows into China are not the result of active FDI promotion. And promotion can only go so far. If the economic base is weak or unstable, no amount of persuasion will attract large and sustained FDI inflows.

The main ways countries have sought to attract FDI and the key sensitive issues that arise in IIAs are:

- *Reducing obstacles to FDI* by removing restrictions on admission and establishment, as well as on the operations of foreign affiliates. The key issues here are how investment is to be defined for liberalizing entry or offering protection (direct and portfolio capital flows may be treated differently) and what kind of control should be exercised over FDI admission and establishment.
- *Improving standards of treatment of foreign investors* by granting them non-discriminatory treatment vis-à-vis domestic or other foreign investors. The key issue here is what degree of national treatment should be granted to foreign affiliates once they are established in a host country.
- *Protecting foreign investors* through provisions on compensation in the event of nationalization or expropriation, on dispute settlement and on guarantees on the transfer of funds. A key issue here is how far the right to expropriate or nationalize extends (especially to what extent certain regulatory actions of governments constitute takings of foreign property). Another is the acceptability of the kind of dispute settlement mechanisms available to foreign investors and countries. Third is what restrictions, if any, are acceptable on the ability of governments to introduce capital controls to protect the national economy.
- *Promoting FDI inflows* through measures that enhance a country's image, provide information on investment opportunities, offer location incentives, facilitate FDI by institutional and administrative improvements and render post-investment services. Host countries do most of this, but home countries may also play a role. The key issues here relate to the use of financial, fiscal or other incentives (including regulatory concessions) and the actions that home countries can take to encourage FDI flows to developing countries.

The general trend is to reduce obstacles, create investor-friendly settings and promote FDI. But the nature and balance of policies applied by countries varies. Why? Because locational advantages differ. Because the cost of some measures is much higher than others. And because governments differ in their perceptions of how best to attract FDI.

## 2. Benefiting more from FDI

Attracting FDI may not be enough to ensure that a host country derives its full economic benefits. Free markets may not lead foreign investors to transfer enough new technology or to transfer it effectively and at the depth desired by a host country. But policies can induce investors to act in ways that enhance the development impact—by building local capabilities, using local suppliers and upgrading local skills, technological capabilities and infrastructure. The main policies and measures used for this include:

- *Increasing the contribution of foreign affiliates to a host country through mandatory measures.* The objective is to prescribe what foreign affiliates should do to raise exports, train local workers or transfer technology. The key issue here relates to the use of performance requirements.
- *Increasing the contribution of foreign affiliates to a host country by encouraging them to act in a desired way.* The key issue here, as in attracting FDI, is using incentives to influence the behaviour of foreign affiliates. (Incentives may be tied to performance requirements.<sup>4</sup>) Particularly important here is enticing foreign affiliates to transfer technology to domestic firms and to create local R&D capacity.

Countries are learning that foreign affiliate activity can be influenced to enhance host country benefits only if they strengthen their capabilities. New technologies can be diffused in a host economy only if the skill base is adequate or if domestic suppliers and competitors can meet TNC needs and learn from them. Export activity can grow only if the quality of infrastructure so permits. Governments need to mount policies to build domestic capabilities, drawing on foreign affiliates and their parent firms in this effort. And again home countries can help in various ways through measures of their own. Indeed, even TNCs can try to increase the benefits to host economies.

### 3. Addressing concerns about TNCs

Despite the general shift of attitudes in favour of FDI, significant concerns remain about potential negative effects.<sup>5</sup> Some major areas of concern:

- Anticompetitive practices by foreign affiliates.
- Volatile flows of investment and related payments deleterious for the balance of payments.
- Tax avoidance and abusive transfer pricing by foreign affiliates.
- Transfers of polluting activities or technologies.
- Crowding out local firms and suppressing domestic entrepreneurial development.
- Crowding out local products, technologies, networks and business practices with harmful sociocultural effects.
- Concessions to TNCs, especially in export processing zones, allowing them to skirt labour and environmental regulations.
- Excessive influence on economic affairs and decisionmaking, with possible negative effects on industrial development and national security.

Voiced in the past by developed and developing countries, these concerns are diminishing in intensity. But they remain strong enough so that many governments feel the need to control inward FDI and the operations of foreign affiliates. Most important are concerns about anticompetitive practices of TNCs, especially restrictive business practices.

\* \* \*

To sum up: governments in developing countries and economies in transition use a range of policies and measures to attract FDI, increase

benefits from it and address concerns about it. The main ones address the ability of countries to pursue development-oriented national FDI policies and are particularly sensitive in the context of international investment negotiations:<sup>6</sup>

- Long-term investment flows that add to production capacity (the definition of investment).
- How to treat FDI entry (national treatment in the pre-establishment phase) and the subsequent operations of foreign affiliates (national treatment in the post-establishment phase).
- Circumstances under which government policies could be regarded as regulatory takings.
- The nature of dispute settlement.
- The use of performance requirements.
- The use of incentives.
- The encouragement of technology transfers.
- The role of competition policy.

When entering into international agreements, countries therefore face some difficult decisions to find the right balance between retaining policy space and flexibility and reaping the benefits from international cooperation.<sup>7</sup> Some policies or measures may be required to facilitate greater FDI inflows (such as opening up and raising standards of treatment). But applying restrictions and conditions to such inflows may be necessary to ensure that investment brings the desired outcomes. Finding the right balance is not easy—and it varies from country to country.

In the past two decades or so, governments have been concluding more agreements at the bilateral, regional and multilateral levels that address investment issues, at least in part. These are referred to here as “international investment agreements” (IIAs).<sup>8</sup> They complement national FDI policies—and interact with them.

## B. The growth of IIAs

Investment rules are multifaceted, ranging from the voluntary to the binding. The obligations they set out differ in geographical scope and coverage. Some of them address only certain aspects of FDI policies. Others address investment policies in general, including policies that affect both domestic and foreign investors (competition rules or anticorruption measures). Still others cover most or all important elements of an FDI framework, ranging from admission and establishment, to standards of treatment to dispute settlement mechanisms. Rising in number (annex

table A.I.13 and A.I.14), IIAs have created an intricate web of commitments that partly overlap and partly supplement one another, creating a complex set of investment rules.

The most important effort to create international rules for investment in the early years after World War II was multilateral—in the framework of the Havana Charter. It failed. The bilateral level proved to be most productive in terms of producing investment rules. It focused first on protection and then on liberalization. The first instruments of choice were treaties for the

protection and promotion of foreign investment—bilateral investment treaties (BITs). Later, free trade agreements took up the matter as well.

### 1. Bilateral agreements

BITs are spinoffs from general treaties dealing with economic relations between countries (such as Friendship, Commerce and Navigation treaties). Since 1959, the year of the first BIT, their number has grown steadily—to 385 by 1989 and to 2,181 by 2002 (figure I.11).<sup>9</sup> Since the second half of the 1990s, their number almost doubled. Now encompassing 176 countries, more BITs are being concluded between developing countries as well as between them and economies in transition (see chapter I), reflecting the emergence of firms from these countries as foreign investors. Today, more than 45% of the BIT universe does not include developed countries. They are the most widely used international agreement for protecting FDI (table III.2).<sup>10</sup> For the world, roughly 7% of the FDI stock was in countries party to a BIT, 88% in those party to a DTT. For developing and CEE countries alone, these figures were, respectively, 27% and 64%.<sup>11</sup>

BITs have remained much the same over time (box III.1). The early focus on protection, treatment and dispute settlement—the reason for these

treaties—remains at their centre. But a few countries extend them with provisions for the right to establishment, performance requirements and employment of key foreign personnel. These changes—mainly in recent BITs, including those being renegotiated—are giving rise to a new generation of BITs with greater obligations, with more far-reaching implications.<sup>12</sup>

The number of bilateral free trade agreements covering investment issues is rising as well, with most early ones involving neighbouring countries and newer ones tending to be concluded between distant countries in different regions and having investment commitments in a separate chapter. Among the main issues addressed: pre-establishment and post-establishment national treatment; most-favoured-nation (MFN) treatment; prohibitions of performance requirements (often going beyond that contained in the Trade-related Investment Measures (TRIMs) Agreement); promotion and protection, including that for expropriation and compensation; dispute settlement, both State-State and investor-State and transfer clauses guaranteeing the free transfer of payments, including capital, income, profits and royalties. An example of such a recent agreement is the Japan–Singapore Agreement for a New-Age Economic Partnership (box III.2).

What has been the impact of BITs on FDI flows? An aggregate statistical analysis does not reveal a significant independent impact of BITs in determining FDI flows (UNCTAD 1998a). At best, BITs play a minor role in influencing global FDI flows and explaining differences in their size among countries.<sup>13</sup> Aggregate results do not mean, however, that BITs cannot play a role in specific circumstances and for specific countries. For example, they could signal that a host country's

**Table III.2. How much FDI is covered by BITs—and how much by DTTs, 2000**

Home countries <sup>b</sup>	Proportion of outward stock protected <sup>a</sup>	
	BITs	DTTs
United States		
Total outward FDI stock	6	96
Stock in developing countries and CEE	19	87
EU <sup>c</sup>		
Total outward FDI stock	9	93
Stock in developing countries and CEE	73	73
Japan		
Total outward FDI stock	7	89
Stock in developing countries and CEE	26	61
World <sup>d</sup>		
Total outward FDI stock	7	88
Stock in developing countries and CEE	27	64

Source: UNCTAD.

<sup>a</sup> As mentioned earlier, BITs are not concluded between developed countries.

<sup>b</sup> To the extent that data on outward FDI for specific recipient countries are not available, the percentage shares are underestimated. However, these countries are typically relatively small FDI recipients.

<sup>c</sup> The data cover nine EU countries that account for 72% of total EU outward FDI stocks.

<sup>d</sup> Based on 27 countries for which data on outward FDI stock by destination are available. They account for more than three-fourths of the world FDI stock.

#### Box III.1. The contents of BITs

The scope and content of BITs have become more standard over the years. Today, the main provisions deal with the scope and definition of foreign investment; admission and establishment; national treatment in the post-establishment phase; MFN treatment; fair and equitable treatment; guarantees and compensation in the event of expropriation; guarantees of free transfers of funds and repatriations of capital and profits; and dispute settlement provisions, both State-State and investor-State. But given the sheer number of BITs, the formulations of individual provisions remain varied, with differences in the language of the BITs signed some decades ago and those signed more recently.

Source: UNCTAD.

### Box III.2. Investment highlights of a new-age economic partnership

The 2002 Agreement between Japan and Singapore for a New-Age Economic Partnership is an example of a recent bilateral agreement that covers a range of issues, comprising trade in goods, rules of origin, customs procedures, mutual recognition, trade in services (including financial, courier and telecoms services), investment, movement of natural persons and government procurement. It also sets out elements for partnership and cooperation: paperless trading, intellectual property, competition policy, financial services, information and communications technology, science and technology, human resource development, trade and investment promotion, SMEs, broadcasting and tourism.

The salient features of its chapter on investment are:

*Definition.* A broad, asset-based open-ended definition of investment: “every kind of asset owned or controlled, directly or indirectly, by an investor, including: ....”.

*National treatment.* National treatment (save the exceptions scheduled in the annex of reservations) for the establishment, acquisition, expansion, management, operation, maintenance, use, possession, liquidation, sale or other disposition of investments.

*Movement of persons.* Facilitating the movement of natural persons between the two countries for business purposes and mutual recognition of professional qualifications.

*Transfers.* Free transfer of payments, including initial capital and additional amounts to maintain or increase investments; profits, capital gains, dividends, royalties, interests and other current incomes accruing from investments; proceeds from the total or partial sale or liquidation of investments; payments made under a contract including loan payments in connection with investments; earnings of investors who work in connection with investments, payments arising out of the settlement of a dispute.

*Expropriation and compensation.* Investments and investors of both countries receive equitable treatment and full protection and security in many respects, including guarantees from expropriation or nationalization of investments, except for a public purpose, on a non-discriminatory basis, in accord with due process of law and upon payment of compensation equivalent to the fair market value of the expropriated investments.

*Prohibited performance requirements beyond those prohibited by the TRIMs Agreement.* Requirement to locate headquarters for a specific region or the world market; requirement to export a given level or percentage of services; requirement to supply goods or services provided to a specific region of the world market exclusively from a given territory; requirement to transfer technology, production processes or other proprietary knowledge; requirement to achieve a given level or value of R&D; requirement to purchase or use services provided in its territory, or to purchase services from natural or legal persons in its territory; and requirement to appointment to senior management positions individuals of any particular nationality. Certain exceptions apply.

*Dispute settlement.* Comprehensive dispute settlement mechanism, both State-State and investor-State. In this regard, the Agreement, as a rule, encourages amicable settlement through consultations between the parties to an investment dispute. If such dispute cannot be settled through such consultations within five months and if the investors concerned have not submitted the investment dispute for resolution under administrative or judicial settlement, or in accord with any applicable, previously agreed dispute settlement procedures, they may either request the establishment of an arbitral tribunal in accordance with the procedures set out in the Agreement, or submit the investment dispute to conciliation or arbitration in accord with the provisions of the ICSID Convention or under the Arbitration Rules of the United Nations Commission on International Trade Law.

*Monitoring (implementation).* Establishes a monitoring system for the purpose of effective implementation of the chapter on investment. To this end, a joint committee on investment is to be set up, entrusted with reviewing and discussing the implementation and operation of the chapter on investment; reviewing the specific exceptions related to national treatment and the prohibition of performance requirements for the purpose of contributing to the reduction or elimination of such exceptions and encouraging favourable conditions for investors of both countries; and discussing other investment-related issues.

There are also provisions on investment in the services chapter.

attitude towards FDI has changed and its investment climate is improving—and to obtain access to investment insurance schemes. Indeed, investors appear to regard BITs as part of a good investment framework.

Why this finding? The policy framework is at best enabling, having by itself little or no effect on FDI flows. It has to be complemented by economic determinants that attract FDI, especially market size and growth, skills, abundant competitive resources and good infrastructure. As a rule, IIAs tend to make the regulatory framework more transparent, stable, predictable and secure—that is, they allow the economic determinants to assert themselves. And when IIAs reduce obstacles to FDI and the economic determinants are right, they can lead to more FDI. But it is difficult to identify the specific impact of the policy framework on FDI flows, given the interaction and relative importance of individual determinants.

## 2. Regional and interregional agreements

The universe of regional and interregional agreements dealing directly with investment matters is growing as well (annex table A.I.13).<sup>14</sup> But only few are devoted exclusively to investment, with the OECD liberalization codes covering capital movements and current invisible operations (1961) and the OECD Declaration on International Investment and Multinational Enterprises (1976) being particularly noteworthy. Recent examples involving developing countries include the Framework Agreement on the ASEAN Investment Area and the Andean Community's Decision 291. Unlike BITs and bilateral free trade agreements, not all regional instruments are binding. Norms of a non-binding nature relating to foreign investment in the Asia-Pacific Economic Cooperation (APEC) have been adopted in the 1994 APEC Non-Binding Investment Principles.

The trend is towards comprehensive regional agreements that include both trade-related and investment-related provisions, even extending to services, intellectual property rights and competition. Indeed, most regional free trade agreements today are also free investment agreements, at least in principle. NAFTA and the MERCOSUR Protocols are examples. So is the Free Trade Area of the Americas, now under negotiation (box III.3). The general aim is to create a more favourable trade and investment framework—through the liberalization not only of regional trade but also of restrictions to FDI and through a reduction of operational restrictions, all to increase the flow of trade and investment within regions.

Generally addressing a broader spectrum of issues than bilateral agreements, regional agreements allow tradeoffs across issue areas. And those between developed and developing countries typically use the panoply of traditional international law tools—such as exceptions, reservations and transition periods—to ensure flexibility in catering to the different needs, capacities and policy objectives of countries.

As with BITs it is difficult to identify the impact on FDI of regional or interregional agreements dealing only with the harmonization of investment frameworks of member countries. They improve the enabling framework. And where they reduce obstacles to FDI (as most regional agreements do), they can increase investment flows—again, if the economic determinants are favourable. The main economic determinant that influences FDI flows in regional agreements is market size. But that is the result of reducing barriers to trade—not of FDI.

## 3. Multilateral agreements

Renewed efforts to create comprehensive multilateral rules for FDI, even non-binding ones undertaken occasionally in the postwar period, have shared the fate of the first effort—and failed. Most prominent among them were the United Nations Code of Conduct on Transnational Corporations (in the late 1970s and 1980s) and a Multilateral Agreement on Investment by the OECD (in the late 1990s). But the World Bank Guidelines on the Treatment of Foreign Direct Investment, a non-binding instrument, set down (in 1992) certain standards of treatment for investors on which a level of international consensus could be said to exist.

Some efforts dealing with specific investment aspects bore fruit as well. The Convention on the Settlement of Investment Disputes between States and the Nationals of other States provides a framework for the settlement of investment disputes. The ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy deals with a range of labour-related issues. The Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) enhances the legal security of FDI by supplementing national and regional investment guarantee schemes with a multilateral one.

The WTO Agreement on TRIMs prohibits certain trade-related investment measures (adopted as part of the Uruguay Round). And the General Agreement on Trade in Services (GATS), also concluded as part of the Uruguay Round, offers a comprehensive set of rules covering all types of

### Box III.3. The Free Trade Area of the Americas

By May 2003 the countries participating in the negotiation of a Free Trade Area of the Americas (FTAA) had completed three negotiating phases, with the fourth to be concluded by a meeting of FTAA ministers responsible for trade in November 2003. Two results are important: the preparation of a draft agreement and the launching of market access negotiations.

The single most important achievement is the draft agreement covering the issues addressed by the FTAA negotiating groups, including the Negotiating Group on Investment. The first draft Agreement was prepared for the FTAA Ministerial Meeting held in Buenos Aires on 7 April 2001, the second draft for the Quito Ministerial Meeting on 1 November 2002. Both drafts are available on the official FTAA website (<http://www.ftaa-alca.org>). A third draft is being prepared for the November 2003 Ministerial.

The Negotiating Group on Investment is one of the negotiating groups (market access, agriculture, services, government procurement and investment) instructed by FTAA ministers to initiate market access negotiations on 15 May 2002. As agreed by the FTAA Trade Negotiations Committee, initial offers had to be presented between 15 December 2002 and 15 February 2003, with submissions of requests for improvements of the offers to be made between 16 February 2003 and 15 June 2003. The process for the presentation of revised offers began on 15 July 2003. In the case of the Negotiating Group on Investment the Committee stated that the initial offer had to be comprehensive and in accordance with current laws and regulations. A negative list approach had to be used. The Committee also agreed that investment offers for the supply of services through commercial presence may be submitted and discussed in the Negotiating Group on Services, in the Negotiating Group on Investment or in both. The Negotiating Groups on Services and Investment shall, as general rule, continue to meet separately. However, if deemed necessary, both groups may meet to hold joint discussions on issues in common, particularly commercial presence. At its April 2003 meeting, the Committee instructed the Chairs of these Negotiating Groups on Services and Investment to hold a joint meeting to discuss commercial presence and investment in services.

All of the text in the Investment Chapter of the November 2002 FTAA draft Agreement is bracketed—that is, participating countries have yet to agree on its language. Issues covered in the chapter include scope, basic definitions, national treatment, MFN treatment, exceptions to national treatment and MFN treatment, standard of treatment, fair and equitable treatment, performance requirements, key personnel, transfers, expropriation, compensation for losses, general exceptions and reservations, dispute settlement, transparency, the commitment not to relax domestic labour or environmental laws to attract investment, the relationship with other chapters, extraterritorial

application of laws on investment-related issues and special formalities and information requirements.

The 2002 FTAA draft Agreement contains several proposals on the definition of investment, most adopting a broad asset-based definition covering not only FDI but also portfolio and intellectual property, among other elements. As the draft text suggests, the discussion in the Negotiating Group on Investment focuses on whether to adopt a broader definition based on the term “asset” or a narrow “FDI-only” definition, whether to include an illustrative or exhaustive list of elements covered in the definition of investment and whether to include a list that clarifies what should not constitute an investment.

There are two different approaches to national treatment. One implies a market access component with a list of reservations (country-specific exceptions). Some proposals under this approach specify all phases of an investment (establishment, acquisition, expansion, management, conduct, operation, sale or other disposition of investment) and require that national treatment be accorded “in like circumstances”. In the other approach, national treatment is granted in accordance with the laws and regulations of the host country. The draft Agreement also includes a provision on national treatment at the subnational level.

On performance requirements, there are two main views in the draft Agreement. One is to adopt a list of prohibited performance requirements (operation and incentives) covering goods and services, the other to favour a much narrower view, not going beyond the WTO TRIMs Agreement. As in NAFTA the issue of investment incentives is addressed under performance requirements only. Some performance requirements, prohibited when mandatory, are allowed when they are combined with an advantage or a subsidy. Examples include requirements to locate production, provide a service, train or employ workers, construct or expand particular facilities or carry out R&D.

The section on expropriation in the second draft of the FTAA Agreement contains language found in many other investment agreements prohibiting a party from directly or indirectly nationalizing or expropriating an investment of an investor of another party—except for a public purpose, on a non-discriminatory basis, in accordance with due process of law and on payment of prompt, adequate and effective compensation. Most relevant here is how the next drafts of the FTAA Agreement take into account the experience of free trade agreements signed in the past decade, such as NAFTA and the Chile–United States Free Trade Agreement. The same can be said of other issues such as fair and equitable treatment and investor-State dispute settlement.

With new governments having taken office this year, some modalities of the negotiations may be reviewed.

international services delivery, including “commercial presence”, akin to FDI. The GATS leaves member countries considerable flexibility on the scope and speed of liberalizing services activities. It allows them to inscribe, within their schedules of commitments, activities that they wish to open and the conditions and limitations for doing this—the positive list approach.

In their Declaration at the Fourth Session of the WTO Ministerial Conference in Doha in November 2001, members of the WTO agreed on a work programme on the relationship between trade and investment (paragraphs 20–22).<sup>15</sup> In doing so, they recognized (in paragraph 21) the need for strengthened technical assistance in the pursuance of that mandate, explicitly referring to UNCTAD.<sup>16</sup> In response, the WTO Working Group on the Relationship between Trade and Investment (set up at the WTO’s 1996 Ministerial Conference

in Singapore) has been deliberating on the seven issues<sup>17</sup> listed in paragraph 22 of the Declaration as well as technology transfer. In its meeting on 1 December 2002, the Group discussed its annual report and an intervention by a group of developing countries dealing with home country measures and investor obligations.

The discussions of the Working Group are reported to the WTO General Council. Recognized at Doha was “the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade” (paragraph 20). It was also agreed “that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations” (WTO 2001b, paragraph 20).<sup>18</sup>

### C. Features of IIAs at different levels

What are the advantages and disadvantages of bilateral, regional and multilateral approaches to negotiating IIAs?<sup>19</sup> There is no straightforward answer, since the three approaches serve different purposes. The main objective of most BITs is to provide investor protection at the international level. Bilateral and regional approaches that combine investment and trade seek to reap the benefits of larger markets through trade liberalization accompanied by investment liberalization and sometimes protection. A multilateral approach can aim at both protection and liberalization. Presented here is a summary of arguments relating to the advantages and disadvantages of IIAs at different levels. They are presented without judgments about which countries should follow. It is their sovereign right to decide the approach that is best for them, if they wish to negotiate IIAs at all.

#### 1. Bilateral approaches

The bilateral approaches, mainly BITs and free trade agreements with an investment component, have the advantage of allowing countries the freedom of choosing the partners to enter into an agreement and how to tailor the agreement to their specific situations. They offer countries flexibility in designing their networks of IIAs, concluding them with countries that are key investors, avoiding countries that are less interesting or that may insist on unwanted provisions. Allowing each treaty to be negotiated separately gives developing countries more flexibility than under a multilateral approach. In

addition, BITs can be negotiated quickly. Important is also that the overwhelming number of BITs cover only the post-establishment stage of investment, leaving admission and establishment—which have the greatest development implications—to be determined autonomously by host countries.

On the other hand, asymmetries in bargaining power put weaker economies at a disadvantage in the negotiations of bilateral agreements. Although this applies in all negotiating situations, it is particularly relevant in agreements between large developed countries and small and poor developing ones—and when bilateral agreements go beyond a narrow coverage. In some recent cases, the principal objective of investor protection has been complemented with liberalization clauses related to the right of establishment and an expanded list of restricted performance requirements. So, the other side of the “flexibility” of the bilateral approach is that developing countries may be entering IIAs of broader scope. The implications of this are—for example because of the MFN clause—still far from fully understood (box V.2).

Moreover, imagine the negotiation of bilateral investment agreements (hypothetically) involving all combinations of members of the United Nations. More than 18,000 agreements would be needed to obtain complete coverage. Such an extensive network would be costly and a challenge to administer. In addition, the extension of bilateral treaty coverage and the freedom of pairs of countries to define their provisions, could lead to uncertainty, potentially inconsistent rules and legal conflicts.

## 2. Regional and interregional approaches

Regional and interregional approaches typically deal with a range of issues, so there is more room for tradeoffs and bargaining. With the overall purpose of expanding the regional market, they often include the liberalization of foreign entry and establishment—and reduce operational restrictions. They offer—indeed require—more flexibility in how treaty provisions are applied to the different countries. Hence, the frequent use of exceptions, reservations, transition periods and the like, intended to ensure flexibility and cater to the needs and capacities of parties at different levels of development (see also chapter V).

Where regional agreements include rules of origin, insiders may benefit in attracting FDI. The downside is that they are discriminatory. Countries outside the integrating region may be hurt by the diversion of investment. Investment by third countries in such a region may also divert trade.

## 3. Multilateral approaches

The advantages and disadvantages of multilateral approaches are difficult to assess. The balance of advantages and disadvantages depends on the objectives, structure, content and implementation. One of the first arguments put forward in favour of a multilateral framework for investment was that it would facilitate further expansion of FDI. It was argued that legally binding multilateral disciplines in investment would improve the enabling environment—by contributing to greater transparency, stability, predictability and security for investment in sectors not yet covered by multilateral rules. International obligations would also help reduce investor risk perceptions and narrow the gap between the actual risk of policy instability that may be suggested by a host country's domestic legislation, and the risk as perceived by foreign investors (Eglin 2002).<sup>20</sup> If multilateral disciplines further reduced obstacles to FDI beyond what other IIAs do, this (plus the right economic determinants) would presumably lead to higher investment flows.

Even then, however, multilaterally agreed investment rules would not by themselves guarantee higher FDI flows.<sup>21</sup> Nor would it be possible to predict the geographical distribution of FDI flows, because this would be determined first and foremost by the economic fundamentals of individual locations.<sup>22</sup>

So, is a new framework needed in the first place? Since the GATS allows selective liberalization to the opening of services (the sector with most restrictions), investment is already covered, and with that some two-thirds of worldwide FDI (although less in the case of the developing countries). Rules for primary and manufacturing industries would of course complete the existing rules on services. But FDI in agriculture is insignificant, and that in natural resources is largely covered by individual contracts between investors and governments. And manufacturing is already open to FDI, with countries competing among themselves to attract investors, providing various incentives. Moreover, a multilateral framework for investment insurance already exists, with MIGA—and for dispute settlement, with ICSID, UNCITRAL, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and various other mechanisms.

Some countries see multilateral disciplines as an important complement to the bilateral and regional IIAs, to create a common legal basis.<sup>23</sup> Indeed, a multilateral agreement could create the “floor” of standards applicable to IIAs in general (though this would not necessarily be uniform if a GATS-type positive list approach were used). Some fear that the floor would be too low, providing lower standards of protection and market access than BITs and regional agreements. Others fear that the floor could be too high (even when exceptions, derogations and the like are allowed), constraining national policy space too much.

Whether the floor is low or high, a multilateral framework would lock in whatever would be agreed. But it would not constitute a ceiling of rules in the investment area<sup>24</sup> because countries would still be free to go beyond multilateral standards when they negotiate bilaterally or regionally. In other words, a multilateral framework would most likely not replace the large and rapidly growing number of IIAs. And it could well be that a multilateral instrument would serve as a starting point for more far-reaching bilateral and regional negotiations in the future.

One reason it may be difficult to reach a high-standard agreement is that the negotiating dynamics of multilateral negotiations often lead to lowest-common-denominator compromises.<sup>25</sup> But there is also a substantive reason: developing countries are concerned that their policy space would be unduly restricted—and that the balance

of rights and responsibilities would be tilted against them. By their nature, multilateral negotiations tend to seek uniform one-size-fits-all solutions, though exceptions and other provisions can be built in. It is in this context that flexibility, special and differential treatment and specific development provisions become pertinent (chapter V).

One also needs to consider that multilateral negotiations may open opportunities for tradeoffs. In reaching explicit consensus on the modalities of investment negotiations, developing countries could put a few issues of their own on the bargaining table (apart from the ones that are already there, beginning with agriculture):

- Broadening mode 4 of the GATS (movement of natural persons).
- Increasing flexibility for the use of prohibited TRIMs and clarifying the precise scope of the TRIMs Agreement's illustrative list to contain its extension.
- Committing to reduce gradually certain investment-related trade measures (UNCTAD 1999e), such as tariff peaks, tariff escalation and anti-dumping rules adopted by developed countries.
- Committing home countries to bind a range of measure to encourage FDI flows to developing countries and increase their benefits.
- Committing to encourage good corporate citizenship by TNCs.
- Agreeing on a substantial and sustained technical cooperation effort in investment.

It is difficult to assess the feasibility of any of these ideas at this stage. But they could be part of a positive investment agenda by developing countries—in an effort to be prepared, if need be, to discuss investment matters on the basis of their own needs and priorities.

Ultimately, the case for a multilateral framework on investment may rest on the extent to which countries judge multilateralism to be a more attractive approach. It has been argued that multilateralism can be a way for weaker countries to pool their influence to give them a better position vis-à-vis stronger ones. However, this does not mean that differences in power disappear. As with bilateral and regional agreements, multilateral negotiations involve bargaining power and negotiating capabilities, with the built-in risk that stronger parties can gain over weaker ones. Moreover, multilateralism in the investment area is not necessarily the same as in the trade area,

where the defining characteristics include reciprocity, non-discrimination and special and differential treatment:

- Reciprocity in trade is based on the fact that every country imports and exports. In investment, every country attracts at least some investment, but for the great majority of developing countries, outward FDI is negligible.
- In trade non-discrimination applies to the treatment of goods and services in markets and is fairly clearly circumscribed, at least in principle. In investment it relates to a broad set of policies—in principle all those bearing on the production (indeed development) process. So it is much more intrusive and sensitive and thus more difficult to tackle.
- The principle of special and differential treatment is well established in trade, finding its expression there in a number of ways, although even here it is not fully implemented. It still needs to be developed further in investment, and put in operation.

So, a multilateral approach to investment, if pursued, raises distinctive questions of its own—questions that also arise for bilateral and regional approaches.

In this respect, multilateral negotiations could in principle give developing countries greater leverage than regional or bilateral ones, at least for those substantive issues on which they can reach common positions. In particular, by pooling their influence, developing countries might be able to obtain what seems to be more difficult to obtain (or protect) at the bilateral and regional levels, foremost more development friendly outcomes on key issues and development provisions. A multilateral framework could also serve as a benchmark for agreements at the bilateral and regional levels, helping countries in this respect by offering an accepted model to consider. And it could be of help to those governments that might want to use multilateral disciplines to support domestic investment reforms.

With investment conflicts likely to become more frequent as FDI grows, it might also be desirable for developing countries to carry out disputes in a framework based on the “rule of law” as opposed to “the rule of power”. But bringing investment issues into the WTO increases the risk of developing countries finding themselves at the receiving end of retaliatory, trade-related actions in the WTO dispute settlement mechanism. Unless ways are found to insulate them from cross-

retaliation,<sup>26</sup> the mechanism could be used to penalize countries in non-investment areas for breaches of investment rules.

There are also broader concerns, most notably that launching multilateral negotiations on investment in the WTO could divert attention from more pressing issues on the already full international economic agenda. If investment liberalization is already happening on a unilateral, bilateral and regional basis, should not the WTO focus on such areas as agriculture, the implementation of existing agreements and special and differential treatment? The negotiation of a multilateral framework within the WTO requires particular attention to coherence across the whole range of WTO agreements and their relation to other agreements in both trade and investment—a difficult task.

To reiterate, these are arguments advanced in the discussions of a multilateral framework for investment. Each country has to decide for itself which of these (and others) reflect its own interest and, in the light of this, decide its own course of action.

\* \* \*

All in all, the proliferation of IIAs at all levels means that national FDI policies take place in a very different context from just 20 years ago. The various approaches to international rule-making all have their merits and weaknesses, their benefits and costs. Whether it is desirable for a country to pursue one approach thus depends primarily on what it seeks from an agreement—investor protection, liberalization, broader international cooperation. Finally, the development orientation of any agreement depends on its objectives, structure, substantive provisions and implementation. What is clear is that agreements affect, and interact with, the eight key national policy issues identified at the beginning of this chapter. How and how much are the subject of chapter IV.

## Notes

<sup>1</sup> For an earlier treatment of many of the issues discussed here see *WIR96*; UNCTAD's *Series on Issues in International Investment Agreements* (Geneva: United Nations, various years); UNCTAD 1998a; and the reports submitted by the WTO Secretariat to the Working Group on the Relationship between Trade and Investment, as well as the reports on its meetings (Geneva: WTO, various years).

<sup>2</sup> Economic considerations have to be seen in the political, social, cultural and historical context in which host country policies are being pursued, though there has been a tendency for economic factors to

become more important in influencing policy objectives.

<sup>3</sup> For a fuller discussion of various types of FDI and their determinants, see *WIR98*, chapter IV.

<sup>4</sup> Performance requirements are linked more to the provision of incentives, making them behavioural incentives as distinguished from locational incentives. For a full discussion of such concerns, see *WIR99*.  
<sup>5</sup> Each of these issues is mentioned in paragraph 22 of the Doha Declaration or was brought up in the discussions of the WTO Working Group on the Relationship between Trade and Investment. The exceptions are regulatory takings and incentives. The former issue has played an important role in the NAFTA context, a role that contributed to the reference to the right to regulate in the Doha Declaration. Incentives are closely linked to performance requirements and, in any event, partly subject to the WTO's Subsidies and Countervailing Measures Agreement. Restrictive business practices were the aspect of competition policy most discussed in the Working Group.

<sup>6</sup> There may be a difference between what kind of policies governments pursue at the national level and what they are prepared to agree to at the international level. For example, a government may have laws and regulations in place that open certain industries to foreign investors; at the same time, it may not be willing to enshrine the right of establishment in IIAs—precisely to maintain the flexibility to change its policy if need arises. The same phenomenon exists in the trade area where actual tariffs are often lower than bound tariffs.

<sup>7</sup> Unless otherwise specified, the IIAs referred to in this chapter and the next ones are contained in UNCTAD, *International Investment Instruments: A Compendium* (Geneva: UNCTAD, various years). The creation of the European Union influenced many regional schemes that would like to repeat its success, even though they do not go as far as the EU on some elements of supranationality. Since the EU is an established supranational legal order dedicated to the integration of its member countries in the field covered by EU law, it will not be discussed in the following chapters.

<sup>8</sup> BITs are not concluded between developed countries, as their legal systems reflect investor protection standards evolved over many years of experience with such issues. Parallel to BITs, countries have also concluded agreements for the avoidance of double taxation (DTTs), 2,256 by the end of 2002 (figure I.11). They address, among other things, the allocation of taxable income, reducing incidents of double taxation.

<sup>9</sup> They are, however, a far cry from a full geographical coverage: 18,145 BITs would be needed to ensure full coverage of the world's 191 economies.

<sup>10</sup> Based on 27 countries for which data on outward FDI stock by destination are available. They account for more than three-quarters of the world FDI stock.

<sup>11</sup> The title of the "Agreement between the Government of the Republic of Korea and the Government of Japan for the Liberalisation, Promotion and Protection of Investment", signed 22 March 2002, is perhaps indicative.

<sup>12</sup> A more recent test similar to UNCTAD's also found that "there was little independent role for BITs in accounting for the increase in FDI" by the end of the 1990s and that "countries that had concluded a BIT

- were no more likely to receive additional FDI than were countries without such a pact” (World Bank 2003, p. 129). But a study of determinants of FDI in CEE found that “bilateral investment treaties, the degree of enterprise reform and repatriation rules tended to stimulate FDI” (Grosse and Trevino 2002, p. 22).
- 14 Most of these instruments (or relevant excerpts) have been published in UNCTAD, *International Investment Instruments: A Compendium* (Geneva: UNCTAD, various years).
- 15 “Ministerial declaration” (WTO 2001b).
- 16 For the text of the relevant paragraphs, see *WIR02*, chapter I. For a progress report on UNCTAD’s activities in this area, see UNCTAD, 2002h, 2003e.
- 17 The Doha Declaration provides in paragraph 22: “In the period until the Fifth Session, further work in the Working Group on the Relationship Between Trade and Investment will focus on the clarification of: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between Members”.
- 18 In an explanatory statement at the end of the Doha Ministerial, the Chair observed: “I would like to note that some delegations have requested clarification concerning paragraphs 20, 23, 26 and 27 of the draft declaration. Let me say that with respect to the reference to an ‘explicit consensus’ being needed, in these paragraphs, for a decision to be taken at the Fifth Session of the Ministerial Conference, my understanding is that, at that session, a decision would indeed need to be taken by explicit consensus, before negotiations on trade and investment and trade and competition policy, transparency in government procurement and trade facilitation could proceed. In my view, this would also give each member the right to take a position on modalities that would prevent negotiations from proceeding after the Fifth Session of the Ministerial Conference until that member is prepared to join in an explicit consensus.” ([www.wto.org/english/thewto\\_e/minist\\_e/min01\\_e/min01\\_chair\\_speaking\\_e.htm](http://www.wto.org/english/thewto_e/minist_e/min01_e/min01_chair_speaking_e.htm))
- 19 There is a wide range of literature on this subject. NGOs have been particularly active in the discussions. See, most recently, for example Action Aid 2003; Chang and Green 2003; CUTS 2003; Hardstaff 2003; Khor 2002; Oxfam 2003a; Oxfam et al. 2003b; World Development Movement and Friends of the Earth 2003.
- 20 On the other hand (and this applies to the bilateral and regional levels as well), risk reduction can also be achieved through investment contracts between TNCs and host countries (as is common practice in some primary industries). These contracts typically have legally binding protection provisions over and above those in applicable bilateral or regional agreements, not to say in domestic legislation. In multi-country investment projects like large infrastructure developments, host countries may enhance investor security by supplementing existing BITs with an intergovernmental agreement committing them to certain standards and incorporating these into the investment contracts with the investors.
- 21 To quote a “Communication from Canada, Costa Rica and Korea” to the WTO Working Group on the Relationship between Trade and Investment: “Similarly, a multilateral framework for investment in the WTO would not *guarantee* greater investment flows” (WTO document WT/WGTI/W/162, p. 2). A recent World Bank report (World Bank 2003b, p. XVII) concludes similarly: “International agreements that focus on establishing protections for investors cannot be expected to expand markedly the flow of investment to new signatory countries”.
- 22 In this connection, it has been suggested that a multilateral system of rules rather than a network of bilateral and regional agreements would contribute to a level playing field worldwide. This would allow investment decisions to be taken more on the basis of economic efficiency and actual opportunities in different host countries. Distortions caused by conflicting rules, incentives, subsidies and market access discrimination could be reduced by closer multilateral cooperation. This would ensure a better allocation of FDI, which would release additional resources that would otherwise be used inefficiently due to distortions.
- 23 One could also argue that multilateral negotiations may be more transparent (as compared to bilateral negotiations) in that they are more likely to receive scrutiny from the public, including civil society groups, given their higher profile.
- 24 Unless explicitly agreed upon in a variation of the GATT Article XXIV economic integration clause.
- 25 But not necessarily so: see the TRIPS Agreement.
- 26 Cases of cross-retaliation authorized by the WTO Dispute Settlement Body are rare.



## CHAPTER IV

# EIGHT KEY ISSUES: NATIONAL EXPERIENCES AND INTERNATIONAL APPROACHES

As countries engage more in international rule-making in investment, they confront complex issues arising from the interaction between national policy making and international investment rule-making. Eight stand out as being particularly important and sensitive:

- How to define investment.
- How to treat the entry of FDI and the subsequent operations of foreign affiliates.
- Where the dividing line should be between legitimate policy action and regulatory takings.
- What mechanisms should be used for dispute settlement.
- How to use performance requirements and incentives.
- How to encourage the transfer of technology.
- How to ensure competition, including the control of restrictive business practices, by foreign affiliates of TNCs.

These eight issues are not all the important issues that deserve attention from negotiators when devising national FDI policies or negotiating IIAs. Others include MFN treatment, fair and equitable treatment, transparency, extraterritoriality concerns and taxation.<sup>1</sup> On balance, there is less controversy surrounding them.<sup>2</sup> There are also broader issues, including the approach to liberalization. With the “negative list” approach, countries list industries they want to keep exempted from liberalization. With the “positive list” (or “GATS-type”) approach, countries list the industries to which specific provisions of an agreement apply and the conditions for applying them. These issues (and others) will be discussed below (chapter V).

### A. Definition of investment

The definition of “investment” in international investment agreements (IIAs), combined with the substantive provisions, has profound developmental implications, because it defines their scope and reach. For developing countries the key issue is whether investment is defined narrowly, focusing on FDI, or broadly, including virtually every asset connected with foreign investors. Developing countries have indicated a preference for a narrow definition in the discussions of the WTO Working Group on the Relationship between Trade and Investment, but the trend in IIAs has been towards a broad asset-based definition. Even a broad definition can be narrowed, for example, through reservations, affording countries the right to exclude certain types of investment (such as portfolio investment) or by limiting the applicability of specific operational provisions. Another approach is to give each government the choice, when negotiating an IIA, to commit to either a narrow or a broad definition.

#### 1. Why the definition of investment matters

The definition of investment on its own has no direct impact on attracting FDI or benefiting more from it. But defining a certain capital flow or asset as “investment” bestows certain rights on foreign investors and thus facilitates foreign investment. The definition also raises concerns. Obligations to meet financial transfer requirements could for many developing countries at times be difficult to fulfil. Possible complications could arise for macroeconomic management of capital flows of a type and magnitude that may be beyond the control of national governments. And volatile capital flows have implications for domestic financial stability.

Thus, the definition of investment is fundamental to national laws and international agreements pertaining to FDI, since it delineates which assets or investment flows are covered by

the operational provisions of those laws and IIAs, for example, as they relate to national treatment. The main question is not whether FDI should be defined as investment—it is. The question is what other investment should be granted the same status: portfolio investment (both equity and debt components), other capital flows (bank loans, non-bank loans and other flows) and various investment assets (both tangible and intangible, including intellectual property rights).<sup>3</sup>

“Investment” does not have a generally accepted meaning. The internationally accepted method for classifying and recording cross-border foreign investment flows for balance-of-payments statistics divides them into direct investment, portfolio investment, financial derivatives and other investment.<sup>4</sup> National laws and IIAs also provide definitions of “investment” and “foreign investment”, which often differ considerably from the balance-of-payments definition. They can include, in addition to some types of cross-border investment flows, a wide variety of assets, both tangible and intangible. Indeed, the definitions utilized in these laws and agreements vary considerably.<sup>5</sup> Note that the legal interpretation of investment cannot be predicted with certainty in the course of the settlement of disputes.

Different types of capital flows have different implications for a host economy: some are long-term flows not normally prone to quick reversal or to speculative movements, and some are highly liquid flows that can easily be reversed. The policy implications of fully liberalizing highly liquid flows may be far reaching. Indeed, the degree of capital account liberalization that may be required of signatories to a given IIA is important for some developing countries.

Developed countries, with relatively well-developed financial markets and regulatory frameworks, relatively stable macroeconomic conditions and convertible currencies, have moved to full liberalization of their capital accounts, covering all forms of capital flows and other types of investment. In negotiations with developing countries, they often seek a broad definition of investment to protect assets generated by investment and to promote liberalization. Private investors also prefer a broader definition, not necessarily because they wish to hedge or speculate but because they want more security.

But many governments of host developing countries, at least in multilateral discussions, are wary. They wish to retain policy tools to deal with different types of flows in different ways rather than define them all as investment in a way that constrains their use. Because portfolio investment instruments and derivatives can be used for

speculative purposes that destabilize foreign exchange markets or domestic financial markets, a government may prefer to exclude them from the definition. This allows governments flexibility to implement policies to maintain financial stability—hence many developing countries prefer (at least in multilateral discussions) to confine the definition of “investment” to long-term flows and exclude potentially volatile capital flows.

The inclusion of non-FDI forms of investment is thus a difficult matter for many countries. Some of these difficulties can be addressed through special provisions, exceptions and safeguards.<sup>6</sup> But the broader the definition, the more complicated it is to do so. Safeguards for traditional balance-of-payments crises, speculative attacks and contagion from crises abroad are important here.<sup>7</sup>

In conceptual terms, FDI and foreign portfolio investment are distinct. Direct investment involves both a long-term interest in, and significant management influence over, a foreign affiliate. Portfolio investment may include a long-term interest, but it seldom involves managerial control. For statistical purposes, a threshold of 10% of share ownership has been established to differentiate equity holdings of direct and portfolio investors.<sup>8</sup> But in practice, the line between different types of investment is sometimes difficult to draw. In some circumstances, foreign investors may use their assets as collateral to borrow from local capital markets and use the proceeds for hedging or speculation.<sup>9</sup> Conversely, venture capitalists can take a significant management interest in a venture without a large shareholding—and their activity, conventionally defined as portfolio investment, is similar to direct investment. But for the bulk of investment flows, a distinction between FDI and non-FDI is possible.

## 2. Scope of definitions

The general trend towards a broad definition of investment is not universal, and there are significant differences by level of development. A number of developed countries do not have specific legislation or policies on FDI and so do not need to define it. Developing countries, concerned about the effects of volatile capital flows, have narrow definitions (in practice if not in the legal terminology). The financial crises of the 1990s strengthened the case for adopting definitions with great care.

The definition can magnify or reduce the scope of an IIA. But because it is exercised through the substantive provisions of an IIA, it cannot be considered in isolation.

IAs have used three types of definitions of investment: asset-based, transaction-based or enterprise-based:

- *Asset-based definitions* are the most common in investment protection agreements. They tend to be broad—including assets and capital flows, movable and immovable property, interests in companies, claims to money, intellectual property rights and concessions. They can, however, be deliberately limited. Governments have, for instance, limited the coverage to investment made in accordance with the laws of the host country or on the basis of previous administrative approval. They have also excluded investment made before the conclusion of the IIA, as well as types of investment, such as portfolio investment. And some place limits on the minimum size of an investment.
- *Transaction-based definitions* protect not assets but the financial flows through which foreign investors create or acquire domestic assets. For example, the OECD Code of Liberalisation of Capital Movements does not define investment, but it has a list of capital transactions between residents and non-residents that are subject to liberalization commitments, including inward and outward investment.
- *Enterprise-based definitions* confine liberalization and protection to the enterprises established by foreign investors in a host country. Used in the Canada–United States Free Trade Agreement of 1988, for example, this definition appears to be narrower than an asset-based definition, which includes assets other than companies and capital flows. Coverage may extend to all investments by the enterprise following establishment, potentially a very broad spectrum.

The way IAs deal with the definition of investment depends primarily on the scope and purpose of each instrument. Some IAs aim at the liberalization of investment regimes—and some at protecting investment.<sup>10</sup> In reality the distinction is not always clear-cut. For example, bilateral investment treaties (BITs) generally aim at investment protection, but they may also have a liberalizing effect—say, through their national treatment provision.

IAs aimed at investment protection, which include BITs but also some regional agreements, tend to use a broad, open-ended, asset-based definition “covering virtually all proprietary rights located in the host State which have a financial asset value” (Wälde 2003) (although it may be qualified, for example, by excluding certain types of investment). The trend has been in this direction.

In particular, most BITs use such an approach. The ASEAN Agreement for the Protection and Promotion of Investments, a regional investment protection treaty (like a BIT in aim and function), has a broad definition covering “every kind of asset”.

Other regional agreements have followed a different approach, depending on the purpose of the investment provisions. Some aimed at the liberalization of investment regimes have used a relatively narrow definition. For example, the 1998 Framework Agreement on the ASEAN Investment Area explicitly excludes portfolio investment, as does the 2000 free trade agreement between the European Free Trade Association members and Mexico.

The GATS does not define investment, instead defining a commercial presence as “any type of business or professional establishment”. In effect the GATS uses an enterprise-based definition. The TRIMs Agreement does not define investment, either.<sup>11</sup>

### 3. Options for the future

The way an investment agreement defines investment should have a direct bearing on the purpose of the agreement:

- Protecting investment—say, against expropriation.
- Liberalizing investment flows—say, by granting the right of admission and establishment or by lowering equity restrictions.
- Promoting investment—say, through the provision of investment insurance.
- Regulating investment—say, in the context of prohibiting corrupt practices.

Where agreements serve several of these purposes, the challenge is to achieve an acceptable balance between (a) permitting flexibility for firms to organize and finance their investments and (b) giving developing countries the flexibility to deal with potentially volatile capital flows. The degree of integration sought by the parties to an agreement may also bear on how investment is defined: the greater the integration sought, the greater can be the expected protection and liberalization sought and the wider the definition that might be adopted.

Under these circumstances, the options<sup>12</sup> available to negotiators range between adopting a narrow definition (focused on FDI) and a broad definition subject to the right to screen inward investment, granting of conditional entry or limiting an agreement’s substantive provisions:

- If the concern is that portfolio investment may be withdrawn quickly, IIAs might include portfolio investment, but the currency-transfer provision could apply only to investment that had been in the host country for some minimum period.
- Another option is to adopt a hybrid of broad and narrow definitions for different purposes in a given agreement. For example, a broad asset-based definition can be used for protecting investment—a narrower transaction-based definition for dealing with cross-border investment liberalization.
- The scope of IIAs can be narrowed through limitations on the types of investment subject

to disciplines—through reservation lists or limited specified commitments.

- One can allow each government to decide whether, for the purposes of a particular agreement, it wants to commit itself to a broad or to a narrow definition. A positive list approach provides this flexibility.

What underlies these considerations? The ultimate effect of an IIA results from the interaction of its definition provisions with its operative provisions. There should be enough flexibility in the use of the definition to assist in achieving developmental objectives.

## B. National treatment

“National treatment” has the greatest development implications. It is also of key importance to foreign investors.<sup>13</sup> In today’s usage, it combines two constructs that used to be dealt with separately:

- “Right of establishment” (or “admission and establishment”) or, now, “national treatment in the pre-establishment phase”, and broadly speaking “market access”.<sup>14</sup>
- “National treatment in the post-establishment phase” of the investment process, the traditional application of “national treatment”.

Despite a considerable (unilateral) opening of host economies, most non-OECD governments preserve their right to control FDI admission and establishment in IIAs. National treatment in the post-establishment phase is more widely accepted.

### 1. The centrality of national treatment

National treatment can be defined as “a principle whereby a host country extends to foreign investors treatment that is at least as favourable as the treatment that it accords to national investors in like circumstances” (UNCTAD 1999b, p. 1). The concept is central to the worldwide strategies of TNCs. Entry is the first (essential) step to transnational operations, allowing enterprises access to the markets and resources they need to establish a portfolio of locational assets to increase their international competitiveness. Post-entry national treatment then allows them to compete on an equal footing with domestic enterprises.<sup>15</sup> Of the two, non-discrimination after establishment is particularly important because it requires treatment that is at least as favourable as the treatment given

to national investors in like circumstances and, therefore, affects directly the day-to-day operations of foreign affiliates.

For host countries, national treatment of foreign investors is directly related to policies to promote national enterprises and build and upgrade domestic capabilities. In international law, a State has the absolute right to control the admission and establishment of investors in its territory, the setting of conditions under which this occurs and the nature of ownership and control rights (UNCTAD 1999a). Control measures can range from total or sectoral exclusion of FDI to a variety of restrictions—for example, on the equity share allowed foreign investors, the requirements of joint ownership or management with local personnel and the screening of entry by a designated agency.

Once foreign investors are established, host countries generally provide national treatment to foreign affiliates (UNCTAD 1999b). But a typical condition for such treatment is that foreign affiliates are in “like circumstances”<sup>16</sup> to local enterprises, leaving open the possibility for governments to provide special support to national firms in different circumstances. But there are differences in policy even here, with exceptions in both developed and developing countries. So sensitive is this issue that the developed countries took almost 25 years after adopting the OECD Code of Liberalisation of Capital Movements in 1961 to accept, between themselves, the right of establishment for their foreign investors.<sup>17</sup>

### 2. Patterns of national policy

The right to control admission and establishment remains the single most important instrument for the regulation of FDI. No surprise,

then, that national restrictions remain two decades after opening up. In fact, no country presently offers an unconditional right of admission to foreign investors (WTO 2002b). But there are significant differences by industry or sector. In manufacturing relatively few restrictions remain on admission and establishment. In natural resources the situation is more varied, reflecting the fact that the factors of production are not mobile. In the past the sector was tightly controlled, with a significant incidence of nationalizations and national control laws during the 1970s. Now, despite some restrictions, policies tend to be more relaxed. In services, too, there is a trend towards gradual liberalization, though the control over admission and establishment varies for services supplied, depending on regulation required to ensure effective operation. For example, tourism tends to be quite open to FDI, while foreign ownership in media is generally restricted. Governments also retain a high level of control in financial services.

After entry, national treatment is not usually guaranteed expressly in national FDI laws. Some constitutions contain a general provision prohibiting discrimination.<sup>18</sup> Other national laws refer to this standard in investor-investment guarantee provisions.<sup>19</sup> Whether post-establishment national treatment is granted explicitly or implicitly, it does not provide grounds for restricting national regulations. It is usually accepted that, as long as national regulations do not introduce a distinction on the basis of nationality, they are a normal exercise of a

country's right to regulate (see chapter V). This interpretation can also be valid for special rights to minorities, ethnic groups, indigenous people or other disadvantaged groups within the host country. If those rights apply to all businesses, they cannot be interpreted as a breach of post-establishment national treatment.<sup>20</sup>

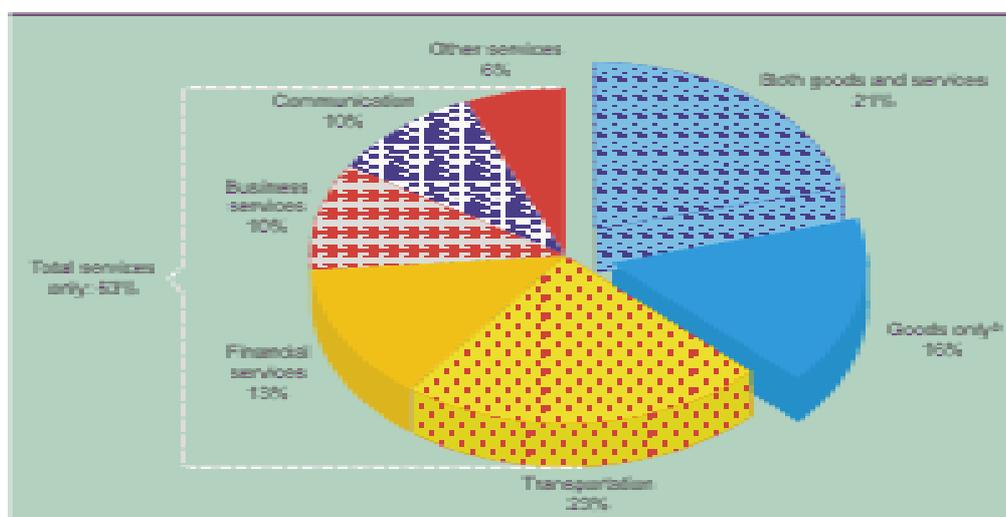
In the pre- and post-establishment stages, national treatment is subject to a range of exceptions, especially in the services sector (figure IV.1). There is also a tendency, especially in OECD countries, to apply the same or similar reservations or exceptions at both stages.

### 3. National treatment and economic impact

National treatment measures have to be assessed against the objectives of FDI policy. Because it is difficult to evaluate how well some of the non-economic objectives are achieved, this section focuses on economic considerations in some detail, given the centrality of national treatment for development. The economic analysis of national treatment revolves around three questions:

1. What is the economic case for the liberalization of FDI policies?
2. What is the case for exercising control on FDI admission and establishment?
3. What are the main considerations for national treatment once TNCs have been allowed to enter an economy?

**Figure IV.1. Reservations in the negotiations of the Multilateral Agreement on Investment,<sup>a</sup> by industry, 1998**



Source: UNCTAD, based on Sauvé, 2002.

<sup>a</sup> MAI reservations relate to the application of the following principles and areas: national treatment, MFN treatment, performance requirements, key personnel, national regulations and dispute settlement.

<sup>b</sup> Reservations relate almost exclusively to performance requirements and nationality/citizenship requirements for companies' boards of directors.

### a. Pre-establishment

The case for liberalizing FDI is similar to that for liberalizing trade: under the right conditions, freer FDI leads to a more efficient allocation of resources across economies and, where markets are not distorted, within a host economy.<sup>21</sup> But this case rests on the often questionable assumption that markets are efficient and that the institutions to make markets work exist and themselves operate efficiently—particularly in developing countries. Many markets are inefficient, and some may be only emerging. Institutions and legal systems tend to be weak. And economies, saddled with rigidities, are unresponsive to (or unprepared for) the challenges of a globalizing world economy.

Market and institutional failures are thus the basic reason for restricting free FDI flows. But their existence is not sufficient for intervening in FDI entry. In the theory of international investment, TNCs exist because of their ability to overcome market imperfections. They have (ownership) advantages that other firms do not possess, and they internalize these advantages rather than sell them in open markets—both violating the precepts of perfect competition. Because FDI rests on exploiting such advantages, there is a case for restricting it only if the use of the advantages harms the host economy—say, if TNCs engage in anticompetitive business practices. This can happen because of the possible divergence between the global interests of TNCs and the interest of any given host economy: TNCs might well maximize their profits worldwide (i.e. overcome “market imperfections”), but the host economy might not be better off. Even where market failures lead freer FDI to be harmful, there may be a case for restricting it only if a host government has the capacity to design and mount effective interventions that result in a socially or economically better result. The cost of government failure must not outweigh market failure; if it does, the economy is worse off.

A case can also be made to control FDI admission and establishment: under free market conditions, unrestricted FDI entry may curtail local enterprise development and not enhance beneficial externalities:

- *Infant domestic entrepreneurship.* The most common fear is that FDI harms the development of local entrepreneurship by deterring potential domestic investors from entering activities with a strong foreign presence—crowding them out where they exist (box IV.1). The infant enterprise argument is similar to the infant industry argument: building competitive capabilities by

domestic firms takes time, and investment is risky and learning is costly.<sup>22</sup> Faced with foreign affiliates that have recourse to the skills, capital, technology and brand names of parent companies, local firms may not be able to build such capabilities. They may then be forced to withdraw to less complex activities or those with a lower foreign presence—perhaps selling their earlier facilities to foreign entrants, as happened in the automotive components industry in Brazil and Mexico (Mortimore 1998).

Note, however, that protecting infant entrepreneurs (and infant industries) is sound only if protected enterprises become fully competitive within a reasonable period. If protection leads to permanent “cripples” rather than healthy infants that grow up, it imposes unjustifiable costs on the host economy. The promoted enterprises must also have the capability to stay competitive. They must master the technology and organizational skills used at the start and stay abreast of subsequent developments. Outstanding examples of this approach are the Republic of Korea and Taiwan Province of China, which in their early development severely restricted FDI inflows to nurture domestic entrepreneurship.

- *Local technological deepening.* A strong foreign presence may deter local competitors from investing in risky innovation (or other) capabilities, as opposed to buying ready-made technologies or skills from abroad. Moreover, new technologies can be expensive and difficult to obtain, as firms from the Republic of Korea found when they became threats to technology suppliers in export markets. If FDI deters R&D in local firms, the technological gap between them and TNCs can grow, marginalizing them in technology-intensive activities. Foreign affiliates may be reluctant to invest in local R&D because of their established innovative activities abroad, with strong links to home country technology institutions and other enterprises (WIR99).
- *Exploitation of new technology.* Where both local and foreign firms engage in R&D activity and create new technologies, local firms may exploit the benefits of innovation within the host economy more than foreign affiliates, which may transmit the knowledge to parent companies to exploit them elsewhere.
- *Greater spillovers.* Even where local and foreign firms are similar in other respects, local firms may create greater spillover benefits because they have better local knowledge and stronger local commitment. They may procure more inputs locally, use more local skills, interact more intensely with local technology and training institutions and so on.

- *Footloose activity.* Foreign investors are likely to relocate to other countries more readily than domestic firms as conditions change, at least where sunk costs are low. Domestic firms are likely to have a stronger commitment to the home economy—and so are likely to invest more in improving the local competitive base.
- *Loss of economic control.* Foreign affiliates respond to signals from international markets and to strategies of decisionmakers based overseas. They may also be responsive to pressures from home country governments. Where local and foreign interests or perceptions

diverge or where sensitive technologies or activities (say, related to national security) are involved, this may impose a cost on the host economy.

Many governments also want FDI for such specific advantages as advanced technology or exports. Where foreign investors do not offer such advantages, governments may feel that local enterprises need not face unnecessary competition from FDI.<sup>23</sup> Many countries restrict FDI in low-technology manufacturing, retailing and similar activities where local enterprises are thought to

### Box IV.1. How serious is crowding out?

The possibility of domestic enterprises being crowded out by inward FDI is a concern for some governments of host developing countries.<sup>a</sup> How frequently does it occur? What does it mean for economic efficiency? And what policy tools can governments use to mitigate its negative repercussions?

Empirical evidence is mixed. In an econometric test covering 39 economies for a long period (1970–1996), some crowding out or crowding in could be detected in 10 countries, but in 19 the effect was neutral (*WIR99*, pp. 172–173). Crowding out was non-existent in Asia but was fairly frequent in Latin America. Earlier studies for Canada (Van Loo 1977) and for 69 developing countries (Borensztein et al. 1995) concluded that, on balance, FDI had stimulated additional domestic investment—had a crowding-in impact. A more recent test (Kumar and Prakash Pradhan 2002) for 83 countries over the period of 1980–1999 found no impact of FDI on domestic investment for 31, net crowding out for 29 and net crowding in for 23.

This diversity may be due to the fact that different countries attract different types of FDI. Countries attracting mostly domestic market-seeking FDI would be more likely to experience crowding out as the establishment of foreign affiliates results in head-on competition with local firms. But for export-oriented FDI, this may be less so.

The empirical studies shed little light on the development implications of crowding out—or the policy options to deal with them. Crowding out may take place because of two main reasons, which, in theory, can be differentiated from each other: (1) when local firms disappear because of higher efficiency and better product quality of foreign affiliates; and (2) cases when they are wiped out because foreign affiliates have better access to

financial resources and/or engage in anti-competitive practices. Unfortunately, empirical evidence is scarce in this respect, although the policy implications of the two scenarios may be different. In the first case, the initial net impact on welfare is positive, hence the economic justification for governmental intervention must be based on the possible negative effects of a denationalization of industry for the stability and economic activity generally through time. In the second case, there is a welfare loss, and governments would need to intervene through various channels. For example, they may need to establish or subsidize financing for local SMEs. In the case of anti-competitive practices, it would be the task of competition authorities to take remedial action.

If the net impact of an FDI project can be foreseen to be negative from the outset, governments may consider action at the entry phase (by denying entry or allowing it only under certain conditions). If the net impact turns out to be negative in the post-establishment phase, the competition authorities or the regulatory agencies of the given industry can usually alleviate the extent of crowding out.

In all cases of crowding out, governments can use tax policy to stimulate the reinvestment of money withdrawn from closed down activities into new investment projects. Moreover, even when the short-term static impact of crowding out is negative, its dynamic impact on efficiency in the host economy may be positive. The issue has not yet been settled one way or the other, and further analysis is required to shed additional light on the relevant issues, in particular: under what circumstances is crowding out more likely to occur and what are the development implications? A more detailed analysis could also help governments design appropriate policy responses in light of their national development objectives.

Source: UNCTAD.

<sup>a</sup> Such crowding out is different from domestic firms being taken over by foreign investors (cross-border M&As) (see *WIR00*), although in some cases they are presented together.

be adequate. Some are particularly sensitive about opening activities populated by SMEs that generate considerable employment and that may embody strong community, craft, design or other traditions.

These arguments for restricting FDI, used by developed and developing countries, have merits. But the evidence of their practical significance and the success of governments in countering the potential costs by restricting FDI is again mixed.

For promoting infant entrepreneurship and innovative capabilities in developing economies, the most successful cases have been the Republic of Korea and Taiwan Province of China. They restricted FDI entry (but not necessarily non-equity links with TNCs, such as technology agreements) and fostered world-class enterprises with strong innovative capabilities. But similar restrictions in many more developing countries did not have these results. These policies did foster local firms, but only a few of them became world-class enterprises. Many of the protected local firms were technologically weak and internationally uncompetitive—and many could not survive exposure to competition when the protection was removed. Conversely, there are also cases of economies with dynamic local firms that benefited from a strong foreign presence—as competitors, buyers or suppliers of their products. Examples include Hong Kong (China) and the second tier of newly industrializing economies in East Asia.

Neither FDI restrictions nor FDI liberalization can foster healthy enterprise development unless other conditions are met. For restrictions, the government must be able to select activities in which local firms have the potential to become and remain competitive. Protection from competition must be supported by strengthening institutions and infrastructure and by upgrading local inputs, such as skills, information, technical support and risk capital. And enterprises must have incentives to build world-class capabilities; if protection is open-ended, such incentives may not work.

Few developing country governments have shown the capacity to blend FDI with institutional, infrastructure and industrial policies. Their interventionist policies have tended to be rigid, prone to “hijacking” by vested interests and open to rent seeking with little improvements in efficiency or skills. So, the costs of government failure can be as high as those of market failure.

On the costs of FDI from “losing” innovations to parent companies and having lower spillover benefits, the evidence is again unclear (*WIR99*). Foreign affiliates that do R&D tend to

interact with capable R&D institutions and universities in the host economy. Although the trend—slow as it is—for TNCs to set up global R&D centres in developing countries (where the skills exist) is growing, R&D activities remain concentrated in home countries and other developed countries. Indeed, it is in their interest to deploy the most efficient technologies where this furthers their competitive advantage. Over the longer term, it is not necessarily the case that foreign affiliates strike fewer local linkages than comparable local firms. On the contrary, their new supply chain management and training techniques often serve as a model.

The specific advantages of R&D by foreign affiliates must also be remembered. Affiliates can gain from the access they have to R&D in the parent firm’s networks. Local firms can capture spillover benefits from R&D in foreign affiliates by learning from their research methods, hiring their trained employees and collaborating with them on specific projects or as suppliers. Note that Ireland and Singapore have induced foreign affiliates to increase local R&D greatly, using a mix of policy tools, including incentives. Foreign firms in Ireland account for around 80% of national enterprise-financed R&D (*WIR02*).

Footloose FDI was much feared some three decades ago when the massive relocation of labour-intensive processes in clothing, footwear, electronics and similar activities started. It was felt that the facilities were temporary and would move elsewhere in response to wage hikes or the end of tax incentives. The fears have generally turned out to be exaggerated. Typically, only very simple assembly activities (primarily apparel and some electronics) have been footloose. Others, particularly in the automobile industry, built local capabilities, with the sunk costs inducing them to upgrade technologies rather than relocate as wages and other costs rise. Large shifts in comparative advantage would force facilities to close or move, but it is not clear that foreign affiliates are more prone to do this than comparable local firms.

Loss of economic control remains a risk, but how much of a risk is difficult to assess. Most governments seem to consider it less important today—the “tolerance threshold” for FDI has risen with experience. That threshold varies by country, region and over time, but there is a general trend for it to rise. Still, countries have legitimate concerns about the vulnerability of their domestic economies to changes in attitude or strategy by TNCs that can impact on their economic prospects.

Also affecting policy on FDI entry today: the world has changed. When the Republic of Korea or Taiwan Province of China used FDI restrictions

to promote domestic firms some 20–30 years ago, technical change was slower and national production systems were not so highly integrated. The costs of keeping FDI out have risen considerably. Technical change is faster. FDI is the dominant form of technology transfer. And integrated production systems are much more prominent, particularly in the most dynamic export products (*WIR02*). So restricting FDI can reduce access to technology and some of the other main drivers of competitiveness.

The conclusions, therefore, must be nuanced. The evidence suggests that there may be good economic reasons for restricting FDI or liberalizing entry selectively and gradually. But that tool has to be used carefully. In the new global setting, strong regulations on market-driven resource allocation may deter FDI and create undesirable distortions in the host economy.

### *b. Post-establishment*

Political and social preferences apart, there can be an economic case for restricting national treatment for foreign investors, resting on market and institutional failures. First, foreign affiliates may be more efficient, and denying them national treatment is a version of the infant enterprise argument. But denying foreign affiliates national treatment on infant enterprise grounds is justified only if the differentiation is limited in duration and local enterprises are able to become fully competitive. There is little economic justification for a long-term or open-ended policy of treating firms differently because of ownership. Host countries can also tap into the greater efficiency of foreign affiliates by insisting on local equity participation or high-level employment.

Second, foreign affiliates may have advantages over local firms—not because they are more efficient but because markets for credit and skills and so on are segmented, with foreign affiliates getting better terms simply because of their foreign ownership. Offering better treatment to local firms offsets the adverse effects of segmentation. But factor market segmentation should be tackled at source rather than by suppressing its symptoms (what economists call a “second best” response). If foreign affiliates are treated better in credit markets because banks are poorly informed about local borrowers, the solution is to improve banking practices. Preventing banks from lending to foreign affiliates may not ensure that credit is efficiently allocated. Note, too, that segmentation is difficult to distinguish from healthy commercial practice: banks may prefer foreign affiliates because they may be better credit risks

or cost less to service. The use of a discriminating national treatment policy thus has to be carefully managed.

Third, foreign affiliates may need to be restricted from privileges that give them access to sensitive strategic information or technologies—or to activities of cultural and social significance. Resting on non-economic premises, this is difficult to evaluate. But it is an important argument, and many otherwise FDI-friendly governments, such as the United States, grant certain subsidies (say, for defence) for national firms.

Fourth, foreign affiliates may become dominant and abuse their market power. Preventing this is another “second best” solution. The best might be to strengthen competition policy rather than hold back some firms on grounds of ownership.

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In all this, government capacities are central. Discretionary instruments of any kind call for considerable skills, information, speed and flexibility in implementation. Moreover, FDI restrictions cannot be mounted in isolation from other capacity-building measures. Simply opening to FDI and removing restrictions is unlikely to be enough to stimulate sustained development. To benefit fully requires policies that encourage TNCs to make the best possible contribution to economic development. These policies go beyond national treatment in the post-establishment phase and involve encouraging the dissemination of the tangible and intangible assets of foreign affiliates to domestic enterprises and, more generally, national enterprise development policies.

## **4. National treatment in IIAs**

The great majority of IIAs preserve full host-government control over admission and establishment, while granting national treatment in the post-establishment phase of an investment. This is the approach in most BITs: to encourage the contracting parties to promote favourable investment conditions, while leaving the precise conditions of admission and establishment to national laws and regulations (Dolzer and Stevens 1995, pp. 50–57; UNCTAD 1998a, pp. 46–48).

Early regional IIAs between developing countries also used this approach, but some went further in introducing a coordinated or common investor-screening regime (Andean Pact and the Customs and Economic Union of Central Africa).<sup>24</sup> The 1967 OECD Draft Convention on the Protection of Foreign Property (UNCTAD 1996b, vol. II, pp. 113–119) left the matter of admission

and establishment to the discretion of member countries. More recently, the Energy Charter Treaty extended national treatment to the post-entry stage, but left its application before entry to a subsequently negotiated supplementary agreement (UNCTAD 1999a, pp. 41–42; Wälde 1996; Wälde and Weiler 2002; Andrews-Speed and Wälde 1996).

Some recent IIAs contain the right of establishment based on a combined national treatment and MFN standard. These include the BITs between the United States and developing countries (and, more recently, between Canada and developing countries), the 2002 economic partnership agreement between Japan and Singapore and the free trade agreement between the United States and Singapore. Exceptions are dealt with through a negative list of industries, for which rights of admission and establishment do not apply. An increasing number of regional agreements offer full reciprocal rights of admission and establishment to firms from member countries, as with MERCOSUR and ASEAN. NAFTA's liberalization also combines national and MFN treatment with negative lists.

So far the GATS is the only multilateral agreement that allows countries to bind themselves on admission and establishment. It does so flexibly, by using a positive list of service activities to which the right applies. The right to national treatment then applies only to those scheduled activities—and only to the extent specified by the host country in its schedule of national treatment commitments.<sup>25</sup>

The great majority of IIAs provide for national treatment in the post-establishment phase of an investment. There are, however, two important issues: the situation to which national treatment applies and the definition of the standard. The standard in many IIA provisions is applied to “like situations”, “similar situations” or “like circumstances”; what constitutes a “like” or “similar” circumstance or situation is an issue that needs to be determined case-by-case. But some IIAs do not contain an explicit reference to “like circumstances”. Instead, they may refer to specific activities to which national treatment applies. Other agreements are silent on this, offering a wider scope for comparison without any limitation to “like circumstances” or specific activities (UNCTAD 1999b, pp. 29–34).<sup>26</sup>

On the second issue, the dominant trend is to offer treatment “no less favourable” than accorded to domestic investors, though some agreements refer to “same” or “as favourable as” treatment (UNCTAD 1999b, pp. 37–40).<sup>27</sup> The latter offers a lower standard of investor protection

in that, to meet the standard, the host country need only accord treatment that is no worse than that offered to domestic investors in like or similar circumstances. The “no-less-favourable” standard goes beyond that: where treatment accorded to domestic investors falls below certain international minimum standards, the foreign investor may be treated more favourably.

Current developments in international legal practice are seeing a shift in dispute settlement from expropriation to national treatment. Three main questions arise. When are two situations really alike? When is treatment “less favourable” to the foreign investor? What is the policy justification for the alleged difference in treatment? A fourth question is whether there is a need for proof of the intention to discriminate by a host country.

Recent decisions under NAFTA have followed WTO jurisprudence on national treatment in trade cases and treated the first question as one of fact, to be decided case-by-case, centring on whether the foreign and domestic investors are in the same economic or business sector. The second question requires that the treatment, under the “no-less-favourable treatment” formulation in NAFTA, be no less favourable than the best treatment accorded to the domestic competitor.

The third question has been approached through a consideration of the objective, design and architecture of the measure as indicating the intention of the host government (Weiler 2002).<sup>28</sup> This case law approach has difficulties. How far should rules dealing with discrimination against goods based on national origin apply to discrimination against an investor on the grounds of their nationality? In addition, the factual contexts of several cases involved an inhibition on the ability of the claimant to provide a cross-border good or service.<sup>29</sup> They did not involve an impairment of the ability to manage, operate, control or dispose of its investment. Perhaps explaining this is that individuals have no rights to bring claims against parties to NAFTA under the trade rules, but only under the investment rules (Menaker 2002).

Both pre- and post-establishment national treatment are generally subject to exceptions. General exceptions may be based on national security, public health or morals. Specific exceptions may be in fields requiring reciprocal treatment by the home countries of investors, as with taxation or intellectual property. Exceptions can also relate to national policy measures like culture or the environment, incentives or public procurement and specific industries.<sup>30</sup> Exceptions based on economic development are particularly

important for developing countries. General exceptions can apply to both pre- and post-establishment phases; country-specific and “generic” exceptions apply to pre-establishment only. There are also differences among sectors: services in general are more prone to exceptions to national treatment than manufacturing industries. Leading examples of a wide-ranging use of exceptions are NAFTA and the OECD Code of Liberalisation of Capital Movements.

## 5. Options for the future

The core development issues here are, first, the extension of national treatment to the pre-establishment phase of an investment and, then, how much flexibility developing countries should have in the application of the principle in the post-entry phase. The liberalization of foreign admission and establishment has until now been largely unilateral. While developing countries have gone far in opening their economies to FDI, most remain cautious about binding themselves in IIAs to preserve flexibility in pursuing development objectives. Enshrining systematically an extension of national treatment to the pre-establishment phase in future IIAs would represent a major policy shift.

But even if that should occur, IIAs can be framed to permit countries to retain flexibility on allowing entry—they can specify the industries into which foreign investors can enter freely (the positive list) or at a minimum they can exclude selected activities from entry (the negative list). In either case limitations and conditions can be attached.

It is, however, common to offer national treatment in the post-establishment phase. The key issue here is what scope exists for exceptions, especially on development grounds.

The two forms of national treatment are furthermore independent of each other: granting pre-establishment national treatment does not affect the post-establishment treatment offered to foreign investors.

Maintaining flexibility is an important matter for many countries. At its core is the desire to preserve their ability to determine the pace and conditions of liberalization. The mechanisms to protect this ability include best-endeavour commitments, a GATS-type positive list approach and exceptions (box IV.2). Decisions need to be made in the context of the development objectives that countries pursue and the tradeoffs that have to be considered.

### Box IV.2. The impact of NAFTA on Mexico’s policy on admission and establishment

NAFTA membership contributed to Mexico’s long-term policy of liberalizing the admission and establishment of FDI in the context of a broader policy to increase the role of FDI in economic development. NAFTA’s investment provisions allowed Mexico to retain certain FDI admission and establishment restrictions for economic and non-economic purposes (protecting domestic SMEs and national culture). Because investment was part of a much broader set of issues, agreement on it needs to be seen in this wider context.

#### Before NAFTA

Mexico started to liberalize its FDI regime prior to NAFTA. But it still restricted foreign entry and foreign equity shares of Mexican companies in some activities for cultural, security and political reasons and for such socioeconomic objectives as the protection of domestic SMEs, income distribution and domestic enterprise development.

The bans and restrictions fell into three categories:

- *Activities reserved for the State in whole or in part*: petroleum and other hydrocarbons; basic petrochemicals; telegraphic and radio-telegraphic services; radioactive materials;

electric power generation; nuclear energy; coinage and printing of money and postal services.

- *Activities reserved for Mexican nationals*: retail sales of gasoline and liquid petroleum gas; non-cable radio and television services; credit unions, savings and loan institutions; development banks; certain professional and technical services and non-rail land transportation within Mexico of passengers and freight, except for messenger or package delivery services (but foreign majority stakes in companies providing point-to-point-trucking services were permitted).
- *Activities with ownership restrictions*: the most important among these were airlines (25%) and cable-TV (49%). Approval was needed for foreign ownership to exceed 49% in cellular telephone services, banking, and oil and gas pipelines.

When NAFTA negotiations began, FDI restrictions were scattered through many pieces of legislation. There was nothing mentioned specifically about standards of treatment of foreign investors in the 1989 FDI regulations and little is known about the practice with respect to treatment (Graham and Wilkie 1999).

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**Box IV.2. The impact of NAFTA on Mexico's policy on admission and establishment (concluded)****NAFTA's effect on Mexico's policy on admission and establishment**

NAFTA took Mexico's FDI liberalization a step further, using the negative list approach. It introduced national treatment standards and extended them to the pre-establishment phase (except in areas reserved for Mexican nationals and the State). Now, all investors (except financial institutions) benefit from national treatment. NAFTA also made Mexico's policies more transparent, giving United States and Canadian investors greater security (Rugman 1994, p. 53). It also gave Mexico the opportunity to consolidate many of the changes to its admission, establishment, treatment and protection of foreign investment in a new Foreign Investment Law enacted in 1993.

How did NAFTA affect Mexico's right to retain existing bans and ownership restrictions on FDI and introduce new ones in the future? NAFTA incorporated existing restrictions in the lists of specific country reservations taken by all NAFTA parties. Mexico reserved the right to adopt any measures (including FDI measures) in entertainment, telecommunication and social services. But it could not introduce any discriminatory admission or establishment measures in "unreserved" activities, particularly against United States and Canadian investors, without breaching the agreement.

Source: UNCTAD.

**Increasing the economic benefits**

One of the Mexico's objectives in NAFTA was to increase the economic benefits from FDI. NAFTA did this in two ways. First, it raised the confidence of United States and Canadian investors and so encouraged their investment in Mexico. Second, by giving free access to the United States and Canadian markets (coupled with the rules of origin), it created an incentive for other investors (apart from Canadian and United States ones) to set up facilities in Mexico. The result: FDI in Mexico rose significantly, especially into export-oriented manufacturing (WIR02, pp. 173–176). Bear in mind, however, that NAFTA is a broad regional integration scheme, not just an IIA—so several factors come into play.

Did NAFTA hinder Mexico's FDI policies, especially its right to regulate? It did not stop Mexico from retaining existing restrictions or introducing new ones in the areas agreed on during negotiations. It did prohibit Mexico (and the other two countries) from making existing regulations on admission and establishment more restrictive for United States and Canadian FDI, except in reserved areas.

**C. Nationalization and expropriation**

Nationalizations and expropriations ("takings of property") are the oldest issue in FDI regulation. Indeed, major takings of foreign-owned property in the 20<sup>th</sup> century led to rules of customary international law that sought to establish the conditions under which such takings could be lawful. Taking property is lawful if it fulfils three basic criteria: it must be for a public purpose, be non-discriminatory and give rise to the payment of compensation. These basic principles have been universally accepted, and many countries refer to them these days as the legal basis for their national laws and practices. They are also extensively referred to in the provisions of IIAs. In addition, some IIAs require that a taking must be in accordance with due process of law.

Until recently, the main controversy was over the precise compensation payable on nationalization or expropriation. This has now been joined by the extent to which indirect takings, including so-called "creeping expropriation" and

"regulatory takings", should be covered by protection standards.

**1. The sensitivity of indirect takings and national policy dilemmas**

Direct takings of property, involving the transfer of the physical possession of an asset as well as the legal title, can take various forms, ranging from outright nationalizations in all economic sectors or on an industry-wide basis, to large-scale takings of land by the State, or specific takings (expropriations).<sup>31</sup> Indirect takings include creeping expropriations, involving an incremental but cumulative encroachment on one or more of the range of recognized ownership rights until the measures involved lead to the effective negation of the owner's interest in the property (UNCTAD 2000b, pp. 11–12; Dolzer 2002). They also include regulatory takings, in which the exercise of governmental regulatory power—the power to tax

or to control operations for environmental protection—diminishes the economic value of the owners' property without depriving them of formal ownership. Distinguishing between the two types is not always easy (Sornarajah 1994, pp. 278–294).

In addition, the notion of indirect takings is itself problematic, given the ever increasing and changing conception of property rights and, in particular, of the social function of property. Against this background, governments have broad powers of regulatory intervention so as to ensure the subjection of private property to the public interest. These powers are highly complex. In the circumstances, indirect takings may be better understood by looking at the results of a governmental action rather than defining the process by which the result is reached.<sup>32</sup>

It is fairly easy to identify acts of outright nationalization or expropriation. They are normally carried out on a given date and on the basis of an explicit national policy. Not so for creeping expropriations. They are usually carried out under the guise of a policy in which the deprivation of the owner's property is not an explicit purpose, and they do not necessarily have a clear date when it can be said that the owners have been deprived of their title to the expropriated property.

For example, the Iran–United States Claims Tribunal had to assess whether emergency measures taken in 1978–1979 in the wake of the revolution in the Islamic Republic of Iran to preserve United States-owned commercial property, after its United States managers had fled, amounted to an indirect taking by the State.<sup>33</sup> Another example may be the action of a host country to intervene in a failing foreign-owned company to protect various stakeholders against an impending bankruptcy (Sornarajah 1994, pp. 306–307). If this effectively deprives the owners of their ability to control the company can this be said to amount to a “creeping expropriation”?

The major difficulty that such cases create is how to identify the point at which a process of governmental action changes to an incremental deprivation of an owner's rights, such that the deprivation becomes the subject of a duty to compensate.<sup>34</sup> If that definition is drawn too widely it will catch entirely legitimate regulatory and administrative action.

Regulatory takings are particularly sensitive because many government regulations can have an impact on the value of private property. So an expansive interpretation of “regulatory takings” can limit the national policy space by hindering a government's right to regulate, creating the risk of “regulatory chill”, with governments unwilling

to undertake legitimate regulation for fear of lawsuits from investors.<sup>35</sup>

The three main criteria of the lawfulness of takings may give rise, in principle, to certain disagreements between investors, both foreign and domestic, and host countries. In some cases, for example, investors challenge the public purpose of a taking before an arbitral tribunal or the courts. In most cases, however, it is difficult to prove a total lack of public purpose. In addition, potential disagreement can arise from the way non-discrimination is interpreted and applied in the case of individual takings.

As for the issue of compensation, a distinction must be made between the standard of compensation on the one hand and the method of calculation on the other. The former issue is practically always addressed in IIAs, whereas the latter issue has received less attention. There is no hard and fast agreement among States as to the appropriate level and method of calculating the compensation payable upon a nationalization or expropriation. The approach taken under national law is within the discretion of the State concerned. However, this can lead to disputes over compensation at the international level where States may differ over the correct approach to compensation (UNCTAD 2000b, pp. 13–14).

In relation to regulatory takings, the national practice of countries does not always provide clear answers to the questions raised (Dolzer 2002, pp. 68–69). Even in a deregulated, liberal market environment, investors need to observe certain basic standards of good market behaviour, as prescribed for example by competition rules, and sound practices in areas of concern to public policy whether these involve the protection of the environment, public health, morals, consumers or the promotion of development. Given that public policy goals may not always be achieved through voluntary compliance on the part of private owners of productive assets, a degree of regulation by the State is inevitable.<sup>36</sup>

The major problem today is to distinguish between a legitimate exercise of governmental discretion that interferes with the enjoyment of foreign-owned property and a regulatory taking that requires compensation. This requires a balance to be struck between:

- Achieving the public policy goals of a regulatory regime, which could reduce property values—or values potentially generated in the absence of regulation by unregulated business entities.
- Preserving the economic value of the productive assets of those entities.

Where the interference with private property rights violates the legitimate rights or expectations of owners, the State may need to provide compensation. But where a measure is undertaken as part of the right to regulate in the public interest, compensation may not be due. Similarly, where a measure is penal, confiscation without compensation may be a part of the sanction to be visited on the owner because they violate required regulatory or criminal standards.

## 2. Coverage in IIAs

Most IIAs contain provisions on taking property, generally defining a “taking” as including traditional notions of nationalization or expropriation as well as creeping expropriations and regulatory takings (UNCTAD 2000b, pp. 19–24). The indirect taking may or may not be qualified by a carve-out for normal regulatory powers, as in the areas of taxation, intellectual property rights and public debt. If such a clause is included, it may subject the carve-out to an obligation that the regulatory powers must be non-discriminatory (UNCTAD 2000b, p. 23).<sup>37</sup> Furthermore, the majority of such agreements require observance, by the contracting parties, of the principal elements of a lawful taking: public purpose, non-discrimination and compensation (UNCTAD 2000b, pp. 24–26). In addition, some agreements refer expressly to the need for observance of due process.<sup>38</sup>

However, there is no uniformity on the standard of compensation to be applied, reflecting an absence of full consensus among States on this issue and, also, the relative bargaining positions of parties to IIAs. Some agreements refer to “appropriate” or “just” compensation, while others refer to “prompt, adequate and effective” compensation or similar phrasing. The trend in recent years has moved towards the latter approach, in both bilateral or regional agreements (UNCTAD 2000b, pp. 26–31).

From a developmental perspective, recent practice in IIAs suggests that developing countries strive to strike a balance between offering reasonable protection to investors and retaining their right to regulate. The utility of IIAs in referring to takings of property has usually been judged for the effect on the investment climate in developing countries. Treaty-based controls over the scope and legal requirements of a valid taking of foreign-owned property are assumed to have been good for investment conditions. But international disciplines have sometimes been criticized as imposing too much control over the sovereign discretion to limit the enjoyment of private property in the public interest. Where a host

country wishes to preserve discretion to discriminate, this may need to be protected under limited and transparent circumstances. The question remains whether the rules of expropriation or other standards of protection, such as non-discrimination, are the best way to offer some protection to investors while preserving the right to regulate.

The issue of compensation may attract renewed interest in light of the emergence of regulatory takings as an important issue. If regulatory measures give rise to compensation, two questions arise: first, when is compensation due and, secondly, how to measure the right amount? For example, if environmental measures were subject to a duty of compensation, could this not, in effect, insure the investor against compliance costs, or the costs of causing environmental harm, if the regulatory measure in question was seen as a regulatory taking? Equally, such a duty to compensate might inhibit a host country from enforcing its laws or from complying with international environmental agreements (UNCTAD 2000b, pp. 15–16).<sup>39</sup> These dilemmas lead governments to protect themselves through interpretative provisions, carve-outs or international review mechanisms—to permit a legitimate exercise of regulatory power.<sup>41</sup> So how will international arbitral tribunals develop the applicable principles in the course of settling disputes brought before them?

There is no one settled approach, but two are emerging (Dolzer 2002, pp. 79–90). The first is that the only relevant criterion for determining whether a regulatory taking requires compensation is the effect on the investor’s property rights, without consideration of the public policy purpose behind the regulatory measure in question. That approach can be discerned in the *Metalclad* case (box IV.3) and the *Santa Elena* Case (box IV.4). The second is to consider both the effect on an investor’s property rights and the public purpose behind the measure and to balance the two. This can be discerned in the *S.D. Myers* and the *Feldman* cases, in which the measure was not seen as a regulatory taking (box IV.3). The former approach gives more protection to the investor’s property rights, while the latter allows more consideration of the regulatory intent.

Provisions on taking property can be expected in future IIAs. Indeed, given the need to determine the proper balance between legitimate regulation and undesirable interference with private property rights through regulatory acts, such provisions are likely to gain in importance. They are closely linked to the “right to regulate” in the context of the development priorities of host countries.<sup>41</sup>

One of the key policy choices is the definition of takings. The traditional “narrow” approach covers only the classical instances of direct takings. A more comprehensive definition includes some forms of indirect takings. Closely related is the boundary between the legitimate exercise of governmental regulatory activity, and regulatory takings (which require compensation).

An affirmation of the right to regulate is the governing principle here. Another policy choice is how far IIAs should permit international review of takings by host country authorities: should these be subject to a prior requirement to exhaust domestic remedies or should international review be available as a matter of right?

### Box IV.3. Regulatory takings under Chapter 11 of NAFTA—four cases

The problems associated with the issue of regulatory takings for national policy space can be illustrated by four cases brought by investors against host countries under Chapter 11 of NAFTA.

*Case 1: Ethyl.* In 1997 the Government of Canada passed legislation banning the use of the gasoline additive MMT from inter-provincial trade and importation into Canada. In 1998 the Ethyl Corporation, a United States importer of MMT into Canada, brought a claim challenging the legislation under Chapter 11 of NAFTA. The Government of Canada settled the claim out of court (without an award being issued by the arbitral tribunal), paying \$13 million to Ethyl, the reasonable and independently verified costs and lost profits in Canada. Ethyl dropped its claims against the Government. The Ethyl case caused alarm over whether the investor protection provisions of NAFTA could be used to limit host country powers to regulate in the field of environment, public health or similar areas (UNCTAD 2000b, pp. 7–8).

*Case 2: Metalclad.* These fears were reinforced by the *Metalclad Corporation vs. Mexico* case. The claimant alleged (among other issues) that an investment in a landfill facility in Mexico had been taken by a measure tantamount to expropriation. Having been assured by the federal Government that the project had complied with all applicable environmental and planning regulations, it had been subsequently denied a construction permit by the local municipal authorities and the land in question had been declared a national area for the protection of rare cactus by the regional government. The Tribunal upheld this claim on the ground that the actions of the municipal and regional governments had denied the use of the property to the claimant, contrary to the assurances given by the federal Government, depriving the owner of the expected benefit in the property. This conduct also amounted to a denial of fair and equitable treatment. The Tribunal awarded a sum of \$16.7 million in compensation. But the Government of Mexico launched a judicial review of the Tribunal’s decision before the Supreme Court of British Columbia, the place of arbitration. That court set aside the award but upheld the finding that the regional government’s decision to make

the landfill site an ecological reserve was expropriation.

*Case 3: S.D. Myers.* Not all regulatory takings have been seen as measures tantamount to expropriation by NAFTA tribunals. In 2000 S.D. Myers, a United States company specializing in the remediation of PCB waste, brought a claim against the Government of Canada, alleging that it had violated Chapter 11 of NAFTA by promulgating an export ban on PCB waste, denying the claimant the opportunity to undertake PCB remediation business based on imports, from Canada, of such waste to its United States remediation facilities. The claimant argued that the ban had been applied in a discriminatory and unfair manner, in effect, favouring Canadian rivals not subject to the ban. The Tribunal found that Canada had violated the national treatment and fair and equitable treatment provisions of NAFTA. But it did not find this to be a case of an expropriation, as regulatory action was not usually to be treated as an expropriation. That did not rule out the possibility of a legitimate complaint on this ground. On the facts the border closure was a temporary postponement of the claimant’s entry into the Canadian market for some 18 months.

*Case 4: Marvin Feldman.* Marvin Feldman, a United States national, brought a claim against Mexico alleging that his investment in a Mexico-based export company had been indirectly expropriated because he was forced to pay export taxes on exports of cigarettes from Mexico while his only appreciable Mexican-owned and controlled competitor received rebates on such taxes. The Tribunal did not uphold the claim of indirect expropriation, though it did find a violation of the national treatment standard. On the indirect expropriation claim, the Tribunal held that not every business problem of a foreign investor is an expropriation under NAFTA. NAFTA and principles of customary international law did not require a State to permit a “grey market” in the export of cigarettes. At no time had the relevant law, as written, afforded Mexican cigarette resellers a right to export cigarettes. The claimant’s business remained under his control and he was able to profit from the export of other products. While none of these factors was conclusive on its own, together they tipped the balance away from a finding of expropriation.

*Source:* UNCTAD, based on ICSID Case No. Arb. (AF)/97/1; 30 August 2000 ([www.worldbank.org/icsid/cases/mm-award-e.pdf](http://www.worldbank.org/icsid/cases/mm-award-e.pdf)); Supreme Court of British Columbia, “The United Mexican States v. Metalclad Corporation”, 2 May 2001 ([www.courts.gov.bc.ca/jdb-txt/sc/01/06/2001bcsc0664.htm](http://www.courts.gov.bc.ca/jdb-txt/sc/01/06/2001bcsc0664.htm)); “North American Free Trade Agreement (NAFTA) arbitration: S.D. Myers, Inc. v. Government of Canada: text of the decision” Award of 12 November 2000, *International Legal Materials*, 40, 6 (2001), pp. 1408–1492; ICSID case no. Arb. (AF)/99/1, 16 December 2002; see [www.naftaclaims.com](http://www.naftaclaims.com).

#### Box IV.4. Calculating compensation—the Santa Elena-Costa Rica arbitration

Consider the calculation of compensation in the ICSID arbitration between the *Compania del Desarrollo de Santa Elena*, a predominantly United States-owned company, and the Republic of Costa Rica. In 1978 the Government of Costa Rica expropriated land owned by the claimant under national regulations with the aim of expanding the Santa Rosa National Park—to make it large enough to act as a reserve for rare flora and fauna. There was no dispute about whether compensation was payable. The main issues concerned the date and the amount of compensation payable.

The Tribunal held that the proper date for calculating compensation was the date of the taking, 5 May 1978, not the present value of the property (regardless of any act of expropriation), as argued by the claimant. The parties agreed that the compensation should be based on fair market value but differed on the actual amount. The claimant asserted \$6.4 million while the

Government asserted \$1.9 million. The Tribunal assessed the value of the assets at the relevant date as \$4.15 million. Adding compound interest lost by the claimant as a result of the expropriation, the final award was \$16 million.

In the course of the award the Tribunal noted that the fact that the measure was taken for the public purpose of environmental protection made no difference to the legal character of the taking for which full compensation, based on the fair market value of the expropriated land, had to be paid. Expropriation for environmental purposes was held to be no different from any other expropriatory measures. The Tribunal added that a measure that gradually deprives owners of the value of their property over time can be identified as the starting point of the expropriation, even where the deprivation of the economic value of the property to its owner does not take effect within a reasonable period of time.

Source: UNCTAD, based on ICSID Case No. ARB/96/1, Award of 17 February 2000.

## D. Dispute settlement

The two key issues in dispute settlement concern the role of investor-State procedures in future IIAs and the extent to which the investment dispute settlement process is self-contained. IIAs normally have State-State dispute settlement provisions, but investor-State procedures are now being included more as well. That raises fears of frivolous or vexatious claims that could inhibit legitimate regulatory action by governments. Another issue is balancing national and international methods of dispute settlement. The second key issue concerns the isolation of investment disputes from existing State-State systems of dispute settlement, such as that in the WTO. Questions also arise as regards open and well-functioning procedures that can deal better with the developmental aspects of investment disputes.

### 1. National policies on dispute settlement in the investment field

The settlement of disputes between investors and host countries is central to national FDI policy. Usually, a host country provides dispute settlement procedures and remedies as a part of the general law of the land. But investors may, in some circumstances, prefer an internationalized approach to dispute settlement, usually arbitration between an investor and a host country. This can be ad hoc,

with a panel and procedure agreed between the investor and the host country. Or there may be an institutional system of international arbitration for the dispute in question.

National policies on investor-State dispute settlement differ. Some require the exclusive use of national procedures and remedies.<sup>42</sup> Some require the prior exhaustion of domestic remedies in the host country before recourse to internationalized dispute settlement systems is permitted.<sup>43</sup> And some offer the investor free choice between national and international dispute settlement (UNCTAD 2003i).

National investment laws often expressly permit such internationalization of investment disputes by enshrining investor choice in a special dispute settlement provision in the FDI legislation.<sup>44</sup> But many FDI laws are silent on this.<sup>45</sup> In such cases, the investor is required to use the internal legal remedies available to them under host country law. The same is true of countries that have no FDI laws. In these cases international remedies may be available under the international treaty obligations of the host country in IIAs.

So a dispute settlement clause in a BIT that allows the investor choice between national and international procedures binds the host country as a matter of international legal obligation. Such an international obligation can also be made

enforceable before national tribunals where the investment contract between the investor and host country includes a dispute settlement clause that incorporates the country's international treaty obligations to allow the use of internationalized systems of dispute settlement.

## 2. Legal effectiveness

The effective settlement of any dispute, not just an investment dispute, often requires adopting the most speedy, informal, amicable and inexpensive method available. In recent years the emphasis has been on “alternative dispute resolution” mechanisms—avoiding procedures provided by the public courts of a country or of an international court. They usually include direct methods of settlement through negotiation or informal methods employing a third party, such as the provision of good offices, mediation or conciliation.<sup>46</sup> Arbitration can be an alternative dispute resolution mechanism, but its practical conduct may be only marginally different from that of a court proceeding (Merills 1998; Asouzu 2001, pp. 11–26).

So the first step in the resolution of any investment dispute is to use direct, bilateral, informal and amicable means of settlement. Only where such informal means fail to resolve a dispute should the parties contemplate informal third-party measures, such as good offices, mediation or conciliation. The use of arbitration should be contemplated only where bilateral and third-party informal measures have failed to achieve a negotiated result. Indeed, this gradation of dispute settlement methods is commonly enshrined in the dispute settlement provisions of IIAs.

The choice of a dispute settlement method is but one choice that the investor and State have to make when seeking to resolve a dispute. Another concerns the forum. Most recent BITs provide for some type of international dispute settlement mechanism to be used in relation to investment disputes. Foreign investors have traditionally maintained that, in developing countries, investor-State disputes should be resolved by internationalized dispute settlement governed by international standards and procedures. But host countries may perceive such an emphasis on international systems as a sign of low investor confidence, which may or may not be justifiable.

The willingness of the host country to accept internationalized dispute settlement may be motivated by a desire to show its commitment to creating a good investment climate. This may be of importance where the country has followed a restrictive policy on FDI and wishes to change that

policy. In so doing, it should be entitled to expect that the internationalized system is impartial and even-handed.<sup>47</sup>

An institutional system of arbitration may be a more reliable means of resolving a dispute than an ad hoc approach. Once the parties have consented to its use, they have to abide by the system's procedures. These are designed to ensure that, while the parties retain a large measure of control over the arbitration, they are constrained from any attempt to undermine the proceedings. Furthermore, an award made under the auspices of an institutional system is more likely to be consistent with principles of procedural fairness applicable to that system—and so is more likely to be enforceable before municipal courts. Indeed, recognition of awards may be no more than a formality. One system has been developed for investment disputes between a host country and a foreign investor: the conciliation and arbitration procedures available under the auspices of ICSID.

## 3. Coverage in IIAs

Dispute settlement has evolved significantly in IIAs. In trade agreements, disputes centre on State-State issues pertaining to either a violation of trade rules under an applicable agreement or to the nullification or impairment of benefits arising from the agreement. For investment, State-State disputes arise over the interpretation and application of an IIA agreement. But IIAs differ from trade agreements in that they recognize disputes between investors and States, virtually unknown before the introduction of the ICSID system in 1965. Most bilateral and many regional agreements now include provisions on investor-State dispute settlement.

Provisions for State-State dispute settlement appear in almost all IIAs.<sup>48</sup> Some regional agreements contain provisions only for disputes arising between the parties, thus not covering disputes between a party and an investor of another party. This is the case for the 1997 EU–Mexico Partnership Agreement, the 1998 Framework Agreement on the ASEAN Investment Area and many of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements recently concluded by the EU.

The usual approach to investor-State disputes in IIAs is to specify that the parties to the dispute must seek an amicable negotiated settlement. Only where such an approach fails to resolve the dispute can they resort to arbitration. Most BITs and some regional agreements provide for the possibility of settling disputes by consultation and negotiation.<sup>49</sup> Some bilateral agreements also have as one of their

main purposes the provision of a consultation mechanism in a bilateral body.<sup>50</sup>

If amicable negotiations fail to resolve a dispute, international arbitration is usually the next step—either on an ad hoc or institutional basis. Agreements differ on the extent of choice. The precise terms of the agreement must be perused to determine which types and systems of arbitration are permitted.

Agreements also differ on the extent of investor choice over the applicable means of dispute settlement. Some agreements require agreement by both parties on the applicable method. But more IIAs now permit unilateral investor choice of a method if amicable means fail to resolve the dispute (UNCTAD 2003i). For this, many agreements refer to the ICSID system of investor-State dispute settlement. That system offers a structured procedure for international investment disputes covering jurisdiction, initiation of proceedings, establishment and selection of panels, choice of applicable law, rules of procedure and evidence and recognition and enforcement of awards (see UNCTAD 2003i; Schreuer 2001). The majority of BITs refer to ICSID arbitration or to a choice between ICSID and other international arbitration systems, most commonly the UNCITRAL Arbitration Rules (UNCTAD 1998a, pp. 94–95).

For regional agreements, Articles 1115–1138 of NAFTA provide for international arbitration of disputes between a party and an investor of another party. An investor may submit to international arbitration a claim that another party has breached an obligation under Chapter 11, or under certain provisions of the chapter on monopolies and State enterprises—and that the investor has incurred loss or damage from that breach. Article 1122 contains the unconditional consent of the parties to the submission of a claim to arbitration.

The investor can elect to proceed under the ICSID Convention, the Additional Facility Rules of ICSID or the UNCITRAL Arbitration Rules. Detailed rules are contained in these provisions on matters such as the constitution of arbitral tribunals, consolidation of claims, applicable law, nature of remedies, and finality and enforcement of arbitral awards. Several regional agreements follow this approach with certain modifications and with varying detail.<sup>51</sup>

Some other regional agreements—such as the 2000 Agreement between New Zealand and Singapore on Closer Economic Partnership and the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR—also provide for international

arbitration of disputes between a party and an investor of another party under the ICSID Convention but do not include as detailed rules as in the NAFTA.

After the choice of ad hoc or institutional arbitration, some further issues must be resolved: the procedure for the initiation of a claim, the establishment and composition of the arbitral tribunal, the admissibility of claims and the determination of the applicable law. Such issues may be directly addressed in the investor-State dispute settlement clause in an IIA. Or they may be left to determination either by the parties to the dispute when ad hoc procedures are chosen or by the instrument that governs the institutional system chosen by the parties. In addition, the resulting award must be a final determination, and it must conform to the requirements of a properly determined decision to be enforceable. Institutional systems of arbitration may provide procedures for enforcement and for the review of an award by another panel of arbitrators when there is an error claimed in the original award.

Last, the costs of arbitration must be determined, clarifying the allocation between an investor and the host country. Generally, the losing party bears the costs or they are shared. But in institutional systems of arbitration, the costs may be pre-determined by the administrative organs of that system. Even so, considerable discretion may remain.

#### 4. Key issues and options for the future

The issues identified at the outset are taken up again here.

*Including investor-State dispute settlement.* In attracting FDI the inclusion of investor-State dispute settlement clauses in IIAs can help improve the investment environment by giving some reassurance to investors that their rights under the agreement can be backed up through third-party procedures of dispute settlement when amicable resolution proves elusive. For many investors an investor-State dispute settlement system is an essential part of an effective protection framework.

Indeed, recourse to investor-State arbitration may offer an alternative to the traditional international remedy of diplomatic protection. The latter converts an investor-State dispute into a State-State dispute, possibly, leading to an increased politicization of the dispute. Such politicization could hinder good relations between the home and host country—and between the host country and the investor—to the long-term detriment of the investment. Because the remedy

is discretionary, there is no guarantee for investors that the claim will be taken up by their governments. And in a complex TNC system, it may even be difficult to ascertain which government is entitled to exercise diplomatic protection, with the nationality of the investor being hard to establish. Because most disputes involve the host country and a locally incorporated affiliate of a foreign owned firm, the affiliate normally possesses the same nationality as the host country, making diplomatic protection difficult.<sup>52</sup> An investor-State dispute settlement system may also be in a better position to give awards. Why? Because it is better suited to assessing the issues and valuing compensation than a more general dispute settlement body with less experience in these types of claims.

The case for an investor-State system's enhancing a good investment climate can be overstated. Investors may be prepared to invest in host countries that do not offer such remedies where the return on investment could be high. Similarly, since diplomatic protection is discretionary and politically sensitive, it may be used with greater restraint. Conversely, because investor-State dispute settlement is a remedy of right in contemporary IIA practice, investors might initiate more disputes. That is why internationalized systems of dispute settlement must guard against frivolous or vexatious claims—safeguards that are usual in national courts and tribunals. There is little reason to depart from this practice in investor-State dispute settlement (box IV.5).

Dispute settlement cases have become very expensive. It is important that the award of damages against a host country be commensurate with the actual loss. Some recent arbitral tribunals have awarded large sums, so there is concern about the ability of developing countries to pay them.<sup>53</sup> The development impact of an award should be taken into account.

International arbitration itself can demand much in resources and expertise, possibly putting developing country parties at a disadvantage. Any international body must also be truly independent, not perceived as favouring investors over host countries or vice versa. Arbitrators should thus be drawn from a wide pool of experience and origin, to ensure a body representative of all the major interests in the investment process.

The trend towards internationalization needs to be balanced against the loss of sovereign control over dispute settlement. Local settlement might be left underused, retarding the development of local expertise, while increasing the costs (Asouzu 2001). So, requiring the prior use of local procedures (whatever the difficulties), before recourse to international procedures, becomes important. But recent IIA practice generally has not followed this approach. A possible disadvantage in requiring the prior exhaustion of domestic remedies is that the investor, after an unsatisfactory outcome, may have recourse to international arbitration, subjecting the host country's national court system to possible "second guessing".

#### **Box IV.5. Investment arbitration and the control of claims made by investors**

In the NAFTA case of *Azanian v Mexico* (ICSID Case No ARB(AF)/97/2, 1 November 1999), the termination of a contractual concession to supply solid refuse collection and disposal services to a local authority in Mexico was claimed to be an expropriation. The tribunal held that the termination could not amount to an expropriatory taking in violation of Chapter 11 of NAFTA because the Mexican authorities had not violated the international law standard embodied in NAFTA. The alleged breach had been reviewed by three levels of Mexican courts, and in none was the alleged breach affirmed. Without proof that the Mexican courts had breached Chapter 11, by violating international standards of due process through a denial of justice or a pretence of form, the claimant's case failed.

The case suggests that an investor-State mechanism should operate within the limits of international law and that its rules should be the only ones that determine whether a claim is valid.

If a claim fails to show that an international standard, embodied in an IIA, has been breached by a host country, it has no right to success before an international tribunal. International law may thus check excessive claims by investors against host countries. Only the most serious claims, involving violations of international standards embodied in IIAs, should be brought before dispute settlement bodies.

Perhaps a penalty could be imposed on a claimant who brings a clearly unmeritorious claim before a tribunal. Or perhaps safeguards could be built into the procedure for determining the admissibility of a claim. Under the ICSID Convention a preliminary review by the Secretary General of ICSID determines whether the request for arbitration is manifestly outside the jurisdiction of ICSID. But this power relates to jurisdiction only. There is no power to determine whether the claim is sufficiently meritorious to warrant a full hearing. That is for the tribunal to decide.

*Dealing with cross-retaliation.* The foregoing concerns are particularly relevant for IIAs that *only* have State-State dispute settlement mechanisms. To allow investor-State procedures would require a substantial reorientation, as for the WTO, should modalities be agreed upon to negotiate investment in that Organization. (The Doha Declaration expressly refers only to “disputes between Members” as a subject for clarification.<sup>54</sup>) To include investment dispute settlement procedures under these circumstances raises the possibility of cross-retaliation—for example, of increasing tariffs or introducing quotas to enforce compliance with an award against the losing State. This could have adverse consequences for the economic welfare of a developing country, doing disproportionate damage to its export earnings.

Countries could protect themselves against cross-retaliation by limiting it or indeed by not allowing it.<sup>55</sup> It is also possible to establish a separate self-contained dispute settlement mechanism (with appeal possibilities) for investment matters. Although ICSID already exists as a self-contained mechanism, it does not provide such wide-ranging functions, focusing instead on the settlement of individual disputes that come before it. In addition it has limited powers to review and annul the award of a tribunal that does not allow for a full appeal process (Schreuer 2001, pp. 891–893). Still, if governments so decide, it may be possible to broaden the competence of ICSID.

Procedures could also be established to prevent the use of retaliatory measures until all other alternative methods of enforcement have been exhausted. Such measures could be excluded until parties have held consultations over compliance, both bilaterally and with the intervention of the relevant dispute settlement body—to arrive at a mutually agreed compliance process. This would seek to reconcile the winning party’s interest in enforcement with the losing party’s essential development needs. In a climate of intense competition for FDI, as well as greater scrutiny of investor action, both parties have an interest in settling disputes amicably.

There is also a broader consideration: State-State procedures may be preferable to investor-State ones because a government could look at a dispute in the broader context of its entire relations with another government, rather than focusing on the narrower concerns of the investor claimant. But a problem could arise if only State-State procedures are available: an investor-State dispute could be introduced under the guise of a State-State dispute.<sup>56</sup> In this situation, the investor has all the resources of its home government at its disposal and (vice versa). (But even in this case, it is the

government’s decision to proceed with a case and, if it does, in what way.) Furthermore, if the claimant country is successful, how should the award be made, and would the home government pass on any advantages to the investor?<sup>57</sup>

*Considering third parties.* A final set of issues, raised especially by NGOs, concerns the participation of third parties who have a stake in the outcome of dispute settlement cases. For example, where an investor and a host country are in dispute over the application of environmental regulations to the investment, local communities affected by the environmental performance of that investment might wish to participate as interested third parties. This can be accommodated through rights of audience before national tribunals in countries in which there is a strong tradition of access to justice by interested third-party individuals or groups.

Where the investor exercises a treaty-based right to international arbitration, interested third parties may have no standing before such a body and will be denied the possibility of a hearing. But a limited right of third-party representation before international arbitral tribunals is beginning to emerge. The WTO Appellate Body has accepted a limited right for third-party participation through the submission of information and technical advice where the WTO panel feels this appropriate, though a panel is obliged to consider only the submissions made by the parties to the dispute (WTO Appellate Body 1998).

Given the significance of stakeholder perspectives on investment issues and disputes, particularly to the development dimension, this issue could be important in future IIAs. But if wider third-party rights of access to tribunals continue to grow, some safeguards against the manipulation of those processes might also be required—to prevent the raising of costs by way of “piling on” third-party interventions on one side or the other of the dispute.

Other measures could aim at enhancing good arbitral practice and the fullest possible review of the development dimension in investment disputes. For example, cases of disputes under IIAs, could be made public, as by ICSID. Procedures could also be more open and transparent, including public access to hearings, the full publication of awards and their reasons and the possibility of an appeal for awards that do not take place within an institutional system that already provides for this. Such issues are already being addressed by arbitral tribunals themselves.

Investment disputes are likely to increase, making dispute settlement procedures more important. But they need to safeguard against frivolous and vexatious claims, as well as cross-retaliation.

## E. Performance requirements

Performance requirements can be an important policy tool to enhance the benefits of inward FDI, so developing countries seek to preserve their right to use them. But developed countries associate them with interventionist strategies of the past and question their effectiveness. The use of performance requirements has declined, and they are typically linked to some kind of incentives. Because there are valid economic arguments for using performance requirements in some circumstances, they are important in the negotiation of IIAs.

### 1. Why use them?

Performance requirements are stipulations imposed on foreign affiliates to act in ways considered beneficial for the host economy. The most common ones relate to local content, export performance, domestic equity, joint ventures, technology transfer and employment of nationals.<sup>58</sup> The requirements can be mandatory (say, as a precondition for entry or access to the local market) or voluntary (as a condition for obtaining an incentive). Requirements can be non-discriminatory, applied to all companies (local and foreign) or they can discriminate between companies by ownership (as an exception to national treatment) or even by particular nationality (as an exception to the MFN standard).

Their purpose is to induce TNCs to do more to promote local development—by raising local content, creating linkages, transferring managerial techniques, employing nationals, investing in less developed regions, strengthening the technological base and promoting exports. TNCs may be unwilling to use a location as an export base since it might compete with other parts of their production systems.<sup>59</sup> Or they may not be fully aware of local potential and so are less willing to invest in using local resources (instead of using production bases abroad). Performance requirements can induce them to explore local resources and, where necessary, invest in improving them.

Moreover, some countries following import substitution strategies tried to counterbalance the anti-export bias of the trade regime by introducing export performance requirements. Local content and joint venture and other requirements have been used to offset or pre-empt restrictive business practices by TNCs.<sup>60</sup> They have also been used to pursue such non-economic objectives as political or economic independence, shifting the distribution of power or securing rents from the exploitation of natural resources (UNCTAD 2003f).

### 2. Declining incidence

Performance requirements have been used extensively by a wide range of countries.<sup>61</sup> In developed countries, performance requirements were particularly used in the 1970s and 1980s in industries in which FDI was concentrated: electrical, transport equipment (especially automobiles), chemicals, non-electrical machinery and primary sector industries such as mining and petroleum.<sup>62</sup> For several reasons, the incidence of performance requirements by developed countries has declined over time (UNCTAD 2003f).<sup>63</sup> This does not mean, however, that developed countries stopped trying to influence the trade and investment behaviour of TNCs. To achieve similar objectives, they now use other strategic trade and investment policy instruments, such as rules of origin and locational incentives.<sup>64</sup> In the 1980s and early 1990s, voluntary export restraints were also used extensively by developed countries (Messerlin 1989; Prusa 1992).<sup>65</sup> These instruments, too, may have distorting effects on international trade and investment (Belderbos 1997; Moran 1998, 2002; Safarian 1993).

Developing countries also use performance requirements (UNCTAD 2003f; OECD 1989; WTO/UNCTAD 2002),<sup>66</sup> particularly because of their desire to promote infant industries and address balance-of-payments problems (UNCTC 1991; Bora 2002). A survey of some 400 European business executives recently noted that the highest incidence of performance requirements was in Brazil, China, India and Russia, all large developing countries or economies in transition (Taylor Nelson Sofres Consulting 2000). But the general policy trend resembles that of the developed countries: there is a declining incidence of performance requirements and a shift from mandatory requirements on investors to requirements linked to investment incentives (UNCTAD 2003f).<sup>67</sup>

The general trend to reduce mandatory performance requirements reflects several factors:

- WTO rules oblige members to abandon some measures—notably those covered by the TRIMs Agreement.
- Falling trade barriers and a more competitive environment for FDI make it more difficult to impose performance requirements without increasing the risk of deterring FDI and affecting competitive performance. Thus, mandatory requirements are now rarely applied in activities in which host countries are in a relatively weak

bargaining position for FDI, such as efficiency-seeking export-oriented FDI. Similarly, they are less used to promote local linkages in activities that feed into exports. Countries have generally shifted from sticks to carrots—they use incentives to induce foreign affiliates (and domestic firms) to operate in a way that promotes the type of development that is desired.

- There is a growing preference among governments for more market-friendly tools to meet development objectives.
- Some of the development objectives that governments sought to promote through performance requirements may now have been realized (UNCTAD 2003f).

### 3. How effective are they?

Broad comparisons of growth or export performance do not show whether the economic benefits of particular performance requirements outweigh their costs (administration, incentives and possible distorting effects). Comparisons with counterfactuals (what would have happened had certain performance requirements not been applied in a given situation) are even more difficult.

Even so, there is evidence that performance requirements can be effective. A number of studies have found positive effects of local content requirements (Balasubramanyam 1991; Wong 1992; Halbach 1989; Dahlman and Sananikone 1990), export performance requirements (Moran 1998; Rosen 1999; Kumar 2002), employment and training requirements (UNCTAD 2001i, 2003f) and domestic equity or joint venture requirements (UNCTAD 2003f, chapter III). By contrast, other studies have found that the measures imposed considerable costs on host countries, suggesting that the results have been inefficient (Moran 2002; Ernst and Ravenhill 2000; Ramachandran 1993; Urata and Kawai 2000; Hackett and Srinivasan 1998; UNCTAD 2003f). It appears that some countries used performance requirements uneconomically, forcing firms to act in a manner that led to higher costs and inefficiencies. But there are also cases where performance requirements were both effective and efficient—namely when local capabilities were high and the supply response was dynamic. And if the host country had strong attractions for FDI, it could impose more stringent requirements without putting off foreign investors.

Countries have to balance the potential benefits of performance requirements against the costs of creating inefficiency and the risks of deterring FDI. The evidence suggests that achieving the objectives of performance requirements depends

largely on the clarity of these objectives, and the broader industrial and trade policies in which the requirements are set (UNCTAD 2003f). Particularly relevant are strong local enterprises, flexible and well-managed institutions and policies that support local capability development.

Also important are the capacity of officials to enforce requirements pragmatically, respond to changing conditions and needs and monitor their impact—not easy, even in advanced economies. Take Canada. The predecessor to the Investment Canada Agency, the Foreign Investment Review Agency, was responsible for implementing and monitoring performance requirements. Even with more than 130 employees, half of whom were professional or technical staff, it had difficulty performing its tasks properly (Safarian 1993).

From an international perspective, the impact of performance requirements on the patterns of trade and investment in third countries needs to be taken into consideration. The growth of local content in one host country, for instance, can adversely affect producers in other countries (which may be more efficient). And export performance requirements imposed by large countries may divert export-oriented FDI from smaller competing locations, which may not be in as strong a position to bargain with a potential investor. Such effects are relevant for IIAs.

### 4. Coverage in IIAs

Performance requirements have received more attention in IIAs over the past decade. They fall into three categories: those explicitly prohibited at the multilateral level; those prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements and those not subject to control by any international agreement.

At the multilateral level, the WTO TRIMs Agreement prohibits certain performance requirements considered to be trade distorting: local content requirements, trade-balancing requirements, restrictions on foreign exchange inflows attributable to an enterprise and export controls.<sup>68</sup> The Agreement prohibits not only mandatory TRIMs but also those linked to an advantage. It applies equally to measures imposed on domestic and foreign enterprises. With the transition periods for phasing out measures agreed for developing countries and LDCs having expired, the Agreement's provisions apply to all WTO members, except those granted an extended transition period.<sup>69</sup> Export performance requirements linked to the receipt of a subsidy are furthermore restricted

under the WTO Agreement on Subsidies and Countervailing Measures. They are prohibited for developed countries and generally for middle income developing countries as of 1 January 2003, with some exceptions.<sup>70</sup>

Both these agreements apply only to measures related to trade in goods. In services, by contrast, the scheduling approach of the GATS (based on a “positive list” combined with the ability of individual countries to schedule specific limitations to market access and national treatment) gives countries the flexibility to use performance requirements.<sup>71</sup>

At the bilateral and regional levels, IIAs traditionally have not addressed performance requirements. But this has started to change.<sup>72</sup> Some countries restrict a wider range of performance requirements than those in the TRIMs Agreement (table IV.1). For example, NAFTA forbids domestic equity requirements, export performance requirements (in goods and services) and requirements to transfer technology, production know-how or other proprietary knowledge for investments by investors from both parties and non-parties.<sup>73</sup> MERCOSUR bans requirements to export and source goods or services locally. BITs and free trade agreements involving the United States and Canada restrict the use of additional performance requirements.

## 5. Options for the future

The treatment of performance requirements in IIAs remains controversial, and there is no consensus either on their effectiveness in helping countries to promote development, or conversely on their distorting effects. Some host developing countries consider performance requirements to be an effective development tool and perceive the disciplining of performance requirements as undue interference with their policy space. Others, mostly developed home countries, believe that such restrictions are necessary to avoid distorting patterns of trade and investment.

As part of the review of the TRIMs Agreement (as stipulated in Article 9), countries may leave the treatment of performance requirements unchanged or renegotiate its provisions.<sup>74</sup> Such renegotiations could change the coverage of investment measures in the Agreement. But to do that, countries would first have to agree on a modification of the coverage of Article 2 for the types of measures that would be subject to the prohibition set out in this Article. Currently, Article 2 refers only to measures deemed inconsistent with Articles III and XI of GATT 1994.<sup>75</sup>

Renegotiation could also focus on ways to extend the transition period or to allow for a new transition period, including criteria for phasing out inconsistent measures that could be applied to countries at different levels of development. (One such criterion could be reaching a certain level of GNP per capita.) As noted, the phase-out periods established under Article 5.2 have already expired for all WTO members. But eight WTO members have been granted an extension of the transition period, which will in turn have expired by the end of 2003. These extensions were given on the condition that the remaining TRIMs be effectively eliminated at the end of the extended period.<sup>76</sup>

There is a considerable divergence of views on how best to proceed. Some developing country governments advocate reopening the TRIMs Agreement to reduce its coverage, make it more flexible and allow greater policy space for governments to decide whether to use performance requirements. For example, in a communication to the WTO, Brazil and India advocated reopening the TRIMs Agreement to increase policy flexibility and to allow developing countries greater freedom in implementing their development policies to promote domestic manufacturing capabilities, technology transfer and competition, for example. The proposal notes that one option could be to extend the range of situations in which developing countries are allowed to deviate from Article 2.<sup>77</sup>

Some developed country governments maintain that further international regulation of performance requirements under the TRIMs Agreement is desirable. The United States, for example, has argued in favour of an expansion of the list of restricted TRIMs to include exports, technology transfer and product mandating requirements.<sup>78</sup>

Some academic experts (such as Moran 2002) maintain that the banning of additional mandatory requirements would be in the interest of developing countries since such policy instruments can deter inward FDI, although as indicated above there is no conclusive evidence for this proposition. Other scholars take the opposite view and caution against further regulation on the ground that host countries may deliberately choose to use performance requirements and take the risk of reducing FDI for the sake of specific development objectives (Balasubramanyam 2002). They also note that the incidence of mandatory requirements has declined even in the absence of multilateral rules restricting their use. This may suggest that developing countries are themselves best positioned to determine the usefulness of various requirements in the light of their specific

Table IV.1. Examples of IIAs prohibiting various types of performance requirements not covered under the TRIMs Agreement

Type of prohibited measure	NAFTA, 1992	Draft MAI	US-Croatia BIT, 1996 <sup>a</sup>	Canada-Chile FTA, 1996 <sup>b</sup>	El Salvador-Peru BIT, 1996	US-Jordan BIT, 1997	Canada-Croatia BIT, 1997 <sup>b</sup>	Mexico-Nicaragua, FTA, 1997	US-Bahrain BIT, 1999	US-El Salvador BIT, 1999	Dominican Republic-Ecuador BIT, 1998	Chile-Mexico FTA, 1999	Mexico-El Salvador, Guatemala, and Honduras FTA, 2000	Japan-Republic of Korea BIT, 2001	Chile-US FTA, 2003	EFTA-Singapore, 2002	Japan-Singapore Economic Partnership, 2002	Chile-Republic of Korea, FTA, 2003	United States-Singapore FTA, 2003	Chile-EU Association, 2003
Establish a joint venture with domestic participation		X														X				X
Requirements to locate headquarters for a specific region or the world market		X															X			
Requirements to export a given level or percentage of services	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Employment performance requirements	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Requirements to supply services provided to a specific region of the world market exclusively from a given territory		X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Requirements to act as the exclusive supplier of services provided	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Requirements to transfer technology, production processes or other proprietary knowledge	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Research and development requirements	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
To restrict sales of services in its territory that such investment produces or supplies by relating such sales in any way to the volume or value of its exports or foreign exchange earnings																				
To purchase or use services provided in its territory, or to purchase services from natural or legal persons in its territory	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Appointment to senior management positions individuals of any particular nationality	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Require labour certification, academic certifications or other procedures of similar effect	X	X	X	X	X	X	X	X	X	X		X	X	X	X		X	X	X	
Numerical restrictions in the form of quotas																				X <sup>c</sup>

Source: UNCTAD.

a Most of the recent BITs signed by the United States contain clauses prohibiting similar measures, for example the BITs with Azerbaijan (1997), Ecuador (1996), Panama (1996), Egypt (1996), Lebanon (1997), Thailand (1997), Croatia (1997), Armenia (1997), Uruguay (1997), and Costa Rica (1998).

b Most of the recent BITs signed by Canada contain clauses prohibiting similar measures, for example the BITs with Romania (1996), Ecuador (1996), Panama (1996), Egypt (1996), Lebanon (1997), and Thailand (1997).

c Pursuant to Article 8 (2) of the treaty, the party seeking to introduce such measure may do so if (a) it notifies the other contracting party of its intent to apply the restriction no later than 60 days before the intended date of the implementation of the restriction; and (b) upon request by the other contracting party before the implementation of the restriction.

Note: Apart from the four performance requirements measures prohibited by the TRIMs (local content requirement, trade-balancing requirements, foreign exchange restrictions related to foreign exchange flows attributable to an enterprise and export controls), countries have continued to include other specific prohibitions in their bilateral and regional agreements. This table is an example of some of the instruments concluded between 1996 and 2003 that have introduced express provisions prohibiting certain types of performance requirements. The NAFTA and draft MAI are included for reference purpose. For additional examples of other agreements see UNCTAD 2001i.

resource endowments and development objectives.<sup>79</sup>

Another relevant question relates to the interaction between the rules governing the use of performance requirements and the application of non-discrimination clauses in IIAs (see also box V.4). The scope of governmental discretion in granting performance requirements is regulated by investor protection standards voluntarily adopted by a country party to the IIA. In particular, non-discrimination standards normally require that performance requirements be applied in a way that does not discriminate between different investors in like circumstances. But this general standard can be subject to qualifications and exceptions that preserve a degree of policy space for differential treatment in appropriate cases. So, much depends on the actual content of the IIA and on the balance of obligations undertaken by the host country in this regard.

International rules on performance requirements are linked to other trade and investment policies that may also give rise to distortions. This is particularly true of location incentives. There is now a regulatory imbalance in IIAs between provisions that limit the use of

performance requirements (applied mainly by developing countries) while omitting provisions to discipline the use of location incentives (notably in the form of up-front grants provided mainly by developed host countries) (Moran 2002). As discussed in the next section on investment incentives, incentive-based competition for FDI may put developing countries at a disadvantage (*WIR02*).

The use of rules of origin and other strategic policies also affects third countries, so these need to be taken into account when discussing performance requirements in future IIAs. It may sometimes be more difficult for developing countries to have recourse to other policy instruments (such as strategic trade policies) to influence TNC behaviour.

As long as governments are aware of the possible costs of performance requirements, they could be left free to weigh their benefits and costs, subject to existing international commitments. Indeed, further discussions on the treatment of performance requirements in IIAs need to recognize the right of developing countries to regulate and allow sufficient policy space for the pursuit of development objectives.

## F. Incentives

Investment incentives induce new investors to establish a presence, to expand an existing business or not to relocate elsewhere. They may also be provided to increase the benefits from FDI by stimulating foreign affiliates to operate in desired ways or to direct them into favoured industries or regions. As the use of investment restrictions has declined, incentives have become more prevalent across the world, especially because the market for FDI in some industries has become global.

In general, IIAs do not address the use of incentives directly, though the principle of non-discrimination may apply to them. The WTO Agreement on Subsidies and Countervailing Measures may also apply to subsidies offered to foreign investors if they relate to activities in trade in goods. And a few agreements have “no-lowering-of-standards” clauses. Still, host countries usually retain considerable discretion in the use of incentives, permitting them to differentiate investment by industry, size and location, for example. In addition, IIAs may include exceptions to allow for differential treatment of investors in like circumstances.

### 1. Why use them?

Governments use three main categories of investment incentives to attract FDI and benefit more from it (UNCTAD 1996a): financial incentives (such as outright grants and loans at concessional interest rates), fiscal incentives (such as tax holidays and reduced tax rates) and other incentives (such as subsidized infrastructure or services, market preferences and regulatory concessions, including exemptions from labour or environmental laws). Incentives can be used for attracting new FDI to a particular host country (locational incentives)<sup>80</sup> or for making foreign affiliates in a country undertake functions regarded as desirable such as training, local sourcing, R&D or exporting (behavioural incentives). Most incentives do not discriminate between domestic and foreign investors, but they sometimes target one of the two. In some countries, such as Ireland, the entire incentive scheme was geared to FDI for a long period.<sup>81</sup> Incentives may also favour small firms over large, or vice versa. They are offered by national, regional and local governments.

The main reason for providing incentives is to correct for the failure of markets to capture wider benefits from externalities of production. Such externalities may be the result of economies of scale, the diffusion of knowledge or the upgrading of skills. They may justify incentives to the point that the private returns equal the social returns (a difficult calculation). Major incentive packages have also been justified on the grounds that the attraction of one or a few “flagship” firms would signal to the world that a location has an attractive business environment and lead other investors to follow.<sup>82</sup> From a dynamic perspective, incentives can reflect potential gains that can accrue over time from declining unit costs and learning by doing. They can also compensate investors for other government interventions, such as performance requirements, or correct for an anti-export bias in an economy arising from tariffs or an overvalued exchange rate. And they can compensate for various deficiencies in the business environment that cannot easily be remedied (UNCTAD 1996a, pp. 9–11).<sup>83</sup>

When considering incentives, governments need to take various cost aspects into account—of different kinds.

- One risk is offering incentives to TNCs that would have invested anyway, so the incentive is a mere transfer from governments to companies (or, in some circumstances, to the treasuries of the home countries).
- Where a fiscal incentive is offered, costs may include revenues forgone by the government,<sup>84</sup> while financial incentives imply a disbursement of public funds to the investor in question, closing the opportunity to use those funds for other purposes, such as improving the infrastructure or training the workforce (locational determinants that enhance the ability of countries to attract sustainable FDI).
- Incentives give rise to administrative costs, which tend to increase as the discretion and complexity of schemes increase.
- There are potential efficiency losses if firms are induced to locate where incentive-based subsidies are most generous and not where locational factors might otherwise be most favourable to an efficient allocation of resources.
- Incentives may sometimes give rise to unintended distortions by discriminating between firms that are relatively capital-intensive and those that are relatively labour-intensive, between projects of different cash-flow profiles or between large and small firms (UNCTAD 1996a; Moran 1998).
- Tax incentives may induce TNCs to use transfer pricing to shift profits to locations with the most generous tax conditions, eroding the tax base in several host countries.

## 2. Incentives-based competition for FDI intensifies

The use of locational incentives to attract FDI has considerably expanded in frequency and value. The widespread and growing incidence of both fiscal and financial incentives is well documented until the mid-1990s (UNCTAD 1996a; Moran 1998; Oman 2000), and anecdotal evidence since then suggests that this trend has continued (*WIR02*; Charlton 2003). In general, developed countries and economies in transition frequently employ financial incentives, while developing countries (which cannot afford a direct drain on the government budget) prefer fiscal measures (UNCTAD 1996a, 2000g).<sup>85</sup>

The expanded use of incentives reflects more intense competition, especially between similar and geographically proximate locations. Governments seeking to divert investments into their territories often find themselves part of various “bidding wars”, with investors playing off different locations against each other, leading them to offer ever more attractive incentive packages to win the investment. Bidding wars are typically regional or local, reflecting competition between different countries, or between regions, provinces or cities within a country. For example, in the United States, more than 20 States have sometimes competed for the same FDI project, and more than 250 European locations competed for a BMW plant, which in 2001 ended up in Leipzig, Germany. For developing countries and economies in transition, bidding wars have been documented, for example, in Brazil and among ASEAN countries, among provinces of China as well as in CEE (Charlton 2003).

An emerging trend in certain industries, in which investment projects can be located anywhere, is that competition over investment incentives has become global, adding a new layer to such competition, which previously had mainly been regional or national.<sup>86</sup> A further consequence of global investment competition has been the increased use of regulatory concessions, frequently used in export processing zones (EPZs). Such zones often create “policy enclaves” in which the normal regulatory rules and practices of the host country may not apply (or are implemented more efficiently) to reduce investment costs.

### 3. Are incentives worth their cost?

The effectiveness of locational incentives can be assessed for their economic desirability or their success in actually attracting new investment—and that of behavioural incentives, for inducing foreign affiliates to operate in particular ways.

Start with the economic desirability of locational incentives, for which there is a long-standing debate on the economic benefits (Charlton 2003). Do they distort the allocation of resources (and so reduce global welfare, including that of developing countries)? And do their costs to particular host countries offset their benefits? They may be economically justifiable if they offset market failures—that is, if they allow a host country to close the gap between social and private returns,<sup>87</sup> to overcome an initial “hump” in attracting a critical mass of FDI or a flagship investor that attracts other investors or to attract investors to efficient but otherwise little known locations.

Locational incentives can be economically inefficient if they divert investment from other locations that would have been selected on economic grounds. And once the incentive ends, the investor may move on if the underlying cause for poor competitiveness still persists. If the offer of incentives by one country leads to a “bidding war” for FDI, host countries lose to the TNC (or to its home country, if it can tax away the concessions). If incentives are used to address market failures, the first best policy may often be to correct the failure rather than to compensate for it; for example, if the incentive intends to overcome an overvalued exchange rate, it may be better to realign the currency than to add a new distortion through the incentive. Moreover, if the incentive tries to offset a decline in the locational advantages of a country (such as rising wages in a labour-intensive activity), it just delays the day of reckoning at considerable cost to the taxpayer.

Another problem is that the asymmetry between developed and developing countries can bias FDI flows, at least where they compete for the same investment. Rich countries can afford to offer more incentives, and in more attractive (upfront grant) forms, than poorer countries. With no constraints on incentives, the richer can out-compete the poorer, or force them into very expensive competition for FDI projects.

There is an emerging consensus among economists that countries should try to attract FDI not so much by offering incentives but by building genuine economic advantages (and offering stable, low and transparent tax rates). Incentives should

not be a substitute for building competitive capabilities. Many governments realize that incentive competition can be costly (particularly against better-endowed rivals). But in the absence of international cooperation on location incentives, each wishes to retain the right to offer them. As a result, all or most countries involved are worse off, and TNCs benefit from the lack of cooperation.

Next comes the issue of whether locational incentives are effective in attracting significant new FDI. It is generally accepted that location incentives are seldom the main determinant of location decisions by TNCs. But where all else is equal, incentives can tilt the balance in favour of a particular location. This is most likely for export-oriented projects seeking a low-wage location in EPZ facilities, where many host countries offer similar conditions and other attributes (UNCTAD 1996a, 2000g; Wells and Allen 2001; Morisset and Pirnia 2001).

Some evidence suggests that locational incentives have become more important as the mobility of firms has increased. Econometric studies that previously found incentives ineffective now find that they have become more significant determinants of FDI flows (Clark 2000; Taylor 2000).<sup>88</sup> For domestic market-seeking or natural resource-seeking FDI, however, locational incentives are not as important—and they are harder to justify.

Activity-specific and behavioural incentives are generally considered more effective. Export subsidies have been frequently used to promote export-oriented FDI, particularly in EPZs (*WIR02*). Incentives to encourage foreign affiliates to increase employee training and assistance to local suppliers seem to have worked well in Hungary, Malaysia, Republic of Korea, Singapore and South Africa (*WIR01*; UNCTAD 2003f). But this does not mean that they should be used indiscriminately. Some incentives can be wasted if foreign affiliates would have undertaken the activity anyway, or if they would have been happy with much smaller incentives. Yet even generous incentives may not have much effect if the setting is wrong. For example, R&D incentives are unlikely to raise affiliate spending on R&D in an economy without the local capabilities and technical skills to undertake design and innovation. In general, incentives alter slightly the ratio of benefits to costs of a particular activity—they cannot change it dramatically.

For regulatory concessions, labour and environmental standards are sometimes lowered in EPZs to attract FDI. Wages on average tend to be higher in the zones than in the rest of the

economy, but working conditions are at times affected by lax labour, safety and health regulations. Trade unions are often barred from organizing to improve those conditions (ILO 1998; *WIR99*, box IX.5). But there is no systematic evidence suggesting that lowering standards helps to attract quality FDI. On the contrary—the cost of offering regulatory concessions as incentives is that countries may find themselves trapped on a “low road” of cost-driven competition involving a race to the bottom in environmental and labour standards.

Countries that pursue more integrated approaches for attracting export-oriented FDI—placing FDI policies in the context of their national development strategies and focusing on productivity improvements, skills development and technology upgrading—have tended to attract higher quality FDI. Ireland and Singapore have pursued such integrated policy approaches, and both made efforts to promote training, facilitate dialogue between labour and management and provide first-class infrastructure for investors. They have demonstrated that good labour relations and the upgrading of skills enhance productivity and competitiveness (*WIR02*).

In sum, incentives can be effective in attracting and influencing the location and behaviour of TNCs. But the economic desirability of locational incentives is not clear, particularly if they detract from building competitive capabilities and encourage bidding wars. The case for incentives at the site, activity and behavioural level is stronger, but only when the setting is appropriate. To increase the chances of efficiently applying both locational and behavioural incentives, governments also use “claw back” provisions that stipulate the return of incentives awarded if conditions are not met.<sup>89</sup> Moreover, behavioural incentives are more likely to be effective in inducing benefits from FDI when complemented with other policy measures aimed, for example, at enhancing the level of skills, technology and infrastructure quality.

#### **4. Few international agreements restrict the use of incentives—but some do**

IAs have not, in the main, covered incentives specifically (UNCTAD 2003h). But there have been a few endeavours at the international level to limit explicitly the use of incentives. The most important instrument in this respect is the WTO Agreement on Subsidies and Countervailing Measures (SCM), which may apply to subsidies granted to foreign investors if they relate to their

activities in trade in goods. The SCM Agreement in principle covers a wide range of incentives (see *WIR02* for a detailed discussion). It prohibits export subsidies and subsidies aimed at increasing local content of manufactured goods. Moreover, other firm-, industry- or region-specific subsidies are actionable under the SCM Agreement if they cause injury to another WTO member’s domestic market or serious prejudice in world markets. The definition of subsidy is fairly broad (see Article 1), including possibly fiscal and financial incentives as well as the provision of land and infrastructure at less than market prices.

Recognizing what subsidies can do for economic development, the SCM Agreement contains some important exceptions to the general rule. The prohibitions concerning export-related subsidies (Article 3.1(a)) do not fully apply to all developing countries: WTO members listed in Annex VII of the SCM Agreement are exempted, and WTO members have agreed to extend the transition period for some additional member countries.<sup>90</sup> Special provisions for developing countries also exist for actionable subsidies.<sup>91</sup>

The disciplines of the SCM Agreement may not be easily applied to all kinds of investment incentives, particularly locational incentives. For example, if a locational incentive is provided as a cash grant before production commences, it can be difficult to prove, at a later stage, that the incentive has led to adverse effects on another WTO member’s industry. A similar issue arises for remedies. By the time production and export have commenced, the incentives aimed to attract the investment may have ended. In this situation, neither a recommendation to withdraw or modify a subsidy under the WTO dispute settlement mechanism, nor the application of a countervailing duty to the exported goods in the context of a domestic action, would be likely to “undo” or change an investment already made (*WIR02*).

At the regional and bilateral levels, IAs discourage the use of regulatory concessions (for example, in social and environmental standards) to attract investment. For instance, Article 1114 of NAFTA discourages the contracting parties to use regulatory incentives to attract investment.<sup>92</sup> In a similar vein, certain free trade agreements concluded between Latin American countries contain a “no-lowering-of-standards” clause preventing a contracting party from relaxing regulatory standards in the fields specified in the clause as an incentive for attracting FDI.<sup>93</sup> Similar provisions or commitments on “not lowering standards” in environment, health and safety have been included in APEC’s Non-binding Investment

Principles, whereas the ILO's Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy contains various positive commitments to certain principles and achieving certain goals over and above minimum standards (Wilkie 2002).<sup>94</sup> The OECD (2002) Guidelines for Multinational Enterprises also stress the responsibility of enterprises, which should "[r]efrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues" (chapter II, paragraph 5).

Some international agreements stipulate that parties shall enter future negotiations to establish multilateral disciplines on incentives. Examples are in Article XV of the GATS, which notes that incentives may have distortive effects on trade in services and that WTO members will negotiate ways to avoid such trade diversion effects.<sup>95</sup> The OECD Declaration and Decisions on International Investment and Multinational Enterprises includes a chapter on "International Investment Incentives and Disincentives", which establishes such a consultation mechanism. And Article 10.8 of the Energy Charter Treaty contains a review clause concerning specific incentives.<sup>96</sup>

Even when IIAs do not explicitly restrict the use of incentives by the parties to an agreement, the non-discrimination principle may have an effect on their use and application. The issue is here whether incentives could be given to domestic investors only, and not to foreign investors in like circumstances, raising the question of non-discrimination. The GATS does allow countries to preserve the right to provide subsidies in a discriminatory manner in scheduled sectors. Where a host country wishes to offer incentives selectively, it has to ensure that such selectivity does not fall foul of the national treatment and MFN standards. The difference in treatment can be justified by referring to the differing circumstances that apply to the favoured investors, as opposed to those not benefiting from the incentive (such as incentives reserved to a specific industry or to SMEs). Or it can be justified by reserving an exception to those standards in the host country schedule of exceptions, where such a practice is permitted under the IIA. NAFTA is the most relevant instrument in this context. Rather than limiting the use of fiscal or financial incentives, it includes important exceptions from the principle of non-discrimination. Following the NAFTA model, some bilateral agreements involving the United States or Canada include exceptions from the non-discrimination principle on subsidies. In United States agreements, the exceptions relate

only to the principle of national treatment; the MFN principle remains applicable. On the other hand, Canadian agreements exclude both principles, in line with the NAFTA approach.

Moreover, most BITs contain legally binding rules only for the post-establishment treatment of foreign investors. This means that the application of the principle of non-discrimination is limited to behavioural incentives once an investment has been made—it does not extend to locational incentives in connection with the establishment of a foreign affiliate.

To alert policymakers to some of the questions that arise for jurisdictions that decide to use incentives, the OECD's Committee on International Investment and Multinational Enterprise adopted (April 2003), after considerable debate, a checklist for assessing FDI incentives policies, with operational criteria in six categories (box IV.6). One of these, the extra-jurisdictional consequences of FDI incentives, may be of particular relevance to IIAs. And the checklist calls on individual authorities to take into account the risk that their actions may trigger policy responses elsewhere that could lead to potentially wasteful bidding wars. According to the Committee, careful evaluation of the checklist and its application would help minimize potential harmful effects of incentives both for those that employ them and for other governments seeking to attract FDI (OECD 2003b).

## 5. Options for the future

Most IIAs do not contain explicit provisions on incentives, though the principle of non-discrimination may apply. The SCM Agreement's provisions limit the use of investment incentives to the extent that they fall under the definition of export subsidies. At the same time, in response to the need among developing countries to influence the activities of investors to enhance the benefits from FDI, there may be a case for making certain incentives "non-actionable" in the WTO if they can be shown to have a clear developmental impact in developing countries (*WIR01*, p. 171). This could involve, for example, the creation of more and deeper linkages, the provision of technology and the training of local suppliers and their personnel.

In general, however, host countries retain considerable freedom to develop and apply incentive programmes to attract FDI and increase the benefits from it. This also gives countries considerable discretion in conducting their development policies. There does, however, seem to be an emerging practice to control regulatory

### Box IV.6. The OECD's checklist on FDI incentives

In April 2003 the OECD Committee on International Investment and Multinational Enterprise agreed on a checklist to serve as a tool to assess the costs and benefits of using incentives to attract FDI; to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentives-based competition. Under six categories, 20 questions are raised:

#### *The desirability and appropriateness of offering FDI incentives*

1. Are FDI incentives an appropriate tool in the situation under consideration?
2. Are the linkages between the enabling environment and incentives sufficiently well understood?

#### *Frameworks for policy design and implementation*

3. What are the clear objectives and criteria for offering FDI incentives?
4. At what level of government are these objectives and criteria established, and who is responsible for their implementation?
5. In countries with multiple jurisdictions, how does one prevent local incentives from canceling each other out?

#### *The appropriateness of strategies and tools*

6. Are the linkages between FDI attraction and other policy objectives sufficiently clear?
7. Are effects on local business of offering preferential treatment to foreign-owned enterprises sufficiently well understood?
8. Are FDI incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?
9. Is sufficient attention given to maximising

effectiveness and minimising overall long-term costs?

#### *The design and management of programmes*

10. Are programmes being put in place in the absence of a realistic assessment of the resources needed to manage and monitor them?
11. Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?
12. Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?
13. What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?
14. What should be the maximum duration of an incentive programme?

#### *Transparency and evaluation*

15. Have sound and comprehensive principles for cost-benefit analysis been established?
16. Is cost-benefit analysis performed with sufficient regularity?
17. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?
18. Is the process of offering FDI incentives open to scrutiny by policymakers, appropriate parliamentary bodies and civil society?

#### *Extra-jurisdictional consequences*

19. Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?
20. Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

Source: OECD 2003b.

concessions in certain areas by way of a no-lowering-of-standards clause. Furthermore, the use of locational incentives might become more controlled, if the recent practice in some IIAs towards extension of the non-discrimination principle to the pre-establishment phase of an investment continues.

Increasing competition for export-oriented FDI risks accelerating the incentives race among competing locations. The difference in financial resources available for public support to private investment suggests that developing countries would be at a disadvantage in such a race. That may further suggest the need to rectify this

imbalance by restricting in the SCM Agreement the use by developed countries of financial location incentives. A reduction of investment subsidies would help governments allocate more resources for the development of skills, infrastructure and other areas that attract export-oriented activities. Given the nature of the problem, any approach to dealing with incentives, including increasing transparency, would have to be regional or multilateral. But further international cooperation remains controversial. There does not seem to be interest among either developed or developing countries to reach an agreement on the use of incentives beyond what is already addressed in the SCM Agreement.

## G. Transfer of technology

The transfer and dissemination of technology and the promotion of innovation are among the most important benefits that host countries seek from FDI. TNCs are the dominant source of innovation. Direct investment by them is an important mode of international technology transfer, possibly contributing to local innovative activities in host countries. But attracting technology and innovative capacities and mastering, upgrading and diffusing them throughout the domestic economy require government support—through national policies and international treaty making.

The policies on technology transfer have changed. Most governments have moved from direct controls and restrictions to market-friendly approaches—improving the business and FDI environment, strengthening legal and other institutions and enhancing the skills and raising the capabilities of local enterprises. Market-friendly approaches are themselves shifting—from providing an enabling environment to stronger pro-innovation (technology seller) regimes, while continuing to encourage technology transfer. In the international arena, national market-friendly approaches are complemented by TRIPS, restrictions on performance requirements and a number of other agreements (UNCTAD 2001h).

Important choices remain on the right balance between regulation and markets in the transfer of technology. The realization that developing countries, particularly the LDCs, need special support has led to some mandatory requirements on technology transfer. But implementation remains an issue.

### 1. The need for policies to promote technology transfer

In a world of rapid technological change and intense competition, creating, acquiring and efficiently using new technologies is a vital ingredient of growth. In the generation and dissemination of new technologies, TNCs can provide them in many forms: internalized in FDI, through non-equity forms (such as strategic alliances) and at arm's length (licensing and other contracts and arrangements). The rising cost of innovation, the perceived need to protect and control intangible assets and the liberalization of policies are leading TNCs to use FDI as the main mode for allowing access to valuable technologies (WIR99). As a result, the role of FDI in

international technology transfer is growing. Indeed, many new technologies, particularly those used in integrated production systems, are available only through FDI (WIR02).

Making the best use of FDI-mediated technology transfer requires policy support in the host economy. To start with, TNCs with the most suitable technologies have to be attracted. Then they have to be induced to transfer the technologies that offer the best potential for local development. If TNCs start with simple technologies suited to the low wage and low skill setting of many developing countries, they have to be persuaded to upgrade them as wages and skills rise. In more advanced economies, they have to be induced to transfer the technology development process itself, undertaking more design and R&D locally (WIR99). The development impact of technology transfer through FDI goes well beyond what happens within foreign affiliates—it extends to diffusing technology and technological capabilities to local suppliers and buyers and contributing to local innovation capacity.

In all these areas, there is a risk that markets will not by themselves optimize technology transfer and development. International technology markets are imperfect and fragmented, dominated by a few large enterprises, mostly TNCs. Once transferred, the efficient use of technology faces problems that may call for policy intervention.<sup>97</sup> Some imperfections are inherent to transactions in information; others arise from weak institutions and markets in host countries, from a legacy of inefficient policies (say, on trade and competition) or from the strategies of technology suppliers. For these reasons, most countries have used policies to influence technology transfer by TNCs.

The measures span a wide range, from those affecting technology transfer through FDI—the focus here—to broader policies on enterprise development, skill creation, inter-firm linkages and the promotion of innovation. Some measures affecting technology transfer through FDI are covered elsewhere in this Part (in the discussions of incentives, performance requirements, targeting and promotion). This section covers direct controls on technology transfer, stipulations on the extent of foreign ownership, technology transfer requirements in FDI contracts, competition law and the protection of intellectual property rights (IPRs).

## 2. Shifting towards a more market-friendly approach in national policies

Developed and developing countries have differed in their technology transfer policies. Most developed countries are significant innovators and both sell and buy new technology. Their concerns have been mainly to strengthen the technological position of their firms—through more stringent IPRs, though several countries, such as Japan and Switzerland, did not fully protect and enforce IPRs at critical stages of development—and encourage local innovative activity by foreign affiliates. Developing countries, as importers of technology, have tried to improve the terms and conditions of technology transfer, strengthen the bargaining position of local firms and promote technology diffusion and generation, sometimes by a relaxed application of IPRs (Kim 2002). They have also used incentives and performance requirements to induce greater technology transfer and diffusion by TNCs (see sections E and F) and to encourage technology generation by local firms.

This pattern is changing: countries are converging in their policies on technology transfer. Developed countries are strengthening IPR protection, while reducing remaining barriers to TNC activities. (But competition policies still counter the abuse of market power by large firms.) Developing countries have moved from the direct regulation of technology transfer towards a more market-friendly approach. Most policy changes have been national, but IIAs mirror this pattern (see below). There are now few developing countries with comprehensive systems for vetting technology contracts, either between independent firms or between TNCs and their affiliates.

Many countries—developed and developing—had slack IPR systems until recently, in part to encourage technological capability development in local firms. Most now offer stronger IPR protection, with the TRIPS Agreement providing the international setting. But the case for strengthening IPRs in countries with a weak technological base remains in dispute. The case is more valid for developing countries whose enterprises are launching into innovation or that host (or would like to host) high-technology TNC activities (sensitive to weak IPRs). But non-innovative poor countries may not receive greater technology inflows and yet have to pay more for patented products and technologies (Lall and Albaledejo 2001; United Kingdom, Commission on Intellectual Property Rights 2002).

Another set of measures on FDI-related technology transfer is less obvious. In the past, many economies restricted FDI as the mode of technology transfer while encouraging imports in other forms to promote local R&D capabilities. Of the ones that succeeded, Japan, the Republic of Korea and Taiwan Province of China are the best-known examples (Lall 2001; Kim 2002). But such strategies did not work well in other countries, largely because the context and the way strategies were applied differed.

Controls on inward FDI (used, among other things, to regulate technology transfer) have declined in recent years. But governments use other policy tools more actively to promote technology transfer and development by TNCs. These include targeting technology-intensive activities and functions by promotion agencies seeking to attract new FDI (*WIR02*), incentives for existing foreign affiliates to upgrade technologies and undertake more R&D and the encouragement of greater local content and stronger local linkages by TNCs (*WIR01*).

The development and refinement of investment promotion tools—this can cover both the attraction of new investments and the upgrading of existing ones—is perhaps the cutting edge of FDI policies for technology transfer. Mature industrial countries use them as actively as developing countries. Ireland and Singapore are cases in point, showing how this is done and how it needs to be combined with improvement in local capabilities. Policies directed only at foreign investors are unlikely to work if the environment is not conducive to more advanced technological activity.

## 3. The right mix of policy instruments and conditions

*Direct controls.* Direct controls on technology transfer and FDI did not fully succeed largely because they did not address two issues: the information and administrative requirements of technology regulation, and the absorption and upgrading of imported technology. Take the first. It is difficult for any government to dictate effectively to private enterprises the best technology to buy, the most economical terms for procuring it and the optimal structure of transfers over time. On the FDI front, it is similarly difficult for governments to dictate which technologies to transfer or how much to restrict entry to encourage infant local enterprises. The difficulties are far greater in developing countries, where information and skills are more scarce, institutional structures

more rigid and local enterprises and institutions less developed.

Controls thus tended to impose uniform, inflexible rules across industries, stipulating the duration of contracts, payment terms, foreign shares and the like without taking the specific circumstances into account. This led in some cases to the transfer of older, less valuable technologies, sometimes barring access to new technologies. The transfer process itself tended to be shallow and incomplete, because the seller had little incentive to transfer more complex segments of the technology or to help the buyer continuously to upgrade technologies over time. The outright prohibition of restrictive clauses in technology transfer contracts by a number of countries often raised the price of the technology and reinforced the propensity to provide less valuable technologies (Contractor 1982; Desai 1988; Correa 1995).

The second issue was that regulations focused on the cost of the transfer, not on the conditions needed for the effective absorption and upgrading of imported technology. It was simply assumed that the technology would be used efficiently and would keep abreast of new developments. This often turned out to be optimistic. It imposed costs on host countries, saddling them with technological lags and inefficiencies. Moreover, the settings for implementing restrictive technology transfer policies—protected regimes that gave few incentives to firms to master and upgrade imported technologies—concealed these inefficiencies and added to the ineffectiveness of such policies (Desai 1988; Lall 1987).

*Stipulating greater local ownership—or requiring transfers.* Many countries sought to encourage technology absorption by stipulating foreign equity shareholding or insisting on minority joint ventures. The presumption was that greater local ownership would lead to better absorption and diffusion of technology. Where imposed on reluctant technology sellers, however, the results were often not in accordance with expectations.<sup>98</sup> The strategy worked best in countries that had strong local firms, a large skills base and an export-oriented environment.<sup>99</sup> It also worked in some large developing countries. For instance, in India, joint ventures—stipulated by domestic equity ownership requirements—were found to have generated substantial local learning and transfers of technology (UNCTAD, 2003f).

The scant evidence on technology transfer requirements suggests that, for the reasons mentioned above, they too did not work well

(Kumar 2002).<sup>100</sup> The requirements tended to raise the cost of transfer to TNCs, inducing them to provide less valuable knowledge or invest less in rooting the technology locally.<sup>101</sup> They thus appeared to be less effective than joint venture requirements.

*Providing behavioural incentives.* The effectiveness of incentives for technology transfer to host countries depends on the competitive environment and the capabilities of local suppliers (WIR99). Where the host economy is open to competition and local suppliers are capable, incentives enhance technology transfer. Some countries used incentives not only to attract TNCs into high-technology activities but also to encourage foreign affiliates to move into more complex technologies and R&D (WIR99). But they were successful not because they gave exceptionally generous incentives—but because they created other preconditions for TNCs to deepen technological activity (such as more advanced skills, better local suppliers, more active and innovative research institutions).

*Strengthening IPRs.* The strengthening of IPRs can be beneficial for some types of technology transfer, but implementing the IPR regime can be costly and challenging. And its effects on development and on FDI flows are controversial.<sup>102</sup> Stronger IPRs can increase the scope for the abuse of market power by technology owners, and developing countries with weak competition policies may not be able to cope with this effectively. Stronger IPRs may also raise the cost of technologies without the compensation, at least in LDCs, of stimulating local innovation or international technology transfer. However, strong IPRs are likely to benefit developing countries with an advanced industrial sector, stimulating local innovation and increasing TNC transfer of technology-intensive activities or R&D functions.

In sum, policies to regulate and stimulate technology transfer through FDI can work, but under special conditions (table IV.2). Where these conditions do not exist, attempts to control contracts and transfer arrangements may not produce the desired results.

#### **4. International agreements mirror the shift in national policies**

International agreements reflect the shift in national technology transfer policies from a regulatory to a market-friendly approach.<sup>103</sup> The regulatory approach was characteristic of

international agreements in the 1960s and 1970s. It concentrated on deficiencies in international markets for technology and sought to reduce its transfer costs rather than promote its absorption, development or diffusion. The prime example was the Andean Community's Decision 24.<sup>104</sup> Under that Decision the Community's countries adopted stringent controls on technology transfer, scrutinizing the terms of individual contracts, setting limits on cost, duration and coverage and intervening to improve the bargaining position of local enterprises. Other international initiatives based on the regulatory approach include the draft UNCTAD Code on Transfer of Technology, which did not materialize into an international agreement (Patel, Roffe and Yusuf 2001).

Market-friendly policies at the national and international levels have replaced controls and regulations used earlier to promote technology transfer through FDI. This does not mean, however, that current international agreements do not envisage any policy interventions. But the market-friendly approach largely leaves technology contracts to the enterprises concerned, treating technology as a private asset that is traded on

market principles, subject, among others, to general competition rules that control abuses. In other words, the inclusion of such practices in licensing arrangements is never entirely out of the reach of competition law.

For example, the TRIPS Agreement addresses some licensing practices pertaining to intellectual property rights, which restrain competition, may have adverse effects on trade and may impede the transfer and dissemination of technology. In doing so, the Agreement provides, for the first time in a binding international instrument, rules on restrictive practices pertaining in licensing contracts (Roffe 1998; UNCTAD 2001f, p. 83; UNCTAD-ICTSD 2003). Enhancing the capacity of developing host countries to undertake regulatory activities and making a commitment to home and host country cooperation in the control of anticompetitive practices would also help to strengthen the international regime for technology transfer to developing countries.

The current approach accepts the potential inequality of market power between sellers and buyers—and that between developed and developing countries—in the market for

**Table IV.2. Technology import strategies, policies and conditions**

Strategy objective	Policy	Policy instrument	Condition
Promote domestic technological capabilities by minimizing reliance on FDI	<ul style="list-style-type: none"> <li>- Conditions on FDI</li> <li>- Incentives to partnership agreements</li> <li>- Government support to domestic firms</li> <li>- Foster national flagship firms</li> </ul>	<ul style="list-style-type: none"> <li>- Foreign ownership restrictions</li> <li>- Financial and tax incentives to local firms</li> <li>- Technical support, R&amp;D promotion programmes</li> <li>- Effective export promotion</li> <li>- Encourage hiring of foreign experts, licensing and capital goods imports</li> </ul>	<ul style="list-style-type: none"> <li>- Exposure to international competition (as by strong export orientation)</li> <li>- Availability of skilled labour</li> <li>- Financial resources</li> <li>- Entrepreneur's willingness and ability to undertake risky technology investment</li> <li>- Institutions able to support skill, technology and export activity</li> </ul>
Promote FDI with minimal government intervention in the expectation that it will involve technology transfer	<ul style="list-style-type: none"> <li>- Encourage large FDI inflows</li> <li>- Relax FDI restrictions</li> <li>- Ensure macroeconomic stability</li> </ul>	<ul style="list-style-type: none"> <li>- Remove FDI restrictions or provide incentives</li> <li>- Liberalize trade</li> <li>- Foster competition and well-structured IPR regimes</li> <li>- Provide good infrastructure</li> <li>- General FDI promotion</li> </ul>	<ul style="list-style-type: none"> <li>- Efficient and credible institutions to administer market-friendly policies</li> <li>- High local absorptive capacity</li> </ul>
Promote technology transfer by FDI with proactive government intervention	<ul style="list-style-type: none"> <li>- Target specific TNCs</li> <li>- Provide incentives for TNCs to upgrade their technologies</li> </ul>	<ul style="list-style-type: none"> <li>- Industrial parks and advanced infrastructure</li> <li>- Well structured IPR regimes</li> <li>- High level skills and strong training system geared to activities promoted</li> <li>- Rigorous quality standards</li> <li>- Targeted incentives for activities and/or firms</li> </ul>	<ul style="list-style-type: none"> <li>- Institutions able to handle incentives</li> <li>- Institutions able to select technologies</li> <li>- Institutions for technology support and skill formation</li> </ul>
Mixed strategy	<ul style="list-style-type: none"> <li>- Promote linkages with domestic economy</li> <li>- Build local technological capabilities</li> <li>- Encourage deepening of TNC activity</li> </ul>	<ul style="list-style-type: none"> <li>- Business incubators</li> <li>- Information clearinghouses</li> <li>- Industrial parks</li> <li>- Supporting R&amp;D</li> <li>- Supporting joint ventures, licensing and collaboration</li> <li>- Supporting training of domestic labour force</li> </ul>	<ul style="list-style-type: none"> <li>- Institutions able to bargain with TNCs</li> <li>- Institutions able to plan strategically</li> <li>- Ability to integrate skills, financial markets, infrastructure and technological capability development</li> </ul>

Source: Adapted from WTO 2002a.

technology. It thus includes provisions to encourage cooperation with—and provide assistance to—developing countries in building a technological base. It also encourages TNCs to transfer technology and innovative capacity to developing countries, and it uses incentives to TNCs by their home countries to encourage technology transfer. For instance, the OECD Guidelines of 1976 noted the need for TNCs to transfer innovative activities as well as technology to developing countries, to help diffuse technology locally and to grant licences on reasonable terms. Various IIAs and agreements concluded by the EU with developing countries also encourage technology transfer.<sup>105</sup>

Perhaps the best example is the TRIPS Agreement, which considerably strengthened IPRs at the international level. While protecting the interests of technology sellers, Article 66.2 of the TRIPS Agreement stipulates that “developed country Members shall provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least developed country

Members in order to enable them to create a sound and viable technological base”. This is a mandatory provision on developed countries to promote technology transfer to LDCs. It does not specify what kind of technology transfer is to be supported and how, but it potentially strengthens the position of technology buyers in poorer countries.<sup>106</sup> The Doha Ministerial Conference then decided that this obligation needed to be strengthened through a monitoring mechanism (WTO 2001a, paragraph 11.2). This led in February 2003 to a reporting mechanism on actions taken or planned in pursuance of the commitments undertaken by developed countries under this article (box IV. 7).

An area receiving special attention concerns environmentally sound technologies, with provisions for their transfer to developing countries are more common in international environmental agreements.<sup>107</sup> These instruments, while market-friendly, accept the need for the commercial transfer of technology but seek to ensure that transfers are not harmful in environmental terms. They encourage TNCs to transfer environmentally

#### Box IV.7. Implementation of transfer of technology provisions

An example of how transfer of technology provisions in an agreement can be implemented is the 19 February 2003 Decision of the WTO Council for TRIPS, which provided for the following:

- “Developed country Members shall submit annually reports on actions taken or planned in pursuance of their commitments under Article 66.2. To this end, they shall provide new detailed reports every third year and, in the intervening years, provide updates to their most recent reports. These reports shall be submitted prior to the last Council meeting scheduled for the year in question.
- The submissions shall be reviewed by the Council at its end of year meeting each year. The review meetings shall provide Members an opportunity to pose questions in relation to the information submitted and request additional information, discuss the effectiveness of the incentives provided in promoting and encouraging technology transfer to least-developed country Members in order to enable them to create a sound and viable technological base and consider any points relating to the operation of the reporting procedure established by the Decision.
- The reports on the implementation of Article 66.2 shall, subject to the protection of business confidential information, provide, *inter alia*, the following information:
  - (a) an overview of the incentives regime put in place to fulfil the obligations of Article 66.2, including any specific legislative, policy and regulatory framework;
  - (b) identification of the type of incentive and the government agency or other entity making it available;
  - (c) eligible enterprises and other institutions in the territory of the Member providing the incentives; and
  - (d) any information available on the functioning in practice of these incentives, such as:
    - statistical and/or other information on the use of the incentives in question by the eligible enterprises and institutions;
    - the type of technology that has been transferred by these enterprises and institutions and the terms on which it has been transferred;
    - the mode of technology transfer;
    - least-developed countries to which these enterprises and institutions have transferred technology and the extent to which the incentives are specific to least-developed countries; and
    - any additional information available that would help assess the effects of the measures in promoting and encouraging technology transfer to least-developed country Members in order to enable them to create a sound and viable technological base.
- These arrangements shall be subject to review, with a view to improving them, after three years by the Council in the light of the experience.”

sound technologies to developing countries that may otherwise not be able to use them.

Overall, most provisions consist of “best endeavour” commitments rather than mandatory rules. These have on the whole proven to be somewhat ineffective. International instruments with built-in implementation mechanisms, including finance and monitoring, have a better implementation record—but these are scarce, used mainly for such “public goods” as environmental protection rather than technology transfer. One indicator of the continuing importance of the subject is that the WTO Doha Ministerial Declaration set up a Working Group on Trade and Transfer of Technology in 2001 to examine the relationship between trade and transfer of technology and to recommend measures to increase flows of technology to developing countries.

This indicates that the concerns prompting earlier interventions in technology transfer have not disappeared, since market and institutional

failures remain to be addressed. What has changed is the perception of how best to tackle them. The current thinking is that measures to strengthen local capabilities, markets and institutions are more likely to promote technology transfer and development than interventions in the contractual process. There is, however, a need to retain preferential treatment for developing countries. Indeed, the requirement that TRIPS places on developed countries to promote transfers to LDCs suggests that this is generally accepted.

Some questions to be tackled in the future: how to operationalize transfer-of-technology provisions for developing countries in international agreements? How to further encourage technology transfer? How to handle the anti-competitive effects of technology transactions? And how to strengthen national innovative capacity? There is thus a need to consider stronger international cooperation in technology generation, transfer and diffusion.

## H. Competition policy

The Declaration of the first ministerial meeting of the WTO in Singapore in 1996 recognized the relationship between investment and competition policy. FDI, particularly in developing countries, may have undesirable effects, stemming especially from restrictive business practices, abuses of dominant positions and cross-border M&As. Competition law and policy are particularly important for FDI, because economic liberalization results in greater reliance on market forces to determine the development impact of that FDI. Host countries want to ensure that the reduction of regulatory barriers to FDI and the strengthening of standards of treatment of foreign investors are not accompanied by the emergence of private barriers to entry and anticompetitive behaviour of firms.

Where countries choose to open their economies and, as part of this process, remove the screening of FDI at the point of entry, competition policy may acquire special importance. The major difficulty in developing countries is adopting effective legal frameworks and monitoring and enforcement systems. International cooperation has a role in this, especially when national policies cannot deal with the full range of cross-border effects of anticompetitive behaviour. Nevertheless, competition issues are typically not addressed in IIAs.

### 1. Policy challenges

Competition policy deals, among other things, with the anticompetitive effects of restrictive business practices, the abuse of a dominant position and M&As. Each presents different issues and challenges. The control of restrictive practices is a major issue for developing countries because restrictive arrangements by TNCs can limit the positive developmental impact of FDI—say by reducing exports or limiting the use of technology. This can happen if a parent company limits the external markets of its individual affiliates (Puri and Brusick 1989; Correa and Kumar 2003). A possible abuse of dominant positions can occur as a result of large cross-border M&As. Indeed, the main interface between competition law and FDI occurs when foreign affiliates are established by significant M&As.<sup>108</sup>

When foreign entry is accomplished by cross-border M&As, the probability of an anticompetitive impact increases for two reasons: first, because the number of competitors may be reduced; second, because cross-border M&As do not necessarily add new capacities. So countries tend to screen those transactions and often regulate them both at the entry and post-entry phases. Regulation at entry considers the potential market effect of the acquisition of a local enterprise by the foreign investor on competition in the host

country industry, where the foreign investor might acquire sufficient market dominance to warrant such review. The control of potential post-entry anticompetitive behaviour by TNCs may be necessary to deal with the conflicting objectives of effective competition and local capacity building. Such action may be particularly needed for a host developing country in which the free play of market forces does not always bring the desired development results (*WIR97*, pp. 229–231).

Developed countries were the first to adopt competition laws and set up regulatory agencies. In 1980 fewer than 40 countries—mostly developed—had competition laws (*WIR97*, p. 189). Since then more developing countries and economies in transition have adopted competition laws as well and set up agencies to administer them. By 1996 the number of economies with competition rules and authorities in place had reached 77 (*WIR97*, p. 290). By the first half of 2003 some 93 economies had adopted competition rules and established competition agencies—in other words: almost half the world’s economies (UNCTAD, forthcoming c).

Some national laws in developing countries and economies in transition have followed developed country models. A significant number of laws in CEE, moreover, have replicated the main provisions of the competition rules of the European Community. This is especially so for economies in transition that have entered association agreements with the EU and that aspire, in due course, to full EU membership. For other countries, however, it is fully recognized that a “one size fits all” competition law is not advisable. Developing countries, based on the commentary in UNCTAD’s Model Law on Competition (UNCTAD 2002g), have adopted different models to suit their needs, taking into account their juridical systems, levels of development, business customs and the like.

In addition, having a competition law and authority in place does not necessarily mean effective action by governments. Competition authorities in poorer developing countries may lack the resources and the expertise to work efficiently, especially when large-scale cross-border M&As, abuse of a dominant position or vertical restraints to competition are involved.

Current models of competition law and policy do not distinguish firms by their nationality. Only their impact on competition matters. Moreover, they assume that maintaining and strengthening competition would lead to more development. Indeed, a shielding from market forces may become counter-productive in the longer term if it prevents enterprises from responding

positively to market stimuli, if it brings about a loss of productive efficiency and innovation or if it allows collaborative R&D activity that is a front for anticompetitive collusion between enterprises.

A host country can limit the application of its competition policy when the expected benefits outweigh the welfare loss due to anticompetitive effects—say, for nurturing particular enterprises, or new and innovative R&D—by providing temporary protection and exclusivity. The aim behind such an exception is to reduce the risk to infant enterprises—and to the undertaking of innovative research that may not be easily undertaken in full competitive conditions, or which requires a degree of inter-firm cooperation that might be otherwise incompatible with rules against anticompetitive collaboration between enterprises. Other reasons for limiting the application of competition policy—typically arising from competing objectives—include ensuring the provision of basic services, reducing foreign exchange shortages, safeguarding national security and culture and avoiding negative externalities through tightly regulating pollution, to mention a few (*WIR97*, pp. 229–233).

Exceptions need to be treated with care, so that an exception unwarranted by market conditions is not permitted to continue indefinitely.

## 2. International cooperation arrangements

Most IIAs do not cover competition issues. It is usually assumed that the international element of competition law and policy is dealt with in a separate, specialized instrument. At the multilateral level, the only instrument to cover all aspects of competition regulation is the 1980 UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices.<sup>109</sup> This instrument stresses the close relationship between the control of restrictive business practices and development policies. Indeed, the UNCTAD Set is the only major international instrument that makes a significant link between the economic policy concerns of developing countries and the control of anticompetitive practices. But some trends are developing for competition provisions in IIAs and free trade agreements.

First, as a supplement to national competition rules and as a response to the unilateral application of competition rules outside the territory of the regulating country, there has been more international cooperation by way of procedural agreements covering competition policy issues

(Woolcock 2003; WIR97). Initially, few of these cooperation agreements involved developing countries, with the exceptions of the Andean Common Market Commission Decision 285 of 1991, the MERCOSUR Protocol on the Protection of Competition of 1996 and certain EU Association Agreements with various southern Mediterranean countries concluded since 1995. More recently, the Cotonou Agreement of 2000 included a commitment, in Article 45, to implement national competition rules in the developing country parties and to further cooperation in this field.

A second trend is the gradual adoption, by regional economic integration organizations, of competition policies administered by a supranational competition authority. Following the model of the EU, other regional organizations that took this step include MERCOSUR, the Caribbean Community and ECOWAS.

A third trend is that some agreements seek to ensure the appropriate application of competition laws in support of trade, development and consumer welfare. Some go even further and seek to harmonize national laws for competition. The Recommendation of the OECD Council concerning Effective Action against Hard Core Cartels (OECD 1998b) is an example of the former, as is NAFTA's Chapter 15.<sup>110</sup> The EU Association and Europe

Agreements that require the non-EU contracting parties to bring their national laws into conformity with the *acquis* of EU law are an example of the latter.

A fourth trend arises in free trade agreements requiring parties to regulate anticompetitive practices that may interfere with the conduct of cross-border trade between the signatory States. Such provisions are a significant feature of trade agreements of EFTA and Turkey with some countries in CEE and between some CEE countries.

Partly as a result of these trends, the WTO has included trade and competition issues in its work programme, beginning with the 1996 Ministerial Meeting. At that time, the link between competition and investment was explicitly recognized.<sup>111</sup> At the subsequent Doha Ministerial Meeting, this explicit link was dropped,<sup>112</sup> suggesting perhaps that—despite the links between FDI and competition identified earlier—competition issues are considered to be sufficiently self-contained to warrant separate attention. Still, an effective competition policy is an important regulatory tool to ensure that FDI contributes fully to development, paying special attention to restrictive business practices and anticompetitive effects of cross-border M&As.

\* \* \*

To conclude, all eight areas reviewed here are key sensitive issues that arise in the interface between national and international rule-making—as countries seek to attract FDI and benefit more from it. In each case, governments face options for treating each individual issue in the context of future IIAs. The option that is most development friendly is specific to the issue under consideration.

However, looking at individual issues or provisions—these eight as well as others—does not offer enough guidance for assessing the overall strengths and weaknesses of agreements. IIAs are packages in which acceptance of one provision may be balanced with concessions on other provisions. So their orientation and impact are informed by the inclusion or exclusion of certain issues, by their objectives, by their overall design (that is, their

structure), by the way provisions are drafted and implemented in practice and by the various and complex interactions among provisions and with other agreements.

IIAs need to strike a balance between the diverging interests and priorities of the countries that negotiate them in light of the goals they seek to achieve. From a developing country perspective, it is important that IIAs are negotiated with the goal of promoting their development. Several issues that cut across individual provisions deserve attention in this regard, notably the importance of national policy space—and thus policy flexibility—to meet development objectives and the special needs of developing countries, especially least developed countries. These cross-cutting issues are addressed in the next chapter.

## Notes

- 1 They are examined in UNCTAD 1999c, 1999d, 2000a, 2001e and forthcoming b.
- 2 Extraterritoriality was quite controversial in the MAI negotiations.
- 3 In addition, a new question is emerging from recent arbitral decisions under NAFTA as to whether measures relating to investment (such as, for example, bans on certain types of cross-border trade) that affect the operation of transnational supply and distribution activities of a foreign investor, should be included in any definition of “investment”.
- 4 IMF 1993 and OECD 1996. Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. It consists of equity (at least 10% of total equity), reinvested earnings and inter-company debt transactions; the last of these includes loans, debt securities and suppliers’ credits between direct investors and their affiliates. Portfolio investment includes equity up to or below 10% ownership (shares, stocks, preferred shares and preferred stock and depositary receipts) and debt securities not included under direct investment (bonds, debentures, notes and money market instruments). Financial derivatives include options (on currencies, interest rates, commodities, indices and the like), traded financial futures, warrants and arrangements such as currency and interest rate swaps. Other investments include trade credits, loans (including financial leases and repurchase agreements), currency (notes and coins in circulation), deposits and other assets and liabilities (such as miscellaneous accounts payable and receivable). In 1999 the IMF Committee on Balance of Payments Statistics created the new functional category of “financial derivatives” in the financial account of the balance of payments and excluded them from “portfolio investment”. For a general description of FDI terms and concepts, see IMF/OECD, n.d.
- 5 An example of a broad, open-ended definition is the following. “The term ‘investment’ shall mean every kind of asset and in particular shall include though not exclusively:
- a) movable and immovable property and any other property rights such as mortgages, liens and pledges;
  - b) shares, stocks and debentures of companies or interests in the property of such companies;
  - c) claims to money or to any performance under contract having a financial value;
  - d) intellectual property rights and goodwill;
  - e) business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources” (ASEAN Agreement for the Promotion and Protection of Investments, article 1(3), from UNCTAD 1996b, volume II, p. 294).
- 6 In the GATS, the Annex on Financial Services excludes from the agreement “services supplied in the exercise of governmental authority”, covering, among other things, activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies (Article 1(b) of the Annex on Financial Services of the GATS Agreement). It also includes a provision on domestic regulation providing for a carve-out for prudential regulations, notably to ensure the integrity and stability of the financial system (Article 2(a) of the Annex on Financial Services of the GATS Agreement).
- 7 See, for example, Article XII of the GATS and Article 1109 of NAFTA for examples of traditional balance-of-payments safeguards.
- 8 The inter-agency task force that produced the *Manual on Statistics on International Trade in Services* in 2002 recommended using majority ownership (more than 50% share ownership) in defining foreign-controlled affiliates for collection of statistics on foreign affiliates’ trade in services. These statistics are designed to provide data categorized along the lines of the four modes of services delivery under the GATS. The threshold used in these statistics to identify foreign affiliates (more than 50%) is much higher than the 10% threshold used for FDI statistics.
- 9 Moreover, the definition of FDI includes reinvested earnings and loans between parent companies and foreign affiliates. These can be used for rapid financial transactions.
- 10 The OECD Code of Liberalisation of Capital Movements seeks specifically to liberalize capital flows between members and to encourage such liberalization between members and non-members.
- 11 There have been discussions within the WTO Working Group on Trade and Investment on the issue of definition. The Doha Declaration (paragraph 20) makes reference to particular types of investment for consideration under trade and investment: “long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade”. Within the Working Group, various WTO members have put forward a range of proposals for defining investment: including FDI only, including FDI and long-term foreign portfolio investment, including FDI and foreign portfolio investment and using a broad, asset-based definition.
- 12 For an elaboration, see UNCTAD 1999f, pp. 61–66.
- 13 Related standards pertain to MFN treatment and fair and equitable treatment. While important, these standards raise fewer sensitive questions, so they are not examined here. For a discussion, see UNCTAD 1999c and 1999d.
- 14 The GATS uses “market access”.
- 15 For why a distinction between pre- and post-establishment national treatment is not advisable, see Wilkie 2001. Note that there is a difference between the “right of establishment” and “national treatment in the pre-establishment phase”. The former refers to an absolute obligation of a host government to admit an investor. The latter remains a relative standard, even in the pre-establishment phase. In other words, where a host country grants a “right of establishment”, it offers a right to set up a permanent business operation (which may be subject to exceptions and restrictions), regardless of how other investors are treated, while the latter conditions the right to enter a host economy on granting treatment that is at least as favourable as the treatment of domestic investors.
- 16 “Like circumstances” can apply to pre-establishment provisions too (for example, in NAFTA).

- 17 The 1984 amendment of the OECD Code of Liberalisation of Capital Movements reads as follows: “The authorities of Members shall not maintain or introduce: Regulations or practices applying to the granting of licences, concessions or similar authorisations, including conditions or requirements attaching to such authorisations and affecting the operations of enterprises, that raise special barriers or limitations with respect to non-resident (as compared to resident) investors, and that have the intent or the effect of preventing or significantly impeding inward direct investment by non-residents”.
- 18 National laws may include a general law prohibiting discrimination based, say, on nationality, such as the United States Civil Rights Act, Title VII. Legal persons could use such laws to challenge what they might perceive as nationality-based discrimination. Thus, in principle, a foreign investor treated more disadvantageously than other investors could say that this is based on nationality and amounts to unlawful discrimination. In the European Union, this would be possible for intra-EU investors under the EC Treaty, Article 12. In any event, in many jurisdictions, foreign affiliates are considered to be domestic firms once they are established.
- 19 See, for example, the Federal Law on Foreign Investment in the Russian Federation (9 July 1999), Article 4: *International Legal Materials*, 39 (4), 2000, p. 894-906.
- 20 The BITs of Canada and the United States treat special programmes directed to minorities as exceptions to national treatment.
- 21 The benefits that FDI offers are well known but worth reiterating. It can add to physical investment. It can provide new technology, skills and organizational and managerial techniques (*WIR99*). It can stimulate local competitors and assist local suppliers (*WIR01*). It can take over and upgrade ailing local private or public enterprises (*WIR00*). It can transfer high value functions like design and development to countries with the requisite skills. It can provide the “missing elements” to develop manufactured exports in economies with weak domestic capabilities (in labour-intensive activities); its traditional strengths, of course, lie in resource-based exports. It can provide access to new global markets, some of which are internal to the TNC (*WIR96*) and so not accessible in any other way. These include the high technology exports organized in integrated production systems that provide the basis of export dynamism in several newly industrializing countries (*WIR02*).
- 22 The infant industry case applies to all enterprises regardless of ownership, and the threat to local capacity-building comes from exposure to imports from countries that have already undergone the learning process. It may therefore also apply to foreign affiliates that need to create new capabilities in a host developing country. But there is a relationship between infant entrepreneurship and infant industry policies: the case for the former (by restricting competition from FDI) is likely to be made only where local enterprises are also protected from import competition. In a liberal trading environment, local enterprises able to cope with import competition are unlikely to need protection from their overseas competitors setting up local affiliates. On the contrary, local enterprises should lead in the learning process because they know local conditions better and have been there longer than a new foreign entrant.
- 23 Note that this is based on an implicit preference for local ownership. It is also sometimes argued that FDI should be restricted from entering highly protected industries because TNCs would make, and repatriate, “excessive” profits. This may well be the case, but the fault lies not necessarily with the foreign affiliates but with the trade and tax regimes that allow excessive profits—it is a secondary matter if the profits are made by foreign rather than local firms.
- 24 For examples, see UNCTAD 1999a, pp. 18–19.
- 25 Under Article I of the GATS, trade in services is defined as the supply of a service, among other things, through the commercial presence of a service supplier of one member in the territory of any other member. By Article XXVIII(d) “commercial presence” is defined as meaning “any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person or (ii) the creation or maintenance of a branch or a representative office within the territory of a Member for the purpose of supplying a service”.
- 26 However, it should be noted that in these latter two cases an objective element of comparison between the domestic and foreign investor is inherent in the standard itself. Thus they do not remove the need to show an objective justification for any difference in treatment between a foreign and domestic investor that are in a competitive situation with each other.
- 27 A further issue of substantive content, but one addressed in only a few IIAs, is whether national treatment extends not only to laws and practices that are on their face discriminatory as between national and foreign investors (“*de jure*”), but also to measures that are not expressly discriminatory but are applied in a manner that leads to *de facto* discrimination between national and foreign investors. This approach is taken in Article XVII (3) of the GATS, which asserts that: “Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member”.
- 28 According to OECD publications on national treatment the issue needs to be determined in good faith and in full consideration of all relevant facts. Among the most important matters are whether the enterprises are in the same industry, the impact of the policy objectives of a host country and the motivation behind the measure involved. A key question in such cases is whether the difference in treatment is motivated, at least in part, by fact that the enterprises are under foreign control (UNCTAD 1999b, pp. 28–34; OECD 1985, pp. 16–17; OECD 1993, p. 22).
- 29 See further the NAFTA cases *S.D. Myers v Canada*, *Pope and Talbot v Canada*, *ADF Group v United States* and *Methanex v United States* available on [www.naftaclaims.com](http://www.naftaclaims.com).
- 30 See UNCTAD 1999b, pp. 43–46. A good example of a national law that uses a range of such exceptions is the 1993 Foreign Investment Act of Mexico, *International Legal Materials*, 33, p. 207 (1994), discussed in Muchlinski 1999, pp. 195–196. These exceptions are, in turn, reserved from the operation of the non-discrimination provisions of NAFTA in Mexico’s schedule of exceptions to that agreement, as are the corresponding exceptions of the United States and Canada.

- 31 The term “nationalization” refers to takings in whole industries or the entire national economy, while “expropriation” denotes takings of individual firms (UNCTAD 2000b, p. 4).
- 32 In the United States–Singapore Free Trade Agreement (2003), an exchange of letters contains, in paragraph 4 of the United States letter to Singapore (which was accepted by Singapore), the following: “...4. The second situation addressed by Article 15.6.1 (Expropriation) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.
- (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
- (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
- (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
- (iii) the character of the government action.
- (b) Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.”
- 33 See for a full discussion Khan 1990, pp. 171–202.
- 34 In the Santa Elena Case (box IV.4), the ICSID Tribunal held that a measure that gradually deprives owners of the value of their property over time can be identified as the starting point of the expropriation, even where the deprivation of the economic value of the property to its owner does not take effect within a reasonable period of time.
- 35 Indeed, the difficulty of drawing a clear line between general regulations, which investors must comply with, and regulatory takings, for which compensation must be paid if they are to be lawful, was one of the controversial issues of the Multilateral Agreement on Investment (MAI) negotiations. In addition, the risk of “regulatory chill” was a major focus of the opposition voiced by civil society groups to the MAI, especially after the proceedings in the case of *Ethyl Corporation v Canada* (Geiger 2002, pp. 97, 100–101). It should be noted that, during the course of the MAI negotiations an interpretative note to Article 1 of Annex 3 explained that the reference to measures “tantamount to expropriation” did not establish “a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments” (OECD 1998a, p. 13).
- 36 For example, in 1993 the Bavarian State Courts ruled that a claimant, who owned property on a lakefront that had become encompassed in a new State-regulated nature reserve, could not receive compensation even though this re-designation of the site meant that he could no longer leave the roads, camp, swim or use any watercraft (Dolzer 2002, p. 77). Some national regulatory takings have given rise to a number of recent arbitral awards under NAFTA; see box IV.3 for examples.
- 37 For example, Article 11 of the MIGA Convention expressly excludes from the covered risk of expropriation “non-discriminatory measures of general application which the governments normally take for the purpose of regulating economic activity in their territories”.
- 38 Only United States agreements expressly use this terminology. Many agreements require the availability of judicial review before national tribunals, though this is usually restricted to a review of the taking after it has occurred. It does not extend to a review of a proposed taking (UNCTAD 2000b, pp. 31–32). Related to this is whether, and how far, IIAs should permit international review of takings by host country authorities: should these be subject to a prior requirement to exhaust domestic remedies or should international review be available as a matter of right? This issue is discussed further in relation to dispute settlement.
- 39 Notwithstanding such concerns, the possibility of governmental action, conducted under the guise of environmental regulation, which actually abuses the rights of investors, cannot be ignored. In such cases, the payment of compensation may well be appropriate, especially where the legitimate expectations of the investor have been undermined through arbitrary governmental action (Wälde and Kolo 2001).
- 40 Policy dilemmas may also arise from the area of punitive takings. If a punitive taking has been properly and lawfully imposed, resulting in a legally sanctioned confiscation of the investor’s assets, would the investor nevertheless be entitled to sue for compensation under international obligations? In order to avoid such an eventuality, some instruments explicitly exclude such takings, for example, punitive tax measures, from the compensation obligation (UNCTAD 2000b, pp. 14–15).
- 41 As mentioned earlier, the issue of takings was not mentioned in paragraph 22 of the Doha Declaration, nor has it been suggested to be discussed by the WTO Working Group on the Relationship between Trade and Investment.
- 42 In keeping with traditional perspectives, some developing countries, and especially Latin American ones among them, have historically maintained that disputes between an investor and a host country should be settled exclusively before the tribunals or courts of the latter (referred to as the Calvo Doctrine; see Shea 1955). This viewpoint was manifested not only in the domestic legislation of individual countries; it also prevailed in certain regional agreements that prohibited parties from accorded foreign investors treatment more favourable than to national investors—and demonstrated a decidedly clear preference for dispute settlement in domestic courts. The United Nations Charter of Economic Rights and Duties of States of 1974 also took such an approach. More recently, Latin American countries have departed from this doctrine, for instance in their BITs and in MERCOSUR. Mexico abandoned the Calvo Doctrine when it entered NAFTA.
- 43 China, for example, requires recourse to local tribunals.
- 44 See for example the Nigerian Investment Promotion Commission Law 1995, section 26.
- 45 See for example the Federal Law on Foreign Investment in the Russian Federation (9 July 1999), *International Legal Materials*, 39 (4), 2000, pp. 894–904.

- 46 The concept of negotiation as a technique of dispute settlement used directly by each party is self-explanatory and requires no further definition. However, the other terms used in the text have some specialized connotations and may be defined as follows: *good offices* involves the use of a third party to liaise with the disputing parties and to convey to each party the views of the other on the dispute. The third party plays no part in suggesting solutions to the dispute. By contrast *mediation* and *conciliation* involve the third party in a more active role, in that they may intervene with suggestions as to how the dispute might be resolved, thereby helping the disputing parties towards a negotiated settlement. In practice it may be difficult to differentiate between mediation and conciliation on a functional basis, and the two terms can be used interchangeably (Asouzu 2001, p. 20). But they differ from arbitration in that the third party has no right or authority to determine the dispute independently of the parties.
- 47 Such impartiality has at times been questioned (Dezaly and Garth 1996).
- 48 This issue is discussed further in UNCTAD 2003d.
- 49 See for instance the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership, the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras, the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR and the 1997 EU–Mexico Partnership Agreement. Many of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements recently concluded by the EU provide for consultation through the body (cooperation or association councils) entrusted with the monitoring and implementation of the specific agreement.
- 50 See the Trade and Economic Cooperation Arrangements between Canada and, respectively the Andean Community (1999), Australia (1995), Iceland (1998), MERCOSUR (1998), Norway (1997), Switzerland (1997) and South Africa (1998), as well as the Agreements Concerning the Development of Trade and Investment Relations between the United States and, respectively, Egypt, Ghana, South Africa and Turkey (all concluded in 1999) and with Nigeria (concluded in 2000).
- 51 See, for instance, the 1994 Mexico–Costa Rica Free Trade Agreement, 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico, the 1997 Canada–Chile Free Trade Agreement, the 1997 Mexico–Nicaragua Free Trade Areas, the 1998 Chile–Mexico Free Trade Agreement, the 1998 Free Trade Agreement between Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) and the Dominican Republic, the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras, the 2000 Agreement between the United States and Viet Nam on Trade Relations and the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership (box III.2).
- 52 In this regard Article 25 (2)(b) of the ICSID Convention establishes that the local affiliate may be treated as a national of a foreign contracting party where it is controlled by nationals of that other contracting party, and it has been agreed between the parties that it should be treated as a foreign national for the purposes of the Convention.
- 53 For example in the case of Central European Media Enterprises Ltd., Bermuda v the Czech Republic (14 March 2003), an award of \$269,814,000 was made, together with \$1,007,750 of costs plus interest and legal costs. This amounted to a total of \$354,943,542. See [www.cetv-net.com](http://www.cetv-net.com).
- 54 The Dispute Settlement Understanding deals with investment related questions under the GATS and TRIMs Agreement.
- 55 Article 23 of the WTO Dispute Settlement Undertaking requires the members to use cross-retaliation only in accordance with the procedures set down in Article 22 and only upon a finding of a violation of the WTO agreements or of a nullification or impairment of benefits by a WTO Panel. Article 24 introduces special provisions for application in the case of LDC members. It requires due restraint in asking for compensation or in the use of cross-retaliation in cases where such members are found to have nullified or impaired the benefits of another member.
- 56 For example the WTO Kodak Fuji case was based on a claim on the part of Kodak that it was being systematically excluded from the Japanese market by the restrictive business practices of its major rival, Fuji. The case was brought before the WTO Panel by the United States, alleging that the restrictive practices of Fuji had been sanctioned by the Government of Japan in breach of its obligations under Article XXIII (1)(b) of the GATT.
- 57 Typically, awards in the investment area have taken the form of monetary compensation. But it is also conceivable that they could take the form of further market opening on the part of the losing disputant, requiring it to open its market in certain areas to the assessed monetary value of the losses caused.
- 58 Joint venture and domestic equity requirements could also be classified as ownership restrictions.
- 59 Surveys of foreign investment in India report a high incidence of export restriction clauses imposed on foreign affiliates (Kumar 2001). Another study concluded that foreign parent firms actually discouraged their affiliates from exporting from India in view of the large domestic market (NCAER 1994).
- 60 These restrictive practices could take the form of market allocation, price fixing, exclusive dealing and collusive tendering (Puri and Brusick 1989). It was felt that local participation in management would lead to more competitive business practices. But such performance requirements sometimes allowed local partners to appropriate the rents from anticompetitive practices at the expense of the larger public.
- 61 See WTO/UNCTAD 2002; Moran 1998; Kumar 2001; Safarian 1993; UNCTAD 2003f.
- 62 Local content requirements have been employed by most of the developed countries from time to time, especially in the automotive industry. For instance, Italy required 75% local content on the Mitsubishi Pajero, the United States imposed a 75% rule on the Toyota Camry and the United Kingdom 90% on the Nissan Primera (Sercovich 1998). Australia imposed an 85% local content rule on motor vehicles until 1989 (Pursell 1999). See also OECD 1989; Safarian 1993; Guisinger et al. 1985; Chang 2002.
- 63 By the end of the 1980s, seven developed countries still had local equity requirements, six had local content requirements, three had export requirements, three had R&D requirements, two applied product

mandate requirements and one a trade-balancing requirement (UNCTC 1991, table 8).

64 Rules of origin are used by, say, the EU and NAFTA member countries to determine the extent of domestic or regional content a product must have to qualify as an internal product in a regional trading area and, hence, have similar effects as local content requirements for the region as a whole. The European Commission has applied various measures to regulate imports of a wide range of consumer-electronic goods and office equipment products from Japan and South-East Asia (Messerlin 1989), and the United States has used measures such as anti-dumping and voluntary export restraints in trade and investment with Japan and other countries. In the United States, provisions of the Buy American Act have acted as local content requirements (Krugman and Obstfeld 2000, p. 205).

65 According to Article 11(1b) of the WTO Agreement on Safeguards, voluntary export restraints are no longer permitted.

66 In a 1989 study as many as 23 of 31 developing countries surveyed used local content requirements, 17 applied local equity requirements, 16 used export performance requirements, 11 had technology transfer requirements and 5 countries imposed R&D requirements (UNCTC 1991, table 8).

67 In India, for example, the overall incidence of performance requirements on FDI approvals has declined sharply over the 1990s. In 1991, 33% of FDI approvals contained performance requirements. This proportion has come down gradually to 18% in 1996 and to just about 9% by 2000 (UNCTAD 2003f, chapter III).

68 These measures were seen as being inconsistent with the national treatment obligation in trade in goods and the prohibition against quantitative restrictions in the GATT (UNCTAD 2001i, pp. 17–26).

69 Argentina, Colombia, Malaysia, Mexico, Pakistan and Thailand have been granted extensions of the transition period until December 2003, the Philippines until June 2003 and Romania until May 2003 under the Agreement's Article 5 provisions (see WTO documents G/L/497 through G/L/504 and document WT/L/441). The implication is that, for those countries to which the TRIMs Agreement applies without any transitional exception, any attempt to reverse the right to impose performance requirements, prohibited by that Agreement through provisions in bilateral or regional IIAs, would be inconsistent with their obligations under the TRIMs Agreement.

70 LDCs and other countries listed in Annex VII of this Agreement are exempted (see footnote 90 in section IV.F).

71 Indeed, the GATS article XIX:2 states that "There shall be appropriate flexibility for individual developing country Members for [...] progressively extending market access in line with their development situation and, when making access to their markets available to foreign service suppliers, attaching to such access conditions aimed at achieving the objectives referred to in Article IV."

72 The way performance requirements are treated in bilateral or regional IIAs varies. Some prohibit certain requirements that are currently not covered by the TRIMs Agreement (with or without exceptions); some make cross-reference to provisions included in other IIAs; some include hortatory provisions on measures not covered by the TRIMs Agreement and many do

not make any reference to performance requirements, save those covered by the TRIMs Agreement, binding on all parties that are also WTO members.

73 NAFTA allows for reservations against the performance requirement article. This can be seen as an embodiment of flexibility that does not apply in some other agreements, including the TRIMs Agreement.

74 Article 9 of the TRIMs Agreement provides that not later than five years after the date of entry into force of the WTO Agreement, the Council for Trade in Goods shall review the operation of the Agreement. No concrete progress has been made so far. Positions remain quite polarized between, on the one hand, some developing countries who want to amend the Agreement so as to allow the use of TRIMs on developmental grounds, and the developed countries on the other hand, who want to maintain the status quo.

75 Article III relates to national treatment and stipulates among other things that "No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources." Article XI is related to the general elimination of quantitative restrictions.

76 Only those TRIMs that were notified in accordance with Article 5.1 of the TRIMs Agreement were eligible to benefit from the transition period in the first place.

77 See the Communication by Brazil and India on the need for an amendment to the TRIMs Agreement (WTO Document G/C/W/428).

78 See the Communication from the United States (WT/GC/W/115).

79 It has, for example, been suggested that local content and trade balancing requirements should instead be examined case-by-case to determine whether they have a significant and adverse effect on trade that outweighs their beneficial development impact (Mashayekhi 2000).

80 A variation of locational incentives are site incentives seeking to influence the choice of a site within an economy, for instance, inducing investors to locate in a backward area or away from a congested area. Similarly, incentives can be used to attract FDI into certain industries.

81 The application of the corporate tax regime in Ireland has never explicitly distinguished between foreign and domestic companies. However, most analysts agree that it was more beneficial to TNCs, because of their greater level of exports and profits.

82 In this case, there are likely to be diminishing returns from the use of incentives.

83 As noted in section IV.E, countries are increasingly using incentives to influence firm behaviour with a view to achieving objectives related to development.

84 Obviously, a tax holiday would not constitute a cost if an investment would not have been attracted in the absence of the incentive scheme, in which case there might not have been a base to tax.

85 CEE countries tend to use a mix of fiscal and financial incentives (Mah and Tamulaitis 2000).

86 For example, when Intel decided to locate its sixth semiconductor assembly and test plant in Costa Rica, it did so after having evaluated sites not only in Latin

- America but also in China, India, Indonesia, Singapore and Thailand (Spar 1998).
- 87 These gaps may arise from the general benefit of attracting TNCs to integrate the host economy more closely into global value chains, from specific technological and skill benefits of FDI, the stimulus to local competition or from launching a cumulative process of building industrial capabilities or agglomerations.
- 88 On the other hand, investments that are largely determined by incentives are more likely to leave as soon as the financial or fiscal benefits expire. In Botswana, for example, which offered generous investment incentives for the duration of five years for individual projects, many companies, both domestic and foreign, decided to close down their activities after the incentives had expired (UNCTAD 2003g).
- 89 For example, economic development agencies in the United States have included claw back clauses in incentive agreements, stating that, if the company concerned did not maintain this many jobs or spend that much capital, then the development agencies had the right to ask for the money back. While this right has traditionally seldom been exercised, there are signs that things are changing. For example, in response to such claims, Alltel, a large telecom company, volunteered to repay \$11.5 million of the \$13 million it got from the state of Georgia two years ago to set up a call centre in the state (*FDI Magazine*, "No more Mr nice guy", 2 February 2003).
- 90 LDCs and members listed in Annex VII until their per capita GNP reaches \$1,000 are exempted. The list of "other countries" consists of Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe. In addition, extended transition periods were granted in December 2002 for specific programmes in Antigua and Barbuda, Barbados, Belize, Colombia, Costa Rica, Dominica, the Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Jordan, Mauritius, Panama, Papua New Guinea, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Thailand and Uruguay. These extensions can be annually renewed until 2007 (WTO Documents G/SCM/50 through G/SCM/102).
- 91 According to Article 27.8, there shall be no automatic presumption that certain subsidies granted by a developing country (i.e. those listed in Article 6.1 of the SCM Agreement) result in serious prejudice. Rather, such prejudice needs to be demonstrated. (However, the legal status of this provision remains unclear given the expiry of Article 6.1.) Finally, Article 29 granted some temporary exemptions for transition economies.
- 92 "The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures..."
- 93 See for example, Article G.14 of the 1997 Canada-Chile Free Trade Agreement. Similar restrictions exist in other Latin American free trade agreements though they are not as detailed as this provision.
- 94 For example, the ILO (2000) Tripartite Declaration "sets out principles in the fields of employment, training, conditions of work and life and industrial relations which governments, employers' and workers' organizations and multinational enterprises are recommended to observe on a voluntary basis" (paragraph 7). Similarly, in paragraph 41, it states that "Multinational enterprises should observe standards of industrial relations not less favourable than those observed by comparable employers in the country concerned".
- 95 Very little progress has been made under this negotiating mandate.
- 96 Accordingly, the modalities of the application of the non-discrimination principle in relation to programmes under which a contracting party provides grants or other financial assistance, or enters into contracts, for energy technology R&D shall be reserved for a "Supplementary Treaty". As of June 2003, this agreement had not yet been concluded. Each contracting party shall, through the ECT Secretariat, keep the Charter Conference informed of the modalities it applies to such programmes.
- 97 The technology "product" may be difficult to define. Its price often depends on the skills, information and bargaining power of the parties involved. Once transferred, the product is difficult to use without building new capabilities and it needs constant upgrading to remain competitive. Where the host economy does not provide the skills needed, the imported technology may not be upgraded sufficiently. The technological functions transferred also may not be upgraded: TNCs may transfer the operational end of technology but not its R&D stages, because the costs of doing so in new locations, particularly developing countries without strong technology systems, can be high (Lall 2002). The local diffusion of technology may be held back by the lack of capable local enterprises. TNCs may hem the transfer, use and diffusion of the technology by clauses to protect and maximize their returns. And stringent government restrictions on foreign ownership, operations and so on may deter TNCs from transferring their most valuable technologies.
- 98 A study of FDI in CEE found that joint ventures in R&D intensive activities led to less technology transfer than wholly owned foreign affiliates (Smarzynska 2000). Another study found that joint-venture obligations affected adversely the quality of technology transferred by foreign firms (Lee and Shy 1992). Moran (2002) argues that mandatory joint ventures are not effective because the technology employed is on average 10 years older than the most advanced technology in the industry, and training by TNCs in joint ventures is a fraction of that in wholly owned affiliates.
- 99 Only a few countries managed to intervene effectively in the transfer process by providing information and assistance to local enterprises in the context of strong export orientation and massive investments in skills creation and development (Kim 1997, 2002). Technologies from TNCs to the Republic of Korea, for example, were transferred mainly through imports of capital goods, reverse engineering in the 1960s and 1970s and various non-equity forms, given the restrictive FDI regime.
- 100 A number of foreign operations failed to meet government requirements because affiliates were unable to achieve full economies of scale, utilize the most advanced techniques or implement rigorous quality control (Moran 2002). A study of United States affiliates in 33 countries found that technology transfer requirements were negatively

- correlated with technology flows to host countries (Blomström and Kokko 1995). Another found that intra-firm technology transfer by Japanese TNCs was discouraged when host authorities imposed technology transfer requirements as a condition of entry (Urata and Kawai 2000).
- <sup>101</sup> For example, technology transfer laws in Nigeria have not led to greater transfers of modern technology (Muchlinski 1999), largely because local capabilities and skills are weak and the business and trade environment is not conducive to technology upgrading (Okejiri 2000).
- <sup>102</sup> The empirical evidence on the impact of stronger IPRs is mixed. One study, based on firm-level data from economies in transition, indicates that a weak IPR system in a host country may discourage all investors, not only those in sensitive industries (Smarzynska-Javorcik, forthcoming). Another study suggests that stricter contract enforcement makes TNCs better off, while the outcome for host countries depends on TNCs' reactions to such enforcement (Markusen 2001). The host country's welfare improves if TNCs switch from exporting to the country to undertaking local production; however, a host country may be made worse off if local production exists and stricter IPRs affect it adversely. Furthermore, referring to various other studies, Kumar (2003) concludes that, in general, there is no strong link between stronger IPRs and FDI inflows and that the strength of patent protection does not appear to be a significant factor in determining the location of TNCs' R&D activities in host economies. See also UNCTAD 1993 and 1997.
- <sup>103</sup> For a compilation of instruments containing transfer-of-technology provisions, see UNCTAD 2001g.
- <sup>104</sup> Decision 24 was superseded by Decision 220, which was, in turn, superseded by Decision 291 of 21 March 1991, which now represents Andean Community policy in this area (UNCTAD 1996b).
- <sup>105</sup> Thus the Lomé Convention of 1989 contained numerous commitments on the part of the EU to assist in the transfer and acquisition of technology by developing countries in a variety of fields, including agriculture, industry, energy and tourism. The more recent Cotonou Agreement of 2000 revises this approach, further emphasizing market-led technology transfer. In a similar vein, agreements concluded between the EU and Latin American economic integration groups contain a commitment to economic cooperation that includes the encouragement of technology transfer.
- <sup>106</sup> Under Article 67 of TRIPS Agreement, developed country members are to provide, on request and on mutually agreed terms and conditions, technical and financial cooperation in favour of developing and least developed countries to facilitate the implementation of the Agreement. A similar approach is found in Article 8 of the Energy Charter Treaty, Article IV of the GATS Agreement and the revised OECD Guidelines for Multinational Enterprises, which state (in section VIII) that TNCs should "endeavour to ensure that their activities are compatible with the science and technology (S&T) policies and plans of the countries in which they operate and as appropriate contribute to the development of local and national innovative capacity". For a detailed discussion see UNCTAD 2001f, pp. 64–67.
- <sup>107</sup> See UNCTAD 2001g, pp. 41–50.
- <sup>108</sup> For an extensive discussion of this issue, see *WIR97*.
- <sup>109</sup> Updated information is available from: [www.unctad.org/en/subsites/cpolicy/docs/CPSet/cpset.htm](http://www.unctad.org/en/subsites/cpolicy/docs/CPSet/cpset.htm).
- <sup>110</sup> NAFTA's Articles 1502 and 1503 seek to ensure that monopolies and State enterprises do not act in a discriminatory fashion towards investments of investors of another party.
- <sup>111</sup> "Investment and Competition  
These groups shall draw upon each other's work if necessary and also draw upon and be without prejudice to the work in UNCTAD and other appropriate intergovernmental fora..." (WTO 1996, paragraph 20). It should be noted that Article 9 of the 1995 TRIMs Agreement also made the connection between investment policy and competition policy by requiring the Council for Trade in Goods to consider whether the TRIMs Agreement should be complemented with provisions on these two issues in the course of its five-year review of the TRIMs Agreement.
- <sup>112</sup> The Doha Ministerial Declaration stated, in its paragraphs 23–25:  
"INTERACTION BETWEEN TRADE AND COMPETITION POLICY  
23. Recognizing the case for a multilateral framework to enhance the contribution of competition policy to international trade and development, and the need for enhanced technical assistance and capacity-building in this area as referred to in paragraph 24, we agree that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations.  
24. We recognize the needs of developing and least developed countries for enhanced support for technical assistance and capacity-building in this area, including policy analysis and development so that they may better evaluate the implications of closer multilateral cooperation for their development policies and objectives and human and institutional development. To this end, we shall work in cooperation with other relevant intergovernmental organisations, including UNCTAD, and through appropriate regional and bilateral channels, to provide strengthened and adequately resourced assistance to respond to these needs.  
25. In the period until the Fifth Session, further work in the Working Group on the Interaction between Trade and Competition Policy will focus on the clarification of: core principles, including transparency, non-discrimination and procedural fairness and provisions on hardcore cartels; modalities for voluntary cooperation and support for progressive reinforcement of competition institutions in developing countries through capacity building. Full account shall be taken of the needs of developing and least-developed country participants and appropriate flexibility provided to address them" (WTO 2001b, p. 5).



## CHAPTER V

# THE IMPORTANCE OF NATIONAL POLICY SPACE

The preceding analysis revealed that IIAs need to accommodate different perspectives on the policy priorities in the investment process. The common goal, shared by all parties to IIAs, is to increase the flows of FDI. In addition, home countries (and their investors) seek transparency, stability, predictability and security—and greater market access. And host developing countries, for their part, want to advance their development by increasing the benefits from FDI. To do so, they need to have enough flexibility to use a range of development-oriented policies. In the final analysis, IIAs have to be acceptable to all parties, many in different development situations with widely differing endowments. IIAs therefore need to strike a mutually advantageous balance of rights and obligations between the diverging interests and priorities of various groups of countries.

The concept of “national policy space” and the flexibility it affords to governments to pursue development-oriented FDI policies is the operational bridge between the differing perspectives of host countries, home countries and investors (UNCTAD 2000d). (Although the focus

here is on developing countries, developed countries also need policy space to pursue their own national objectives.) Its foundation is the right to regulate, a sovereign prerogative that arises out of a State’s control over its own territory and that is a fundamental element in the international legal regime of State sovereignty. Although host countries already limit their regulatory autonomy as a result of liberalization policies—and have their autonomy limited as part of the wider process of economic globalization—IIAs create distinctive issues in this connection. Such international agreements, like other legal texts, are specifications of legal obligations that limit the sovereign autonomy of the parties. Given that international legal obligations generally prevail over domestic rules, tension can arise between the will to cooperate at the international level through binding rules and the need for governments to discharge their domestic regulatory functions.<sup>1</sup> This challenge is not unprecedented: similar issues of the relationship between a country’s commitments and its regulatory discretion have arisen in trade agreements (box V.1).

### Box V.1. Regulatory discretion in international trade agreements

The scope of a country’s regulatory discretion has been debated and litigated in the GATT/WTO system, where the dispute settlement process has been used to review domestic regulatory measures that have an impact on trade. The main instrument for reviewing regulatory discretion in the WTO is found in Article III of the GATT, which contains a non-discrimination (national treatment) obligation as complemented by the exceptions contained in Article XX. Article III provides that internal taxes and regulations must not treat imports less favourably than domestic products in like circumstances. If a domestic regulatory measure is found to discriminate against imports, the regulating government may attempt to justify the discrimination by proving that it is necessary to achieve some legitimate purpose. Article XX exceptions include those necessary to protect public morals; to protect human, animal and plant life or

health and those relating to the conservation of exhaustible resources.

It should be noted that this list of policies is “closed” and thus provides limited scope for claiming an exception in many areas in which countries may want to pursue regulatory action. It is also subject to the general requirement that the exception does not constitute a means of arbitrary discrimination or a disguised restriction on international trade. This requirement has been interpreted as introducing a principle of proportionality, in that a country must apply the least trade-restrictive exception compatible with its regulatory policy.

The WTO Agreement on Technical Barriers to Trade explicitly calls for an integrated examination of the purpose of the measures in question and its trade-restricting effects. The Agreement requires a balancing of the degree of

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**Box V.1. Regulatory discretion in international trade agreements (concluded)**

trade restriction against the regulatory purpose of the disputed measure. Furthermore, the analysis of the regulatory aim is part of the review of the legality of the measure itself, with an illustrative (not closed) list of legitimate objectives. In this context, there is no need first to establish a violation (which requires a conclusive determination of likeness), followed by a review of the regulatory justification by way of exception. The balancing analysis also calls for an appreciation of the trade effects in light of existing less restrictive alternatives and of the risk of non-fulfilment of the regulatory objectives.

The WTO Agreement on Sanitary and Phytosanitary Standards adopts a similar approach to the control of regulatory discretion as the Technical Barriers to Trade Agreement and Article XX of GATT. It affirms the right of WTO members to impose sanitary or phytosanitary measures, provided that they are applied “only to the extent necessary” and that they are based on scientific principles and evidence. Where the scientific evidence is insufficient, members may

Source: UNCTAD.

adopt such measures on the basis of “available pertinent information”.

While the GATS recognizes the sovereign right of a country to regulate services for legitimate purposes (box V.2), Article VI seeks to prevent the use of administrative decisions to disguise protectionist measures. Generally applied measures that affect trade in services for which a country has made commitments must be applied reasonably, objectively and impartially. Applications to supply services under such commitments must receive a decision within a reasonable period. The Council for Trade in Services is called on to develop rules to prevent requirements governing qualifications for service suppliers, technical standards or licensing from being unnecessary barriers to trade. Until such rules are ready, governments are to follow (in activities in which they have undertaken specific commitments) the same principles in applying their requirements and standards, so that these do not nullify or impair specific commitments (on market access and national treatment).

For investment the right to regulate has recently gained renewed prominence in investment protection from expropriation and in national treatment. It was evoked as a “shield” against an expansive use of expropriation claims by investors that have threatened to encroach on a sovereign government’s right to regulate in the public interest, with the possible effect of “regulatory chill”. It involves the determination of where the property rights of investors could be legitimately subjected to the regulatory power of governments and where they could not. (This was discussed in IV.C.)

The right to regulate arose concretely in the context of investor-State disputes under NAFTA, particularly in environmental protection. The three member countries of NAFTA adopted in 2001 a “Note of Interpretation of Certain Chapter 11 Provisions” (NAFTA 2001) to clarify the provision governing the minimum standard of treatment to be accorded to foreign investors under the fair and equitable treatment provision in Article 1105 (1). They determined that the NAFTA’s standard is the customary international law minimum standard of treatment. The concept of the “right to regulate” was also included in the GATS, the WTO Doha Ministerial Declaration and the draft Multilateral Agreement on Investment (MAI). And it was highlighted in intergovernmental deliberations within the context of UNCTAD’s Commission on Investment, Technology and Related Financial Issues (box V.2).

**Box V.2. The right to regulate**

The language in these instruments is as follows:

*The GATS (Preamble):*

“Recognizing the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right;” (UNCTAD 1996b, I, p. 287).

*WTO Doha Ministerial Declaration (paragraph 22):*

“Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest.” (WTO 2001b, p. 5).

*Draft Multilateral Agreement on Investment:*

**Article 3****Right to Regulate<sup>a</sup>**

“A Contracting Party may adopt, maintain or enforce any measure that it considers appropriate to ensure that investment activity is undertaken in a manner sensitive to health, safety or environmental concerns, provided such measures are consistent with this agreement...” (OECD 1998a, p. 14).

/...

As these references suggest—and this is consistent with the sovereign prerogative of States to regulate the entry and behaviour of aliens into their own territories—the right to regulate is broader in its conceptual scope than the specific context in which it recently gained renewed prominence. It is, in effect, the principle on which the notion of “national policy space” and hence flexibility is based.

Ensuring sufficient flexibility is a difficult balancing act. In IIAs it is the result of negotiations in the light of overlapping—but not identical—objectives between home and host countries. It finds expression in the objectives of IIAs, their structure, content and implementation, including through the recognition of the concept of special and differential treatment, and the use of exceptions and the like, to further development goals. Each is considered in turn (UNCTAD 2000d).

### Box V.2. The right to regulate (concluded)

*UNCTAD Commission on Investment, Technology and Related Financial Issues:*

“Many delegates stressed that policies needed to reflect the special circumstances prevailing in a country and that they should evolve over time. In this context, many delegates underscored the need to ensure sufficient policy space for the pursuit of national policy objectives and the importance of the right to regulate. Specific reference was made to the LDCs’ need of special and differential treatment in the context of various international agreements” (paragraph 50).

“The right to regulate was relevant in this context, in particular the recognition of the public interest to pursue objectives related to security, health, morals, and so forth. Exceptions were also important, especially those related to balance-of-payments safeguards” (paragraph 57) (UNCTAD 2003j, pp. 14 and 16).

<sup>a</sup> Text as contained in Chairperson’s proposed package on Labour and Environment.

## A. Objectives of IIAs

Many IIAs incorporate the objective of development among their basic aims, purposes or principles, as a part of their preambular statements or as specific declaratory clauses articulating general principles. For example, the Preamble to the GATS Agreement (which covers FDI in services) includes among its objectives “the expansion of [services] trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries”. It also expresses a desire for the “early achievement of progressively higher levels of liberalization of trade in services through successive rounds of multilateral negotiations aimed at promoting the interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while

giving due respect to national policy objectives”. It continues, by expressing a further desire, “to facilitate the increasing participation of developing countries in trade in services and the expansion of their service exports including, *inter alia*, through the strengthening of their domestic services capacity and its efficiency and competitiveness”.

The main advantage of such provisions is that they may assist in the interpretation of other substantive obligations, permitting adoption of the most development friendly interpretation. This in turn assists in the promotion of flexibility and the right to regulate by ensuring that the objective of development is implied in all obligations and exceptions thereto—and that it informs the standard for assessing the legitimacy of governmental action under an agreement.

## B. Structure

The structure of agreements may reflect development concerns through the application of special and differential treatment for developing country parties. This entails differences in the extent of obligations undertaken by developed and developing country parties, with the latter assuming less onerous obligations, either on a temporary or permanent basis, that are also non-reciprocal. This may be achieved in a number of ways:

- Agreements can distinguish between developed and developing countries, with different obligations for both. MIGA, for example, restricts its investment insurance to investment in developing countries only, listed in an annex to the MIGA Convention.
- Differences may be introduced for stages and degrees of participation by developing country parties, with accession less onerous for them

or allowing for association rather than full commitment to treaty obligations.

Particularly important is the approach to arrive at commitments:

- Under the “negative list” approach, countries agree on a series of general commitments and then list individually all those areas to which these commitments do not apply. For example, the NAFTA parties have agreed to grant the right of establishment; at the same time, each of the parties lists those activities to which this right does not apply. To all other activities, it applies. This approach tends to produce an inventory of all non-conforming measures. It also locks in the status quo.
- Under the (GATS-type) “positive list” approach, countries list commitments they agree to make, and the conditions they attach to them.<sup>2</sup> For example, the GATS parties list all activities that they agree to make subject to the provisions of the Agreement concerning, for example, commercial presence, and the conditions under which this is the case (such as only a certain number of foreign affiliates can be established in a particular industry). The implication is that the same provisions do not apply to all other activities—that is, they remain “unbound”. This approach has the advantage that countries can take commitments at their own pace and determine the conditions under which this occurs. For these reasons, the positive list

approach is generally regarded as more development friendly than the negative list approach.

In theory, both approaches should arrive at the same result, if countries had the capacity to make proper judgments about individual activities—or, more broadly, about the taking of commitments—at the time of concluding an agreement. In practice, the negative list approach tends to involve greater liberalization. In practice, too, even a positive list approach can lead to liberalization, because negotiations put pressure on countries to assume higher and broader commitments, particularly since those negotiations are bilateral.<sup>3</sup> Under both approaches countries often use various devices to keep options open when scheduling their commitments. Moreover, once a commitment has been made, it is locked in, making it virtually impossible to reverse it.

Table V.1 presents graphically how a broad positive list approach could work for investment should countries decide on modalities to negotiate and should they consider a positive list approach. It is “broad” because it applies not only to activities but also to other issues addressed in IIAs. It is structured along the two main fracture lines that emerged during the analytical discussions in the WTO’s Working Group on Trade and Investment:

- National treatment in the pre-establishment phase versus national treatment in the post-establishment phase.

**Table V.1. A thought experiment to help analysis—applying the positive list approach to investment**

Issue/measure	National treatment in the pre-establishment phase		National treatment in the post-establishment phase	
	FDI	Foreign portfolio investment	FDI	Foreign portfolio investment
Definition				
National treatment				
MFN				
Fair and equitable treatment				
Transparency				
Nationalization and expropriation				
Home country measures				
Good corporate citizenship				
Dispute settlement (State-State, investor-State)				
Incentives				
Transfer of technology				
Competition policy				
Other				

Source: UNCTAD, based on Eglin 2002.

- FDI versus foreign portfolio investment, financial derivatives and other investment—that is, the scope of an agreement.

In this approach, countries would need to decide, cell by cell, whether they would want to commit themselves and, if so, under what conditions. For example, a country prepared to offer high standards could do so by filling out every cell attaching few conditions to its commitments; a country that wants to commit itself only to certain standards as regards FDI (for example, national treatment in the post-establishment phase) could do so as well, including by attaching the conditions it requires to promote its development. In other words, each country would fill out the table as best suits its own interests. (Certain cells that do not apply would remain empty.) In principle, a party

to such an agreement could also refrain from filling out any cell.

A variation of this approach is that certain commitments are taken by all parties for a limited number of issues.<sup>4</sup> Such commitments would be easiest in areas that are important but not particularly sensitive in international investment negotiations—such as MFN treatment and transparency. This approach could be combined with a general commitment to extend, in due course and through negotiations, such stronger commitments to other issues, such as national treatment in the post-establishment phase.

Whatever the approach chosen, the experience of international economic agreements suggests that countries in most cases prefer a gradual approach.

### C. Content

As to the substantive content of agreements, the key substantive issues were addressed in the preceding chapter. Central to IIAs, they determine their effect on national policies. For each of them, more development friendly or less development friendly solutions exist. (For example, as discussed earlier, national treatment at the pre-establishment phase—market access—is perhaps the single most difficult issue for developing countries to accept in IIAs.) And given their importance, they require the full attention of negotiators.

When negotiating content, flexibility can also be introduced through various means:

- Flexibility can be ensured by excluding some issues altogether. For example, excluding provisions on incentives from the draft MAI would have allowed countries to have maximum policy flexibility in this area (consistent with other international obligations). Most IIAs exclude taxation issues (covered in double taxation treaties).
- Circumscribing the scope of key provisions—say, by limiting the definition of investment to FDI only.
- Agreements can include provisions of special interest to developing countries, such as those pertaining to transfer of technology or home country measures.

- Various traditional methods can preserve policy space. These range from various kinds of exceptions, reservations, derogations and waivers to transition arrangements that aim to ensure that signatories retain their prerogative to apply non-conforming domestic regulations in certain areas. Examples include exclusions from the non-discrimination principle;<sup>5</sup> safeguards aimed at preserving the right to regulate (box V.3), as in balance-of-payments difficulties; and general exceptions for reasons of public security and order, public health and morality.

Note that the provisions of IIAs interact with one another to complement, clarify, expand, limit or elaborate on the rights and obligations of parties. For example, general exclusion or exception clauses have the effect of limiting the scope of an agreement or modifying the application of its provisions. Similarly, general standards of treatment, such as national treatment or fair and equitable treatment, affect and complement the substance of more specific standards dealing with, for example, operational conditions or expropriation. These interactions offer multiple possibilities for structuring and combining provisions in IIAs to achieve the desired overall balance of rights and obligations, and accommodate diverging country interests (for examples of these combinations, see UNCTAD 2000d).

### Box V.3. Emergency safeguard mechanisms in the area of investment

To preserve the right of countries to regulate in the public interest, various safeguards are often used in international agreements. Safeguards, or “escape clauses”, are provisions that allow parties to take action otherwise not permitted by an agreement, to cope with exceptional events arising after its adoption. Relevant provisions normally set definite limits, in time and substantive measures, on the action to be taken. The most common situations contemplated in safeguard clauses in IIAs relate to balance-of-payments safeguards.

In trade, if a production sector in a country suffers because of increased imports, the WTO Agreement on Safeguards authorizes WTO members to restrict imports temporarily by imposing higher tariffs or by directly limiting import quantities under certain conditions which may cause or threaten to cause serious injury to the domestic industry that produces like or indirectly competitive products. The main rationale for this provision is that the particular sector in the country should be allowed time to adjust to the new competition from imports.

If similar emergency safeguard mechanisms (ESMs) were included in IIAs, some complex issues would have to be addressed. What conditions would have to be met, and what procedures would have to be observed in order to invoke the ESM in the context of an investment agreement? What would be the equivalent of an import surge in the investment context, and how would one address emergency situations arising, for example, from the “crowding out” of SMEs? Could emergency situations also be considered in case of sudden withdrawal of investment (as opposed to a surge in inflows)? Moreover, since it may be difficult to distinguish between foreign affiliates and domestic firms once the former are established, would an ESM have to focus on new investment only?

The complexities can be seen from the lack of progress on this for trade in services. Article X of the GATS states that: “There shall be multilateral negotiations on the question of emergency safeguard measures based on the principle of non-discrimination. The results of such negotiations shall enter into effect on a date not later than three years from the date of entry into force of the WTO Agreement”. Still, after more than seven years of discussions, the Working Party on GATS Rules has failed to produce an agreement. These discussions are relevant to the area of investment, since Mode 3 of trade in services (commercial presence or establishment trade) involves FDI.

So, very few IIAs include ESMs other than those associated with balance-of-payments

difficulties. One example is Article 14 of the ASEAN Investment Area Agreement (AIA), which states that:

“1. If, as a result of the implementation of the liberalisation programme under this Agreement, a Member State suffers or is threatened with any serious injury and threat, the Member State may take emergency safeguard measures to the extent and for such period as may be necessary to prevent or to remedy such injury. The measures taken shall be provisional and without discrimination.

2. Where emergency safeguard measures are taken pursuant to this Article, notice of such measure shall be given to the AIA Council within 14 days from the date such measures are taken.

3. The AIA Council shall determine the definition of serious injury and threat of serious injury and the procedures of instituting emergency safeguards measures pursuant to this Article.”

Although the ESM in the ASEAN Agreement has never been used, it serves the purpose of providing an assurance to countries that if exceptional consequences seriously or adversely affect their economies as a result of liberalization measures undertaken by them, they could resort to safeguard measures. Liberalization is something that some countries are cautious about in view of the possible impact on domestic industries.

If countries wish to include an ESM when negotiating IIAs, another approach could be along the lines of the Europe Agreements between the EU and various Central and Eastern European countries. In the Europe Agreement with Poland (1991), for example, Article 50 provides for the use of “safeguards” during specified transitional periods if certain industries are undergoing restructuring; are facing serious difficulties; face the elimination or a drastic reduction of the total market share held by Polish companies or nationals in a given sector or industry in Poland or are newly emerging industries in Poland. Safeguard measures (not specified) used shall cease to apply, at the latest two years after the expiration of the first stage or upon the expiration of the transitional period; they relate only to establishments in Poland to be created after the entry into force of such measures and shall not introduce discrimination concerning the operations of Community companies or nationals already established in Poland. The Agreement further notes that Poland shall, prior to the introduction of these measures, consult the Association Council. Upon the termination of the first stage or of the transitional period, Poland may introduce such measures only with the authorization of the Association Council and under conditions determined by the latter.

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## D. Implementation of IIAs

The implementation of IIAs can also be designed with flexibility for development as its organizing principle. Two approaches are particularly relevant here: first, the legal character, mechanisms and effects of an agreement, and second promotional measures and technical assistance:

- Whether an agreement is legally binding or voluntary affects the intensity of particular obligations. Indeed, it is possible to have a mix of binding commitments and non-binding “best effort” provisions in one agreement. Thus, development-oriented provisions could be either legally binding or hortatory, depending on the extent to which the parties are willing to undertake commitments in this area. Evidently, “best effort” development provisions are of considerably less value to developing countries than legally binding ones.
- The asymmetries between developed and developing country parties to IIAs can be tackled by commitments addressed to the developed country parties to undertake measures of assistance to the developing and especially LDC parties. A leading example is the technology transfer commitment by developed country

parties to the TRIPS Agreement towards LDCs. (The wider issue of home country commitments in IIAs to promote the flow of FDI to developing countries is discussed further in chapter VI.) Such developed country commitments can be complemented by provisions for technical assistance through relevant international organizations. These are particularly important, given the complexity of the subject matter and the limited capacity of many developing countries, and especially the LDCs, to undertake FDI related policy analysis and development, as well as human and institutional development. The last of these also involves assistance to developing countries to attract FDI and benefit more from it.

Beyond that, each IIA is part of a larger set of investment agreements at bilateral, regional, inter-regional and global levels—and addresses a broad range of issues related to investment and the operations of TNCs. When the same parties participate in various agreements, their respective provisions also interact, to complement, elaborate, expand or limit these parties’ obligations. It is therefore important, when designing IIAs, to bear in mind this broader context, and ensure that the standards, exceptions and the like that the parties seek to negotiate in agreements would not be modified or otherwise affected by other agreements in ways that were not intended. One example is the question of how investor protection standards interact with the environmental obligations of countries in multilateral environmental agreements.

In case of possible conflict between provisions in different agreements, it is also important to consider how IIAs can ensure their compatibility with conflicting obligations arising from these agreements. In principle, questions of compatibility between agreements are resolved in accordance with the principles set out by Article 30 of the Vienna Convention on the Law of Treaties. When the parties desire to ensure that no conflict of compatibility arises between an IIA and other treaties to which the signatory States may be a party, they can do so by inserting clauses in the agreement expressing this intent. Examples of such clauses include the “regional economic integration organization” clause, which ensures that the benefits of membership of such an organization are not extended to non-member countries that are also partners to the IIA on the basis of the MFN clause, and the preservation of rights clause found in bilateral investment treaties (BITs). Difficult questions remain however in this area, notably the operation of MFN clauses in BITs (box V.4).

### **Box V.3. Emergency safeguard mechanisms in the area of investment (concluded)**

A number of features of the approach taken in the Europe Agreements are worth noting. “Serious injury” is not stipulated as a test or condition, nor is “causation” (of the injury or of any of the circumstances specified), nor is “unforeseen developments” or “unforeseeability”, nor is “sudden surge in investment or imports”. The article simply lists circumstances or situations that would be sufficient to justify, during the transitional period, derogations from a specific obligation. The language also avoids the problem of discrimination by limiting the derogation to companies that have not yet established themselves in Poland. Notification and authorization requirements are intended to prevent protectionist abuse. Many developing countries could identify with the situations listed in Article 50. Moreover, developing countries could enjoy such “safeguards” or derogations only during a transitional period—that is, until their rising incomes and competitiveness led to their disqualification.

Source: UNCTAD.

**Box V.4. The effect of the MFN clause in BITs—the example of performance requirements**

The MFN standard in IIAs seeks to prevent discrimination between different foreign investors. It does so by requiring that the foreign investor protected by the standard enjoys treatment no less favourable than that enjoyed by the most favourably treated foreign investor. The application of this standard raises some particular problems for the operation of IIAs. The example of performance requirements is used here to illustrate these problems. The national treatment standard is also discussed so as to give a more complete analysis of how non-discrimination can operate in this context.

The great majority of IIAs, particularly BITs concluded by countries other than the United States or Canada, do not contain specific rules on the use of performance requirements. But such IIAs may nevertheless constrain the flexibility of governments to impose and implement performance requirements. The reason is that virtually all IIAs contain non-discrimination provisions, typically national treatment and MFN treatment. Thus, even if governments are otherwise free to impose performance requirements, they may not do so in a way that treats differently foreign and domestic investors—or foreign investors from different countries—in like circumstances. Such restrictions may, in turn, be subject to conditions and qualifications, described here.

**National treatment standard**

The national treatment standard (in both the pre- and post-establishment phases) precludes governments from discriminating between foreign and domestic enterprises in like circumstances when they impose performance requirements. A government may impose different performance requirements on investors that are not in like circumstances. This flexibility, however, is not unlimited: “like circumstances” are typically understood to refer to broad, objective characteristics of a business, such as its economic sector, the size of the entity or its geographic location.

So performance requirements could be imposed on foreign investors to ensure compliance with national development policies. These could be specifically geared to the particular benefits hoped to be obtained from their investments, investments that domestic investors may be unable or unwilling to undertake. Equally, preferential treatment of domestic investors could be justifiable on the basis of their actual economic condition—for example, with firms classified as “infant enterprises”. The scope of protection thus needs to be determined case-by-case. Discrimination based on “circumstances” related only to the

investors’ nationality usually violates the national treatment obligations of IIAs.

Governments concluding IIAs often do not take commitments or negotiate to exempt certain activities or certain geographic regions from the market access and national treatment provisions of those agreements—as is the case under the “opt-out” provisions on national treatment in NAFTA, under which even entire industries (such as air transport) can be excluded. Articles XVI and XVII of the GATS allow governments selectively to liberalize particular industries of the economy by way of an “opt-in” provision and then to delimit the scope of national treatment in those industries. In such cases, or where national treatment is restricted in its application, a government could impose different performance requirements on foreign and domestic entities without breaching its treaty obligations to provide national treatment. Outside such situations any performance requirements must be imposed in an even-handed manner on foreign and domestic enterprises that are similarly situated.

**MFN standard**

The MFN provisions of IIAs have a similar effect. Even if the IIAs to which a country is a party do not preclude the imposition of performance requirements as such, the government will not be able to impose different requirements on investors from different foreign countries that are otherwise in like circumstances. Here, as with national treatment, “like circumstances” refer to neutral characteristics, such as industries, scale of operations, geographic regions and so forth. Where a government intends to discriminate between foreign investors from different countries, it can seek to include an exemption from MFN treatment for particular industries when negotiating an IIA. In most cases, it is difficult to justify such exemptions, but there are cases in which granting more favourable treatment to investors from certain countries is necessary. For example, a common exemption from the MFN standard is the one that permits preferential treatment for fellow members of a regional economic organization. Under the GATS, member countries can exempt specific measures from the MFN provision.

A particular issue that arises in the context of the MFN standard, but not in relation to the national treatment standard, is whether investors from a home country that has concluded a BIT (BIT A) with a host country, without a specific clause prohibiting the use of performance requirements, could nonetheless benefit from such a prohibition in a BIT between the host country and a second home country (BIT B), on the basis

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**Box V.4. The effect of the MFN clause in BITs—the example of performance requirements (concluded)**

of the MFN obligation in BIT A. Investors from home country A could assert that they have been discriminated against, in violation of the MFN standard, because they are subject to performance requirements that cannot be extended to investors from home country B by virtue of the prohibition against such requirements in BIT B. The success of such a claim would initially depend on establishing that the investors from country A and those from country B are in fact in like circumstances. Assuming this to be so, the next question is whether such a claim can be sustained on the terms of the BITs themselves. This question has not yet been faced or resolved in dispute settlement proceedings under IIAs.

The BIT with each home country is a specifically negotiated instrument. According to the ICSID Tribunal in the case of *Maffezini v Spain* (Case No. Arb/97/7 Decision on Objections to Jurisdiction, 25 January 2000), if the third-party treaty deals with matters not dealt with in the basic treaty applicable between the parties, those matters cannot be transferred to the basic treaty through the MFN clause. But where the third-party treaty does deal with the same subject matter, MFN treatment can apply to extend the better treatment in that treaty to investors under the basic treaty that is under review. Thus, in the *Maffezini* case, MFN was applied to the procedural question of the scope of the dispute settlement provision in the BIT between the parties. It was held that the MFN clause allowed the application of the higher standard of treatment offered by third-party treaties.

This was a special case. But it opens the issue of whether it is possible to argue that provisions other than procedural provisions might be subject to MFN review. An investor from Country A may seek to use the MFN provision in BIT A and argue, on the basis of *Maffezini*, that the prohibition of performance requirements in BIT B should also extend to investors from Country A and that it has been denied that protection. This is a question that stands to be determined by reference to the intention of the parties to the BIT, as expressed in the actual terms and text of the agreement—and in the subsequent

investment treaty practice of the parties. This was a matter that the Tribunal in *Maffezini* considered in some detail as regards the approach of the countries concerned, Argentina and Spain, to the scope of dispute settlement clauses in their BIT practice.

Could it be said that, in concluding BIT A, the host country intended the more beneficial investment protection terms that it concluded in BIT B automatically to extend to investors and investments from country A? It is within the discretion of host countries to conclude BITs on more or less favourable terms with different home countries as they see fit. So, in the absence of clear evidence of such an intention, it is unlikely that BIT A could be interpreted on its face to extend the specific prohibition against performance requirements negotiated by home country B in favour of its investors and investments, to those of home country A, which did not negotiate a similar prohibition. The MFN standard does not confer benefits on the investors from country A in view of the substantive scope of BIT A. One case in which such an argument could succeed is where the host country adopts a general policy that prohibits the use of performance requirements, at the national level, or through a long and consistent practice of prohibition of such requirements in its BITs, but still applies such requirements to investors and investments from home country A. Here, there is discrimination as the application of the requirements would not be in accordance with a general policy, and only investors from A are being affected by the imposition of prohibited requirements. So long as the host country continues to apply performance requirements in general, it is free to offer preferential treatment to certain foreign investors if it so wishes.

The foregoing makes it obvious that the application of the non-discrimination provisions of IIAs, and of the MFN standard in particular, has considerable implications for the interactions between different IIAs. The issue needs to be borne in mind in the conclusion, application and interpretation of these agreements.

Source: UNCTAD.

## Notes

<sup>1</sup> There is no common understanding of the notion of regulation. In the OECD context “regulation refers to the instruments by which governments place requirements on enterprises, citizens, and government itself, including laws, orders and other rules issued by all levels of government and by bodies to which governments have delegated regulatory powers. Economic regulation intervenes directly in enterprise and market decisions such as pricing, competition,

market entry or exit. Social regulation protects values such as health, safety, the environment and social cohesion. Administrative regulation concerns government formalities and paperwork, so-called ‘red tape’” (OECD 2001c, p. 2).

<sup>2</sup> In a sense, the conditions attached to any commitments imply a negative list approach to conditions—unless a country does not take any commitments in the first instance. To quote Oxfam

et al. (2003b, p. 4): “It requires governments to know, in advance, all the possible GATS-incompatible regulations they, or successive governments, might want to use in future in order to list exemptions at the time of making commitments”.

<sup>3</sup> The matter is further complicated by the fact that most developing countries are only host countries and not (or only marginally so) home countries. In request-offer bargaining situations these countries may therefore not have much to request when it comes

to commercial presence.

<sup>4</sup> This, for instance, is the case in the GATS.

<sup>5</sup> For example, development considerations play a role in the case of Germany’s approach in bilateral investment treaties (BITs) to national treatment in the post-establishment phase, insofar as Germany has accepted certain exceptions to the national treatment principle provided that these are undertaken for development purposes only (for example, to develop small-scale industries) and that the measures do not substantially impair investments by German investors (see the BIT between Germany and Papua New Guinea, 1980).

## CHAPTER VI

# HOME COUNTRIES AND INVESTORS

The investment process involves host countries, home countries and TNCs making investments. In general only the host country has been addressed in IIAs, with the most important and sensitive aspects reviewed in the preceding chapters. In future IIAs consideration should especially also go to home countries, actual parties to such agreements, to encourage FDI flows to developing countries and help increase the benefits from them. It is against this background that this chapter takes up home country measures and good corporate citizenship.

Home country measures (HCMs) seek to facilitate—partly in the interest of home countries themselves—FDI flows into developing countries by helping to overcome various problems that developing countries face when seeking to attract FDI and increasing benefits from it. Good corporate citizenship makes relations harmonious between investors and the economies they operate in—and it can help advance development. How future IIAs will deal with these matters is an open question. The analysis here explores options for governments to consider.

### A. Home country measures

Outward FDI from developing countries increased rapidly in the late 1990s, but they remain net importers of FDI. Developed countries, by contrast, have a more balanced pattern of inward and outward flows.<sup>1</sup> So the focus for most developing countries and economies in transition is to attract inward FDI and benefit more from it. Measures that facilitate more and better FDI into developing countries—and that address concerns related to such investment—would do more than help developing countries. They could also be undertaken by “self-enlightened” home countries to create new investment and trade opportunities for their business communities.

Many developed home countries already have in place a wide range of unilateral policies and measures in this area. But IIAs have traditionally paid limited attention to them. Possible options range from hortatory policy declarations that recognize the need for home countries to promote FDI into developing host countries—to mandatory assistance and cooperation obligations set out in the agreements themselves. Binding commitments might make HCMs more transparent, stable and secure than if they are entirely voluntary, the norm today.

#### 1. Broad scope of measures

Many types of HCMs can influence the magnitude and the quality of FDI flows to developing host countries.

- General aid-based development assistance to strengthen a host country’s business environment.
- Improving the access of goods and services produced by developing countries to the markets of the developed countries.<sup>2</sup>

While aid-based measures and market access are important, the focus here is on measures directly related to FDI,<sup>3</sup> many of them already undertaken by home countries (UNCTAD 2001a, pp. 8–11):

- *Liberalizing outflows.* Home countries can remove obstacles to FDI outflows.
- *Providing information.* They can assist developing countries in collecting and disseminating information related to investment opportunities through cooperation with investment promotion agencies (IPAs), the provision of technical assistance, the organization of investment missions and seminars and the like.
- *Encouraging technology transfers.* Home countries can promote technology transfer by providing assistance to strengthen a host country’s technological base, its capacity to act as a host to FDI in technology-intensive industries and its capacity in reaching specific technology-intensive goals.

- *Providing incentives to outward investors.* Various forms of financial and fiscal incentives can be provided to outward investors or to support feasibility studies and environmental assessments.
- *Mitigating risk.* Home countries can help to mitigate risk—say, by providing investment insurance against losses arising from political or other non-commercial risks that may not normally be covered through the private insurance market.

In addition, some new issues are being raised. These require the use of a home country's legal and regulatory system to ensure that TNCs based there conform to certain standards of good corporate citizenship through the sanctions of such home country laws and regulations. Of significance has been the increasing demand to apply home country liability rules to parent companies for the wrongful acts of their foreign affiliates in developing countries (Muchlinski 2001a, 2001b). This has already occurred in the course of litigation, mainly in the United States and United Kingdom, where foreign claimants have sought redress for wrongs allegedly committed against them in the host country by foreign affiliates (United States Court of Appeals Second Circuit 1987; United Kingdom House of Lords 2000). Cases have been brought in the United States for alleged violations of fundamental human rights standards by United States-based TNCs in their foreign operations, under the Alien Tort Claims Act (Muchlinski 2001a, 2001b, 2002; United States Court of Appeal for the Ninth Circuit 2002).<sup>4</sup>

Other areas of concern to home countries, as the principal regulators of parent company activities, may include combating corruption by penalizing TNCs that use corrupt practices to further their FDI activities and regulating fraudulent behaviour and unacceptable corporate accounting practices that may adversely affect the global operations of TNCs.<sup>5</sup> Other possible action arises for the global environmental practices of TNCs, ranging from control over trade in hazardous technology to determining responsibility for environmental damage.

In addition, it might be possible for current policies of international cooperation to evolve in ways that assist developing countries. For example, if developing countries could gain access to the competition enforcement systems of the EU and the United States, this would empower them, in dealing with anticompetitive practices of TNCs, to use the stronger regulatory and institutional frameworks of developed countries. And developed

home countries could perhaps do more to assist developing countries by sharing information about the “track record” of an investor, to alert host countries about firms with a poor record of business probity.

Such approaches do have problems. Under what conditions do claimants in a host country have the right to bring a claim before courts in the parent company's home country? Can they show that the parent firm was sufficiently involved in the alleged wrongdoing to be itself liable? Or in the absence of direct involvement in an alleged wrongdoing, can the parent firm nonetheless be held liable on the basis of “piercing of the corporate veil” between itself and its overseas affiliate?<sup>6</sup> Such litigation could however undermine the attraction of the home country as a base for TNCs, indeed encourage “floods of litigation” that the courts of a given home country might be unable to deal with (Lord Hoffmann 1997).

On some of these measures, a potential problem is that action by a home country involves an assertion of an extraterritorial jurisdiction to prescribe legal standards for operations that, by definition, occur in the territory of another sovereign State. This increases the risk of conflicting requirements, especially where policies and laws in the home and host countries diverge. The problem arises not only where there is a divergence of approach to the resolution of a common problem, but where different procedural policies apply. For example, disputes have arisen between the United States, European countries and Japan over extraterritorial prescription and enforcement of United States regulatory laws on foreign affiliates of United States companies and on non-United States companies that were allegedly involved in breaches of United States laws (Muchlinski 1999, chapter 5; Wallace 2002).

## 2. Current use by developed countries

All home countries have measures that affect FDI flows to developing countries. In general, developed countries have removed most national obstacles on outward FDI. But policy declarations aimed at encouraging outward FDI are seldom linked to specific international commitments to that effect (UNCTAD 2001a). With some exceptions, assistance remains at the discretion of each country and is commonly shaped to serve a home country's business interests and general development objectives. This home country perspective is especially evident in the design of financial or fiscal assistance programmes as well as preferential market access measures.

Information on the investment climate is an important element for FDI decisionmaking. Home country assistance can be offered to gather, publish and disseminate basic information on a country's regulatory framework, macroeconomic conditions, sectoral conditions and other factors that affect investment opportunities. Although host developing countries do compile many of these data, their efforts can be supported, particularly in the dissemination stage, by home country governments and relevant international institutions. Indeed, a number of home countries provide assistance of such a kind. For example, the Swiss Organisation for Facilitating Investments facilitates matchmaking between Swiss and foreign enterprises in developing countries and economies in transition and supports the transfer of know-how. At the international level, various programmes strengthen the capabilities of developing country IPAs and disseminate information about investment opportunities.<sup>7</sup>

Some HCMs are geared specifically to facilitating the transfer of technology (see IV.G), and several international agreements contain

clauses in this regard. The measures include (UNCTAD 2001f):

- Supporting technology partnerships between firms from developed and developing countries to strengthen the technological capabilities of the latter, either through facilitating access to advanced technology or learning in the interaction between firms. Supported by various initiatives, such partnerships can take many forms, ranging from sharing technology on an ad hoc basis to entering long-term contractual or business engagements. The Business Linkages Challenge Fund of the United Kingdom is one such approach (box VI.1).
- Promoting the transfer of specific technology (such as telecommunications, energy production and environmental protection technologies) is at the heart of several developed country initiatives.
- Targeting measures for R&D at specific technological problems of developing countries can provide a venue for public-private cooperation in promoting transfers of technology.

#### Box VI.1. The Business Linkages Challenge Fund

Established by the Department for International Development in the United Kingdom, the Business Linkages Challenge Fund provides grants for the development of innovative business linkages that transfer the technology, skills, information and market access necessary for LDC enterprises to compete in the global economy and bring benefits to the poor. Grants of £50,000 to £1 million are allocated on a competitive basis, and bids must be led by private sector partners. All grant awards have to be matched by an equal or greater contribution from the linkage partners.

Projects must be implemented in LDCs. The target are countries in central and southern Africa and in the Caribbean. One leg of the partnership must fall within a targeted country. But because the United Kingdom qualifies as a targeted country, linkage partnerships between United Kingdom companies and developing country counterparts can be supported. Similarly, partnerships between companies in South Africa and companies in developing countries outside the Fund's target regions are also eligible, hence the project in the United Republic of Tanzania linking with BP South Africa.

The programme has been running in sub-Saharan Africa and the Caribbean since 2001. To date, 32 projects have been supported, with total grants of £8 million and more than £10 million of

private sector resources mobilized. In the United Republic of Tanzania, the Fund supports a project that aims to develop links between BP Tanzania and other major local corporations, and local SME suppliers. The project builds on BP's experience working with local suppliers in South Africa to develop their capacity to latch onto the supply chains of large corporations. BP Tanzania's major partners include Kahama Mining Corporation, Kolombo Sugar Company, National Microfinance Bank, Sumaria Group, Tanga Cement Company and Tanzania Breweries. In 2002 the eight participating corporations spent 35% of their \$60 million purchasing budget on supplies from SMEs. The objective of the project is to increase this proportion and gradually ratchet up the quality and complexity of goods and services bought locally, developing the "missing middle" of the Tanzanian economy.

Other project examples include linkages between a sports management company in the United Kingdom and South African partners, to expand the capacity in South Africa to host and staff major sporting events; linkages between small fruit farmers in Mozambique and South Africa to increase access to export markets in Europe; and linkages between a large cocoa cooperative in the Dominican Republic and a Swiss chocolate manufacturer to develop a supply of high-quality organic cocoa.

Source: United Kingdom, Department for International Development (DFID).

Many developed countries have specialized agencies to provide long-term financing for private sector development in developing and transition economies.<sup>8</sup> This assistance is usually channelled through development finance institutions that provide both loan and equity financing for FDI projects in developing countries, sometimes by taking minority equity positions. For example, the mission of the Overseas Private Investment Corporation (OPIC) of the United States is to mobilize and facilitate the participation of United States private capital and skills in the economic and social development of developing countries and economies in transition to complement the development assistance objectives of the United States. OPIC's main instruments are investment funds and medium- to long-term financing, but it also provides political risk insurance (see below). Several public organizations in developed countries support outward FDI by SMEs. The Swiss "Start-up Fund", for example, offers loans for studies, pilot projects, purchases of machinery and technology transfer.

Complementing these unilateral efforts are various schemes of international institutions that provide financial assistance for projects in developing countries (for a summary see Hughes and Brewster 2002). Within the World Bank Group, the International Finance Corporation and its decentralized instruments for the Caribbean and the South Pacific provide various forms of financial and technical assistance to promote private enterprise. The regional development banks use a range of instruments to facilitate investment in developing countries.<sup>9</sup> The Commonwealth Private Investment Initiative has established several investment funds.

In mitigating risk, investment insurance to alleviate non-commercial risk is particularly important. Some of the largest official bilateral insurers are OPIC (United States), the Export Insurance Department of the Ministry of Trade and Industry (Japan), HERMES and Treuarbeit (Germany), the Compagnie Française d'Assurance pour le Commerce Extérieur (France) and the Export Credit Guarantee Department (United Kingdom). Similar institutions exist in Australia, Canada, Italy, the Netherlands, Spain and Sweden (Mistry and Olesen 2003, pp. 212–213). In general, such insurers will only insure investment in developing countries with which their own countries have a bilateral investment treaty (BIT). In 2001, bilateral institutions insured outward FDI of some \$20–25 billion (*ibid.*).

Of multilateral institutions, the Multilateral Investment Guarantee Agency (MIGA) is the most important, with a capital base of almost \$2 billion

in 2001.<sup>10</sup> The regional development banks and other institutions, such as the Inter-Arab Investment Guarantee Agency, also provide non-commercial risk insurance. In the EU, the European Investment Bank has established an "Investment Facility" to provide risk capital and guarantees in support of domestic and foreign investment, loans and credits (Cotonou Agreement, Article 76, Annex II, Article 2).

The trade policies of home countries—even though not FDI-specific—can also have an important effect on the scope for especially export-oriented FDI in developing countries. Non-reciprocal preferential schemes are particularly important here, including the Generalized System of Preferences, and trade preferences under the Cotonou Agreement, the Caribbean Basin Initiative, the EU's Everything-but-Arms Initiative and the United States' African Growth and Opportunity Act. The Government of Japan also grants certain LDC exports (corresponding to 99% of industrial products) duty-free and quota-free access to its market. Such schemes remain important for the location of export production but do not—in and by themselves—provide either a sufficient or a sustainable basis for developing competitive export industries. Home countries also use a variety of trade and industry policies to restrict access to their markets. These include anti-dumping and safeguard measures as well as targeted subsidies in developed countries.

### 3. Effectiveness

Lack of information and difficulties in isolating the influence of other factors complicate the evaluation of the effectiveness of the wide range of HCMs. In addition, the use and impact of HCMs is a vastly under-researched area. But some important considerations can be identified for enhancing the effectiveness of HCMs as a development tool.

A stronger link between the explicit needs of developing countries and the design and execution of HCMs would likely enhance the beneficial impact of such programmes on development. As noted earlier, most HCMs remain at the discretion of each developed country and are commonly shaped to serve a home country's own business interests along with general development objectives. Moreover, the awareness among developing countries of HCMs is generally low. Interviews with IPAs from developing countries indicate that HCMs are not yet regarded a strategic complementary element to their own promotion efforts. This may imply that the measures have not been well advertised or that they are not perceived to be very effective. It may also

suggest a need for closer developing country involvement in the design and execution of future HCMs.

For the dissemination of investment information, there is a clear need for assistance, especially for the least known FDI locations (such as LDCs) and for informing SMEs. For the 49 LDCs, investment guides of the sort produced by international consulting firms are available only exceptionally.<sup>11</sup> Nor do available sources always match the requirements of investors. The information revolution has in some ways aggravated the situation by sharpening the contrast between the LDCs and other countries—which can update information available through the Internet, for example.

On mitigating financial cost and risks, there are many examples of investments that have benefited from home country or international schemes for financing and investment insurance.<sup>12</sup> But it has also been argued that such efforts often do not trickle down to those countries that need assistance the most (Hughes and Brewster 2002). While most international finance institutions have policy statements that acknowledge the need to focus on such countries, LDCs tend to lag far behind the rest of the developing world in the use of finance and insurance schemes. One of the reasons is that many of the investment funds are publicly funded only in part and therefore tend to be managed on commercially based criteria, with less focus on the least developed investment locations as a result.

Interestingly, there seems to be a trend towards making HCMs more development-oriented. For example, the Government of Norway has obliged the Norwegian Investment Fund for Developing Countries to invest at least a third of its capital in LDCs, with the obligation to have Norwegian co-investors abolished.<sup>13</sup> A similar shift has been noted for OPIC (United States), which specified in its 2003 budget request that it would continue to refocus its efforts on providing support to projects in locations and sectors in which the developmental impact will be greatest.

HCMs could result in policy conflicts between host and home countries. One general issue is the potential for extraterritorial control. For example, home country tax policies and transfer pricing regulations sometimes influence FDI flows to developing countries. Some countries employ a residence-based system of taxing foreign source income and claim tax revenues on income generated worldwide. Such extraterritorial tax policies are based on a general principle that tax reductions

should not encourage FDI from the home country—and may in effect offset the impact of lower tax rates or tax holidays offered by developing countries as an incentive to attract FDI. To counter such effects, several developed countries have adopted tax-sparing treaty practices. A contracting State agrees to grant relief from residence taxation for source taxes that have not actually been paid (taxes that have been “spared”). Because such clauses may induce firms to engage in sophisticated tax planning and avoidance behaviour, OECD guidelines include the specific inclusion in treaties of an anti-abuse clause and the setting of time limits for any tax-sparing relief (OECD 1998c).

#### 4. The IIA dimension

Traditionally, HCMs have attracted little attention in IIAs, which have instead emphasized the obligations of host countries to protect inward FDI through their standards and guarantees. But with the investment process involving home countries, it is relevant to consider if and how HCMs are—and could be—addressed in IIAs. This question has implications for the potential development impact of such agreements and for the effectiveness of various HCMs. Arguably, the stronger the policy commitments in international agreements—running along a continuum from hortatory declarations to binding obligations accompanied by detailed implementation plans (backed by financial resources) and monitoring mechanisms—the bigger the likely impact of HCMs. Just as countries see advantages in complementing unilateral efforts in trade and investment liberalization with commitments in international agreements, IIA provisions addressing HCMs could lend greater transparency, predictability and stability to the way HCMs address development concerns (UNCTAD 2001a, p. 53).

Some emerging trends may be the basis for further developments in this field. These go beyond simple general exhortations for the parties to an IIA to promote investment through appropriate measures, which may, by implication, include investment-promoting HCMs.<sup>14</sup> They encompass, first, the emergence of a cooperation process expressed through international agreements involving multiple developed and developing countries and containing specific provisions on HCMs. Second, a number of IIAs contain cooperation provisions concerning technology transfer, possibly the most common type of HCM provision in these agreements. Third, regional and multilateral investment insurance schemes (such as that of MIGA) complement national insurance schemes.

For instruments involving multiple developing country participants, the key example is the Cotonou Agreement between the EU and the ACP countries, the successor to the Fourth Lomé Convention (UNCTAD 2001c, p. 441). It includes detailed provisions related to investment promotion, investment finance and support and investment guarantees (box VI.2). Moreover, in the area of

investment protection, the Community and the ACP States affirm the need for such protection and the importance of concluding investment promotion and protection agreements, which could also provide the basis for investment insurance and guarantee schemes (Article 78). The parties also agree that special agreements on particular projects may be concluded, with the Community and

### Box VI.2. Support for investment and private sector development in the Cotonou Agreement

#### Article 74

“Cooperation shall, through financial and technical assistance, support the policies and strategies for investment and private-sector development as set out in this Agreement.”

#### Article 75: Investment promotion

“The ACP States, the Community and its Member States [...] shall:

- (a) implement measures to encourage participation in their development efforts by private investors [...];
- (b) take measures and actions which help to create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate;
- (c) encourage the EU private sector to invest and to provide specific assistance to its counterparts in the ACP countries under mutual business cooperation and partnerships;
- (d) facilitate partnerships and joint ventures by encouraging co-financing;
- (e) sponsor sectoral investment fora to promote partnerships and external investment;
- (f) support efforts of the ACP States to attract financing, with particular emphasis on private financing, for infrastructure investments and revenue-generating infrastructure critical for the private sector;
- (g) support capacity-building for domestic investment promotion agencies and institutions involved in promoting and facilitating foreign investment;
- (h) disseminate information on investment opportunities and business operating conditions in the ACP States;
- (i) promote [...] private-sector business dialogue, cooperation and partnerships [...].”

#### Article 76: Investment finance and support

“1. Cooperation shall provide long-term financial resources, including risk capital, to assist in promoting growth in the private sector and help to mobilise domestic and foreign capital for this purpose. To this end, cooperation shall provide, in particular:

- (a) grants for financial and technical assistance to support policy reforms, human resource development, institutional capacity-building or other forms of institutional support related to a specific investment, measures to increase the competitiveness of enterprises and to strengthen the capacities of the private financial and non-financial intermediaries, investment facilitation and promotion and competitiveness enhancement activities;
- (b) advisory and consultative services to assist in creating a responsive investment climate and information base to guide and encourage the flow of capital;
- (c) risk capital for equity or quasi-equity investments, guarantees in support of domestic and foreign private investment and loans or lines of credit [...];
- (d) loans from the Bank’s own resources. [...].”

#### Article 77: Investment guarantees

“[...] 2. Cooperation shall offer guarantees and assist with guarantees funds covering the risks for qualified investment. Specifically, cooperation shall provide support to:

- (a) reinsurance schemes to cover foreign direct investment by eligible investors; against legal uncertainties and the major risks of expropriation, currency transfer restriction, war and civil disturbance, and breach of contract. [...]
- (b) guarantee programmes to cover risk in the form of partial guarantees for debt financing. [...]
- (c) national and regional guarantee funds, involving, in particular, domestic financial institutions or investors for encouraging the development of the financial sector.

3. Cooperation shall also provide support to capacity-building, institutional support and participation in the core funding of national and/or regional initiatives to reduce the commercial risks for investors [...].

4. [...] The ACP and the EC will within the framework of the ACP-EC Development Finance Cooperation Committee undertake a joint study on the proposal to set up an ACP-EC Guarantee Agency to provide and manage investment guarantee programmes.”

European enterprises contributing to their financing. These provisions represent the most comprehensive instrument on HCMs concluded to date at the international level. But a careful evaluation of the implementation of these provisions (and the corresponding ones under Lomé IVbis) has still to be made. The prime instruments are the Investment Facility and Proinvest of the European Investment Bank.

Apart from the Cotonou Agreement, certain intra-regional cooperation agreements between developing countries introduce various home country commitments to promote investment in host countries party to the agreement. For example, the Treaty Establishing the Caribbean Community differentiates between the more and less developed countries among its membership, establishing a special regime for financial assistance “with a view to promoting the flows of investment capital to the Less Developed Countries” (chapter VII, article 59(1)). The Agreement on Investment and Free Movement of Arab Capital Among Arab Countries endorses a policy in article 1(a) that “Every Arab state exporting capital shall exert efforts to promote preferential investments in the other Arab states and provide whatever services and facilities required in this respect”. As a follow-up mechanism to this commitment, the Convention Establishing the Inter-Arab Investment Guarantee Corporation provides investment insurance as well as other promotional activities designed to stimulate FDI.

Provisions encouraging development-oriented transfer of technology go beyond the sharing of know-how in most development assistance programmes and require a more substantial application of technology to business operations.<sup>15</sup> Most provisions dealing with this issue have tended to be non-binding hortatory provisions (see section IV.G).

For regional, interregional and multilateral investment insurance schemes, an early and continuing example is the Convention Establishing the Inter-Arab Investment Guarantee Corporation, which established an intra-regional insurance scheme for use by investors from an Arab home country in an Arab host country. More recently, as noted, the Cotonou Agreement has reaffirmed the importance of investment guarantee insurance. To this end, the Agreement calls for the ACP-EU Development Finance Cooperation Committee to “undertake a joint study on the proposal to set up an ACP-EU Guarantee Agency to provide and manage investment guarantee programmes” (Article 77(4), Cotonou Agreement in UNCTAD 2001a, p. 38). The only multilateral instrument in this field is the MIGA Convention approved in 1988. Its objective, under Article 2, is “to encourage the flow

of investments for productive purposes among member countries, and, in particular to developing member countries”. This is done by reducing investor concerns about non-commercial risk through a multilateral investment insurance fund to arrange cover against such risk.<sup>16</sup>

## 5. Enhancing the development dimension

Greater attention in IIAs to the role of HCMs by developed countries would help incorporate the “second point” of the triangular relationship between host countries, home countries and TNCs—and enhance the development dimension of FDI.<sup>17</sup> In the WTO Working Group on Trade and Investment, for example, some developing countries put the issue on the table. It has been argued that “Home governments should undertake obligations: (1) to refrain from policies or measures that influence [TNCs] originating in their territories to have operations or behaviour in host members that are adverse to the interests of the host members; (2) to institute measures that influence and oblige [TNCs] originating in their territories to behave and operate with full corporate responsibility and accountability in their operations in host members, and to fulfil their [...] obligations to the host member and government, in accordance with the objectives and policies of the latter.”<sup>18</sup>

In a non-binding, hortatory approach a general expression of commitment to improving investment flows to developing country parties could be included, though its practical effect might be questioned. More concrete, but still non-binding, would be to link general policy language with more specific commitments to HCMs, possibly project-by-project. And commitments could be made on “soft” cooperation such as cooperative information exchange, assisted outreach to home-country business groups, FDI seminars and general education on business opportunities in developing countries.

An alternative approach is to introduce binding obligations to give assistance to host developing countries in promoting FDI. As noted, many developed countries—either unilaterally or through intermediaries—are already offering various measures. But such a step would give IIAs more balance in the distribution of rights and obligations of parties involved and could strengthen their impact as development-promoting instruments—while in most cases also serving the self-interest of home countries. In this situation, home countries would accept obligations, recognizing the real difficulties associated with turning the aspiration of host developing countries

for more investment into reality. The inclusion of obligations would seek to offset some of the locational disadvantages of developing host country parties not only through—in a defensive way—enhanced investor protection provisions of IIAs, but through proactive economic and commercial policies aimed at facilitating more and better FDI to developing countries, particularly the least developed.

Where possible, commitments should be linked to follow-up implementation programmes and specific mechanisms to monitor implementation. Practical outcomes are more likely if an agreement's general statement of policy principles is followed by provisions containing a more detailed list of measures or a specific implementation process that will translate policy into practice, including actions involving other types of HCMs. Some IIAs include for this purpose a provision for a "Supervisory Committee" to ensure the proper implementation of what has been agreed.<sup>19</sup> A forum is put in place for the future development of more specific policies of home country assistance for investment in host

developing countries. The recent decision to introduce a monitoring mechanism to implement Article 66.2 of the TRIPS Agreement is an interesting step in this direction (box IV.7). Review and monitoring through follow-up mechanisms help create an organic progression in policy development through dialogue and the sharing of common experience. Indeed, as cooperation proceeds, more "hard" commitments, involving specific or general assistance through funded programmes, could become feasible. The utility of the organic development of cooperation in this field should not be overlooked.

A further issue is whether HCMs should be directed to a particular group of developing countries, such as the LDCs, under special and differential treatment provisions. LDCs are likely to need disproportionate help from home countries in attracting FDI. One recent study identified measures that home countries can take in the short, medium and long terms to mitigate risks and unblock FDI flows to LDCs by addressing both the entry-cost and post-entry risk barriers for investors (box VI.3). The Commonwealth Secretariat has

### Box VI.3. Home country measures to mitigate risk linked to FDI in LDCs

In a study commissioned by the Government of Sweden on ways to mitigate risk associated with investing in LDCs, a number of measures were identified, some of them listed here:

#### *Short-term measures to extend risk mitigation capabilities*

- Increase funding of multilateral risk insurance agencies (such as MIGA and the political risk insurance facilities being opened up in regional banks) specifically to cover LDC political and other non-commercial risk through a special purpose capital or guarantee pool provided.
- Create more effective regional risk cover capacity either by: (a) regionalizing more effectively the operations of MIGA and transforming it into a more independent global facility; or (b) create separate MIGA-like regional multilateral political risk insurance capacity affiliated with the regional development banks.
- Increase the non-commercial risk insurance capacity of bilateral Export Credit Agencies and Official Bilateral Insurers through specific funding or subsidies for covering a much wider range of non-commercial risks in LDCs.
- Provide project-related subsidies to cover part of the premium costs for PRI or NCRI for specific projects being undertaken by OECD source country or eligible developing country firms in LDCs.

- Encourage the development of public-public partnerships between official bilateral insurers and their nascent counterparts in key developing countries that are becoming major home countries for FDI in neighbouring LDCs.
- Establish credit enhancement arrangements for mobilizing available domestic funding (in order to reduce currency risk) in developing countries (particularly LDCs).

#### *Other short-term measures to increase FDI to LDCs*

- Provide full (100%) or large partial (50–80%) tax credits, rebates or deductions for the equity invested by home country companies in LDCs against their tax liabilities in their home countries.
- Establish special-purpose "FDI-in-LDCs" investment promotion departments (with commensurate budgets) within bilateral aid or investment agencies thus ensuring that support for FDI flows would be as important a bilateral priority as any other in aid programmes. They could extend the limited capacity of LDC-IPAs by enabling them to leverage their limited resources. Their activities could include: determining investment priorities; targeting specific companies in their home countries; informing them of opportunities in LDCs; helping to finance environmental and social impact assessments; helping to prepare documentation

/...

suggested that a new facility be set up in the form of a dedicated and separate fund owned by international finance institutions but legally distinct from them. The fund would focus specifically on LDCs and other small and vulnerable economies. It would assist private investment in the production of traded goods and services in eligible States by offering domestic-currency loans, quasi-equity investment capital and guarantees—and by retailing a specially simplified form of MIGA cover for political risk (Hughes and Brewster 2002).

Dealing with HCMs is a new but potentially important aspect of how to make the evolving architecture of IIAs more development friendly.

It is by no means an easy task, especially because the degree and extent of binding commitments on the part of home countries in IIAs have been rather limited. But all developed countries have already put various HCMs in place on their own. At the multilateral level, the Doha Declaration (paragraph 22) recognizes the need for any framework to “reflect in a balanced manner the interests of home and host countries”. The same principle could apply to IIAs at other levels as well. This suggests that future IIAs should contain commitments for home country measures, building on the experience to date.

### Box VI.3. Home country measures to mitigate risk linked to FDI in LDCs (concluded)

(such as Memoranda of Understanding, Letters of Intent) and institutional capacity building in partner-IPAs.

- Explore the possibility of establishing a small special purpose LDC Infrastructure Investment Fund that would provide equity and debt financing as well as mobilize domestic currency resources for lending to infrastructure projects in LDCs.

#### *Medium-term initiatives by home countries*

- Working with multilateral partners and the private sector to develop financial systems and capital markets of LDCs more rapidly than currently envisaged.
- Bilateral aid agencies can make a unique contribution over multilateral counterparts in engaging in intensive “regulatory-partnership” arrangements between financial system regulators in particular donor countries with regulatory agencies in LDCs to ensure not only that sound laws, rules and regulations are developed, but that they are applied and enforced.
- Bilateral aid agencies can provide seed funding to encourage their non-banking institutions to establish a presence in LDC financial systems that would be shunned by the private sector.
- Bilateral donors (especially members of the EU) can do more to provide open access to their domestic consumer markets to all products of LDCs; encourage their domestic firms through favourable tax treatment or through grant support for partial cost coverage to develop supply sources so that LDCs can take advantage of the preferential access they have but are not availing of and encourage developing country investors to invest in LDCs to take advantage of privileged access to donor markets.

- Set up an International Commercial Court specifically designed to resolve disputes between LDCs (not all developing countries) and foreign investors, especially where complex infrastructure investments involving regulatory risk are concerned.

#### *Long-term options for home countries to consider*

- Providing sustained long-term institutional and human capacity building assistance for LDC accounting, legal and judicial systems to improve their performance and capacities when it comes to dealing with foreign investors swiftly, impartially and equitably. Such assistance could be provided through counterpart accounting, legal firms and judiciaries in partner donor countries through long-term partnership programmes that would be partly funded by aid.
- Providing similar support for political and broader governance institutions, that is, government machinery and ministries, especially the law and justice ministries as well as for parliament and parliamentary institutions for the effective functioning of democracy and representative civil society institutions that can exert additional checks and balances in ways that even parliamentary systems in developed countries cannot. In some LDCs it may be appropriate to take a pause in pushing through successive rounds of further economic reforms that are unlikely to work unless they can be embedded in political and judicial reform.
- Supporting the future evolution and development of political and non-commercial risk insurance capacity in their own domestic markets and in the wider regional European market through more productive public-private partnerships between official bilateral insurers and private risk insurers

Source: Mistry and Olesen 2003.

## B. Good corporate citizenship

To what extent can foreign investors themselves complement the efforts of host (and home) countries and help especially developing countries to reap maximum benefits from FDI? There has been an increasing number of international instruments on this, but most of them are voluntary. Moreover, most instruments deal with social and environmental issues, leaving economic development issues out of their scope. Indeed, there has been a notable lack of debate on issues pertaining directly to the economic development interests of developing countries.

Even so, there are rising expectations that TNCs can contribute directly to the advance of development goals as one aspect of good corporate citizenship. Such firms are expected not only to abide by the laws of the host country, but also pay greater attention to contributing to public revenues, creating and upgrading linkages with local enterprises, creating employment opportunities, raising skill levels and transferring technology. But how could IIAs contribute to enhancing such good corporate practices, especially with international treaties normally focusing on State conduct, not on the conduct of non-State actors?

### 1. The concept

With liberalization and globalization, there is a greater mutual interest for host country governments and TNCs to cooperate with each other to achieve their public and private goals. Firms benefit from the more open, market-oriented and business-friendly policy frameworks of the recent decade. Host countries expect, in return, to draw net economic and social benefits from the presence of TNCs. As these firms have transnationalized, their impact on host countries has increased. A case can be made therefore that the increased role of TNCs, as the most important actors in the global economy, should be accompanied by an increased recognition of their responsibilities towards the countries in which they operate.

The concept that captures the essence of a cooperative relationship between TNCs and their host countries, aimed at achieving a balance of public and private objectives and benefits, is good corporate citizenship. It can complement actions of developing countries and home countries to maximize the benefits of FDI, while minimizing the costs. To ensure full support, however, the content of this concept should be defined with the full involvement of all stakeholders, beginning of course with business.

Good corporate citizenship encompasses standards of business behaviour that apply to domestic companies as well as TNCs. Still, TNCs are seen to have special responsibilities (especially in developing countries) because of their economic power and because they get rights under IIAs that can go beyond those available to domestic firms and because the capacity of many host developing countries to introduce and implement certain laws is limited.<sup>20</sup> Good corporate citizenship differs from the concept of “corporate social responsibility”<sup>21</sup> in that it addresses economic aspects more explicitly.<sup>22</sup> Normally, a company is a legal entity and thus the subject of direct rights and obligations under the law. But compliance with the law is little more than a minimum standard necessary for a company’s existence and operation, especially in developing countries. Corporate citizenship commitments that extend beyond compliance with the letter of the law are particularly important to meet societal expectations, especially in the absence of fully developed legal frameworks and the capacity to enforce them.<sup>23</sup>

The discussion of how the responsibilities of companies should be defined is as old as the idea of free enterprise, evolving over time. The emergence of an increasingly diverse civil society illustrated by a growing number of interest groups in developed and developing countries confronts firms with growing societal expectations. Increasingly, companies are held responsible not only to shareholders but also to other stakeholders, including creditors, employees, consumers—and more generally to those directly or indirectly affected by their business activities (*WIR99*, chapter XII). For TNCs, the underlying intellectual foundation for good corporate citizenship is complicated by the fact that they operate in multiple societies around the world and thus have to respond to different—sometimes conflicting—expectations.

The global goals of TNCs do not always coincide with the social and developmental goals of the individual countries they operate in. In fact, the responsibility of foreign affiliates is not only to their host countries, but also to their parent firms. Yet governments welcome TNCs with the expectation that they contribute to national economic and social objectives, while benefiting from their global strategies and capabilities. TNCs, on their part, have a self-interest in maintaining a mutually supportive relationship with their host countries—to avoid revocation of their enhanced rights and freedoms. They also have a self-interest

in keeping a good reputation and the value of their brands, to prevent competitors from gaining advantages from irresponsible behaviour.

The range of issues considered under the umbrella of good corporate citizenship is broad. It includes developmental responsibilities, socio-political responsibilities, environmental protection, employment and labour relations, ensuring competition and refraining from restrictive business practices, consumer protection, corporate governance, corruption, disclosure and reporting requirements and respect for human rights (UNCTAD 2001b, pp. 4–12; OECD 2001a). But the discussion focuses on environment, human rights and labour rights, at least in developed countries.<sup>24</sup> Their dominance may be a function of the societal preferences of these countries, the emergence of influential civil society interest groups that challenge companies to engage in a dialogue on their policies and performances and the fact that globally agreed standards on these issues exist. A number of companies accept this challenge as these groups are often able to influence the decisions of consumers, business partners, financiers and employees. Even if companies do not feel responsible for certain issues, they might need to engage in a dialogue with stakeholders as to how they handle certain issues, being aware that refusing to do so might have economic consequences for their core businesses.<sup>25</sup>

There is, however, little debate about issues pertaining directly to the economic development interests of developing countries.<sup>26</sup> This is curious for at least two reasons. One, the first and foremost impact of companies is economic—after all, they are business entities. Two, this impact has increased in recent years with the expansion of FDI, particularly for developing countries (*WIR99*). The matter is complicated, however, by the fact that there is no single model for successful development. Nor is there a single internationally agreed instrument from which one could derive specific development obligations, as in human rights. But there are societal expectations about the potential developmental contributions of TNCs, not often fully captured by either competitive market disciplines or (insufficient) government regulation. The resulting governance void poses a challenge for good corporate citizenship (*WIR99*, chapter XII).

The starting point is that TNCs (like other firms) need to respect in good faith the laws of their host countries. They should not be tempted to take advantage of weak legal and administrative systems—say, by engaging in anticompetitive practices (especially restrictive business practices)

or corrupt practices.<sup>27</sup> On the contrary, they might be expected to go beyond the local law to meet important needs of host developing countries where legal norms relating to good corporate citizenship may be absent or underdeveloped.

Beyond that, TNCs can make a difference in advancing development goals by making an effort in addition to what they already do, while still serving their own corporate objectives:

- *Contributing to the public revenues of host countries.* Domestic public revenues are one of the principal sources of financing development, especially when it comes to infrastructure and basic services. Tax minimization can have serious repercussions for the development needs of host developing countries. TNCs are thus expected to abide by the spirit of a country's tax law and to meet their tax obligations in good faith—and not purposely shift revenues through abusive transfer pricing to deny the governments of taxes on income originating in their territories.<sup>28</sup> To that end, they are expected to cooperate with the tax authorities of relevant countries and provide appropriate accounting data and tax reconciliation records for tax inspections when required.
- *Creating and upgrading linkages with domestic firms.* Forging linkages between foreign affiliates and local firms—for example, through supplier and other sub-contractual relations—enhances the competitiveness of the domestic enterprise sector, especially where this is consistent with a dynamic comparative advantage. This requires a strong and long-term commitment by foreign affiliates to integrate into the local economy, source locally and increase over time the technological sophistication of their production in developing countries. An often-cited example of a proactive, long-term collaboration between public authorities, local business and TNCs has been the electronic industry cluster in Penang, Malaysia (*WIR01*). In this case, foreign affiliates also made a considerable contribution to Malaysia's exports.
- *Creating employment opportunities and raising local skills level.* In addition to employing and training people directly, TNCs that create linkages with local companies can have a multiplier effect in creating jobs and raising skill levels. Corporate commitments in these respects can generate important positive spillovers for the host economy and thus enhance its development prospects. Parent companies are also expected to cooperate to reduce negative effects that would result, for example, from decisions to close down large existing operations

(WIR99, chapter IX). This is also recognized in the OECD Guidelines.<sup>29</sup>

- *Transferring technology.* TNCs can help bring important developmental benefits to host countries by cooperating with local suppliers, private institutions and host governments in the transfer and dissemination of technologies and management skills. They can contribute to upgrading local technological capabilities through various modalities that do not put at risk their technological edge vis-à-vis competitors (WIR99, chapter VII).

There are, of course, other ways for TNCs to make a positive contribution to development. For example, they can seek to influence home country governments to open their markets more for imports from developing countries. They can help create a business-enabling environment by actively participating in public-private fora on improving investment conditions in a given country. And they can also serve on advisory panels to national governments and regional bodies.<sup>30</sup>

## 2. Its international dimension

In many respects, good corporate citizenship is linked to liberalization and globalization (Picciotto 2002). The more that companies expand their operations beyond national boundaries, the more the debate about good corporate citizenship shifts from the national level to the international. The growth of civil society groups around the globe, with enhanced means of sharing information on corporate activities, facilitates this process.

Yet the issue is not new. The ILO adopted its Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy in 1977. The purpose of the declaration (article 2) is “to encourage the positive contribution which multinational enterprises can make to economic and social progress and to minimize and resolve the difficulties to which their various operations may give rise [...]”. But the OECD Guidelines for Multinational Corporations, adopted in 1976, are probably the most comprehensive instrument for corporate citizenship issues of interest to developed and developing countries alike.<sup>31</sup> The Guidelines have been revised over the years (the latest revision dates from 2000) and adapted to reflect changing priorities (box VI.4).

Developmental standards—stressing duties of enterprises to contribute to economic and social developmental objectives, encouraging local capacity building or encouraging human capital formation, among others—can also be found in the International Chamber of Commerce Guidelines

for International Investment of 1972, as well as the World Development Movement’s Core Standards of 1999. But responsibilities on economic matters, which were prominent in the past, are receiving less attention in recent international instruments, reflecting the general tendency to leave economic matters to the discipline of market forces (WIR99; UNCTAD 2001b, p. 11).

International standards of good corporate citizenship are for the most part embodied in voluntary instruments or codes of various types, including those prepared by NGOs and individual companies. The scope, content and formality of these instruments vary considerably, especially the arrangements for monitoring compliance.<sup>32</sup> And there are few legally binding provisions, mainly because treaties normally entail binding obligations on States not firms. Even though they can also be drawn up to create obligations for individuals, the procedure for creating binding law for individuals or firms at the international level is cumbersome and uncertain (Picciotto 2002, p.16). The growing number of international conventions and declarations dealing with labour, human rights, environmental, ethical and other social issues—as well as regional efforts to harmonize relevant national laws—shows that companies are operating under clearer national and international frameworks on key good corporate citizenship issues. They are thus bound (directly or indirectly) by relevant minimum standards. This aspect is stressed in the 1999 initiative by the Secretary-General of the United Nations for “A Compact for the New Century”. The Global Compact calls on world business to embrace and enact—both in their individual corporate practices and in support of their appropriate public policies—nine universally agreed values and principles derived from United Nations instruments (Kell and Ruggie 1999).

The question is whether and how IIAs can address the issue of good corporate citizenship of TNCs in a way that combines best the interests of host developing countries and TNCs. Several approaches and instruments, direct and indirect, can be considered:

- *To enshrine good corporate citizenship principles in non-binding instruments.* The OECD Guidelines for Multinational Enterprises are an example of an inter-governmental instrument containing voluntary recommendations for TNCs. Similarly, the Asia Pacific Economic Cooperation (APEC) Non-Binding Principles contain specific provisions for investor behaviour. This “soft-law” approach offers advantages to countries that recognize the need for international standards in this area, but

are not ready to negotiate binding rules. It also offers advantages to TNCs by allowing them flexibility in adapting to different conditions and practices in developing countries, rather than being locked into one standard to be applied everywhere. Voluntary standards can be monitored through formal and informal means.

- *To link voluntary instruments to legally binding ones.* For example, countries adhering to the OECD Guidelines for Multinational Enterprises could sign a binding commitment to promote them among TNCs operating in or from their territories. The same approach was, at one point, proposed for the draft OECD Multilateral Agreement on Investment. The Joint Declaration in the Chile–EU Agreement reminds, in hortatory language, the TNCs of these countries “of their recommendation to observe the OECD Guidelines for Multinational Enterprises, wherever they operate”.
- *To prescribe that treaty benefits are granted only to investments made in accordance with the national laws and regulations of the host country.* Alternatively, a treaty can prescribe that the admission, establishment and operation of foreign investors is subject to the national laws and regulations of the host country. The model BIT used by the People’s Republic of China, for example, in article 1.1, states that “‘investment’ means every kind of asset invested by investors of one Contracting Party in accordance with the laws and regulations of the other Contracting Party in the territory of the Latter...” (UNCTAD 1996b). In this approach—reflected in the majority of BITs—good corporate citizenship issues are not explicitly mentioned in an IIA. Nor are voluntary corporate actions—an integral part of good corporate citizenship—affected. But to the extent that the laws of the countries parties to an IIA reflect certain good corporate citizenship standards, these become part of the obligations investors have to observe if they want to benefit from treaty coverage (which may even become relevant in dispute settlement procedures). As mentioned earlier, firms may even be expected to exceed the requirements of local laws. And the inclusion of this type of provision in an IIA—however indeterminate and indirect—offers guarantees to foreign investors that such

standards would need to be applied in a manner consistent with the protection standards (such as non-discrimination, fair and equitable treatment) granted in the same agreement.

- *To include a reference to the importance the parties attach to observing good corporate citizenship objectives in the preamble of IIAs.* Preambular language is not part of the operational provisions of an agreement. Instead, it reflects the context, objectives and philosophy behind it. It can therefore influence the interpretation of provisions in a manner consistent with development concerns.
- *To create mandatory procedural obligations for governments* to encourage firms to comply with substantive good corporate citizenship standards and to provide a mechanism for follow-up. This is the case with the OECD Guidelines for Multinational Enterprises.
- *To incorporate legally binding provisions into IIAs* to deal with good corporate citizenship issues. Transfer-of-technology provisions in various international agreements are examples (chapter IV.G).

Both binding and voluntary approaches have their advantages and shortcomings. The effectiveness of both approaches depends on appropriate monitoring mechanisms (which public pressure may increasingly demand). In the future, it is likely that both will be pursued in parallel or in combination with each other, on the national and international levels. IIAs cannot be expected to set out comprehensive rules for business activities. Nor can they substitute for voluntary corporate citizenship actions, NGO instruments or specific international agreements. But IIAs are the instruments that focus on the investment process, and that process involves TNCs. So IIAs could in principle address all relevant actors.

How that is done, and how far negotiations can go, is a function of the interests of the actors and the negotiating process. But in a time when the societal implications of corporate actions are receiving more attention and scrutiny, good corporate citizenship—especially when it combines the interests of host countries and firms—deserves a careful examination in future IIAs.

#### Box VI.4. The OECD Guidelines for Multinational Enterprises

##### “II. General Policies

Enterprises should take fully into account established policies in countries in which they operate and consider the views of other stakeholders. In this regard, enterprises should:

- Contribute to economic, social and environmental progress with a view to achieving sustainable development.
- Respect the human rights of those affected by their activities consistent with the host government’s international obligations and commitments.
- Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise’s activities in domestic and foreign markets, consistent with the need for sound commercial practice.
- Encourage human capital formation, in particular by creating opportunities and facilitating training opportunities for employees.
- Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental health, safety, labour, taxation, financial incentives or other issues.
- Support and uphold good corporate governance principles and develop and apply good corporate governance practices.
- Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and

mutual trust between enterprises and the societies in which they operate.

- Promote employee awareness of, and compliance with, company policies, including through dissemination of these policies, including through training programmes.
- Refrain from discriminatory or disciplinary action against employees who make *bona fide* reports to management or, as appropriate, to the competent authorities, on practices that contravene the law, the *Guidelines*, or the enterprise’s policies.
- Encourage, where practicable, business partners, including suppliers and subcontractors, to apply principles of corporate conduct compatible with the *Guidelines*.

Abstain from any improper involvement in local political activities.”

Other chapters of the Guidelines deal with disclosure, employment and industrial relations, environment, combating bribery, consumer interests, science and technology and competition and taxation. The science and technology chapter reads as follows:

“...endeavour to ensure that their activities are compatible with the science and technology (S&T) policies and plans of the countries in which they operate and as appropriate contribute to the development of local and national innovative capacity.”

Source: UNCTAD 2001c, p. 34 and p. 40; OECD 2002.

### Notes

<sup>1</sup> The stock of outward FDI from developing countries increased rapidly since the 1990s and stood at \$849 billion in 2002. (It was, however, only about a third of the inward stock of about \$2.3 trillion.) The 10 largest developing economy sources—with Hong Kong (China), Singapore, Taiwan Province of China and the Republic of Korea in the top four positions—accounted for 85% of the outward stock. Only 13 of 116 developing economies for which data are available reported outward stocks of more than \$10 billion in 2002.

<sup>2</sup> Market access regulations in home countries can affect—negatively or positively—the scope for export-oriented FDI in developing countries. Measures that inhibit domestic market access for exports from overseas facilities (such as anti-dumping regulations, countervailing measures and technical barriers to trade), or conversely grant favoured treatment to imports from selected countries, affect the comparative profitability of FDI in various developing country locations.

<sup>3</sup> Issues related to foreign affiliates themselves will be dealt with in the next section on good corporate citizenship.

<sup>4</sup> Such cases may be of particular relevance where evidence exists of a systematic abuse of fundamental labour rights or the abuse of child labour contrary to international law and international conventions.

<sup>5</sup> For example, the United States Sarbanes-Oxley Act (2001) has been passed to deal with such practices on an international level in the wake of the Enron scandal.

<sup>6</sup> To date only one case, decided in the United States in 1984, has found the parent to be liable for the wrongs of its foreign affiliates, both as a direct wrongdoer and as a result of the parent subsidiary relationship between itself and its operating subsidiaries: Amoco Cadiz (1984). In recent cases in the United Kingdom claimants have been granted the right to bring proceedings against a United Kingdom-based parent company where the host country’s courts and legal system can be shown not to be capable of ensuring that substantive justice is done to the claim (United Kingdom, House of Lords, 2000).

- 7 Assistance is provided, for example, by UNCTAD, the World Bank (MIGA and FIAS) and the World Association of Investment Promotion Agencies. The “Proinvest” programme of the EU is dedicated to making IPAs in the ACP countries more effective and efficient in attracting FDI and making FDI achieve national development objectives. One of its tasks is to link outward investment promotion agencies in Europe with IPAs in the ACP countries.
- 8 In Europe alone, there are at least 12 development finance institutions (see, for example, <http://www.edfi.be>).
- 9 The regional development banks include the African Development Bank, Asian Development Bank, Caribbean Development Bank and the Inter-American Development Bank.
- 10 MIGA was established in 1988 and works as a complement to national and regional FDI guarantee programmes as well as private insurers to issue guarantees, including co-insurance and re-insurance. Since 1990 MIGA has provided \$11 billion in coverage and has facilitated \$45.8 billion in FDI to developing countries. Other relevant World Bank institutions include the International Finance Corporation and ICSID.
- 11 A compilation by UNCTAD found only five exceptions in 1999—hence UNCTAD’s project (with the ICC) to produce such guides; see UNCTAD-ICC 2000a– Ethiopia, 2001a – Mali, 2000b – Bangladesh, 2001c – Uganda, 2001b – Mozambique, 2003–Nepal, and forthcoming – Cambodia.
- 12 For example, the Norwegian Norfund has committed 265 million kroner to 17 projects across 15 countries, many of which are in Africa, Asia and Latin America (Torp and Rekve, 2003). The Overseas Private Investment Corporation has reportedly helped host developing countries develop more than 600,000 jobs over its 30-year history and as of September 2001 was managing a portfolio of 133 active finance projects and 254 active insurance contracts. And MIGA has issued more than 500 guarantees for projects in 78 developing countries since 1988. According to the MIGA website, total coverage issued exceeded \$9 billion in June 2001, bringing the estimated amount of FDI facilitated since inception to more than \$41 billion. The agency mobilized an additional \$153 million in investment coverage in fiscal 2001 through its Cooperative Underwriting Program, encouraging private sector insurers into transactions they would not have otherwise undertaken, and helping the agency serve more clients.
- 13 The corresponding financing institutions in Denmark have 12% and of their investments in LDCs and those in Sweden 7% (Torp and Rekve 2003).
- 14 For examples of such general policy exhortations, see UNCTAD 2001a, pp. 13–18.
- 15 For a compilation of provisions in international arrangements for the transfer for technology, see UNCTAD, 2001h.
- 16 See further the MIGA website at [www.miga.org](http://www.miga.org).
- 17 Although a number of developing countries too have emerged as home countries, the principal purpose of HCMs in the context of IIAs is to enhance investment flows from developed to developing countries.
- 18 See “Investors’ and home governments’ obligations”, Communication from China, Cuba, India, Kenya, Pakistan and Zimbabwe (WTO doc. WT/WFTI/W/152).
- 19 See for example Chapter I, Article 8 of the Agreement between Japan and Singapore for a New Age Partnership (box III.2).
- 20 This raises an issue that deserves consideration, namely that private entities (primarily from developed countries) are implicitly called upon to take on functions (such as upholding certain norms) that are normally reserved for governments.
- 21 For a fuller discussion on the nature, scope and content of the corporate social responsibilities of TNCs, see *WIR99*, chapter XII, and UNCTAD 2001b.
- 22 The Monterrey Consensus (paragraph 23), adopted in 2002 by the Financing for Development Conference, uses “good corporate citizenship”. This is not to say that issues relating, for example, to the environment and social matters (such as industrial relations) are not also an integral part of development. Here, the focus is on economic issues themselves. In any event, it should be noted that that the concept does not cover corporate philanthropy as this has in a strict sense little to do with a company’s core business.
- 23 Good corporate citizenship should be distinguished from “corporate governance”, which is limited to issues of how a corporation should be structured or organized to achieve effective control over its activities in the interests of shareholders and other direct stakeholders such as employees and creditors. But corporate governance is beginning to interact with “corporate social responsibility” to the extent that the interests of indirect stakeholders—that is, groups affected by the activities of a company, but without direct economic ties to it—may seek a formal role in the organizational structure of a company.
- 24 In these areas the elaboration of good corporate citizenship standards has received increased attention in recent years, both in general instruments (such as the OECD Guidelines) as well as specialized ones developed by international and regional organizations (such as the United Nations and its specialized agencies, the OECD, international federations of business, trade unions, professional associations and individual companies). Examples of increasingly detailed and sector-specific standards are numerous (UNCTAD 2001b, g; Karl 1998). The development of corporate standards in these areas is facilitated by broadly accepted international conventions and supported by civil society groups. A current effort in this area is being undertaken by the Working Group on the Working Methods and Activities of Transnational Corporations of the Sub-Commission on the Promotion and Protection of Human Rights, see its draft “Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights” (E/CN.4/Sub.2/2002/13, annex). Several new issues are emerging in the international good corporate citizenship sphere. One is corporate governance for which standards are being clarified and strengthened in, for example, the OECD Principles of Corporate Governance (1999). The Principles aim at reinforcing the rights of minority shareholders, while giving increasing recognition to the rights of other stakeholders and stressing duties of proper reporting and consultation.
- 25 The way parts of the good corporate citizenship agenda is set may constitute a problem for policymakers in developing countries. While some standards (such as ILO labour standards) are globally

set, there is also a tendency towards the establishment of standards involving only companies or industry associations on the one hand, and NGOs on the other. Governments are sometimes bypassed when these standards are set. At the same time, however, standards negotiated without government participation might have concrete effects on where companies are locating their investments, with which suppliers they choose to do business and other decisions with a concrete bearing on a country's trade and investment performance and, ultimately, their economic development. An example of this is the United States Fair Labor Association (FLA). This body was formed by 11 leading apparel companies (including Nike, Patagonia and Liz Clairborne) as well as NGOs such as the Lawyers Committee for Human Rights and the National Consumers League. FLA members have developed a code that prohibits forced as well as child labour and supports freedom of association, minimum wages, limits on working hours and a plethora of similar rights (Garten 2002). While such codes and standards are often meant to raise and harmonize production standards in the industry worldwide, they can have side effects, too. The negotiated standards might help to divert trade and investment flows from countries that do not yet meet these standards without, however, their being involved in setting them. While some countries may benefit from such business-NGO partnership initiatives in terms of additional FDI, other countries might lose out. Thus, the emergence of these non-governmental standard setting initiatives poses a challenge to policymakers particularly in developing countries.

26 A number of companies, in their own materials, however, make reference to such matters as tax returns, local development and local business partners.

27 This is actually one of the most common commitments that TNCs make publicly; see OECD 2001b. The situation is, however, more difficult when national laws do not reflect the spirit of internationally accepted standards, such as in the case of the apartheid regime in South Africa. Good corporate citizenship would, in these cases, require different behaviour than just "playing by the rules".

28 The OECD and ISAR, for example, have guidelines concerning transfer pricing (OECD 2001b; UNCTAD/ISAR 1998). It should be noted that tax competition between countries invites TNCs to shift tax burdens across borders.

29 "Enterprises should:... In considering changes in their operations which would have major effects upon the livelihood of their employees, in particular in the case of the closure of an entity involving collective lay-offs or dismissals, provide reasonable notice of such changes to representatives of their employees, and, where appropriate, to the relevant governmental authorities, and co-operate with the employee representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects." (UNCTAD 2001c, Section IV (6)).

30 Such advisory councils exist in Malaysia, Singapore and South Africa, as well as for ASEAN. UNCTAD and the International Chamber of Commerce established an Investment Advisory Council for LDCs.

31 Other instruments were negotiated during the 1970s and early 1980s but not completed. These include the draft United Nations Code of Conduct on Transnational Corporations and the draft Code of Conduct on the Transfer of Technology. They tended to reflect the concerns of developing countries at that time.

32 For a comprehensive review of voluntary codes of conduct, their current status and prospects of future expansion and effectiveness, see Sethi 2003.

## PART TWO CONCLUSIONS

# THE CHALLENGE OF THE DEVELOPMENT DIMENSION

Most host countries conclude international investment agreements (agreements that address, at least in part, investment issues) mainly to help attract FDI to further their development. Most home countries conclude them mainly to make the regulatory framework for FDI in host countries more transparent, stable, predictable and secure—and to reduce obstacles to future FDI flows. Because the regulatory framework for FDI—at whatever level—is at best enabling whether FDI actually flows depends mainly on the economic determinants in host countries.

The number of IIAs has greatly increased in the past decade, particularly at the bilateral and regional levels, and more are under negotiation. They reflect and complement national policies which have become more welcoming to FDI. They also set parameters for national policies, putting investment at the interface of national and international policies in the globalizing world economy.

Issues relating to IIAs are coming to the fore in international economic diplomacy regardless of what will or will not happen at the multilateral level, simply because of what is happening now at both the bilateral and regional levels. But if negotiations should take place at the multilateral level, these issues will acquire even greater importance. Whether governments negotiate IIAs—and, if so, at what level and for what purpose—is their sovereign decision. This *WIR* has sought to throw light on issues that need to be considered when negotiating IIAs, seeking to clarify them from a development perspective.

What are the issues?

The most important challenge for developing countries in future IIAs is to strike a balance between the potential for IIAs to increase FDI flows and the ability of countries to pursue development-oriented FDI policies—as an expression of their right to regulate in the public interest. This requires maintaining sufficient policy space to give governments the flexibility to use such policies within the framework of the

obligations established by the IIAs they are parties to. The tension is obvious. Too much policy space reduces the value of international obligations. Too stringent obligations overly constrain the national policy space. Finding a development-oriented balance is the challenge.

When negotiating IIAs, this challenge is addressed in respect to the objectives of IIAs, their structure, content and implementation. Their content is central as the quest for a development friendly balance plays itself out in the resolution of issues that are particularly important for the ability of countries to pursue development-oriented national FDI policies and that are particularly sensitive in international investment negotiations, because countries have diverging views about them in light of their own predominating objectives.

From a development perspective, these issues are: the definition of “investment”, because it determines the scope and reach of the substantive provisions of an agreement; the scope of national treatment (especially as it relates to the right of establishment), because it determines how much and in which ways preference can be given to domestic enterprises; the circumstances under which government policies should be regarded as regulatory takings, because this involves testing the boundary line between the legitimate right to regulate and the rights of private property owners; the scope of dispute settlement, because this raises the question of the involvement of non-State actors and the extent to which the settlement of investment disputes is self-contained and the use of performance requirements, incentives, transfer-of-technology policies and competition policy, because they can advance development objectives. (Other important matters also arise in negotiations of IIAs, especially MFN, fair and equitable treatment and transparency. But these appear to be less controversial in investment negotiations.)

For each of these issues, more development friendly and less development friendly solutions exist. From the perspective of many developing countries, the preferable approach is therefore a

broad GATS-type positive list approach that allows each country to determine for itself for which of these issues to commit itself to in IIAs, under what conditions, and at what pace, commensurate with its individual needs and circumstances.

In pursuit of an overall balance, furthermore, future IIAs need to pay more attention to commitments by home countries. In fact, all developed countries (the main home countries), out of their own self-interest, already have various measures to encourage FDI flows to developing countries in place. And a number of bilateral and regional agreements contain commitments. Developing countries would benefit from making home country measures more transparent, stable and predictable in future IIAs.

TNCs too can contribute more to advancing the development impact of their investment in developing countries, as part of good corporate citizenship responsibilities, whether through voluntary action or more legally-based processes. Areas particularly important from a development perspective are contributing fully to public revenues of host countries; creating and upgrading linkages with local enterprises; creating employment opportunities; raising local skill levels; and transferring technology.

These issues are all complex. Because the potential implications of some provisions in IIAs are not fully known, it is not easy for individual countries to make the right choices. The complexities and sensitivities are illustrated by the experience of NAFTA for the regional level; that

of the MAI negotiations for the interregional level and that of the GATS and the TRIMs Agreement for the multilateral level. Given the evolving nature of IIAs, other complexities tend to arise in applying and interpreting agreements. Indeed, disputes may arise from these processes, and their outcome is often hard to predict.

That is why governments need to ensure that such difficulties are kept to a minimum. How? By including appropriate safeguards at the outset to clarify the range of special and differential rights and qualifications of obligations that developing country parties might enjoy. Moreover, the administrative burden arising from new commitments at the international level is likely to weigh disproportionately on developing countries, especially the least developed, because they often lack the human and financial resources needed to implement agreements. This underlines the importance of capacity-building technical cooperation to help developing countries assess better various policy options before entering new agreements and in implementing the commitments made.

The overriding challenge for countries is to find a development-oriented balance when negotiating the objectives, content, structure and implementation of future IIAs at whatever level and in whatever context. The development dimension has to be an integral part of international investment agreements—in support of national policies to attract more FDI and to benefit more from it.