

United Nations Conference on Trade and Development

World Investment Report

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



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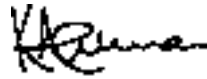
PREFACE

With its enormous potential to create jobs, raise productivity, enhance exports and transfer technology, foreign direct investment is a vital factor in the long-term economic development of the world's developing countries. Yet global investment inflows have declined significantly, from \$1.4 trillion in 2000 to \$650 billion in 2002, raising considerable concerns about prospects for achieving the Millennium Development Goals.

The World Investment Report 2003 looks in detail at what lies behind the downturn, how various regions and countries have fared, and what the chances are for recovery and growth in FDI flows at the global and regional levels.

The *Report* also assesses the interaction between national and international FDI policies and the implications this has for development. As competition for foreign direct investment increases, policies vis-à-vis transnational corporations are evolving. While national policies are the most important consideration in attracting such investment and benefiting more from it, they are increasingly being affected by rule-making at the international level. The challenge is to find a development-oriented balance.

Toward that end, the *Report* highlights some of the key issues, from the perspective of development, that need to be considered in investment agreements. Whether, how and where governments negotiate investment agreements is, of course, their own sovereign decision. But if such agreements are negotiated, the need to reduce poverty and stimulate development should take a central place as a guiding principle of such negotiations. Only then will we be able to say that investment can truly achieve its objectives.



Kofi A. Annan

Secretary-General of the United Nations

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OVERVIEW

FDI FALLS AGAIN—UNEVENLY

Global FDI flows fall again in 2002 amid weak economic performance.

Global FDI inflows declined in 2002 for the second consecutive year, falling by a fifth to \$651 billion—the lowest level since 1998. Flows declined in 108 of 195 economies. The main factor behind the decline was slow economic growth in most parts of the world and dim prospects for recovery, at least in the short term. Also important were falling stock market valuations, lower corporate profitability, a slowdown in the pace of corporate restructuring in some industries and the winding down of privatization in some countries. A big drop in the value of cross-border mergers and acquisitions (M&As) figured heavily in the overall decline. The number of M&As fell from a high of 7,894 cases in 2000 to 4,493 cases in 2002—and their average value, from \$145 million in 2000 to \$82 million in 2002. The number of M&A deals worth more than \$1 billion declined from 175 in 2000 to only 81 in 2002—again, the lowest since 1998.

For the largest transnational corporations (TNCs) most indicators of the size of their foreign operations declined slightly in 2001 (the latest year for which data are available), the beginning of the FDI downturn. Despite the burst of the bubble in the information and communication technology market, there has been no significant shift in the industrial composition of FDI—nor in the ranking of the world's top 100 TNCs, the top 50 TNCs from developing countries and the top 25 TNCs from Central and Eastern Europe (CEE).

The decline in FDI in 2002 was uneven across regions and countries. It was also uneven sectorally: flows into manufacturing and services declined, while those into the primary sector rose. The equity and intra-company loan components of FDI declined more than reinvested earnings. FDI entering host economies through M&As went down more than that through greenfield projects.

Geographically, flows to developed and developing countries each fell by 22% (to \$460 billion and \$162 billion, respectively). Two countries, the United States and the United

Kingdom, accounted for half of the decline in the countries with reduced inflows. Among developing regions, Latin America and the Caribbean was hit hard, suffering its third consecutive annual decline in FDI with a fall in inflows of 33% in 2002. Africa registered a decline of 41%; but after adjusting for the exceptional FDI inflows in 2001, there was no decline. FDI in Asia and the Pacific declined the least in the developing world because of China, which with a record inflow of \$53 billion became the world's biggest host country. CEE did the best of all regions, increasing its FDI inflows to a record \$29 billion.

The main developments by region were:

- There was a sizable decline in FDI inflows to developed countries, accompanying a continuing slowdown in corporate investment, declining stock prices and a slowdown in the consolidation of activities in some industries—all influenced by weak economic conditions. In several countries, repayments of intra-company loans contributed to lower FDI flows. For instance, a large part of the decline in the United States was due to repayments of loans by foreign affiliates to parent companies, presumably to take advantage of the lower interest rates in the United States as well as for other reasons (such as improving the debt-to-equity ratio of parent firms). The most notable feature of the decline in FDI in the developed countries was the plunge in cross-border M&As, especially in the United States and the United Kingdom. In all, FDI inflows declined in 16 of the 26 developed countries. Australia, Germany, Finland and Japan were among the countries with higher FDI inflows in 2002.

FDI outflows from the developed countries also declined in 2002 to \$600 billion; the fall was concentrated in France, the Netherlands and the United Kingdom. Outflows from Austria, Finland, Greece, Norway, Sweden and the United States increased. In both outflows and inflows Luxembourg headed the list of largest host and home countries (for special reasons). The prospects for 2003 depend on the strength of the economic recovery, investor confidence

and a resumption of cross-border M&As. With many TNCs continuing to follow cautious growth and consolidation strategies, M&As are not yet showing much dynamism. As a group, developed countries are not likely to improve their FDI performance in 2003.

- Africa suffered a dramatic decline in FDI inflows—from \$19 billion in 2001 to \$11 billion in 2002, largely the result of exceptionally high inflows in 2001 (two M&As in South Africa and Morocco, not repeated in 2002). Flows to 23 of the continent's 53 countries declined. FDI in the oil industry remained dominant. Angola, Algeria, Chad, Nigeria and Tunisia accounted for more than half the 2002 inflows. Only South African enterprises made significant investments abroad. Oil exploration by major TNCs in several oil-rich countries make the 2003 outlook for FDI inflows more promising.
- The Asia-Pacific region was not spared, either, from the global decline in FDI inflows in 2002. FDI inflows to the region declined for the second consecutive year—from \$107 billion in 2001 to \$95 billion, uneven by subregion, country and industry. All subregions, except Central Asia and South Asia, received lower FDI flows than in 2001. Flows to 31 of the region's 57 economies declined. However, several countries received significantly higher flows. Intra-regional investment flows, particularly in South-East Asia and North-East Asia, remained strong, partly as a result of the relocation of production activities, expanding regional production networks and continued regional integration efforts. FDI in the electronics industry continued to decline due to the rationalization of production activities in the region and adjustments to weak global demand. While long-term prospects for an increase in FDI flows to the region remain promising, the short-term outlook is uncertain.
- In Latin America and the Caribbean, FDI flows declined for the third consecutive year, from \$84 billion in 2001 to \$56 billion, affecting all subregions and 28 of the region's 40 economies. Factors specific to the region contributed to this decline, especially the acute economic crisis in Argentina and economic and political uncertainty in some other countries. The services sector was affected most by the decline. Manufacturing FDI proved to be quite resilient, with barely any change, despite the slowdown from the region's major export destination, the United States, and the growing relocation of labour-intensive activities to Asia. FDI is expected to remain at the same level in 2003 and to start rising thereafter.

- CEE again bucked the global trend by reaching a new high of \$29 billion in FDI inflows, compared to \$25 billion in 2001. That increase masked divergent trends, however, with FDI falling in 10 countries and rising in 9. FDI flows varied across industries as well, with the automobile industry doing quite well, and the electronics industry facing problems. There was also a tendency of firms (including foreign affiliates) in several CEE countries, particularly those slated for accession to the EU, to shed activities based on unskilled labour and to expand into higher value-added activities, taking advantage of the educational level of the local labour force. Led by a surge of flows into the Russian Federation, and fuelled by the momentum of EU enlargement, the region's FDI inflows are likely to increase further in 2003. Of the two factors determining this trend, the surge of FDI into the Russian Federation seems to be more fragile in the medium and long term than the spur of EU enlargement. In the short term, however, both factors are helping overcome the impact of the completion of privatization programmes and the slowdown of GDP growth expected in some key CEE countries.

UNCTAD's Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size, calculated as the ratio of the country's share in global FDI inflows to its share in global GDP. The Index for 1999–2001 indicates that Belgium and Luxembourg remained the top performer. Of the top 20 performers, 6 are industrialized, 2 are mature East-Asian tiger economies, 3 are economies in transition and the remaining 9 are developing economies, including three from sub-Saharan Africa. UNCTAD's 1999–2001 Inward FDI Potential Index, measuring the potential—based on a set of structural variables—of countries in attracting FDI, indicates that 16 of the 20 leading countries are developed countries and four of them, mature East-Asian tiger economies.

Many industrial, newly industrializing and advanced transition economies are in the *front-runner* category (with high FDI potential and performance), while most poor (or unstable) economies are in the *under-performer* category (with both low FDI potential and performance). Economies in the *above-potential* category (with low FDI potential but strong FDI performance) include Brazil, Kazakhstan and Viet Nam. Economies in the *below-potential* category (with high FDI potential but low FDI performance) include Australia, Italy, Japan, Republic of Korea, Taiwan Province of China and the United States.

Prospects remain dim for 2003, but should improve thereafter.

All in all, UNCTAD predicts that FDI flows will stabilize in 2003. Flows to the developing countries and developed countries are likely to remain at levels comparable to those in 2002, while those to CEE are likely to continue to rise. In the longer run, beginning with 2004, global flows should rebound and return to an upward trend. The prospects for a future rise depend on factors at the macro-, micro- and institutional levels.

The fundamental economic forces driving FDI growth remain largely unchanged. Intense competition continues to force TNCs to invest in new markets and to seek access to low-cost resources and factors of production. Whether these forces lead to significantly higher FDI in the medium term depends on a recovery in world economic growth and a revival in stock markets, as well as the resurgence of cross-border M&As. Privatization may also be a factor. FDI policies continue to be more favourable, and new bilateral and regional arrangements could provide a better enabling framework for cross-border investment.

Findings of surveys of TNCs and investment promotion agencies (IPAs) carried out by UNCTAD and other organizations paint an optimistic picture for the medium term. IPAs in developing countries are far more sanguine than their developed world counterparts. Developing countries are also expected to be more active in outward FDI. IPAs expect greenfield investment to become more important as a mode of entry, especially in developing countries and CEE. Tourism and telecom are expected to lead the recovery.

Government policies are becoming more open, involving more incentives and focused promotion strategies...

Facing diminished FDI inflows, many governments accelerated the liberalization of FDI regimes, with 236 of 248 regulatory changes in 70 countries in 2002 facilitating FDI. Asia is one of the most rapidly liberalizing host regions. An increasing number of countries, including those in Latin America and the Caribbean, are moving beyond opening to foreign investment to adopting more focused and selective targeting and promotion strategies.

Financial incentives and bidding wars for large FDI projects have increased as competition intensified. IPAs, growing apace in recent years, are devoting more resources to targeting greenfield investors and to mounting after-care services for existing ones.

... as well as participation in more investment and trade agreements.

More countries are concluding bilateral investment treaties (BITs) and double taxation treaties (DTTs), as part of a longer trend, and not solely in response to the FDI downturn. In 2002, 82 BITs were concluded by 76 countries, and 68 DTTs by 64 countries. Many countries are concluding BITs with countries in their own region to promote intra-regional FDI. Asian and Pacific countries, for instance, were party to 45 BITs, including 10 signed with other countries in that region.

There has also been an increase in the number of trade and investment agreements. Many recent trade agreements address investment directly—or have indirect implications for investment, a trend conspicuously different from earlier regional and bilateral trade agreements. The largest number in developed countries were concluded by the EU, mainly involving partners in CEE and Mediterranean countries. The EU enlargement through the accession of 10 new members in 2004 and the forthcoming negotiations of ACP-EU Economic Partnership Agreements might also have an impact on FDI in the respective regions.

In Asia and the Pacific, the number of such agreements has increased rapidly—to improve competitiveness, attract more FDI and better meet the challenges emanating from heightened competition. ASEAN is taking the lead. In Latin America and the Caribbean, NAFTA has been the most prominent example, leading to increased FDI flows especially into the assembly of manufactured goods for the United States market. The Free Trade Area of the Americas, now under negotiation, could expand market access, promoting efficiency-seeking FDI. In Africa, progress towards the creation of functioning free trade and investment areas has been slow, though several agreements, mostly subregional, have been concluded. AGOA (not a free trade agreement but a unilateral preference scheme) holds some promise for the expansion of trade and investment in the region.

For the EU-accession countries of CEE, a policy challenge is to harmonize FDI regimes with EU regulations, with the twin aims of conforming to EU regulations and maximizing the potential benefits from EU instruments, such as regional development funds. Successful adjustment to EU membership in the accession countries will also depend on their ability to establish and develop the institutional framework required to administer and properly channel the variety of funds available from European Community sources for assisting

economic development. The non-accession countries face the challenge of updating and modernizing their FDI promotion to optimize the potential benefits being on a “new frontier” for efficiency-seeking FDI—by attracting firms choosing to switch to lower cost locations within CEE.

Converging patterns of FDI links and investment and trade agreements are generating mega blocks.

The global stock of FDI, owned by some 64,000 TNCs and controlling 870,000 of their foreign affiliates, increased by 10% in 2002—to more than \$7 trillion. Technology payments, mostly internal to TNCs, held steady in 2001 despite the near halving of FDI flows. Value added by foreign affiliates in 2002 (\$3.4 trillion) is estimated to account for about a tenth of world GDP. FDI continues to be more important than trade in delivering goods and services abroad: global sales by TNCs reached \$18 trillion, as compared with world exports of \$8 trillion in 2002. TNCs employed more than 53 million people abroad.

The developed world accounts for two-thirds of the world FDI stock, in both ownership and

location. Firms from the EU have become by far the largest owners of outward FDI stock, some \$3.4 trillion in 2002, more than twice that of the United States (\$1.5 trillion). In developing countries, the inward FDI stock came to nearly one-third of GDP in 2001, up from a mere 13% in 1980. Outward FDI stocks held by developing countries have grown even more dramatically, from 3% of their GDP in 1980 to 13% in 2002.

Over time, the concentration of outward and inward FDI in the Triad (EU, Japan and the United States) has remained fairly stable. By 2002 the pattern of DTTs was quite similar to the Triad pattern of FDI flows, while the pattern of BITs had a weaker resemblance. For both BITs and DTTs, the Triad’s associate partners (countries with more than 30% of their FDI with a Triad member) score higher than non-associate partners. This suggests that the “economic space” for Triad members and their developing country associates is being enlarged from national to regional—and that treaties are making investment blocks stronger. The emerging nexus of mutually reinforcing trade and investment agreements may be providing gains for the developing countries that are “insiders” in such mega blocks.

ENHANCING THE DEVELOPMENT DIMENSION OF INTERNATIONAL INVESTMENT AGREEMENTS

Countries seek FDI to help them grow and develop. Their national policies are key to attracting FDI and increasing its benefits.

To help attract FDI, countries increasingly conclude IIAs ...

Countries conclude international investment agreements (IIAs)—at the bilateral, regional and multilateral levels—for various reasons. For most host countries, it is mainly to help attract FDI. For most home countries, it is 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. In either case, the regulatory framework for FDI, at whatever level, is at best enabling. Whether FDI flows actually take place depends in the main on economic determinants.

The number of IIAs, especially at the bilateral and regional levels, has greatly increased in the past decade, reflecting the importance of FDI in the world economy (see Part One of this *WIR*).

At the bilateral level, the most important instruments are bilateral investment treaties (BITs) and double taxation treaties (DTTs), with 2,181 BITs and 2,256 DTTs signed by the end of 2002. BITs are primarily instruments to protect investors, although recent agreements by a few countries also have more of a liberalizing effect. (They are not concluded between developed countries.) They cover an estimated 7% of the stock of world FDI and 22% of the FDI stock in developing and CEE countries. DTTs are primarily instruments to address the allocation of taxable income, including to reduce the incidence of double taxation. They cover some 87% of world FDI and some 57% of FDI in developing and CEE countries.

Although a few regional agreements deal exclusively with investment issues, the trend so far has been to address such issues in trade agreements. (The same applies to bilateral trade agreements.) In effect, free trade agreements today are often also free investment agreements.

At the multilateral level the few agreements that exist deal with specific investment-related issues (such as trade-related investment measures, insurance, dispute settlement, social policy matters) or they are sectoral (such as the General Agreement on Trade in Services (GATS)). There is no comprehensive multilateral agreement for investment, although issues pertaining to such an idea are currently being discussed in the WTO.

Overall, the growth in the number of IIAs and their nature reflect the fact that national policies in the past decade have become more welcoming to FDI. During 1991–2002, 95% of 1,641 FDI policy changes had that effect.

Issues relating to IIAs are therefore coming to the fore in international economic diplomacy. This is so irrespective of what will or will not happen at the multilateral level, simply because of what *is* happening *now* at 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, at what level and for what purpose is their sovereign decision. The objective of this *WIR* is simply to throw light on a range of issues that needs to be considered when negotiating IIAs, seeking to clarify them from a development perspective (and regardless of the outcome of the ongoing multilateral investment discussions).

Almost by definition, IIAs affect, to a greater or lesser extent, the regulatory framework for FDI, depending on their exact content. As a rule, they tend to make the regulatory framework more transparent, stable and predictable—allowing the economic determinants to assert themselves. The expectation is that, if the economic determinants are right, FDI will increase. In that respect, therefore, IIAs can influence FDI flows when they affect their determinants.

... which, by their nature, entail a loss of national policy space.

Experience shows that the best way of attracting FDI and drawing more benefits from it is not passive liberalization alone. Liberalization can help get more FDI. But it is certainly not enough to get the most from it. Attracting types

of FDI with greater potential for benefiting host countries (such as FDI in technologically advanced or export oriented activities) is a more demanding task than just liberalizing FDI entry and operations. And, once countries succeed in attracting foreign investors, national 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, better protect the environment and consumers and so on. They can also counter the potential dangers related to FDI. For example, they can contain anticompetitive practices and prevent foreign affiliates from crowding out viable local firms or acting in ways that upset local sensitivities. The instruments needed to put these policies in place tend to be limited—or excluded altogether—by entering into IIAs.

The challenge for developing countries is to find a development-oriented balance...

What are the issues?

For developing countries, the most important challenge in future IIAs is to strike a balance between the potential contribution of such agreements to increasing FDI flows and the preservation of the ability to pursue development-oriented FDI policies that allow them to benefit more from them—that is, the 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 to which they are parties. The tension this creates is obvious. Too much policy space impairs the value of international obligations. Too stringent obligations overly constrain national policy space. Finding a development-oriented balance is the challenge—for the objectives, structure, implementation and content of IIAs.

... when negotiating the objectives, structure and implementation of IIAs...

Many IIAs incorporate the objective of development among their basic purposes or principles, as a part of their preambular statements or as specific declaratory clauses articulating general principles. The main advantage of such provisions is that they may assist in the interpretation of substantive obligations, permitting the most development friendly interpretation. This promotes 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.

The structure of agreements may reflect development concerns through special and differential treatment for developing country parties. This entails differences in the extent of obligations of developed and developing country parties, with the latter assuming, either temporarily or permanently, less onerous obligations that are also non-reciprocal. Particularly important is the approach to determine the scope of commitments.

- Under a “negative list” approach, countries agree on a series of general commitments and then list, individually, all the areas these commitments do not apply to. This approach tends to produce an inventory of non-conforming measures. It also increases predictability because it locks in the status quo.
- Under a (GATS-type) “positive list” approach, countries list commitments they agree to make and the conditions they attach to them. This approach has the advantage that countries can make commitments at their own pace and determine the conditions for doing this. 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 making commitments—when concluding an agreement. In practice, it is unlikely that developing countries would have all the information necessary to make the necessary judgments at the time of concluding agreements. As a result, the negative list approach might involve greater liberalization than countries may wish to commit themselves to start with. But even a positive list approach can lead to significant liberalization—because in practice, negotiations generate pressures on countries to assume higher and broader commitments. And once a commitment has been made, it is difficult to reverse it.

The implementation of IIAs can also be designed with flexibility for development as the 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. So, development-oriented provisions could be either legally binding or hortatory, depending on how much the parties are willing to undertake commitments.

- The asymmetries between developed and developing country parties to IIAs can be tackled by commitments of the developed country parties to provide assistance to the developing parties, especially LDCs. An example is the TRIPS Agreement, in which developed countries have made commitments to facilitate technology transfer to LDCs. Also relevant here is the wider issue of home country commitments to promote the flow of FDI to developing countries, perhaps complemented by provisions for technical assistance through relevant international organizations. These are important, given the complexity of the subject matter and the limited capacity of many developing countries, especially LDCs, to fund FDI-related policy analysis and development and for human and institutional development. Institutional development also involves assistance to developing countries to attract FDI and benefit more from it.

... and especially their content ...

The quest for a development friendly balance plays itself out most importantly in the negotiations of the content of IIAs. Central here is 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.

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 what ways preferences can be given to domestic enterprises.
- The circumstances under which government policies should be regarded as regulatory takings, because it 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.

- 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 for IIAs, especially most-favoured-nation treatment, fair and equitable treatment and transparency. But these appear to be less controversial.

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 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. All developed countries (the main home countries) already have various measures to encourage FDI flows to developing countries in place. And a number of bilateral and regional agreements contain such 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 investments 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.

... by making development objectives an integral part of international investment agreements.

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. In short: the development dimension has to be an integral part of international investment agreements—in support of policies to attract more FDI and to benefit more from it.



Rubens Ricupero
Secretary-General of UNCTAD

Geneva, July 2003