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THE REIO EXCEPTION IN MFN TREATMENT CLAUSES

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NOTE

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The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

A blank in a table indicates that the item is not applicable;

A slash (/) between dates representing years, e.g. 1994-1995, indicates a financial year;

Use of a hyphen (-) between dates representing years, e.g. 1994-1995, signifies the full period involved, including the beginning and end years.

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PREFACE

The secretariat of the United Nations Conference on Trade and Development (UNCTAD) is implementing a programme on international investment arrangements. It seeks to help developing countries to participate as effectively as possible in international investment rule-making. The programme embraces policy research and development, including the preparation of a Series of issues papers; human resources capacity-building and institution-building, including national seminars, regional symposia, and training courses; and support to intergovernmental consensus-building, as well as dialogues between negotiators and groups of civil society.

This paper is part of a new Series on International Investment Policies for Development. It builds on, and expands, UNCTAD's Series on Issues in International Investment Agreements. Like the previous one, this new series is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers.

The Series seeks to provide a balanced analysis of issues that may arise in the context of international approaches to investment rule-making and their impact on development. Its purpose is to contribute to a better understanding of difficult technical issues and their interaction and of innovative ideas that could contribute to an increase in the development dimension of IIAs.

The Series is produced by a team led by Karl P. Sauvant and James Zhan. The members of the team include Victoria Aranda, Anna Joubin-Bret, Federico Ortino, Elisabeth Tuerk and Jörg Weber. Members of the Review Committee are Mark Koulen, Antonio Parra, Patrick Robinson, Pierre Sauvé, M. Sornarajah and Kenneth Vandevelde. The Series' principal advisor is Peter Muchlinski.

The present paper is based on a manuscript prepared by Joachim Karl. The final version reflects comments and inputs from Padma Mallampally and Martin Roy.

Carlos Fortin
Geneva, September 2004 Officer-in-Charge of UNCTAD

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UNCTAD has carried out a number of activities related to the work programme in cooperation with other intergovernmental organizations, including the Agence pour la Francophonie, Banco Centroamericano de Integración Económica, CARICOM Secretariat, German Foundation for Development, Inter-Arab Investment Guarantee Corporation, Inter-American Development Bank (BTD/INTAL), League of Arab States, Organization of American States, Secretaria de Integración Económica Centroamericana and the Secretaria General de la Comunidad Andina. UNCTAD has also cooperated with non-governmental organizations, including the Centre for Research on Multinational Corporations, the Consumer Unity and Trust Society (India), the Dutch Foundation for Research on Multinationals (SOMO) (the Netherlands), the Economic Research Forum (Egypt), the European Roundtable of Industrialists, the Friedrich Ebert Foundation (Germany), the German Foundation for International Development, the International Confederation of Free Trade Unions, the Labour Resource and Research Institute (LaRRI) (Namibia), Oxfam, the Third World Network and World Wildlife Fund International. Since 2002, a part of the work programme has been carried out jointly with the World Trade Organization (WTO).

Funds for the work programme have so far been received from Australia, Brazil, Canada, France, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the European Commission. Argentina, Botswana, China, Colombia, Costa Rica,

Croatia, Cuba, Czech Republic, Djibouti, Egypt, Gabon, Germany, Guatemala, India, Indonesia, Jamaica, Malaysia, Mauritania, Mexico, Morocco, Namibia, Pakistan, Peru, Qatar, Singapore, South Africa, Sri Lanka, Thailand, Trinidad and Tobago, Tunisia, Venezuela and Yemen have also contributed to the work programme by hosting regional symposia, national seminars or training events.

In pursuing this programme of work, UNCTAD has also closely collaborated with a number of international, regional and national organizations, particularly with the Centro de Estudios Interdisciplinarios de Derecho Industrial y Económico (the Universidad de Buenos Aires), the Indian Institute of Foreign Trade, the Legon Centre of Accra (Ghana), ProInversión (Peru), Pontificia Universidad Católica del Perú, the National University of Singapore, Senghor University (Egypt), the University of Dar Es Salaam (Tanzania), the University de Los Andes (Colombia), the University of Campinas (Brazil), the University of Lima (Peru), the Universidad del Pacífico (Peru), the University of Pretoria (South Africa), the University of Tunis (Tunisia), the University of Yaoundé (Cameroon), the Shanghai WTO Affairs Consultation Center (China) and the University of the West Indies (Jamaica and Trinidad and Tobago). All of these contributions are gratefully acknowledged.

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EXECUTIVE SUMMARY

The possible effects of a regional economic integration organisation (REIO) exception in international investment agreements (IIAs) is an issue that has arisen in the context of bilateral, regional and multilateral arrangements. Such a provision excludes the applicability of the principle of most-favoured-nation (MFN) treatment with regard to preferential treatment that members of a REIO grant other REIO members and their investors. While REIO members defend this clause as indispensable for the pursuit of their internal investment policies, including possible future integration measures, non-REIO countries are concerned that it might undermine the principle of non-discrimination as one of the essential rights in IIAs. In particular, developing countries may be concerned about the particular effects of such an exception upon their ability to benefit from membership of IIAs.

To pursue their economic integration in the investment field, REIO member countries agree upon an internal investment regime. Common rules may likewise exist concerning external relations with third countries and their investors, although in most cases it is the individual REIO member that sets the entry conditions for investors from outside the region. Many REIOs pursue, in general, an open door policy in relation to investors of non-REIO member countries. This does not exclude that REIO members continue to maintain some restrictions for foreign investors, either for investors of any foreign country or for investors of non-REIO members only. In the latter case there is a risk of investment distortion to the detriment of investors from outside the region.

REIOs show various degrees of integration in investment matters, ranging from a pure political commitment to closer, legally binding forms of cooperation. It may be based on the principle of non-discrimination (MFN treatment and/or national treatment), include a right of establishment for investors of REIO members, and amount to full economic integration in the form of a common market with an institutional component.

When a REIO member undertakes an unconditional obligation to grant MFN treatment in an IIA with a third country, it would have to extend the benefits of the REIO investment regime to investors of that third country. Whether it is willing to accept this outcome would seem to depend on the relationship between, on the one hand, the degree of internal integration in investment matters in the REIO and, on the other, the degree of investment liberalization established in the IIA. The request for a REIO exception in IIAs may be linked to the question of whether the investment regime of a REIO and an IIA are symmetric or asymmetric. This means that, the more liberalized the investment regime in the REIO is, the more difficult it may become for REIO members to provide similar treatment unilaterally to investors from outside the region.

The differences in the level of integration between the REIO regime and the IIA may also have a vital impact on the kind of exception the members of a REIO might seek in an IIA. The more the internal treatment granted to investors of other REIO members resembles the standard of treatment in a given IIA, the more likely it may be that remaining differences in treatment could be reflected in individual country-specific exceptions. For instance, if both investment regimes are based on the MFN principle and the principle of national treatment, REIO members might be satisfied with this type of exception to reflect the fact that amongst themselves the national treatment principle applies fully, whereas some individual restrictions apply to investors from outside the region. By contrast, a more general REIO exception might be demanded if the investment regimes of the REIO and a given IIA follow substantially different integration concepts (e.g. national treatment within the REIO; only MFN treatment in the IIA). In this case, it would be difficult to capture the existing asymmetry in individual country-specific exceptions.

Asymmetries between investment regimes may exist independently of the actual policies that a REIO and its members pursue concerning foreign direct investment (FDI) from third countries. Even if a REIO were completely open to investors of non-

REIO member countries, it might have an interest that this openness is not made into a legal obligation in an IIA (e.g. by committing itself to extend the REIO-internal standard of national treatment to investors of non-REIO member countries) as long as the contracting parties not being REIO members do not have the same obligation. On the other hand, the inclusion of a REIO exception in IIAs does not necessarily mean that REIO members would actually make use of it and discriminate against investors of non-REIO member countries.

IIAs involving REIO members usually contain a REIO exception. However, there is no common approach towards the content of a REIO clause. REIO exceptions differ substantially with regard to such fundamental questions as to what kind of regional organizations should be covered, and under what conditions REIO members may have recourse to this provision. Often, REIO exceptions are drafted in such a broad and open-ended manner that they result in considerable ambiguity about their legal consequences. Some recent IIAs have, however, introduced a number of permissibility requirements with a view to render the scope, content and effect of a REIO exception more precise. In particular, some legal safeguards for investors of non-REIO member countries have been included, such as the requirement that the REIO must not raise the overall level of barriers to investment from outside the region.

These individual examples could constitute steps towards finding a broad international consensus on the treatment of REIOs in IIAs. However, given the fact that the REIO exception touches upon one of the most fundamental concepts in international investment law – the MFN principle – additional efforts seem to be necessary towards clarifying the issue of a REIO exception in IIAs. In this context, it seems that future negotiators of IIAs would have to make a number of critical decisions. These include an assessment about the extent to which decisions about REIO clauses in IIAs should/could be guided by experiences with existing REIO clauses in trade agreements.

At the outset, negotiators might have to assess whether there is a need for a REIO exception at all. This depends on whether or not they can identify certain investment-related benefits or advantages in regard to which they would agree that the MFN principle should not apply. Thereafter, they would need to decide whether such privileges should be covered by a generic REIO exception or whether it would be sufficient to take individual, country-specific exceptions with regard to certain economic sectors or activities. Contrary to a generic REIO clause, the latter approach would not be a REIO-specific method of taking exceptions, but it would be available to any party to the IIA.

If the REIO and its members choose the first alternative, they may wish to clarify the content and the effects of the REIO exception as far as possible. For this purpose, they could, for instance, agree upon a definition of the REIO, the scope of the non-applicability of the MFN principle, and the requirements under which recourse to the REIO exception is permissible. Furthermore, they could address the issue of a possible modification of the REIO's internal investment regime – including the adherence of new REIO members – after conclusion of an IIA and its consequences for the obligations of REIO member countries vis-à-vis the other contracting parties. On the whole, a balance would need to be found between the legitimate interests of a REIO and its members that an IIA does not jeopardize their internal economic integration, and the equally legitimate interest of non-REIO member countries in a fair and predictable framework for foreign investment in which all contracting parties basically share the same rights and obligations.

INTRODUCTION

One of the fundamental rules in international investment matters is the principle of most-favoured-nation treatment. It obliges host countries not to treat investors of any particular foreign country less favourably than investors of any other foreign country. Most international investment agreements include such a clause (for more details, see UNCTAD, 1999a). At the same time, countries worldwide seek closer regional integration through the creation of free trade areas, customs unions, economic or monetary unions, or even political unions.[1] This may cover different economic activities, such as trade, services, and capital movements, including foreign investment. Regional integration may imply privileging investors of other REIO members when they make an investment in the region, or after they have established themselves therein. In practice, it appears that such privileges are often confined to pre-establishment (or market access) treatment.[2]

Most REIOs covering investment issues limit themselves the establishment of an internal investment regime, thereby leaving it up to individual REIO members on how they want to deal with outside investors. This means that REIO members have, in principle, the possibility to extend the benefits of REIO membership to investors of third countries making an investment in their territory, unless the REIO itself decides otherwise.

Preferential treatment of investors of REIO members could be in conflict with the MFN principle. However, given the potential benefits of regional integration, the international community has long since allowed REIOs and their members to deviate from the MFN standard if certain conditions are fulfilled. In the area of international trade in goods, the relevant provision is Article XXIV of the 1947 General Agreement on Tariffs and Trade (GATT). It permits members of a free trade area or customs union to grant themselves preferential treatment, provided that (a) the purpose of the REIO is to facilitate internal trade, and (b) the REIO does not create new trade barriers for importers from outside its territory. The provision allowing such deviation from the MFN principle is usually referred to as a “REIO

exception" or "REIO clause". Although originally a trade issue, the REIO exception has likewise made its way into IIAs.

Supporters of a REIO clause claim that without this provision the integration policies within the REIO would be jeopardized. A REIO exception would be needed, because otherwise investors of non-REIO member countries could unilaterally claim the benefits of the internal investment regime. This would distort the mutual balance of commitments and create a politically unacceptable "free rider" position by which non-members could take the benefits accruing to members of the organization but not the obligations of membership. In addition, an unconditional MFN commitment would weaken the position of a REIO and its members in future negotiations of an IIA with third countries. If investors of non-REIO members could automatically claim the benefits of the internal investment regime, including possible future liberalization steps, their home countries would loose any incentive to grant investors of REIO members reciprocal advantages. REIO members could not expect that these "free riders" grant similar benefits on a voluntary basis, and would therefore give up an important bargaining chip.

Conversely, opponents of a REIO clause in IIAs argue that it would be against the spirit of multilateralism, as embodied in the MFN principle, to allow for privileged treatment of investors of members of a particular region. The REIO exception would defeat the very purpose of any IIA – namely to create legal stability and predictability for the contracting parties, and equal rights and obligations.

One major difficulty in this context derives from the fact that both the MFN principle and the existing REIO exceptions typically have a very broad scope. Moreover, there is considerable confusion about the relationship between a REIO exception in IIAs and the actual investment policies that a REIO and its members pursue vis-à-vis investors of non-REIO members. Another difficulty is how to identify the investors from outside a REIO to which the REIO benefits would not apply.[3] An investing parent company, organized and located

outside the REIO territory, may nevertheless be owned or controlled by nationals of REIO member states (Karl, 1996, p. 26). Another question would arise if a foreign company incorporates a subsidiary in order to gain access to the benefits offered within the REIO (box 1).

Box 1. REIO exceptions and non-REIO investors: the potential to avoid adverse impact

One might assume that in a situation in which – by virtue of a REIO exception clause – REIO investors are entitled to better treatment than non-REIO investors,[a] a non-REIO investor may avoid this adverse impact by establishing an affiliate in a REIO member. This could allow a non-REIO investor to become a REIO investor and enjoy the benefits offered within the REIO. Although in some circumstances such an approach may indeed be feasible, in many cases a non-REIO investor may face certain problems in implementing it.

For example, the non-REIO investor might simply not enjoy a right of establishment in any of the REIO members, thus potentially facing difficulties when seeking to incorporate in a REIO member in the first place. Second, even if the establishment in one of the REIO members is possible, the REIO may qualify the granting of REIO benefits to non-members' enterprises established within the REIO by placing further conditions upon them. This can be done in a number of ways. For example, some regional agreements provide that a party may deny the benefits of the agreement to an enterprise that is owned or controlled by persons of a non-party, if the enterprise has no substantial business operations in the territory of the party under whose laws it is constituted.[b] The 2003 Mainland-Hong Kong Closer Economic Partnership Arrangement, for example, sets out in detail the criteria for determining whether or not an enterprise has substantive business operations.[c]

/…

Box 1. (concluded)

Aside from these impediments, there might be other reasons discouraging a non-REIO investor from establishing in a particular REIO member with a view to enjoying the benefits of a REIO. These impediments might include, for example, legal and regulatory systems of the host state that are inconvenient for the investor, a low level of intellectual property protection (particularly important for investors in the intellectual property-intensive industries), or the desire to retain a more centralized management structure.

In light of the relevant legal and commercial factors a non-REIO investor may need to make a careful decision weighing the pros and cons of establishing in the REIO. Only in cases in which a non-REIO investor is admitted to at least one REIO member, this investor can avoid the adverse impact of a REIO exception clause provided that it also meets other requirements for non-member enterprises in the REIO.

Source: UNCTAD

[a] For example, this might be the case if REIO investors are accorded national treatment while non-REIO investors are not.

[b] See, for example, Article 1113.2 of NAFTA, and Article 25 of the New Zealand-Singapore Agreement.

[c] Mainland-Hong Kong Closer Economic Partnership Arrangement, 2003, http://www.tid.gov.hk/ english/cepa/index.html.

A further issue raised by REIO exceptions is their effect on developing countries. It should be considered in two separate contexts. The first concerns the case in which developing countries are themselves members of a REIO. In this situation, these members may have a common interest with the other REIO members, whether developed or developing countries, to reserve the privileges and benefits of membership in relation to non-members. Accordingly, they may seek a REIO exception as members of the REIO.

The second case concerns the situation of a developing non-member of a REIO that enters into an IIA with REIO members. Here, the REIO clause will act to limit access to the benefits of the REIO. These benefits could be of value in contributing to the development policy of the non-member and, in particular, to its better exploitation of commercial opportunities in the REIO market. However, this is to re-state the "free rider" issue. Should it make any difference that the "free rider" is a developing or least developed country? This in turn raises questions as to whether the REIO clause should make allowances for developing and least developed non-members and accord certain special privileges to them by reason of their status. This issue in effect goes beyond the technical questions raised by the REIO clause itself and introduces the further question of whether special and differential treatment for developing and least developed countries should be a feature of IIAs as such. Equally, it may well be that the REIO has a specific policy of development cooperation with developing and least developed non-members whereby an element of privileged treatment already exists. Such policy may itself be reserved so that its benefits only pass to those developing and least developed countries selected for preferential treatment. Whatever the specific issues that are raised by the above cases, the REIO clause may be a feature of future IIA negotiations with REIO partners and developing countries must be aware of its implications.

These and related considerations are examined in this paper in order to assist negotiators of future IIAs in assessing the need for a REIO exception in IIAs and in finding a proper concept and formulation of the respective clause, where it would be deemed necessary.

Notes

[1] For an overview of some REIOs, see Brewer and Young, 2000, p. 160.
[2] For an explanation of these concepts see further UNCTAD, 1999b.
[3] The question of "who is us?" was discussed at length by Reich, 1990.

I. GENERAL CHARACTERISTICS OF REIOs IN THE INVESTMENT FIELD

An essential characteristic of a REIO in the investment field is the existence of a common legal framework for the treatment of investors within the region. Such a regime is usually created by including a chapter on investment into a broader REIO agreement such as a free trade agreement, an economic partnership, a customs union or another type of agreement. There exist various degrees and methods of economic integration in the investment area. In general, one can distinguish the following approaches:[1]

- Regional integration may be confined to a political commitment, or encompass legally binding obligations.
- Regional integration may be based on, and limited to, the MFN principle.
- Regional integration may encompass the principle of non-discrimination as a whole, i.e. include the principle of national treatment.
- Regional integration may include the dismantling of market access obstacles for investment, whether of a discriminatory nature or not, i.e. include a right of establishment. This REIO model usually also has an institutional component, such as the establishment of common administrative, juridical or legislative bodies with competences in the area of investment.

It appears that there is a crucial relationship between the degree of economic integration within a REIO and the request for a REIO exception in IIAs with third countries: the deeper the economic integration within a region, the more the REIO and its members might feel a need to reflect this situation in a derogation from the MFN principle in the IIA (see section III below).

Whereas almost all REIOs dealing with investment have a common internal investment regime, this is not necessarily the case with regard to their external relations with non-REIO members. In most instances, REIOs do not have a uniform legal regime in respect of investors from outside the region, although the REIO members may

seek to harmonize existing admission requirements. Rather, the individual REIO members set the entry conditions for investors from outside the region on the basis of domestic legislation. The situation is thus comparable to a free trade zone where each member decides independently on its external tariffs vis-à-vis third countries. On the other hand, there are REIOs that are developing a common external investment regime.[2]

The division of competences between a REIO and its members concerning its external relations may have consequences for a possible REIO exception in IIAs. Depending on who is competent, the REIO itself and/or its member states may seek a REIO exception (see further below).

In principle, a REIO and/or its members have the following options to deal with investors of non-members:

- They treat investors of non-REIO members no less favourably than investors of REIO member countries.[3]
- While being open to investment from third countries, they favour investors of REIO member countries.[4]
- They restrict the making of investments of non-REIO investors without applying similar restrictions to non-REIO investors (discrimination in the pre-establishment phase).
- They discriminate against investors of non-REIO member countries not only with regard to their establishment, but also in the post-establishment phase.

In practice, REIOs often apply a mixture of the above-mentioned approaches. This means, in particular, that there is no general rule according to which REIOs would be less open to investors of non-REIO members than to investors from within the region, and that they would privilege their own investors.

Notes

[1] For more detailed discussion of the approaches see section III.

[2] An example is the European Union (EU). However, this example is not typical.

[3] One could question the need for a REIO exception clause in this situation. However, such a clause might still be warranted if a given REIO member wishes to retain flexibility in its policies towards non-REIO investors. This might be the case if a REIO member *de facto* treats investors from a given non-REIO country better than required by the IIA with this country (i.e. if the treatment is *de facto* the same for REIO and non-REIO investors). In this case, the REIO exception would be a tool to change an outside-REIO policy would such a need arise. Secondly, a REIO clause might be warranted in case a country wishes to engage in a different integration scheme in the future.

[4] Examples would include the granting of subsidies only to REIO investors or imposition of performance requirements only on non-REIO investors.

II. ECONOMIC RATIONALE FOR REIO EXCEPTIONS

A. Economic justification with regard to trade

In the area of trade, REIO members do not extend their tariff liberalization to outsider countries because, otherwise, they would unilaterally open their markets to non-members without gaining the same access to the respective markets for their products (Karl, 1996, p. 24). This concept of mutual exchange of export products (or mutual "give and take") is inherent to trade (Bhagwati, 1993, p. 39). Moreover, unilateral import liberalization vis-à-vis non-REIO members – while beneficial to consumers – may have a negative impact on less competitive domestic companies.

B. Economic justification with respect to FDI

Are these justifications relevant with respect to investment? To which extent can decisions about REIO clauses in IIAs be guided by experiences with REIO clauses in trade agreements? The concept of a mutual give and take might be less pronounced in investment matters than in trade relations (Bhagwati, 1993). The benefits of FDI to a host country occur irrespective of whether or not the home country of the particular company provides the same treatment to host country enterprises and grants them equal access (OECD, 1993, p. 24). Furthermore, reciprocity in the area of investment might be much more difficult to assess given the fact that the legal framework governing investment is much more complex and variable than trade rules (Fatouros, 1995).

One argument that has been put forward to justify REIO clauses in the area of investment relates to the higher import propensity of foreign affiliates compared to domestic firms (Graham and Krugman, 1995, p. 64). This could lead to a deterioration of the current account balance. However, it is not clear whether the effects of a higher import propensity would be different depending on whether or not the parent company is located inside or outside a regional economic area (Karl, 1996, p. 26).

In practice, as explained in the previous section, a REIO as a whole – or its members individually – may pursue two different strategies vis-à-vis investment from outside the region: they may pursue an open door strategy or a restrictive policy with some discriminatory elements.

1. Open-door policies

Countries worldwide – including those members of REIOs – actively seek to attract FDI, no matter where it comes from. REIO members following an open door policy may be convinced that it would make economically little sense to discriminate between investors of different foreign nationalities. The non-discriminatory character of the investment promotion strategies of REIOs is most pronounced with regard to the protection of investors once they have made an investment in the region. Such protection is usually granted to investors irrespective of their nationality. Furthermore, the general legislation of REIO members (e.g. on taxation, labour, health, safety, environmental protection, import/export regulations) typically applies to all companies established in their territories irrespective of the nationality of the shareholders. Given the general openness of REIOs towards FDI from *any* foreign country and the frequent absence of discrimination, the need for a REIO clause seems to be less obvious in investment matters than in trade. Conversely, investors of non-REIO members might have to fear less from a REIO exception in an IIA if, in practice, it would not change the open character of the REIO.

2. Restrictive policies

A REIO and/or its members may wish to restrict foreign investment as part of their development strategies. An important distinction to be made is between restrictions that the REIO and/or its members may impose on investors of *any* foreign nationality, including within the REIO, and restrictions on investors of non-REIO member countries only.

REIO members may apply restrictions to *any* foreign investor, including investors of other REIO members. For instance, screening for national security considerations often applies to any foreign investment. REIO members might also follow such an approach – although it is less common – in order to develop and protect their national industries in specific sectors of the economy. Such a policy thus allows partial deviation from the objective of regional integration.

Alternatively, a REIO and/or its members may wish to maintain specific restrictions only vis-à-vis investors of non-REIO member countries as part of a strategic investment policy, e.g. to develop "regional champions". This was the case, for example, with regard to the creation of Airbus Industrie, the European civil airliner producer, in the European Union (EU) in the late 1960s. The plan was perceived as a strategic partnership, for which the participating countries provided direct subsidies to their respective Airbus member companies to assist in the development of the project. Investors of non-EU member countries were not allowed to participate in the project.[1]

Reciprocity provisions may also have a discriminatory effect on investors of non-REIO members. The REIO legislation may include national treatment clauses under which investors from third countries may be denied the right of establishment in the region if the REIO determines that the investor's home country denies national treatment to investors of REIO members. Such clauses exist, for instance, in the EU in the area of banking, insurance and investment services. It seems, however, that they have so far not been applied in practice.

Furthermore, privileges for investors of REIO members might become relevant in the context of privatization programmes of REIO members. REIO members might find it politically easier to privatize if – as a first step – only investors of REIO members are permitted to make an investment. They might also want to ensure that investors of other REIO members receive preferential treatment in privatization procedures. For instance, such policies have, been followed by individual EU members in the telecommunications and energy industries.

Another example could be investment incentives. For instance, if a REIO wishes to create "regional champions", it may reserve incentives and other forms of subsidies to REIO investors only.[2]

It needs to be underlined that, despite such specific cases of preferential treatment for investors from REIO members, REIOs do not generally discriminate against investors from non-REIO members.[3]

C. Effects of REIOs on investment flows

The economic effects of REIOs have been examined predominantly with regard to trade.[4] The debate has focused on the issue of whether REIOs result in trade creation or trade diversion in respect of non-REIO member countries (Viner, 1950). As noted above, a precondition for allowing regional integration schemes under GATT is that they do not raise barriers to trade with third parties, or that any such effect is offset by at least the proportionate degree of trade liberalization.

Similarly, non-REIO-members might be concerned that regional economic integration results in a distortion of investment flows by diverting third country FDI flows from their territories into the region. They may fear that, while the existence of a REIO may lead to an increase of investment activities within the region, it may reduce investment from and/or into third countries. Whether or not investment diversion or investment creation[5] takes place depends mainly on what kind of policies a REIO follows vis-à-vis investors of non-REIO countries.

- To the extent that a REIO adopts an "open door" policy with respect to all investors, investment liberalization within the REIO may have an investment creation effect on FDI flows from non-member countries.
- Even if a REIO maintains some restrictions vis-à-vis investors of non-REIO members, its internal dynamics may provide for progressive liberalization and a gradual rollback of remaining

investment obstacles over time. In this case, the REIO may be a first step towards full liberalization and a possible investment creation effect on FDI flows from non-member countries in the future.

- On the other hand, there would be the risk of investment diversion if a REIO systematically restricted FDI in the region from non-member countries – either in respect of certain economic sectors or across the board – or if it even followed a strategy of de-liberalization with regard to them.
- There may be a further risk of investment diversion in that a REIO might divert investment flows from non-REIO-member countries to REIO-members because the larger REIO market as such might make the area more attractive for investment, including FDI, from outside the region.
- Whether the mere existence of a REIO could create a risk of investment diversion may also depend on the kind of economic activity involved. One example relates to investments in the exploration and exploitation of mineral resources. The REIO could not distort these investment flows if such resources were located only outside its area. More generally, it seems that the risk of investment diversion increases with the degree of mobility of a particular industry.
- Another factor to be taken into account is the natural scale of a particular industry. For instance, in industries in which globalization is the norm (e.g. electronics, pharmaceuticals, aerospace), or in which globalization is emerging (semiconductors, vehicles), the effects of a REIO-related investment diversion on an optimal scale operation could be significant (Kobrin, 1995). By contrast, transnational corporations (TNCs) in food or consumer products that predominantly operate on a country-by-country basis might find it easier to reorganize themselves.
- The risk of investment diversion could be reduced if third countries have the possibility of becoming REIO members, or at least of concluding association agreements, or establishing some other forms of privileged economic cooperation.

D. The dynamics of regional integration

A REIO might wish to preserve the possibility of introducing new privileges for investors of members in the future. However, it might not be in a position to give a clear indication with regard to which activities or sectors such a policy might become relevant. For that purpose it would need a precautionary REIO exception in an IIA. As a result, the REIO would not be subject to a "standstill" obligation, which usually prohibits contracting parties from introducing any new discriminatory investment restrictions after conclusion of the agreement. Non-REIO contracting parties might find this unacceptable. On the other hand, the impact of internal regional dynamics on the REIO exception might diminish in importance during the lifetime of a REIO as it proceeds with its integration process. In more advanced REIOs that have already achieved a high degree of internal integration, there would be less and less unfinished liberalization left, in relation to which they might seek an MFN exception in an IIA.

Notes

1 However, in more recent years, since the enterprise has become an independent company, it has acquired the power to sub-contract work to firms from non-EU member countries on a purely commercial basis.

2 See also below section IV.A.3 and UNCTAD, 2003.

3 This fact has been confirmed, for instance, by the EU and the United States (as a North American Free Trade Agreement (NAFTA) member) in their annual reports on existing barriers to trade and investment in their respective other country/region. While the EU and the United States identify some specific cases of discrimination against each other, neither of them complains that there is any kind of systematic and across-the-board discrimination of their investors concerning their investment in the other country/region (United States Trade Representative, 2002; European Commission, 2002).

4 For a discussion of the investment-related economic aspects of REIOs, see also Brewer and Young, 2000, pp. 167-170.

5 For a discussion of these concepts see UNCTAD, 1991, chapter III.

III. MAIN FEATURES OF THE INVESTMENT REGIME OF SELECTED REIOs

This section examines the relevant characteristics of the investment regimes of several REIOs as examples of different models of regional integration as outlined above. It is, however, sometimes difficult to categorize a specific REIO because it may combine elements of different integration models. These range from a non binding "best efforts" approach to a number of legally binding approaches ranging from the provision of MFN only to full integration. Each approach is examined in turn.

A. Non-binding "best efforts" approach

The weakest form of regional cooperation in the investment field is a "best efforts" commitment to grant non-discriminatory treatment to investors of other REIO members. Thus the Asia Pacific Economic Cooperation (APEC) "Non-binding Investment Principles" (APEC Principles) encourage member economies to extend to investors *from any economy* treatment in relation to the establishment, expansion and operation of their investments which is no less favourable than that accorded to investors from any other economy in like situations, without prejudice to relevant international obligations and principles.[1] From the outset, the APEC Principles therefore try to avoid the emergence of a situation in which there would be a difference in the degree of protection afforded by the internal and external investment regime for investors who are in a like situation.

B. MFN treatment only

A REIO may pursue its integration in the investment field exclusively on the basis of the MFN principle. This would mean that each REIO member commits itself not to discriminate between foreign investors of different REIO nationalities. The application of the MFN principle could be limited to treatment of established investors, or extend to the pre-establishment phase. By contrast, investors of other REIO members could not claim the treatment that a REIO member accords to its own investors. The resulting level of integration would

therefore be relatively low. This may be a reason why apparently very few REIOs have chosen this model in practice.

One example is the Association of South East Asian Nations (ASEAN) Agreement on the Promotion and Protection of Investments.[2] It provides for MFN treatment in the post-establishment phase. The Agreement confirms that it does not affect the rights and obligations of the contracting parties with respect to investments of investors of non-ASEAN members. It should be noted that the agreement does not contain legally binding provisions concerning the making of an investment by investors of other member countries. This may have important consequences for the question of whether or not such REIOs might need a REIO exception in IIAs (see below).

C. MFN treatment and national treatment combined

Under this integration model, REIO member states undertake – in addition to the MFN obligation – to treat investors of other REIO member countries no less favourably than their domestic investors (i.e. to grant national treatment). A number of existing REIOs fall into this category. This treatment might apply only to established investors, or extend to both the pre- and post-establishment phase. Each REIO member may have the right to take individual exceptions to this obligation. Such exceptions may be permitted only with regard to non-discrimination in the pre-establishment phase, or cover post-establishment treatment as well.

Within the category of REIOs, at least three sub-groups can be distinguished, on the basis of the extent, if any, to which the REIO controls the policy of individual members in relation to the treatment of REIO and non-REIO investors:

1. Internal investment regime without rules on external relations

Among the most prominent examples are the North American Free Trade Agreement (NAFTA) and the European Free Trade Association (EFTA).[3] According to Articles 1102 and 1103 of

NAFTA, each contracting party shall accord to investors of another contracting party and their investments treatment no less favourable than that which it accords, in like circumstances, to its own investors or to investors of any other party or of a non-party. This obligation exists with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. Pursuant to Article 1108 NAFTA, each contracting party may take individual exceptions to these obligations.

In a similar vein, Article 23.1 of the EFTA Agreement, states that there shall be no restrictions on the right of establishment of companies or firms, formed in accordance with the law of a member state and having their registered office or principal place of business therein. According to Article 24, the principle of national treatment applies with regard to the right of establishment and the operations of investors of other EFTA members. Articles 23.3 and 23.5 allow each member to take exemptions regarding the right of establishment. In sectors covered by an exemption, each member shall accord to investors of another member treatment no less favourable than that accorded to investors of third parties other than the European Community (EC). According to Article 23.3, each member shall endeavour to eliminate gradually remaining discriminations as reflected in its list of exemptions. Pursuant to Article 23.4, neither member shall adopt new or more discriminatory measures as regards the establishment and operation of investors of other members.

Neither the NAFTA nor the EFTA deal with investment coming from third countries. The members therefore retain the freedom to conduct independently their external investment relations with non-REIO members. This might raise concerns in the REIO if the individual REIO members have different strategies vis-à-vis investors of non-REIO parties. If some REIO members adopt an open door policy in respect of investors from outside the region, while other REIO members follow a more restrictive approach, the REIO rules on *internal* investment liberalization might undermine such distinct strategies.

2. Internal investment regime and rules on external relations

If REIO members wish to avoid the above-mentioned outcome, they would have the possibility of agreeing upon common rules concerning their external relations with third countries.[4] An example of this approach is the Mercado Comùn del Sur (MERCOSUR). Its "Protocol on the Reciprocal Promotion and Protection of Investments within MERCOSUR" grants to investors of MERCOSUR parties non-discrimination (national treatment and MFN treatment) both in the pre- and post-establishment phase. As far as non-discrimination in the pre-establishment phase is concerned, each MERCOSUR party has the right to take temporary, sector-specific exceptions as listed in an annex to the agreement. Moreover, the "Protocol on the Promotion and Protection of Investments coming from States not Parties to MERCOSUR" emphasizes, in its Preamble**,** the wish of the MERCOSUR parties to attract investment from outside the region. It points out that the creation of favourable conditions for investors of non-MERCOSUR parties intensifies economic cooperation, stimulates individual economic activity and furthers development in the four contracting parties. They therefore agree to establish a common legal framework for the promotion and protection of those investments. At the same time, they see a need to avoid investment distortions within their area. To this end, the contracting parties agree not to accord to investors of non-MERCOSUR parties treatment, that is more favourable than that laid down in the Protocol. The Protocol goes on to establish obligations of MERCOSUR parties in connection with investments of investors of non-parties. These consist of national treatment and MFN treatment in the *post*-establishment phase.

As compared to the Protocol on the Reciprocal Promotion and Protection of Investments within MERCOSUR, the Protocol governing the external relations of MERCOSUR member countries is more restrictive. Whereas in respect of MERCOSUR's internal investment regime national treatment and MFN treatment apply both in the pre- and post-establishment phases, the application of these standards is limited to post-establishment treatment concerning the relations of MERCOSUR members with third countries.

In addition, the Protocol is one of the few REIO agreements that itself includes a REIO clause. It states, inter alia, that the contracting parties do not extend to investors from third countries any preferential treatment deriving from the participation or association of a contracting party to a free commercial zone, a customs union, or a similar regional agreement.

3. Combined rules on internal and external investment liberalization

Rarely, REIO agreements include rules on both internal and external investment liberalization. One example of this approach is the Framework Agreement on the ASEAN Investment Area (AIA). According to Article 3, the main objective of the Agreement is to establish a competitive ASEAN Investment Area**,** with a more liberal and transparent investment environment amongst members, by 2010. To this end, it is intended, *inter alia*, to increase substantially the flow of investment into ASEAN from both ASEAN and non-ASEAN sources.

Up to this point, the Framework Agreement resembles the approach taken in MERCOSUR. However, the Framework Agreement goes further. Pursuant to Article 4, the AIA shall be an area where national treatment is extended to ASEAN investors by 2010, and to all investors by 2020, subject to exceptions provided for under the Agreement, and where all industries are opened for investment to ASEAN investors by 2010, and to all investors by 2020, subject to exceptions provided for under the Agreement.

The treaty contains detailed rules concerning the MFN principle. Pursuant to Article 8, each member accords immediately and unconditionally to investors and investments of another member MFN treatment in the pre- and post-establishment phases. Contrary to the approach taken under MERCOSUR, the ASEAN Framework Agreement does not deal with the issue of MFN exceptions vis-à-vis investors of non-ASEAN members. Rather, it deals with the case in which ASEAN members would like to take an MFN exception vis-à-

vis other ASEAN members: any preferential treatment granted under any existing or future arrangement to which a member is a party shall be extended on an MFN basis to all other members. However, this does not apply in respect of those agreements notified by members to the AIA Council within six months after the date of signing the Framework Agreement.

Another special feature of the ASEAN Framework Agreement might be of particular relevance in the context of a REIO exception: as explained above, the treaty provides for a gradual extension of the principle of national treatment to investors of non-ASEAN members.

D. The "full integration" model

Article 43 of the Treaty Establishing the European Community lays down the principle of non-discrimination of investors from other EU member States. To remove remaining internal investment obstacles that are formally non-discriminatory, the EU has developed special liberalization methods that are unknown in other IIAs. The concept of mutual recognition is one important element of the broader EU strategy to harmonize investment conditions in its territory in order to facilitate cross-border investment and to establish a common market. This includes the possibility that the EU adopts common legislation, which replaces or supplements investment-related laws of individual EU members. Furthermore, economic integration within the EU is not limited to the freedom of establishment of investors of other EU members. The EC Treaty provides for the free movement of goods, personnel, services and capital within the region. The objective of a common market may require addressing the issue of national monopolies. The common policies of the EU therefore include measures directed at opening up closed markets in which monopolistic structures still exist, as in telecommunications, post and energy.

The investment regime of the EU has an important institutional aspect. The EU has established a new international legal order under which members have partially transferred their national sovereignty to a supranational body. This is substantially different from other REIOs, for which, as yet, no common law-making authority exists with the

right to adopt legislation that is binding on the members and which overrides conflicting domestic legislation. The European Court of Justice, endowed with far-reaching powers, controls the observance of treaty obligations by the member countries.

The competences of the EU are not limited to its internal investment integration, but extend to external relations with third countries. However, the EC Treaty does not give the EU a general external competence for dealing with investment matters, including the conclusion of IIAs. Rather, the EU's competence in the investment field derives from its competences in a variety of areas, such as capital movements and trade, and it is shared with the competence of the EU members. The legal situation is therefore quite complex. It follows that the EU has various competences both with regard to the establishment of investors of non-EU members in the Community (see Articles 57, 59, 60 of the Treaty Establishing the EC) and concerning the protection of established foreign investors (see Articles 59, 60, 133 of the Treaty Establishing the EC). Nevertheless, the protection against political risks (e.g. expropriation, discrimination, war and civil strife) remains to a large extent in the competence of the members, notwithstanding the fact that expropriation cases may also be covered by the right of property provisions of the Protocol to the European Convention on Human Rights. This is why it is they – and not the EU – that conclude IIAs with third countries on the protection of foreign investment.

Another example of the full integration model is the Treaty Establishing the African Economic Community (AEC). Pursuant to Article 4 of the agreement, one of its objectives is the establishment of a common market. This includes the gradual removal, among members, of obstacles to the free movement of persons, goods, services and capital, and the right of residence and establishment. According to Article 43, members agree to adopt, individually, at bilateral or regional levels, the necessary measures, in order to achieve progressively the free movement of persons, and to ensure the enjoyment of the right of residence and the right of establishment by their nationals within the Community. For this purpose, members agree to conclude a protocol on the free movement of persons, right of residence and right of establishment. Further illustrations of this

approach include the Treaty establishing the Caribbean Community (CARICOM) and the Revised Treaty of the Economic Community of West African States (ECOWAS). It should be noted that the meaning of the term "right of establishment" in these treaties is uncertain. It could either imply the granting of national treatment to investors of other REIO members, or an absolute establishment right. Finally, these agreements differ substantially from the EU Treaty insofar as they have not, as yet, created a supranational organization.

Notes

[1] Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996, 2000, 2001, 2002 and 2004a; the texts of the bilateral investment treaties (BITs) mentioned in this paper may be found in the collection of BITs maintained online by UNCTAD at www.unctad.org/iia.

[2] This agreement has been supplemented by the Framework Agreement on the ASEAN Investment Area, see below section C.I.3.

[3] However, it should be noted that the NAFTA provision on performance requirements, Article 1106, applies to investors of a party or of a non-party.

[4] Another possibility would be that the internal rules of the REIO on investment liberalization apply only to such investing companies that are owned or controlled by nationals of REIO members.

IV. THE RELATIONSHIP BETWEEN THE INVESTMENT REGIME OF A REIO AND IIAs

The issue of a REIO exception in IIAs is linked to the relationship between the autonomous investment regime of the REIO (covering both its internal and external relations), and the investment rules in IIAs. The more a REIO's internal investment rules resemble those included in IIAs with third countries, the less reason there may be for a REIO exception. Conversely, the more the investment regime within a REIO differs from those that exist in relation to the outside world, the need for a REIO clause may be perceived as greater by the members. In other words: the inclusion of a REIO exception in IIAs seems to depend on whether or not the investment regimes of the REIO and the IIA are symmetric.

A. General considerations

1. Possible symmetries/asymmetries between the investment regimes

The usual benchmark for assessing whether or not there is symmetry between the investment regimes of a REIO and an IIA is the principle of MFN treatment. If a REIO bases its integration exclusively on this principle, it should – in general – have few difficulties in subscribing to the same concept in an IIA with third countries. If, by contrast, the investment regime within the REIO reaches beyond the MFN principle, whereas the IIA is limited to this concept, REIO members might be reluctant to extend such treatment unilaterally to investors of non-REIO members in the IIA. However, the MFN principle is not the only possible point of reference on the basis of which to compare the investment regime of a REIO and that of an IIA. As outlined above, one can distinguish four fundamental integration policies in the investment field.[1]

With regard to the integration policies based on the principles of MFN treatment and/or national treatment, a further distinction can be made. Non-discrimination can be granted on the basis of a "bottom up" or "top down" approach. Under the former procedure the principle of non-discrimination would only apply with regard to those sectors or activities for which the contracting parties have made an explicit commitment**.** Under the second procedure it would become a general

obligation to which contracting parties would have the right to take individual exceptions.[2]

The following table gives an overview of the main possible scenarios:

Table 1. The interaction between IIAs and a REIO investment regime

		REIO investment regime			
		Political commitment	MFN	MFN + NT	Right of establishment/ full integration
IIA	Political commitment				
	MFN		+	+ +	+ +
	MFN + NT			+/++	+ +
	Right of establishment/ full integration				+

Source: UNCTAD.

The crosses in the table indicate the situations in which a REIO member might seek an MFN exception when concluding an IIA with third countries. The blank areas indicate cases in which such an exception is unlikely to be sought, as the obligations in the REIO towards internal investors are no stronger than the obligations undertaken by the REIO members in the IIA. Equally, the top line of the matrix remains blank, as the "best efforts" approach contains no legally binding obligations that could create an incompatibility with the preferential treatment accorded to REIO investors.

From the table, one can distinguish cases in which the investment regime of a REIO and the IIA differ strongly (marked with two crosses) and others for which the divergence is less obvious

(marked with one cross). Depending on the degree of difference, a REIO member might feel a strong or a moderate need for a REIO clause in an IIA. A substantial difference would exist if the investment regime of the REIO and the IIA fall into different categories of investment liberalization. The difference would be less strong – but would still exist – if the investment regime of the REIO and the IIA follow the same basic approach (e.g. are both based on the MFN principle). If both investment regimes are based on the MFN/NT principles, the divergence may be small or strong, depending on whether or not both apply the same method of investment liberalization ("bottom-up" versus "top-down" approach).

2. Individual country-specific exceptions vs. generic REIO exception

The degree of similarity or discrepancy between the investment regime of a REIO and an IIA might also have an influence on the type of MFN exception in the IIA. If both regimes are based on the same concept – albeit, perhaps, to various degrees – such differences might be taken care of in individual country-specific exceptions that the REIO and/or its members take with regard to the MFN principle in the IIA. Such exceptions could be clearly defined and relate to specific sectors or activities (e.g. subsidies, public procurement). If, by contrast, the investment regimes of the REIO and the IIA are substantially different (i.e. follow dissimilar methods of investment liberalization), individual and well-defined country-specific exceptions might not suffice to identify the differences in treatment. A broader and less concise MFN exception – a generic REIO exception – might be required to reflect properly the extent to which the two investment regimes differ. Both country-specific exceptions and a generic REIO exception may have their advantages and disadvantages.

The taking of individual, country-specific exceptions might better reflect the general openness of a REIO to investors of non-REIO members. It might be more acceptable to investors from outside the region than a general REIO exception, while at the same time be sufficient to meet the interests of the REIO in excluding the application of the MFN principle with regard to specific measures or activities.

Moreover, the method of individual exceptions would be more transparent than a general REIO clause, since REIO members would be obliged to identify the concrete measures for which they seek an exception to the MFN principle. Country-specific exceptions might have the additional advantage of reflecting the fact that**,** in most REIOs**,** it is the individual REIO member – not the REIO as such – which sets the entry conditions for investors from outside the region.[3]

On the other hand, there are several arguments in favour of a general REIO exception. It might avoid possible difficulties in identifying those measures or activities in relation to which the contracting parties would agree to exclude the application of the MFN principle, and eliminate the risk that individual REIO members come to different conclusions with regard to the question of the taking of an exception. Furthermore, it might be difficult, if not impossible, to capture possible future developments towards liberalization in the absence of a general exception clause. Finally, a generic REIO clause might convey the political message that non-REIO member countries will not enjoy the same legal status as a REIO member.

A potential weakness of a generic REIO exception is that the concrete scope of the carve-out of the MFN principle could remain unclear. This might be in conflict with one of the main purposes of concluding an IIA – which is to establish legal certainty and transparency concerning the rights and obligations of the contracting parties, including exceptions to them.

One possibility for reconciling these two approaches might be to combine both (country-specific exceptions and generic REIO exception). For instance, one could imagine that a REIO (or its members) take country-specific exceptions with regard to existing sector-specific measures or activities that do not conform to the MFN principle. A generic REIO exception might be taken for the remaining more general non-conforming measures or activities that reflect existing asymmetries in the investment regimes of the REIO and the IIA. One important advantage of this combined approach might be that it provides for more certainty and transparency concerning the treatment of investors of non-REIO member countries.

3. The distinction between pre- and post-establishment phases

The investment regime of a REIO and an IIA may consist of rules on the making of investments, and on the protection of established investments (provisions on pre- and post-establishment). Accordingly, the question of a possible symmetry or asymmetry between the two investment regimes can – at least theoretically – becomes relevant with regard to both investment phases. In reality, however, substantial discrepancies are mostly limited to pre-establishment treatment. Countries in general – irrespective of whether or not they are members of a REIO – have fewer difficulties in according non-discriminatory treatment to foreign investors in the post-establishment phase.

There are, however, cases of REIOs discriminating against investors of non-REIO member countries in the post-establishment phase. An example is the granting of investment incentives. Decision 292 of the Commission of the Cartagena Agreement (Article 12) provides that:

> "Andean Multinational Enterprises shall be eligible for export incentives under the same conditions contemplated for national companies in their respective sector, provided that they fulfil the requirements for said companies in the corresponding legislation. Likewise, Andean Multinational Enterprises may make use of the special systems for importation and exportation established in the national legislation of the Member Country of the principal domicile and of any branches."

Article 1 (d) of Decision 292 defines an "Andean Multinational Enterprise" as a company that, *inter alia*, must have contributions of property from national investors from two or more member countries that together are greater than 60% of the capital of the enterprise.

As noted in the introduction, there is an issue whether the special benefits that a REIO offers to investors from its members could be captured by investors from non-member countries, for example by

establishing themselves in the integration area (box 1). In other words, could a REIO-based affiliate of an investor of a non-REIO member enjoy the benefits of REIO membership, including the internal freedom of establishment when making an investment in another REIO member country (example: a United States affiliate in Germany making an investment in Portugal)?

The answer depends, amongst others, on how the REIO defines its own investors, i.e. whether, for purposes of enjoying the benefits of the REIO's internal investment regime, it is sufficient that the investing company is simply located (i.e. incorporated) in a REIO member, or whether it is additionally required that the company engages in substantive business operations, or that it is owned or controlled by nationals of REIO members.

Most REIOs follow the first approach based on the location (i.e. incorporation) in the REIO for being considered a REIO investor. For instance, Article 1139 of the NAFTA defines an "enterprise of a Party" as an "enterprise constituted or organized under the law of a Party, and a branch located in the territory of a Party and carrying out business activities there". As discussed earlier (box 1), this approach is frequently complemented by a so-called "denial of benefits" clause, which introduces a "substantive business operations" test. The mentioned clause usually provides that a party of the REIO agreement may deny the benefits of the agreement to an enterprise that is owned or controlled by persons of a non-party, if the enterprise has *no* substantial business activities in the territory of the party under whose laws it is constituted (in the case of the NAFTA, this rule is embodied in Article 1113).

In these situations, the issue of a REIO exception in IIAs is therefore predominantly a matter of pre-establishment treatment of investors of non-REIO members. Consequently, the question of a possible symmetry or asymmetry between the investment regime of a REIO and an IIA becomes pertinent mainly in respect of the admission of non-REIO investors into the REIO. If the right of establishment is available in any of the REIO members, investors that were originally non-REIO investors may enjoy the benefits of the REIO simply by

establishing themselves in the REIO and engaging in business operations there. Alternatively, if none of the REIO countries grants the right of establishment to non-REIO investors, it is harder for such (non-REIO) investors to enjoy the benefits of the REIO. Thus, this approach may offer a possibility to render free riding more difficult.

The issue of a REIO exception also persists in the second of the above-mentioned approaches towards defining what is a REIO investor. These are REIOs where, in order to qualify as a REIO investor, the investing company must not only incorporate in the REIO, but also be owned or controlled by nationals of a REIO member. In these cases the benchmark for enjoying the benefits of a REIO is higher – even if the right of establishment is available in any of the REIO members.

Thus, while the above scenarios have identified ways to make it more difficult for a non-REIO investor to reap the benefits of a REIO investment regime, none of them totally rules out the possibility of free riding on REIO benefits.

4. REIO exception and open door policies of REIOs – a contradiction?

Would it be more appropriate to assess the case for a REIO exception in an IIA exclusively on the basis of the actual policies that a REIO applies vis-à-vis investors of non-REIO member countries? Such an argument would misunderstand the purpose of a REIO clause. Its main objective is to rule out unilateral claims for preferential treatment, as enjoyed by REIO members and investors, from non-REIO members and their investors under an IIA, because this would result in unbalanced commitments of the contracting parties. This does not exclude the possibility that in practice non-REIO members and their investors do receive such preferences. Even if there were identical treatment between investors of REIO members and investors of non-REIO members, the REIO and its members might still have an interest that such treatment is not made into an international obligation in an IIA, because it would not be matched by reciprocal obligations of the non-REIO members.

On the other hand, the degree of openness of a REIO and its members vis-à-vis third countries (and vice versa) might have a certain impact on a REIO's negotiating position concerning the need for a REIO clause, and its possible content. The more a REIO and its members are open to investors of non-REIO members, the less it would have to change its investment policies in respect of them when accepting the MFN principle unconditionally in an IIA. It would, therefore, in substance, amount to a prohibition against future de-liberalization (standstill-obligation).

Second, it seems that the negotiating position of the REIO would likewise depend on how open non-REIO members are for investors of REIO members. An unconditional MFN principle in an IIA might be less politically acceptable, the more there is a perceived difference in the degree of openness between the REIO and its members, on the one hand, and non-REIO members, on the other.

B. REIO exception in the case of selected REIO types

This section attempts to apply the above general considerations concerning the possible need for a REIO exception in IIAs to the different types of REIOs presented in the previous section, excluding non-binding commitments to investment integration, since the issue of an MFN exception does not become relevant in the latter context.

1. Principle of MFN treatment

REIOs based exclusively on the MFN principle would not make any unilateral commitments when undertaking the same obligation in an IIA with third countries. The degree of internal integration would not go beyond the MFN principle in the IIA. If, nevertheless, REIO members wanted to privilege investors of other REIO members to some extent, it seems that they could do so by taking individual exceptions to the MFN principle in the IIA. For instance, they could exclude the applicability of the MFN clause with regard to certain sectors of economic activity.

2. Principle of MFN treatment and national treatment

The MFN principle in an IIA would mean that the internal obligation of REIO members to grant investors of other REIO members national treatment had to be extended to investors of non-REIO members. If REIO members do not wish to go so far they could seek to take an MFN exception in an IIA.

Such an exception may be relatively straightforward if the REIO members apply**,** in their internal relations**,** the principle of national treatment on the basis of the bottom-up approach. This method might ensure a relatively easy identification of those cases in which investors of other REIO members can claim national treatment. It might then be equally simple to single out those sub-cases with regard to which REIO members would not want the MFN principle to apply. This method might, however, not work if REIO members applied internally the national treatment principle on the basis of the top-down approach, with the result that the REIO exception would need to be of a more general nature.

A similar situation – although possibly less pronounced – may emerge if both the investment regime of a REIO and an IIA are based on the principles of MFN treatment and national treatment. The taking of exceptions might further be influenced by the way REIOs deal with their external relations with non-members. Two specific cases deserve particular attention:

- **IIAs limited to post-establishment treatment.** A REIO exception may be unwarranted if the IIAs concluded by individual REIO members establish legally binding obligations only in respect of the post-establishment phase (as it is the case for many BITs).
- **Gradual rollback of the REIO exception.** As explained above, it is possible that a REIO agreement provides for the gradual extension of the principle of national treatment to investors of non-REIO members (see the example of the Framework Agreement on the ASEAN Investment Area). Members of such a REIO might wish to reflect this approach in their IIAs with third countries. For instance, they could draft the REIO exception as a "sunset" clause,

i.e. contracting parties to the IIA would agree that the exception becomes obsolete after a certain period of time, by which the REIO agreement provides for full national treatment of investors of non-REIO members.

3. The "full integration" model

a. The case for a generic REIO exception

As explained above, given its unique degree of internal integration, it appears that the EU would be in an asymmetric situation vis-à-vis the level of investment liberalization envisaged in an IIA, given that such an agreement is unlikely to adopt the "full integration" model. This means that the EU member State might seek a REIO exception if the IIAs, which it wants to conclude, only contain the MFN principle. A REIO exception might likewise be demanded if the IIAs contain the national treatment principle, either on the basis of the bottom-up or top-down approaches. The reason is that EU integration goes beyond the granting of national treatment by including a right of establishment of investors of EU members and the principle of mutual recognition. It appears that a REIO exception for the EU would be of a general character. Given the broad concept of internal EU integration, it would be difficult to identify in IIAs all possible individual situations in which internal EU integration exceeds external liberalization and to list them as individual exceptions under a top-down approach. On the other hand, where IIAs include the national treatment principle, the scope for exceeding liberalization in the EU (i.e. better than national treatment) may be relatively limited. Furthermore, given the internal dynamics of the EU, the REIO exception might need to extend to future integration steps. It is difficult to see how such possible future privileges for investors of EU members could be covered in the absence of a generic REIO exception. On the other hand, in view of the high degree of integration that the EU has already achieved, it is not clear what these further privileges could be.

b. Country-specific exceptions

One possibility for improving transparency concerning the scope of the REIO exception would be to substitute it as far as possible by country-specific exceptions of the REIO and its individual members. Such an approach might be appropriate if the contracting parties to an IIA are of the opinion that not all the cases to be covered by the REIO exception have their origin in existing asymmetries between the investment regime of say, the EU and IIAs. One example is a ceiling for capital participation. Another example exists in the area of financial services. EU countries may also grant each other certain tax exemptions and privileges. This could likewise justify an individual MFN exception, unless IIAs include a general carve-out of taxation matters. Other possible cases where one could imagine that a REIO might want to privilege its own investors and reflect this policy in individual exceptions relate to participation in de-monopolization/privatisation procedures, the acquisition of real estate, or the compliance with certain registration procedures.

c. Institutional considerations

In the EU, it is the Union – not the individual members – that has the exclusive competence for the internal investment liberalization. In addition, the EU and its members share the competence concerning the establishment and protection of investors of non-EU members.[4] Thus, if EU members subscribed to the MFN standard in an IIA with third countries, they would not know which investment-related measures the EU might adopt in the future – measures to which the MFN principle would apply.

Even if EU members were nevertheless willing to apply the MFN principle unconditionally, they would have to respect the EU competences with regard to the establishment and protection of investors of third countries in the Union. To avoid internal conflicts of competence, the individual EU members and the EU itself might wish to become jointly contracting parties of the IIAs involved.

C. Conclusions

The above section offers some further important conclusions:

- It seems that the request for a REIO exception in IIAs crucially depends on the question of whether the investment regimes of REIOs and IIAs are symmetric or not.
- The degree of symmetry/asymmetry might have importance for the kind of MFN exception in IIAs (country-specific exceptions vs. generic REIO exception). One could also imagine a combination of both types of exceptions in IIAs.
- The dynamics of investment integration in a REIO might result in a request of the REIO to cover future integration steps in the REIO exception.
- A REIO might wish to seek a REIO exception irrespective of its actual degree of openness vis-à-vis investors of third countries. However, the investment-related policies of the REIO and the respective third countries might have some impact on the possible content of the REIO exception.
- Given the shared competence between the EU and its members in investment matters, the EU itself – and not only the EU members – might seek to be covered by a REIO exception.

Notes

[1] Namely: a political commitment, the MFN principle, the MFN and NT principles, and full integration.

[2] An example of the former approach is the GATS, an example of the latter the NAFTA.

[3] One example of this approach would be Article II of the GATS, which allows countries to list their MFN exemptions. Such individual country-specific exceptions were also specified for the EU and its member States in the framework of the ultimately unsuccessful negotiations in the OECD on a Multilateral Agreement on Investment (MAI).

[4] In its proposal of summer 2003 to revise the EU Treaty, the EU Convention suggested, however, to make the EU exclusively competent for "foreign direct investment" (Article III.217 of the draft). This proposal is currently under discussion at the EU Intergovernmental Conference level.

V. REIO EXCEPTIONS IN IIAs

IIAs do not show a uniform approach towards a REIO exception. To the extent that IIAs include a REIO clause at all, they significantly differ from each other:

- While some REIO clauses include a generic definition of a REIO, others refer to specific integration models like customs unions or free trade zones.
- Existing generic definitions of a REIO are not uniform.
- Depending on the scope of the agreement to which they belong, some REIO clauses cover both trade and investment matters, while others are limited to either trade or investment.
- Some REIO clauses are limited to an MFN exception, while according to others the entire IIA shall not impede preferential treatment in a REIO.[1]
- Some REIO clauses provide for a complete, unconditional and open-ended REIO exception, while others – like Article V of the GATS – permit recourse to the REIO exception only under certain conditions. The latter REIO clauses therefore include some legal safeguards for non-REIO members concerning their applicability.
- Some REIO clauses are more specific than others concerning the identification of measures that REIO members are allowed to take under it.

Notwithstanding the variety of REIO clauses, a widespread feature seems to be that if REIO members conclude IIAs with third countries, these agreements usually contain a REIO clause.

A. Article V of the GATS

Article V of the General Agreement on Trade in Services (GATS) deserves particular attention, because no other investment-related REIO clause has been accepted by so many countries. It is also a comprehensive provision that covers different modes of supplying services, including through a commercial presence. The latter encompasses foreign direct investment.

1. Definition of a REIO

Article V of the GATS does not define a REIO as such. Rather, it defines the agreement that constitutes the REIO. It is defined as an agreement liberalizing trade in services, provided that it:

> "(a) has substantial sectoral coverage, and
> (b) provides for the absence or elimination of substantially all discrimination related to national treatment between or among the parties, in the sectors covered under subparagraph (a), through:
> (i) elimination of existing discriminatory measures, and/or
> (ii) prohibition of new or more discriminatory measures, either at the entry into force of that agreement or on the basis of a reasonable timeframe, except for measures permitted under Articles XI, XII, XIV and XIV bis."[2]

Pursuant to Article V.2, in evaluating whether the above conditions relating to non-discrimination are met, consideration may be given to the relationship of the agreement with the wider process of economic integration or trade liberalization among the countries concerned. Article V.3 deals with agreements liberalising trade in services involving developing countries. In this case, flexibility shall be provided regarding the conditions that the agreement must meet, particularly with reference to the issue of elimination/absence of discriminatory measures, in accordance with the level of development of the countries concerned, both overall and in individual sectors and sub-sectors.

2. Non-applicability of the MFN principle

Similar to Article XXIV GATT 1947, Article V.1 of the GATS states that the Agreement – including the MFN principle under Article II – shall not prevent any of its Members from being or becoming a party to a REIO.

3. Permissibility requirements for a REIO exception

Article V of the GATS follows a similar approach to Article XXIV of the GATT concerning the permissibility requirements for a REIO exception. By virtue of paragraph 4, any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not**,** in respect of any member outside the agreement**,** raise the overall level of barriers to trade in services within the respective sectors or sub-sectors compared to the level applicable prior to such an agreement. This means that the creation of new barriers to service suppliers from outside the region is prohibited, i.e. any rollback of the existing level of liberalization.

Article V of the GATS includes a number of safeguards for non-REIO members. They relate to transparency and reporting obligations (Article V.7 (a) (b) (c)), and the protection of established service suppliers in the REIO. Article V.6 stipulates that a service supplier of any other GATS party that is a juridical person constituted under the laws of a party to a REIO agreement shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the REIO. However, there is an exception to this rule if the REIO involves only developing countries. In this case, according to Article V.3(b), more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to the REIO (i.e. established investors of non-REIO parties may not be entitled to the benefits of the REIO agreement).

4. Modification of commitments

As with Article XXIV of the GATT, Article V.5 of the GATS deals with the situation that in the context of concluding, enlarging or significantly modifying a REIO agreement, a GATS party intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule. In this case, it shall provide at least 90 days advance notice of such amendment, and the procedure for compensatory adjustments under Article XXI of the GATS shall apply. This procedure has recently been invoked by a

number of countries that were concerned that the accession of Austria, Finland and Sweden to the European Union would affect the specific commitments of these three states under their schedules.[3] This arose because the new EU members brought their MFN exceptions under Article II into line with their new membership obligations.

B. Other REIO clauses in IIAs

1. Definition of a REIO

Most BITs of countries that belong to a REIO include a REIO clause.[4] A considerable number cover specific types of regional integration that are expressly mentioned in the agreement. For instance, Article 4.4 of the Swiss model agreement covers a free trade area, a customs union or a common market. A similar provision can be found in the German model agreement. The Organisation for Economic Co-operation and Development (OECD) Code of Liberalisation of Capital Movements refers to a "special customs or monetary system".

An important subgroup of BITs extends the scope of the REIO exception to similar arrangements. For instance, the United Kingdom model agreement refers to "any existing or future customs union or similar international agreement to which either of the Contracting Parties is or may become a party" (Article 7). The French model agreement refers to a free trade area, a customs union, a common market or any other form of regional economic organization. Examples also exist at the regional level. The Protocol on Promotion and Protection of Investments coming from States not Parties to MERCOSUR stipulates, *inter alia*, that the contracting parties do not extend to investors from third countries any preferential treatment deriving from the participation or association of a contracting party to a free commercial zone, a customs union, or a similar regional agreement.

A small group of IIAs include a general definition of a REIO. For instance, Article 25.2 of the Energy Charter Treaty defines the term "Economic Integration Agreements". It "means an agreement substantially liberalizing, inter alia, trade and investment, by providing

for the absence or elimination of substantially all discrimination between or among parties thereto through the elimination of existing discriminatory measures and/or the prohibition of new or more discriminatory measures, either at the entry into force of that agreement or on the basis of a reasonable time frame". The definition is therefore similar to the approach taken in Article V of the GATS.

A substantially different definition had been proposed during the negotiations on the OECD draft Multilateral Agreement on Investment (draft MAI). It reads as follows: "For the purpose of this Agreement, a REIO is an organisation of sovereign states which have committed themselves to abolish in substance all barriers to investment among themselves and to which these states have transferred competence on a range of matters within the purview of this Agreement, including the authority to adopt legislation and to make decisions binding on them in respect of those matters" (Article 10.1). This definition is considerably narrower than the Article V GATS-type definition, since it requires a law-making authority of the REIO in investment matters.

2. Non-applicability of the MFN principle

All examined REIO clauses include a carve-out from the MFN principle. A typical example is once again Article 4.4 of the Swiss model agreement. It stipulates that, if a contracting party accords special advantages to investors of any third state by virtue of an agreement establishing a free trade area, a customs union or a common market, it shall not be obliged to accord such advantages to investors of the other contracting party.

The non-applicability of the MFN principle is explicitly mentioned in Article 25.1 of the Energy Charter Treaty. It states that the provisions of this Treaty shall not be so construed as to oblige a contracting party which is party to an economic integration agreement to extend, by means of most-favoured-nation treatment, to another contracting party which is not a party to that Integration Agreement, any preferential treatment applicable between the parties to that Integration Agreement as a result of their being parties thereto.

The same approach has been followed in the MERCOSUR Protocol on Promotion and Protection of Investments Coming from States not Parties to MERCOSUR, and the draft MAI. It may be interesting to note the difference with the GATS approach, which declares the entire agreement inapplicable as far as the granting of REIO-specific privileges is concerned.

3. Permissibility requirements for a REIO exception

Contrary to Article V of the GATS, BITs do not contain any such requirements or any other safeguards for countries and investors not belonging to a REIO. The situation is the same under the Energy Charter Treaty, the MERCOSUR and the draft MAI (see, however, the next section). The OECD Code of Liberalisation of Capital Movements requires that REIO members inform the Organisation of its membership and those of its provisions that have a bearing on the Code.

4. Modification of commitments

Among the examined IIAs, only the draft MAI deals with the issue of a modification by a REIO member of the existing legal entry conditions for investors of non-REIO members after the agreement has been concluded. However, the draft MAI addresses only two specific matters in this context, namely (1) the harmonization of the domestic laws of REIO members, and (2) the adherence of new members to the REIO. None of these issues is expressly dealt with in Article V of the GATS. The draft MAI addresses these issues because its REIO exception is particularly meant to cover the EU – in which the harmonization of national legislation and the accession of new members is particularly relevant.

According to paragraph 3 of the draft MAI REIO clause, nothing would have prevented a REIO and its members from applying, consistent with the objectives of the Agreement, new harmonized measures adopted within the framework of such organization and which replace the measures previously applied by these states.

Pursuant to paragraph 4, a contracting party that joins a REIO, would not have been prevented from applying in place of its previous national legislation the corresponding legislation of the said organization from the day of its accession to it. If a contracting party has concluded an agreement with a REIO and its members in preparation for its accession to it, nothing in the Agreement would have prevented it from aligning its national legislation to the measures applied in the framework of such organization. Conversely, the Agreement would not have prevented members of a REIO from extending to the investors and their investments of such a contracting party more favourable treatment than they accord to investors and their investments from other contracting parties.

C. Conclusions

The development of existing REIO exceptions in IIAs can be summarized as follows:

- While BITs usually contain a broad REIO exception, there is a trend in more recent regional and multilateral IIAs to narrow the conditions under which the REIO exception applies.
- To this end, some recent REIO clauses deal explicitly with the issues of definition of a REIO, exception from the MFN principle (or IIA obligations in general), permissibility requirements, and the modification of commitments. However, not all recent REIO exceptions contain these elements.
- In particular, some recent IIAs require that a REIO must not establish new barriers for investors of non-REIO members. In addition, they allow for the possibility to provide compensatory adjustment in case that a REIO member intends to make these entry conditions more restrictive.

Notes

[1] It seems, however, that these two versions would have the same practical result.

[2] These exceptions relate to measures in respect of payments and transfers (Article XI), restrictions to safeguard the balance of payments (Article XII), general exceptions (Article XIV), and security exceptions (Article XIV bis).

[3] See the notifications brought under Article XXI of the GATS by the Philippines (WTO Document S/L7145, 26 August 2003); Brazil (WTO Document S/L/144, 26 August 2003); New Zealand (WTO Document S/L/140, 25 August 2003); Canada (WTO Document S/L/142, 26 August 2003); Customs Territory of Taiwan (WTO Document S/L/135, 25 August 2003).

[4] An important exception is the model BIT of the United States.

VI. POSSIBLE OPTIONS FOR A REIO EXCEPTION IN FUTURE IIAs

A. General considerations

The two previous sections have examined situations in which there might be a case for a REIO exception in an IIA, and what kinds of REIO clauses currently exist. Based on these analyses, this final section outlines a number of options on the possible content of REIO exceptions in future IIAs. These proposals intend, in particular, to address deficiencies in the way REIO exceptions are currently drafted. The most important shortcomings can be summarized as follows:

- Current REIO exceptions are often drafted in such a broad and general manner that the concrete scope of the carve-out of the MFN principle in IIAs remains unclear.
- REIO exceptions are included in IIAs irrespective of the concrete symmetries/asymmetries between the investment regimes in the REIOs and the IIAs. As a result, the scope of the REIO exception might be broader than required by the actual degree of the asymmetry. In addition, country-specific exceptions are rarely considered as a possible alternative to a generic REIO clause.
- In more recent IIAs, some steps have been undertaken to introduce certain permissibility requirements into the REIO exception and to deal with the issue of modification of commitments. While these efforts have helped to reduce legal uncertainty, they have not yet established a common legal practice. Moreover, as will be shown below, they have left a number of issues unresolved.

It needs to be underlined that there is no iron rule that a REIO and its members would always wish and need a REIO exception in an IIA. Moreover even if an IIA includes a REIO exception, this does not necessarily mean that the REIO and its members will in fact make use of it. While the REIO clause permits the REIO and its members to privilege investors of other REIO members, it does not exclude the possibility that investors of non-REIO members receive the same benefits. As explained above, the actual investment policies of existing REIOs suggest that the practical relevance of a REIO exception might be quite limited.

B. Possible elements of a REIO exception

1. Definition of a REIO

As explained above, there is no common approach in IIAs concerning the definition of a REIO. Negotiators might therefore prefer to include their own definition of a "REIO" or a "REIO agreement" in the IIAs they negotiate. A first distinction could be made between those that are limited to investment and those that also cover trade. As shown above, examples for both kinds of definition of a REIO exist. It seems, however, that the reason for this distinction has less to do with different views concerning the required depth of economic integration within a REIO. Rather, it appears that the dissimilarity simply reflects the different substantive coverage of a particular IIA. If the IIA covers both trade and investment (e.g. GATS, Energy Charter Treaty), it seems reasonable that the definition of the REIO likewise includes both types of economic cooperation. Equally, if an IIA only deals with investment (e.g. draft MAI), it makes sense that the definition of a REIO is limited to integration in the investment field.

The definition could be further narrowed if it were required that the REIO establishes a common market in which there is a free flow of trade, employment, services and capital. An intermediate solution could be to limit the definition to investment/trade, but to add a separate provision clarifying that the IIA does not prevent the REIO and its members from pursuing their economic integration in areas other than trade/investment. An example is Article V.3(b) of the GATS concerning the issue of labour market integration.

Another core element of a definition could be that the REIO provides for the elimination of substantially all discrimination**,** and the prohibition of new discrimination**,** between or among the REIO members in respect of the sectors covered by an agreement. Different options would be available with regard to the required degree of internal integration. As explained above, the definition could require that REIO members are politically committed to integration, or that they respect among themselves the principle of non-discrimination

(MFN treatment and/or national treatment). The definition could be still more demanding by covering only those REIOs that provide for full economic integration (including a right of establishment). Finally, the definition could be narrowed even further if it covered only those REIOs that have the legal competence to deal with investment matters, including the right to adopt legislation that is binding on the member States.

There is also the issue of whether the definition should likewise require – like Article V of the GATS – that a REIO agreement has substantial sectoral coverage. It seems that the answer depends on the type of IIA involved. If it is a pure investment agreement (i.e. covering only investment, like, for instance, BITs), it might be sufficient that the REIO agreement likewise only covers investment. If, on the other hand, the IIA covers trade and investment, the REIO agreement might need to have a similar broad scope. The requirement that the two agreements substantially overlap might help to avoid the situation in which a REIO can escape from the obligation to grant MFN treatment concerning the entire scope of the IIA when the REIO agreement itself covers only parts of it.

2. Non-applicability of the MFN principle

Another core element of a REIO exception in IIAs would be the non-applicability of the MFN principle. Based on the preceding analysis, contracting parties to an IIA would have the choice between two basic alternatives on how to secure the non-applicability of the MFN principle. They could explicitly limit the application of the REIO exception to the MFN principle.[1] Another option would be to follow the GATS approach and agree generally that nothing in the IIA shall prevent the contracting parties from being or becoming members of a REIO. The first alternative might have the advantage that it is more precise concerning the legal consequences of a REIO membership for the rights and obligations of the contracting parties to the IIA.

Even if the scope of the REIO exception were limited to the MFN principle, there would still remain considerable uncertainty about the meaning and content of those “benefits or advantages” or

"preferential treatment" that investors of non-REIO members would not be entitled to claim. To address potential concerns about this ambiguity, one could try to clarify further the scope of application of the MFN principle. To this end, one could attempt identifying those privileges that the REIO and its members would like to reserve to investors of REIO members.

a. Protection of established investors

A starting point could be to seek agreement on those measures of REIO members to which the REIO exception would *not* apply. The contracting parties to an IIA would thus attempt to identify such treatment of foreign investors in their territory that they would *not* consider as "preferential treatment" reserved to investors of other REIO members. As explained above, it seems that the issue of a REIO exception would mostly be relevant with regard to the *establishment* of a foreign investor in a REIO member. If contracting parties to an IIA come to this conclusion, they might wish to confirm in their agreement that no such preferential treatment shall apply with regard to the post-establishment phase (i.e. once an investment has been legally made in a REIO member). Another option – leading to the same result – would be to limit the scope of the REIO exception explicitly to the pre-establishment phase. If, in rare cases, a REIO or its members do not see themselves in a position to grant investors of non-REIO members non-discriminatory treatment after their establishment in their territories, they could seek individual exceptions to cover this situation.

b. Identification of asymmetries

Contracting parties to the IIA could reduce legal uncertainty about the scope of the REIO exception by agreeing upon a positive list of internal REIO preferences in relation to which the MFN principle would not apply. Contrary to the system of country-specific exceptions, under which one would list individual sector-specific measures or activities, the positive list approach would mean, in this context, a need to identify certain principles and methods of investment integration in the REIO, from which investors of non-REIO members could not benefit under the MFN principle when making an investment

in a REIO country. The contracting parties to the IIA would therefore make out such cases of preferential treatment within a REIO, which reflects existing asymmetries in the investment regimes of the REIO and the IIA.

As explained above, one can distinguish different cases of asymmetries. It appears that the most relevant in the present context would be the following:

- The investment regime in an IIA could be based on the MFN principle, while the internal investment rules of a REIO provide for both MFN treatment and national treatment, or an even higher degree of integration. In this case, the contracting parties to the IIA could consider clarifying that the preferential treatment reserved to investors of non-REIO members covers national treatment and any other treatment that reaches beyond national treatment (both limited to treatment in the pre-establishment phase). To the extent that the REIO and its members can identify concrete examples for which the national treatment principle should not apply (e.g. sector-specific restrictions), they could list them as individual, country-specific exceptions in an annex to the IIA.
- In the second scenario, the investment regime in an IIA would be based on the principles of MFN treatment and national treatment, whereas the internal investment rules of the REIO would reflect the full integration model. In this case, one could consider a clarification that the preferential treatment reserved to investors of non-REIO members covers treatment that goes beyond national treatment. Furthermore, one could try to identify examples of such treatment, such as the concept of mutual recognition, as it applies, for instance, in the area of professional qualification requirements, or positive discrimination in favour of foreign investors.

3. Permissibility requirements for a REIO exception

Based on the GATS model, a REIO exception could stipulate that the REIO agreement shall be designed to facilitate investment between the parties to the agreement and shall not**,** in respect of any contracting party not being a REIO member**,** raise the overall level of

barriers to investment within the respective sectors or sub-sectors compared to the level applicable prior to the agreement.

This clause would allow REIO members to pursue their internal investment liberalization, provided they do not establish new investment obstacles for investors from outside the region. In concrete terms, this means that any kind of de-liberalization vis-à-vis investors of non-REIO members, such as the closing of an economic sector or the introduction of previously not existing capital ceilings, would be prohibited. The assessment of whether or not the overall level of barriers to investment from outside the region is raised in a REIO may sometimes be difficult (see next subsection).

Another permissibility requirement could relate to transparency obligations. Based on the GATS model (Article V.7), the REIO members could be obliged to notify promptly any enlargement or significant modification of the REIO agreement to the other contracting parties to an IIA. They might also have the obligation, upon request, to make available to the other contracting parties relevant information. In addition, a requirement could be established that REIO members being parties to a REIO agreement implemented on the basis of a timeframe shall report periodically to the other contracting parties to the IIA on its implementation. Finally, procedures could be established under which all contracting parties would examine such reports, and make joint recommendations to the REIO parties.

4. Modification of commitments

a. Issues at stake

In common with Article V of the GATS, a REIO exception could deal with a situation in which, after conclusion of an IIA, the REIO and/or its members intend to introduce new or more restrictive barriers for investors of non-REIO members. Under the GATS approach, such amendments are, in principle, permitted in the context of the conclusion, enlargement or significant modification of a REIO agreement. A further requirement is that the individual REIO member intending to introduce new restrictions negotiates with the affected

GATS parties on compensatory adjustments. This means that the introduction of new investment barriers in *one REIO member country only* would be sufficient to trigger the adjustment obligation. It would not be taken into account whether the deterioration of the entry conditions for investors of non-REIO members in one REIO member might be offset by a simultaneous improvement of the investment conditions in other REIO members.

One particular case in which such a worsening of entry conditions might become relevant is the issue of adherence of new members to a REIO. Most REIOs are open to accession by non-members. If a non-member joins, it may be obliged to adopt the REIO's investment regime. Depending on whether the adhering country has been previously more or less open to foreign investment than the REIO, the accession might result in the creation of new investment barriers for investors from outside the region. This problem recently arose in connection with the enlargement of the EU with new members and candidates from Central and Eastern Europe (box 2).

Furthermore, there can be situations of a concurrent liberalization and de-liberalization between various members of a REIO. One important example relates to harmonization measures within the REIO vis-à-vis investors of non-REIO members. In this case, the harmonization of admission policies of REIO members may imply a compromise through which the most open members have to de-liberalize to some extent, whereas the most restrictive members have to move into the opposite direction.

b. Challenges for IIA negotiators

This leads to the issue of how to deal in an IIA with the issue of harmonization of legislation in a REIO. This includes, in particular, the concern under what conditions the mechanism for compensatory adjustment by REIO members should be triggered, and what such compensation should be.

Box 2. BITs between the United States and the new EU member States and candidate countries

A number of provisions of the BITs between some of the new EU member States and candidate countries[a] and the United States were amended to facilitate these countries' meeting their obligations, whether existing or future, and to take steps to address potential incompatibilities between their existing international agreements and their obligations of EU membership.

BITs between these countries and the United States contained commitments on protection and market access for the FDI of investors of the contracting parties. In particular, they contained the principles of national treatment and most-favoured-nation treatment (MFN) at the pre- and post-establishment phases. With respect to some specific matters and industries (e.g. subsidies, agriculture and audio-visual), the Commission believed that these obligations would be inconsistent with specific obligations deriving from the EC Treaty and EU regulation. In addition, concerns with respect to national and MFN treatment, the obligations on performance requirements in some industries (i.e. audio visual and agriculture) were believed to raise issues of compatibility with EU rules as well.

To address the issue of compatibility between EU legislation and these BITs, the new EU members and candidate countries to the EU, the European Commission and the United States signed a Memorandum of Understanding (MoU) in September 2003 (box table). This MoU served as a guide for amending and clarifying provisions in the individual BITs.

The amendments excluded from the scope of these BITs national and MFN treatment obligations measures with respect to agriculture, audiovisual, transport, financial services, fisheries and energy, to the extent such measures are necessary to meet EU obligations. The Understanding also addressed the EU concern that its authority, in accordance with article 60 of the EC Treaty, to adopt measures limiting capital movements and payments to and from third countries, and its authority under article 59 of the EC Treaty, to enact safeguard measures to preserve the functioning of the economic and monetary union, not be infringed.

/…

Box 2 (concluded)

Box table 1. Specific BITs of new EU members and candidate countries with the United States

Country	Date of signature [a]	Date of entry into force	Date of expiry [a]
Bulgaria	23 September 1992	2 June 1994	1 June 2004
Czech Republic	22 October 1991	19 December 1992	18 December 2002
Estonia	19 April 1994	16 February 1997	15 February 2007
Latvia	13 January 1995	26 December 1996	25 December 2006
Lithuania	14 January 1998	22 November 2001	21 November 2011
Poland	21 March 1990	6 August 1994	5 August 2004
Romania	28 May 1992	15 January 1994	14 January 2004
Slovakia	22 October 1991	19 December 1992	18 December 2002

Source: UNCTAD, BIT/DTT database (www.unctad.org/fdistatistics).

a BITs are tacitly renewed on the expiry date, but can be renounced at any time, with a one-year advanced notification after an initial period of ten years. As the BITs stood in their original version, before amendment, the acquired rights of established foreign investors remained valid for an unlimited period after the renunciation of the agreement. Following the amendments, the protection of acquired rights of established investors is limited in time, from ten to twenty years.

Among the various issues dealt with under the amendments are obligations related to national and MFN treatment. For example, the Additional Protocol between the United States and Poland states that, in certain industries, the EU member country may take a reservation against national and MFN treatment obligations of the BIT, provided that such reservation is necessary to meet the country's obligations under EU law, and subject to the exception that, notwithstanding any such new reservation, existing United States investments in the country shall remain protected under the national or MFN treatment obligations of the BIT for at least 10 years from the date of the relevant EU law which made the reservation necessary. The Additional Protocol also provides that the United States reserves the right to make or maintain limited exceptions to national treatment obligations to fisheries and subsidies, and to the MFN treatment obligation in fisheries.[b]

Source: UNCTAD, 2004b.

a The countries concerned are Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania and Slovakia. The candidate countries are Bulgaria and Romania.

b The American Society of International Law, *International Law in Brief*, 7 April 2004 (http://www.asil.org/ilib/ilib0706.htm).

A first question is whether a REIO and its members should have the right to introduce new investment restrictions in the context of legislative harmonization at all times, or only in the framework of the conclusion, enlargement or significant modification of a REIO agreement. Second, would it be sufficient for the obligation to make compensatory adjustments if a REIO member introduces an individual measure that results in a new investment barrier for investors of non-REIO members? Or could the effects of such a measure be neutralized by the introduction of equally favourable measures for these investors? This problem exists at three different levels: within one REIO member alone, within the REIO as a whole, and as a purely formal issue in case of a transfer of competence from the REIO members to the REIO as such.

One could argue that de-liberalization in only one REIO member would already be sufficient to result in the prohibition of the harmonization measure. According to the opposite point of view, a partial de-liberalization in some REIO member would be permitted if it were offset by at least an equal degree of liberalization in other REIO members. Similar problems may arise if a REIO opens one specific sector for investors from non-REIO members and simultaneously establishes restrictions in another one. It should be recalled, however, that in practice there have been very few cases of de-liberalization. The issue, therefore, seems to be of limited practical relevance.

Third, there is the issue of how to assess what could be a compensatory adjustment in the investment field. Such an assessment might be relatively straightforward in trade, where the introduction of higher tariffs for one product could be offset by an equal tariff reduction for another product. In investment matters, such an equation might be much more difficult to make. If, for instance, a REIO decided to close one particular sector of its economy (e.g. agriculture) to investors of non-REIO members, what other sector(s) would it need to open up in order to provide adequate compensation? How could one properly take into account the differences in economic importance between the various sectors of an economy, and the different number and agents involved?

Finally, if negotiators decided to deal expressly with regional harmonization measures in a REIO clause, it would have the formal consequence that not only the specific REIO member, but also the REIO itself would need to be covered by the provision.

5. Additional flexibility for developing countries

a. Flexibility for REIOs involving developing countries

In principle, a REIO clause could offer an important tool to developing countries members of REIOs for fostering their economic development by benefiting from the special privileges shared between a limited group of REIO countries. On the other hand, given the fact that most developing countries continue to have a strong interest in capital, technology and know-how from developed countries, the scope for privileged treatment between REIO developing countries – both with regard to the covered activities and the type of advantages – might be limited. Developing countries may want to explore ways by which they can enhance the potential developmental advantages of a REIO clause in a variety of ways.

For example, based on the GATS model, in which developing countries are parties to a REIO, an IIA could allow for additional flexibility regarding the permissibility requirements of the REIO. Thus, flexible arrangements could be worked out for developing REIO members with respect to a requirement to eliminate substantially all discrimination between the REIO members. For instance, despite becoming a REIO member, a developing country might wish to restrict investment of investors of other REIO members in specific sectors. These arrangements would enable developing countries to enjoy certain advantages of the REIO on a non-reciprocal basis (i.e. without having to grant similar treatment to other REIO members).

Furthermore, if a REIO involves only developing countries, one could think of allowing privileges for their investors in the post-establishment phase in accordance with the Article V of the GATS model. Article V.6 establishes that a service supplier of any other member constituted under the laws of a REIO party shall be entitled to

treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement. However, according to Article V.3(b) in the case of a REIO involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

In addition, the regional development strategies of developing REIO member countries might include an element of selective interventionism with regard to the entry of foreign investors from outside the region. For instance, developing REIO member countries might be of the opinion that, in order to set up competitive regional players, it is necessary to restrict temporarily FDI from third countries. As a result, the overall level of barriers to investment in the REIO by investors from outside the region might increase compared to the level applicable prior to the agreement. The GATS model (Article V.5) would allow such an outcome only in the framework of concluding, enlarging or significantly modifying a REIO agreement. In addition, the REIO member concerned would have to make compensatory adjustments in accordance with Article XXI of the GATS.

One could ask whether future IIAs should allow for some more flexibility for developing REIO member countries in this respect. For example, a general dispensation – i.e. not conditioned to the conclusion, enlargement or substantial modification of the REIO agreement – for temporarily closing an economic sector or introducing a previously non-existing capital ceiling in specific sectors for investors of non-REIO countries, would give developing countries members of a REIO policy flexibility to pursue development strategies that reduce the exposure of such sectors to external competition. Rights of already established investors in the REIO would, however, have to be respected. Alternatively, one could think of applying the GATS model (Article V.5) in principle, but to soften the obligation of developing REIO member countries to make compensatory adjustments.

Another option in this context would be that – based on the MERCOSUR model (see above) – developing REIO member countries

agree among themselves not to enter into any legally binding obligations concerning the establishment of investors of non-REIO parties in their territories.

Conversely, one could imagine that a developing REIO member country, rather than restricting foreign investment from outside the region, would like to strengthen its economic relations with particular developed countries. Depending on the scope of non-discrimination principle applying within the REIO, such privileges for outside investors might be prohibited. In this case, developing REIO member countries might wish to follow the model of the ASEAN Framework Agreement on Investment (see above), which gives its members the right to take exceptions to the non-discrimination principle with regard to specific agreements concluded with other states.

b. Enhancing the position of developing countries that are non-members of REIOs

An increasing – albeit still relatively small – number of investors of developing countries undertake FDI abroad. They may have a considerable interest that developed REIO member countries grant special treatment to them and their home countries in IIAs on account of their development needs. There are a number of possibilities for addressing this issue:

- First, there is the question whether the developed REIO member countries need a REIO exception at all in an IIA with developing countries. As explained above the issue of a REIO exception predominantly becomes relevant in IIAs covering the pre-establishment phase of an investment. The typical – although not exclusive – form of an IIA between developed and developing countries is a bilateral treaty that is limited in scope to the post-establishment phase. One could argue that such an IIA needs to include a REIO clause only in the exceptional case in which the internal investment regime of the REIO includes privileges for established investors of other REIO members.

- Second, if the IIA includes a REIO exception, developing countries may be keen that the IIA defines the "REIO" narrowly. They may also be interested that the privileges, which the REIO would like to reserve to its own investors, are clearly identified and limited in number.

- Third, the REIO exception could include a special and differential (S&D) treatment device either prohibiting any kind of de-liberalization (i.e. the introduction of new investment obstacles) vis-à-vis developing countries or privileging developing countries with regard to compensatory adjustments in case of a de-liberalization. This latter option means that developed country REIOs would have to grant a higher compensation to developing non-REIO countries than to developed non-REIO countries, in case that they close an economic sector or otherwise modify the REIO arrangement to the detriment of REIO outsiders.

- Fourth, one could imagine that developed country REIOs and their member countries conclude IIAs with individual developing countries, in which they unilaterally extend some of their internal privileges to them. Examples of special treatment can be found in partnership or association agreements signed by the EU with a number of countries, some of which are intended to prepare for EU membership at a future date. The privileges granted to outsider developing countries may be granted on a reciprocal or non/reciprocal basis. On the other hand, such an approach might cause difficulties in a multilateral system that includes the MFN principle. Although a REIO exception in this case would dispense the REIO members from respecting the MFN principle, such dispensation might not apply if REIO members expressly renounce its applicability with regard to a particular group of countries. However, it might not be possible to grant such REIO privileges only to outsider developing countries, unless all parties of a particular multilateral system consent.

- Fifth, a REIO clause could include a provision according to which the REIO and/or its developed country members would endeavour (i.e. make best efforts to that effect) to extend the benefits of their internal investment liberalization to investors from non-REIO developing countries. This would mean that, when adopting new liberalization measures, the REIO and/or its members would have to give serious consideration to the possibility to include investors from outside the region into the programme. If it does not, it would have to justify this refusal. Furthermore, a commitment for best endeavours clause could include a commitment to reduce – as far as possible – remaining investment obstacles for investors of non-REIO developing countries ("rollback" commitment)

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Note

[1] See the example of Article 25 Energy Charter Treaty.

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