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CHAPTER IV

EIGHT KEY ISSUES: NATIONAL EXPERIENCES AND INTERNATIONAL APPROACHES

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

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

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

A. Definition of investment

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

1. Why the definition of investment matters

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

Thus, the definition of investment is fundamental to national laws and international agreements pertaining to FDI, since it delineates which assets or investment flows are covered by the operational provisions of those laws and IIAs, for example, as they relate to national treatment. The main question is not whether FDI should be defined as investment—it is. The question is what other investment should be granted the same status: portfolio investment (both equity and debt components), other capital flows (bank loans, non-bank loans and other flows) and various investment assets (both tangible and intangible, including intellectual property rights).[3]

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

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

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

But many governments of host developing countries, at least in multilateral discussions, are wary. They wish to retain policy tools to deal with different types of flows in different ways rather than define them all as investment in a way that constrains their use. Because portfolio investment instruments and derivatives can be used for speculative purposes that destabilize foreign exchange markets or domestic financial markets, a government may prefer to exclude them from the definition. This allows governments flexibility to implement policies to maintain financial stability—hence many developing countries prefer (at least in multilateral discussions) to confine the definition of "investment" to long-term flows and exclude potentially volatile capital flows.

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

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

2. Scope of definitions

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

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

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

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

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

IIAs aimed at investment protection, which include BITs but also some regional agreements, tend to use a broad, open-ended, asset-based definition "covering virtually all proprietary rights located in the host State which have a financial asset value" (Wälde 2003) (although it may be qualified, for example, by excluding certain types of investment). The trend has been in this direction. In particular, most BITs use such an approach. The ASEAN Agreement for the Protection and Promotion of Investments, a regional investment protection treaty (like a BIT in aim and function), has a broad definition covering "every kind of asset".

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

The GATS does not define investment, instead defining a commercial presence as "any type of business or professional establishment". In effect the GATS uses an enterprise-based definition. The TRIMs Agreement does not define investment, either.[11]

3. Options for the future

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

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

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

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

- If the concern is that portfolio investment may be withdrawn quickly, IIAs might include portfolio investment, but the currency-transfer provision could apply only to investment that had been in the host country for some minimum period.
- Another option is to adopt a hybrid of broad and narrow definitions for different purposes in a given agreement. For example, a broad asset-based definition can be used for protecting investment—a narrower transaction-based definition for dealing with cross-border investment liberalization.
- The scope of IIAs can be narrowed through limitations on the types of investment subject to disciplines—through reservation lists or limited specified commitments.
- One can allow each government to decide whether, for the purposes of a particular agreement, it wants to commit itself to a broad or to a narrow definition. A positive list approach provides this flexibility.

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

B. National treatment

"National treatment" has the greatest development implications. It is also of key importance to foreign investors.[13] In today's usage, it combines two constructs that used to be dealt with separately:

- "Right of establishment" (or "admission and establishment") or, now, "national treatment in the pre-establishment phase", and broadly speaking "market access".[14]
- "National treatment in the post-establishment phase" of the investment process, the traditional application of "national treatment".

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

1. The centrality of national treatment

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

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

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

2. Patterns of national policy

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

After entry, national treatment is not usually guaranteed expressly in national FDI laws. Some constitutions contain a general provision prohibiting discrimination.[18] Other national laws refer to this standard in investor-investment guarantee provisions.[19] Whether post-establishment national treatment is granted explicitly or implicitly, it does not provide grounds for restricting national regulations. It is usually accepted that, as long as national regulations do not introduce a distinction on the basis of nationality, they are a normal exercise of a country's right to regulate (see chapter V). This interpretation can also be valid for special rights to minorities, ethnic groups, indigenous people or other disadvantaged groups within the host country. If those rights apply to all businesses, they cannot be interpreted as a breach of post-establishment national treatment.[20]

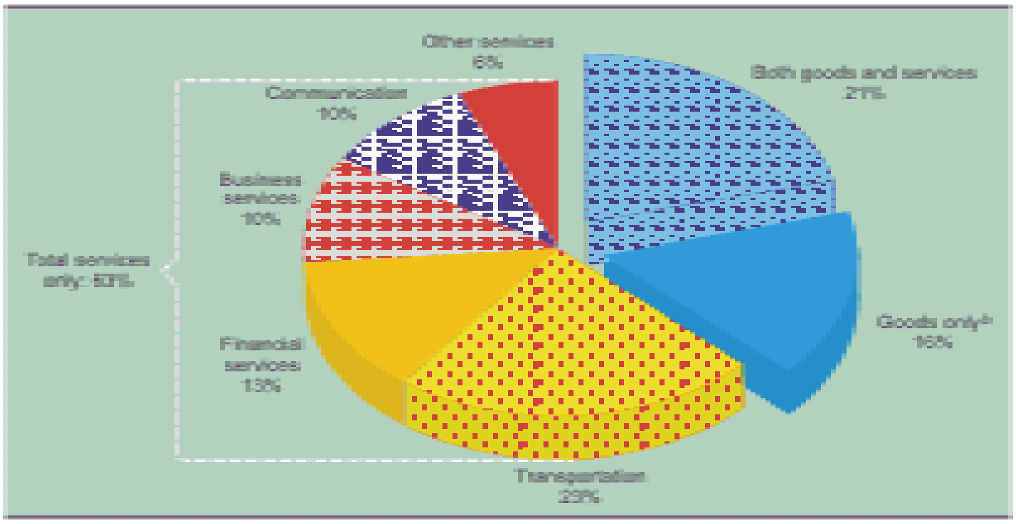
In the pre- and post-establishment stages, national treatment is subject to a range of exceptions, especially in the services sector (figure IV.1). There is also a tendency, especially in OECD countries, to apply the same or similar reservations or exceptions at both stages.

3. National treatment and economic impact

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

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

Figure IV.1. Reservations in the negotiations of the Multilateral Agreement on Investment,[a] by industry, 1998



Source: UNCTAD, based on Sauvé, 2002.

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

[b] Reservations relate almost exclusively to performance requirements and nationality/citizenship requirements for companies' boards of directors.

a. Pre-establishment

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

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

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

- *Infant domestic entrepreneurship*. The most common fear is that FDI harms the development of local entrepreneurship by deterring potential domestic investors from entering activities with a strong foreign presence—crowding them out where they exist (box IV.1). The infant enterprise argument is similar to the infant industry argument: building competitive capabilities by domestic firms takes time, and investment is risky and learning is costly.[22] Faced with foreign affiliates that have recourse to the skills, capital, technology and brand names of parent companies, local firms may not be able to build such capabilities. They may then be forced to withdraw to less complex activities or those with a lower foreign presence—perhaps selling their earlier facilities to foreign entrants, as happened in the automotive components industry in Brazil and Mexico (Mortimore 1998).

  Note, however, that protecting infant entrepreneurs (and infant industries) is sound only if protected enterprises become fully competitive within a reasonable period. If protection leads to permanent "cripples" rather than healthy infants that grow up, it imposes unjustifiable costs on the host economy. The promoted enterprises must also have the capability to stay competitive. They must master the technology and organizational skills used at the start and stay abreast of subsequent developments. Outstanding examples of this approach are the Republic of Korea and Taiwan Province of China, which in their early development severely restricted FDI inflows to nurture domestic entrepreneurship.
- *Local technological deepening*. A strong foreign presence may deter local competitors from investing in risky innovation (or other) capabilities, as opposed to buying ready-made technologies or skills from abroad. Moreover, new technologies can be expensive and difficult to obtain, as firms from the Republic of Korea found when they became threats to technology suppliers in export markets. If FDI deters R&D in local firms, the technological gap between them and TNCs can grow, marginalizing them in technology-intensive activities. Foreign affiliates may be reluctant to invest in local R&D because of their established innovative activities abroad, with strong links to home country technology institutions and other enterprises (*WIR99*).
- *Exploitation of new technology*. Where both local and foreign firms engage in R&D activity and create new technologies, local firms may exploit the benefits of innovation within the host economy more than foreign affiliates, which may transmit the knowledge to parent companies to exploit them elsewhere.
- *Greater spillovers*. Even where local and foreign firms are similar in other respects, local firms may create greater spillover benefits because they have better local knowledge and stronger local commitment. They may procure more inputs locally, use more local skills, interact more intensely with local technology and training institutions and so on.

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

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

Box IV.1. How serious is crowding out?

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

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

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

The empirical studies shed little light on the development implications of crowding out—or the policy options to deal with them. Crowding out may take place because of two main reasons, which, in theory, can be differentiated from each other: (1) when local firms disappear because of higher efficiency and better product quality of foreign affiliates; and (2) cases when they are wiped out because foreign affiliates have better access to financial resources and/or engage in anti-competitive practices. Unfortunately, empirical evidence is scarce in this respect, although the policy implications of the two scenarios may be different. In the first case, the initial net impact on welfare is positive, hence the economic justification for governmental intervention must be based on the possible negative effects of a denationalization of industry for the stability and economic activity generally through time. In the second case, there is a welfare loss, and governments would need to intervene through various channels. For example, they may need to establish or subsidize financing for local SMEs. In the case of anti-competitive practices, it would be the task of competition authorities to take remedial action.

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

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

Source: UNCTAD.

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

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

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

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

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

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

On the costs of FDI from "losing" innovations to parent companies and having lower spillover benefits, the evidence is again unclear (*WIR99*). Foreign affiliates that do R&D tend to interact with capable R&D institutions and universities in the host economy. Although the trend—slow as it is—for TNCs to set up global R&D centres in developing countries (where the skills exist) is growing, R&D activities remain concentrated in home countries and other developed countries. Indeed, it is in their interest to deploy the most efficient technologies where this furthers their competitive advantage. Over the longer term, it is not necessarily the case that foreign affiliates strike fewer local linkages than comparable local firms. On the contrary, their new supply chain management and training techniques often serve as a model.

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

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

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

Also affecting policy on FDI entry today: the world has changed. When the Republic of Korea or Taiwan Province of China used FDI restrictions to promote domestic firms some 20–30 years ago, technical change was slower and national production systems were not so highly integrated. The costs of keeping FDI out have risen considerably. Technical change is faster. FDI is the dominant form of technology transfer. And integrated production systems are much more prominent, particularly in the most dynamic export products (*WIR02*). So restricting FDI can reduce access to technology and some of the other main drivers of competitiveness.

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

b. Post-establishment

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

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

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

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

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

4. National treatment in IIAs

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

Early regional IIAs between developing countries also used this approach, but some went further in introducing a coordinated or common investor-screening regime (Andean Pact and the Customs and Economic Union of Central Africa).[24] The 1967 OECD Draft Convention on the Protection of Foreign Property (UNCTAD 1996b, vol. II, pp. 113–119) left the matter of admission and establishment to the discretion of member countries. More recently, the Energy Charter Treaty extended national treatment to the post-entry stage, but left its application before entry to a subsequently negotiated supplementary agreement (UNCTAD 1999a, pp. 41–42; Wälde 1996; Wälde and Weiler 2002; Andrews-Speed and Wälde 1996).

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

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

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

On the second issue, the dominant trend is to offer treatment "no less favourable" than accorded to domestic investors, though some agreements refer to "same" or "as favourable as" treatment (UNCTAD 1999b, pp. 37–40).[27] The latter offers a lower standard of investor protection in that, to meet the standard, the host country need only accord treatment that is no worse than that offered to domestic investors in like or similar circumstances. The "no-less-favourable" standard goes beyond that: where treatment accorded to domestic investors falls below certain international minimum standards, the foreign investor may be treated more favourably.

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

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

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

Both pre- and post-establishment national treatment are generally subject to exceptions. General exceptions may be based on national security, public health or morals. Specific exceptions may be in fields requiring reciprocal treatment by the home countries of investors, as with taxation or intellectual property. Exceptions can also relate to national policy measures like culture or the environment, incentives or public procurement and specific industries.[30] Exceptions based on economic development are particularly important for developing countries. General exceptions can apply to both pre- and post-establishment phases; country-specific and "generic" exceptions apply to pre-establishment only. There are also differences among sectors: services in general are more prone to exceptions to national treatment than manufacturing industries. Leading examples of a wide-ranging use of exceptions are NAFTA and the OECD Code of Liberalisation of Capital Movements.

5. Options for the future

The core development issues here are, first, the extension of national treatment to the pre-establishment phase of an investment and, then, how much flexibility developing countries should have in the application of the principle in the post-entry phase. The liberalization of foreign admission and establishment has until now been largely unilateral. While developing countries have gone far in opening their economies to FDI, most remain cautious about binding themselves in IIAs to preserve flexibility in pursuing development objectives. Enshrining systematically an extension of national treatment to the pre-establishment phase in future IIAs would represent a major policy shift. But even if that should occur, IIAs can be framed to permit countries to retain flexibility on allowing entry—they can specify the industries into which foreign investors can enter freely (the positive list) or at a minimum they can exclude selected activities from entry (the negative list). In either case limitations and conditions can be attached.

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

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

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

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

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

Before NAFTA

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

The bans and restrictions fell into three categories:

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

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

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

NAFTA's effect on Mexico's policy on admission and establishment

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

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

Increasing the economic benefits

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

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

Source: UNCTAD.

C. Nationalization and expropriation

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

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

1. The sensitivity of indirect takings and national policy dilemmas

Direct takings of property, involving the transfer of the physical possession of an asset as well as the legal title, can take various forms, ranging from outright nationalizations in all economic sectors or on an industry-wide basis, to large-scale takings of land by the State, or specific takings (expropriations).[31] Indirect takings include creeping expropriations, involving an incremental but cumulative encroachment on one or more of the range of recognized ownership rights until the measures involved lead to the effective negation of the owner's interest in the property (UNCTAD 2000b, pp. 11–12; Dolzer 2002). They also include regulatory takings, in which the exercise of governmental regulatory power—the power to tax or to control operations for environmental protection—diminishes the economic value of the owners' property without depriving them of formal ownership. Distinguishing between the two types is not always easy (Sornarajah 1994, pp. 278–294).

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

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

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

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

Regulatory takings are particularly sensitive because many government regulations can have an impact on the value of private property. So an expansive interpretation of "regulatory takings" can limit the national policy space by hindering a government's right to regulate, creating the risk of "regulatory chill", with governments unwilling to undertake legitimate regulation for fear of lawsuits from investors.[35]

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

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

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

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

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

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

2. Coverage in IIAs

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

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

From a developmental perspective, recent practice in IIAs suggests that developing countries strive to strike a balance between offering reasonable protection to investors and retaining their right to regulate. The utility of IIAs in referring to takings of property has usually been judged for the effect on the investment climate in developing countries. Treaty-based controls over the scope and legal requirements of a valid taking of foreign-owned property are assumed to have been good for investment conditions. But international disciplines have sometimes been criticized as imposing too much control over the sovereign discretion to limit the enjoyment of private property in the public interest. Where a host country wishes to preserve discretion to discriminate, this may need to be protected under limited and transparent circumstances. The question remains whether the rules of expropriation or other standards of protection, such as non-discrimination, are the best way to offer some protection to investors while preserving the right to regulate.

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

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

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

One of the key policy choices is the definition of takings. The traditional "narrow" approach covers only the classical instances of direct takings. A more comprehensive definition includes some forms of indirect takings. Closely related is the boundary between the legitimate exercise of governmental regulatory activity, and regulatory takings (which require compensation). An affirmation of the right to regulate is the governing principle here. Another policy choice is how far IIAs should permit international review of takings by host country authorities: should these be subject to a prior requirement to exhaust domestic remedies or should international review be available as a matter of right?

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

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

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

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

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

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

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

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

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

The Tribunal held that the proper date for calculating compensation was the date of the taking, 5 May 1978, not the present value of the property (regardless of any act of expropriation), as argued by the claimant. The parties agreed that the compensation should be based on fair market value but differed on the actual amount. The claimant asserted $6.4 million while the Government asserted $1.9 million. The Tribunal assessed the value of the assets at the relevant date as $4.15 million. Adding compound interest lost by the claimant as a result of the expropriation, the final award was $16 million.

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

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

D. Dispute settlement

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

1. National policies on dispute settlement in the investment field

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

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

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

So a dispute settlement clause in a BIT that allows the investor choice between national and international procedures binds the host country as a matter of international legal obligation. Such an international obligation can also be made enforceable before national tribunals where the investment contract between the investor and host country includes a dispute settlement clause that incorporates the country's international treaty obligations to allow the use of internationalized systems of dispute settlement.

2. Legal effectiveness

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

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

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

The willingness of the host country to accept internationalized dispute settlement may be motivated by a desire to show its commitment to creating a good investment climate. This may be of importance where the country has followed a restrictive policy on FDI and wishes to change that policy. In so doing, it should be entitled to expect that the internationalized system is impartial and even-handed.[47]

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

3. Coverage in IIAs

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

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

The usual approach to investor-State disputes in IIAs is to specify that the parties to the dispute must seek an amicable negotiated settlement. Only where such an approach fails to resolve the dispute can they resort to arbitration. Most BITs and some regional agreements provide for the possibility of settling disputes by consultation and negotiation.[49] Some bilateral agreements also have as one of their main purposes the provision of a consultation mechanism in a bilateral body.[50]

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

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

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

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

Some other regional agreements—such as the 2000 Agreement between New Zealand and Singapore on Closer Economic Partnership and the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR—also provide for international arbitration of disputes between a party and an investor of another party under the ICSID Convention but do not include as detailed rules as in the NAFTA.

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

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

4. Key issues and options for the future

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

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

Indeed, recourse to investor-State arbitration may offer an alternative to the traditional international remedy of diplomatic protection. The latter converts an investor-State dispute into a State-State dispute, possibly, leading to an increased politicization of the dispute. Such politicization could hinder good relations between the home and host country—and between the host country and the investor—to the long-term detriment of the investment. Because the remedy is discretionary, there is no guarantee for investors that the claim will be taken up by their governments. And in a complex TNC system, it may even be difficult to ascertain which government is entitled to exercise diplomatic protection, with the nationality of the investor being hard to establish. Because most disputes involve the host country and a locally incorporated affiliate of a foreign owned firm, the affiliate normally possesses the same nationality as the host country, making diplomatic protection difficult.[52] An investor-State dispute settlement system may also be in a better position to give awards. Why? Because it is better suited to assessing the issues and valuing compensation than a more general dispute settlement body with less experience in these types of claims.

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

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

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

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

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

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

The case suggests that an investor-State mechanism should operate within the limits of international law and that its rules should be the only ones that determine whether a claim is valid. If a claim fails to show that an international standard, embodied in an IIA, has been breached by a host country, it has no right to success before an international tribunal. International law may thus check excessive claims by investors against host countries. Only the most serious claims, involving violations of international standards embodied in IIAs, should be brought before dispute settlement bodies.

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

Source: Schreuer 2001, pp. 458–459; Muchlinski 2000, pp. 1051–1052.

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

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

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

There is also a broader consideration: State-State procedures may be preferable to investor-State ones because a government could look at a dispute in the broader context of its entire relations with another government, rather than focusing on the narrower concerns of the investor claimant. But a problem could arise if only State-State procedures are available: an investor-State dispute could be introduced under the guise of a State-State dispute.[56] In this situation, the investor has all the resources of its home government at its disposal and (vice versa). (But even in this case, it is the government's decision to proceed with a case and, if it does, in what way.) Furthermore, if the claimant country is successful, how should the award be made, and would the home government pass on any advantages to the investor?[57]

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

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

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

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

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

E. Performance requirements

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

1. Why use them?

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

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

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

2. Declining incidence

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

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

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

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

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

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

3. How effective are they?

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

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

Countries have to balance the potential benefits of performance requirements against the costs of creating inefficiency and the risks of deterring FDI. The evidence suggests that achieving the objectives of performance requirements depends largely on the clarity of these objectives, and the broader industrial and trade policies in which the requirements are set (UNCTAD 2003f). Particularly relevant are strong local enterprises, flexible and well-managed institutions and policies that support local capability development.

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

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

4. Coverage in IIAs

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

At the multilateral level, the WTO TRIMs Agreement prohibits certain performance requirements considered to be trade distorting: local content requirements, trade-balancing requirements, restrictions on foreign exchange inflows attributable to an enterprise and export controls.[68] The Agreement prohibits not only mandatory TRIMs but also those linked to an advantage. It applies equally to measures imposed on domestic and foreign enterprises. With the transition periods for phasing out measures agreed for developing countries and LDCs having expired, the Agreement's provisions apply to all WTO members, except those granted an extended transition period.[69] Export performance requirements linked to the receipt of a subsidy are furthermore restricted under the WTO Agreement on Subsidies and Countervailing Measures. They are prohibited for developed countries and generally for middle income developing countries as of 1 January 2003, with some exceptions.[70]

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

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

5. Options for the future

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

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

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

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

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

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

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

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

Source: UNCTAD.

a Most of the recent BITs signed by the United States contain clauses prohibiting similar measures, for example the BITs with Azerbaijan (1997), Bolivia (1998), Lithuania (1998), and Mozambique (1998).

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

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

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

resource endowments and development objectives.[79]

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

International rules on performance requirements are linked to other trade and investment policies that may also give rise to distortions. This is particularly true of location incentives. There is now a regulatory imbalance in IIAs between provisions that limit the use of performance requirements (applied mainly by developing countries) while omitting provisions to discipline the use of location incentives (notably in the form of up-front grants provided mainly by developed host countries) (Moran 2002). As discussed in the next section on investment incentives, incentive-based competition for FDI may put developing countries at a disadvantage (*WIR02*).

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

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

F. Incentives

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

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

1. Why use them?

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

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

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

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

2. Incentives-based competition for FDI intensifies

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

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

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

3. Are incentives worth their cost?

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

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

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

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

There is an emerging consensus among economists that countries should try to attract FDI not so much by offering incentives but by building genuine economic advantages (and offering stable, low and transparent tax rates). Incentives should not be a substitute for building competitive capabilities. Many governments realize that incentive competition can be costly (particularly against better-endowed rivals). But in the absence of international cooperation on location incentives, each wishes to retain the right to offer them. As a result, all or most countries involved are worse off, and TNCs benefit from the lack of cooperation.

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

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

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

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

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

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

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

IIAs have not, in the main, covered incentives specifically (UNCTAD 2003h). But there have been a few endeavours at the international level to limit explicitly the use of incentives. The most important instrument in this respect is the WTO Agreement on Subsidies and Countervailing Measures (SCM), which may apply to subsidies granted to foreign investors if they relate to their activities in trade in goods. The SCM Agreement in principle covers a wide range of incentives (see *WIR02* for a detailed discussion). It prohibits export subsidies and subsidies aimed at increasing local content of manufactured goods. Moreover, other firm-, industry- or region-specific subsidies are actionable under the SCM Agreement if they cause injury to another WTO member's domestic market or serious prejudice in world markets. The definition of subsidy is fairly broad (see Article 1), including possibly fiscal and financial incentives as well as the provision of land and infrastructure at less than market prices.

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

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

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

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

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

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

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

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

5. Options for the future

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

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

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

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

The desirability and appropriateness of offering FDI incentives

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

Frameworks for policy design and implementation

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

The appropriateness of strategies and tools

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

The design and management of programmes

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

Transparency and evaluation

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

Extra-jurisdictional consequences

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

Source: OECD 2003b.

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

Increasing competition for export-oriented FDI risks accelerating the incentives race among competing locations. The difference in financial resources available for public support to private investment suggests that developing countries would be at a disadvantage in such a race. That may further suggest the need to rectify this imbalance by restricting in the SCM Agreement the use by developed countries of financial location incentives. A reduction of investment subsidies would help governments allocate more resources for the development of skills, infrastructure and other areas that attract export-oriented activities. Given the nature of the problem, any approach to dealing with incentives, including increasing transparency, would have to be regional or multilateral. But further international cooperation remains controversial. There does not seem to be interest among either developed or developing countries to reach an agreement on the use of incentives beyond what is already addressed in the SCM Agreement.

G. Transfer of technology

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

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

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

1. The need for policies to promote technology transfer

In a world of rapid technological change and intense competition, creating, acquiring and efficiently using new technologies is a vital ingredient of growth. In the generation and dissemination of new technologies, TNCs can provide them in many forms: internalized in FDI, through non-equity forms (such as strategic alliances) and at arm's length (licensing and other contracts and arrangements). The rising cost of innovation, the perceived need to protect and control intangible assets and the liberalization of policies are leading TNCs to use FDI as the main mode for allowing access to valuable technologies (*WIR99*). As a result, the role of FDI in international technology transfer is growing. Indeed, many new technologies, particularly those used in integrated production systems, are available only through FDI (*WIR02*).

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

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

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

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

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

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

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

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

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

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

3. The right mix of policy instruments and conditions

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

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

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

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

The scant evidence on technology transfer requirements suggests that, for the reasons mentioned above, they too did not work well (Kumar 2002).[100] The requirements tended to raise the cost of transfer to TNCs, inducing them to provide less valuable knowledge or invest less in rooting the technology locally.[101] They thus appeared to be less effective than joint venture requirements.

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

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

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

4. International agreements mirror the shift in national policies

International agreements reflect the shift in national technology transfer policies from a regulatory to a market-friendly approach.[103] The regulatory approach was characteristic of international agreements in the 1960s and 1970s. It concentrated on deficiencies in international markets for technology and sought to reduce its transfer costs rather than promote its absorption, development or diffusion. The prime example was the Andean Community's Decision 24.[104] Under that Decision the Community's countries adopted stringent controls on technology transfer, scrutinizing the terms of individual contracts, setting limits on cost, duration and coverage and intervening to improve the bargaining position of local enterprises. Other international initiatives based on the regulatory approach include the draft UNCTAD Code on Transfer of Technology, which did not materialize into an international agreement (Patel, Roffe and Yusuf 2001).

Market-friendly policies at the national and international levels have replaced controls and regulations used earlier to promote technology transfer through FDI. This does not mean, however, that current international agreements do not envisage any policy interventions. But the market-friendly approach largely leaves technology contracts to the enterprises concerned, treating technology as a private asset that is traded on market principles, subject, among others, to general competition rules that control abuses. In other words, the inclusion of such practices in licensing arrangements is never entirely out of the reach of competition law.

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

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

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

Strategy objective	Policy	Policy instrument	Condition
Promote domestic technological capabilities by minimizing reliance on FDI	- Conditions on FDI - Incentives to partnership agreements - Government support to domestic firms - Foster national flagship firms	- Foreign ownership restrictions - Financial and tax incentives to local firms - Technical support, R&D promotion programmes - Effective export promotion - Encourage hiring of foreign experts, licensing and capital goods imports	- Exposure to international competition (as by strong export orientation) - Availability of skilled labour - Financial resources - Entrepreneur's willingness and ability to undertake risky technology investment - Institutions able to support skill, technology and export activity
Promote FDI with minimal government intervention in the expectation that it will involve technology transfer	- Encourage large FDI inflows - Relax FDI restrictions - Ensure macroeconomic stability	- Remove FDI restrictions or provide incentives - Liberalize trade - Foster competition and well-structured IPR regimes - Provide good infrastructure - General FDI promotion	- Efficient and credible institutions to administer market-friendly policies - High local absorptive capacity
Promote technology transfer by FDI with proactive government intervention	- Target specific TNCs - Provide incentives for TNCs to upgrade their technologies	- Industrial parks and advanced infrastructure - Well structured IPR regimes - High level skills and strong training system geared to activities promoted - Rigorous quality standards - Targeted incentives for activities and/or firms	- Institutions able to handle incentives - Institutions able to select technologies - Institutions for technology support and skill formation
Mixed strategy	- Promote linkages with domestic economy - Build local technological capabilities - Encourage deepening of TNC activity	- Business incubators - Information clearinghouses - Industrial parks - Supporting R&D - Supporting joint ventures, licensing and collaboration - Supporting training of domestic labour force	- Institutions able to bargain with TNCs - Institutions able to plan strategically - Ability to integrate skills, financial markets, infrastructure and technological capability development

Source: Adapted from WTO 2002a.

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

Perhaps the best example is the TRIPS Agreement, which considerably strengthened IPRs at the international level. While protecting the interests of technology sellers, Article 66.2 of the TRIPS Agreement stipulates that "developed country Members shall provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least developed country Members in order to enable them to create a sound and viable technological base". This is a mandatory provision on developed countries to promote technology transfer to LDCs. It does not specify what kind of technology transfer is to be supported and how, but it potentially strengthens the position of technology buyers in poorer countries.[106] The Doha Ministerial Conference then decided that this obligation needed to be strengthened through a monitoring mechanism (WTO 2001a, paragraph 11.2). This led in February 2003 to a reporting mechanism on actions taken or planned in pursuance of the commitments undertaken by developed countries under this article (box IV. 7).

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

Box IV.7. Implementation of transfer of technology provisions

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

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

Source: WTO 2003a.

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

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

This indicates that the concerns prompting earlier interventions in technology transfer have not disappeared, since market and institutional failures remain to be addressed. What has changed is the perception of how best to tackle them. The current thinking is that measures to strengthen local capabilities, markets and institutions are more likely to promote technology transfer and development than interventions in the contractual process. There is, however, a need to retain preferential treatment for developing countries. Indeed, the requirement that TRIPS places on developed countries to promote transfers to LDCs suggests that this is generally accepted.

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

H. Competition policy

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

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

1. Policy challenges

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

When foreign entry is accomplished by cross-border M&As, the probability of an anticompetitive impact increases for two reasons: first, because the number of competitors may be reduced; second, because cross-border M&As do not necessarily add new capacities. So countries tend to screen those transactions and often regulate them both at the entry and post-entry phases. Regulation at entry considers the potential market effect of the acquisition of a local enterprise by the foreign investor on competition in the host country industry, where the foreign investor might acquire sufficient market dominance to warrant such review. The control of potential post-entry anticompetitive behaviour by TNCs may be necessary to deal with the conflicting objectives of effective competition and local capacity building. Such action may be particularly needed for a host developing country in which the free play of market forces does not always bring the desired development results (*WIR97*, pp. 229–231).

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

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

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

Current models of competition law and policy do not distinguish firms by their nationality. Only their impact on competition matters. Moreover, they assume that maintaining and strengthening competition would lead to more development. Indeed, a shielding from market forces may become counter-productive in the longer term if it prevents enterprises from responding positively to market stimuli, if it brings about a loss of productive efficiency and innovation or if it allows collaborative R&D activity that is a front for anticompetitive collusion between enterprises.

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

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

2. International cooperation arrangements

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

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

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

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

A third trend is that some agreements seek to ensure the appropriate application of competition laws in support of trade, development and consumer welfare. Some go even further and seek to harmonize national laws for competition. The Recommendation of the OECD Council concerning Effective Action against Hard Core Cartels (OECD 1998b) is an example of the former, as is NAFTA's Chapter 15.[110] The EU Association and Europe Agreements that require the non-EU contracting parties to bring their national laws into conformity with the *acquis* of EU law are an example of the latter.

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

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

* * *

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

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

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

Notes

1 They are examined in UNCTAD 1999c, 1999d, 2000a, 2001e and forthcoming b.

2 Extraterritoriality was quite controversial in the MAI negotiations.

3 In addition, a new question is emerging from recent arbitral decisions under NAFTA as to whether measures relating to investment (such as, for example, bans on certain types of cross-border trade) that affect the operation of transnational supply and distribution activities of a foreign investor, should be included in any definition of "investment".

4 IMF 1993 and OECD 1996. Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. It consists of equity (at least 10% of total equity), reinvested earnings and inter-company debt transactions; the last of these includes loans, debt securities and suppliers' credits between direct investors and their affiliates. Portfolio investment includes equity up to or below 10% ownership (shares, stocks, preferred shares and preferred stock and depositary receipts) and debt securities not included under direct investment (bonds, debentures, notes and money market instruments). Financial derivatives include options (on currencies, interest rates, commodities, indices and the like), traded financial futures, warrants and arrangements such as currency and interest rate swaps. Other investments include trade credits, loans (including financial leases and repurchase agreements), currency (notes and coins in circulation), deposits and other assets and liabilities (such as miscellaneous accounts payable and receivable). In 1999 the IMF Committee on Balance of Payments Statistics created the new functional category of "financial derivatives" in the financial account of the balance of payments and excluded them from "portfolio investment". For a general description of FDI terms and concepts, see IMF/OECD, n.d.

5 An example of a broad, open-ended definition is the following. "The term 'investment' shall mean every kind of asset and in particular shall include though not exclusively:
a) movable and immovable property and any other property rights such as mortgages, liens and pledges;
b) shares, stocks and debentures of companies or interests in the property of such companies;
c) claims to money or to any performance under contract having a financial value;
d) intellectual property rights and goodwill;
e) business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources" (ASEAN Agreement for the Promotion and Protection of Investments, article 1(3), from UNCTAD 1996b, volume II, p. 294).

6 In the GATS, the Annex on Financial Services excludes from the agreement "services supplied in the exercise of governmental authority", covering, among other things, activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies (Article 1(b) of the Annex on Financial Services of the GATS Agreement). It also includes a provision on domestic regulation providing for a carve-out for prudential regulations, notably to ensure the integrity and stability of the financial system (Article 2(a) of the Annex on Financial Services of the GATS Agreement).

7 See, for example, Article XII of the GATS and Article 1109 of NAFTA for examples of traditional balance-of-payments safeguards.

8 The inter-agency task force that produced the *Manual on Statistics on International Trade in Services* in 2002 recommended using majority ownership (more than 50% share ownership) in defining foreign-controlled affiliates for collection of statistics on foreign affiliates' trade in services. These statistics are designed to provide data categorized along the lines of the four modes of services delivery under the GATS. The threshold used in these statistics to identify foreign affiliates (more than 50%) is much higher than the 10% threshold used for FDI statistics.

9 Moreover, the definition of FDI includes reinvested earnings and loans between parent companies and foreign affiliates. These can be used for rapid financial transactions.

10 The OECD Code of Liberalisation of Capital Movements seeks specifically to liberalize capital flows between members and to encourage such liberalization between members and non-members.

11 There have been discussions within the WTO Working Group on Trade and Investment on the issue of definition. The Doha Declaration (paragraph 20) makes reference to particular types of investment for consideration under trade and investment: "long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade". Within the Working Group, various WTO members have put forward a range of proposals for defining investment: including FDI only, including FDI and long-term foreign portfolio investment, including FDI and foreign portfolio investment and using a broad, asset-based definition.

12 For an elaboration, see UNCTAD 1999f, pp. 61–66.

13 Related standards pertain to MFN treatment and fair and equitable treatment. While important, these standards raise fewer sensitive questions, so they are not examined here. For a discussion, see UNCTAD 1999c and 1999d.

14 The GATS uses "market access".

15 For why a distinction between pre- and post-establishment national treatment is not advisable, see Wilkie 2001. Note that there is a difference between the "right of establishment" and "national treatment in the pre-establishment phase". The former refers to an absolute obligation of a host government to admit an investor. The latter remains a relative standard, even in the pre-establishment phase. In other words, where a host country grants a "right of establishment", it offers a right to set up a permanent business operation (which may be subject to exceptions and restrictions), regardless of how other investors are treated, while the latter conditions the right to enter a host economy on granting treatment that is at least as favourable as the treatment of domestic investors.

16 "Like circumstances" can apply to pre-establishment provisions too (for example, in NAFTA).

17 The 1984 amendment of the OECD Code of Liberalisation of Capital Movements reads as follows: "The authorities of Members shall not maintain or introduce: Regulations or practices applying to the granting of licences, concessions or similar authorisations, including conditions or requirements attaching to such authorisations and affecting the operations of enterprises, that raise special barriers or limitations with respect to non-resident (as compared to resident) investors, and that have the intent or the effect of preventing or significantly impeding inward direct investment by non-residents".

18 National laws may include a general law prohibiting discrimination based, say, on nationality, such as the United States Civil Rights Act, Title VII. Legal persons could use such laws to challenge what they might perceive as nationality-based discrimination. Thus, in principle, a foreign investor treated more disadvantageously than other investors could say that this is based on nationality and amounts to unlawful discrimination. In the European Union, this would be possible for intra-EU investors under the EC Treaty, Article 12. In any event, in many jurisdictions, foreign affiliates are considered to be domestic firms once they are established.

19 See, for example, the Federal Law on Foreign Investment in the Russian Federation (9 July 1999), Article 4: *International Legal Materials*, 39 (4), 2000, p. 894-906.

20 The BITs of Canada and the United States treat special programmes directed to minorities as exceptions to national treatment.

21 The benefits that FDI offers are well known but worth reiterating. It can add to physical investment. It can provide new technology, skills and organizational and managerial techniques (*WIR99*). It can stimulate local competitors and assist local suppliers (*WIR01*). It can take over and upgrade ailing local private or public enterprises (*WIR00*). It can transfer high value functions like design and development to countries with the requisite skills. It can provide the "missing elements" to develop manufactured exports in economies with weak domestic capabilities (in labour-intensive activities); its traditional strengths, of course, lie in resource-based exports. It can provide access to new global markets, some of which are internal to the TNC (*WIR96*) and so not accessible in any other way. These include the high technology exports organized in integrated production systems that provide the basis of export dynamism in several newly industrializing countries (*WIR02*).

22 The infant industry case applies to all enterprises regardless of ownership, and the threat to local capacity-building comes from exposure to imports from countries that have already undergone the learning process. It may therefore also apply to foreign affiliates that need to create new capabilities in a host developing country. But there is a relationship between infant entrepreneurship and infant industry policies: the case for the former (by restricting competition from FDI) is likely to be made only where local enterprises are also protected from import competition. In a liberal trading environment, local enterprises able to cope with import competition are unlikely to need protection from their overseas competitors setting up local affiliates. On the contrary, local enterprises should lead in the learning process because they know local conditions better and have been there longer than a new foreign entrant.

23 Note that this is based on an implicit preference for local ownership. It is also sometimes argued that FDI should be restricted from entering highly protected industries because TNCs would make, and repatriate, "excessive" profits. This may well be the case, but the fault lies not necessarily with the foreign affiliates but with the trade and tax regimes that allow excessive profits—it is a secondary matter if the profits are made by foreign rather than local firms.

24 For examples, see UNCTAD 1999a, pp. 18–19.

25 Under Article I of the GATS, trade in services is defined as the supply of a service, among other things, through the commercial presence of a service supplier of one member in the territory of any other member. By Article XXVIII(d) "commercial presence" is defined as meaning "any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person or (ii) the creation or maintenance of a branch or a representative office within the territory of a Member for the purpose of supplying a service".

26 However, it should be noted that in these latter two cases an objective element of comparison between the domestic and foreign investor is inherent in the standard itself. Thus they do not remove the need to show an objective justification for any difference in treatment between a foreign and domestic investor that are in a competitive situation with each other.

27 A further issue of substantive content, but one addressed in only a few IIAs, is whether national treatment extends not only to laws and practices that are on their face discriminatory as between national and foreign investors ("*de jure*"), but also to measures that are not expressly discriminatory but are applied in a manner that leads to *de facto* discrimination between national and foreign investors. This approach is taken in Article XVII (3) of the GATS, which asserts that: "Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member".

28 According to OECD publications on national treatment the issue needs to be determined in good faith and in full consideration of all relevant facts. Among the most important matters are whether the enterprises are in the same industry, the impact of the policy objectives of a host country and the motivation behind the measure involved. A key question in such cases is whether the difference in treatment is motivated, at least in part, by fact that the enterprises are under foreign control (UNCTAD 1999b, pp. 28–34; OECD 1985, pp. 16–17; OECD 1993, p. 22).

29 See further the NAFTA cases *S.D. Myers v Canada, Pope and Talbot v Canada, ADF Group v United States* and *Methanex v United States* available on www.naftaclaims.com.

30 See UNCTAD 1999b, pp. 43–46. A good example of a national law that uses a range of such exceptions is the 1993 Foreign Investment Act of Mexico, *International Legal Materials*, 33, p. 207 (1994), discussed in Muchlinski 1999, pp. 195–196. These exceptions are, in turn, reserved from the operation of the non-discrimination provisions of NAFTA in Mexico's schedule of exceptions to that agreement, as are the corresponding exceptions of the United States and Canada.

31 The term "nationalization" refers to takings in whole industries or the entire national economy, while "expropriation" denotes takings of individual firms (UNCTAD 2000b, p. 4).

32 In the United States–Singapore Free Trade Agreement (2003), an exchange of letters contains, in paragraph 4 of the United States letter to Singapore (which was accepted by Singapore), the following: "…4. The second situation addressed by Article 15.6.1 (Expropriation) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.
(a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:
(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
(iii) the character of the government action.
(b) Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."

33 See for a full discussion Khan 1990, pp. 171–202.

34 In the Santa Elena Case (box IV.4), the ICSID Tribunal held that a measure that gradually deprives owners of the value of their property over time can be identified as the starting point of the expropriation, even where the deprivation of the economic value of the property to its owner does not take effect within a reasonable period of time.

35 Indeed, the difficulty of drawing a clear line between general regulations, which investors must comply with, and regulatory takings, for which compensation must be paid if they are to be lawful, was one of the controversial issues of the Multilateral Agreement on Investment (MAI) negotiations. In addition, the risk of "regulatory chill" was a major focus of the opposition voiced by civil society groups to the MAI, especially after the proceedings in the case of *Ethyl Corporation v Canada* (Geiger 2002, pp. 97, 100–101). It should be noted that, during the course of the MAI negotiations an interpretative note to Article 1 of Annex 3 explained that the reference to measures "tantamount to expropriation" did not establish "a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments" (OECD 1998a, p. 13).

36 For example, in 1993 the Bavarian State Courts ruled that a claimant, who owned property on a lakefront that had become encompassed in a new State-regulated nature reserve, could not receive compensation even though this re-designation of the site meant that he could no longer leave the roads, camp, swim or use any watercraft (Dolzer 2002, p. 77). Some national regulatory takings have given rise to a number of recent arbitral awards under NAFTA; see box IV.3 for examples.

37 For example, Article 11 of the MIGA Convention expressly excludes from the covered risk of expropriation "non-discriminatory measures of general application which the governments normally take for the purpose of regulating economic activity in their territories".

38 Only United States agreements expressly use this terminology. Many agreements require the availability of judicial review before national tribunals, though this is usually restricted to a review of the taking after it has occurred. It does not extend to a review of a proposed taking (UNCTAD 2000b, pp. 31–32). Related to this is whether, and how far, IIAs should permit international review of takings by host country authorities: should these be subject to a prior requirement to exhaust domestic remedies or should international review be available as a matter of right? This issue is discussed further in relation to dispute settlement.

39 Notwithstanding such concerns, the possibility of governmental action, conducted under the guise of environmental regulation, which actually abuses the rights of investors, cannot be ignored. In such cases, the payment of compensation may well be appropriate, especially where the legitimate expectations of the investor have been undermined through arbitrary governmental action (Wälde and Kolo 2001).

40 Policy dilemmas may also arise from the area of punitive takings. If a punitive taking has been properly and lawfully imposed, resulting in a legally sanctioned confiscation of the investor's assets, would the investor nevertheless be entitled to sue for compensation under international obligations? In order to avoid such an eventuality, some instruments explicitly exclude such takings, for example, punitive tax measures, from the compensation obligation (UNCTAD 2000b, pp. 14–15).

41 As mentioned earlier, the issue of takings was not mentioned in paragraph 22 of the Doha Declaration, nor has it been suggested to be discussed by the WTO Working Group on the Relationship between Trade and Investment.

42 In keeping with traditional perspectives, some developing countries, and especially Latin American ones among them, have historically maintained that disputes between an investor and a host country should be settled exclusively before the tribunals or courts of the latter (referred to as the Calvo Doctrine; see Shea 1955). This viewpoint was manifested not only in the domestic legislation of individual countries; it also prevailed in certain regional agreements that prohibited parties from according foreign investors treatment more favourable than to national investors—and demonstrated a decidedly clear preference for dispute settlement in domestic courts. The United Nations Charter of Economic Rights and Duties of States of 1974 also took such an approach. More recently, Latin American countries have departed from this doctrine, for instance in their BITs and in MERCOSUR. Mexico abandoned the Calvo Doctrine when it entered NAFTA.

43 China, for example, requires recourse to local tribunals.

44 See for example the Nigerian Investment Promotion Commission Law 1995, section 26.

45 See for example the Federal Law on Foreign Investment in the Russian Federation (9 July 1999), *International Legal Materials*, 39 (4), 2000, pp. 894–904.

46 The concept of negotiation as a technique of dispute settlement used directly by each party is self-explanatory and requires no further definition. However, the other terms used in the text have some specialized connotations and may be defined as follows: *good offices* involves the use of a third party to liaise with the disputing parties and to convey to each party the views of the other on the dispute. The third party plays no part in suggesting solutions to the dispute. By contrast *mediation* and *conciliation* involve the third party in a more active role, in that they may intervene with suggestions as to how the dispute might be resolved, thereby helping the disputing parties towards a negotiated settlement. In practice it may be difficult to differentiate between mediation and conciliation on a functional basis, and the two terms can be used interchangeably (Asouzu 2001, p. 20). But they differ from arbitration in that the third party has no right or authority to determine the dispute independently of the parties.

47 Such impartiality has at times been questioned (Dezaly and Garth 1996).

48 This issue is discussed further in UNCTAD 2003d.

49 See for instance the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership, the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras, the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR and the 1997 EU–Mexico Partnership Agreement. Many of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements recently concluded by the EU provide for consultation through the body (cooperation or association councils) entrusted with the monitoring and implementation of the specific agreement.

50 See the Trade and Economic Cooperation Arrangements between Canada and, respectively the Andean Community (1999), Australia (1995), Iceland (1998), MERCOSUR (1998), Norway (1997), Switzerland (1997) and South Africa (1998), as well as the Agreements Concerning the Development of Trade and Investment Relations between the United States and, respectively, Egypt, Ghana, South Africa and Turkey (all concluded in 1999) and with Nigeria (concluded in 2000).

51 See, for instance, the 1994 Mexico–Costa Rica Free Trade Agreement, 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico, the 1997 Canada–Chile Free Trade Agreement, the 1997 Mexico–Nicaragua Free Trade Areas, the 1998 Chile–Mexico Free Trade Agreement, the 1998 Free Trade Agreement between Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) and the Dominican Republic, the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras, the 2000 Agreement between the United States and Viet Nam on Trade Relations and the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership (box III.2).

52 In this regard Article 25 (2)(b) of the ICSID Convention establishes that the local affiliate may be treated as a national of a foreign contracting party where it is controlled by nationals of that other contracting party, and it has been agreed between the parties that it should be treated as a foreign national for the purposes of the Convention.

53 For example in the case of Central European Media Enterprises Ltd., Bermuda v the Czech Republic (14 March 2003), an award of $269,814,000 was made, together with $1,007,750 of costs plus interest and legal costs. This amounted to a total of $354,943,542. See www.cetv-net.com.

54 The Dispute Settlement Understanding deals with investment related questions under the GATS and TRIMs Agreement.

55 Article 23 of the WTO Dispute Settlement Undertaking requires the members to use cross-retaliation only in accordance with the procedures set down in Article 22 and only upon a finding of a violation of the WTO agreements or of a nullification or impairment of benefits by a WTO Panel. Article 24 introduces special provisions for application in the case of LDC members. It requires due restraint in asking for compensation or in the use of cross-retaliation in cases where such members are found to have nullified or impaired the benefits of another member.

56 For example the WTO Kodak Fuji case was based on a claim on the part of Kodak that it was being systematically excluded form the Japanese market by the restrictive business practices of its major rival, Fuji. The case was brought before the WTO Panel by the United States, alleging that the restrictive practices of Fuji had been sanctioned by the Government of Japan in breach of its obligations under Article XXIII (1)(b) of the GATT.

57 Typically, awards in the investment area have taken the form of monetary compensation. But it is also conceivable that they could take the form of further market opening on the part of the loosing disputant, requiring it to open its market in certain areas to the assessed monetary value of the losses caused.

58 Joint venture and domestic equity requirements could also be classified as ownership restrictions.

59 Surveys of foreign investment in India report a high incidence of export restriction clauses imposed on foreign affiliates (Kumar 2001). Another study concluded that foreign parent firms actually discouraged their affiliates from exporting from India in view of the large domestic market (NCAER 1994).

60 These restrictive practices could take the form of market allocation, price fixing, exclusive dealing and collusive tendering (Puri and Brusick 1989). It was felt that local participation in management would lead to more competitive business practices. But such performance requirements sometimes allowed local partners to appropriate the rents from anticompetitive practices at the expense of the larger public.

61 See WTO/UNCTAD 2002; Moran 1998; Kumar 2001; Safarian 1993; UNCTAD 2003f.

62 Local content requirements have been employed by most of the developed countries from time to time, especially in the automotive industry. For instance, Italy required 75% local content on the Mitsubishi Pajero, the United States imposed a 75% rule on the Toyota Camry and the United Kingdom 90% on the Nissan Primera (Sercovich 1998). Australia imposed an 85% local content rule on motor vehicles until 1989 (Pursell 1999). See also OECD 1989; Safarian 1993; Guisinger et al. 1985; Chang 2002.

63 By the end of the 1980s, seven developed countries still had local equity requirements, six had local content requirements, three had export requirements, three had R&D requirements, two applied product

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

America but also in China, India, Indonesia, Singapore and Thailand (Spar 1998).

87 These gaps may arise from the general benefit of attracting TNCs to integrate the host economy more closely into global value chains, from specific technological and skill benefits of FDI, the stimulus to local competition or from launching a cumulative process of building industrial capabilities or agglomerations.

88 On the other hand, investments that are largely determined by incentives are more likely to leave as soon as the financial or fiscal benefits expire. In Botswana, for example, which offered generous investment incentives for the duration of five years for individual projects, many companies, both domestic and foreign, decided to close down their activities after the incentives had expired (UNCTAD 2003g).

89 For example, economic development agencies in the United States have included claw back clauses in incentive agreements, stating that, if the company concerned did not maintain this many jobs or spend that much capital, then the development agencies had the right to ask for the money back. While this right has traditionally seldom been exercised, there are signs that things are changing. For example, in response to such claims, Alltel, a large telecom company, volunteered to repay $11.5 million of the $13 million it got from the state of Georgia two years ago to set up a call centre in the state (*FDI Magazine*, "No more Mr nice guy", 2 February 2003).

90 LDCs and members listed in Annex VII until their per capita GNP reaches $1,000 are exempted. The list of "other countries" consists of Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe. In addition, extended transition periods were granted in December 2002 for specific programmes in Antigua and Barbuda, Barbados, Belize, Colombia, Costa Rica, Dominica, the Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Jordan, Mauritius, Panama, Papua New Guinea, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Thailand and Uruguay. These extensions can be annually renewed until 2007 (WTO Documents G/SCM/50 through G/SCM/102).

91 According to Article 27.8, there shall be no automatic presumption that certain subsidies granted by a developing country (i.e. those listed in Article 6.1 of the SCM Agreement) result in serious prejudice. Rather, such prejudice needs to be demonstrated. (However, the legal status of this provision remains unclear given the expiry of Article 6.1.) Finally, Article 29 granted some temporary exemptions for transition economies.

92 "The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures…"

93 See for example, Article G.14 of the 1997 Canada–Chile Free Trade Agreement. Similar restrictions exist in other Latin American free trade agreements though they are not as detailed as this provision.

94 For example, the ILO (2000) Tripartite Declaration "sets out principles in the fields of employment, training, conditions of work and life and industrial relations which governments, employers' and workers' organizations and multinational enterprises are recommended to observe on a voluntary basis" (paragraph 7). Similarly, in paragraph 41, it states that "Multinational enterprises should observe standards of industrial relations not less favourable than those observed by comparable employers in the country concerned".

95 Very little progress has been made under this negotiating mandate.

96 Accordingly, the modalities of the application of the non-discrimination principle in relation to programmes under which a contracting party provides grants or other financial assistance, or enters into contracts, for energy technology R&D shall be reserved for a "Supplementary Treaty". As of June 2003, this agreement had not yet been concluded. Each contracting party shall, through the ECT Secretariat, keep the Charter Conference informed of the modalities it applies to such programmes.

97 The technology "product" may be difficult to define. Its price often depends on the skills, information and bargaining power of the parties involved. Once transferred, the product is difficult to use without building new capabilities and it needs constant upgrading to remain competitive. Where the host economy does not provide the skills needed, the imported technology may not be upgraded sufficiently. The technological functions transferred also may not be upgraded: TNCs may transfer the operational end of technology but not its R&D stages, because the costs of doing so in new locations, particularly developing countries without strong technology systems, can be high (Lall 2002). The local diffusion of technology may be held back by the lack of capable local enterprises. TNCs may hem the transfer, use and diffusion of the technology by clauses to protect and maximize their returns. And stringent government restrictions on foreign ownership, operations and so on may deter TNCs from transferring their most valuable technologies.

98 A study of FDI in CEE found that joint ventures in R&D intensive activities led to less technology transfer than wholly owned foreign affiliates (Smarzynska 2000). Another study found that joint-venture obligations affected adversely the quality of technology transferred by foreign firms (Lee and Shy 1992). Moran (2002) argues that mandatory joint ventures are not effective because the technology employed is on average 10 years older than the most advanced technology in the industry, and training by TNCs in joint ventures is a fraction of that in wholly owned affiliates.

99 Only a few countries managed to intervene effectively in the transfer process by providing information and assistance to local enterprises in the context of strong export orientation and massive investments in skills creation and development (Kim 1997, 2002). Technologies from TNCs to the Republic of Korea, for example, were transferred mainly through imports of capital goods, reverse engineering in the 1960s and 1970s and various non-equity forms, given the restrictive FDI regime.

100 A number of foreign operations failed to meet government requirements because affiliates were unable to achieve full economies of scale, utilize the most advanced techniques or implement rigorous quality control (Moran 2002). A study of United States affiliates in 33 countries found that technology transfer requirements were negatively

correlated with technology flows to host countries (Blomström and Kokko 1995). Another found that intra-firm technology transfer by Japanese TNCs was discouraged when host authorities imposed technology transfer requirements as a condition of entry (Urata and Kawai 2000).

101 For example, technology transfer laws in Nigeria have not led to greater transfers of modern technology (Muchlinski 1999), largely because local capabilities and skills are weak and the business and trade environment is not conducive to technology upgrading (Okejiri 2000).

102 The empirical evidence on the impact of stronger IPRs is mixed. One study, based on firm-level data from economies in transition, indicates that a weak IPR system in a host country may discourage all investors, not only those in sensitive industries (Smarzynska-Javorcik, forthcoming). Another study suggests that stricter contract enforcement makes TNCs better off, while the outcome for host countries depends on TNCs' reactions to such enforcement (Markusen 2001). The host country's welfare improves if TNCs switch from exporting to the country to undertaking local production; however, a host country may be made worse off if local production exists and stricter IPRs affect it adversely. Furthermore, referring to various other studies, Kumar (2003) concludes that, in general, there is no strong link between stronger IPRs and FDI inflows and that the strength of patent protection does not appear to be a significant factor in determining the location of TNCs' R&D activities in host economies. See also UNCTAD 1993 and 1997.

103 For a compilation of instruments containing transfer-of-technology provisions, see UNCTAD 2001g.

104 Decision 24 was superseded by Decision 220, which was, in turn, superseded by Decision 291 of 21 March 1991, which now represents Andean Community policy in this area (UNCTAD 1996b).

105 Thus the Lomé Convention of 1989 contained numerous commitments on the part of the EU to assist in the transfer and acquisition of technology by developing countries in a variety of fields, including agriculture, industry, energy and tourism. The more recent Cotonou Agreement of 2000 revises this approach, further emphasizing market-led technology transfer. In a similar vein, agreements concluded between the EU and Latin American economic integration groups contain a commitment to economic cooperation that includes the encouragement of technology transfer.

106 Under Article 67 of TRIPS Agreement, developed country members are to provide, on request and on mutually agreed terms and conditions, technical and financial cooperation in favour of developing and least developed countries to facilitate the implementation of the Agreement. A similar approach is found in Article 8 of the Energy Charter Treaty, Article IV of the GATS Agreement and the revised OECD Guidelines for Multinational Enterprises, which state (in section VIII) that TNCs should "endeavour to ensure that their activities are compatible with the science and technology (S&T) policies and plans of the countries in which they operate and as appropriate contribute to the development of local and national innovative capacity". For a detailed discussion see UNCTAD 2001f, pp. 64–67.

107 See UNCTAD 2001g, pp. 41–50.

108 For an extensive discussion of this issue, see *WIR97*.

109 Updated information is available from: www.unctad.org/en/subsites/cpolicy/docs/CPSet/cpset.htm.

110 NAFTA's Articles 1502 and 1503 seek to ensure that monopolies and State enterprises do not act in a discriminatory fashion towards investments of investors of another party.

111 "Investment and Competition
These groups shall draw upon each other's work if necessary and also draw upon and be without prejudice to the work in UNCTAD and other appropriate intergovernmental fora…" (WTO 1996, paragraph 20). It should be noted that Article 9 of the 1995 TRIMs Agreement also made the connection between investment policy and competition policy by requiring the Council for Trade in Goods to consider whether the TRIMs Agreement should be complemented with provisions on these two issues in the course of its five-year review of the TRIMs Agreement.

112 The Doha Ministerial Declaration stated, in its paragraphs 23–25:
"INTERACTION BETWEEN TRADE AND COMPETITION POLICY
23. Recognizing the case for a multilateral framework to enhance the contribution of competition policy to international trade and development, and the need for enhanced technical assistance and capacity-building in this area as referred to in paragraph 24, we agree that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations.
24. We recognize the needs of developing and least developed countries for enhanced support for technical assistance and capacity-building in this area, including policy analysis and development so that they may better evaluate the implications of closer multilateral cooperation for their development policies and objectives and human and institutional development. To this end, we shall work in cooperation with other relevant intergovernmental organisations, including UNCTAD, and through appropriate regional and bilateral channels, to provide strengthened and adequately resourced assistance to respond to these needs.
25. In the period until the Fifth Session, further work in the Working Group on the Interaction between Trade and Competition Policy will focus on the clarification of: core principles, including transparency, non-discrimination and procedural fairness and provisions on hardcore cartels; modalities for voluntary cooperation and support for progressive reinforcement of competition institutions in developing countries through capacity building. Full account shall be taken of the needs of developing and least-developed country participants and appropriate flexibility provided to address them" (WTO 2001b, p. 5).