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**INTERNATIONAL INVESTMENT AGREEMENTS:
KEY ISSUES
Volume II**



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Selected UNCTAD publications on FDI and TNCs

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Chapter 13. State Contracts

Executive summary

One common mode of entry for foreign direct investment is through the making of a foreign investment contract with the State. State contracts have played a major role in the foreign direct investment process, especially in developing countries that are dependent upon the exploitation of natural resources for their economic welfare. Often, operation in a sector, such as petroleum, is open only to a State entity or through the making of a contract with the relevant State entity.

The issue of State contracts, as it relates to international investment agreements, concerns a number of specific matters. First, the extension of investment agreements' protection to State contracts depends on the scope of the definition of investment, the exclusion of certain State contracts from their coverage and in how far dispute settlement provisions of the agreements apply to State contracts. Arbitral tribunals have interpreted so-called umbrella clauses differently so that their protective effect cannot be fully assessed yet. Second, the preservation of host country discretion in the negotiation, conclusion and regulation of State contracts can be based on inscribing the basic principle of good faith and periodic review into an international investment agreement. Third, the duties towards private investor parties to State contracts compensate for the more favourable position of the State by allowing for clauses on stabilization, choice of law, arbitration and the breach of contract on the part of the host country government. Fourth, the development of substantive regimes of State contracts in international investment agreements is related to the commitment on the side of the government.

The conclusion identifies three policy options. First, countries that want to maintain complete freedom of action in relation to State contracts and avoid as far as possible international investment protection standards can exclude State contracts from international investment agreements. This option might signal caution to foreign investors, in cases when the

host country's legal system does not fully protect investors' rights. Second, countries wishing to extend protection to foreign investment, but maintain regulatory discretion, can opt for a limited protection of State contracts under international investment agreements by means of positive and negative lists, restrictions on the definition of contractual breaches and dispute settlement clauses, the exclusion of certain protection standards and an umbrella clause, as well as the inclusion of public policy exceptions. Third, full protection for investors into State contracts under international investment treaties can be achieved through unlimited definition of investment, unconditional dispute settlement, an umbrella clause and stabilization commitments.

Introduction

A “State contract” can be defined as a contract made between the State, or an entity of the State, which, for present purposes, may be defined as any organization created by statute within a State that is given control over an economic activity, and a foreign national or a legal person of foreign nationality. State contracts can cover a wide range of issues, including loan agreements, purchase contracts for supplies or services, contracts of employment, or large infrastructure projects, such as the construction of highways, ports or dams. One of the commonest forms of State contracts is the natural resource exploitation contract, sometimes referred to as a “concession agreement”, though this is not a strict term of art (Brownlie, 2003, p. 522). Such agreements feature prominently in the natural resource sectors of developing countries. Historically, these sectors have provided the most important source of income for the domestic economy and have often been State controlled, so that foreign entrants into the sector had to make contracts with the State entity in control¹.

A common mode of entry for foreign investors, especially into developing countries, is through the making of a foreign investment contract with the State or a State entity. This is

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often the case in sectors in which the State entity functions as a statutory monopoly under local laws. As a result, State contracts assume a special importance in the making of foreign direct investment (FDI) in developing countries. It is against this background that the issue of how international investment agreements (IIAs) treat State contracts needs to be considered. In particular, the extent to which IIA provisions can regulate the behaviour of countries, in their use and operation of State contracts, is a major concern.

This becomes all the more important when it is borne in mind that State contracts are generally viewed as being different from ordinary commercial contracts. Given the strong public policy considerations that may underlie governmental contracting, whether in relation to FDI projects or other State sponsored economic functions, an element of public law regulation and governmental discretion is often asserted in relation to the negotiation, conclusion, operation and termination of such contracts. The distinction between ordinary commercial contracts between private parties and a State contract made between a private party and a State or its entity is universally recognized in several domestic legal systems (especially in the French "*contrat administratif*" concept), although the precise approach varies from system to system (Turpin, 1972; Langrod, 1955). Generally, domestic legal systems treat contracts made with the State or State entities as a special category of contract subject to specialized regulatory rules.² For example, the rules of capacity of a State entity to make contracts will be stated in the legislation creating it, which may also identify the types of areas in which the State entity has the capacity to conclude contracts. Equally, the source of the law applicable to the contract is usually to be found in statutes and regulations on the subject matter of the contract as well as on the State entity concluding the contract.³ Often, operation in sectors, such as the petroleum sector, is open only to a State entity or in association with a State entity. Thus, entry into such a sector by other investors is possible only through the making of a contract with the relevant State entity.

In addition, domestic legal systems normally have restraints on the manner in which public funds are spent and received, and subject such matters to careful scrutiny through regulatory laws.⁴ Ministerial signature of a

contract may be a requirement, and there may be other specific procedures for review and scrutiny of the contract. The requirement for such care in controlling capacity and procedure itself indicates that State contracts are quite different from ordinary commercial contracts as they implicate State interests and may involve large parts of a State's financial and other resources.

Finally, the termination of a State contract may depend on conceptions of public need. This may attract rules for determining damages that are not entirely based on the commercial considerations that may apply to ordinary contracts. The means of termination may also differ between ordinary commercial contracts and State contracts. While both may be terminated by breaches, State contracts are often terminated, or their performance made wholly or partially impossible, by State action. Under several theories of domestic law, the power of the legislature may not be restricted by the existence of contractual commitments, although as a rule compensation may be owed under constitutional protections.⁵

As a result of such public policy-based control and discretion, the balance of rights and obligations under State contracts may favour the governmental party, for policy reasons that the governmental parties consider entirely legitimate. At the same time that balance can expose the private contracting party to the risk of interference with the commercial expectations that have induced the latter into the contract. It is this commercial risk that has motivated the development of rules of customary international law on State responsibility for breaches of State contracts. The main reason for the "internationalization" of States contracts is the concern over the impartiality of domestic courts and the objective to neutralize the in-built superiority of host country institutions, because of their sovereign powers of legislation abrogating or interfering with contracts. If such concerns would not exist, the need of the separate category of State contracts and their international protection by treaties and arbitration clauses disappears. Many of the most significant early foreign investment disputes concerned the operation and termination of such contracts, in particular, through renegotiation, expropriation or nationalization (Muchlinski, 1999, ch.14). These disputes resulted in international arbitral awards that considered and developed the relevance of State contracts and of the doctrines

associated with such contracts to the international law on foreign investment.⁶

State contracts were regarded to be subject, in principle, to the domestic laws of the host country but at least in the case of petroleum contracts, a tendency developed in the 1950s to regard these contracts as subject to a process of “internationalization”. Such contracts came to be regarded as “economic development agreements”, which should be subjected to international legal norms. Under the traditional view, the conditions for the validity of a State contract, including such matters as the capacity of the parties and the process of formation of a contract, are governed by the domestic law of each host country. It is recognized that, even in regimes subject to IIAs, if the contract in pursuance of which a foreign investment is made is illegal and void in terms of the domestic law, there is no scope for the invocation of a treaty to protect the investment.⁷ The theory of internationalization of contracts suggests, however, that the obligations arising from a contract may reside in an external system.⁸ This external system is variously described as transnational law of business, general principles of law, *lex mercatoria* and even as international law. This theory states that the use of certain clauses may have the effect of internationalizing the contract for certain purposes, at least those connected with termination and dispute resolution.⁹

One purpose of IIAs has been to bring about settled norms as between the parties to deal with a conflict. State contracts and the conflict of doctrines associated with them may be seen as a core purpose of making investment treaties. In this respect, IIAs are not normally designed to protect an individual contract, which is left for the parties to negotiate, but to ensure the stability of the operating structure of the investment within the host country (which may include investments covered by State contracts).

Accordingly, the aim of this chapter is to consider more specific IIA provisions that act to affect the negotiation, conclusion and observance of State contracts by both the governmental and private parties. The substantive standards of treatment that governments may be expected to observe, in relation to foreign investors that are parties to State contracts, are covered by other chapters in these volumes.

Section I Explanation of the Issue

As noted in the Introduction, the process of negotiation, conclusion, operation or termination of a State contract is of relevance to IIAs as it often forms the legal basis of the investment relationship between a foreign investor and a host country. Indeed, State contracts can be seen as part of a multiplicity of legal norms that affect the conduct of a host country’s FDI policy and, by extension, its relations with particular investors. Apart from the State contract itself, the investment relationship is governed by applicable rules of national law and policy, any bilateral investment agreements (BITs) concluded between the host and home country of the investor, any applicable regional or multilateral regimes and customary international law.

The issue of State contracts, as it relates to IIAs, concerns a number of specific matters:

- *The extension of IIA protection to State contracts.* At the outset it should be made clear that, in the absence of specific provisions of the type discussed below, an IIA, whether bilateral, regional or multilateral, does not automatically cover matters relating to State contracts. This is so even if an IIA incorporates by reference the standards of customary international law, because it is generally accepted that not every breach of State contract on the part of a State automatically entails a violation of international law, or a breach of an applicable IIA. It is generally accepted that, for such an effect to ensue from a governmental breach, this action must amount to a breach of international law, as where the breach amounts to a denial of justice or expropriation without adequate compensation, or a breach of an international agreement by which the host has accepted international responsibility for breaches of contractual obligations owed to nationals of other contracting States (Schreuer, 2004, pp. 249-250) or a breach caused by an act taken in a government capacity, as distinguished from a mere commercial act.¹⁰ Such a jurisdiction must be included in the agreement, especially given the public policy sensitivity surrounding the process of governmental contracting with private

parties. This may be accomplished through the definition of investment used in the agreement, and through any dispute settlement provisions that delimit the types of investment dispute that can be placed before the investor-State dispute settlement system offered under the terms of the agreement.

Also, numerous IIAs contain provisions granting protection for obligations assumed by a host country towards foreign investors, thereby bringing such obligations within the protection of the IIA. Such clauses are termed “umbrella clauses”. They add compliance with investment contracts, or other undertakings of the host country, to the substantive standards of the IIA. A violation of the investment contract becomes thereby a violation of the applicable IIA (Schreuer, 2004, p. 250).

- *The preservation of host country discretion in the negotiation, conclusion and operation of State contracts.* As noted in the Introduction, State contracts are often used in politically sensitive investment areas. Thus, they are usually subject to a special legal regime that gives considerable discretion to the government in the contractual process. This regime is an expression of a government’s right to regulate an investment in accordance with its national policy priorities. In effect, the national legal regime aims to preserve national policy space (UNCTAD, 2003a, chapter V). Given the protection offered to investors under the legal regime of IIAs, the exercise of certain discretionary powers by a host country under the applicable national legal order pertaining to State contracts may entail interference with an investor’s protection rights established in the IIA. In order to avoid such an eventuality, and as a means of preserving the host country’s legitimate rights to regulate in the national policy interest, IIA provisions can be drawn up to recognize the need for such policy space on the part of the host country. In the first place, the definition and scope provisions of an IIA can be drafted so as to preserve national discretion in the regulation of investments made through a State contract. In addition, provisions can require the negotiation and implementation of State contracts in good faith on the part of the

investor and the State; allow for periodic review; reaffirm national sovereignty over certain types of economic activity (see e.g. the Energy Charter Treaty, Art. 18); recognize the legitimacy of certain kinds of regulatory action in relation to investors, such as, for example, controls over illicit payments and the extension of competition laws to their activities; and preserve discretion to take measures for national security or other vital public policy reasons. In seeking to include such measures in IIAs, governments need however to consider the kind of signal they may be sending to potential investors.

- *Duties of the State towards private investor parties to State contracts.* In addition to the preservation of national policy space, IIAs can also introduce certain provisions that seek to establish certain duties of the State towards private foreign investors who enter into State contracts. This may reflect the concern that such parties can be adversely affected by the tendency of national State contract regimes to favour the State party. Such provisions can cover a range of possible questions, including, for example, the preservation of confidentiality of commercially sensitive information obtained by the State contracting party in the course of the conclusion of the State contract; a duty on the part of the host country government to negotiate in good faith; a commitment to accept responsibility for breaches of the State contract going beyond the express terms of an umbrella clause which requires mere observance of obligations; and the acceptance of an obligation to stabilize the national legal regime applicable to the State contract by undertaking not to make subsequent legal changes that affect the regulatory regime to which the contract is subject.
- *Development of substantive regimes of State contracts in IIAs.* It is rare to find IIA provisions that seek to affect the substantive detail of State contracts.¹¹ However, the content of such national laws and policies may lead to the application of provisions that are incompatible with the broad terms and objectives of international investment regimes as expressed in IIAs or in wider ranging free trade agreements that contain an investment element. For example, a State

contract could contain a preferential treatment provision that ensures the government will privilege the private investor party to the agreement over other foreign investors, contrary to the most-favoured-nation (MFN) principle. This has been a particular concern in the area of government procurement contracts. Such contracts can be seen as investment contracts where they involve the commercial presence of the private foreign party, as in the case of a long-term construction project, or a long-term services supply agreement. It is now the case that certain more recent free trade agreements are beginning to include some detailed provisions on the conduct of government procurement contracts. While it is hard to say that a trend is emerging towards the inclusion of detailed provisions on the substantive content of State contracts as such, this development is at least worthy of note, as a departure into the development of substantive international treaty obligations that may affect the operation and content of national contracting policies.

Section II

Stocktaking and Analysis

There are not many instances of direct reference to State contracts in IIAs. A contract is primarily a matter for the parties involved. States normally provide the operating conditions for contracts not only for purely domestic but also for State contracts. For this reason, it is not common for an IIA to make direct reference to State contracts as such, despite the obvious importance of State contracts for FDI. Nonetheless, the issues identified in the previous section do appear in the provisions of IIAs, and each will be examined in turn.

A. The extension of IIA protection to State contracts

1. *Definition of State contracts in IIAs*

The extent to which IIAs cover State contracts depends first of all on the scope of the definition of investment provided for in an agreement. The concept of “investment” is not static, but can evolve to meet new expectations. The extension

of IIA coverage to State contracts is therefore possible, given the use of an appropriate definition.

This is dependent on the application of a wide asset-based approach that includes “every kind of asset” and which elaborates on this general phrase with an express reference to breach of contractual obligations, owed by the host country to an investor of another contracting country, as a type of protected asset. This category can include rights such as those created by concession agreements conferring on an investor the right, for example, to search for, extract or exploit natural resources (UNCTAD, 1998a, p. 35). Examples of such provisions may be found in the 1994 BIT between Ecuador and the United Kingdom¹² which extends to “business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources” (Article 1(a)(v)) and in the 1995 BIT between Canada and the Philippines which covers “rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources” (Article 1(f)(vi)).¹³

The concession agreements that are usually referred to in these provisions are a variety of State contract. The purpose of their inclusion is usually to ensure that agreements in natural resources industries come within the definition of investments. Petroleum and natural resources contracts played a dominant role in the development of this area of the law and continue to receive attention because of the amount of investment that takes place in the sector. The term “business concessions” used in the treaties may be regarded as wide enough to capture terms in foreign investment contracts that confer special privileges upon an individual foreign investor.¹⁴ What is contemplated are privileges that lie within the sole prerogative of the State. Some treaties specifically refer to “business concessions under public law”.¹⁵ Rights over natural resources lie within such public law powers.

There are also a few treaties that define foreign investment as including the whole range of contractual rights. Such treaties may have the effect of extending the scope of the treaty's investment disciplines to include contract-based rights.¹⁶ An example is the following formulation:

“contractual rights, such as under turnkey, construction or management contracts, production or revenue-sharing contracts, concessions, or other similar contracts”.¹⁷

Such a formulation is broad enough to capture a large number of contractual rights, even those that do not fall within the realm of public law. The inclusion of such a provision may elevate the whole contract into the realm of treaty protection.

Apart from long-term contractual rights, such as licensing, management, franchise or turnkey contracts, protected contract rights may also include certain short-term rights such as claims to money and performance. However, contracts requiring immediate payment are unlikely to be seen as “investment” (UNCTAD, 1998a, p. 35).

In addition, the definitional provision may capture so-called “new property” such as administrative licenses and permits necessary to carry out the activity of the foreign investor in a host country. Screening laws require that a contract be submitted to, approved by and later be supervised as to its functioning by an administrative agency of the host country. This requires that, from the point of view of protection, the administrative licenses that are obtained by a foreign investor also be treated as property of the foreign investor and be protected. The 1994 Energy Charter Treaty, in Article 1(6)(f), defines investment to include “any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector”. In such instances, the IIA objective to neutralize the public law element is visible in the fact that the withdrawal of such licenses (once granted) is subject to treaty provisions. The licenses themselves, though not forming a part of the contract, are granted on the basis of the contract that has been formed and could properly be taken to be part of such contract.

2. Exclusion of certain State contracts from IIA coverage

A few IIAs, especially those adopting a general broad definition of investment covered by an agreement, tend to exclude certain types of contracts from their scope. For example, Article 1139 (h) of NAFTA excludes government

procurement contracts from the scope of the chapter on investment in the provision on definition of investment. It states that:

“[...] investment does not mean claims to money that arise solely from (i) commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party”.

This provision excludes private sales contracts, but it also seems to exclude sales contracts made with State enterprises.¹⁸

3. Dispute settlement provisions

As to the issue of dispute settlement, in order for an IIA dispute settlement clause to deal with disputes arising between a host country and a foreign investor under the State contract between them, it must be clear that this clause extends to breaches of obligations other than those found in the IIA itself. This is dependent on the wording that extends the jurisdiction of the dispute settlement body in question to any dispute “relating to investment” or “concerning the investment”, thus making clear that not only breaches of the IIA but also breaches of other obligations owed to the foreign investor, such as those found in the State contract that forms the legal basis of the investment.¹⁹

It is arguable that, where the definition of “investment” is wide enough to cover State contract obligations it may be presumed that disputes arising out of a State contract are within the jurisdiction of the dispute settlement body, in the absence of any express exclusion of such obligations from the dispute settlement clause. This view is reinforced in the case of agreements that contain an “umbrella clause”, as explained in the next section.

4. Umbrella clauses

There are general provisions in some IIAs that refer to the protection of obligations undertaken towards the nationals of other parties (box II.1). For example, Article 2(2) of the 1983 BIT between St. Lucia and the United Kingdom requires that:

“each Contracting Party shall observe any obligations it may have entered into with regard to investments of nationals or companies of the other Contracting Party”.

Box II.1. Umbrella clauses

From model BITs practice, at least two main approaches may be discerned with regard to the use of umbrella clauses. Most European model BITs, should they include such a clause, do so within the article on promotion and protection of investment. The clause usually reads as follows: "Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals or companies of the other Contracting Party" (1991 United Kingdom model BIT, Article 2(2); see also 2000 Denmark model BIT, Article 2.3, and the 2002 Sweden model BIT, Article 2(4)). The Swedish model is notable for the fact that the umbrella clause is combined with the full protection and security standard.

A further approach is exemplified by Article 8(2) of the German model BIT, which includes a provision almost identical to the umbrella clauses found in the majority of European model BITs in a non-derogation article. Article 8 of the German model BIT reads as follows:

"1. If the legislation of either Contracting State or obligations under international law [...] contain a regulation [...] entitling investments by investors of the other Contracting State to a treatment more favourable than is provided for by this Treaty, such regulation shall to the extent that it is more favourable prevail over this Treaty.
2. Each Contracting State shall observe any other obligation it has assumed with regard to investments in its territory by investors of the other Contracting State."

Source: UNCTAD.

Such clauses have been referred to as "umbrella clauses".

There is some uncertainty as to the precise nature and effect of these clauses. On the one hand, it has been asserted that such provisions protect an investor's contractual rights against "any interference which might be caused by either a simple breach of contract or by administrative or legislative acts" (Dolzer and Stevens, 1995, p. 82). Such a provision is included in a BIT in order to avoid the uncertainty under general international law whether such breaches of contract constitute infringements of international law. However, it is unclear whether the obligation that is created vis-à-vis the two State parties to the contract can be enforced by the foreign investor itself.²⁰

This issue has generated some recent case law. In particular, two recent arbitral decisions brought by the Swiss-based transnational corporation (TNC) Société Générale de Surveillance (SGS) against Pakistan and the Philippines have attempted, without much success, to clarify the extent to which an investor's claim against a host country government for breach of contract can be elevated to a claim under a BIT by relying on an umbrella clause in a BIT between the investor's home country and the host country. In each case, the central question was whether, through the umbrella clause in the applicable BIT, the investor's contractual claims against the host country (for breaches of contracts entered into for the provision of pre-shipment customs inspection services) could be resolved under the arbitration provisions of the BIT, rather than under the dispute resolution provisions of the contract under dispute.

The arbitral tribunal in *SGS v. Pakistan*²¹ had to interpret Article 11 of the 1995 BIT between Pakistan and Switzerland, which reads as follows:

"Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party."

The tribunal held that, unless expressly stated, an umbrella clause does not derogate from the widely accepted international law principle that a contract breach is not by itself a violation of international law, particularly if such contract had a valid forum selection clause. The tribunal added that the umbrella clause was not a "first order" standard obligation; rather, it provided a general pledge on the part of the host country to ensure the effectiveness of State contracts. A different interpretation would make many of the articles in the treaty "substantially superfluous".²² The Tribunal noted that:

"There would be no real need to demonstrate a violation of those substantive treaty standards if a simple breach of contract, or of municipal statute or regulation, by itself, would suffice to constitute a treaty violation on the part of a Contracting Party and engage the international responsibility of the Party".²³

Moreover, the structure of the treaty and the place in which the umbrella provision appeared also led the tribunal to conclude that

the provision did not elevate the contract into the protection regime of the treaty. The precise interpretation to be given to that provision, as well as the rationale of umbrella clause, was, however, left unclear. If the customary law principle that no international obligations arise from the mere breach of a foreign investment agreement were to be changed, one would assume that this would have been done through the precise use of language evidencing the intention of the parties.

The arbitral tribunal in *SGS v. the Philippines*²⁴ returned to the question of the effect of an umbrella clause. While the contract between SGS and the Philippines provided that the courts of the Philippines would have exclusive jurisdiction over disputes under the contract, SGS commenced ICSID arbitration proceedings on the ground that its contract claim could be elevated to a treaty claim under the umbrella clause of the BIT between the Philippines and Switzerland. In this case, the tribunal (not being bound by a strict doctrine of precedent) interpreted the umbrella clause in a way diametrically opposed to the interpretation adopted by the previous tribunal. It held that the umbrella clause did, in principle, have the effect of conferring jurisdiction on an arbitration tribunal constituted under the BIT to determine purely contractual claims between an investor and the host State. The tribunal disagreed that the umbrella clause was merely a “second order” protection, instead preferring the view that the clause “means what it says”. However, the tribunal held that even though it had jurisdiction under the BIT to arbitrate purely contractual claims, it would not exercise such jurisdiction in the case at hand since the parties had agreed to submit their contractual disputes to the exclusive jurisdiction of the Philippines courts. The investor should not commence arbitration based on the host country’s breach of contract if arbitrating the dispute would not be in compliance with the dispute resolution provision of the same agreement. Consequently, the tribunal stayed its own proceedings in favour of the Philippines courts.²⁵

The above cases do not offer a uniform or clear approach to the umbrella clause. From the perspective of an investor, the approach taken by the *Philippines* tribunal would offer greater protection, as it would make clear that a breach of a State contract amounts to a breach of a primary obligation in the BIT, placed upon the

host country by the umbrella clause, to observe contractual commitments (Schreuer, 2004, p. 255). On the other hand, the interpretation taken in the *Pakistan* case gives greater discretion to the host country to interfere with the contractual relationship with the investor and to have that action judged, not by reference to the mere fact of a breach of the underlying investment contract (which may well be entirely lawful under the national laws and policies of the host country), but by reference to other substantive treatment standards in the BIT. These require a more difficult standard of proof and, as a result, the protection offered by the BIT applies only where an investor meets that standard. It will not be met by reference to the breach of the State contract alone. Arguably, this approach could be seen as depriving the umbrella clause of any independent meaning, in that it would annul any possibility of viewing a breach of an obligation entered into by the host country under a State contract as amounting to a breach of the BIT by reason of an infringement of the umbrella clause.²⁶

B. Preservation of host country discretion and the creation of investor duties in the negotiation, conclusion and operation of State contracts

A significant issue that IIAs deal with in relation to State contracts concerns the preservation of host country discretion over this process and the creation of certain duties for the private party.

In particular, IIA provisions may contain requirements on the part of an investor and a government to negotiate in good faith and for periodic review of the State contract. These objectives were introduced into the 1983 draft United Nations Code of Conduct on Transnational Corporations, in its provisions concerning review and renegotiation of contracts (paragraph 11).²⁷ By this provision:

“Contracts between Governments and transnational corporations should be negotiated and implemented in good faith. In such contracts, especially long-term ones, review or renegotiation clauses should normally be included.

In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract or agreement was based, transnational corporations, acting in good faith, shall/should co-operate with

Governments for the review or renegotiation of such contract or agreement.

Review or renegotiation of such contracts or agreements shall/should be subject to [the laws of the host country] [relevant national laws and international legal principles].”

This formulation, including the alternative negotiating drafts, expresses exactly the essence of the conflict of norms concerning the operation of State contracts, described in the Introduction. In particular, while there was agreement on the issue of negotiation in good faith (an obligation that applied not only to a TNC but also to the host country government) and on the value of a renegotiation clause in such contracts, there was no agreement as to the legal force that this provision should have, nor upon the applicable laws. Developing countries would have favoured a binding provision in which national laws prevailed, while the major capital exporting countries would have preferred a non-binding provision and the application of national and international laws to the process. The disagreement over the status and effect of renegotiation clauses further reflected the uncertainty that existed at the time of the draft United Nations Code over whether changed circumstances could require a renegotiation, or whether this would undermine the theory of internationalization of contracts, which is built on the notion of the sanctity and immutability of contracts.

Apart from the draft United Nations Code, no explicit references to renegotiation appear to exist in IIAs. However, the 1985 draft United Nations Code on the Transfer of Technology contained some more detailed provisions on the conduct of negotiations leading towards a technology transfer agreement (see Chapter 5 “Responsibilities and Obligations of Parties”). Given that the draft Code on the Transfer of Technology contains a definition of “party” to a technology transfer agreement, which includes “States, Government agencies.... when they engage in an international transfer of technology transaction which is usually considered to be of a commercial nature...”, it is clear that the provisions of Chapter 5 of the draft Code could apply to State contracts for the transfer of technology. The thrust of these provisions was to emphasise the need of the parties to be responsive to the economic and social development objectives of, in particular, the technology acquiring country and to observe

fair and honest business practices, taking into account the state of development of the country concerned. Equally, requests for relevant information should be met and confidentiality protected.

In order to meet the issue of changed circumstances, a system of periodic review may be built into the terms of an IIA. One example comes from the 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tbilisi-Ceyhan Main Export Pipeline.²⁸ Article VI of this Agreement establishes an inter-governmental Implementation Commission. According to Article VI (2), its task is to provide a consultation forum for both the Governments parties to the Agreement and the project investors, in order to give prompt and effective assistance on the implementation of the pipeline project as well as to resolve, in good faith, any complications, issues, problems or disputes that may arise in connection with the Agreement, or to discuss any matter relating to the interpretation, application or enforcement of the Agreement. This provision is notable, as it appears wide enough to permit for the review, and possibly renegotiation, of certain terms of the Agreement, with the project investors.

C. Duties towards private investor parties in State contracts

As noted in the Introduction, the fact that a State or a State entity is one of the parties to a contract means that the State party is in a more favourable position, given that it has legislative and administrative power. The counterbalancing of this element of State power in a foreign investment contract is normally left in the hands of the foreign investor, as part of the negotiating process. This has resulted in the development and use of several types of contractual clauses that seek to protect the interests of foreign investors against arbitrary and unwarranted interference. These include *stabilization clauses*, which seek to preserve the law of the host country as it applies to the investment at the time the State contract is concluded, and which ensures that the future changes to the law of the host country are inapplicable to the foreign investment contract; *choice of law clauses*, may refer to a supranational system of law, such as transnational law, general principles of law or even international law, thereby putting the

contract beyond the host country's law; and *forum selection or arbitration clauses*, which have the effect of allowing an investor to submit disputes arising under the contract to an international tribunal usually constituted outside the territory of the host country. These clauses, either together or independently, can "internationalize" the transaction rather than subject it to the domestic law of the host country. The ability of such clauses, especially the stabilization clause, to fetter the legislative sovereignty of the host country is often doubted.²⁹ But arbitral awards have given effect to such clauses as indicating that they seek to achieve contractual stability at least for short periods (Tschanz, 1984). However, the question remains whether such clauses receive protection also from IIAs. On the whole, there is little practice in IIAs that bears expressly upon this problem. On the other hand, certain examples exist of provisions that seek to establish duties on the part of a host country in its dealings with investors under State contracts.

Turning, first, to stabilization clauses, no IIA contains such a clause as an international treaty obligation. However, the Italian model BIT states, in Article XII (3):

"After the date when the investment has been made, any substantial modification in the legislation of the Contracting Party regulating directly or indirectly the investment shall not be applied retroactively and the investments made under this Agreement shall therefore be protected."

While not amounting to a full stabilization clause, in that it permits subsequent changes in the laws and regulations that apply to the investment, this provision makes clear that such changes cannot apply retroactively.

A possible way by which the stabilization of legal conditions can be introduced into an IIA is displayed by the 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tbilisi-Ceyhan Main Export Pipeline. By Article II thereof, the contracting States warrant to each other that they shall promptly ratify this Agreement in accordance with their respective domestic constitutional requirements, take all steps necessary to establish the legal regime applicable to the pipeline construction project (the MEP Project) that is the subject of the Agreement, and that there are no obligations, whether in domestic or international legal commitments, that may

conflict with the terms of this Agreement. This warranty is further reinforced by the terms of Article II (7), which expressly relates the warranty to conformity of domestic and international legal commitments with the terms of the host country government agreement that each contracting State is to sign with the consortium of investors that are to undertake the project, that is the State contract used for this project. Article II (7) goes on to add to the warranty of conformity "any rights, privileges, exemptions, waivers, indemnifications or protections granted or arising under this Agreement or the other applicable Project Agreements". "Other Project Agreements" is defined as meaning "all written agreements and documented commitments, other than this Agreement and the Host Government Agreements, entered into by a State and/or any State Authority, on the one hand, and any Project Investor,³⁰ on the other hand, with respect to the MEP Project, as any or all of the foregoing agreements may be hereafter entered into, amended, modified or extended in accordance with their terms" (Article I). Therefore the warranty can cover all relevant agreements and commitments made to investors in relation to the MEP Project. It should be added that the host country government agreements contain a stabilization clause in Article 7(2)(xi), which defines a change in the law that must be rectified by the host country government as including inconsistent national or international obligations. Thus, to the extent that the intergovernmental agreement requires no inconsistency with the terms of the host country government agreement, this can be taken to include the need to ensure conformity with the stabilization clause contained in that agreement.

Other IIAs do not have such detailed provisions concerning the duties of government parties. However, certain provisions can be found that offer a degree of protection to the non-governmental party. For example, the United Nations draft Code of Conduct on TNCs placed the obligation to negotiate in good faith not only upon the TNC party but also on the host country government (paragraph 11). In addition, the United Nations draft Code required the governmental party to accord reasonable safeguards for the confidentiality of information provided to it by a TNC that contained confidential business information or legitimate business secrets (paragraph 51). Such

information could be obtained in the course of negotiating an investment agreement.

In certain model BITs, general non-derogation provisions seek to protect rights acquired by an investor under a State contract. For example, Article 16 of the 2004 United States model BIT reads as follows:

“This Treaty shall not derogate from any of the following that entitle covered investments to treatment more favourable than that accorded by this Treaty:
[...]

3. obligations assumed by a Party, including those contained in an investment authorization or an investment agreement” (See also 1998 United States model BIT, Article XI; Burundi model BIT, Article 7.1).

A further area of protection that has been considered in IIAs concerns the provision of insurance against risks of loss due to breach of contract on the part of the host country government. Thus, the 1985 MIGA Convention (Article 11(a)(iii)) includes, among the risks it covers:

“any repudiation by breach by the host government of a contract with the holder of a guarantee, when (a) the holder of a guarantee does not have recourse to a judicial or arbitral forum to determine the claim of repudiation or breach, or (b) a decision by such forum is not rendered within such reasonable period of time as shall be prescribed in the contracts of guarantee pursuant to the Agency’s regulations, or (c) such a decision cannot be enforced”.

This provision is echoed, in substantially the same terms, by Article 19(2)(c) of the 1992 Articles of Agreement of the Islamic Corporation for the Insurance of Investment and Export Credit. In a similar vein, the 1971 Convention Establishing the Inter-Arab Investment Guarantee Corporation covers, by Article 18(1)(a):

“[m]easures taken by the public authorities in the host country, either directly or through an agency, whereby the investor is deprived of his substantial rights with respect to his investment, and, in particular, confiscatory measures, nationalization, sequestration, expropriation, compulsory seizure,

deprivation of a creditor of his rights including the right of assignment, and the imposition of moratoria of unreasonable length.”

Although this provision mentions a number of specific acts, it is wide enough to encompass a breach of a State contract where this has the effect of depriving investors of their substantial rights under the agreement.

Finally, certain IIAs contain a clause that requires responsibility for breach of contract on the part of the host country government. This goes beyond the umbrella clause, which requires only observance of obligations but does not expressly deal with the consequences of a breach by the government party. Thus, the 1992 World Bank Guidelines on the Treatment of Foreign Direct Investment state that the rules applicable to the expropriation of foreign private investment will apply “with respect to the conditions under which a State may unilaterally terminate, amend or otherwise disclaim liability under a contract with a foreign private investor for other than commercial reasons, i.e. where the State acts as a sovereign and not as a contracting party” (paragraph 11 of Section IV). Compensation due to the investor in such cases is to be determined in the light of the rules prescribed by the Guidelines in paragraphs 2 to 9 of Section IV. On the other hand, liability for repudiation of a contract for commercial reasons, that is where the State acts as a contracting party, is determined under the applicable law of the contract.

Article 10 of the 1980 Unified Agreement for the Investment of Arab Capital in the Arab States also requires the compensation of an Arab investor for damages sustained due to a number of actions on the part of the State or one of its public or local authorities or institutions. These include: the undermining of rights or guarantees by reason of a decision by a competent authority; breach of international obligations arising out of this Agreement; preventing the execution of an enforceable judgment that has direct connection with the investment; and causing damage to an Arab investor “in any other manner, whether by deed or prevention, by contravening the legal provisions in force within the State in which the investment is made”.

D. Development of substantive regimes for State contracts in IIAs

The 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tbilisi-Ceyhan Main Export Pipeline is also of note in that it contains a number of substantive commitments as to the applicable regime under which the MEP Project is to take place, including the use of security forces to ensure the safety and security of project personnel, applicable technical, safety and environmental standards, and the applicable taxation regime. It is, thus, an international agreement that affects the content and operation of the specific State contracts and other binding commitments made between the consortium of investors and the three host countries.

However, this agreement is a special instance of a particular regime related to a specific major investment project. Most IIAs do not contain such specific substantive provisions that delineate the scope of the commitments that the government party has to include in the terms of the State contract. It should be borne in mind, however, that the General Agreement on Trade in Services (GATS) can have implications for agreements between private service providers and host country governments. Where these are to be put into effect through a Mode 3 (commercial presence) method of supply, such an agreement would be an investment agreement based on a State contract. Equally, a number of recent free trade agreements contain extensive provisions on the procedures to be followed in relation to government procurement contracts. Such provisions can be found, for example, in the United States-Singapore (Chapter 13)³¹, the Chile-United States (Chapter 9)³², the Chile-European Union (Title IV of Part IV)³³, the Chile-Republic of Korea (Part IV)³⁴, and the Australia-Singapore free trade agreement (Section 06).³⁵ They are based on the provisions of the 1994 WTO plurilateral Agreement on Government Procurement. In addition, some free trade agreements signed by Turkey contain commitments to the applicability of the MFN principle in government procurement.³⁶

Section III Interaction with other Issues and Concepts

If included in the coverage of an IIA, the issue of State contracts interacts with a significant number of other issues in IIAs (table 1). Apart from issues of scope and definition and dispute settlement – which, as noted in section II, are the most important provisions that deal directly with State contracts – the substantive standards of treatment all have a strong bearing on such contracts, given that the manner in which a private party is treated should comply with those standards.

Table 1. Interaction across issues and concepts

Issue	State contracts
Admission and establishment	+
Competition	++
Dispute settlement: investor-State	++
Dispute settlement: State-State	+
Employment	+
Environment	+
Fair and equitable treatment	++
Home country measures	0
Host country operational measures	++
Illicit payment	++
Incentives	+
Investment-related trade measures	0
Most-favoured-nation treatment	++
National treatment	++
Scope and definition	++
Social responsibility	+
Taking of property	++
Taxation	+
Transfer of funds	+
Transfer of technology	+
Transfer pricing	+
Transparency	+

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

The substantive content of State contracts is based on national economic laws and policies, which may also be the subject of

obligations under IIAs. Thus, there may be overlap with IIA provisions on taxation, host country operational measures, transfer of funds, technology transfer and the taking of property. Furthermore, State contracts may raise issues concerning the environmental protection, employment and social responsibility obligations of a private investor party. As with purely economic issues, such social matters are usually dealt with under the applicable national laws and policies. Given the nature of current practice, social issues are unlikely to be covered directly by an IIA, though this may well be the case in some agreements. On the other hand, the State party to a contract may be obliged to ensure that the terms of that contract are consistent with its international obligations in these areas, as may be provided for in specialized international instruments.

Issues of admission and establishment may be of more limited relevance, as a contract with the host country forms the basis of the admission decision. Thus, where a government concludes an investment contract with a foreign investor, admission based on that contract usually is automatic. Indeed, it can be expected that the State party to the contract is obliged to facilitate the granting of all relevant licenses, permits and authorizations necessary for an investment to be properly approved in accordance with national laws and regulations. Failure to do so may amount to a breach of the investment contract.³⁷

- **Competition.** Competition provisions can apply to a State contract where an IIA covers both private and public entities in the investment process and contractual rights are included in the definition of protected investment under the agreement in question.
- **Dispute settlement: investor-State.** As shown in section II, the scope of the investor-State dispute settlement provision is a key issue when determining the extent of protection that an IIA can give to the private party to a State contract. The availability of such dispute settlement mechanisms for disputes arising out of a State contract can be assured where the scope and definition clause covers contractual obligations and there are no limitations against such disputes in the dispute settlement clause. Such protection can be reinforced through the inclusion of an umbrella clause in an IIA. However, the issue of the availability of

international dispute settlement for breaches of State contracts has caused considerable controversy in cases in which a State contract contains a forum selection clause that refers disputes exclusively to domestic courts and tribunals. In such cases, it is unclear whether the arbitration clause in an IIA is available to investors, given that the latter have apparently consented, under the terms of the State contract, to waive their rights to international dispute settlement under the IIA. Much depends on the particular wording of the forum selection clause in the State contract,³⁸ as well as in the umbrella clause of the IIA that may provide for the application of "other obligations to the extent that they are more favourable" or to the contrary, provide that "in case of conflict, the provisions of the State contract will apply", as, e.g. in article 9.2 of the 1996 Italy-Jordan BIT. In addition the Energy Charter Treaty, Article 26.3c in connection with Annex IA, allows contracting parties that do not accept international arbitration under this Treaty with regard to State contracts, to exclude this on an individual basis (see also chapter 12).

- **Fair and equitable treatment.** This general standard of treatment may interact with State contracts to the extent that it may impose an obligation on the host country to act in good faith towards the foreign investor party to a contract and to observe general standards of good governance in this relationship. Where the standard is linked to international law in the IIA, it may introduce an additional duty to comply with the international minimum standard of treatment as interpreted in State practice and in relevant international arbitral awards. This does not require treatment additional to that needed to meet the international minimum standard.³⁹ On the other hand, given the controversy surrounding the application of the international minimum standard to State contracts, as described in the Introduction, the reference to this standard could be seen as a significant inroad into the host country's right to regulate. In addition, there remains considerable controversy as to the relationship between breaches of a State contract and breaches of substantive provisions of an IIA. For example, it may not always be certain that a breach of

contract amounts to a breach of the fair and equitable treatment standard as defined in an IIA or, indeed, whether it amounts to a regulatory taking as discussed below. This has been an issue in recent NAFTA arbitrations.⁴⁰ A further issue that arises is how far the principle of fair and equitable treatment can be used to introduce comparative administrative law analogies with the principle of legitimate expectations in the treatment of State contracts.⁴¹ Several recent arbitral awards have relied on the standard of legitimate expectations (or “detrimental reliance”, “estoppel”, “*venire contra factum proprium*”) as a standard of customary international law that also gives specific content to the “fair and equitable” investment discipline.⁴²

- **Host country operational measures.** A diversity of measures can be taken by host States to ensure that a foreign investment contract incorporates certain requirements on the part of an investor that contain a public interest element, such as, for example, minimum employment requirements. In the context of State contracts concerning foreign investment, such requirements become either express or implied terms of the contract. IIAs may contain a clause that prohibits, or limits, the imposition of performance requirements. Thus, where the host country is a member of the WTO, such requirements have to be consistent with the TRIMs Agreement (see chapter 14). NAFTA Article 1106 (1), for example, goes further and prohibits certain performance requirements not covered by the TRIMs Agreement. Such provisions negate the possibility of the inclusion of any clause relating to performance requirements in foreign investment contracts that are inconsistent with the host country’s treaty commitments in this regard. In this sense, IIA provisions controlling the use of performance requirements limit the host country’s freedom to impose performance requirements on investors through the terms of a State contract.
- **Illicit payments.** Prohibitions on illicit payments in international agreements have the effect of requiring the host country to control such practices through criminal law, and to prohibit such practices in relation to international business transactions, including

State contracts. Thus, a good governance standard is introduced into the negotiation, conclusion and operation of State contracts (see chapter 19).

- **MFN treatment.** In essence, a host country is free to choose with which foreign investor it concludes a foreign investment agreement. On the other hand, where a major investment project is put out to competitive tender, the MFN obligation requires that this process is carried out without discrimination between competing bidders from different countries. Accordingly, rules relating to government procurement may contain an MFN requirement. However, most recent agreements containing disciplines on government procurement do not have an MFN clause, but are restricted to national treatment protection, given the bilateral nature of the commitments involved. On the other hand, if a host country frequently concludes State contracts based on a settled practice arising out of its national laws and policies, then a failure to follow these established practices in a particular case could raise MFN compatibility issues. This may require the host country to show that the case in question is not in “like circumstances” to other cases and therefore merits a departure from usual practice.
- **National treatment.** This standard ensures that foreign investors are not discriminated against in the process of concluding and operating State contracts as compared to domestic investors. Again issues of contractual freedom arise in that a host country may wish to offer more favourable treatment to domestic investors for - policy reasons it regards legitimate. In such cases, an exception to national treatment may be required. In relation to government procurement, recent free trade agreements and the WTO Government Procurement Agreement all contain a national treatment provision.
- **Scope and definition.** The strong significance of this issue to State contracts has already been discussed in some detail in section II.
- **Taking of property.** This is the most difficult provision to deal with when considering the situation from the theoretical perspective of State contracts. In the old customary international law, the issue as to

whether the violation of a foreign investment contract through governmental interference gave *per se* rise to State responsibility was a contested issue. Today, the expropriation provision in an IIA may be drafted to cover both direct and indirect expropriation as well as acts tantamount to an expropriation. This provision usually requires that a lawful expropriation must be for a public purpose. It requires the payment of full compensation, even where the requirement of public purpose is satisfied.⁴³ The difficulty in determining compensation has become apparent in recent arbitral jurisprudence in relation to regulatory takings (UNCTAD, 2003a, chapter IV.C; Wälde and Kolo, 2001). More recent IIAs address this concern. Thus, the 2003 free trade agreement between Singapore and the United States contains an exchange of letters that sets out an understanding covering the matter of regulatory takings.⁴⁴ Respective letters state that:

“[e]xcept in rare instances, non-discriminatory 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” (para. 4(b)).

A similar technique is used in the 2003 free trade agreement between Chile and the United States (see Annex 10-D).⁴⁵ Such provisions may be seen as protecting a degree of regulatory discretion that may be particularly important in areas where FDI is undertaken through the means of a State contract.

Conclusion: Economic and Development Implications and Policy Options

State contracts have played a major role in the FDI process, especially in developing countries that are dependent upon the exploitation of natural resources for their economic welfare. As such, they represent an important tool of development policy. Without the use of such contracts significant opportunities for the introduction of FDI into strategic national industries may well have been lost.

On the other hand, such contracts, when used in relation to FDI, have themselves created

issues of concern to the development policies of host countries. In particular, earlier types of concession agreements, which included stabilization, choice of external law and internationalized arbitration clauses, began to be seen as inconsistent with the aims of host country development policies and with the right to regulate major investment projects. Although such difficulties led to major investment disputes in the second half of the 20th century, they also gave rise to newer types of provisions that allow for the regular review of long-term investment contracts (Muchlinski, 1999, ch. 14). Indeed, if State contracts are to act as a useful device for investment and development, they need to allow for a balance between the legitimate commercial expectations of an investor party and the right of a host country party to oversee the evolution of the resulting relationship in a manner that is consistent with national development policies. To the extent that IIAs can do so, they may be seen as a means of furthering that balancing process, particularly where they are geared towards flexibility in their provisions, a flexibility that can allow for a development-friendly approach to FDI policy, including policy towards State contracts.

Against this background a number of options present themselves for the treatment of State contracts in IIAs:

Option 1: the exclusion of State contracts from IIAs

Such an approach may be attractive to countries that want to retain complete freedom of action in relation to State contracts and to avoid, as far as possible, the application of international investment protection standards to such contracts. This can be achieved through the express exclusion of such contracts from the scope of an IIA and/or exclusion of references to breaches of contractual obligations as protected assets in the definition of investment. In addition, it may be made clear in the dispute settlement clause that it does not apply to disputes arising out of State contracts. Furthermore, the agreement would not have an umbrella clause.

The effect of such an approach might be to signal caution on the part of foreign investors as to the advisability of entering into State contracts with the host country in question. However, much would depend on the capacity of the host country's legal system to offer full protection and security for the rights of an investor under the State contract to which it has

become a party. If such protection is available, the added protection of IIA provisions may not be necessary to attract investors, and for them to have confidence in the security of their contractual rights with the government of the host country.

Option 2: limited protection for State contracts under IIAs

Where a host country wishes to extend protection under international commitments to investors that conclude State contracts with the government of that country, but wishes to maintain considerable discretion to regulate the resulting investment relationship, it may be possible to offer a limited degree of protection for the investor under the IIA. This may be achieved through a combination of any one or more of the following strategies:

- A positive listing of the types of State contracts that are covered by an IIA, allowing for the exclusion from the operation of the IIA of those not listed; or the negative listing of those types of State contracts that are excluded from the operation of the agreement, allowing for its application to those types of State contract that are not listed. Positive listing may be preferred by countries that do not wish to commit to a general application of the IIA to State contracts, but that wish to allow for its protection to specified classes of agreement, while negative listing may be attractive for countries that are committed to the extension of IIAs to State contracts, save for certain defined categories of excluded agreements.
- A restrictive definition of the kinds of contractual breaches that can attract the protection of an agreement with, for example, exceptions for public policy discretions to terminate the contract for public policy reasons.
- The restriction of dispute settlement clauses to those types of disputes arising out of State contracts that a host country is willing to subject to international dispute settlement mechanisms under the IIA.
- The possible exclusion of certain investor protection standards from particular types of State contracts, for example, by industry or size of investment.
- Inclusion of national security and general public policy exceptions into an IIA. The presence of such a clause may, of itself, be sufficient to protect regulatory discretion

even in an otherwise broadly protective treaty regime for State contracts.

- The exclusion of an umbrella clause.

Such an approach may engender a cautious response from investors. On the other hand, it would show a willingness on the part of the host country to limit its regulatory discretion in specific areas in which it wishes to encourage FDI through State contracts, while retaining it in those areas that are more policy sensitive and that require greater regulatory discretion based on national laws and regulations.

Option 3: full protection of State contracts

Full protection for investors entering into State contracts can be achieved through the following:

- An unlimited and unconditional definition of investment that includes any contractual obligation owed to the investor by the host country.
- A similarly unlimited and unconditional dispute settlement clause that applies to disputes arising out of State contracts.
- The reinforcement of protection under an IIA of State contracts through the inclusion of an umbrella clause.
- The introduction of a stabilization commitment into an IIA that acts to reinforce the stabilization clause in the State contract.

In addition, where a country wishes to accept international disciplines concerning the substantive content of certain types of State contract, it may conclude provisions containing such disciplines. These then inform the content of national policy and of specific contracts concluded with foreign investors.

* * *

Notes

- 1 For a recent discussion of State contracts, see Leben, 2004.
- 2 Some States have legislation governing such contracts. See, for example, the Government Contract Act in India and in Malaysia. That is not to say, however, that there is complete convergence between national laws on how this is to be done. For example, under French law a developed doctrine concerning administrative contracts (*contrat administratif*) has evolved, while in common law countries public law considerations have been introduced into general

principles of the common law of contract to cover government contracts.

- 3 Thus, in some States, a State entity cannot subject itself to arbitration abroad. There may also be restrictions as to choice of external legal systems. Such restrictions will not exist in the case of ordinary commercial parties.
- 4 For practice in Australia, see Fitzgerald, 2002, pp. 37-52.
- 5 See e.g. the decision by the United States Supreme Court in *United States v. Winstar* that upheld the validity of contracts against legislative abrogation (116 SCT 2432 (1996)).
- 6 For the literature on state contracts in international investment law, see Fatouros, 1962, 1969; Amerasinghe, 1967, pp. 66-119; Paasirvirta, 1990; Nassar, 1995, pp.133-135; Sornarajah, 2000, pp. 85-112; Bowett, 1988, pp. 49-74; Maniruzzaman, 2001.
- 7 See *Azinian v. Mexico*, Award of the Tribunal, para. 100.
- 8 This is a contested theory. Its proponents argue that the use of certain phrases (such as choice of law clauses) indicating transnational law, stabilization clauses that freeze the host country law at the time of entry and arbitration clauses which indicate arbitration outside the State have the effect of internationalizing the contract. See Schwebel (1987) on whether the breach by a State of a contract with an alien is a breach of international law. For a critical view, see Sornarajah, 2004.
- 9 See especially *Texaco/Calasiatic v. Libya*, 53 ILR (1979), pp. 389. Critical: see Sornarajah, 2000, pp. 223-278. For a similar conflict of norms, see the development and relevance of the Calvo doctrine in international investment law: Shea, 1955; Fatouros, 1962, 1969; Schrijver, 1997.
- Over the past ten and in particular five years, an extensive arbitral jurisprudence has developed based on IIAs. This jurisprudence may gradually be developing an international law of State contracts in applying the usually very open-ended provisions of investment treaties to specific situations. For a recent study of the contribution of recent investment arbitration, see Benhamida, forthcoming. For an up to date discussion on the contribution by recent NAFTA Chapter XI arbitrations, see Weiler 2004. For a review of investment disputes arising from BITs and NAFTA, see UNCTAD 2004a.
- 10 There are several recent arbitral awards (on jurisdiction) that deal with the relationship between treaty arbitration on the one hand, and (concession) contracts under domestic law and with domestic jurisdiction clauses, on the other. Notably, *CMS vs. Argentina*, *Azurix vs.*

Argentina, *Siemens vs. Argentina*, and most authoritatively, the decision of the ICSID annulment committee in the *Vivendi-Argentina* case (see. www.worldbank.org/ICSID).

- 11 Except in intergovernmental agreements signed in the past by socialist countries, or in project-specific intergovernmental agreements (e.g. for the Channel tunnel).
- 12 Unless otherwise indicated, the texts of the BITs and other agreements and instruments mentioned in this chapter may be found in UNCTAD's on-line databases on BITs or international investment instruments (www.unctad.org/ia).
- 13 See also Article I(3)(e) of the 1987 ASEAN Agreement for the Promotion and Protection of Investments, which reads as follows: "business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources." This provision captures primary industries, including plantations as well as natural resources.
- 14 The concession, however, denotes a right that is within the power of the government to confer rather than a negotiated term.
- 15 1989 BIT between Germany and Guyana (Article 1.1(e)).
- 16 Such a provision would be: "rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources" (Article 1(f)(vi) of the 1995 BIT between Canada and the Philippines).
- 17 This formulation can be found in a number of United States BITs. See, for example, Article I(d)(iii) of the 1998 Bolivia-United States BIT.
- 18 For a similar provision, see the 2004 Canada model BIT, Article 1(X) (on the definition of "investment").
- 19 For examples of this approach, see Article 8(1) of the 1991 Argentina-France BIT or Article 9 of the 1994 Lithuania-Netherlands BIT.
- 20 Dolzer and Stevens leave the matter unclear in their short reference to the issue. Their discussion opens with the statement: "These provisions seek to ensure that each Party to the treaty will respect specific undertakings towards nationals of the other Party" (Dolzer and Stevens, 1995, p. 81).
- 21 Decision on Objections to Jurisdiction, 6 August 2003.
- 22 See paras. 165-170 of the Award.
- 23 Para. 168 of the Award.
- 24 Decision on Objections to Jurisdiction, 29 January 2004.
- 25 On the issue of waiver of international jurisdiction over investment disputes through a dispute resolution provision in a state contract, see further Spiermann (2004).

- ²⁶ See further on the question of whether an umbrella clause can turn a breach of contract into a breach of the IIA: Dolzer and Stevens, 1995; Karl, 1996; Schreuer, 2004; Schwebel, 1994; Sinclair, 2004; Vandevelde, 1992, p. 78; Wälde, forthcoming. An analysis of the origin, as well as original and changing context of the umbrella clause suggests that it was not intended to elevate all sorts of commercial and contract law disputes to the level of international law and the jurisdiction of a treaty-based tribunal, but rather is intended to capture the reliance on (probably mainly abusive reliance) government powers and prerogatives to allow a government to escape from its own contractual commitments. It is therefore in the historical context rather a specific sub-set of the expropriation discipline that, before umbrella clauses were used and where they are not used, is applied to cover cases of governments using their sovereign powers to escape from contractual commitments.
- ²⁷ On the renegotiation of international investment contracts, see Kolo and Wälde, 2000; Berger, 2003.
- ²⁸ Agreement among the Azerbaijan Republic, Georgia and the Republic of Turkey Relating to the Transportation of Petroleum via the Territories of the Azerbaijan Republic, Georgia and the Republic of Turkey through the Baku-Tbilisi-Ceyhan Main Export Pipeline. For the text see <http://www.caspiandevlopmentandexport.com/Downloads/BTC/Eng/agmt4/agmt4.PDF>.
- ²⁹ See for a statement of this position Sornarajah, 2000, pp. 50-51. For an alternative perspective, based on a survey of past treaty practice, see Ndi and Wälde, 1996.
- ³⁰ Defined as “each Person that is a party to a Host Government Agreement (other than the Government of any of the respective States in the capacity of a host government counterparty to any such Agreement), and any operating company, branch, office, permanent establishment, affiliate, nominee, agent or representative of such Person, and any successor or assignee of any of the foregoing in respect of the MEP Project”(Article I).
- ³¹ For the text of the Agreement see http://www.mti.gov.sg/public/FTA/frm_FTA_Default.asp?sid=36.
- ³² For the text of the Agreement see http://www.sice.oas.org/Trade/chiusa_e/chiusaind_e.asp.
- ³³ For the text of the Agreement see http://www.sice.oas.org/Trade/chieu_e/cheuin_e.asp.
- ³⁴ For the text of the Agreement see http://www.sice.oas.org/Trade/Chi-SKorea_e/ChiKoreaind_e.asp.
- ³⁵ For the text of the Agreement see <http://www.dfat.gov.au/trade/negotiations/safta/index.html>.
- ³⁶ See, for example, the Lithuania-Turkey FTA (Article 28), or Croatia-Turkey FTA (Article 28).
- ³⁷ This issue has recently been treated in the following arbitral awards: MTD v. Chile (2004); Tecmed v. Mexico (2003). Available at www.worldbank.org/icsid and www.naftaclaims.com.
- ³⁸ On this issue see further Spiermann (2004).
- ³⁹ See *Pope & Talbot Inc. v. Canada*, Award on Damages, 31 May 2002.
- ⁴⁰ See *Azanian v Mexico* (1999) and UNCTAD, 2003a, at pp. 113 and 117.
- ⁴¹ See *Occidental v Ecuador*, LCIA Case No. UN3467, 1 July 2004.
- ⁴² MTD v. Chile, 2004; *Occidental v. Ecuador*, 2004; *CME V. Czech Republic*, 2003; 42 ILM 811; *Tecmed v. Mexico*, 2004; *Metalclad v. Mexico*, 2000 - available at www.worldbank.org/icsid and www.naftaclaims.com. The issue is being considered at present in other BIT-based arbitration cases. "Legitimate expectations" is a principle of international law, but also in developed countries' administrative law and in the law applied by the WTO and the EU to provide external disciplines over domestic administrative action. It usually involves a balancing between the legitimate expectation of investors with public policy objectives in order not to lose the flexibility for future policies.
- ⁴³ There are widely diverging arbitral awards with respect to damages for cancellation of contracts. In some agreements, the investor has obtained compensation to include both past expenditures and the net present value of expected future cash flows (*CME v. Czech Republic*, 2003; *Karaha Bodas v. Indonesia*, 1999). In other cases, in particular where a contract had as yet not been implemented, compensation was calculated to include only expenditures spent so far. In the first Energy Charter Treaty case, partial compensation was awarded for under-payment of contractual charges due, together with an order to pay all contractually due future tariff charges (Wälde and Hober, forthcoming).
- ⁴⁴ For the text of the Agreement see http://www.mti.gov.sg/public/FTA/frm_FTA_Default.asp?sid=36.
- ⁴⁵ For the text of the Agreement see http://www.sice.oas.org/Trade/chiusa_e/chiusaind_e.asp.

Chapter 14. Host Country Operational Measures*

Executive summary

The concept “host country operational measures” (HCOMs) captures the vast array of measures implemented by host countries concerning the operation of foreign affiliates once inside their jurisdictions. HCOMs can cover all aspects of investment (such as ownership and control, hiring of personnel, procurement of inputs, sales conditions) and usually take the form of either restrictions or performance requirements. They are usually adopted to influence the location and character of foreign direct investment (FDI) and, in particular, to increase its benefits in the light of national objectives. Some are those investment measures affecting trade flows, better known as trade-related investment measures (TRIMs). Often, HCOMs are also methods of intervention whose aim is to correct actual or perceived market distortions.

In international investment agreements (IIAs), HCOMs have rarely been considered as a separate issue. More often than not, the international regulation of such measures has to be deduced from more general norms on post-entry treatment of investment. One IIA, however (the WTO Agreement on TRIMs¹), specifically deals with a number of HCOMs. The more recent IIAs that regulate HCOMs tend towards the restriction of some of these measures. However, the majority of IIAs, especially most bilateral investment treaties (BITs), adopt an approach to investment that does not explicitly address the use of operational restraints as a specific issue on its own; each host country government is free to regulate FDI within its jurisdiction, in line of course with its international obligations.

This chapter groups HCOMs into three categories (table 1) and proceeds with discussing them in the context of some of their restrictions at different international levels:

- HCOMs that are explicitly prohibited at the multilateral level, i.e. by the TRIMs Agreement. A number of interregional,

regional and bilateral agreements also explicitly prohibit the same HCOMs (or, where these agreements are in a draft form, envisage their prohibition). To use a traffic light analogy, these are “red light” HCOMs, i.e. measures that the international community as a whole (or, more precisely, as represented in the WTO) has agreed should not be employed (although not all countries feel comfortable with the implementation of this agreement).

- Additional HCOMs that are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements (or drafts thereof). These are “yellow light” HCOMs in the sense that negotiators of IIAs ought to be aware that some countries (or groups of countries) have indeed prohibited them in some IIAs and perhaps would like to do so also at the multilateral level. Categorizing these measures as yellow light HCOMs should not suggest that they are not as legally binding as the red light HCOMs. Indeed both derive from instruments governed by international law, and which, among the parties, create binding legal obligations. The point of emphasis is that the red light HCOMs have, in terms of parties, a wider application.
- All other HCOMs. These are “green light” HCOMs. Such measures are generally not subject to control through IIAs although their use may be subject to other international obligations, e.g. to apply national treatment.

Today, countries negotiating international investment rules need to take as given the first group of HCOMs (unless there should be a renegotiation or modification of the TRIMs Agreement). Negotiations — should they at all include HCOMs — are likely to focus on “yellow light” HCOMs. But options go beyond either covering or not covering certain HCOMs. For example, the extent to which certain HCOMs are tied to certain conditions (e.g. incentives) or the legal nature of any coverage (e.g. best-efforts clauses) can introduce some flexibility. In fact, even

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when it comes to the TRIMs Agreement, various options as to its further implementation exist.

Table 1. Three categories of HCOMs

Category	HCOM
“Red light” HCOMs	Local content requirements Trade-balancing requirements Foreign exchange restrictions related to foreign exchange inflows attributable to an enterprise Export controls
“Yellow light” HCOMs	Requirements to establish a joint venture with domestic participation Requirements for minimum level of domestic equity participation Requirements to locate headquarters for a specific region or the world market Employment performance requirements Export performance requirements Restrictions on sales of goods or services in the territory where they are produced or provided Requirements to supply goods produced or services provided to a specific region or the world market exclusively from a given territory Requirements to act as the exclusive supplier of goods produced or services provided Requirements to transfer technology, production processes or other proprietary knowledge Research-and-development requirements Measures contrary to the principle of fair and equitable treatment
“Green light” HCOMs	All other HCOMs

Source: UNCTAD.

Introduction

Governments of host countries adopt various measures that affect the day-to-day life of foreign affiliates and domestic firms in a number of ways and for a number of reasons. In fact, virtually all

countries have an elaborate regulatory framework that prescribes the rights and responsibilities of firms. A number of these measures are specifically designed to affect the operations of foreign investors. It is the latter set of measures that is labelled “host country operational measures”. Among them are local content and export requirements, that is to say, measures requiring that a certain percentage (determined either by value or by quantity) of the output resulting from a foreign investment has to be locally sourced or has to be exported. Also used are local equity participation requirements (which may shift management decisions to domestic interests), as well as measures affecting the employment and training of personnel, particularly at the managerial and professional levels; technology transfer and research-and-development requirements; trade-balancing requirements (which link imports/exports of one product to exports/imports of another product); foreign exchange restrictions (such as limiting the availability of foreign exchange to an amount related to foreign exchange inflows attributable to a firm); and earnings remittance limits (which specifically restrict the amount of profit which can be repatriated).

Usually, HCOMs are implemented with the aim of influencing the location and character of investment and, in particular, its costs and benefits. Governments frequently attempt to influence the pattern of resource use through investment policies. For example, local content requirements have been imposed on affiliates of transnational corporations (TNCs) to encourage industrialization or to expand local employment; technology transfer obligations have been used to develop and diffuse industrial skills; and minimum export requirements have been imposed to earn foreign exchange. Local equity requirements have also been used to ensure a certain degree of control for local management, and licensing requirements to strengthen the position of domestic firms in contract negotiations with foreign enterprises. In this sense, HCOMs are intended to perform a developmental role. On the other hand, it has been argued that efforts by Governments to influence where or how production should take place, except to correct for negative externalities or byproducts of firms’ actions that damage society (like pollution), often lead to a misallocation of resources. Policies that affect the free interplay of market forces can also cause distortions in the pattern of international trade and investment (see also UNCTAD, 2003b).

More generally, HCOMs are usually part of a broader policy regime aimed at enhancing national welfare. Moreover, such measures are often used by host country Governments in conjunction with other specific policy instruments such as investment incentives. Incentives may be granted in various forms such as cash grants, tax breaks, inputs and factor subsidies or export incentives. FDI may also be favourably induced by the prospect of supplying a protected market. In the bargaining process with potential investors, Governments can thus use HCOMs, together with incentives, to impose some kind of development-conditionality on an investment (UN/DESD/TCMD, 1992a).

Section I Explanation of the Issue

A number of HCOMs gained prominence as an investment policy tool during the 1970s. During that period, host countries increasingly evaluated the contribution of FDI towards their own major development objectives (e.g. the improvement of their balance of payments, the strengthening of technological capacity and improved labour skills) and their non-economic interests (e.g. social and cultural values, environmentally friendly development). As they determined that the contribution of FDI was not always fully consistent with their objectives, a number of host country Governments started implementing measures aimed at modifying the behaviour of foreign affiliates. This was the birth of a more widespread use of HCOMs.

The increasing role of FDI during the 1980s and 1990s as an important and more stable source of private capital inflows to developing countries contributed to a change in attitude of Governments to the use of HCOMs. There was a recognition that the potential to attract foreign investors is not a static phenomenon, and that policy measures by host country Governments play a role in designing an environment conducive to FDI. There was also an increasing recognition that not all HCOMs had positive effects under all circumstances and that, in a number of areas, other policy tools may be more effective. Nevertheless, HCOMs remain a policy tool used by Governments to further their development objectives (as discussed further in the concluding section of this chapter).

A commonly accepted definition of what constitutes a HCOM does not exist. Literally, the term “host country operational measure” refers to

any policy measure adopted by a host country Government to influence the operations of foreign investors. In this broad sense, HCOMs could include not only operative restrictions or performance requirements (see below), but also investment incentives and any administrative requirement likely to impinge on the activity of a foreign investor. Moreover, HCOMs are often deliberately opaque or sometimes even regarded as a matter of confidentiality between a host Government and an investing firm.

All these complex factors make it difficult to categorize HCOMs in a comprehensive and accurate way. To overcome this complexity, HCOMs have usually been elucidated by a documentary approach, that is to say, by illustrative lists of measures so far observed (box 1).

Box 1. Illustrative list of HCOMs

- Restrictions on employment of key foreign professional or technical personnel, including restrictions associated with the granting of visas and permits.
- Requirements to establish a joint venture with domestic participation.
- Requirements for a minimum level of domestic equity participation.
- Requirements on location of headquarters for a specific region or the world market.
- Public procurement restrictions (e.g. foreign affiliates are excluded as Government suppliers or subject to providing special guarantees).
- Restrictions on imports of capital goods, spare parts, manufacturing inputs.
- Restrictions/conditions on access to local raw materials, spare parts and inputs.
- Restrictions on long-term leases of land and real property.
- Restrictions to relocate operations within a country.
- Restrictions to diversify operations.
- Restrictions on access to telecommunications networks.
- Restrictions on the free flow of data.
- Restrictions relating to monopolies or participation in public companies (e.g. an obligation to provide a public service at a certain price).
- Restrictions on access to local credit facilities.
- Restrictions on access to foreign exchange (e.g. to pay for foreign finance, imports of goods and services or remitting profits).
- Restrictions on repatriation of capital and profits (e.g. case-by-case approval, additional taxation or remittances, phase out of transfers over a number of years).
- “Cultural” restrictions, mainly in relation to educational or media services.
- Disclosure of information requirements (e.g. on the foreign operations of TNCs).

/...

Box 1 (concluded)

- Special requirements on foreign firms in certain sectors/ activities (e.g. on branches of foreign banks).
- Operational permits and licences (e.g. to transfer funds).
- Special requirements on professional qualifications, technical standards.
- Advertising restrictions for foreign firms.
- Ceilings on royalties and technical assistance fees or special taxes.
- Limits on the use of certain technologies (e.g. territorial restrictions), brand names, etc., or case-by-case approval and conditions.
- Rules of origin, tracing requirements.
- Linking local production to access or establishment of distribution facilities.
- Restrictions related to national security, public order, public morals, etc.
- Sourcing/local content performance requirements.
- Manufacturing performance requirements.
- Technology transfer requirements.
- Regional and/or global product mandates.
- Research-and-development requirements.
- Employment performance requirements.
- Training requirements.
- Export requirements.
- Trade-balancing requirements.
- Import restrictions, local sales requirements.
- Linking export quotas to domestic sales.
- Export/foreign exchange earning requirements.

Source: Based on UNCTAD, 1996a; UNCTAD, 1996b p.179; and UNCTAD, 2000a.

Although such an inventory can be quite detailed, it provides little insight into the different characteristics of the various measures listed, as well as into the characteristics and political economy of this category as a whole.² Further considerations can help the elaboration of some special characteristics of HCOMs:

- ***They are meant to respond to special host country Governments' policies...***

HCOMs are typically adopted in the framework of special host country Governments' policies, either through instruments of general application (laws, regulations, administrative guidelines) or on a specific basis during the investor-host State bargaining process that may precede an investment decision.

- ***... cover a very wide range of measures ...***
HCOMs may affect almost all aspects of foreign affiliates' operations. They range from restrictions or requirements on ownership and control, to sourcing of inputs, production technologies, and sales.

- ***... are specifically designed to affect FDI ...***
Among the vast array of national measures that may concern the operations of foreign investors, only those specifically designed to affect foreign affiliates are usually categorized as HCOMs by IIAs. If such a distinctive criterion is not applied, almost any law or regulation of a host country could be viewed as an operative requirement, thus indeed rendering the category of HCOMs so vast as to be almost meaningless.³
- ***... generally focus on the post-entry phase of investment ...***
- HCOMs focus on the post-entry phase of investment, i.e. the actual operating life of foreign affiliates. Although various Government measures are sometimes imposed on foreign investors at the time of entry and often affect the same aspects of FDI as admission measures, HCOMs are here distinguished from restrictions and conditions imposed by Governments that apply only in the pre-entry phase of investment.⁴
- ***... and are often used in conjunction with incentives.***

HCOMs and investment incentives are often used in conjunction with one another and are also often based on the same economic rationale. Indeed, some IIAs emphasize this relationship.⁵ However, it is important to note that incentives and HCOMs operate in a different manner. Investment incentives provide advantages, such as tax relief, subsidies and cash grants, that are designed to induce foreign affiliates to bring about certain results.⁶ HCOMs, on the other hand, are designed to prescribe a certain behaviour for foreign affiliates to bring about (perhaps the same) results.

A distinction can also be made between two main forms that HCOMs usually assume. The first are limitations, expressed either as behavioural constraints or as quotas, that a host country imposes on the operations of foreign affiliates; in other words, they are obligations *non facere*. The second form comprises governmentally imposed stipulations ("performance requirements") that firms meet certain specified goals with respect to their operations within the Government's jurisdiction (Graham and Krugman, 1995). They are thus obligations *facere*, requiring a positive action from (or imposing a positive condition on) foreign investors. Often, the results achieved by the imposition of either type of obligation are the

same. For instance, the promotion of local employment can be achieved either by imposing a quota or other form of restriction (visas, work permits, etc.) on the employment of foreign personnel, or by establishing a local hiring target that foreign affiliates have to meet. But even such a classification fails to address the fundamental issue that faces negotiators of IIAs, namely whether to prohibit, restrict or simply not deal with certain HCOMs.

For the purpose of this chapter, no effort is made to categorize HCOMs along substantive lines. Rather, they are grouped in three categories, with the discussion focusing on the first two:

- **HCOMs explicitly prohibited at the multilateral level, i.e. the WTO Agreement on TRIMs.** To use a traffic light analogy, these are “red light” HCOMs, so to speak, i.e. measures that the international community as represented in WTO has agreed should not be employed (although not all countries feel comfortable with the implementation of this Agreement). This affects both HCOMs that are mandated as well as those whose performance is necessary for the receipt of an advantage. More specifically, the TRIMs Agreement prohibits trade-related investment measures that are inconsistent with Articles III and XI of the General Agreement on Tariffs and Trade (GATT) (WTO, 1995a).⁷ The Agreement mentions specifically certain types of measures:

- local content requirements;
- trade-balancing requirements;
- foreign exchange restrictions related to foreign exchange in flows attributable to an enterprise; and
- export controls.

A number of interregional, regional and bilateral agreements also explicitly prohibit the same HCOMs (or, where these agreements are in draft form, envisage their prohibition).

- **Additional HCOMs that are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not multilateral) agreements (or drafts thereof).** For the purpose of this chapter, these are “yellow light” HCOMs, so to speak, in the sense that negotiators of IIAs ought to be aware that some countries (or groups of countries) have indeed prohibited or restricted their use in some IIAs and perhaps would like to do so also at the multilateral level. These additional HCOMs include:

- requirements to establish a joint venture with domestic participation;
- requirements for minimum level of domestic equity participation;
- requirements to locate headquarters for a specific region or the world market;
- employment performance requirements;
- export performance requirements;
- restrictions on sales of goods or services in the territory where they are produced or provided;
- requirements to supply goods produced or services provided to a specific region or the world market exclusively from a given territory;
- requirements to act as the exclusive supplier of goods produced or services provided;
- requirements to transfer technology, production processes or other proprietary knowledge;
- research-and-development requirements; and
- measures contrary to the principle of fair and equitable treatment.

In contrast to the approach taken by the TRIMs Agreement, such IIAs in some cases allow these additional HCOMs (or some of them) in so far as they are linked to incentives. In other words, their use is restricted to specified circumstances.

- **HCOMs that are not contested.** For the purpose of this chapter, these are “green light” HCOMs, so to speak, although their use may be subject to other international obligations, e.g. to apply national treatment. In other words, HCOMs not included in the two preceding categories are, presumably, not contested. This reflects the general view that each host country is free to regulate FDI within its jurisdiction, in line of course with its international obligations. There is, however, also a broader, and more fundamental, issue to be considered. Any analysis of HCOMs must begin from the economic nature of most of these measures. But a conclusion as to their utility cannot be based solely on economic considerations. Any legal framework is rooted within specific national or regional traditions and cultures. At the core of legal rules, some of which might affect the operations of enterprises, lie fundamental societal values. In effect, some legal rules give expression to core societal values, and most governments find

their legitimacy in so far as they take heed of such values. Thus, some HCOMs — especially those dealing with areas such as standards for the preservation of public health, employment rights and the environment, and, in the particular case of developing countries, those specifically meant to advance development — have at their roots core values. A Government that limits its sovereignty in such a way as to not be able to mandate measures that reflect such core values, when necessary, could jeopardize its legitimacy. It is important to realize therefore that, as investment rules delve deeper into areas that had not previously been subject to international disciplines, there are areas that may need to remain within the sovereignty of national Governments, on whose legitimacy the international system still depends. In any event, any negotiations touching upon HCOMs would need to be cognizant not only of the economic justifications, but also of the societal values that they reflect. In fact, even in the context of a proliferation of IIAs, many regulatory measures are not only uncontested but, in some instances, even encouraged by IIAs.

In various discussions concerning IIAs, emphasis has been put on a Government's prerogative to regulate at the national level with regard to such matters. In the ministerial statement on the Multilateral Agreement on Investment (MAI) of 28 April 1998, the ministers confirmed "that the MAI must be consistent with the sovereign responsibility of governments to conduct domestic policies" (OECD, 1998a, p. 1). In an Expert Group Meeting of the UNCTAD Commission on Investment, Technology and Related Financial Issues, dealing with international investment agreements, the Agreed Conclusions noted similarly "that flexibility, including with regard to a Government's normal ability to regulate, can be reflected, *inter alia*, in the objectives, content, implementation and structure of IIAs" (UNCTAD, 1999a, p. 2). They also noted "that a key issue involves finding the proper balance between flexibility on the one hand and predictability and security on the other" (*ibid.*).

Section II

Stocktaking and Analysis

No investment policy is effective until it is enforced through some form of national law,

whether a statute, a regulation, administrative action or other provision. Similarly, no HCOM is effective until it is embodied in either a legal obligation imposed by the host country on a foreign investor or a contractual undertaking by the investor. This variegated and composite array of national obligations has then to be in conformity with the international law instruments that the same countries have established to regulate their exercise of national jurisdiction over foreign investors. The purpose of this section is to analyze, where and how the issue of host countries' adoption of operational measures has been addressed in IIAs.

A. HCOMs explicitly prohibited at the multilateral level

1. The TRIMs Agreement

On the multilateral level, the most important norms prohibiting the use of certain HCOMs can be found in the GATT. The GATT did not contain specific norms on investment.⁸ However, certain measures that affect trade flows were covered by the GATT principle of national treatment contained in article III (in particular paragraph 4, dealing with measures indirectly applied to trade), and by the general elimination of quantitative restrictions of article XI.⁹

In the light of this, the WTO Agreement on TRIMs, which was negotiated during the Uruguay Round and entered into force on 1 January 1995,¹⁰ specifically regulated certain TRIMs. Article 2 of the Agreement provides that, "[w]ithout prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994". An illustrative list in the Annex to the Agreement describes measures that are inconsistent with Article III(4) and Article XI (1):

"1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

- (a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of

volume or value of products, or in terms of a proportion of volume or value of its local production; or

- (b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

2. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which restrict:

- (a) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;
- (b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise; or
- (c) the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production".

The Agreement bans not only TRIMs that are obligatory in nature, but also those whose compliance is necessary in order to obtain an advantage. Furthermore, no distinction is made among TRIMs with regard to the time of the investment at which they are imposed; the prohibition of Article 2 of the TRIMs Agreement thus applies to measures applied both at the time of the entry of the investment as well as afterwards.

On the other hand, two features of the TRIMs Agreement should be noted:

- The Agreement prohibits only a specific subset of operational measures as discussed in section I. In fact, a number of other HCOMs prohibited by some other IIAs – such as export performance requirements, mandatory technology transfer requirements, and limits on equity participation and remittances – are not covered by the TRIMs Agreement.

- The Agreement applies only to investment measures related to trade in goods. It does not cover trade in services. Measures concerning service industries are addressed on the WTO General Agreement on Trade in Services (GATS) (box 2).

Box 2. The GATS

The GATS does not contain explicit rules dealing with HCOMs or TRIMs. However, the establishment-related nature of much trade in services and the structure of the GATS require some further observations. The GATS is a framework agreement, whose main provisions can be divided into general obligations that apply to all services and other specific obligations, against both of which WTO members enter into commitments in their national schedules. Examples of the first type of obligations are most-favoured-nation treatment, transparency and reasonable, objective and impartial administration of domestic regulations. Specific commitments can, on the other hand, be assumed in relation to market access (see article XVI) and national treatment (see article XVII). Thus, for example, to the extent that a WTO member has made national treatment commitments with regard to services in a particular industry, it cannot apply domestic content requirements solely to foreign investors.

With regard to the latter obligations, the GATS does not require the immediate abolition of all non-conforming measures. Market access and national treatment are granted to foreign enterprises only in those service industries specifically indicated in a member country's schedule, and only to the extent described there. Thus, market access may be absent in all or some service industries, or may be conditional on national participation in management, or else may be limited to a certain percentage of ownership. Similarly, the presence of natural persons, be they individual foreign providers of services or employees of a foreign affiliate, may be subject to visa or other administrative requirements (the formula often used is "subject to the law and regulations" of the host country), or may be quantitatively limited to a certain yearly number, or, in the alternative, qualitatively limited to certain professional profiles. In a number of schedules, a member country's commitments for particular services are not even required to be undertaken before a given date. This flexibility allows each WTO member to open its market to foreign suppliers of services in the industries and under the terms and conditions deemed more appropriate for its level of development and for the attainment of its economic objectives (Mashayekhi, 2000a). At the same time, though, once these commitments are inscribed in the schedules, they cannot be withdrawn or lessened.

Source: UNCTAD.

Under Article 5.1, States that were members of the WTO on 1 January 1995 were required to notify to the Council for Trade in Goods, within 90 days after the date of entry into force of the WTO Agreement, any TRIMs that were not in conformity with the Agreement. A decision adopted by the WTO General Council in April 1995 provided that Governments that had not been members of the WTO on 1 January 1995, but were entitled to become original members within a period of two years after 1 January 1995, should make notifications under Article 5.1 within 90 days after the date of their acceptance of the WTO Agreement (table 2) (WTO, 1995b). Article 7 established a Committee on Trade-Related Investment Measures that monitors the operation and implementation of the Agreement and reports there on annually to the Council for Trade in Goods.

The TRIMs Agreement allows some flexibility for developing countries, by both recalling the GATT norms on balance-of-payments difficulties, as well as by allowing developing countries and least developed countries longer transition periods for the implementation of its rules. Article 4 allows developing countries to deviate temporarily from the obligations of the Agreement, as provided for in Article XVIII of GATT 1994 and related WTO provisions on safeguard measures for balance-of-payment difficulties. With regard to transition periods, developed, developing and least-developed countries were given, respectively, two, five and seven years from the date of entry into force of the WTO agreement to eliminate notified TRIMs. Furthermore, upon request, the transition period could be extended for developing and least developed countries that demonstrate particular difficulties in implementing the provisions of the Agreement.¹¹

In May 2000, WTO members agreed to direct the Council for Trade in Goods to give positive consideration to individual requests for extensions of the transition periods presented in accordance with Article 5.3 (box 3). In this connection, it should be noted that some WTO members had already sought information on steps taken by other members that made notifications under Article 5.1 on how they are complying with their obligation to eliminate notified measures by the end of the transition period specified in Article 5.2 (WTO, 1999a).

Box 3. TRIMs transition period issues agreed by the General Council

“In consultations held over the past weeks regarding the transition period issues in the TRIMs Agreement, and taking into account the Chairman’s statement on 17 December in the General Council urging countries to exercise restraint on deadline issues:

Members have noted the efforts made by many developing country Members to implement their commitments under the TRIMs Agreement within the time period provided to them under Article 5.2, and that some Members have decided to exercise their rights under Article 5.3 to request an extension of the transition period for their measures notified under Article 5.1.

Members have also indicated that there is a need to preserve the multilateral character of this process and that the requested extensions shall be examined in accordance with the rights and obligations of Members under Article 5.3 of the TRIMs Agreement, taking into account the particular difficulties of any kind, including internal and external, encountered by developing countries in implementing the provisions of the Agreement, and the development, financial and trade needs of the country in question.

Taking into account such elements, Members agree to direct the Council for Trade in Goods to give positive consideration to individual requests presented in accordance with Article 5.3 by developing countries for extension of transition periods for implementation of the TRIMs Agreement.

Members have noted the concerns of those Members who have not notified TRIMs or have not yet requested an extension. Consultations on the means to address these cases should also be pursued as a matter of priority, under the aegis of the General Council, by the Chairman of the Council for Trade in Goods.

Members affirm that the above decisions are without prejudice to the mandated review provided for in Article 9 of the TRIMs Agreement.

The Chairman of the Council for Trade in Goods should be invited to pursue informal consultations in order to facilitate the process and to reinforce the multilateral character of the exercise and its rapid conclusion. The Chairman of the Goods Council should also be invited to keep the General Council informed of progress including information provided by the parties concerned.”

Source: WTO, 2000a, p. 1.

An important aspect of the TRIMs Agreement is that it is subject to further review. Article 9 of the Agreement provides that, not later than five years after the date of its entry into force, the Council for Trade in Goods shall review the operation of the TRIMs Agreement.¹² In this review, consideration is to be given as to whether

Table 2. Notifications submitted under Article 5.1 of the TRIMs Agreement, February 2001

Member	Date of communication ^a	Sector	Category of the illustrative list
Argentina	30 March 1995; 21 March 1997	Automotive industries	Paragraph 1 (a) and 2 (a)
Barbados	31 March 1995	Pork processing enterprises	Paragraph 1 (a)
Bolivia ^b	24 June 1998	Hydrocarbons sector	Paragraph 2 (c)
Chile ^c	14 December 1995	Automotive industries	Paragraph 1 (a) and 1 (b)
Colombia	31 March 1995; 4 June 1995; 31 July 1995; 30 September 1996	Agro-industry	Paragraph 1 (a) Paragraph 2 (a)
Costa Rica ^d	30 March 1995	General	Paragraph 1 (a)
Cuba ^e	18 July 1995	Fuel, raw and other materials, tools, equipment, spare parts accessories, consumer goods; transport and marine insurance	Paragraph 1 (a)
Cyprus ^f	30 October 1995	Cheese and groundnuts products	Paragraph 1 (a)
Dominican Republic	26 April 1995	General	Paragraph 1 (a), 1 (b) and 2 (a)
Ecuador	20 March 1996	Automotive industries	Paragraph 1 (a)
Egypt	29 September 1995	General	Not specified
India	31 March 1995; 22 December 1995; 18 March 1996; 11 April 1996	Consumer goods	Paragraph 2 (c)
Indonesia	23 May 1995; 28 October 1996	Automotive industries, utility boilers, soyabean and fresh milk products	Paragraph 1 (a)
Malaysia	31 March 1995; 14 March 1996	Automotive industries and industrial sector	Paragraph 1 (a)
Mexico	31 March 1995	Automotive industries	Not specified
Nigeria ^g	17 July 1996	General	Not specified
Pakistan	30 March 1995	Engineering, electrical goods and automotive industries	Paragraph 1 (a)
Peru	3 March 1995	Milk powders, anhydrous fat and other milk products	Paragraph 1 (a)
Philippines	31 March 1995	Automotive industries and coconut-based chemicals	Paragraph 1 (a) and 2 (b)
Poland ^h	28 September 1995	Cash registers	Paragraph 1 (a)
Romania	31 March 1995	General	Paragraph 1 (a)
South Africa	19 April 1995	Automotive industries, telecom-munication equipment, tea and coffee	Paragraph 1 (a)
Thailand	30 March 1995	Automotive industries, manufacture of milk and dairy products, aluminium sheets, TV picture tubes, transformers, air conditioners and paper products	Paragraph 1 (a)
Uganda	17 June 1997	General	Not specified
Uruguay	31 March 1995; 30 August 1995	Automotive industries	Paragraph 1 (a)
Venezuela	31 March 1995	Automotive industries	Paragraph 1 (a)

Source: WTO, 2000b.

^a Most of the TRIMs notified are probably no longer in place as only ten members (Argentina, Chile, Colombia, Egypt,

^b Malaysia, Mexico, the Philippines, Pakistan, Romania and Thailand) have sought extension of the transition period. Bolivia subsequently submitted a notification indicating that it does not apply any TRIMs that are not in conformity with the Agreement.

^c Initially, Chile notified its measure under the Automotive Statute as a prohibited subsidy under the WTO Agreement on Subsidies and Countervailing Measures. However, after further analysis, this measure was also notified as a TRIM.

^d Costa Rica subsequently submitted a notification indicating that it intends to eliminate measures notified under Article 5.1 in advance of the expiry of the transition period.

^e Cuba subsequently informed the Committee that the measures notified by Cuba under Article 5.1 are no longer in force.

^f This notification superseded Cyprus' previous one of 29 June 1995; Cyprus subsequently submitted a notification indicating that it has eliminated measures notified under Article 5.1.

^g Nigeria subsequently submitted a notification indicating that the Nigerian Enterprises Promotion Act of 1989 has been repealed and replaced with the Nigerian Investment Promotion Commission Decree 1995.

^h Poland had subsequently submitted a notification indicating that it has eliminated measures notified under Article 5.1.

the Agreement should be supplemented with provisions on investment policy and competition policy. The first WTO Ministerial Conference, held in Singapore in 1996, established “Working Groups” on trade and investment and on trade and competition to examine the relevant issues, “having regard to the existing WTO provisions on matters related to investment and competition policy and the built-in agenda in these areas, including under the TRIMs Agreement”. The importance of the review of the TRIMs Agreement lies in the fact that there is the possibility that WTO members may be faced with a number of options for consideration in this respect. Such options include the elimination of certain provisions and the incorporation of others which may prove more beneficial to developing countries. The various options are discussed in the Conclusion of this chapter.

2. Similar HCOMs prohibited by interregional, regional or bilateral agreements

The TRIMs Agreement is the only multilateral instrument that prohibits certain HCOMs. It is however noteworthy that all or some of the same types of measures prohibited by this Agreement are also banned — or, in the case of draft agreements, were sought to be banned — by a number of instruments at the interregional, regional and bilateral levels. Some did so before the TRIMs Agreement was adopted, others did so thereafter.

As early as 1988, the Free Trade Agreement between Canada and the United States foreshadowed the prohibition of local content HCOMs covered by the TRIMs Agreement. Article 1603 of the Free Trade Agreement provides:

“1. Neither Party shall impose on an investor of the other Party, as a term or condition of permitting an investment in its territory, or in connection with the regulation of the conduct or operation of a business enterprise located in its territory, a requirement to:

...

- b) substitute goods or services from the territory of such Party for imported goods or services;
- c) purchase goods or services used by the investor in the territory of such Party or from suppliers located in such territory or accord a preference to goods or services produced in such territory; or
- d) achieve a given level or percentage of domestic content”.

The 1992 North American Free Trade Agreement (NAFTA) is another example in this regard. Article 1106 prohibits, on the part of States parties to the agreement, the imposition or enforcement of a number of performance requirements “in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party ...” (box 4). The prohibited performance requirements include some of the measures mentioned in the Illustrative List of the TRIMs Agreement:

- to achieve a given level or percentage of domestic content;
- to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;
- to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment.

Box 4. NAFTA provisions on HCOMs

Article 1106: Performance Requirements

- “1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory:
- (a) to export a given level or percentage of goods or services;
 - (b) to achieve a given level or percentage of domestic content;
 - (c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;
 - (d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;
 - (e) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;
 - (f) to transfer technology, a production process or other proprietary knowledge to a person in its territory, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws or to act in a manner not inconsistent with other provisions of this Agreement; or

/...

Box 4 (concluded)

- (g) to act as the exclusive supplier of the goods it produces or services it provides to a specific region or world market.
2. A measure that requires an investment to use a technology to meet generally applicable health, safety or environmental requirements shall not be construed to be inconsistent with paragraph 1(f). For greater certainty, Articles 1102 and 1103 apply to the measure.
 3. No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:
 - (a) to achieve a given level or percentage of domestic content;
 - (b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory;
 - (c) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment; or
 - (d) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings.
 4. Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory.
 5. Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs.
 6. Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on international trade or investment, nothing in paragraph 1 (b) or (c) or 3 (a) or (b) shall be construed to prevent any Party from adopting or maintaining measures, including environmental measures:
 - (a) necessary to secure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement;
 - (b) necessary to protect human, animal or plant life or health; or
 - (c) necessary for the conservation of living or non-living exhaustible natural resources”.

Source: UNCTAD 1996a.

In line with the approach taken by the TRIMs Agreement, article 1106(3) of the NAFTA makes it clear that no Party may “condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party” on

compliance with any of the above prohibited HCOMs.

Some IIAs involving only developing countries have also followed this trend. An example is the 1994 Treaty on Free Trade between the Republic of Colombia, the Republic of Venezuela and the United Mexican States which covers the same measures covered by the TRIMs Agreement (Article 17-04):

“1. No Party shall impose performance requirements by adopting investment-related measures that are mandatory or required for the establishment or operation of an investment, or for which compliance is necessary in order to obtain or maintain an advantage or incentive, or which prohibit:

- (a) the purchase or use by an enterprise of goods of national origin of that Party, or from its national sources, whether specified in terms of specific goods, in terms of volume or value of the goods, or as a proportion of the volume or value of its local production;
- (b) the purchase or use of imported goods by an enterprise from being limited to an amount related to the volume or value of the local goods exported by the enterprise;
- (c) restrictions on imports of goods used by an enterprise in its local production or related thereto, limiting access by the enterprise to foreign exchange to an amount related to the entry of foreign exchange imputable to said enterprise;
- (d) restrictions on the exportation or the sale for exportation of goods by an enterprise, whether specified in terms of the volume or value of the goods, or as a proportion of the volume or value of its local production”.

Some BITs also specifically prohibit a number of the same HCOMs covered by the TRIMs Agreement. For example, Article V of the 1995 BIT between Canada and the Philippines prohibits local content and trade balancing requirements. It provides:

“Neither Contracting Party may impose any of the following requirements in connection with permitting the establishment or acquisition of an investment or enforce any of the following requirements in connection with the subsequent regulation of that investment:

...

- (b) to achieve a given level of percentage of domestic content;
- (c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in that territory;
- (d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment” (UNCTAD, 1998a, p. 82).

The 1998 BIT between Costa Rica and Canada specifically cross-references its HCOMs prohibitions to the provisions of the TRIMs Agreement. Article VI of that BIT provides as follows:

“Neither Contracting Party may impose, in connection with permitting the establishment or acquisition of an investment, or enforce in connection with the subsequent regulation of that investment, any of the requirements set forth in the World Trade Organization Agreement on Trade-Related Investment Measures contained in the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, done at Marrakesh on 15 April 1994” (OAS, 1998).

The 2000 Agreement between the United States of America and Viet Nam on Trade Relations takes a similar approach. Article 11(1) provides as follows:

“Subject to the provisions of paragraph 2, neither Party shall apply any trade-related investment measures (TRIMs) which are inconsistent with the Agreement on Trade-Related Investment Measures of the WTO. The illustrative list of TRIMs set forth in the WTO Agreement on TRIMs (“the List”) is contained in Annex I of this Agreement. TRIMs contained on the List will be considered inconsistent with this Article regardless of whether they are imposed in laws, regulations, or as conditions for individual investment contracts or licenses” (UNCTAD, 2001a).

Furthermore, this Agreement reinforces the provisions of the TRIMs Agreement on the transition periods within which notified TRIMs have to be eliminated. Indeed, the provisions of the United States-Viet Nam Agreement seem to limit the flexibility that would otherwise be allowed for Viet Nam as a developing country to request for an extension of the transition period. Article 11(2) provides that:

“The Parties agree to eliminate all TRIMs (including those contained in laws, regulations, contracts or licenses) which fall under subparagraphs 2(A) (trade balancing requirements) and 2(B) (foreign exchange controls on imports) of the List by the time this Agreement enters into force. Vietnam shall eliminate all other TRIMs no later than five years after the date of entry into force of the Agreement, or the date required under the terms and conditions of Vietnam’s accession to the WTO, whichever occurs first” (*ibid.*).

In the MAI negotiations, performance requirements were dealt with under the heading “Treatment of Investors and Investments”, as one of the necessary corollaries to other basic obligations, namely, national treatment, most-favoured-nation treatment and transparency. The Negotiating Text provisions on performance requirements prohibited the imposition, enforcement and maintenance of certain HCOMs with regard to “the establishment, acquisition, expansion, management, operation, maintenance, use, enjoyment, sale or other disposition of an investment”, no matter whether the investment originated in the jurisdiction of a contracting party or not. Among the number of prohibited HCOMs listed in the Negotiating Text were those covered by the TRIMs Agreement. Specifically, paragraph 1 (b) through (d) prohibited any of the following requirements:

- “(b) to achieve a given level or percentage of domestic content;
- (c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;
- (d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;”

The fact that some or all of the measures covered by the TRIMs Agreement are similarly covered by some other IIAs may suggest that the prohibitions in that Agreement are generally acceptable. At the same time, it is interesting to note that many of the prototype model BITs formulated since 1995 do not seem to address this issue in any detail (for examples of such BITs see part three, UNCTAD, 2000a). This may reflect increasing consensus that the measures prohibited by the TRIMs Agreement are adequately covered therein, and the subject requires no further treaty

elaboration. On the other hand, it could simply mean that most countries consider it inappropriate to include such provisions in their BITs.

B. *Additional* HCOMs explicitly prohibited, conditioned or discouraged by interregional regional or bilateral (but not multilateral) agreements

1. *Prohibited measures*

While a number of the measures prohibited by the TRIMs Agreement have also found their way into interregional or regional agreements (or drafts thereof) and the BITs of some countries, there also are some instances in which explicit prohibitions of a number of HCOMs in non-multilateral IIAs go beyond those mentioned in the Illustrative List of the TRIMs Agreement. This is particularly the case in some regional agreements involving predominantly developed countries, as well as recent BITs involving a number of developed countries (table 3).

At the regional level, the NAFTA provides an example of an IIA whose list of prohibited HCOMs goes beyond that of the TRIMs Agreement. To begin with, it covers both goods and services. Furthermore, in addition to the prohibitions similar to the ones covered by the TRIMs Agreement, Article 1106(1) (e) also prohibits requirements “to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings”.

There are also examples of additional HCOMs prohibited at the bilateral level. A number of BITs signed by Canada go further than the TRIMs Agreement and have also prohibited requirements related to export performance and transfer of technology, examples being the BITs concluded by Canada with Barbados, Philippines, Trinidad and Tobago and Venezuela (UNCTAD, 1998a, p. 81). Paragraph (e) of Article V of the 1995 BIT between Canada and the Philippines provides:

“Neither Contracting Party may impose any of the following requirements in connection with permitting the establishment or acquisition of an investment or enforce any of the following requirements in connection with the subsequent regulation of that investment:

(a) to export a given level or percentage of goods;

...

Table 3. Examples of IIAs with “yellow light” HCOMs

HCOM	IIA
Requirements to establish a joint venture with domestic participation	MAI
Requirements for minimum level of domestic equity participation	MAI
Requirements to locate headquarters for a specific region or the world market	MAI
Employment performance requirements	MAI
Export performance requirements	NAFTA Canada - Barbados BIT Canada - Philippines BIT Canada - Trinidad and Tobago BIT Canada - Venezuela BIT United States - Trinidad and Tobago BIT United States - Bolivia BIT MAI
Restrictions on sales of goods or services in the territory where they are produced or provided	NAFTA United States - Bolivia BIT MAI
Requirements to supply goods produced or services provided to a specific region or the world market exclusively from a given territory	United States - Trinidad and Tobago BIT MAI
Requirements to act as the exclusive supplier of goods produced or services provided	NAFTA
Requirements to transfer technology, production processes or other proprietary knowledge	NAFTA Canada - Barbados BIT Canada - Philippines BIT Canada - Trinidad and Tobago BIT Canada - Venezuela BIT United States - Trinidad and Tobago BIT United States - Bolivia BIT MAI
Research-and-development requirements	United States - Trinidad and Tobago BIT United States - Bolivia BIT MAI
Measures contrary to the principle of fair and equitable treatment	French model BIT German model BIT

Source: UNCTAD.

(e) to transfer technology, a production process or other proprietary knowledge to a person in its territory unaffiliated with the transferor, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority, either to remedy an alleged

violation of competition laws, or acting in manner not inconsistent with the provisions of this Agreement” (*ibid.*, p. 82).

The 1994 United States model BIT and some BITs the United States has concluded with other countries also go further than the TRIMs Agreement to cover requirements related to export performance, product mandates, transfer of technology and research and development. For example, the 1994 BIT between the United States and Trinidad and Tobago provides in Article VI (e) and (f) as follows:

“Neither Party shall mandate or enforce, as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment, any requirement (including any commitment or undertaking in connection with the receipt of a governmental permission or authorization):

...

c) to export a particular type, level or percentage of products or services, either generally or to a specific market region;

...

e) to transfer technology, a production process or other proprietary knowledge to a national or company in the Party’s territory, except pursuant to an order, commitment or undertaking that is enforced by a court, administrative tribunal or competition authority to remedy an alleged or adjudicated violation of competition laws; or

f) to carry out a particular type, level or percentage of research and development in the Party’s territory” (United States, Department of State, 1994).

In the Negotiating Text of the MAI, the list of prohibited measures also went beyond those covered by the TRIMs Agreement. Paragraphs 1 (a) and (e) prohibited the following requirements:

“(a)to export a given level or percentage of goods or services;

...

(e) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales to the volume or value of its exports or foreign exchange earnings;...”

Besides these examples of IIAs that utilize an expanded documentary or illustrative list approach, some IIAs may cover additional HCOMs through an interpretative approach. BITs, in particular, although not explicitly mentioning

HCOMs, could conceivably be interpreted to deal with them in connection with fair and equitable treatment. For example, article 4 of France’s 1999 model BIT considers as contrary to the principle of fair and equitable treatment, and therefore unlawful, the use of restrictions on access to inputs, manufacturing requirements, sales and transport limitations, and all other measures having an equivalent effect:

“Chacune des Parties contractantes s’engage à assurer, sur son territoire et dans sa zone maritime, un traitement juste et équitable, conformément aux principes du Droit international, aux investissements des nationaux et sociétés de l’autre Partie et à faire en sorte que l’exercice du droit ainsi reconnu ne soit entravé ni en droit, ni en fait. En particulier, bien que non exclusivement, sont considérées comme des entraves de droit ou de fait au traitement juste et équitable, toute restriction à l’achat et au transport de matières premières et de matières auxiliaires, d’énergie et de combustibles, ainsi que de moyens de production et d’exploitation de tout genre, tout entrave à la vente et au transport des produits à l’intérieur du pays et à l’étranger, ainsi que toutes autres mesures ayant un effet analogue.”

This provision continues by urging a positive approach, in the national laws of the Contracting Parties, towards the entry, stay, work permits and free movement of personnel from one Contracting Party engaged in an investment project on the territory of the other Contracting Party:

“Les Parties contractantes examineront avec bienveillance, dans le cadre de leur législation interne, les demandes d’entrée et d’autorisation de séjour, de travail, et de circulation introduites par des nationaux d’une Partie contractante, au titre d’un investissement réalisé sur le territoire ou dans la zone maritime de l’autre Partie contractante.”

Another approach is found in those BITs that, even if they do not address the issue of HCOMs *per se*, nevertheless impose an obligation on contracting parties not to impair the maintenance, use, enjoyment or disposal of investment. This may be interpreted to amount to a prohibition of HCOMs. For instance, as early as 1991, article 2 of the German model BIT provided that:

“Each Contracting Party shall in its territory promote as far as possible investments by nationals or companies of other Contracting

Party and admit such investments in accordance with its legislation. It shall in any case accord such investments fair and equitable treatment.

Neither Contracting Party shall in any way impair by arbitrary or discriminatory measures the management, maintenance, use or enjoyment of investments in its territory of nationals or companies of the other Contracting Party.”

However, this obligation is in some IIAs limited to the avoidance of “arbitrary”, “unreasonable” or “discriminatory measures”.¹³ No specification is given in many such instruments on what constitutes an “unreasonable” or “discriminatory” measure.¹⁴

2. Restricted discretion to impose operational measures

The HCOMs discussed so far are measures that, beyond the TRIMs Agreement, are prohibited in specific non-multilateral agreements. In a number of cases, however, these measures are allowed, provided they meet certain conditions. Usually this is for a particular purpose or for a specified period of time.

a. As conditions for the receipt or continued receipt of an advantage¹⁵

A number of HCOMs are a *quid pro quo* for investment incentives. In this case, parties to an IIA may not treat the measures as mere restrictions on TNCs operations, but as a legitimate part of a framework designed to attract investment, while, at the same time, directing it towards the promotion of national objectives. As such, these HCOMs can be considered as part of a package of “conditioned incentives”.

In the NAFTA, article 1106(4) explicitly allows the parties to condition the receipt of an advantage on compliance with a requirement to “locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development...”. In addition, implicit under article 1106(1) is that a number of other HCOMs may be linked to investment incentives. As noted before, while this article does not address the issue of conditioned incentives, article 1106(3), in referring to the list of HCOMs covered by article 1106(1), singles out HCOMs that cannot be linked to incentives, thus implying that the remaining

HCOMs on the list may be coupled to advantages. These are requirements of an investor:

- to export a given level or percentage of goods or services;
- to transfer technology, a production process or other proprietary knowledge to a person in its territory, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws or to act in a manner not inconsistent with other provisions of the Agreement; or
- to act as the exclusive supplier of the goods it produces or services it provides.

Under the 1990 Charter on a Regime of Multinational Industrial Enterprises in the Preferential Trade Area for Eastern and Southern African States, the benefits accorded to an enterprise established according to the rules of the Charter are balanced by a series of obligations. The benefits regard the transfer of funds, the granting of visas and residence permits for employees, exemptions from import duties, tax exemptions, granting of licences and permits, infrastructure support, preferential tariff and non-tariff treatment. They are thus very similar to the incentives usually offered at a national level. The obligations, on the other hand, replicate the most common HCOMs and require the increase of local value added of products (where “local” is equivalent here for “regional”), export support, training, minimum volume of supply for the national market and disclosure of information.

A good example of conditional restrictions of HCOMs is provided by the provisions of some United States BITs. Article VI (2) of the 1994 BIT between the United States and Trinidad and Tobago provides that the prohibition of HCOMs in its paragraph (1) does not “preclude a Party from providing benefits and incentives conditioned upon such requirements”; the exception thus covers even those HCOMs listed in paragraph 1 that are prohibited by the TRIMs Agreement (United States, Department of State, 1994). Even the more recent BITs, concluded by the United States after the TRIMs Agreement, provide such exceptions, covering, *inter alia*, requirements prohibited by the TRIMs Agreement. Thus, for instance, Article VI of the 1998 BIT with Bolivia provides as follows:

“Neither Party shall mandate or enforce, as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment, any requirement

(including any commitment or undertaking in connection with the receipt of a governmental permission or authorization):

- (a) to achieve a particular level or percentage of local content, or to purchase, use or otherwise give a preference to products or services of domestic origin or from any domestic source;
- (b) to restrict imports by the investment of products or services in relation to a particular volume or value of production, exports or foreign exchange earnings;
- (c) to export a particular type, level or percentage of products or services, either generally or to a specific market region;
- (d) to restrict sales by the investment of products or services in the Party's territory in relation to a particular volume or value of production, exports or foreign exchange earnings;
- (e) to transfer technology, a production process or other proprietary knowledge to a national or company in the Party's territory, except pursuant to an order, commitment or undertaking that is enforced by a court, administrative tribunal or competition authority to remedy an alleged or adjudicated violation of competition of laws; or
- (f) to carry out a particular type, level or percentage of research and development in the Party's territory.

Such requirements do not include conditions for the receipt or continued receipt of an advantage" (United States, Department of State, 1998a).

Similar provisions are contained in other more recent BITs concluded between the United States and other countries. Examples include article VI of the 1998 BIT with Mozambique and article 6 of the 1999 BIT with Bahrain (United States, Department of State, 1998b and 1999).¹⁶

In the negotiation of the draft MAI, one of the issues discussed was whether the prohibition of certain HCOMs should cover both mandatory measures and requirements linked to the granting of an advantage to the investor, i.e. investment incentives, or whether a separate provision should be drafted for the latter. In other words, there were two options: whether certain HCOMs should be completely prohibited; or whether, when linked to an incentive, they should be considered as a legitimate *quid pro quo* (Engering, 1996). The last MAI draft text indicates that certain HCOM would have been permitted if linked to an advantage. While there was no final agreement concerning the

specific HCOMs that would have been allowed if linked to an advantage, the draft explicitly permitted, under this condition, certain non-trade related HCOMs, namely the following requirements:¹⁷

- “(f) to transfer technology, a production process or other proprietary knowledge to a natural or legal person in its territory, except when the requirement
 - is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws, or
 - concerns the transfer of intellectual property and is undertaken in a manner not inconsistent with the TRIPS Agreement.
- (g) to locate its headquarters for a specific region or the world market in the territory of that Contracting Party;
- (h) to supply one or more of the goods that it produces or the services that it provides to a specific region or the world market exclusively from the territory of that Contracting Party;
- (i) to achieve a given level or value of research and development in its territory;
- (j) to hire a given level of nationals;
- (k) to establish a joint venture with domestic participation; or
- (l) to achieve a minimum level of domestic equity participation other than nominal qualifying shares for directors or incorporators of corporations.”¹⁸

Specifically with respect to these measures, paragraph 2 of the article on performance requirements provides:

“A Contracting Party is not precluded by paragraph 1 from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of a Contracting Party or of a non-Contracting Party, on compliance with any of the requirements, commitments or undertakings set forth in paragraphs 1 (f) through 1 (l).”

b. As a part of Government economic development programmes

Some IIAs recognize the necessity of certain HCOMs in the context of economic development programmes. Article 5 of the Energy Charter Treaty prohibits the application by member States of investment measures that are inconsistent

with article III or XI of GATT. However, it qualifies the prohibition by allowing the application of certain requirements applied as a condition of eligibility for export promotion, foreign aid, government procurement or preferential tariff or quota programmes.¹⁹ It provides as follows:

- “(1) A Contracting Party shall not apply any trade-related investment measure that is inconsistent with the provisions of article III and XI of the GATT; this shall be without prejudice to the Contracting Party’s rights and obligations under the GATT and Related Instruments and Article 29.
- (2) Such measures include any investment measure which is mandatory or enforceable under domestic law or under any administrative ruling, or compliance with which is necessary to obtain an advantage, and which requires:
- (a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production; or
 - (b) that an enterprise’s purchase or use of imported products be limited to an amount related to the volume or value of local products that it exports; or which restricts:
 - (c) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;
 - (d) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise; or
 - (e) the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.
- (3) Nothing in paragraph (1) shall be construed to prevent a Contracting Party from applying the trade-related investment measures described in subparagraphs (2)(a) and (c) as a condition of eligibility for export promotion,

foreign aid, government procurement or preferential tariff or quota programmes.”

The 1992 World Bank Guidelines on the Treatment of Foreign Direct Investment implicitly recognise the need for operational measures in support of Government economic development programmes. Thus with regard to employment of local labour and transfers of capital, the Guidelines accept the existence and the need to protect other interests, in that they exhort host countries to authorize the employment of foreign personnel, but, at the same time, also recognize the host State’s right to require a foreign investor “to reasonably establish his inability to recruit the required personnel locally ... before he resorts to the recruitment of foreign personnel ...” (UNCTAD, 1996a, vol. I, p. 250).

Some draft IIAs proposed by non-governmental organisations have adopted the approach of overriding exceptions relating to economic development programmes. The 1998 draft International Agreement on Investment prepared by the Consumer Unity and Trust Society (CUTS) lays out what, according to CUTS, an equitable alternative international agreement on investment should look like.²⁰ In the draft, under the section on “Performance Requirements”, certain obligations are sought to be imposed on contracting States. Paragraph 1 contains 12 clauses prohibiting the contracting States from imposing requirements relating to export production, local content, volume of imports, sales, transfer of technology, location of headquarters, supply of goods, achieving a given level of production, hiring local personnel, establishing joint ventures or achieving a minimum level of local equity participation. Paragraphs 2,3,4,5 and 6 permit certain relaxations of the prohibition for specific measures and to varying degrees. In addition, and importantly in this context, paragraph 7 then provides a blanket exemption in the following terms:

“Notwithstanding anything contained in paragraph 1, a Contracting Party shall be free to adopt a measure otherwise prohibited by that paragraph for compelling social or economic reasons”.

3. The “best efforts” approach

Some IIAs merely discourage the use of HCOMs through “best efforts” clauses. The 1984 BIT between the United States and Zaire (now the Democratic Republic of Congo) only requires the

host country to use its best efforts to avoid imposing operational measures. Article II (7) provides:

“Within the context of its national economic policies and goals, each Party shall endeavor to avoid imposing on the investments of nationals or companies of the other Party conditions which require the export of goods produced or the purchase of goods or services locally. This provision shall not preclude the right of either Contracting Party to impose restrictions on the importation of goods and services into their respective territories”(UNCTAD, 1998a, p. 82).

A number of other (also not so recent) United States BITs use similar language.²¹ For example, Article II (7) of the 1985 United States-Turkey BIT provides:

“Each party shall seek to avoid performance requirements as a condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced, or which specify that goods or services must be purchased locally, or which impose any other similar requirements” (United States, Department of State, 1985, p.5).

Some BITs between developing countries also address HCOMs through this approach. For example, the 1991 BIT between Malaysia and the United Arab Emirates provides (Article 2) as follows:

“Contracting States shall seek as far as practicable to avoid performance requirements as a condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced or which specify that goods or services must be purchased locally or which impose any other similar requirements” (UNCTAD, 1998a, p. 82).

Similarly, in 1994, the Asia-Pacific Economic Cooperation (APEC) countries adopted Non-Binding Investment Principles that expressly call on members to “minimize the use of performance requirements that distort or limit expansion of trade and investment”.

As compared to such older clauses, a more specific indication of the desire to phase out some operational measures can perhaps be found in the 1998 Association of South-East Asian Nations (ASEAN) regional Framework Agreement on the ASEAN Investment Area. Article 3 calls for the progressive reduction or elimination of “investment regulations and conditions which may impede investment flows and the operation of

investment projects in ASEAN”. Schedule III of the Agreement invites member States to “liberalise, among others, (i) rules, regulations and policies relating to investment”.

C. HCOMs that are not contested

The right to impose a number of HCOMs remains uncontested in IIAs. While the prohibition of certain of these measures is now embedded in a multilateral agreement—the TRIMs Agreement—and even some additional measures are being brought into the ambit of other IIAs in which some countries seek to restrict their usage, the underlying context remains one in which it is recognised that States have the right to exercise regulatory powers with respect to investors operating within their jurisdictions, including through the imposition of operational measures.

For example, NAFTA article 1106(2) specifically excludes the mandating of the use of certain technologies as being considered a performance requirement under Chapter 11. It provides:

“A measure that requires an investment to use a technology to meet generally applicable health, safety or environmental requirements shall not be construed to be inconsistent with paragraph 1(f). For greater certainty, Articles 1102 and 1103 apply to the measure.”

In some cases, the liberty to impose HCOMs has, in fact, been expressly encouraged by regional agreements. Thus, the 1984 Caribbean Common Market (CARICOM) Guidelines for use in the Negotiation of Bilateral Treaties reads as follows under the heading “Performance Obligations”:

- “(i) CARICOM countries should not accept any restrictions on their freedom to impose performance obligations;
- (ii) performance obligations, which should include but not limited to, export performance, employment, conformity with national laws and with trade union practices, and transfer of technology, should be linked to the benefits to be derived and in this context provision should be made for such obligations to be reviewed periodically”.

Some IIA draft proposals by non-governmental organizations have treated the topic of HCOMs in similar fashion. One such example is the text titled “Toward a Citizens’ MAI: An Alternative Approach to Developing a Global

Investment Treaty Based on Citizens' Rights and Democratic Control" and prepared by a non-governmental organization as an input to the discussions during the MAI negotiations.²² As opposed to suggesting any restrictions on HCOMs, its section on "Performance Standards" provides that, to "ensure that corporations fulfill their social obligations, States may impose performance requirements". Particular areas recommended for such HCOMs relate to job creation, labour standards, environmental safeguards, sustainable communities, and social security.

Recognition of the right of States to impose some operational measures has a number of precedents. At the multilateral level, the 1948 Havana Charter for an International Trade Organization is instructive. On the one hand, it was recognized in article 12 that "international investment, both public and private, can be of great value in promoting economic development and reconstruction, and consequent social progress", and provided that "the international flow of capital will be stimulated to the extent that Members afford nationals of other countries opportunities for investment and security for existing and future investments". On the other hand, each member retained the right (article 12 (1)):

" ...

- (ii) to determine whether and to what extent and upon what terms it will allow future foreign investment;
- (iii) to prescribe and give effect on just terms to requirements as to the ownership of existing and future investments;
- (iv) to prescribe and give effect to other requirements with respect to existing and future investments".

In other words, FDI had to be promoted, but control of inward investment and imposition of HCOMs were recognized as legitimate rights of host States. The latter rights, however, were strongly contested by some key countries (see chapter 1).

In the context of the call for a New International Economic Order, the "[r]egulation and supervision of the activities of transnational corporations" through measures taken "in the interest of the national economies of the countries where such transnational corporations operate" were considered as founding principles.²³ On this basis, requirements related to transfer of technology and managerial skills, limits on repatriation of profits²⁴ and, more generally, measures to ensure that the activities of TNCs

conformed with a country's economic and social policies, were confirmed among the basic economic rights of States.²⁵

The 1985 draft International Code of Conduct on the Transfer of Technology also explicitly recognized the subject of host countries' use of HCOMs. In regulating the flow and effects of transfer of the technology, States were accorded (in article 3.4) the possibility to "deal with", among other things, the use of local and imported components; terms, conditions and duration of transactions; and loss of ownership and/or control of domestic technology acquiring firms.

Yet another example of this approach is the 1983 United Nations draft Code of Conduct on Transnational Corporations. It reaffirmed the right of host countries to treat TNCs in accordance with their laws, regulations and administrative practices; and it affirmed the duty of TNCs to collaborate with host States. Among the latter, some reflect closely the usual objectives of some HCOMs: local equity participation, employment of host country nationals, export promotion, repatriation of capital, transfer of technology, and environmental protection.

A different approach has been taken by the Declaration on International Investment and Multinational Enterprises, first adopted by the Organisation for Economic Co-operation and Development (OECD) member countries in 1976, and revised in 2000 (OECD, 2000a). An integral part of the Declaration are the Guidelines for Multinational Enterprises. They constitute recommendations jointly addressed by member countries to TNCs operating in their territories and beyond. Rather than *discourage* host countries from utilising HCOMs, they *encourage* TNCs to undertake some activities among which some touch on areas traditionally covered by certain HCOMs. Thus, the text and Commentary of the Guidelines asks TNCs, among other things, to encourage local capacity building through close co-operation with the local community, including business interests; to create employment opportunities and facilitate training opportunities for employees; and to transfer technology (*ibid.*).

The majority of BITs, including those between developing and developed countries, adopt, although to different degrees, an approach that leaves open the issue of HCOMs. However, by providing that host countries retain the right to regulate the mode and manner in which investments are made in their territories, they implicitly recognise the right of States to utilise

them. A common inference of this is the principle that foreign investments are to be made “in accordance with the host State’s laws and regulations”.²⁶

* * *

Virtually any measure taken by a Government may affect, positively or negatively, the interests of the enterprises operating in its territory. Most routine regulatory actions, such as the issuance of a construction permit, are not contested. The same applies to those that fall in categories such as the protection of public health or the protection of the environment. Others are becoming increasingly subject to international scrutiny — a reflection of the internationalization of production (UNCTAD, 2000b) and, with it, of the domestic policy agenda. The stocktaking undertaken in this section suggests that the realm of measures coming under international scrutiny is expanding. Care needs to be taken, however, that this does not occur at the expense of the ability of Governments to promote development.

Section III

Interaction with other Issues and Concepts

Given the broad range of HCOMs, the connections they have with other issues addressed in these volumes are numerous and, in fact, indicate at least some moderate interaction with all of them (table 4). However, some of these have extensive interaction, as elaborated in this section.

- **Admission and establishment.** HCOMs are designed to affect the operational life of foreign affiliates, i.e. the post-entry phase of investment. Nonetheless, they present many points of contact with measures meant to regulate the entry and establishment of FDI. First of all, the limits and requirements imposed by the two sets of measures may concern the same aspects of investment. Restraints on foreign ownership, for instance, may well apply both as a condition to entry and as a requirement necessary for the continued operation of an investment. Similarly, restrictions on the import of capital goods or exchange control requirements can equally affect the ability of investors to enter a market and their ability to remain in that market. Second, HCOMs may well be imposed at the time an investment is

established and can constitute preconditions for the investment being allowed in the first instance. Examples of such HCOMs include those regulating technology transfer or local-content requirements.

- **Incentives.** Incentives may be defined as any measurable economic advantage granted to specific enterprises or categories of enterprises

Table 4. Interaction across issues and concepts

Issue	HCOMs
Admission and establishment	++
Competition	++
Dispute settlement (investor-State)	+
Dispute settlement (State-State)	+
Employment	++
Environment	++
Fair and equitable treatment	++
Home country measures	+
Illicit payments	+
Incentives	++
Investment-related trade measures	+
Most-favoured-nation treatment	++
National treatment	++
Scope and definition	+
Social responsibility	+
State contracts	+
Taking of property	+
Taxation	+
Transfer of funds	++
Transfer of technology	++
Transfer pricing	+
Transparency	++

Source : UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

by host countries in order to encourage them to behave in a certain manner (UNCTAD, 1996c). Very often, an explicit link exists between the granting of investment incentives and the use of certain HCOMs. Governments usually offer incentives in their competition to attract FDI or to improve its performance, and then use HCOMs to impose some kind of conditionality on foreign affiliates with a view towards encouraging this FDI to contribute as much as possible to national development objectives. From this point of view, the role of HCOMs with respect to incentives is a redistributive one. According to some commentators, such measures would simply not exist were it not for pre-existing distortions caused, among other things, by investment incentives for TNCs (Greenaway, 1992).²⁷

- **Most-favoured-nation treatment, national treatment, fair and equitable treatment.** As measures related to the “operation and maintenance” of an investment, HCOMs might be expected to be covered by the standards imposed on host countries for the treatment of investment in its post-entry phase. However, this is not frequently the case. The majority of IIAs dealing with the treatment of foreign investment require that it shall receive fair and equitable treatment in the host country, or, in other words, that all “unreasonable” and “discriminatory” measures shall be prohibited with regard to the activities of the investment. In this sense, HCOMs are no exceptions. Thus, in the many arrangements that are silent on the use of such measures, the standard of fair and equitable treatment can serve to limit their legitimacy. More complex is the relationship of HCOMs with the most-favoured-nation and national treatment standards. The reason is that HCOMs are designed, by their very nature, to impose some form of conditionality on FDI qua FDI. Even if some HCOMs maybe concealed in language which, in principle, applies to both foreign and domestic firms, in practice they would apply only to the foreign firms.
- **Employment, environment, funds transfer, transfer of technology.** The interaction of HCOMs with these issues is of a substantive nature. The promotion of employment, protection of the environment, regulation of funds transfers, and the transfer of technology are among the economic objectives for which HCOMs are usually applied. Consequently, rules on such measures are not only found in general investment clauses regulating the treatment of foreign affiliates’ operations, but also in agreements or provisions specifically covering these specialized areas.
- **Transparency.** HCOMs often involve confidential arrangements between a host Government and an investing firm, especially where the granting of certain advantages is involved. Yet, at the same time, for other foreign investors, knowing the regulatory environment of a host State in as transparent a manner as possible may be essential to their investment decisions and to the management of their operations. The TRIMs Agreement recognizes this by establishing an obligation of transparency, to be fulfilled through the

publication of all laws, regulations and administrative decisions pertaining to TRIMs and through notification to the WTO Secretariat of all publications in which they may be found; as well as an obligation of notification of all TRIMs in force at the entry into force of the Agreement. Provisions establishing transparency obligations are also found in other multilateral and regional instruments, such as for instance article III of the GATS and article 20 of the Energy Charter Treaty. These also contemplate, in order to facilitate requests of information and thus transparency, the creation by member States of enquiry points. On the contrary, no provisions on transparency are usually found in BITs.

- **Competition.** Another reason given for the existence of some HCOMs concerns restrictive business practices (e.g. limitations on exports by foreign affiliates). In these instances, HCOMs are justified as a means to counteract restrictive business practices of TNCs. The implication is that the elimination of restrictive business practices would reduce the need for host countries to use HCOMs (Morrissey and Rai, 1995).

Conclusion: Economic and Development Implications and Policy Options

A general economic analysis of HCOMs and of their developmental implications is difficult for several reasons. First, the concept itself comprises a wide range of measures whose characteristics and effects differ substantially. Second, while these measures are applied in different industries, where their influence varies greatly, there is little systematic evidence on the frequency of HCOMs and their effect; the (partial) data available are fairly dated (see UNCTC and UNCTAD, 1991, pp. 24-25), and do not suggest that they are prevalent. Third, they are usually part of a larger framework of investment incentives and disincentives in which their effects may be difficult to distinguish from those of other measures. Finally, a general appraisal of HCOMs presupposes the availability of a theoretical framework of analysis which, given the different levels of development and market structures of the States which use them, is hard to establish.

A. Development strategies and HCOMs

Notwithstanding these difficulties, a review of the empirical evidence on the use of some HCOMs — especially TRIMs — allows at least some considerations that can help structure the policy options open to host Governments.²⁸ It suggests that the outcome from such measures cannot be assumed to be automatically undesirable or distortionary. In other words, public sector intervention can either have a positive impact on national development or, if carried out improperly, worsen the situation rather than improve it (UNCTC and UNCTAD, 1991; Moran, 1998, UNCTAD, 2003b).²⁹ Of course, this leaves public policy analysts with a demanding task. Every kind of intervention requires a micro-level, cost-benefit examination of the economic (or non-economic) objectives that are meant to be achieved and of its possible impact over national welfare.

But what is important to note is that investment policies in general, and some HCOMs in particular, can help capture— and, indeed, increase — a part of the benefits associated with FDI. For example, it has been demonstrated that such HCOMs as export performance requirements have sometimes played a crucial role in stimulating TNCs to reorient their patterns of international sourcing to include a given host country site within the parent firms' regional or global networks (Greenaway, 1992). The resulting operations have often offered particularly valuable benefits to the host country economy, first from the operations of the foreign affiliates; second from the enhanced performance of the indigenous suppliers linked to these affiliates; and third from the spillovers and externalities associated with such operations. A *prima facie* case can, in such situations, be made that export performance requirements, as a tool of host country development policy, make economic sense under certain circumstances (Balasubramanyam, 1991; Greenaway, 1992).

On the other hand, from the long-term perspective of what policies best serve host country development, a number of HCOMs often do not, in fact, seem to serve to create viable and competitive operations within host countries (Moran, 1998). Instead, they can position host country firms behind the frontier of best practices and most advanced technology used in a given industry. Therefore, they can generate high cost and relatively inefficient firm behaviour. Furthermore, they may not generate the dynamic learning and

positive incentive structure to move firms or their suppliers along the path from infancy to competitive maturity. There has been, for example, some evidence that foreign affiliates subject to local-content requirements, adopted with an infant-industry logic to promote industrial development or job creation, have high costs, can lead to less efficient production, and have little hope to mature to competitive levels (Moran, 1998). Similarly, while in a number of cases joint-venture requirements adopted for the attainment of development objectives (such as technology transfer) have achieved those objectives, it has been argued that they sometimes cause friction between partners, instability and, in fact, result in a slow pace of technology transfer to the local economy (*ibid.*).

However, in the context of negotiating HCOMs in IIAs, Governments often cannot just focus on the long-term perspective. In the short term, the elimination of some HCOMs may throw firms and employees in industries into an unsustainable position, possibly leading to economic disarray. Thus, for example, in the area of domestic content requirements a long-term perspective on what best serves the development needs of a country might suggest the elimination of such requirements as being in the best self-interest of the country concerned, whereas the short-term perspective may require an orderly process of phasing in certain obligations for adjustment reasons. An over hasty termination of domestic content requirements, for example, may well lead to widespread dislocation in industries in which such requirements are prevalent. Firms (and, for that matter, TNCs) will, irrespective of the consequences, redeploy their assets to uses that are viable without artificial support. In the absence of adjustment and retraining mechanisms, this could lead to serious economic disruption. To minimize the impact of such disruptions, a host country might want to establish a phase-out period and schedule for such domestic content requirements. This would provide appropriate incentives for firms and workers alike, and could serve to avoid the preservation of uncompetitive and antiquated operations.

In addition, there is the further consideration that HCOMs, in particular those subject to the TRIMs Agreement, are not the sole aspects of investment policies meant to influence investment flows and their impact on national economies. The influence of HCOMs is part of a wider framework of regulations for investment,

some of which may be provided by home countries. Of particular importance here are high domestic content rules of origin, certain forms of anti-dumping actions, and locational incentives.³⁰ To the extent that they produce the same effect as some HCOMs, their increasing use, by home countries, can have developmental implications as well.

These various considerations raise a number of questions. What role should host countries assign to certain operational measures in the framework of their development strategies? Should they resist any expansion of prohibited HCOMs? Should they seek to balance the prohibition of certain HCOMs with restrictions on investment-holding or investment-diverting measures, such as rules of origin and anti-dumping regulations? Should they apply for extensions of their phase-out periods under the TRIMs Agreement? Should countries, as part of their review of the TRIMs Agreement, expand the agenda by addressing the various complementarities among trade, investment, and competition policies? Or should these issues be dealt with in IIAs other than the WTO TRIMs Agreement? All these questions imply a number of options for IIA negotiators on the issue of HCOMs. Some of them require particular attention in light of the review of the TRIMs Agreement that has begun in 2000. But they are also relevant because the negotiation of other IIAs increasingly touch upon HCOMs. Various policy options available in this respect are outlined next.

B. Policy options: the TRIMs Agreement

In considering the TRIMs Agreement, two provisions are of particular relevance to a discussion of policy options:

- Article 5.3 offers developing and least developed countries that demonstrate particular difficulties in implementing the TRIMs Agreement the option to request an extension of the transition period for the elimination of TRIMs. In considering such requests, the Council for Trade in Goods is instructed to take into account the development needs of the country making a request; the financial and trade needs of the country making a request; and particular difficulties in implementing the TRIMs Agreement.

- Article 9 of the TRIMs Agreement calls for a review of the Agreement after five years and for proposals to the Ministerial Conference to change the text, as might be appropriate. Article 9 specifies consideration, in particular, of whether the Agreement should be complemented with provisions on investment policy and competition policy. There is a possibility that negotiations on the review may end with a recommendation that no changes be immediately made to the Agreement. The Agreement would therefore continue to be applied as is currently done. A possible argument in this regard may be that, since the advantages and disadvantages of applying some TRIMs remain debatable, the subject-matter requires still further study by the WTO.

Option 1: Close or decrease coverage

In the light of the difficulties to meet obligations to date, one option might be to close the TRIMs list to its current coverage. A related alternative may in fact be to reconsider and reduce the list of TRIMs (box 5). However, since the TRIMs Agreement interprets Articles III and XI of the GATT, the substantive obligations under those provisions would also have to be reconsidered. Otherwise, according to this logic, even if the TRIMs Agreement ceased to exist, this would not affect the substantive obligation of WTO members under GATT articles III and XI. On the other hand, this logic would imply that the negotiation of the

Box 5. Proposals regarding the Agreement on TRIMs in terms of paragraph 9(a)(i) of the Geneva Ministerial Declaration: Communication from India

“Measures taken by governments to impose conditions to encourage and direct investment according to certain national priorities are considered as “trade-related investment measures — TRIMs”. The Agreement on TRIMs prohibits five types of such measures as they are considered to be inconsistent with GATT rules on “national treatment” and the rules against use of “quantitative restrictions”. Important among these are “domestic content” and “export performance” requirements. The developing countries have a transitional period of five years, that is up to 1.1.2000, to eliminate TRIMs covered by the Agreement, provided they have notified them to WTO when the Agreement became operational.

However, the domestic content is an extremely useful and necessary tool from the point of view of developing countries. Such a requirement is often necessary for (i) encouraging domestic economic activities

/...

Box 5 (concluded)

in raw material and intermediate input sectors; (ii) up-gradation of input production; (iii) prevention of wastage of foreign exchange in the import of raw material and intermediate inputs; (iv) ensuring linkages of FDI with domestic economic activities; (v) encouraging indigenization in case of FDI; and (vi) acting in several other ways as an important instrument in the development process. Similarly developing countries also find export performance requirements to be useful and necessary from the point of view of balanced economic growth and national development.

In the light of the above, there is therefore a need to review these provisions in the Agreement, as they come in the way of accelerating economic growth in developing countries and deny these countries the means to maintain balance-of-payments stability. In particular, the transition period mentioned in Article 5 paragraph 2 needs to be extended and developing countries be provided another opportunity to notify existing TRIMs measures.

The Agreement poses problems both with respect to the limited transition period available for removing TRIMs and the denial of freedom to countries to channelize investments in such a manner that fulfils their developmental needs. There is therefore a need to review provisions in the Agreement relating to local-content requirements as the existing provisions come in the way of accelerating the industrialization process in developing countries and deny these countries the means to maintain balance-of-payments stability. With a view to ensuring that these instruments may be maintained by developing countries till such time that their developmental needs demand, the transition period mentioned in Article 5 paragraph 2 needs to be extended.

Article 5:3, which recognizes the importance of taking account of the development, financial and trade needs of developing countries while dealing with trade related investment measures, has remained inoperative and ineffectual. The provisions of this Article must therefore be suitably amended and made mandatory.

The TRIMs Agreement should be modified to provide developing countries another opportunity to notify existing TRIMs measures which they would be then allowed to maintain till the end of the revised transition period.

Developing countries should be exempted from the disciplines on the application of domestic-content requirement by providing for an enabling provision in Article 2 or Article 4 to this effect.”

Source: WTO, 1999b.

TRIMs Agreement was therefore a redundant exercise of no consequence. This is a questionable conclusion considering that the view by many developing countries prior to the TRIMs Agreement was that the GATT did not apply to investment related measures (Hoekman and Kostecki, 1995). It can be argued that the point of

view of these developing countries is explicitly affirmed by virtue of the eventual negotiation and conclusion of the TRIMs Agreement by all the WTO members.

Option 2: Extend phase out period

An argument can be made that extension of the phase out period is needed to give developing countries more time to address their specific needs regarding economic, financial or social policies. It may be argued that the five year period disregards inequalities among countries and there is need to allow developing countries some flexibility or policy space to implement development policies that may still include the use of some TRIMs (box 6). The point has also been made that the five year period appears arbitrary and unfair in light of longer phase-out periods granted to developed countries for some obligations incurred by the latter; for example, the Multi-Fibre Arrangement has a ten year horizon for elimination. If this were a model, the current phase-out period for TRIMs could be extended by five years (box 7). It has also been suggested that developing countries be allowed to maintain TRIMs indefinitely (box 8).

What this discussion suggests is that — if an extension is considered — the development of objective criteria on the basis of which a phase-out period can be considered, could be of help. Since individual countries are making the case that some TRIMs have been of economic benefit and have served developmental ends, the development of such criteria might call for individual country studies.

Option 3: Increase coverage

Another option for consideration is the expansion of the TRIMs Agreement so as to enlarge the list of TRIMs covered (box 9). The fact that a number of HCOMs beyond those specifically covered in the TRIMs Agreement are being prohibited in certain bilateral or regional contexts suggests that a number of countries may, indeed, like to move in this direction. However, the enlargement of the TRIMs list maybe perceived as placing further limitations on some policy tools available to host countries, and this may not be acceptable to many of them, especially since some are already pressing for mitigating what they consider certain rigours of the existing TRIMs Agreement. One variation would be to adopt an approach in which countries only commit themselves to disciplines over additional HCOMs once they feel they can do so. This would provide a

Box 6. The Agreement on TRIMs: Communication from Brazil

“The WTO Agreement on Trade-Related Investment Measures (TRIMs Agreement) established equal disciplines, rights and obligations for all Members. Except for a few transitional provisions, there are no actual clauses for special and differential treatment, which would allow developing countries to address specific needs regarding economic, financial or social policies.

The disciplines of the TRIMs Agreement disregard obvious structural inequalities among Members, which could not have been overcome within the five-year transition period. Solutions to those problems would require, for the most part, long-lasting policies and adequate financing for their execution.

However, the implementation of development policies is usually constrained by lack of official funds, either from domestic or foreign sources. Investments from the private sector could cover those shortcomings, but they have proved to be, for the most part, highly volatile and closely linked to the fortuitous circumstances of the international financial markets.

Apart from the fundamental need of developing countries to attract investments in order to maintain adequate economic growth and to improve social conditions, other important fiscal and monetary factors come into play. The high volatility of international capital flows, for example, aggravates balance-of-payment difficulties inherent to the early stages of productive investments, when expenditures with imports largely outstrip export revenues. Liberalizing undertakings, such as those expected to ensue from a multilateral round of negotiations, usually set off an investment cycle that requires special care in sensitive areas such as employment relocation, currency stability, and fiscal equilibrium.

All these elements make clear that developing countries must have some flexibility when making use of trade-related investment measures. Developing countries should be allowed some latitude in devising policies that may attenuate the negative effects of investment cycles, create a hospitable environment for foreign and domestic investors, and promote social and economic development, also addressing the situation of impoverished regions. Thus, it would be fair and imperative to review the concepts that led to the acceptance of horizontal and uniform TRIMs disciplines without due consideration to the needs and singularities of developing countries. Brazil therefore submits the following proposal to the General Council and reserves its right to complement it with other proposals or to further specify its particulars.

Specific provisions shall be included in the TRIMs Agreement to provide developing countries the necessary flexibility to implement development policies (intended to address, among others, social, regional, economic, and technological concerns) that may help reduce the disparities they face vis-à-vis developed countries.”

Source: WTO, 1999b.

Box 7. The Agreement on TRIMs: Communication from Mexico

“The Agreement on Trade-Related Investment Measures regulates the application of the TRIMs that are considered to be incompatible with Articles III (National Treatment) and XI (General Elimination of Quantitative Restrictions) of the GATT 1994. The TRIMs considered to be incompatible with those provisions are set out in an Illustrative List attached to the Agreement.

The Agreement on TRIMs established different transitional periods for maintaining certain TRIMs and deciding on their dismantling, provided that they have been notified to the Committee on TRIMs. The transitional periods originally established were of five years as from the entry into force of the WTO for developing countries and seven years for the least developed countries.

When the Agreement on TRIMs was negotiated, many doubts were raised as to whether the established transitional periods were sufficient, both for practical reasons as well as for reasons of balance and equity with regard to other WTO Agreements in which developed countries insisted on and obtained transitional periods in their interests of up to ten years.

From a practical standpoint, when the Agreement on TRIMs was being negotiated, there was no guarantee that the original transitional periods would be enough for carrying out the structural adjustments that would enable developing countries, including the least developed, to eliminate the use of the TRIMs notified to the Committee, without thereby causing developmental dislocations and problems in sensitive areas of their economy.

Hence, unlike other agreements, the Agreement on TRIMs clearly and explicitly made provision for:

- (a) The right to request that the Council for Trade in Goods prolong the transitional period initially envisaged (see Article 5.3 of the Agreement), and
- (b) The review of the Agreement based on experience, leaving open the possibility of proposing amendments to any of its provisions (see Article 9).

In the preparatory work for the Third Ministerial Conference a large number of developing countries have spoken out in favour of a review of the substance of the Agreement on TRIMs, including its transitional periods, and a number of developing countries have expressed their interest in extending their TRIMs.

In the light of the foregoing, Mexico believes that rather than having to agree on the way of going about granting the extensions envisaged in Article 5.3 of the Agreement and determining how those extensions would relate to the review envisaged in Article 9 of that same Agreement, it would be best for the Ministerial Conference to decide to extend the original transitional periods by a further five years.”

Source: WTO, 1999b.

Box 8. Proposal regarding the Agreement on TRIMs: Communication from Colombia

“The Agreement on Trade-Related Investment Measures provides for the elimination of TRIMs by the end of 1999 at the end of the five-year transition period granted to developing countries. It also provides that account will be taken of the developing countries’ development, financial and trade needs.

TRIMs include measures to encourage the use of products of domestic origin, which plays an important role in the process of improving the industrial base of developing countries and the ensuing generation of income, employment and balance-of-payments equilibrium.

In the absence of large-scale investment, whether in the form of foreign direct investment or production subsidies, the five years provided for as a transition period are insufficient for restructuring the industrial base of developing countries in order to obtain the income and employment benefits stemming from the application of TRIMs.

Accordingly, bearing in mind the present circumstances of developing countries in terms of unemployment and competitiveness, it is necessary for them to be able to maintain TRIMs indefinitely.”

Source: WTO, 1999b.

certain degree of flexibility. Another variation would be to increase coverage to additional HCOMs but allow their use provided they meet certain conditions such as the continued receipt of an advantage or incentive.

The counter arguments include the suggestion that, with the inevitable prospect of a phase-out, host country authorities would find it in their own interest to see to it that foreign investor operations that are granted some new transition arrangement are governed in the interim by a specific schedule for drawing-down their TRIMs requirements to ensure that adjustment is accomplished in an orderly fashion. A simultaneous schedule for lowering trade protection and/or other protection from international competition would ensure the creation of appropriate signals to all concerned, with an aim towards providing new resources to render the hitherto protected operations more competitive or towards redeploying resources to more viable uses.

C. Policy options: other IIAs

While the TRIMs Agreement is to date the most comprehensive multilateral agreement that most countries adhere to as far as certain HCOMs are concerned, the negotiation of other IIAs on this

issue and their policy implications remain relevant. It is of course important when negotiating them to take into account the existing obligations under the TRIMs Agreement. At the same time, such IIAs can be used to deal with real or perceived loopholes in the TRIMs Agreement. But if this is done, and where the inclusion of additional HCOMs goes beyond the coverage of the TRIMs Agreement, it must be realized that this can create precedents that could be used to build support for the expansion of the current multilateral list. In negotiating such IIAs a number of options present themselves.

Box 9. General Council discussion on mandated negotiations and the built-in agenda, 23 November 1998: Communication from the United States

“Article 9 of the Agreement requires a review of the Agreement not later than five years after the date of entry into force by the Council on Trade in Goods. Its purpose is to consider the operation of the Agreement, propose amendments as appropriate and consider whether the Agreement should be complemented with provisions on investment policy and competition policy. Neither the Committee nor the Council have established any plans or procedures for conducting this review, which is to be conducted before the end of next year.

Issues for the Review: The work of the TRIMs Committee is likely to be influenced by work underway in the Working Groups established at Singapore on Investment and on Competition Policy and the reports to be submitted to the General Council before the end of the year. Nonetheless, the Committee and Council on Trade in Goods should examine additional improvements in the review.

The Committee and the Council should consider the desirability of broadening the Agreement by expanding the disciplined list of TRIMs to include export performance requirements, technology transfer requirements, and product mandating requirements.”

Source: WTO, 1998a.

Option 1: Prohibition of certain HCOMs not covered by the TRIMs Agreement

One option that host countries have in negotiating IIAs is to prohibit some HCOMs (presumably those all parties involved consider as not important to promote their development objectives), in addition to those already covered by the TRIMs Agreement. This can be done on a one-off basis or incrementally as countries commit themselves not to use certain HCOMs if and when they are ready to do so. The issue is how to link the creation of a favourable investment climate for FDI with the need of maintaining a certain policy space

to pursue national development objectives through utilizing ,amongst other policy measures, certain HCOMs.³¹

Option 2: Restrict HCOMs, but allow exceptions

Host countries may choose to negotiate the possibility of restricting the use of a particular HCOM, limiting it on the basis, for instance, of a non-discriminatory application, or of an application only in certain pre-determined industries or under special circumstances. In this case, the message sent to international investors is that host countries retain the right to impose a particular contested operational measure, but this right is limited by internationally agreed, and thus internationally enforceable, rules.

Limitations based on most-favoured-nation and national treatment.

One way of limiting the effect of HCOMs is through a requirement that they be applied on a most-favoured-nation and national treatment basis only. In this case, foreign affiliates would be subject to operational restrictions that are no more unfavourable than those applied to domestically owned firms in like circumstances.

Limitations based on specific measures.

Under this option, host countries could agree to apply certain HCOMs only in certain areas. This limited use could in particular take into account a number of issues that the market cannot cope with, such as the restructuring of economic activities and the modernization of infrastructure, or with socially optimal investments in such areas as training, education and the environment.

Limitations based on the provision of incentives.

Countries may want to deal with HCOMs together with incentives. This option would involve a quid pro quo: TNCs accepting the receipt of an advantage (such as investment incentives) would at the same time commit themselves to observe certain HCOMs. Under this option, host countries may also retain the right to impose certain HCOMs in respect of products by investors benefiting from regional preferential status. It is interesting to note that, at the same time that the TRIMs Agreement has obligated Governments to eliminate domestic content requirements on foreign investors, there has been a simultaneous increase in the use of rules of origin to protect investors in preferential trading arrangements or shift production to them. Participants in regional trade agreements have been using rules of origin to demand that high percentages of certain products that enjoy preferential status be created locally. The (high domestic content) rules of origin require the

purchase or use by an enterprise of products of internal origin, often specified in terms of specific products, volume or value of products, or a proportion of volume or value of local production, frequently with explicit quantitative specifications.

Option 3: Cross-references

Host countries could provide in one IIA that their obligations concerning operational measures will always be the same as, or not derogate from, those that may be enumerated in another specified IIA. Any changes in the obligations of the latter mentioned IIA would automatically apply to the former. States, for example, may wish simply to incorporate their existing (and future) obligations under the TRIMs Agreement in other bilateral or regional IIAs. An important point to note in this regard is that, while the substantive effect of this technique is the same as under the first two options, the interpretation and application of the provisions within the context of bilateral or regional investment relations could be different. This option allows for the interpretation and application of the provisions under the specific dispute settlement provisions of a given IIA, which might provide for investor-State dispute settlement processes, thus providing the investor with direct access to dispute settlement procedures not presently available under the WTO dispute settlement processes.

Similarly, States might wish to confine any specific State-to-State dispute settlement provisions in the IIA to the relevant parties, thereby limiting the scope of any ruling to their specific bilateral or regional context, rather than providing precedent for rulings concerning them within the multilateral system of the WTO.

Option 4: Hortatory or “best efforts” provisions on measures not covered by TRIMs

For host countries that wish to send the signal that they are not in favour of certain HCOMs, but are reluctant to foreclose the issue altogether, a hortatory approach maybe an option. By definition, the hortatory approach does not create a binding obligation on host States not to impose those measures. States could go a little further and indicate that they commit themselves to make best efforts towards a progressive elimination of certain measures.

Option 5: No references to HCOMs

Since the TRIMs Agreement already provides generally accepted prohibitions of certain HCOMs, the question arises whether there is any need for further elaboration on the issue by other IIAs. In the past, most BITs (as well as other IIAs)

kept open the issue by not specifically addressing the question of whether to prohibit some measures. Today, States may simply opt not to address the issue in an IIA on the understanding that it is adequately addressed by the TRIMs Agreement.

* * *

The analysis conducted in this chapter shows that the scope for an unconditional use of HCOMs as regards foreign affiliates has narrowed over the past two decades. At the same time, the debate remains open as to which, how and under what circumstances HCOMs do or do not contribute to the development process. Ideally, therefore, any such regulation should be preceded by careful study and determination of the contribution by a specific HCOM to the development efforts of developing countries.

Notes

¹ Unless otherwise noted, all instruments cited herein may be found in UNCTAD 1996a or 2000a.

² More elaborate classifications, which try to gain an insight into the political economy of the measures at hand, exist mainly in relation to a particular category of HCOMs, namely “TRIMs”. See, for instance, UNCTC and UNCTAD, 1991, and Greenaway, 1991.

³ However, one important IIA that deals with HCOMs does not use this criterion: the TRIMs Agreement is not limited to measures specifically directed at FDI. Thus, for example, a local content requirement may violate the TRIMs Agreement regardless of whether the nationality of the ownership of (or control in) a firm to which the measure applies is local or foreign.

⁴ The topic of conditions for admission and establishment of FDI is examined in chapter 4.

⁵ Thus, some commentators have included investment incentives in their analysis of TRIMs (e.g. Balasubramanyam, 1991, p. 1215; Maskus and Eby, 1990, p. 527), whilst others suggest that the treatment of TRIMs in the WTO context only relates to performance requirements (Morrissey and Rai, 1995, p. 711).

⁶ The topic of “incentives” is examined in more detail in chapter 15. See also UNCTAD, 1996c.

⁷ The TRIMs Agreement provides an illustrative list of measures that are prohibited. It is important to keep in mind how some subsequent WTO dispute settlement rulings have interpreted the Agreement with respect to the nature of the list. In particular, in the Canada — *Certain Measures Affecting the Automotive Industry* case (WTO, 2000c), Canada argued that the Illustrative List in the TRIMs Agreement supported its view that “a measure linking an advantage to the use of domestic products is inconsistent with Article III:4 only if

the measure ‘requires’ the use of domestic products” (*ibid.*, p. 372). With respect to this argument, the dispute settlement panel noted “that by definition the illustrative nature of the List means that it does not constitute an exhaustive statement of measures incompatible with Article III:4” (*ibid.*). (This case was appealed to the WTO Appellate Body on other grounds.) On the other hand, the measures listed continue to be specifically referred to in a number of WTO members’ official communications as the ones delimiting the extent of coverage of the TRIMs Agreement (see, for instance, boxes 5 and 7).

⁸ At the beginning of the 1980s, a United States paper on “Investment performance requirements and incentives” expressed concern that “the increasing world-wide use of such measures might also affect third countries’ trading interests, even to the point of impairing benefits negotiated under the GATT” (GATT, 1982, p. 75). On this basis, the United States, Japan and the European Community asked for a survey of trade-related investment performance requirements and incentives to be undertaken within the GATT to ascertain if any of these practices violated specific GATT provisions. The developing countries objected to this proposal, arguing that “the competence of GATT to deal with many of the practices referred to was doubtful... If GATT’s activities were to be extended in this direction, it would also be necessary to cover the activities of transnational corporations, access to capital markets, structural adjustment, restrictive business practices and so on” (*ibid.*, p. 76). No further action followed this debate until the launch of the Uruguay Round in 1986.

⁹ On this basis, discriminatory requirements or Government regulations that imposed import or export quotas were prohibited by GATT rules. This was ascertained at the beginning of the 1980s when the United States contested, in the context of the GATT dispute settlement mechanism, Canada’s Foreign Investment Review Act. The legislation authorized the Government of Canada to enter into written undertakings with foreign investors on the basis of which the investors were to give preference to the purchase of Canadian goods over imported goods and to meet certain export performance requirements. The United States submitted that these undertakings constituted requirements giving less favourable treatment to imported products than to like products of national origin, imposing quantitative regulations relating to investors’ processing and use of products and preventing the investors from acting solely in accordance with commercial considerations. They thus violated, in the United States view, Article III and Article XI of the GATT. The Panel judging the case agreed with the United States submission that these measures were inconsistent with Article III, but, in the case at issue, did not find any violation of Article XI (GATT, 1984). The importance of this Panel decision goes beyond the solution of the

factual issue at stake. For the first time, the GATT dispute settlement mechanism had been used to evaluate the effects of investment policies that could cause restrictions of imports and exports of contracting parties. Although all parties involved strongly stated the general lack of competence of GATT on investment, this case nonetheless acknowledged that TRIMs were, to some extent, covered by existing GATT rules.

¹⁰ For a close analysis of the negotiating positions of developed and developing countries, see Stewart, 1993; and Mashayekhi, 2000b. For an analysis of the TRIMs Agreement itself, see UNCTAD, 1994, chapter VII.

¹¹ Members that (as of February 2001) had sought extensions of the transition period were Argentina, Chile, Colombia, Egypt, Malaysia, Mexico, the Philippines, Pakistan, Romania and Thailand.

¹² The Council for Trade in Goods formally initiated the review provided for under Article 9 in October 1999 but, as of September 2000, no specific proposals had been made by members in this context.

¹³ See, for instance, article 4 of the 1995 Swiss model BIT and article 3 of the 1994 Chilean model BIT.

¹⁴ For further elaboration on investor treatment issues, see chapters 5, 6 and 7 in volume 1.

¹⁵ It should be noted that the TRIMs Agreement specifically provides that the measures it prohibits include those that may have to be complied with to obtain an advantage or incentive.

¹⁶ To the extent that such provisions may not be compatible with the TRIMs Agreement, reliance is placed on Article XI of the 1994 United States model BIT (found in all the BITs mentioned here) which specifies that “[t]his Treaty shall not derogate from any of the following that entitle covered investments to treatment more favorable than that accorded by this Treaty: ... (b) international legal obligations.” The effect of that provision is understood as fulfilling the requirements of customary international law, as reflected in Article 30 (2) of the Vienna Convention of the Law of Treaties (United Nations, 1969), according to which when a Treaty “specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty...” that earlier or later treaty prevails in case of conflict.

¹⁷ See, para. 2 of the article on performance requirements (UNCTAD, 2000a).

¹⁸ The prohibitions against HCOMs addressed in the MAI, other than those also covered by the TRIMs Agreement, were subject to a number of exceptions and/or qualifications. These are provided for in the original text as well as in relevant footnotes, but are omitted here.

¹⁹ It should be noted that one of the parties to the Treaty is not a member of GATT/WTO and the provisions of the Treaty are applicable only between the Energy Charter Treaty parties. But, otherwise, Article 4 of the Energy Charter Treaty provides that nothing in the Treaty “shall derogate,

as between particular Contracting Parties which are parties to the GATT, from the provisions of the GATT and Related Instruments as they are applied between those Contracting Parties.”

²⁰ The draft was prepared for discussions at the UNCTAD Round Table between Ambassadors and NGOs on a Possible Multilateral Framework on Investment, jointly organized with the United Nations Non-governmental Liaison Service in Geneva on 10 June 1998.

²¹ Bangladesh 1986 BIT, art. II:7; Egypt 1986 BIT, art. II:6; Haiti 1983 BIT, art. II:7; Morocco 1985 BIT, art. II:5; Tunisia 1990 BIT, art. II:5; Turkey 1985 BIT, art. II:7.

²² The instrument was prepared by the Polaris Institute for the Council of Canadians in 1998 as a working instrument designed to assist civil society in developing “an alternative MAI”. Inputs were made by various individuals and institutions from a number of countries around the world. The document contains a set of propositions with the aim that citizen activists in each country could study them, modify them if necessary, and develop a negotiating agenda. Thus the proposed texts were seen as part of an ongoing process of developing consensus amongst civil society groups regarding an alternative approach to global investment rules (CoC, 1998).

²³ United Nations General Assembly Resolution 3201 (S-VI): Declaration on the Establishment of a New International Economic Order (UNCTAD, 1996a).

²⁴ See United Nations General Assembly Resolution 3202 (S-VI): Programme of Action on the Establishment of a New International Economic Order of 1974 (UNCTAD, 1996a).

²⁵ See Article 2 of United Nations General Assembly Resolution 3281 (XXIX): Charter of Economic Rights and Duties of States of 1974 (UNCTAD, 1996a).

²⁶ See for example, article 1(1) of the model 1994 BIT of the People’s Republic of China.

²⁷ Other commentators approach the relation between investment incentives and HCOMs from a different point of view and consider that the former are offered to offset the negative effects derived from the imposition of the latter (Maskus and Ebi, 1990).

²⁸ Most of the studies on this issue concern TRIMs, and were conducted in the wake of the Uruguay Round negotiations. Detailed reviews of some of these surveys can be found in Moran and Pearson, 1988; Greenaway, 1991; UNCTC and UNCTAD, 1991; and Moran, 1998.

²⁹ For comprehensive economic explanations of some of the most common HCOMs, see Moran, 1998; on local content requirements: Davidson, Matusz and Kreinin, 1985; Balasubramanyam, 1991; Greenaway, 1991; Moran and Pearson, 1988; on export requirements: Rodrik, 1987; Greenaway, 1991, 1992; on ownership regulations: Balasubramanyam, 1991; Greenaway, 1992; for a recent review of the impact of performance requirements, see UNCTAD, 2003b.

³⁰ For a detailed study of the treatment of anti-dumping in the Uruguay Round, see Cumby and Moran (1996).

³¹ A concept that can help make the link is “flexibility”, which can be defined as the ability of

IIAs to adapt to the particular conditions prevailing in developing countries and to the realities of the economic asymmetries between these countries and developed countries (see chapter 2).

Chapter 15. Incentives*

Executive summary

Incentives are frequently used as a policy instrument to attract foreign direct investment (FDI) and to benefit more from it. They can be classified as financial, fiscal or other (including regulatory) incentives.

The issue of incentives is a relatively new phenomenon in international investment agreements (IIAs). Up to now, the great majority of IIAs have not contained specific provisions related to them. Rather, the “normal” treaty rules on investment protection apply, such as the principle of non-discrimination, and provisions on taxation and State contracts. This approach leaves considerable discretion to host countries in the design and application of their national incentive programmes. They remain free to reserve incentives to certain categories of companies or to certain investment locations, provided that they respect the principle of non-discrimination. The only multilateral agreement to control certain incentives is the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM Agreement). It covers trade-related subsidies. It may also cover trade-distorting investment subsidies including investment incentives.

Given the important role that incentives are seen to play in the global competition to attract FDI and benefit more from it, the tendency in more recent IIAs – in particular at the regional and multilateral level – has been to deal with them explicitly. Issues that most frequently arise in this context are the definition of “incentives”, the application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements), transparency in relation to incentives policies, addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control and consultation mechanisms with regard to the granting of incentives, and the encouragement of development-oriented incentives both on the part of host and home countries.

Incentives can be a tool for countries to pursue their development strategies. If used properly, they can compensate for some

deficiencies in the business environment that cannot easily be remedied. They can also help correct the failure of markets to capture wider benefits from externalities of production. At the same time, incentives may result in competition between countries and divert financial resources that could otherwise be more effectively used for development purposes. Moreover, the effectiveness of incentives is uncertain in a number of circumstances. Experience suggests that incentives do not rank high among the determinants of FDI and that in many instances incentives can be a waste of resources.

The main options for dealing with incentives in IIAs lie between not having any specific rules on incentives in IIAs and including provisions on incentives. In the latter case, certain further options present themselves, including a definition of “incentives”; relying on the principle of non-discrimination to regulate incentives policies, including the conditioning of incentives to performance requirements; ensuring transparency in relation to incentives policies; addressing incentives competition by limiting the lowering of standards; establishing international control or consultation mechanisms for the granting of incentives; and encouraging development-oriented incentives both on the part of host and home countries.

Introduction

One of the features of globalization is the worldwide competition for FDI. Over the past two decades, most countries have liberalized their investment regimes and opened most sectors of their economies to foreign investors. During 1991-2003, 95% of 1,885 FDI policy changes created a more welcoming environment for FDI (UNCTAD, 2004b). In 2003 alone, 244 changes in FDI laws were made, of which 220 (96%) created a more favourable investment climate (UNCTAD, 2004b, p. 8). Incentives are one of the policy tools used for this purpose. Furthermore, they are used to increase benefits from FDI for host countries. They can involve financial aid, fiscal benefits or other incentives (including the relaxation of regulatory

* The present chapter is based on a 2003 manuscript prepared by Joachim Karl and Marcela Anzola. The final version reflects comments received inter alia from Anders Ahnlid, Ivo Kaufmann, Mark Koulen and M. Sornarajah.

standards that foreign investors would otherwise have to respect).

Surveys indicate that the number of countries granting investment incentives and the range of possible incentive measures is on the rise (UNCTAD, 1996a, pp. 3-4; UNCTAD, 2003a, p. 124). This reflects the growing number of countries that proactively pursue investment promotion efforts. The result is a highly competitive world market for FDI which, in light of the recent downturn in global FDI flows (UNCTAD, 2003a), is likely to become even more competitive. Against this background, the purpose of this chapter is to describe and analyse how incentives are dealt with in the context of IIAs.

Section I defines “investment incentives” and outlines the key issues in the current policy debate on this topic: the definition of “incentives”, the application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements), transparency in relation to incentives policies, addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control or consultation mechanisms with regard to the granting of incentives and the encouragement of development-oriented incentives both on the part of host and home countries. This section further examines the function of incentives from different angles, including the perspective of foreign investors and host countries. From the point of view of foreign investors, it is important to know under which conditions they are entitled to incentives, and whether they are protected against discrimination. Host countries need to assess whether and under what circumstances incentives may promote their development objectives, and whether they do in fact make a difference to the achievement of those objectives.

Section II gives an overview of how IIAs deal with the key issues pertaining to incentives. Section III then analyses the interaction of incentives with other issues and concepts included in IIAs. Section IV examines the economic and development implications of incentives and puts forward options of how this issue could be dealt with in IIAs.

Section I Explanation of the Issue

A. What are investment incentives?

There is no uniform definition of what constitutes an “investment incentive”. (Box I.1. contains a list

of commonly used incentives.) The only major international instrument that contains a partial definition is the SCM Agreement (see below). Governments use three main categories of investment incentives to attract FDI and to benefit more from it:

- financial incentives, such as outright grants and loans at concessionary rates;
- fiscal incentives such as tax holidays and reduced tax rates;
- other incentives, including subsidized infrastructure or services, market preferences and regulatory concessions, including exemptions from labour or environmental standards.

Incentives can be used for attracting new FDI to a particular host country (locational incentives)¹ or for making foreign affiliates in a country undertake functions regarded as desirable

Box I.1. Types of incentives

Financial incentives

- Investment grants: “direct subsidies” to cover (part of) capital, production or marketing costs in relation to an investment project.
- Subsidized credits and credit guarantees: subsidized loans/ loan guarantees/ guaranteed export credits.
- Government insurance at preferential rates/ publicly funded venture capital participating in investments involving high commercial risks. Government insurance at preferential rates, usually available to cover certain types of risks such as exchange-rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil (often provided through an international agency).

Fiscal incentives

- Profit-based: reduction of the standard corporate income tax rate/ profit tax rate/ tax holiday.
- Capital-investment-based: accelerated depreciation/ investment and reinvestment allowance.
- Labour-based: reduction in social security contribution/ deductions from taxable earnings based on the number of employees or on other labour related expenditure.
- Sales-based: corporate income tax reductions based on total sales.
- Import-based: duty exemptions on capital goods, equipment or raw materials, parts and inputs related to the production process; tax credits for duties paid on imported materials or supplies.
- Export-based: export tax exemptions; duty drawback; preferential tax treatment of income from exports, income-tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales

/...

Box I.1 (concluded)

in return for export performance; income-tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries.

- Based on other particular expenses: corporate income tax deduction based on, for example, expenditures relating to marketing and promotional activities.
- Value-added-based: corporate income tax reductions or credits based on the net local content of outputs; granting income-tax credits based on net value earned.
- Reduction of taxes for expatriates.

Other incentives*Regulatory incentives*

- Lowering of environmental, health, safety or labour standards.
- Temporary or permanent exemption from compliance with applicable standards.
- Stabilization clauses guaranteeing that existing regulations will not be amended to the detriment of investors.

Subsidized services

- Subsidized dedicated infrastructure: electricity, water, telecommunication, transportation/designated infrastructure at less than commercial price.
- Subsidized services, including assistance in identifying sources of finance, implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials and supply of infrastructure, advice on production processes and marketing techniques, assistance with training and retraining, technical facilities for developing know-how or improving quality control.

Market privileges

- Preferential government contracts.
- Closing the market to further entry or the granting of monopoly rights; protection from import competition.

Foreign exchange privileges

- Special treatment with respect to foreign exchange, including special exchange rates, special foreign debt-to-equity conversion rates, elimination of exchange risks on foreign loans, concessions of foreign exchange credits for export earnings, and special concessions on the repatriation of earnings and capital.

Source: UNCTAD, based on UNCTAD, 1996a and WTO, 1998b.

such as training, local sourcing, research and development 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.² Incentives may also favour

small firms over large, or vice versa. They are offered by national, regional and local governments (UNCTAD, 2003a, p. 123).

Among the broad range of possible incentives, financial and fiscal incentives are the ones most frequently employed. Developing countries often prefer fiscal instruments, such as tax holidays, concessionary tax rates, accelerated depreciation allowances, duty drawbacks and exemptions, whereas developed countries mainly use financial incentives, including cash grants (exceeding sometimes 50% of the investment costs) and interest-free or subsidized loans. This may be seen as reflecting differences in wealth, as developed countries can afford to use up-front subsidies for inward investment whereas developing countries can, at best, afford to ease the tax burden *ex post*.

B. What key policy issues are at stake?

As noted above, incentives are a policy tool in the global competition to attract FDI and benefit more from it. This raises a number of key policy issues, in particular:

- The definition of “incentives”. The definition of incentives acquires special urgency in the context of IIAs where the applicability of their provisions on incentives will be determined, in the first instance, by the definition of what constitutes an incentive. Given the relative lack of precedents in this area, arising from the fact that only a few IIAs deal expressly with incentives, some guidance may be offered by the SCM Agreement.
- The application of the non-discrimination principle to regulate incentives (including the conditioning of incentives to performance requirements). The principle of non-discrimination, in the form of the national treatment and the most-favoured-nation (MFN) treatment, may be employed, in the context of IIAs, to prohibit host countries from differentiating in their incentives programmes on the basis of the nationality of an investor or an investment. But its applicability does not preclude the selection of investors/investments eligible for incentives on the basis of other objective criteria, such as the business sector or the size or location of a company. In addition, the applicability of the non-discrimination principle to incentives may be subject to several important limitations, for

example, with regard to incentives granted at the pre-establishment phase of an investment, subsidies provided by a government entity, fiscal incentives or subsidies granted for research and development purposes. But investment incentives conditioned on the fulfilment of certain performance requirements by a foreign investor as an industrial development instrument may, under certain conditions, be caught by the principle of non-discrimination. The aim behind such requirements is to ensure the fullest economic utility of an investment to a host country and, in particular, its development objectives. On the other hand, such measures could be regarded as having negative effects on economic efficiency, by imposing unwanted additional burdens upon investors (UNCTAD, 2003a, pp. 119-120).

- Transparency in relation to incentives policies. Transparency relates to the openness and impartiality of the decision-making process in the design, introduction and administration of incentives. It provides firms with more predictable conditions for access to, and operation in, foreign markets; it also helps to reveal covert discrimination and reduces the risk of arbitrary administrative or political decisions. A lack of transparency may be the single greatest cost of incentive programmes, because it creates significant possibilities for corruption and other types of rent-seeking behaviour. This in turn can be detrimental to the development of competitive markets and indeed to development itself (Oman, 2000, pp. 5, 73, 101).
- Addressing incentives competition by limiting the lowering of regulatory standards or by establishing international control or consultation mechanisms with regard to the granting of incentives. First, by lowering their domestic standards in areas such as health, environment or labour (through, for example, temporary exemptions from applicable rules or the stabilization of the existing legal regime to the effect that foreign investors are not adversely affected by future legislative changes),³ host countries may seek to reduce the investment costs for foreign investors, thereby increasing their attractiveness as a potential production site. In addition, some countries seek to control the availability of

incentives and the terms upon which they are made available to investors, so as to minimize the risk of “incentives races” whereby countries compete for internationally mobile FDI projects by way of incentives that seek to better those on offer from other potential host countries that are seeking to attract the same investment.

- The encouragement of development-oriented incentives on the part of host and home countries. Certain development-oriented incentive policies have been used in regional integration agreements, mainly between developing countries in order to encourage the evolution of regional enterprises in developing regions by encouraging or even requiring the use of incentives by host countries. As such, these regimes raise issues of preferential access to markets and the preservation of an element of special and differential treatment for investors from other developing countries within the region. In addition, home countries may be able to encourage investment in developing countries through incentives offered to their investors to undertake such investments (e.g. technical assistance, technology transfer requirements, financial and fiscal incentives and investment insurance).

Section II Stocktaking and Analysis

This section gives an overview of how IIAs deal with investment incentives, focussing in particular on the key issues identified in the preceding section. Only relatively few treaties – mostly at the regional or multilateral levels – deal explicitly with incentives. However, the lack of express provisions on incentives does not necessarily mean that incentives are not subject to disciplines. Indeed, even within the negotiation concerning the Multilateral Agreement on Investment (MAI) by the Organisation for Economic Co-operation and Development (OECD), several delegations believed that no provision expressly addressing investment incentives was necessary since other draft articles sufficiently covered the issue.⁴ However, the number of IIAs addressing expressly some types of incentives is gradually increasing, indicating the growing importance that some countries place upon this matter.

A. The definition of “incentives”

The definition of an “incentive” can be very broad, covering virtually any assistance offered by a country to investors, or it can be narrower, covering only specific types of assistance to investors. However, not many IIAs contain definitions of this term or related terms. For example, neither the General Agreement on Trade in Services (GATS), which refers to “subsidies” in article XV, nor the North American Free Trade Agreement (NAFTA), which excludes “subsidies or grants” from the operation of the national treatment and MFN obligations in its investment provisions, contain definitions of these terms.⁵ The SCM Agreement is the only multilateral agreement containing a definition of a “subsidy”. The purpose of this agreement is the establishment of an international control mechanism concerning the granting of trade-related subsidies (box II.1). Nevertheless, its definition of a “subsidy” is relevant in the present context, because the terms “subsidy” and “incentive” overlap. As will be shown below, a “subsidy” in the meaning of the SCM Agreement is likewise an “incentive”, if granted to an investor.

Box II.1. Evolution of the rules on subsidies in the GATT

Article XVI GATT constitutes the first international obligation on subsidies of a multilateral character. In 1979, the “Tokyo Round” negotiations began over a more detailed discipline of subsidies and countervailing duties, resulting in a Subsidies Code, which covered not only export subsidies, but also “other than export subsidies” (article 11).

The “Uruguay Round” text on subsidies, mandatory for all members and officially entitled “Agreement on Subsidies and Countervailing Measures”, is extensive and detailed. Part I defines subsidies. Parts II, III and IV divide all specific subsidies into one of three categories: prohibited (red basket), actionable (yellow basket), and non-actionable (green basket) and establish certain rules and procedures with respect to each category, including specific dispute-settlement rules and procedures for each category. Part V establishes the substantive and procedural requirements that must be fulfilled for the application by a member of a countervailing measure against subsidized imports. Part VIII includes exemptions and transition periods for developing countries.^a

Source: WTO, 1995a.

^a For further discussion see UNCTAD, 2001b, 2002a.

The SCM Agreement applies only to subsidies that affect trade in goods. According to

article 1 of the SCM Agreement, a “subsidy” shall be deemed to exist if the following two conditions are fulfilled (WTO, 1995a):

- there must be a “financial contribution by a government or any public body” or “any form of income or price support in the sense of Article XVI [Subsidies] of GATT [General Agreement on Tariffs and Trade] 1994;” and
- a benefit is thereby conferred”.

Article 1 provides further details as regards the issue of what constitutes a “financial contribution by a government or any public body...”. The following measures are considered to fulfil this condition:

- a government practice involving a direct transfer of funds (e.g. grants, loans and equity infusion), or a potential direct transfer of funds or liabilities (e.g. loan guarantees);
- government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
- a government provides goods or services other than general infrastructure, or purchases goods;
- a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated above (see the three previous bullets), which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

A “subsidy” as defined in article 1 is subject to the substantive rules of the SCM Agreement if it is “specific”. Pursuant to article 2, this is the case if the subsidy is granted to an enterprise or industry or group of enterprises or industries. Article 2, in connection with Article 3, gives further guidance concerning the question whether a subsidy is “specific” or not:

- A subsidy is specific in the following four cases:
 - the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises;
 - it is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority;
 - it is contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I to the Agreement;

- it is contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.
- A subsidy is not specific:
 - where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in a law, regulation, or other official document, so as to be capable of verification. Objective criteria or conditions, as used in this provision, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.
 - where the setting, or change, of generally applicable tax rates, by all levels of government entitled to do so, is concerned.
- In case of doubts whether a subsidy is specific or not, the following factors may be considered: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. In regard of the latter, in particular, information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered. In applying these factors, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

Thus, the SCM Agreement contains a broad definition that covers any kind of fiscal or financial incentive that relates to trade in goods and is found to be “specific” pursuant to the Agreement itself. It does not include regulatory incentives, like the lowering of environmental or social standards, since such incentives do not constitute a “financial contribution” by the government or other public

bodies. Nor does it include general infrastructure advantages (regardless of whether it is provided at market prices). As a result, the SCM Agreement – while applying to fiscal and financial incentives – does not impose any obligations on governments concerning the granting of regulatory incentives or upon the provision of general assistance to businesses. Thus, for example, governments remain free to attract FDI through the use of export processing zones (EPZs), provided that they do not accord the grant of subsidies on condition that investors reach a given level of export performance, or that they use a certain level of domestic rather than imported inputs, or make subsidies specific to certain enterprises (Roessler and Valles, forthcoming).

During the ultimately unsuccessful negotiations on a draft MAI in the OECD, two suggestions had been made for a definition of an “investment incentive” to be applied specifically in relation to FDI. One proposal resembled strongly the definition in the SCM Agreement (see above). The alternative text in the draft reads as follows:

“[...] an ‘investment incentive’ means:

The grant of a specific advantage arising from public expenditure [a financial contribution] in connection with the establishment, acquisition, expansion, management, operation, or conduct of an investment of a Contracting Party or a non-Contracting Party in its territory.”

This definition is in some respects narrower than the definition in the SCM Agreement. First, it is limited to defining the term “investment incentive”, whereas the SCM Agreement defines a “subsidy” as such. Second, the draft MAI definition covers only those advantages that are “specific”. This term intends to distinguish incentives given across-the-board from those to which only certain investors or investments are entitled. It should be noted, however, that the SCM Agreement uses the same concept, although not in the context of the definition of a subsidy. In the SCM Agreement, “specificity” becomes relevant for the question of whether a subsidy is actionable or not.

In two respects, the scope of the definition in the draft MAI is broader than that of in the SCM Agreement. First, it would have covered incentives granted to investments of non-contracting parties. The reason for this approach was that otherwise the draft MAI discipline on incentives would have had a major loophole – as compared to the WTO, the OECD has a much smaller membership. MAI contracting parties would have remained free to

grant incentives to investors of non-contracting parties, thereby jeopardizing the objective to limit incentive-based competition for FDI comprehensively. Secondly, the draft MAI would have covered not only incentives relating to manufacturing and raw materials but also those applicable to services, whereas the SCM Agreement does not extend to the latter given its limitation to trade-related subsidies.

B. Non-discrimination

1. National and MFN treatment

The principle of non-discrimination, as applied in the context of IIAs, generally encapsulates the national and the MFN treatment obligations. They require that contracting parties treat foreign investors and investments in their territory at least as favourably as domestic investors and investments (national treatment) or as investors and investments from any other third country (MFN treatment). In certain cases, such requirements are subject to a further condition that investors or investments be “in like circumstances”. Since incentives are granted in connection with investment-related activities, national and MFN treatment obligations can apply to them.

These two obligations may prohibit host countries from differentiating in their incentive programmes on the basis of the nationality of the investor. This means that – unless exceptionally permitted – they would not be allowed to reserve incentives for their domestic investors alone, or to target investors of only one particular foreign country. This does not preclude, however, the selection of investors eligible for incentives on the basis of other objective criteria, such as the business sector, the size or location of a company, or the amount of the invested capital. The principle of non-discrimination would therefore leave host countries considerable discretion to design their incentive programmes according to their individual investment policies and strategies.

In addition, there are some important limitations to the applicability of the non-discrimination principle to incentives. In this regard, two kinds of limitations have been used. On the one hand, there are limitations relating to specific sectors, resulting either from country-specific reservations (under a negative-list approach) or from the non-inclusion of a particular sector under a positive-list approach. On the other

hand, a number of IIAs (such as NAFTA Chapter 11) exclude subsidies from the application of the national and MFN treatment obligations. Also, the applicability of national and MFN treatment to taxation measures is usually quite closely circumscribed.

a. The extent of protection

The great majority of bilateral investment treaties (BITs) only cover the “post-establishment phase”, i.e. they grant rights to foreign investors once they have established themselves in a host country. In other words, such BITs do not contain legally binding rules concerning the treatment of foreign investors wishing to make an investment. This means that incentives for making an investment (locational incentives) are not covered by the non-discrimination principle. Host countries would therefore be allowed, under these BITs, to reserve incentives for the establishment of an investment to their domestic investors. They would likewise have the right to favour investors of a particular foreign country over other foreign investors. However, caution would need to be exercised by a host country that is a member of the WTO to ensure that such favourable treatment is consistent with the requirements of the SCM Agreement in that the treatment would be generally available to all enterprises of a particular nationality and not to specific enterprises, and that it would not be conditional on the types of trade-related subsidies prohibited by the terms of the SCM Agreement (see further UNCTAD, 2002a, pp. 208-210).

Some regional or multilateral IIAs extend the application of the non-discrimination principle to the pre-establishment phase. This is the case, e.g. in the NAFTA. According to its articles 1102 and 1103, national and MFN treatment obligations apply, *inter alia*, to the establishment and acquisition of an investment. A more restricted approach is followed by the GATS: while it covers the establishment of a commercial presence (akin to the making of an investment), it establishes as a general rule only one part of the non-discrimination principle, namely, MFN treatment, although members do have the possibility of including temporary MFN exemptions in their schedules (article II), thus providing a legal basis to discriminate in the granting of incentives in sectors covered by an exemption. National treatment applies only if a member makes a voluntary commitment in this respect (article

XVII), and such commitments may be subject to country-specific limitations and conditions. To the extent that IIAs extend the principle of non-discrimination to the pre-establishment phase, it applies to locational incentives granted by a host country to foreign investors when making an investment. However, such IIAs may likewise contain an exception clause concerning the applicability of the non-discrimination clause to incentives that reverses this effect.

b. Exclusion of the non-discrimination principle from incentives

A few BITs exclude the applicability of the non-discrimination principle to incentives. For instance, according to article VI.2 of the 1996 BIT between Canada and Trinidad/ Tobago, the principle of non-discrimination does not apply to subsidies or grants provided by a government or a State enterprise, including government-supported loans, guarantees and insurance. Identical wording can be found in articles VI.2 of the Canadian BITs with Ecuador (1996), Panama (1996) and Barbados (1996).⁶ Similarly, the BITs concluded by the United States give the Government of that country the right to adopt or maintain exceptions in respect of subsidies and grants. However, such exceptions relate only to the principle of national treatment. The MFN treatment obligation remains applicable.

Pursuant to article 1108 (7) of the NAFTA, the principle of non-discrimination does not apply to procurement measures by a party or State enterprise, or to subsidies or grants provided by a party or a State enterprise, including government-supported loans, guarantees and insurance. More specifically, according to article 1108 (1) of the NAFTA, the principle of non-discrimination does not apply to any existing non-conforming measure that is maintained by a contracting party. This means that under NAFTA any non-conforming investment incentive has been “grand-fathered”, provided that it has been listed in a country-specific schedule annexed to the Agreement. In addition, pursuant to article 1108 (3), contracting parties had the possibility to exclude the application of the non-discrimination principle in respect of measures concerning *sectors, sub-sectors or activities* that they have set out in their schedule to an annex to the Agreement. Accordingly, any NAFTA partner could exclude the applicability of the nondiscrimination clause with regard to any *future* investment incentive

granted for the sectors, sub-sectors, or activities specified in the schedule.

c. The treatment of fiscal incentives

Incentives are often granted in the form of fiscal measures (e.g. tax relief). IIAs usually exempt taxation matters from the scope of the agreement, as these are governed by separately negotiated bilateral taxation treaties between countries. The equilibrium of these agreements could be upset if the provisions of IIAs also extended to taxation. Two main approaches can be distinguished. The strongest exclusion can be found in the draft MAI. It excluded, in principle, taxation measures entirely from the scope of the Agreement. Only the provisions on expropriation and transparency remained applicable to such measures. By contrast, other IIAs modify the application of the principle of non-discrimination with regard to taxation measures:

- Some BITs exclude any taxation measure, irrespective of whether it is based on internal legislation or an international agreement, from the scope of application of the non-discrimination principle. This is, for instance, the case for the BITs concluded by the United Kingdom and France. BITs concluded by Malaysia include provisions excluding taxation measures from the application of the MFN treatment obligation.⁷
- Some countries exclude only those advantages from the nondiscrimination principle that are included in an agreement relating wholly or partially to taxation. This is the case, for example, for the BITs concluded by Chile and Germany. Another group of countries in this category (e.g. China, Switzerland) have adopted a narrower approach by referring only to advantages included in an agreement on the avoidance of double taxation.
- Pursuant to article 2103 (1) of the NAFTA, the Agreement does not, in principle, apply to taxation measures. However, according to article 2103 (4) the principle of non-discrimination remains applicable to taxation measures other than those – *inter alia* – on income, capital gains or on the taxable capital of corporations (i.e. mostly indirect taxes). In no case does the MFN treatment obligation apply with respect to an advantage accorded by a contracting party pursuant to a tax convention or to a nonconforming provision of any existing taxation measure.

- The Energy Charter Treaty (ECT) pursues a similar approach. Article 21 excludes, in principle, taxation measures of contracting parties from the scope of the agreement. However, according to article 21 (3), the principle of non-discrimination remains applicable to taxes other than those on income and on capital. Even with regard to those taxes, the MFN treatment obligation does not apply concerning advantages accorded by a contracting party pursuant to international taxation agreements or resulting from membership of a regional economic integration organization. Likewise, the principle of non-discrimination does not apply with regard to taxation measures aimed at ensuring the effective collection of taxes, except where this results in arbitrary discrimination. Finally, pursuant to article 21 (5), the ECT provision on expropriation remains applicable to taxation measures.
- Article XIV of the GATS states the following: “Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures [...] inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes [...]”. According to article XIV (e), the same applies with regard to measures inconsistent with the MFN treatment obligation (article II), provided that the difference in treatment is the result of an agreement on the avoidance of double taxation.

In conclusion, all the IIAs mentioned above restrict the applicability of the treaty with regard to fiscal incentives. In particular, the principle of non-discrimination is either inapplicable or applies only to a limited extent.

d. Other exceptions

Article 10.8 of the ECT contains a review clause concerning specific incentives. 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 research and development shall be reserved for a so-called “Supplementary Treaty”. Each contracting party shall, through the ECT Secretariat, keep the Charter Conference informed of the modalities it applies to such programmes. BITs sometimes contain similar provisions excluding non-discrimination obligations with regard to special advantages granted to development finance institutions established for the exclusive purpose of development assistance.⁸

In addition, the ECT contains other types of exception clauses concerning certain investment incentives. Pursuant to article 24.2 (b) (iii), the Treaty

“shall not preclude any Contracting Party from adopting or enforcing any measure [...] designed to benefit Investors who are aboriginal people or socially or economically disadvantaged individuals or groups or their Investments and notified to the Secretariat as such, provided that such measure (A) has no significant impact on that Contracting Party’s economy; and (B) does not discriminate between Investors of any other Contracting Party and Investors of that Contracting Party not included among those for whom the measure is intended, provided that no such measure shall constitute a disguised restriction on Economic Activity in the Energy Sector, or arbitrary or unjustifiable discrimination between Contracting Parties or between Investors [...]. Such measures shall be duly motivated and shall not nullify or impair any benefit one or more other Contracting Parties may reasonably expect under this Treaty to an extent greater than is strictly necessary to the stated end.”

A similar clause may be found in the 1997 BIT between Canada and Lebanon where a provision in Annex I excludes the application of several general disciplines (e.g. prohibition of non-discrimination, performance requirements) to any measures denying investors of the other contracting party and their investments any rights or preferences provided to the aboriginal peoples of Canada (section III, paragraph 5(c)).⁹

2. Incentives in conjunction with performance requirements

Host countries sometimes condition the granting of an incentive upon the fulfilment of certain performance requirements that are not

prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs Agreement), which is binding on all WTO members.¹⁰ For example, they may demand from investors that they create a certain minimum number of jobs, establish the investment in a specific region or transfer a certain technology. In response to this issue, two categories of provisions can be distinguished in IIAs: provisions that prohibit the granting of incentives from being conditional upon the fulfilment of certain performance requirements; and provisions that exempt from the prohibition of performance requirements certain measures that are associated with the granting of an incentive.¹¹

The most important instrument in respect of the first issue is the TRIMs Agreement. According to article 2 of the Agreement, no contracting party shall apply any trade-related investment measure that is inconsistent with the provisions of article III (obligation of national treatment) and article XI (obligation of general elimination of quantitative restrictions) of the GATT 1994. An annex to the TRIMs Agreement includes an illustrative list of prohibited measures. No member of the WTO can attempt to reverse the prohibition on the imposition of such performance requirements through the provisions of bilateral or regional IIAs that would be inconsistent with their obligations under the TRIMs Agreement.

An example of the second approach can be found in the 1994 model BIT of the United States as revised in 1998. Pursuant to its article VI, “[n]either Party shall mandate or enforce [performance requirements], as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment...”. However, according to the last paragraph of this article “[s]uch requirements do not include conditions for the receipt or continued receipt of an advantage”. This approach has been reflected, for example, in the United States BITs with El Salvador (1999), Bolivia (1998), Honduras (1995), Nicaragua (1995) and Trinidad and Tobago (1994).

Canada follows a similar approach. The Canadian BITs contain a clause that explicitly excludes the granting of subsidies and advantages from the prohibition to establish performance requirements. For instance, pursuant to article VI(2) of the Canadian BITs with Trinidad and Tobago (1996), Ecuador (1997), Panama (1998) and Barbados (1997), “[t]he provisions of Articles II, III, IV and V [performance requirements] of this Agreement do not apply to [...] subsidies or grants provided by a government or a state enterprise,

including government-supported loans, guarantees and insurance; ...”.¹²

A similar approach applies under the NAFTA. According to its article 1106, paragraph 3, no party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a party or of a non-party, on compliance with any trade-related requirements. However, the same article provides that “[n]othing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory”. Therefore NAFTA prohibits, consistent with the TRIMs Agreement, the conditioning of incentives to trade-related performance requirements, while permitting incentives that are linked to other types of requirements (so-called investment-related performance requirements).¹³

C. Transparency

The majority of IIAs that specifically address the issue of transparency do so in general terms. It is therefore not always clear whether the resulting transparency obligations extend to incentives. The usual formulation is to refer to laws, regulations, procedures and administrative practices of general application in respect to any matter covered by the IIA in question, coupled with the obligation that these are promptly published or otherwise made available to interested parties (see chapter 10). To the extent that incentives provisions are contained in such instruments, the transparency obligation extends to them as well. Beyond that, certain agreements make an explicit connection between incentives and transparency. Thus, the section on “Investment Incentives” in the draft MAI included a provision that expressly applied the transparency provision in the draft MAI to investment incentives.

In other instruments transparency in the operation of investment incentives is placed on a hortatory basis. Thus, the OECD Declaration on International Investment and Multinational Enterprises, paragraph IV (International Investment Incentives and Disincentives), states, *inter alia*, that member countries will endeavour to make measures concerning investment incentives

and disincentives “as transparent as possible, so that their importance and purpose can be ascertained and that information on them can be readily available”. In a similar fashion, article 160 of the Treaty Establishing the Common Market for Eastern and Southern Africa addresses the need for the member States to “undertake to increase awareness of their investment incentives, opportunities, legislation, practices, major events affecting investments and other relevant information through regular dissemination and other awareness-promoting activities.”

The SCM Agreement contains mandatory, detailed transparency provisions dealing with incentives. For example, article 25 of this Agreement requires members to notify subsidies covered by the Agreement in order to enable other members to evaluate the trade effects and to understand the operation of the notified subsidy programmes. Article 22 also requires members to notify and make publicly available the initiation of an investigation on the legality of subsidy programmes of other members, providing clearly the types of information to be included in the public notice.

D. Addressing incentives competition

Competition over investment incentives may have several negative effects (UNCTAD, 1996c). It may also encourage host countries to adopt “race-to-the-bottom” policies or discourage them to undertake “race-to-the-top” policies. Incentives competition may also lead to distortions and misallocations of investment, thereby possibly compromising the potential effects of regional integration aimed at broadening the market. These effects may be addressed by, for example, prohibiting the lowering of regulatory standards or establishing international control or consultation mechanisms.

1. Limits on the lowering of regulatory standards

Provisions in this area cover either environmental or labour standards or combine them into a more comprehensive provision. Some agreements also include a reference to health and safety standards.

a. Environmental protection

Article 1114, paragraph 1, NAFTA, confirms the sovereign right of contracting parties to take measures necessary for the protection of the environment. Article 1114, paragraph 2, states that:

“[t]he Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement”.

NAFTA also contains a Side Agreement on Environmental Cooperation. Its objectives include the protection and improvement of the environment, the promotion of sustainable development, and the increase of cooperation between the parties. In the context of incentives, its Article 3 is of particular relevance. It reads as follows:

“Recognizing the right of each Party to establish its own levels of domestic environmental protection and environmental development policies and priorities, and to adopt or modify accordingly its environmental laws and regulations, each Party shall ensure that its laws and regulations provide for high levels of environmental protection and shall strive to continue to improve those laws and regulations.”

In a similar manner, article G.14 of the 1996 Free Trade Agreement between Canada and Chile states:

“1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or

otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that the other Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.”¹⁴

Environmental measures have also been addressed in the 1994 Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles. They provide that “Member economies will not relax health, safety, and environmental regulations as an incentive to encourage foreign investment.”¹⁵ Furthermore, the sixth recital of the preamble of the BIT between Bolivia and the United States emphasizes the agreement between the parties that the treaty’s objectives (i.e. the encouragement and reciprocal protection of investment) “can be achieved without relaxing health, safety and environmental measures of general application”.

b. Labour rights

This issue has been dealt with in international labour conventions. For example, paragraph 46 of the 1977 International Labour Organisation’s (ILO) Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (as amended in 2000) states the following:

“Where governments of host countries offer special incentives to attract foreign investment, these incentives should not include any limitation of the workers’ freedom of association or the right to organize and bargain collectively.”

In addition, there are several ILO Conventions/ Declarations establishing certain minimum social rights that member countries have to respect. Among the most important of these instruments are the 1998 Declaration on Fundamental Social Rights (ILO, 1998), and the 1999 Convention on the Worst Forms of Child Labour (ILO, 1999). The fundamental social rights include the freedom of association and the right of collective bargaining, the elimination of all forms of forced labour, the elimination of child labour, and the elimination of discrimination concerning work and profession.

NAFTA includes a Side Agreement on Labor Cooperation. Its objectives are, *inter alia*, to improve working conditions and living standards, to promote as much as possible the labour principles set out in Annex 1 of the Agreement, and to encourage cooperation between the Parties. Of particular importance in the context of incentives is article 2. It reads as follows:

“Affirming full respect for each Party’s constitution, and recognizing the right of each Party to establish its own domestic labor standards, and to adopt or modify accordingly its labor laws and regulations, each Party shall ensure that its labor laws and regulations provide for high labor standards, consistent with high quality and productivity workplaces, and shall continue to strive to improve those standards in that light.”

c. Joint approaches

A few IIAs address both environmental and labour standards.

The 2000 OECD Guidelines for Multinational Enterprises include a provision in the chapter on “General Policies” regarding regulatory incentives. Accordingly, “[e]nterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises should [inter alia] [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”.

During the MAI negotiations, there was a broadly shared view that a provision, discouraging the lowering of labour and environmental standards to attract foreign investment, should be included. Various drafting suggestions were made. They focused around the following text:

“[The Parties recognise that it is inappropriate to encourage investment by lowering [domestic] health, safety or environmental [standards] [measures] or relaxing [domestic] [core] labour standards. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such [standards] [measures] as an encouragement for the establishment, acquisition, expansion or retention of an investment in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it

may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.]”

Recent free trade agreements concluded by the United States follow the joint approach by including provisions recognizing that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic environmental and labour laws.¹⁶ However, these provisions employ hortatory language, such as:

“[...] each Party shall strive to ensure that it does not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such laws in a manner that weakens or reduces the protections afforded in those laws as an encouragement for trade with the other Party, or as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory.”¹⁷

Incentives in the form of lowering regulatory standards are still a relatively new issue for IIAs. To the extent that IIAs deal with this matter, it appears that provisions concerning environmental standards are more frequent than rules on labour rights. In view of the ongoing debate about the effects of globalization, one can expect that the issue will gain further importance.

2. Establishment of international control or consultation mechanisms

The development of international disciplines on investment incentives remains a controversial issue, especially in relation to the policies of developing host countries, for whom the retention of flexibility in regulatory techniques, including the use of investment incentives, is a major concern. Notwithstanding this cautious approach, as explained in section I, a number of IIAs seek to control, or even prohibit, incentives and/or establish a consultation mechanism between the parties.¹⁸

This sub-section reviews the practice of international instruments in this area commencing with provisions that discourage the use of certain approaches to investment incentives and those that envisage regional harmonization of investment incentives, followed by a review of the only mandatory control instrument in this area, namely the SCM Agreement. Although primarily concerned with issues related to trade, the SCM

Agreement is the most advanced international instrument in this respect. Finally the section ends with a review of consultation provisions.

a. Discouraging certain approaches to the granting of incentives

Some instruments, while not legally binding, expressly advise against the use of certain approaches in the development of incentives policy. Thus, the World Bank Guidelines on the Treatment of Foreign Direct Investment (World Bank Guidelines), while encouraging home country incentives for the enhancement of investment flows to developing countries, at the same time discourage the granting of certain incentives. According to section III.9, nothing in the World Bank Guidelines suggests that a State should provide foreign investors with tax exemptions or other fiscal incentives. Where such incentives are deemed to be justified by the State, they may to the extent possible be automatically granted, directly linked to the type of activity to be encouraged and equally extended to national investors in similar circumstances. Reasonable and stable tax rates are deemed to provide a better incentive than exemptions followed by uncertain or excessive rates. As examined above, recent free trade agreements address the issue of regulatory incentives by discouraging especially the lowering of environmental and/or labour standards.

b. Regional harmonization

In order to avoid investment distortions and misallocations due to incentives competition and to preserve the potential effects of economic integration, CARICOM member countries envisage the regional harmonization of investment incentives. Article XIV of the Protocol Amending the Treaty Establishing the Caribbean Community (Protocol III on Industrial Policy), which inserts the new article 49 into the Treaty, provides that “Member States shall harmonise national incentives to investments in the industrial, agricultural and services sectors”. In this regard, this provision grants to the Council for Finance and Planning (COFAP) the authority to formulate proposals for the establishment of regimes for the granting of incentives, which should be consistent with relevant international agreements.

c. Control mechanisms

The SCM Agreement distinguishes between prohibited, actionable and non-actionable subsidies. Only “specific” subsidies may fall into the categories of prohibited or actionable subsidies (see further UNCTAD, 2002a; Roessler and Valles, 2003).

- *Prohibited subsidies.* According to article 3, subsidies related to import/ export requirements (i.e. subsidies that are contingent upon export performance or upon the use of domestic over imported goods) are prohibited. This ban would likewise apply to investment incentives that are conditioned to the fulfilment of such requirements. In case of a dispute over these subsidies, article 4 provides for a detailed dispute resolution mechanism.¹⁹
- *Actionable subsidies.* These are subsidies that are not automatically prohibited. Most specific subsidies fall into this category. In case of an actionable subsidy, a member may invoke the WTO dispute-settlement mechanism pursuant to article 7 if a specific subsidy has adverse effects on its industry, causes nullification or impairment to its benefits under GATT or causes serious prejudice to its interests. Article 7 establishes a dispute resolution mechanism for “actionable subsidies” similar to the one existing for prohibited subsidies.²⁰
- *Non-actionable subsidies.* Article 8 identifies a number of subsidies that are non-actionable, i.e. they are not subject to the WTO dispute-settlement mechanism. These are subsidies that are either not specific or that fall into one of the following categories: assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms; assistance to disadvantaged regions within the territory of a member given pursuant to a general framework of regional development and non-specific (within the meaning of article 2) within eligible regions; and assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/ or regulations which result in greater constraints and financial burden on firms. Article 8 applies only provisionally for a period of five years following the entry into force of the WTO Agreements. The Committee on Subsidies and Countervailing

measures did not extend the application of this provision. As a result, all subsidies that are specific to certain enterprises are now actionable (Roessler and Valles, 2003).

The incentive rules of the European Union (EU) go beyond the SCM Agreement in that they prohibit subsidies that are contingent on certain import/ export requirements and any subsidy that may distort competition between member States and that affects trade between them. Thus their applicability to anti-competitive and/or trade distorting investment aids is clear (box II.2).

Box II.2. The EU experience in regulating State aid

The EU has attempted to coordinate policies in the area of State aid to reduce the risk of harmful competition within the Union. Under the Treaty of Rome, the European Commission operates controls over market-distorting, anti-competitive State aids to investment. State aid includes grants, loans and guarantees, tax exemptions and infrastructure projects benefiting identifiable users. Pursuant to Article 87:

“any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market” (TEC, 1997, p. 73).

Not covered by this ban are government support measures of a general nature. This is the case if:

- there is no specificity in terms of sector, region or category;
- the eligibility of the aid is based on objective criteria, without any discretionary power of the authorities; or
- the measure is in principle not limited in time or by a predetermined budget.

However, the Commission may exempt the following State support from the prohibition:

- aid to promote economic development in poor regions;
- aid to promote an important project of common European interest or to remedy serious economic disturbance;
- aid to promote regional economic development, if it does not negatively impact other regions’ trading positions;
- aid to promote cultural and heritage conservation; and
- other categories of aid as may be determined by the Council.

Much in this list may be of relevance to developing countries. Many of the above criteria are development related criteria, or emergency criteria that may well apply to the economic and social realities of the developing countries.

Source: UNCTAD.

d. Provisions on consultation or future negotiations

To address the possible distortive effects of incentives upon market conditions as related to investment, several instruments provide for mutual information and consultations between the parties. Some IIAs go one step further and stipulate that the parties shall enter into future negotiations in order to establish multilateral disciplines on incentives. Thus, Article XV of the GATS states that:

“Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects. The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.”

The OECD Declaration and Decisions on International Investment and Multinational Enterprises introduced consultations in the field of investment incentives and disincentives through a Ministerial Decision of May 1984. Such consultations take place at the request of a member country that considers that its interests may be adversely affected by the impact, on its flow of “international direct investment”, of measures taken by another member country that provides significant official incentives and disincentives to FDI. Having full regard to the national economic objectives of the measures and without prejudice to policies designed to redress regional imbalances, the purpose of the consultations is to examine the possibility of reducing adverse effects to a minimum. The Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC) may be periodically invited to express their views on these matters. It appears that, up to now, these procedures have never been used.

During the MAI negotiations, a suggestion was made concerning the treatment of investment incentives. The draft article provided for a

consultation mechanism between contracting parties and for future negotiations on the establishment of legally binding rules on the granting of incentives. The draft provision reads as follows:

“1. The Contracting Parties confirm that Article XX (on NT and MFN) and Article XX (Transparency) applies to [the granting of] investment incentives.

2. [The Contracting Parties acknowledge that [, incertain circumstances,] even if applied on a nondiscriminatory basis, investment incentives may have distorting effects on the flow of capital and investment decisions. [Any Contracting Party which considers that its investors or their investments are adversely affected by an investment incentive adopted by another Contracting Party and having a distorting effect, may request consultations with that Contracting Party.] [The former Contracting Party may also bring the incentive before the Parties Group for its consideration.]]

3. [In order to further avoid and minimise such distorting effects and to avoid undue competition between Contracting Parties in order to attract or retain investments, the Contracting Parties [shall] enter into negotiations with a view to establishing additional MAI disciplines [within three years] after the signature of this Agreement. These negotiations shall recognise the role of investment incentives with regard to the aims of policies, such as regional, structural, social, environmental or R&D policies of the Contracting Parties, and other work of a similar nature undertaken in other fora. These negotiations shall, in particular, address the issues of positive discrimination, [transparency], standstill and rollback.]”

Recent free trade agreements addressing the issue of regulatory incentives (by discouraging the lowering of environmental and/or labour standards) make use of general cooperation and consultation mechanisms to deal with any matter arising under such provisions. For example, chapter 18 on Environment of the 2003 free trade agreement between Singapore and the United States includes language discouraging regulatory incentives (article 18.2) as well as general provisions requiring the pursuit of cooperative environmental activities (article 18.6) and consultation to resolve any matter arising under this chapter (article 18.7).

The above provisions consider incentives as an important investment issue that requires a

policy dialogue between the parties concerned. However, some instruments also recognize that this might not be sufficient, and that the granting of incentives should be subject to additional rules. However, the conclusion of binding regional or multilateral disciplines controlling the availability of investment incentives as a policy tool, including simply increasing transparency, is 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 approach.

E. Encouragement of development-oriented incentives

IAs can explicitly encourage or even require the use of incentives by host countries in order to pursue development policies. One possibility in this respect is to entitle host countries parties to regional agreements to offer, under certain conditions, incentives to certain categories of companies established in one of the contracting parties. This may include the harmonization of domestic incentives. Another approach addresses home country incentives (see further UNCTAD, 2003a, section VI). In this regard, some instruments encourage the granting of incentives by the home countries, with a view towards increasing FDI flows and their benefits for developing countries.

1. Host country incentives

Agreements that allow host countries to grant incentives have been concluded between developing country parties to regional agreements. For example, Decision 292 of the Commission of the Cartagena Agreement (article 12) provides that:

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

This provision is reserved for the treatment of specialized regional enterprises established under the particular supranational regime of the Andean Multinational Enterprise.

On the other hand, certain agreements extend incentives to all classes of investors from within the region. Thus, article 4 of the 1981 Agreement on Promotion, Protection and Guarantee of Investments Among Member States of the Organisation of the Islamic Conference provides that “[t]he contracting parties will endeavour to offer various incentives and facilities for attracting capitals and encouraging its investment in their territories such as commercial, customs, financial, tax and currency incentives, especially during the early years of the investment projects, in accordance with the laws, regulations and priorities of the host state”. In a similar vein, the Protocol Amending the 1998 Treaty Establishing the Caribbean Community (CARICOM) (Protocol III: Industrial Policy) provides rules on the harmonization of investment incentives, including a positive statement to grant incentives to investors in specific sectors. The relevant provision, article XIV (inserting a new article 49 into the Treaty), reads as follows:

“1. Member States shall harmonise national incentives to investments in the industrial, agricultural and services sectors.

2. The COFAP shall, consistent with relevant international agreements, formulate proposals for the establishment of regimes for the granting of incentives to enterprises in the sectors mentioned in paragraph 1. In particular, such proposals shall accord support for industries considered to be of strategic interest to the Community.

3. In formulating the proposals mentioned in paragraph 2, the COFAP shall give due consideration to the peculiarities of the industries concerned and, without prejudice to the generality of the foregoing, may provide for the following:

- (a) national incentives to investment designed to promote sustainable, export-led industrial and service-oriented development;
- (b) investment facilitation through the removal of bureaucratic impediments; and
- (c) non-discrimination in the granting of incentives among Community nationals.”

A further example comes from the Customs and Economic Union of Central Africa. According to chapter I, section 1, of the Common Convention on Investments in the States of the 1965 Customs and Economic Union of Central Africa, any investment falling into one of the categories listed therein may benefit from a special

decision admitting it to a preferential schedule. These categories mainly cover activities in the areas of agriculture, exploitation of natural resources, power production and tourism. The following criteria shall in particular be taken into consideration during the examination of the project: (a) importance of the investment, (b) participation in the implementation of the economic and social plans, (c) creation of employment and vocational training, (d) participation of nationals of the countries of the Union in the formation of capital, (e) use of technically guaranteed equipment, (f) priority use of local raw materials and, in general, local products and (g) registered office established in a country of the Union. Approved undertakings may benefit from various tax benefits and may be given priority in the granting of foreign currency in order to buy equipment goods and raw materials necessary for their operations. Pursuant to chapter II, undertakings of cardinal importance to national economic development, involving exceptionally high investments, may also be granted the stabilization of fiscal provisions. Chapter IV allows for the possibility that undertakings considered as being especially important to the social and economic development plans of the member country benefit from an establishment convention granting to them certain guarantees and imposing certain obligations. In addition to certain fiscal guarantees, the government may grant guarantees as to the financial, legal and economic stability and stable conditions for financial transfers and the marketing of goods, guarantees as to the entry and movement of labour, freedom of employment, and the free choice of suppliers and services, and guarantees as to the renewal of lumbering and mining permits if necessary. This approach is echoed in article 23 of the Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) which states that “[a]ny enterprise as defined under article 2 which meets the conditions for authorization under this Code may benefit from the economic, financial and tax advantages provided for under basic regime I as hereinafter established”. A similar approach has been taken with regard to tariff preference in the context of an ASEAN industrial joint venture according to the 1987 Revised Basic Agreement on ASEAN Industrial Joint Ventures (article III).

The above IIAs are based on the understanding that incentives can play a useful role and should therefore be permitted. At the same time, these IIAs – which are all regional

agreements – seek to minimize the risk of investment distortions by establishing common principles for the granting of incentives. To this end, the IIAs identify categories of companies that are eligible for incentives or types of incentives that may be offered.

2. Home country incentives

Technical assistance, technology transfer requirements, financial and fiscal incentives and investment insurance provided by some home country governments for the purpose of encouraging investment in developing countries are recognized as positive instruments to encourage and promote FDI flows to developing countries (see chapter 22). While home country incentives are usually of a hortatory nature, encouraging firms from the home country to invest in developing countries, certain stronger commitments have also been used.

The only comprehensive, mandatory international agreement addressing the issue of home country incentives is the 2000 Partnership Agreement between the Members of the African, Caribbean and Pacific Group of States of the One Part, and the European Community and Its Member States, of the Other Part (the Cotonou Agreement), the successor to the Fourth Lomé Convention. The Cotonou Agreement includes several provisions on different types of home country incentives. The Agreement, for example, reaffirms the importance of technology transfer objectives by calling for cooperation in the “development of scientific, technological and research infrastructure and services; including the enhancement, transfer and absorption of new technologies” (article 23). More generally, the Agreement provides a list of investment promotion measures to be undertaken by the parties to the Agreement, including the home countries. Article 75 states that:

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

- (a) implement measures to encourage participation in their development efforts by private investors [...];
- (b) take measures and actions which help to create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate;
- (c) encourage the EU private sector to invest and to provide specific assistance to its

- counterparts in the ACP countries under mutual business cooperation and partnerships;
- (d) facilitate partnerships and joint ventures by encouraging co-financing;
 - (e) sponsor sectoral investment fora to promote partnerships and external investment;
 - (f) support efforts of the ACP States to attract financing, with particular emphasis on private financing, for infrastructure investments and revenue-generating infrastructure critical for the private sector;
 - (g) support capacity-building for domestic investment promotion agencies and institutions involved in promoting and facilitating foreign investment;
 - (h) disseminate information on investment opportunities and business operating conditions in the ACP States;
 - (i) promote [...] private-sector business dialogue, cooperation and partnerships [...].”

The Agreement recognizes, moreover, the role that financing measures play in development objectives. Article 76 on “Investment finance and support” states that:

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

- (a) grants for financial and technical assistance to support policy reforms, human resource development, institutional capacity-building or other forms of institutional support related to a specific investment, measures to increase the competitiveness of enterprises and to strengthen the capacities of the private financial and non-financial intermediaries, investment facilitation and promotion and competitiveness enhancement activities; [...]
- (c) risk-capital for equity or quasi-equity investments, guarantees in support of domestic and foreign private investment and loans or lines of credit on the conditions laid down in Annex II “Terms and Conditions of Financing” to this Agreement; [...].”

Finally, the Cotonou Agreement affirms the importance of investment protection through

investment guarantees. In this regard, article 77 of the Agreement states in part that:

- “1. Investment guarantees are an increasingly important tool for development finance as they contribute to reducing project risks and inducing private capital flows. Cooperation shall therefore ensure the increasing availability and use of risk insurance as a risk-mitigating mechanism in order to boost investor confidence in the ACP States.
- 2. Cooperation shall offer guarantees and assist with guarantees funds covering risks for qualified investment. [...]
- 3. Cooperation shall also provide support to capacity-building, institutional support and participation in the core funding of national and/ or regional initiatives to reduce the commercial risks for investors [...].
- 4. [...] The ACP and the EC will within the framework of the ACP-EC Development Finance Cooperation Committee undertake a joint study on the proposal to set up an ACP-EC Guarantee Agency to provide and manage investment guarantee programmes.”

Aside from the Cotonou Agreement, there are other IIAs that address the issue of home country incentives albeit not on such a comprehensive basis. Among the international agreements requiring home countries to grant incentives to promote technology transfers, the leading example is the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). According to article 66.2 of that Agreement, “[d]eveloped 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.” Although it does not specify what type of technology transfer is to be supported and how, this mandatory provision potentially strengthens the position of technology buyers in least-developed countries (UNCTAD, 2003a, pp. 131-134).

Certain intra-regional cooperation agreements between developing countries introduce various home country commitments to promote investment in host countries party to the agreement. For example, the Treaty Establishing the Caribbean Community differentiates between the more and less developed countries among its

membership, establishing a special regime for financial assistance “with a view to promoting the flows of investment capital to the Less Developed Countries” (chapter VII, article 59(1)). The Agreement on Investment and Free Movement of Arab Capital Among Arab Countries endorses a policy in article 1(a) that “Every Arab state exporting capital shall exert efforts to promote preferential investments in the other Arab states and provide whatever services and facilities required in this respect” (see further UNCTAD, 2003a, chapter VI).

Furthermore, regional investment agreements among developing countries often contain provisions on fiscal incentives that guarantee tax-free asset transfers or provide reduced tax levels for qualifying preferred investors. In its formulation of a draft provision on the “promotion and encouragement of investments”, the Asian-African Legal Consultative Committee suggested under article 2(1) the use of “appropriate incentives, wherever possible, which may include such modalities as tax concessions and investment guarantees”. Tax-sparing provisions in double taxation treaties can alleviate the problem of home country taxation nullifying the FDI incentive effect of fiscal privileges granted to foreign investors by host countries. Many developed countries, with the notable exception of the United States, have been willing to accept tax-sparing provision in double taxation treaties signed with developing countries (see chapter 21). The International Chamber of Commerce (ICC) essentially endorsed tax-sparing provisions in its 1972 Guidelines for International Investment, proposing under paragraph 2(e) of chapter IV that home country governments “should refrain from frustrating the effects of development reliefs granted by host countries in respect of new investment by affording appropriate matching reliefs” (see chapter 22).

The World Bank Guidelines suggest that developed and capital surplus States should not obstruct flows of investment from their territories to developing countries; rather, they are encouraged to adopt appropriate measures to facilitate such flows, including taxation agreements, investment guarantees, technical assistance, and the provision of information (section III.10).

* * *

This section has highlighted the variety of provisions that exist in IIAs covering investment incentives, and investment-related trade incentives.

Outside the trade field, these are not very comprehensive and fall short of a developed international code on incentives. Nonetheless, a certain level of control already exists through the general non-discrimination provisions common to most IIAs. However, governments remain relatively free to use investment incentives, subject to non-discrimination standards (to which a number take exceptions) and to their obligations as members of the WTO under the TRIMs and SCM Agreements. Whether future IIAs will contain more developed rules on incentives is open to discussion. These could go in a number of directions, from a positive encouragement of what may be seen as development friendly incentives, offered not only by host, but also by home countries, to increased controls over incentives. In this process, consultation and exchanges-of-information mechanisms over incentive policies and their effects may become stronger.

Section III Interaction with other Issues and Concepts

This section examines and explains how the issue of incentives interacts with other issues and concepts commonly found in IIAs. Table 1 shows the range of interaction with the most common investment issues. The most important interactions concern the issues of admission and establishment, home country measures, host country operational measures, MFN treatment, national treatment, state contracts, taxation and transparency.

- **Admission and establishment.** Incentives may be granted to encourage foreign investors to make an investment in a host country. To the extent that IIAs include rules on admission and establishment of foreign investors, they may apply to such incentives. Indeed, the availability of incentives may be made conditional on the investor complying with certain conditions of entry specified at the point of entry. The scope of a host country’s discretion in the granting of incentives at this stage will depend on the extent of its treaty obligations in applicable IIAs. Thus, where the host country accords pre-entry rights to investors, the range and availability of incentives will need to accord with general standards of treatment and guarantees given to investors under such an agreement. On the other hand, where the relevant IIA applies

only to the post-entry phase, the host country retains considerable discretion to design its FDI incentive programme, as treatment of investors at the point of entry would fall outside the coverage of the IIA (see further chapter 4).

Table 1. Interaction across issues and concepts

Issue	Incentives
Admission and establishment	++
Competition	+
Dispute settlement: investor-State	0
Dispute settlement: State-State	0
Employment	+
Environment	+
Fair and equitable treatment	+
Home country measures	++
Host country operational measures	++
Illicit payment	0
Investment-related trade measures	+
MFN treatment	++
National treatment	++
Scope and definition	0
Social responsibility	+
State contracts	++
Taking of property	+
Taxation	++
Transfer of funds	0
Transfer of technology	+
Transfer pricing	0
Transparency	++

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

- **Home country measures.** The issue of incentives has a strong potential for interaction with home country measures. As discussed in section II, some agreements have provisions encouraging or requiring home developed countries to take active steps in promoting outward direct investment in host developing countries by firms from such home countries. The value of such provisions lies in the enhancement of investment conditions in developing host countries, to the extent that investment costs can be mitigated through financial support, technical assistance investment, risk insurance and other support measures provided by home countries (UNCTAD, 2003a; see also chapter 22). In addition, such provisions in IIAs can serve to place home country measures on a footing of greater transparency, stability and security than unilateral measures of this kind, which tend to be offered at the discretion of the home

country concerned. Indeed, where such measures are based on positive legal duties they can add to the development effect of an IIA by coordinating host country obligations to guarantee certain investor rights with home country commitments to offer support to investors. This may encourage investment in host developing countries and increase the likelihood that such countries benefit more fully from it (see further UNCTAD, 2003a, chapter VI.A). Even where commitments to home country measures are hortatory in nature, positive effects could ensue in that they can serve to create a more investment friendly environment of cooperation between parties to the agreement in question, from which stronger obligations could grow over time.

- **Host country operational measures.** Host country operational measures include all measures implemented by host countries concerning the operation of foreign affiliates inside their jurisdictions. They usually take the form of either restrictions or performance requirements (see chapter 14). The fulfilment of such requirements may be a condition for the granting of incentives. For example, a host country might offer incentives in order to encourage the transfer of technology into its territory. IIAs may deal with this issue in the context of host-country operational measures. Equally, investment-related trade measures, such as export financing programmes or export processing zones, can also function as an incentive for attracting export-oriented FDI (see chapter 25). The objective behind such kinds of policies may be to balance the aim of attracting internationally mobile investment, through the use of incentives, with a degree of conditionality imposed through host country operational measures, with a view to encouraging investors to contribute as much as possible to national development objectives.
- **National treatment/MFN treatment.** As discussed in section II, the principle of non-discrimination is central to the treatment of incentives in IIAs.
- **State contracts.** An incentive may be granted on the basis of an individual investment contract concluded between an investor and a host country, as is often the case in connection with major investment projects. Incentives in State contracts may not only include fiscal and financial aid, but likewise regulatory incentives. The State party to a contract may

establish a special legal regime for the investment in the contract that is more favourable to the investor than the “normal” regulatory framework. Such preferential treatment may include stabilization clauses according to which the State party commits itself for example not to amend existing legislation to the disadvantage of the foreign investor. The failure by a host country to provide the incentive in accordance with the terms of the contract would constitute a breach of its contractual obligations. In addition, foreign investors might be protected under an IIA. It may include a provision according to which each contracting party will respect any other commitment (i.e. a commitment other than those in the IIA) it has entered into with regard to an investment of an investor of another contracting party. This means that the breach of the individual investment contract would become a violation of the IIA.

In addition, the issue arises whether the principle of non-discrimination applies to incentives granted under an investment contract. IIAs do not explicitly address this question. The application of the non-discrimination principle could mean that a host country that has promised an incentive in an investment contract to one investor is obliged also to grant incentives in other investment contracts that it concludes. Such an outcome might, however, be in contradiction to the principle of freedom of contract. In addition, even if the non-discrimination principle applied, foreign investors may find it difficult to prove that they are in like circumstances to the competitor who initially received the incentive (see chapter 13).

- **Taxation.** Fiscal incentives are among the most commonly used types of incentives. Their underlying purpose is to reduce the effective tax rate applicable to foreign investment, thus increasing its rate of return (UNCTAD, 1996a). The applicability of IIAs with regard to fiscal incentives is usually very limited (see chapter 21). The principal provisions of IIAs as they relate to fiscal incentives have been already considered in section II above.
- **Transparency.** As highlighted in section II, transparency is of crucial importance in the context of incentives, and some IIAs contain express provisions on this matter (see chapter 10).

Conclusion: Economic and Development Implications and Policy Options

A. Economic and development implications²¹

Incentive packages have 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. 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, 1996c, pp. 9–11).

On the other hand, countries give incentives in order to benefit from FDI. This can be done by using incentives to influence firm behaviour with a view to achieving objectives related to development, or to correct for the failure of markets to capture wider benefits from externalities of production. Such externalities, which may be the result of economies of scale, the diffusion of knowledge or the upgrading of skills, may justify incentives to the point that the private returns equal the social returns.

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, 1996c; Moran, 1998; Oman, 2000). Anecdotal evidence since then suggests that this trend has continued (UNCTAD, 2002a; 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, 1996c, 2001c).²²

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 an 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 the Central and Eastern European countries (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.²³ A further consequence of global investment competition has been the increased use of regulatory concessions, frequently used in export-processing zones. Such zones often create “policy enclaves” in which the normal regulatory rules and practices of the host country may not apply to reduce investment costs.

There is a long-standing debate on the economic benefits of locational incentives (UNCTAD, 1996c; 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,²⁴ 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 an 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 an 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 an 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 adjustment 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. In other words, the richer can out-compete the poorer, or force them into an expensive competition for FDI projects.

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 export-processing zone facilities, where many host countries offer similar conditions and other attributes (UNCTAD, 1996c, 2001c; Wells et al., 2001; Morisset and Pirnia, 2001).

Still, 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).²⁵ For domestic market-seeking or natural resource-seeking FDI, however, locational incentives are not as important—and they are harder to justify. More generally, 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 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).

Activity-specific and behavioural incentives are generally considered more effective. Export subsidies have been frequently used to promote export-oriented FDI, particularly in export-processing zones (UNCTAD, 2002a). 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 (UNCTAD, 2001b, 2003c). 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, research and development incentives are unlikely to raise affiliate spending on research and development 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 export-processing zones 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, 1998a; UNCTAD, 1999b, 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 (UNCTAD, 2002a).

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.²⁶ 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.

B. Policy options: alternative approaches and formulations

The above overview has shown that international instruments deal with incentives in different ways. Parties to an IIA have various choices. The concrete option that a country chooses depends on the general policy that it pursues vis-à-vis attracting FDI and benefiting from it, and the role that it accords to incentives in the framework of its development strategies.

Against this background a number of choices present themselves as to the form and content of IIA provisions relating to incentives. The discussion begins with the prevailing approach, namely, the omission of provisions dealing with incentives in IIAs. The discussion continues by highlighting a number of further options that may arise should countries decide to include rules on incentives in an IIA. These are discussed in an order that considers, first, the issue of definition; second, the types of provisions that could be employed to preserve governmental discretion in the use of incentives through exclusions to the non-discrimination principle; third, linking incentives and performance requirements; fourth, provisions on transparency; fifth, provisions addressing incentives competition by limiting the lowering of regulatory standards; and sixth, by establishing an international regime of policy co-ordination over incentives; and finally, provisions that seek to encourage development-oriented incentives.

Option 1: No specific rules on incentives

The most important effect of this option is that the principle of non-discrimination may apply to the granting of incentives. Through this policy, contracting parties confirm not to treat foreign investors less favourably with regard to incentives than their domestic counterparts or other foreign investors. It reflects the actual practice followed by most countries, namely, not to differentiate in their incentive programmes between domestic and foreign investors or between different foreign

investors, in accordance with the national treatment and MFN principles.

There is the issue of how the principle of non-discrimination would relate to a host country's economic and development strategies. Host countries would retain the right to develop and apply their incentive programmes. In particular, they would not be impeded from granting aid to investments in specific economic sectors, regions or to certain categories of investments, provided that they do not infringe on the national treatment and MFN standards. In addition, investors claiming non-discriminatory treatment would have to prove that they are "in like circumstances" as those investors who actually receive the incentive. This gives host countries considerable discretion in conducting their development policies in that a number of factors need to be taken into account when deciding what constitutes "like circumstances", including the relevant business sector, relative firm size and geographical location. Furthermore, host countries would, in principle, remain free to grant incentives in State contracts with individual investors.

Option 2: Specific provisions on incentives

Option 2(a): Definition of incentives

As noted in section II, most IIAs do not define this term as they do not cover the issue. Even those that refer to "subsidies", such as the GATS and NAFTA, have not defined that term. On the other hand, the SCM Agreement offers a comprehensive trade-oriented definition. But it too does not deal with certain questions relevant to investment incentives, notably the lowering of regulatory standards. Thus there is little precedent as to how to deal with this important matter. The choice lies in essence between a wide definition that covers all possible types of incentives and a narrower definition that covers only certain types of incentives. In the latter instance, the criteria for selection may include whether to cover both general and specific incentives, or only one type or the other; whether or not to cover financial, fiscal and other (including regulatory) incentives or only some of these; and whether to cover only direct assistance from governmental sources or to include non-governmental assistance as well.

Option 2(b): Exclusions from the non-discrimination principle

The principle of non-discrimination might, in certain circumstances, impede the discretion of host countries to reserve incentives for their domestic investors only. This may be dealt with by way of a country-specific exception to national

treatment, should the IIA in question offer such a choice. A host country that wants to adopt exceptions has several alternatives. For example, it may design a limited list of domestic companies or industries to which it wants to grant preferential treatment concerning incentives. Likewise, a host country may decide that only specific incentive programmes should be exempted from the non-discrimination principle. However, these options have the disadvantage that they are static and may not allow taking into account possible future changes in the incentive schemes. Another possibility is to include into an IIA a phase-out provision concerning the preferential treatment of domestic companies. Foreign investors could therefore claim non-discriminatory treatment with regard to incentives once this transition period has expired. This option might be preferred by developing countries seeking, in particular, to assist their infant enterprises. To this end, they may wish to take over fully or partially their start-up costs and terminate incentives once the infant industries have matured.

As noted in section II, many IIAs exempt taxation matters from the application of the treaty. The possible options range from a complete exclusion of taxation to more limited approaches, such as the non-application of the MFN treatment or national treatment obligations in respect of advantages granted in an agreement on the avoidance of double taxation. These limitations could likewise cover fiscal incentives. Host countries opting for this alternative would therefore have the right to support their domestic investors by reserving fiscal benefits exclusively to them. Preferential tax treatment may, particularly, be an option for developing countries that do not have the financial means for other kinds of incentives (e.g. cash grants). It needs to be underlined, however, that the special treatment of taxation issues in IIAs is not intended to allow for discrimination against foreign investors. Rather, this approach reflects the wish of governments to deal with international taxation matters predominantly or exclusively in taxation agreements, thereby avoiding possible conflicts between these types of treaties and IIAs.

Option 2(c): Linking incentives to performance requirements

As noted in section II, host countries may condition the award of incentives upon the fulfilment of certain performance requirements by investors. This is, as noted above, subject to the limits placed upon host country discretion by

adherence to the TRIMs Agreement, which prohibits outright certain types of performance requirements. On the other hand, outside such prohibited requirements, host countries remain free to pursue such a linkage policy in IIAs, subject to other international agreements they have concluded. The main development effect of such an approach is to allow for some direction as to the manner in which an investor can operate their investment, with the aim of enhancing its development effects. Hence the emphasis may be on requirements that enhance the transfer of technology, encourage “spill over” effects of technology and good business practice to domestic firms, promote employment and ensure adequate investment in less developed regions of the host country. This could be seen as the “price” to be paid for access to incentives. However, the linking of incentives to such requirements could also act as a disincentive for investors, where they may be seen as imposing excessive compliance costs upon firms, thereby making the host country location less attractive than one where fewer or no such requirements are imposed. Thus host countries need to weigh up carefully the projected positive development effects of performance requirements combined with incentives against the possible disincentive to investment that such conditionality might introduce.

On the other hand, in order to discourage the potentially distorting effects of such linkage, countries may decide to include provisions in IIAs restricting their discretion to offer such conditional incentives. This may be done in at least two alternative ways. First, following the example of the TRIMs Agreement, through the prohibition of import or export-related performance requirements and incentives connected to them. By contrast, host countries continue to have the right to impose non-trade related performance requirements (e.g. research and development requirements, minimum level of domestic employment). Secondly, host countries could clarify the extent to which they restrict their power to condition the granting of incentives upon performance requirements. To this purpose, they could include a list of prohibited performance obligations in the IIA.

Option 2(d): Transparency

Host countries wishing to improve transparency could do so by establishing transparency obligations in IIAs that explicitly cover incentives. Host countries would commit themselves to publish or make otherwise publicly available information about their incentive

programmes. Investors would therefore have the possibility of informing themselves as to what programmes are available and under what conditions they would be eligible to take advantage of them. This approach could also be followed at the regional level, including through incentive reviews (UNCTAD, 1995, p. 302).

There arises the further difficult issue of whether a transparency obligation would extend to incentives granted in individual investment contracts. Whatever the answer to that question may be, host countries have the possibility of publishing investment contracts on a voluntary basis, provided that the investors parties to the agreements agree. It is not clear whether such contracts can be considered as having the character of a “law or regulation”, thereby raising a degree of uncertainty as to whether the transparency obligation covers such instruments.

Option 2(e): Addressing incentives competition by limiting the lowering of regulatory standards

As noted in section I, countries may hold the view that certain social, health, labour and environmental conditions are an integral part of their development strategies. Such countries may, however, be concerned that other countries could undermine their efforts by seeking to lower standards of protection in these areas thereby possibly diverting FDI flows and causing so-called “social/environmental dumping”. Such behaviour could weaken the formers’ position in the global competition for FDI, and could result in a “regulatory chill”. To diminish the risk of this type of incentives competition, countries would have the option of including, in an IIA, a clause prohibiting the lowering of standards in the designated regulatory fields as an instrument to attract FDI. Equally, a legally non-binding political declaration on the avoidance of lowering regulatory standards to specific investments or investors could be adopted. Contracting parties could also commit themselves to work towards a constant improvement of standards to protect environment and labour rights. One example of such an approach is the NAFTA where this commitment has been made in the form of “Side Agreements”.

Option 2(f): Addressing incentives competition by establishing international control or consultation mechanisms for the granting of incentives

Another option to address the negative effects of incentives competition is for countries to deal comprehensively with incentives in IIAs. One approach would be to establish a mutual

information or consultation mechanism, especially for locational incentives. It could be invoked if a contracting party were of the opinion that incentives granted or considered by another contracting party could have a negative impact on its own competitive position. Since competition for FDI can involve many countries, it may be the case that such information or consultation efforts would need to be undertaken at a regional or even global level in order to be effective. Although IIAs have not, to date, explicitly prohibited the use of incentives through, for example, a blanket ban on the granting of advantages to investors, certain approaches aimed at dealing with incentives can be envisaged on the basis of international and national practices.

a. Conditional incentive-limitation clause

One option would be for governments to include in their IIAs a conditional incentive-limitation clause that would only become operative if a specified number or set of countries adopted the same clause. For example, a developing country facing its stiffest competition from, say, four neighbouring countries, could be reluctant to accept a bilateral discipline on incentives on its own, but might be willing to abide by such a discipline if its competitors had also agreed to such a clause. In this example, bilateral treaties would not have to be negotiated simultaneously; clauses would be activated only upon the signing of the required minimum number of treaties. Such an approach might be more promising if the principal home countries were to agree on a common incentive-limitation clause that each would insert into its model treaty (UNCTAD, 1995, p. 302).

b. Limiting the amount of financial assistance available through incentives

A further method of controlling or limiting the operation of incentives may be to set upper limits on the amount of financial assistance that a host country can give to foreign investors in an IIA. This could help avoid “incentives races” by limiting the final amount that a country could offer to an investor. On the other hand, this would also raise significant questions concerning the definition of an “incentive”, as a narrow definition could permit considerable discretion in the avoidance of the limit through the use of devices not normally considered incentives but which

could have the same economic effect as an incentive, as discussed in section I above. Equally, there may be difficulties in determining the applicable limits, and the criteria by which these are to be set. A further option may be for governments to agree on criteria to discontinue gradually some of the most distorting incentives and, based on the agreed-upon criteria, to make the granting of incentives subject to approval by a regional or multilateral entity (UNCTAD, 1995). The discouragement of economically harmful incentives is a policy that would be attractive to countries that wish to control the amount of public expenditure on FDI projects and to limit their discretion in such fields so as to enhance the operation of market forces in investment decisions. Other countries may prefer to preserve their discretion in these matters.

c. Limiting incentives to essential social and economic objectives

Following the example of the European Union state aid provisions, briefly discussed in box II.2, an IIA may restrict the award of incentives to those cases in which an overriding social need (for example, the provision of essential infrastructure) or economic exigency (for example, the need to regenerate an economically underdeveloped region or other identifiable entity) requires a level of economic risk reduction to ensure that the required investment takes place.

A variation of this approach is to make the grant of incentives to foreign investors conditional upon the unavailability of sufficient private sector finance to make the project viable in the absence of public sector subsidy. Where private sector finance is available, the foreign investment in question most probably does not require a public subsidy given that the rate of return on the investment would be sufficient to attract private investment capital. However, certain investments, that may be highly desirable from a social, economic and developmental perspective, may offer too lengthy a period of return to generate sufficient private sector interest. In such cases it may well be important for the government to underwrite part (in exceptional cases possibly all) of the investment capital required for the investment. This could be made subject to the fulfilment of performance targets so that the risk of wasted subsidy can be minimized (see further Muchlinski, 1999, chapter 7).

d. Checklist of FDI incentives

The evaluation of incentives is a difficult matter. Countries could agree on a checklist of points that governments may want to take into account in their incentives policy and practices. It could help to assess the costs and benefits of using incentives and provide operational criteria for assessing their effects (UNCTAD, 1995, pp 303-304).

Option 2(g): Encouraging development-oriented incentives

As noted above, certain types of incentives may be useful tools for the economic development of developing countries. Behavioural incentives in particular can fulfil this role, if they are part of a wider development policy. Accordingly, IIA provisions could seek to promote such “development friendly incentives”, through permissive clauses that preserve the host country’s discretion to offer such incentives. For instance, incentives for the transfer of technology and skills could be expressly encouraged, by making them “non-actionable”, i.e. making them secure against legal action.

In addition, provisions could be included to extend to the activities of home countries. These can be divided into two types: first, provisions that limit the use of financial incentives on the part of host developed countries to attract FDI, so as to avoid unfair competition over internationally mobile investment to the detriment of developing host countries that may be unable to afford such incentives; second, provisions encouraging development friendly home country incentives.

The main development effect of such provisions, as explained in sections II and III above, is to act as a spur to investment in developing host countries. The latter, in particular, could be considered as part of the range of home country measures to encourage FDI flows to developing countries and increase the benefits from them (see further UNCTAD, 2003a, chapter VI). Such provisions would incorporate home country measures into IIA obligations. Such home country

provisions could be hortatory in nature and could encourage “soft” cooperation in such areas as information exchange, assisted outreach to home country business groups and seminars and other educational activities geared to improving awareness of investment opportunities in host developing countries. On the other hand, binding obligations could also be included, though this may be a more difficult step. Such provisions could require financial commitments on the part of developed home country parties to IIAs through e.g. assistance programmes. In addition commitments could be linked to follow up programmes that seek to ensure the fulfilment of such commitments. Finally such provisions would need to take into account possible extraterritorial effects of home country measures and ensure that the obligations contained therein do not contradict but complement host country incentives measures. Thus a degree of cooperation between countries party to an agreement containing home country incentives measures may be necessary.

* * *

The foregoing discussion has highlighted issues concerning the use of incentives to attract FDI and benefit more from it. A number of alternative approaches exist in this respect. There may be strong reasons, especially of a developmental nature, for adopting special treatment of foreign or domestic investors (as the case may be). Where such reasons are strong, it may be important to preserve the policy space of host countries in appropriate provisions in IIAs. On the other hand, such reasons must be balanced against possible distortions of market mechanisms that may ensue from governmental intervention in this area. Thus, the challenge for negotiators of IIAs, should they wish to include provisions on incentives in future agreements, is to find ways of enhancing market mechanisms while accepting that, in certain circumstances, the use of incentives may be justifiable. However, this issue remains highly sensitive and so the development of IIA provisions in this field is likely to be approached with considerable caution.

Notes

- ¹ 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.
- ² 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 transnational corporations (TNCs), because of their greater level of exports and profits (UNCTAD, 2003a, p. 141).
- ³ Employment and environment are analyzed in detail in other chapters in this volume.
- ⁴ See further Daly, 1998.
- ⁵ Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996a, 2000a, 2001a, 2002a and 2004c; the texts of the BITs mentioned in this chapter may be found in the collection of BITs maintained online by UNCTAD at www.unctad.org/ia.
- ⁶ Similar provisions are also contained in Annex I of the 1997 BIT between Canada and Lebanon (section III, paragraph 5(b)).
- ⁷ See e.g. 1994 BIT between Indonesia and Malaysia (article III).
- ⁸ See the 1998 BIT between Chile and South Africa (article IV, paragraph 4) and the 1995 BIT between South Africa and The Netherlands (article 4, paragraph 4).
- ⁹ See also a provision in the BIT between Mauritius and South Africa granting parties the freedom to adopt "any law, the purpose of which is to promote the achievement of equality in its territory, or designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination in its territory" (article 3, paragraph 4(c)).
- ¹⁰ In this context, it should be noted that Argentina, Colombia, Malaysia, Mexico, Pakistan and Thailand were granted extensions to their transitional period for compliance with the TRIMs Agreement until 31 December 2003, the Philippines until 30 June 2003 and Romania until 31 May 2003 under the provisions of article 5.3 of the TRIMs Agreement. Performance requirements are analysed broadly in chapter 14. For a recent study of the effects of performance requirements, see UNCTAD, 2003c.
- ¹¹ See further Guisinger and Associates, 1985.
- ¹² See in this regard also the free trade agreements between Mexico and Costa Rica (1994, article 13-06), between Mexico and Nicaragua (1992, article 16-05) and between Mexico and Chile (1998, article 9-07); also the 1990 Free Trade Agreement between Colombia, Mexico and Venezuela (article 17-04) and the 1988 Free Trade Agreement between Canada and the United States (article 1603).
- ¹³ In a spirit similar to that of the NAFTA, the draft MAI did not preclude a party from conditioning the receipt or continued receipt of an advantage, in connection with "an investment in its territory of an investor of a Contracting Party or of a non-Contracting Party..." on compliance with a number of listed requirements, commitments or undertakings.
- ¹⁴ Note however, that the 1996 Free Trade Agreement between Canada and Chile has been supplemented by the 1997 Agreement on Environmental Cooperation and an Agreement on Labour Cooperation.
- ¹⁵ For other examples of IIAs dealing with this type of environmental regulatory restrictions, see the free trade agreements between Mexico and Costa Rica (1994, article 13-16), between Mexico and Nicaragua (1992, article 16-14) and between Mexico and Chile (1998, article 9-15); also the 1990 free trade agreement between Colombia, Mexico and Venezuela (article 17-13).
- ¹⁶ See the 2003 free trade agreement between Chile and the United States (articles 18.2 and 19.2) and 2003 free trade agreement between Singapore and the United States (articles 17.2 and 18.2). See also the 2003 model BIT of the Belgian-Luxemburg Economic Union (articles 5 and 6).
- ¹⁷ Article 18.2 of the 2003 free trade agreement between Singapore and the United States.
- ¹⁸ In this regard, reference should be made to the 2003 OECD's checklist on FDI incentives agreed upon by the Committee on International Investment and Multinational Enterprise to serve as a tool to assess the costs and benefits of using incentives to attract FDI (UNCTAD, 2003a, pp. 127128).
- ¹⁹ Pursuant to article 27.1, members recognize that subsidies may play an important role in the economic development programmes of developing member countries and thus the SCM Agreement contains a number of significant exceptions/modifications to the "normal" WTO regime on subsidies. The prohibitions concerning export/import-related subsidies (article 3) do not fully apply to developing countries:
- As far as subsidies for export performance are concerned (article 3.1 (a)), Annex VII of the SCM Agreement lists a number of developing countries for which the prohibition shall not apply. These are the least developed countries as designated by the United Nations. According to article 27.2(b), other developing countries are exempt from the prohibition for a period of eight years from the date of entry into force of the WTO Agreement (i.e. until 1 January 2003). For the following countries, the obligation to respect the prohibition after eight years applies only once the annual gross national product (GNP) per capita has reached \$1,000: Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe (see Annex VII of the SCM Agreement). According to article 27.4, further extensions may be granted where it is necessary to apply such subsidies (see the

"Procedures for Extensions under Article 27.4 for Certain Developing Country Member" adopted by the SCM Committee on 20 November 2001, WTO document G/SCM/39 and subsequent decisions by the SCM Committee).

- With regard to subsidies concerning import substitution (article 3.1 (b)), the prohibition did not apply to developing countries for a period of five years from the date of entry into force of the WTO Agreement (i.e. until 1 January 2000). For the least developed countries, the period was eight years (i.e. until 1 January 2003).

²⁰ Special provisions for developing countries also exist with regard to actionable subsidies. 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) result in serious prejudice. Rather, such prejudice needs to be demonstrated. With regard to other actionable subsidies (i.e. those where not even article 6 provides for an automatic presumption of serious prejudice), article 27.9 establishes less stringent dispute-settlement procedures. Furthermore, according to article 27.13, none of the WTO provisions on actionable subsidies shall apply to direct forgiveness of debts or subsidies to cover social costs when such subsidies are granted in the framework of a privatisation programme of a developing country. Both such a programme, and the subsidies involved, need to be granted for a limited period and notified to the Committee, and the programme needs to result in eventual privatisation of the enterprise. Finally, article 29 granted exemptions for transition economies. Members in the process of transformation from a centrally planned into a market, free-enterprise economy could apply programmes and measures necessary for such a transformation. For such members, subsidy programmes falling within the scope of prohibited subsidies and notified accordingly had to be phased out or brought into conformity with the SCM Agreement within a period of seven years from the date of entry into

force of the treaty (i.e. until 1 January 2002). In exceptional circumstances, the Committee may permit to those members departures from their notified programmes, measures and their time frame if such departures are deemed necessary for the process of transformation.

²¹ This section draws on UNCTAD, 2003a, pp. 124-126.

²² Central and Eastern European countries tend to use a mix of fiscal and financial incentives (Mah and Tamulaitis, 2000).

²³ 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).

²⁴ 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.

²⁵ 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, 2003d).

²⁶ 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 (Oliver, 2003).

Chapter 16. Environment*

Executive summary

The issue of the environment touches all areas of human endeavour. Its preservation and sustainable utilization is an important component of development. Nonetheless, this issue has only recently caught the attention of national and international rule-makers. Therefore, it is increasingly beginning to find its way into a wide variety of international agreements. When it comes to international investment agreements (IIAs), however, mention of environmental protection and related matters has, to date, been largely absent. This may not be surprising, because IIAs might not be considered as the primary instruments with which to address environmental matters. Yet, linkages between environmental concerns and international investment rules do exist, including where there is intent to ensure that investment rules do not frustrate host countries' efforts to protect the environment. Moreover, IIAs can provide for a framework to encourage the transfer of clean technology and environmentally sound management practices to host countries, which could contribute to development objectives.

Since the present volumes focus on IIAs, this chapter concentrates on the few such instruments containing environmental references. Nonetheless, where appropriate, other relevant international instruments are also discussed. The following are key issues that have been addressed in them: the general protection of the environment through general references to the desirability of safeguarding the environment; preserving national regulatory space for environmental protection and/or avoiding to attract foreign direct investment (FDI) through a lowering of environmental standards; and the transfer of environmentally sound technology and management practices.

IIAs mention the environment mostly by making reference to the need to protect the environment, sometimes linked to the principle of sustainable development. They address the issue in general terms, primarily in the preamble or general provisions. These references are typically

expressed in hortatory language, often in the form of mere "string references", where the environment is simply mentioned in a clause along with other concerns. Beyond such general references to the environment, and in the context of environmental regulation, provisions in IIAs sometimes take the form of assertions (or assurances) that the agreements' provisions will not be injurious to the environment or will not prevent the parties from regulating environmental matters. Alternatively, such provisions may actually affirm the right of a host state to regulate environmental matters. A close corollary to the last approach is that of urging compliance with already existing environmental legislation or international agreements and undertaking to not lower environmental standards in order to attract FDI. With respect to the latter, concerns go beyond the actual lowering of environmental standards, and include lax implementation of such standards, or halting improvements thereto. Yet, certain developments in IIAs could run counter to such assertions, affirmations and undertakings, for example, where IIAs provide for mechanisms through which private investors could directly challenge all governmental measures that affect their investments. Such challenges, or even the threat of a challenge, might discourage host countries from adopting or enforcing measures to protect the environment.

Going beyond these more general approaches, IIAs are sometimes designed in a manner that encourages transnational corporations (TNCs) to utilize more fully the potential they have to contribute especially to the transfer of clean technologies and environmentally sound management practices, particularly to developing countries. The wider diffusion and use of environmentally sound technologies, in part achieved through environmentally sensitive management, could help to reduce the damaging effects of certain activities. In this connection, the discussion in this chapter also draws on the Rio Declaration and its Agenda 21, which is particularly significant in that it has informed — and been specifically referred to in — a number of

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important instruments since its adoption. However, where relevant provisions are included in IIAs, they are typically formulated in non-binding language. In addition, a few IIAs prohibit host countries from imposing requirements on firms to transfer technology. Such prohibitions, without safeguards or qualifications, could be construed to include transfer of environmentally sound technologies.

Environmental protection interacts with several other topics covered in these volumes. In particular, there are interactions with admission and establishment, especially in terms of screening investments for their environmental impacts; with incentives geared to attract FDI; and the promotion of transfer of technology, of which environmentally sound technologies and possibly management practices are a sub-group. Another interaction arises in relation to takings of property, if protection granted in an IIA against expropriation is construed to encompass environmental regulation that could result in a loss of the value of a covered investment. In some instances, a further interaction might be with issues concerning social responsibility, a concept that includes core values with respect to the protection of the environment.

A number of options exist with respect to the way in which environmental matters could be dealt with in IIAs. Parties could choose not to address environmental protection issues. Secondly, an IIA may include general, hortatory provisions that stress the importance of environmental preservation. Thirdly, specific clauses that affirm or preserve the regulatory powers of host countries with respect to environmental protection could be included in IIAs. Equally, an IIA might contain carve-put clauses for environmental measures. Fourthly, parties could address environmental protection through provisions that oblige them not to lower standards in order to attract FDI. Finally, IIAs could include mandatory legal duties, addressed to actors in FDI, to observe certain environmental standards, including those related to environmentally sound technology and management practices, which could be provided for, or incorporated by reference, in the respective IIAs.

Introduction

The area of environmental concerns gained in importance in relations between host countries and

TNCs over the decade of the 1990s. At that time, there was a growing awareness, on the part of countries, of the importance of environmental protection and the need for the restoration, in some countries, of degraded environments. Simultaneously, there was a heightened consciousness of the possible linkage between some of these concerns and the activities of TNCs, without however implying an inherent incongruence between measures taken by a host country to protect the environment and to attract FDI.

Environmental issues cover a broad scope of activities and are dealt with in a wide spectrum of instruments beyond those specific to FDI. The concept of environmental protection is wide, and includes among other issues, the quality of air, water and soil; the sustainable use of natural resources; human, animal and plant health; as well as macro- and micro-ecosystems. Environmental regulations cover all firms, domestic and foreign-based. It is recognized that what is good as regards TNCs is also good as regards domestic firms. However, in light of the specific objectives of these volumes, the present chapter concerns itself only with the interface between the environment and FDI. Since few IIAs actually contain provisions that refer directly to the environment or environmental protection, this chapter also cites environmental agreements with *direct* reference to FDI or TNCs, as the relevant provisions are useful to IIA negotiators grappling with the same concerns. This is all the more important as future IIA negotiators may well need to address environmental concerns.

Section I Explanation of the Issue

The internationalization of production of goods and services through FDI increases the likelihood of the extension of any related environmental damage to a greater number of countries and, therefore, to a larger part of the world's environment. At the same time, this process offers an opportunity for the improvement of the environment in many countries through the diffusion and use of environmentally sound technologies and management practices that are at the disposal of TNCs. Thus, the role that FDI and TNCs can play in abating environmental degradation and promoting sustainable development is of considerable importance.

Efforts with regard to environmental preservation are taken primarily at the national level through regulation that apply mandatory, statute based, rules of conduct (UNCTAD, 1999b, p. 291 and UN/DESD/TCMD, 1992b, pp. 235-237). Increasingly, however, private enterprises and non-governmental organizations (NGOs) are also making efforts to contribute to the preservation of the environment.¹ At the international level, and with particular reference to IIAs, the question arises of how such instruments have addressed the responsibility of the relevant actors concerning environmental protection. Several key issues can be identified, which have informed discussions and provisions that address the interface between the environment and FDI:

- **General protection of the environment.** An important component of development is environmental welfare and sustainability. It is now generally accepted that, to be effective, environmental protection — from reversing environmental degradation to increasing environmental welfare through the development and use of environmentally sound technologies and management practices — is a matter that has to be pursued by both public and private actors at all levels. At the international level, cooperation on the preservation of the environment has included efforts to develop working models of sustainable development that integrate economic, social and environmental concerns (UN/DESD/TCMD, 1992b). The pace and breadth of such efforts increased significantly during the 1990s, highlighting the importance of environmental preservation in general.
- **Preserving national regulatory space for environmental protection.** From a regulatory perspective, the need to accommodate national environmental concerns could sometimes be construed to conflict with obligations contained in IIAs. Without the preservation of some flexibility to regulate for the protection of the environment, therefore, a number of measures could be construed as triggering a State's breach of its obligations under IIAs.² One way in which the general protection of the environment can be addressed in IIAs is, therefore, to ensure that Governments seeking to protect the environment cannot be challenged as acting contrary to their obligations under IIAs, i.e. have sufficient national regulatory space for environmental protection.

Discussions on international investment rule-making also include concerns relating to environmental measures that might be seen as constituting arbitrary means of discriminating against foreign investors. Home countries may also be seen as attempting to impose their environmental standards beyond their own borders through legislation aimed at the operations of their nationals abroad. (The latter issue of extra-territorial measures is being discussed in more detail in chapter 22) Moreover, concerns do not necessarily relate solely to actual environmental damage, but could also encompass serious threats or irreversible damage to the environment under the "precautionary principle".³

- **Attracting FDI through a lowering of environmental standards.** All countries seek to attract FDI because of the tangible and intangible assets it can bring to a country to advance its development process. In their eagerness to attract such investment, host countries may sometimes be tempted to lower their environmental standards to increase their locational advantages to TNCs — or TNCs may sometimes suggest that such a lowering would positively influence their locational decision making. The issue goes beyond the actual lowering of environmental standards. The non-application or lax implementation of such standards might have the same effect. Equally, there may be concerns that countries would not improve their environmental regulations out of concern for the impact this might have on their locational advantages to TNCs. This "chilling-effect" is therefore another component of the concept of the relaxation of environmental standards in the interest of attracting FDI.
- **Transfer of environmentally sound technology and management practices.** Beyond these general questions, a key issue concerns the extent to which the transfer of environmentally sound technology and management practices to developing countries can be encouraged. Today, there is growing recognition that protecting the environment requires that the entire range of production processes and products be environment-friendly. One problem in this respect is the continued use, in many countries, of obsolete, environmentally damaging industrial production techniques and management practices. The response of TNCs to environmental issues differs in one important respect from that of uninational firms. In

addition to managing the environment through pollution-abatement practices, environmental management systems, education and training, TNCs must also manage these issues in relation to affiliates located in different countries. Hence, an added dimension for them is cross-border environmental management, which is a key issue in assessing their impact on the environment in host developing countries. Thus, the specific decisions that TNCs take with regard to the application and transfer of environmentally sound technologies and management practices can play an important role in the overall environmental health of a host country. One recent study showed that it is even cost-effective to do so (UNCTAD, 1999b).

One possible spin-off of such transfers is a “demonstration effect” on other enterprises, as expressed in the Commentary on the recent 2000 OECD Guidelines for Multinational Enterprises (OECD Guidelines). It states that TNCs “often have access to technologies or operating procedures which could, if applied, help raise environmental performance overall. Multinational enterprises are frequently regarded as leaders in their respective fields, so the potential for a ‘demonstration effect’ on other enterprises should not be overlooked” (OECD, 2000b, p. 9).⁴

* **

The key issues with the most direct relevance to the interaction between FDI and TNCs on the one hand and environmental protection on the other, have been sketched out above. Several other issues have also received attention, including assessing the environmental impact of production and environmental financial and non-financial reporting standards. Typically, however, these issues are not elaborated in IIAs and therefore, will only be briefly documented in this chapter. Finally, issues related to the implementation and enforcement of environmental obligations in IIAs are not addressed here. (For a general discussion of such issues, see UNCTAD, 2000b.)

Section II Stocktaking and Analysis

As previously mentioned, environmental concerns are largely addressed at the national level (box 1). However, countries are now increasingly pursuing ways to enhance environmental protection and the

contribution of TNCs thereto at the international level.

Indeed, efforts at the national level are being reflected in instruments at the international level. Interestingly, though, while many investment related regulatory developments progress internationally from bilateral to regional, and regional to multilateral levels, this is typically not the case with respect to environmental matters. In fact, bilateral investment treaties (BITs) are largely silent on the issue of the protection of the environment. Instead, the efforts at the national level in this respect have been internationalized primarily in regional and multilateral fora.

Box 1. Protection of the environment at the national level

Efforts to address environmental concerns at the national level often involve Governments, enterprises and civil society. With respect to governmental regulation, many countries have adopted measures related to the protection of the environment. Their scope and level of sophistication varies, which creates stark differences between national frameworks for the protection of the environment. Most Governments rely on regulatory frameworks that apply mandatory, statute based, rules of conduct, as well as the imposition of taxes and charges. Increasingly, however, some positive incentives and market-based policies are introduced, which include reliance on environmental impact assessment studies and providing for financial guarantees against environmental damage.

Complementing governmental regulation, some enterprises, including TNCs and industry groupings, have also contributed to efforts regarding environmental protection through the adoption and maintenance of relevant corporate/industry codes of conduct. Such codes are internal rules and, as such, are typically not enforced by national authorities. Through the adoption and observance of these environmentally friendly codes of conduct throughout their operations, TNCs — by improving their own environmental performance — can enhance the environmental performance of their host countries and, in particular, make up for implementation deficits that might exist in some countries in which they operate. In addition, TNCs are quite familiar with the need for environmental assessments in project planning, design and implementation, and often undertake such studies themselves.

Moreover, the involvement of civil society, including NGOs, coupled with increasing consumer demand for environment-friendly products and processes, are factors that are providing additional incentives for protection of the environment.

Source: UNCTAD.

The remainder of this section takes stock of how IIAs have addressed the issue of environmental protection. In doing so, attention is also being given to international agreements that, although not IIAs, address TNCs specifically. This is particularly the case in the 1992 Rio Declaration on Environment and Development and the related Agenda 21 (UNCED, 1993) adopted by the 1992 United Nations Conference on Environment and Development. This international commitment contains a number of provisions directly addressed to TNCs and explicitly meant to protect the environment in the context of FDI. Its clauses relate to global corporate environmental management, environmentally sound production and consumption patterns, risk and hazard minimization, full-cost environmental accounting, and international environmental support activities.⁵

A. General protection of the environment

1. General references to the environment

References meant to ensure the general protection of the environment take a number of forms in IIAs, including “string” references and other similar hortatory language in the preamble or general provisions that merely mention the issue. They address both Governments and enterprises.

a. Provisions relating to the responsibility of Governments

An example of a string-type reference addressed to Governments is that appearing in the Treaty Establishing the Latin American Integration Association.⁶ Article 14 of the Treaty exhorts member countries to “take into consideration, among other matters, scientific and technological cooperation, tourism promotion and preservation of the environment”.

During the negotiations of the Multilateral Agreement on Investment (MAI), certain preambular language had been proposed by the Chairperson of the negotiations as part of the “package” of environmental provisions, as follows:

“Recognising that investment, as an engine of economic growth, can play a key role in ensuring that economic growth is sustainable, when accompanied by appropriate environmental and labour policies; ...

Re-affirming their commitment to the Rio Declaration on Environment and Development,

and Agenda 21 and the Programme for its Further Implementation, including the principles of the polluter pays and the precautionary approach; and resolving to implement this Agreement in a manner consistent with sustainable development and with environmental protection and conservation; ...”⁷

Notes that accompany the MAI Draft Negotiating Text suggest there was still considerable disagreement among the negotiators as to whether these provisions had struck the right balance between the investment liberalization objectives and the various environmental instruments and principles cited.⁸

References to environmental preservation have also been included in general provisions of other instruments. In the Fourth ACP-EEC Convention (Lomé IV), under article 77, actual mention is made of investment in connection with environmental concerns:

“In order to facilitate the attainment of the industrial development objectives of the ACP States, it is important to ensure that an integrated and sustainable development strategy, which links activities in different sectors to each other, is evolved. Thus sectoral strategies for agricultural and rural development, manufacturing, mining, energy, infrastructure and services should be designed in such a way as to foster interlinkages within and between economic sectors with a view to maximizing local value added and creating, where possible, an effective capacity to export manufactured products, while ensuring the protection of the environment and natural resources.

In pursuit of these objectives the Contracting Parties shall have recourse to the provisions on trade promotion for ACP products and private investments, in addition to the specific provisions on industrial cooperation”.

Here, though a binding agreement, Lomé IV does not include mandatory environmental provisions. Even the “shall” language is not linked to a clearly identifiable obligation but only indicates “recourse” to other provisions.

Lomé IV was replaced in 2000 by the Cotonou Agreement, which introduces a number of clauses that link economic development and the environment. The link, more specifically, between FDI and the environment in the Cotonou Agreement may not be apparent at first glance. It is provided for, however, at the outset, in article 1 of

the Agreement entitled “Objectives of the partnership”. Article 1 states that efforts to integrate “the ACP countries into the world economy in terms of... private investment”, which, in the context of this Agreement, includes FDI, shall apply and integrate, at every level, the “principles of sustainable management of natural resources and the environment” (Cotonou Agreement, 2000). While the number of references with regard to environmental protection have increased significantly in this instrument,⁹ they nevertheless comprise statements of objectives, political commitments on cooperation and general references to the environment.

An example of a provision with stronger language in article 51 (1)(b) of the Treaty for the Establishment of the Economic Community of Central African States, where its member States have agreed “to arrange for an appropriate application of science and technology in the development of agriculture ... and preservation of the environment; ...”. It should be noted that, while the provision is in mandatory language, its effectiveness might be diminished to the extent that the obligation extends only to the *arrangement for appropriate* application of science and technology.

IAs occasionally go beyond general references and address environmental protection in more detail.

An example including particulars on the environment can be found in the Cotonou Agreement. Article 32 entitled “Environment and natural resources”, provides for cooperation in relation to the protection of specified areas of the environment.¹⁰ According to the principles that underlie the Agreement, these must be taken into account in all joint efforts by the Parties, including efforts to channel FDI to ACP countries. It is interesting to note that the Agreement also takes into account the special needs of some of the Cotonou partners.

In stronger language, the Convention on Environmental Impact Assessment in a Transboundary Context, signed by over 25 European countries, Canada and the United States, provides, in article 2(1), that:

“1. The Parties shall, either individually or jointly, take all appropriate and effective measures to prevent, reduce and control significant adverse transboundary environmental impact from proposed activities” (ICEL, 1995, p. 12).

While this Convention is not an IIA, its significance in terms of FDI – in the context of

transboundary environmental harm – should not be overlooked. This is because according to its article 1(v), ... “Proposed activity” means any activity or any major change to an activity subject to a decision of a competent authority in accordance with an applicable national procedure” (*ibid.*), a definition which is broad enough to include activity arising from FDI.

b. Provisions relating to the responsibility of TNCs

Some international instruments also address directly, through general references, the responsibility of enterprises concerning the environment. An example of a string reference is furnished by the original 1976 and revised 1991 OECD Guidelines, which were the precursors to the 2000 OECD Guidelines. Enterprises were exhorted, under “General Policies” (paragraph 2), to “give due consideration to [member] countries’ aims and priorities with regard to economic and social progress, including industrial and regional development, the protection of the environment and consumer interests, the creation of employment opportunities, the promotion of innovation and the transfer of technology”.¹¹

In the 2000 OECD Guidelines, the string reference was replaced by a dedicated (albeit one-line) paragraph 1, which, again under “General Policies”, states:

“... enterprises should:

1. [c]ontribute to economic, social and environmental progress with a view to achieving sustainable development; ...” (OECD, 2000a, p. 3).

Paragraph 2 of the Commentary on the 2000 OECD Guidelines, under the heading “Commentary on General Policies”, unambiguously states that “[o]beying domestic law is the first obligation of business” (OECD, 2000b, p. 3). Thus, the recommendations seek to promote corporate action and results that go beyond those envisioned under domestic law. This demonstrates how the Guidelines have evolved on the subject of environmental protection. The Guidelines are addressed to TNCs, not to Governments. They are non-binding commitments. Nevertheless, it should be noted that the 2000 OECD Guidelines’ implementation procedures — an important component of the instrument — were strengthened as compared to its predecessors.

Section V of another OECD instrument, the Principles of Corporate Governance,¹² states

that one of the responsibilities of a company's board is "to implement systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws".

Beyond general references, provisions in IIAs sometimes address, with some specificity, the responsibility of TNCs with respect to the environment. The United Nations draft Code of Conduct on Transnational Corporations does so in some detail (box 2).

Box 2. The United Nations draft Code of Conduct on the issue of environment

In its section on the "Activities of Transnational Corporations", subsection "Economic, financial and social", paragraphs 41-43 deal with "Environmental protection":

"Transnational corporations shall/should carry out their activities in accordance with national laws, regulations, administrative practices and policies relating to the preservation of the environment of the countries in which they operate and with due regard to relevant international standards. Transnational corporations shall/should, in performing their activities, take steps to protect the environment and where damaged to [restore it to the extent appropriate and feasible] [rehabilitate it] and should make efforts to develop and apply adequate technologies for this purpose.

Transnational corporations shall/should, in respect of the products, processes and services they have introduced or propose to introduce in any country, supply to the competent authorities of that country on request or on a regular basis, as specified by these authorities, all relevant information concerning:

Characteristics of these products, processes and other activities including experimental uses and related aspects which may harm the environment and the measures and costs necessary to avoid or at least to mitigate their harmful effects;

Prohibitions, restrictions, warnings and other public regulatory measures imposed in other countries on grounds of protection of the environment on these products, processes and services.

Transnational corporations shall/should be responsive to requests from Governments of the countries in which they operate and be prepared where appropriate to cooperate with international organizations in their efforts to develop and promote national and international standards for the protection of the environment".

Source: UNCTAD, 1996, vol. I, pp. 169-170.

NGOs have been particularly active in addressing environmental matters. An example is the "Principles" of the Coalition for Environmentally Responsible Economies (CERES), a document that was drafted by an investor grouping. The endorsers of the CERES Principles affirm in the introduction, their "belief that corporations have a responsibility for the environment, and must conduct all aspects of their business as responsible stewards of the environment by operating in a manner that protects the Earth". This includes a pledge to "update ... practices constantly in light of advances in technology and new understandings in health and environmental science" (*ibid.*). The document highlights the commitment to reduce or eliminate damage to certain areas of the environment, such as the biosphere and natural resources. In addition, certain practices related to waste disposal, energy conservation, human health hazards, production processes and products and their relevant management practices, environmental restoration, and information management are addressed. While the CERES Principles address TNCs indirectly, the draft NGO Charter on Transnational Corporations prepared by The People's Action Network to Monitor Japanese TNCs, does so directly, in a section entitled "Protection of nature, the environment and natural resources" (box 3).

Box 3. The draft NGO Charter on Transnational Corporations

"13. The TNC shall take full account of its effect and impact on the environment and natural resources and fully conform to national/ local laws and regulations regarding protection of the environment and the ecosystem, and the conservation of natural resources in the country/region where it operates while conforming to the relevant international standards. When doing so, the TNC shall observe the following:

- (1) Implement an environmental assessment and follow up with a review.
- (2) Establish an environmental/conservation policy and guideline and develop a pro-environmental management system.
- (3) Freely disclose information on the company's environmental policy.

14. When any environmental destruction or other negative impact due primarily to the operations of the TNC, it shall take the appropriate measures including compensation for the damage caused by the environmental damage and restore the environment to its original state".

Source: UNCTAD, 2000a, vol. V, p. 403.

Thus, these instruments reflect that the responsibility of TNCs with respect to environmental protection goes beyond compliance with relevant national or international standards. Responsibilities extend to, among others, the development and maintenance of best practices on environmental restoration, conservation, risk and impact assessment and information dissemination, as well as cooperation with national authorities.

* * *

The preceding discussion shows that a limited number of IIAs address environmental protection issues through general references addressed either at Governments or TNCs. The language is mostly hortatory but, in some cases, mandatory language has been used. The remainder of this sub-section turns to more specific issues that arise in the context of IIAs concerning governmental measures that affect the environment.

2. Preserving national regulatory space for environmental protection

The protection of the environment requires a systemic undertaking by all actors concerned. With respect to Governments, such an undertaking typically comes through environmental regulation. The ability to take environmental measures is an issue addressed in some IIAs.

Sometimes the language of an agreement simply provides that its provisions should *not prevent* the parties from regulating their own environment. For example, the 1992 North American Free Trade Agreement (NAFTA, article 1114, paragraph 1) stipulates that:

“Nothing in [Chapter Eleven on investment] shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns”.

Similar language is contained in the 1994 World Trade Organization (WTO) General Agreement on Trade in Services (GATS, article XIV: General Exceptions) and in article G-14(1) of the 1996 Canada-Chile Free Trade Agreement, which actually uses the NAFTA language *verbatim*.

Other agreements go further to *affirm* the right of a host state to regulate environmental

matters. In other words, the same substantive right can be expressed in a more positive manner, as was recommended for inclusion in the MAI Draft Negotiating Text by the Chairperson of the negotiations:

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

Both of the above treaty texts fall short of using mandatory language to oblige a party to take the measure described. However, they also appear to limit the scope of the “guarantees” or of the “affirmative right” to regulate, by requiring that measures be otherwise “consistent” with an IIA’s substantive obligations.

An example of the right to regulate on environmental protection, free of this conditionality, is found in article 18 of the 1994 Energy Charter Treaty (ECT) on sovereignty over energy resources:

“Each state continues to hold in particular the rights to decide the geographical areas within its Area to be made available for exploration and development of its energy resources, the optimization of their recovery and the rate at which they may be depleted or otherwise exploited, ... and to regulate the environmental and safety aspects of such exploration, development and reclamation within its Area ...”.

The legal nature and the limited scope of the first two examples notwithstanding, all three examples underline the negotiators’ intent not to unduly restrict, or even discourage, the discretion of Governments to regulate investment activities for environmental purposes.

The Tratado de Libre Comercio entre Centroamérica y República Dominicana, though not an IIA, illustrates that obligations to adopt measures to assure the observance of domestic environmental legislation, with specific reference to investors, can exist as part of a binding agreement. This Treaty, while specifically excluding environment from the scope of the application of its investment chapter (Chapter IX, article 9.15), provides that:

“Each Party shall adopt, maintain or take whatever measures, consistent with this chapter, that it considers appropriate to assure

that the investments in its territory observe the legislation in matters of the environment ...” [author’s translation].

However, the conditionality — “consistent with this chapter” — still limits a broader application. Moreover, the obligation extends to measures that each party *considers appropriate*, which implies that each party retains wide discretion in addressing the observance of its existing environmental regulation by investors. Thus, the practical effect of the provision to ensure the protection of the environment depends upon the commitment of the parties to the environment, within the confines of the legal structure of the chapter.

Another approach is evident in the BIT between Costa Rica and the Netherlands, where an investment is covered under the agreement if it has been made “in accordance with the laws and regulations” of the host country, which includes “its laws and regulations on ... environment” (article 10). Here, compliance with, *inter alia*, environmental laws, is an explicit prerequisite for the application of the BIT to an investment. (Presumably however, such an explicit reference is not needed when a treaty refers to “in accordance with laws and regulations” of the host country, as these include also those on the environment.) Upon entering as an investor, all environmental laws have to be observed and, it goes without saying, that the new legislation will likewise have to be adhered to in cases in which a duly qualified investment under article 10 is confronted with a subsequently enacted, more stringent environmental regulation.

The *inclusion* of the right to regulate for environmental protection in an IIA often actually takes the form of certain *exclusions* or general exceptions, whereby environmental matters are carved out of an agreement and are thereby not subject to its provisions. This can provide a legal basis for justifying investment-related environmental measures that might otherwise be precluded by the agreement. Articles XX of the General Agreement on Tariffs and Trade (GATT) and XIV of GATS provide good examples of direct and indirect implications for TNCs, not only in the area of trade in goods and services, and investment in services (e.g. article XVI.2 (f) of the GATS), but also in investment activity generally. Both the GATT and the GATS, while safeguarding their well-entrenched principle of non-discrimination, allow an exception for measures “necessary to protect human, animal or plant life or health”

(WTO, 1995a, p. 455). However, they are not to be “applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same [GATS: “like” (ibid., pp. 296-297)] conditions prevail, or a disguised restriction on international trade [GATS: “trade in services”]” (ibid.).

At the same time, NAFTA’s article 2101 provides that:

“GATT Article XX and its interpretative notes, or any equivalent provision of a successor agreement to which all Parties are a party, are incorporated into and made part of this Agreement. The Parties understand that the measures referred to in GATT Article XX(b) include environmental measures necessary to protect human, animal or plant life or health, and that GATT Article XX(g) applies to measures relating to the conservation of living and non-living exhaustible natural resources” (ILM, 1993a, p. 699).¹³

This whole area of general exceptions is important in that it has been a principal mechanism for dealing with environmental matters where they appear in IIAs and other agreements with environmental components or ramifications. Thus, measures under environmental exceptions, whether they are based on multilateral environmental agreements (box 4) or more general environmental objectives, provide a kind of safety valve for environmental protection in the context of investment and trade liberalization agreements.

Box 4. Multilateral environmental agreements

Multilateral environmental agreements (MEAs) need to be specifically mentioned, since the potential for conflict between MEAs and international investment rules may have been heightened by the use, in some MEAs, of mechanisms that seek to require or promote the transfer of environmentally friendly technologies, to regulate access to and investment in natural resources, and to stimulate investment in particular countries or categories of projects. Each of these initiatives may require individual states or international organizations to promote certain kinds of investments or investors for environmental purposes, in a way that may directly or indirectly discriminate on the basis of country of origin (Werksman and Santoro, 1998).

Faced with concerns about potential conflicts with trade rules, the NAFTA parties have agreed that, should any conflict arise between their investment or trade obligations under that agreement and “specific trade obligations” set out in selected MEAs, the obligations in these MEAs “shall prevail” to the extent of the inconsistency, provided that, where a party has a

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Box 4 (concluded)

choice among equally effective and reasonably available means of complying with such obligations, the party chooses the alternative that is the least inconsistent with the other provisions of this Agreement (article 104, paragraph 1). This specific exception would not apply, however, unless it is shown that the party defending the measure, if faced with an “equally effective and reasonably available means of complying” with its obligation under the MEA, has chosen “the alternative that is the least inconsistent” with the NAFTA (*ibid.*). This explicit subordination of an IIA to an MEA was unprecedented when the NAFTA text was agreed. It reflected the recognition, by the parties, of the importance of these particular MEAs, the wide support these agreements have received from the international community, and the very specific nature of the trade measures that they authorize. The NAFTA exception is, however, drawn very narrowly. It applies only with respect to specified treaties and would not extend to any investment (or trade-related) measures that a party might choose to use to meet its international environmental commitments. Furthermore, it appears to place the burden of proving that the measure was the “least trade inconsistent” measure possible, on the responding party (Johnson and Beaulieu, 1996).

Source: UNCTAD.

These exceptions allow a country the opportunity to defend a challenged environmental measure that might otherwise have been found to violate an IIA. It should be noted, however, that, in the context of a formal dispute, when exceptions have been invoked, they have been interpreted narrowly by dispute settlement bodies. For example, the use of exceptions in the context of GATT disputes panel proceedings have led to the conclusion that, generally, such clauses have been strictly construed (Hudec, 1993).

This conclusion also holds with specific reference to the application of general exceptions clauses to environmental measures in the context of not only the GATT, but also the 1988 Canada-United States Free Trade Agreement (the precursor to NAFTA)(box 5). Thus, the concern arises as to whether or not general exceptions provide for an adequate protection against possible challenges to measures taken to protect the environment.

Another form of including exceptions to particular substantive provisions is through a specific clause contained in such provisions, as is exemplified by the MAI Draft Negotiating Text, in its section relating to performance requirements, which states:

Box 5. General exceptions and environmental measures in international trade disputes

There are no provisions in GATT directly prohibiting member countries to enact environmental protection measures. A number of GATT articles are, however, relevant to such measures. These include article I on most-favoured-nation treatment, article III on national treatment on internal taxation and regulation and article XI on the general elimination of quantitative restrictions, as well as certain sections of article XX on general exceptions. Specifically, article XX, in its relevant parts, states that:

“Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:

... (b) necessary to protect human, animal or plant life or health;

... (g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption (WTO, 1995a, p. 455)”.

Thus, with particular reference to environmental measures, paragraphs (b) and (g) of article XX allow WTO members to adopt GATT-inconsistent policy measures provided that the measures do not result in arbitrary or unjustifiable discrimination between countries where the same conditions prevail and, do not constitute disguised restriction on international trade (general requirements of article XX).

In general, the interpretation of GATT panels in disputes where parties have sought to rely on paragraphs (b) and (g) of article XX to justify their measures have focussed on the terms “necessary” in paragraph (b) and “relating to” in paragraph (g). For example, the GATT Panel on *Section 337* of the United States *Tariff Act* defined the term “necessary” in paragraph (b) in a two-level analysis. First, it decided that “necessary” implies that no GATT-consistent measure could reasonably be undertaken. Second, it held that the measure undertaken had to be shown as having the “least degree of inconsistency with other GATT provisions”.^b In the *United States-Mexico Tuna-Dolphin case*,^c the panel held that the necessity of the protective measure related to the product and not the production method, and further, that an unilateral, extra-territorial measure did not benefit from the article XX (b) exception.

With respect to article XX (g) of the GATT, the panel in the *Herring and Salmon*^d dispute held that a measure “relating to” conservation would be justifiable under article XX(g) only if it is primarily aimed at conservation. A follow-up case was submitted to a dispute settlement panel under the Canada-United States Free Trade Agreement, which incorporated into

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Box 5 (continued)

the Agreement the relevant GATT articles. Here, the CUSFTA Panel^e concluded that the measure in question should not be broader in scope or application than necessary for achieving the specific conservation aims to which it relates.

Thus, under the jurisprudence of GATT and CUSFTA panels, no contested measure was found to be either “necessary” or “relating to” environmental protection. The general requirements of article XX were analyzed implicitly through the legal definitions of the terms “necessary” and “relating to”, but were not specifically addressed.

However, the WTO Appellate Body (AB), in its first decision on the exception under article XX (g) in the *Standards for Reformulated Gasoline* case,^f provided an alternative interpretation of article XX. The AB noted that the proper construction of that article required that a balance be struck, on a case-by-case basis, between, on the one hand, the rights and obligations of the parties to market access and, on the other hand, their rights and obligations to protect the environment. The AB devised a two-tiered analysis for article XX of the GATT, under which it first decides whether provisional justification by reason of characterization of the measure under XX (g) exists, and second, if the same measure, on its face or in its application, fulfils the general requirements of article XX.

Here, the AB stated that a measure would qualify under paragraph (g) if it had a “substantial relationship” to the conservation of natural resources. It further clarified that this would not include measures that are “incidentally or inadvertently aimed at” conservation of natural resources.

The AB followed the analysis introduced in the *Gasoline* case in the *Import of Shrimp Products*^g case. The *Shrimp Products* case clarified that in making the determination on whether a measure is justified under paragraph (g) of article XX, “the treaty interpreter essentially looks into the relationship between the measure at stake and the legitimate policy of conserving exhaustible natural resources” (*ibid.*, paragraph 135). Thus, the general design and the structure of the measure should not be “disproportionately wide in its scope and reach in relation to the policy objective of ... conservation” (*ibid.*, paragraph 141); that is, the means should be, “in principle, reasonably related to the ends” (*ibid.*). The AB further reiterated that it is not enough for a measure to be “fair and just on its face”, but also that it must not be “actually applied in an arbitrary or unjustifiable manner”. The AB also held that unilaterally imposing conditions on trading partners to “adopt essentially the same policies” or, treating trading partners differently in terms of time limitations to comply with regulations or the transfer of the technology necessary for such compliance, constitutes unjustified discrimination. Moreover, in making reference to article X:3 of the GATT 1994, which “establishes certain minimum standards for transparency and procedural fairness in the administration

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Box 5 (continued)

of trade regulations”, the AB held that where authorities administer regulations and procedures without regard to the requirements of article X:3, such treatment could constitute “arbitrary discrimination” between countries where the same conditions prevail, and thus be contrary to the general requirements of article XX.

As the preceding cases indicate, the WTO AB is adopting a less narrow interpretation of article XX (g) than previous GATT panels. In so doing, the AB has emphasized the need to maintain a balance between the right to invoke the Exceptions provisions, on the one hand, and the rules on market access, on the other hand. In interpreting the general requirements of article XX, the AB was locating this “line of equilibrium”. These rulings explicitly recognize that it was not the task of the panel or the AB to question a country’s environmental standards or to challenge a country’s right to promote environmental goals; the examination was restricted to whether these objectives were carried out in a discriminatory manner.

In conclusion, while this development in the WTO jurisprudence lessens the burden for countries to justify, at least provisionally, their environmental measures that are inconsistent with the GATT, they still have an obligation of assuring that they fulfil the general requirements of article XX. An important point with respect to the inclusion of general exceptions — such as those found in the GATT — in IIAs to ensure that a State could regulate for environmental protection, is that such provisions are susceptible to different methods of interpretation. In the context of trade agreements and in particular the GATT, it has been shown that there is an exacting standard with respect to Exceptions clauses, one which countries with ample institutional and administrative capacities could fail to match. It remains to be seen whether or not for countries with less administrative resources and capacities, these requirements will prove to be insurmountable obstacles.

Source: UNCTAD

- a In addition, some of the Uruguay Round agreements could interact with environmental measures, including the Agreement on Technical Barriers to Trade and the Agreement on Agriculture.
- b *Section 337 of the Tariff Act of 1930* (United States), BISD 36S/345; see also, *Restrictions on Importation of and Internal Taxes on Cigarettes* (Thailand), BISD 37S/200.
- c *Restriction on Imports of Tuna* (United States), GATT Panel Report No. DS21/R.
- d *Measures Affecting Exports of Unprocessed Herring and Salmon* (Canada), BISD, 35S/114.
- e *In the Matter of Canada’s Landing Requirement for Pacific Coast Salmon and Herring* (Canada), Final Report of the Panel under Chapter 18 (Oct. 16, 1989).
- f *Standards for Reformulated and Conventional Gasoline* (United States), WT/ DS2/9.
- g *Import Prohibition of Certain Shrimp and Shrimp Products* (United States), WT/DS58/AB/R.

“1. A Contracting Party shall not, in connection with the establishment, acquisition, expansion, management, operation, maintenance, use, enjoyment, sale or other disposition of an investment in its territory of an investor of a Contracting Party or of a non-Contracting Party, impose, enforce or maintain any of the following requirements, or enforce any commitment or undertaking:

...

(b) to achieve a given level or percentage of domestic content;

(c) to purchase, use or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;

...

4. [Provided that such measures are not applied in an arbitrary or unjustifiable manner, or do not constitute a disguised restriction on investment, nothing in paragraphs 1(b) and 1(c) shall be construed to prevent any Contracting Party from adopting or maintaining measures, including environmental measures:

...

(b) necessary to protect human, animal or plant life or health;

(c) necessary for the conservation of living or nonliving exhaustible natural resources]”.

Similar language is found in the NAFTA (article 1106, paragraph 6) and other NAFTA-informed instruments such as the 1996 Canada-Chile Free Trade Agreement (article G-06: Performance Requirements, paragraph 6).

Preserving a State’s power to prescribe regulation for environmental protection could be supplemented — as expressed in the Commentary on the 2000 OECD Guidelines — by encouraging enterprises to “work to raise the level of environmental performance in all parts of their operations, even where this may not be formally required by existing practice in the countries in which these enterprises operate” (OECD, 2000b, p. 9). It has been recognized in the Commentary that TNCs are typically subject to differing legal expectations concerning various aspects of their environmental performance, depending on where they operate.

The issue of the right to regulate for environmental protection is of particular importance as regards the treatment and protection

clauses in IIAs. There are concerns that such provisions in IIAs, coupled with investor-State dispute settlement procedures provided for therein, could be used by private investors to challenge measures by host Governments intended to preserve the environment. The concern is not merely academic, as is illustrated by a number of cases that have arisen in the context of NAFTA (box 6).

Box 6. Challenging environmental measures under NAFTA

NAFTA, in its investment chapter (Chapter 11), provides for treatment standards for covered investment (articles 1102-1105), disciplines on performance requirements (1106), expropriation and compensation (article 1110), and investor-State dispute settlement (articles 1115-1138). Notwithstanding article 1114(1) of NAFTA (quoted above), which stipulates that its member States retain the right to regulate for environmental concerns, investors are free to challenge such measures in international arbitration. This is because article 1114(1) contains the proviso that environmental measures should be otherwise consistent with Chapter 11, and the issue of whether or not a given environmental measure is consistent with the NAFTA chapter on investment is always actionable. The following cases illustrate the point:

Ethyl vs. Canada (1997). Canada’s Manganese-based Fuels Additives Act came into force on 24 June 1997. Under the Act, the gasoline additive MMT was placed on a schedule, which resulted in banning inter provincial trade and importation into Canada of MMT. Three legal challenges to the legislation were launched against the Government of Canada: an investor-State challenge under NAFTA Chapter 11 by Ethyl Corporation (United States); a constitutional challenge in the Ontario Court by Ethyl’s Canadian subsidiary (Ethyl Canada); and a dispute settlement panel was established under the Agreement on Internal Trade at the request of Alberta (joined by three other provinces).

On 20 July 1998, the Government announced its decision to lift the trade restrictions on MMT by removing MMT from the schedule annexed to the Act. This decision responded to the Agreement on Internal Trade Panel recommendations announced 19 July 1998, concerning the inconsistency of the Act with obligations under the Agreement on Internal Trade. The Government also dealt with the NAFTA investor-State challenge launched by Ethyl Corporation and the constitutional challenge in the Ontario Court. Under the terms of settlement, the Government paid \$13 million to Ethyl, representing reasonable and independently verified costs and lost profits in Canada. Ethyl dropped

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Box 6 (continued)

both claims. At the time of settlement, the NAFTA case had not moved beyond a preliminary jurisdictional challenge initiated by the Government, and the merits of the claim had not yet been heard.

Metalclad vs. Mexico (1997). Metalclad Corporation (United States) had operations related to facilities for the treatment, storage and disposal of industrial waste in several Mexican states. It filed a claim for arbitration against the Government of Mexico with the International Centre for Settlement of Investment Disputes (ICSID) under Chapter 11 of NAFTA. The landfill operation in question was reportedly on top of an illegal hazardous waste dump site, the remediation of which was a partial consideration for the Mexican Federal authorities in granting some of the necessary permits. However, local construction and operating permits were not granted by the municipality in the face of opposition from residents of Guadalcázar and environmental NGOs. Metalclad claimed that its investment was expropriated when the Governor of San Luis Potosi declared a large area, which included the location of Metalclad's investment, an ecological zone. This was after an environmental impact assessment revealed the existence of an underground alluvial stream in the zone.

On 30 August 2000, a NAFTA arbitration tribunal rendered its award in Metalclad Corporation vs. United Mexican States. The tribunal found that Mexico was financially responsible for the inability of Metalclad to successfully operate the facility. It found that Mexico had breached NAFTA articles 1105 and 1110, and awarded Metalclad \$16,685,000 in damages. Mexico does not agree with the conclusions of the panel, and is considering its options with respect to the award.

S. D. Myers vs. Canada (1998). S. D. Myers, Inc. (United States) filed a lawsuit under NAFTA's chapter 11 dispute settlement procedures against Canada for lost profits during a 15-month (November 1995 — February 1997) ban of polychlorinated biphenyls (PCBs) exports. The ban by Canada was imposed amid concerns that PCBs, a hazardous coolant used in electricity transformers, were not being safely handled. The United States company claimed that the temporary Canadian ban on the export of PCB wastes harmed its alleged investment in Canada. Claimed damages were \$20 million. On 13 November 2000, a NAFTA Tribunal decision concluded that Canada's temporary ban breached two provisions of the NAFTA investment chapter. Specifically, Canada was found to have breached its obligations under NAFTA Chapter 11 with respect to National Treatment (1102) and Minimum Standard of Treatment (1105). This decision also held that Canada did not breach Chapter 11 with respect to Performance Requirements (1106) and Expropriation (1110).

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Box 6 (concluded)

It should be noted that the Tribunal's decision was with respect to an interim order, which is no longer in effect in Canada. Furthermore, the tribunal explicitly acknowledged the right of NAFTA members "to establish high levels of environmental protection. They are not obliged to compromise their standards merely to satisfy the political or economic interests of other states". Thus, the decision confirms that NAFTA members retain the ability to regulate the safe movement and disposal of hazardous wastes, including PCB wastes. Finally, the amount of damages that S.D. Myers has suffered, if any, will be determined at the next stage of the arbitration.

Methanex vs. United States (1999). Methanex Corporation (Canada) filed a NAFTA claim against the United States for damages allegedly resulting from an executive order by the Governor of the State of California. Methanex contended that the order required the removal of MTBE — a chemical compound produced from methanol and isobutylene that can render water undrinkable under certain circumstances — from all fuel marketed in California. The California action was taken in light of a study raising concerns about the contamination of water resources in the event of MTBE leakage.

Methanex contested the validity of the environmental evidence and claimed that the measure has or will negatively impact the global price of its product, methanol, which it markets in part through an indirect United States subsidiary and sometimes produces from a manufacturing plant in the United States. The company asserted that California's measure was tantamount to an expropriation, for which it is entitled to compensation under article 1110 of NAFTA. As of this writing, the arbitration case was pending resolution.

Source: UNCTAD.

3. Attracting FDI through a lowering of environmental standards

Another means of protecting the environment sometimes included in IIAs is an undertaking not to *relax* environmental standards in order to attract FDI. Such a provision has been included in some IIAs in order to answer concerns in both home and host countries that the liberalization of investment rules between States may provide an incentive for host states to lower their environmental standards in order to attract FDI. It is feared that removing restrictions on flows of capital and products would encourage companies from "high"-standard countries to relocate to "low"-standard countries (the "pollution haven" hypothesis — box 7). Under the "pollution haven" hypothesis, investors seek to reduce

production costs by relocating, while maintaining access to the markets of both countries. Environmentalists on both sides would be concerned about creating pollution “hot spots” in low-standard countries, and about promoting downward pressure on environmental standards on both sides of the border.

Short of an actual *undertaking* not to relax environmental standards as an incentive to FDI, an agreement may simply include an assurance, as in the preambular statement of the 1998 BIT between Bolivia and the United States of America, that the agreement’s economic objectives will not be *injurious* to the environment and can indeed “be

Box 7. The “pollution haven” hypothesis

There have been several approaches to testing the general “pollution haven” hypothesis (Adams, 1997). The first has been to correlate outward FDI with environmental standards. The results have found no support for the “pollution haven” hypothesis, e.g. the hypothesis that TNCs direct their investment to countries with lax standards (Leonard, 1998; Repetto, 1995; Lucas *et al.*, 1992, Eskeland and Harrison, 1997; Warhurst and Bridge, 1997). One study (Xing and Kolstad, 1997) does find the predicted effect, but its robustness has been questioned because of the use of sulphur dioxide emissions as a proxy for environmental regulation in a larger model of locational choice. Again, the studies find that the environmental variable is rarely significant. The most important variables remain the traditional ones of locational choice: factor endowments, infrastructure quality, distance and market size (Eskeland and Harrison, 1997).

There is also a third approach — to use case studies. This approach, which examines specific company decisions, has proved to be more successful in finding cases that support the notion that environmental standards are a factor in TNC location decisions (WWF, 1998a). Examples of both — Governments failing to enforce environmental legislation and firms acknowledging that lower environmental standards were a factor — were found in Costa Rica, Mexico, India, Indonesia, Papua New Guinea and the Philippines (WWF, 1998 and 1999 a and b).

All three approaches have inherent difficulties. The first two suffer from imprecise measurement of the variables, such as environmental stringency and the difficulties plaguing FDI data and affiliate production data in general; they also rely heavily on data from the United States. The third suffers from selection bias - firms that have actually shifted are documented.

Source: From UNCTAD, 1999b, p. 298.

achieved without relaxing health, safety and environmental measures of general application” (UNCTAD, 1999a, p. 119). In fact, this preambular clause featured in the April 1994 model BIT of the United States. A similar formulation has been considered in a recent BIT negotiation involving the Netherlands and Mozambique.

The 2000 OECD Guidelines, provide that “Enterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises should:

... 5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues...” (OECD, 2000a, chapter 2).

As explained in the Commentary on the 2000 OECD Guidelines, paragraph 6, the words “or accepting” also draw attention to a corollary — the role of Governments in offering these exemptions.

NAFTA’s Chapter 11 contains a similar clause in its article 1114 (paragraph 2):

“The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement”.

This NAFTA “pollution haven” clause has been criticized by some legal observers as weak (e.g. Johnson and Beaulieu, 1996). The NAFTA parties chose to express this commitment in non-binding language — acknowledging the “inappropriateness” of lowering standards, and stating that parties “should not” do so — rather than prohibiting them from doing so. Furthermore, this provision is governed by its own, “soft” enforcement provision, which directs parties to use consultation procedures rather than the binding NAFTA dispute settlement provisions, to resolve any concerns.

Utilizing stronger legal language in the “Package of proposals for text on environment and labour” annexed to the MAI Draft Negotiating Text (Proposal 3: Affirmation of the Right to Regulate), the Chairperson proposed the following text:

“A Contracting Party shall not waive or otherwise derogate from, or offer to waive or otherwise derogate from, its domestic health, safety, environmental, or labour measures, as an encouragement to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of an investment of an investor”.

While the commitment stated here is in mandatory language, the corollary task of linking the obligation to the MAI dispute settlement procedures had not been discussed by the negotiators (*ibid.*, p. 215). Linking such a provision to a mandatory dispute settlement procedure could in fact raise some problems. Were either the NAFTA or the MAI provisions to be litigated, a claimant party would face substantial evidentiary challenges. Providing evidence that a party had intentionally re-designed its domestic legislation “as an encouragement” to attract FDI could be difficult. Indeed some of the critics of the NAFTA provision have suggested that vigorously enforcing such a commitment could have the reverse of its intended effect. It has been suggested that, if Governments were aware that they might be subject to suit each time they lowered an environmental standard, this might provide a disincentive for experimenting with higher standards in the first instance (Johnson and Beaulieu, 1996).¹⁴

On the other hand, it would seem that the standard of proof would not necessarily have to show that the re-designed domestic legislation was “an encouragement” to attract FDI, but could instead show whether or not the lowering of standards reflected a change in available scientific evidence. The standard of proof would in any event need to be considered within the larger context of a comparison between the levels of protection afforded by the old and the new legislation. Should Governments be in a position to argue the changes in their policies on such an objective basis, rather than the subjective element of intent, there would be no reason not to experiment with higher protective standards.

Indeed, as previously indicated, the concept of the relaxation of environmental

standards to attract FDI includes concerns with respect to the non-application or lax implementation of environmental regulations, and the chilling-effect that the attraction of FDI might have on improvements to such regulations.

In a few instances, therefore, countries have found it necessary to enter into parallel environmental agreements, or have considered including provisions, to buttress their IIAs in this respect. For example, concern over the environmental effects of liberalized trade and investment led to the establishment of a North American Commission for Environmental Cooperation through the 1994 North American Agreement on Environmental Cooperation (NAAEC) (ILM, 1993b) in the framework NAFTA. The NAAEC is a notable effort to tie environmental performance to investment (and trade) negotiations. The NAAEC, also known as the NAFTA environmental “side agreement” (together with the North American Agreement on Labour Cooperation) was negotiated in response to perceived inadequacies in the way in which NAFTA had dealt with environmental concerns. In particular the NAAEC addressed “the need for supplemental instruments to address the social agenda . . . to the satisfaction of vocal interest groups and the citizenry” of the three countries (Johnson and Beaulieu, 1996, p. 121). The NAFTA parties agreed that the environmental objectives of the NAFTA included enhanced levels of environmental protection, which was expressly included in article 1 (d) of NAAEC. Furthermore, articles (f) and (g) of the NAAEC specifically stated that the objectives of the NAFTA environmental side agreement was to strengthen cooperation on the improvement of environmental laws and regulations, as well as the enhancement of their enforcement.

The NAAEC contains “no specific protective measures, environmental standards, codes or substantive rules” (*ibid.*, p. 128). Nevertheless, it does provide a procedural means whereby complaints can be addressed by one NAFTA party “about the quality of the domestic administration and enforcement of environmental protection schemes of another party” (*ibid.*, p. 126). These complaints can be resolved through compulsory arbitration, leading to the imposition of “monetary enforcement assessments” and, as a last resort, the denial of NAFTA benefits (such as the raising of tariffs). Furthermore, the Commission on Environmental Cooperation, established by the NAAEC, through the NAFTA

Secretariat, accepts submissions from NGOs, business and other individuals or organizations “asserting that a Party is failing to effectively enforce its environmental law” (*ibid.*, p. 152). While these complaints from citizens can lead to the publication of a “factual record” of non-enforcement, only States party to the NAFTA are authorized to take forward such evidence to formal dispute settlement.

As to levels of environmental protection, article 3 of the NAAEC, while recognizing the right of each State to develop its own environmental development policies, provides that: “... each party shall ensure that its laws and regulations provide for high levels of environmental protection and shall strive to continue to improve those laws and regulations” (ILM, 1993b, p. 1483). Such environmental provisions can also be included in IIAs, as it was proposed for the draft MAI, in the context of annex 1, under “Additional Environmental Proposals”. The proposal contained provisions similar to article 3 of the NAAEC.

B. Transfer of environmentally sound technology

Provisions on the transfer of clean technologies and environment-friendly products and processes seem to be gaining ground, not only in environmental agreements, but also in IIAs.¹⁵ To set this question in historical context, it is useful to review the treatment of this matter in earlier agreements in which a recognizable interface between environment and FDI existed.

As early as 1972, principle 12 of the Stockholm Declaration (United Nations Conference on the Human Environment) (UNCHE, 1972) recognized the need to make international technical assistance available to developing countries. Principle 20 called for “environmental technologies to be made available to developing countries on terms which would encourage their wide dissemination without constituting an economic burden” (*ibid.*). Twenty years later, the United Nations Conference on Environment and Development (UNCED) in Rio de Janeiro produced Agenda 21. Chapter 34 of Agenda 21 (“Transfer of Environmentally Sound Technology Cooperation and Capacity-Building”) reflects at least a limited commitment on the part of the international community to give attention to the transfer of environmentally sound technology and technical assistance (box 8), though the objectives

of Agenda 21 in this regard are mainly to help ensure access for developing countries to scientific and technological information.¹⁶ The observation has been made that it will be left for more formal treaty arrangements to translate the objectives into actual binding transfer-of-technology commitments (Sands, 1995).

Box 8. Agenda 21: selected TNC-related provisions on the transfer of environmentally sound technologies

Agenda 21 addresses the role of TNCs and FDI with respect to the transfer of environmentally sound technologies in several chapters. Chapter 30 of Agenda 21, entitled “Strengthening the role of business and industry”, provides that “... transnational corporations, and their representative organizations should be full participants in the implementation ... of activities related to Agenda 21” [30.1]. With specific reference to technology transfer, “[m]ultinational companies, as repositories of scarce technical skills needed for the protection and enhancement of the environment, have a special role and interest in promoting cooperation in and related to technology transfer, as they are important channels for such transfer ...” [34.27]. Thus, the role of TNCs with respect to the transfer of environmentally sound technologies is clearly established.

The role of FDI with respect to transfer of technology is similarly acknowledged in Agenda 21. Chapter 33, entitled “Financial resources and mechanisms”, states that “[m]obilization of higher levels of foreign direct investment and technology transfers should be encouraged through national policies ...” [33.15], and makes specific reference to modalities for such transfers, for example, joint ventures. Such modalities between suppliers and recipients of technology, together with FDI, “could constitute important channels of transferring environmentally sound technologies” [34.28].

For the purposes of Agenda 21, technological knowledge is divided into that which is available in the public domain or is publicly owned [34.9], and proprietary or privately owned technology, which is available through commercial channels [34.11]. With respect to the latter, “[c]onsideration must be given to the role of patent protection and intellectual property rights along with an examination of their impact on the access to and transfer of environmentally sound technology” [34.10], including “providing fair incentives to innovators that promote research and development of new environmentally sound technologies” [34.11]. At the same time, “the concept of assured access for developing countries to environmentally sound technology in its relation to proprietary rights” [34.10], as well as modalities therefore [34.11], should be explored.

/...

Box 8 (concluded)

Several provisions in Agenda 21 specifically refer to Chapter 34, among which issues relating to changing consumption patterns [4.2], energy-efficient technology [7.49], conservation of biodiversity [15.7], and the marine environment [17.37] should be mentioned. It should also be noted that the implementation of activities related to the support and promotion of access to transfer of technology rests with Governments, through measures that, in the context of FDI, could be regarded as host and home country measures [34.18]. In connection with such measures, the question of “how effective use can be made of economic instruments and market mechanisms in ... the development and introduction of environmentally sound technology and its ... transfer to developing countries” should be considered [8.33].

Source: UNCTAD, based on UNCED, 1993.

a Bracketed references are to the original Agenda 21 provisions.

In the present context, the most important contribution of Agenda 21 is that it provides a framework for environmental responsibility, which explicitly makes reference to the role of TNCs and FDI. Moreover, it has lasting significance in that it represents an international commitment to the protection of the environment, which as demonstrated by the references to it in important contemporary instruments, serves as a continuous point of reference.

The long delay in establishing practical and effective means to ensure the transfer of environmentally sound technologies since the 1972 Stockholm Declaration is also reflected in the failed efforts of the international community to adopt the 1985 draft International Code of Conduct on the Transfer of Technology elaborated under the auspices of UNCTAD. The draft Code had, in any case, only mild references to environmental issues *per se*. Essentially it was limited to information-sharing as a responsibility and obligation of parties (Chapter 5, paragraph 5.2(c)(i)). It also made reference to cooperation and assistance in the development and administration of laws and regulations designed to avoid health, safety and environmental risks associated with technology or resultant products (Chapter 6, paragraph 6.2(vi)). Real progress on linking technology transfer concerns with environmental issues has been equally slow even as regards international environmental agreements themselves. Early treaties included only general language on the exchange of information on appropriate

technologies (Sands, 1995).¹⁷ Thus, it is not surprising that this would also be the case in IIAs.

More concrete legal developments in the area of the transfer of environmentally sound technology occurred under the 1985 Vienna Convention for the Protection of the Ozone Layer (ILM, 1987a). The Vienna Convention requires parties to facilitate and encourage the exchange of scientific, technical, socio-economic, commercial and legal information. Moreover, it requires parties to cooperate, in conformity with their national laws, in promoting the “development and transfer of technology and knowledge” (article 4 and annex II). Article 10 (2) (d) of the 1989 Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal requires parties to: “cooperate actively, subject to their national laws, regulations and policies, in the transfer of technology and management systems related to the environmentally sound management of hazardous wastes and other wastes” (United Nations, 1992). References that specifically address FDI had still not been featured as of this time.

As with general protection clauses — and owing to the paucity of environmental provisions in IIAs — it is again useful (not only for background but also for more substance on the interface between environment and FDI) to refer to environmental agreements with direct or implicit reference to investment for their relevance to IIA negotiators in this area. Moreover, some international environmental agreements provide obligations on Governments that can translate into obligations on TNCs. The Montreal Protocol on Substances that Deplete the Ozone Layer (ILM, 1987b) is an example of this.¹⁸ The original 1987 Montreal Protocol simply provided for cooperation in information exchange and in promoting technical assistance to developing countries for the purpose of facilitating participation in and implementation of the Protocol (articles 9 and 10). It was not until the London and Copenhagen Amendments that the Protocol required each party to take steps to ensure that the “best available, environmentally safe substitutes and related technologies are expeditiously transferred to” (article 10A) developing-country parties and that those transfers occur under fair and most favourable conditions. Under the amended Protocol, the establishment of the Multilateral Fund provides a mechanism for helping developing countries to meet the incremental costs of enabling compliance as well as meeting the cost of

supplying substitutes to controlled substances (article 10(1)).¹⁹ Moreover, it has been suggested that the Montreal Protocol could be interpreted to prohibit the transfer of technologies that do not satisfy the standards of being “environmentally safe”, without expressly stating that commitment (Sands, 1995). Whether or not TNCs are directly addressed in the Protocol, the implications are self-evident.

The Clean Development Mechanism of the 1992 Framework Convention on Climate Change (FCCC) (ILM, 1992a) has been called “[t]he most relevant and significant international environmental agreement currently under discussion for the theme of TNCs and sustainable FDI” (Krut and Moretz, 1999). The FCCC requires all parties to promote and cooperate in “full, open and prompt” exchange of relevant scientific, technical, socio-economic and legal information related to the climate system and climate change (article 4(1)(h)). The provision of financial resources by developed-country parties includes resources for the transfer of clean technology. These parties are required to take “all practicable steps to promote, facilitate, and finance, as appropriate, the transfer of, or access to, environmentally sound technologies and know-how to other provisions of the Convention” (articles 4(5) and 11(1)). The Kyoto Protocol (article 12) (United Nations, 1997) established the Clean Development Mechanism which, if ratified, would also have various financial mechanisms to stimulate climate-friendly investments in developing countries. It may well be that national policy action will increasingly be complemented by international action, which would not be surprising given the growing importance and global nature of this issue (UNCTAD, 1999b).

As mentioned at the outset, there is a growing recognition that the protection of the environment requires giving attention to the entire range of production processes and products. Moreover, it is recognized that “protection” largely comes in the form of transferred clean technologies and environment-friendly products. Again, explicit positive obligations in these areas are scarce in IIAs. Indeed, even in IIAs that do mention transfer of technology, the natures of obligations provided for in that respect are tentative.

For example, the Telecommunications annex to the WTO-GATS agreement, in its paragraph 6 entitled “Technical cooperation”, provides that:

“... (d) Members shall give special consideration to opportunities for the least-

developed countries to encourage foreign suppliers of telecommunications services to assist in the transfer of technology, training and other activities that support the development of their telecommunications infrastructure and expansion of their telecommunications services trade”.

It is arguable that this undertaking includes clean technologies and management practices, especially as they relate to the development of an adequate infrastructure, which might otherwise in some cases entail a threat to the environment. However, it should be noted that although the provision is in mandatory language, the obligation only extends to giving special consideration to opportunities for *least* developed countries.

A somewhat stronger obligation that could again be argued to include environmentally sound technology and management practices can be found in article 66 of the WTO-TRIPS agreement, which states:

“...2. 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”.

An example of an even more germane commitment is provided in article 7 of part II of the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects:

“1. Consistent with the provisions of the Energy Charter Treaty, Contracting Parties shall encourage commercial trade and co-operation in energy efficient and environmentally sound technologies, energy-related services and management practices.

2. Contracting Parties shall promote the use of these technologies, services and management practices throughout the Energy Cycle ” (ECP, 1995).

Again, it should be realized that the obligations under this Protocol extend to the encouragement and promotion of trade in, and the use of, environmentally sound technology and management practices.

With respect to the responsibility of TNCs as regards the transfer of environmentally sound technology, the 1991 Business Charter for Sustainable Development: Principles for Environmental Management, prepared for the International Chamber of Commerce (ICC) Commission on Environment, was adopted to

promote meeting the needs of the present without compromising the ability of future generations to meet their own needs. Principle 13 specifically exhorts businesses to contribute to the transfer of environmentally sound technology. The earlier 1987 report of the World Commission on Environment and Development, "Our Common Future" (WCED, 1987), expressed the same challenge and called on the cooperation of business in tackling it.

In similar but clearer diction, the 2000 OECD Guidelines, in Chapter VIII entitled "Science and Technology", provides in its article 2 that "Enterprises should:

... where practicable, ... permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights" (OECD, 2000a, p. 7).

Article 4 of chapter VIII furthermore indicates that enterprises, "when granting licenses for the use of intellectual property rights or when otherwise transferring technology, do so on reasonable terms and conditions and in a manner that contributes to the long term development prospects of the host country" (*ibid.*).

Among relevant international agreements on environment with a bearing on the environmental aspects of transfer of technology, it is worth mentioning the 1992 Biodiversity Convention (ILM, 1992b). This Convention established a range of provisions that serve further to encourage, but still not actually require, the transfer of environmentally sound technology. The Convention addresses the relationship between technology transfer and intellectual property rights and not investment *per se*. It is nonetheless important that this Convention "links the effective implementation by developing countries of their commitments with the effective implementation by developed-country parties of their commitments related to, *inter alia*, transfer of technology" (Sands, 1995, p. 745, with reference to article 20(4)). Despite the absence of a direct reference to FDI, TNCs seem to be recognized as the main channel for technology transfer from developed to developing countries.

Under the Biodiversity Convention, the appropriate standard to be met – by TNCs or other investors – in transferring their technologies are actually elaborated in obligatory language. The Convention provides that: parties "*must*" provide and /or facilitate access for, and transfer to, other parties "technologies that are relevant to the

conservation and sustainable use of biological diversity or make use of genetic resources and do not cause significant damage to the environment" (article 16(1)) (ILM, 1992b). The access and transfer to developing-country parties of those technologies by, for example, TNCs, should take place under "fair and most favourable terms, including on concessional and preferential terms where mutually agreed" (*ibid.*) and on terms that recognize (and are consistent with) the adequate and effective protection of intellectual property rights (article 16(2)). Technologies that make use of genetic resources provided by parties, in particular developing-country parties, are to be accessed by and transferred to those parties on "mutually agreed terms", including technology protected by patents and other intellectual property rights, where necessary, through the provision of the Convention relating to financial resources and the financial mechanism (article 16(3); see also articles 20 and 21). Moreover, each party must take appropriate measures with the aim that the private sector facilitates access to and joint development and transfer of these technologies (article 16(4)).

Thus, IIAs and other relevant international instruments promote the transfer of environmentally sound technology and encourage measures on the part of both Governments and TNCs in this respect. Yet, some IIAs that would not allow such promotion to take the form of performance requirements. For example, NAFTA, in its article 1106(1)(f) provides that "no Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory... to transfer technology, a production process or other proprietary knowledge to a person in its territory...". This is subject to any order intended to remedy a violation of the competition laws of the host country or, to act in a manner not inconsistent with other provisions of NAFTA. However, article 1106 (2) of the NAFTA provides that "a measure that requires an investment to use a technology to meet generally applicable ... environmental requirements shall not be construed to be inconsistent with paragraph 1(f)". Such measures are nevertheless subject to national and most-favoured-nation treatment standards of the Treaty. The NAFTA, while allowing a State to mandate the *use* of environmentally sound technologies, would still preclude their *transfer*.

A more robust example of this approach is the 1998 BIT between Bolivia and the United States. The parties undertook not to mandate or enforce, as a “condition for the establishment, ... conduct or operation of a covered investment, any requirement (including any commitment or undertaking in connection with the receipt of a governmental permission or authorization) ... to transfer technology ” (UNCTAD, 1999b, p. 120). This is subject to any order intended to remedy a violation of the competition laws of the host country, or any incentives. Thus, the Bolivia-United States BIT could operate against possible measures by the host country to mandate the transfer of environmentally sound technologies.

The preceding review of provisions that address transfers of clean technology reflects, as is the case with the protection of the environment in general, the recognition of the need to address this issue in international agreements. Indeed, as the analysis confirms, there is room to strengthen relevant provisions. Naturally, it is realized that the real test of any provision is in its implementation.

C. Transfer of environmentally sound management practices

In addition to the transfer of environmentally sound technologies, the diffusion and utilization of sound environmental management practices is another component that FDI could offer towards the objective of environmental preservation. In 1990, the United Nations Centre on Transnational Corporations (UNCTC) elaborated a set of “Criteria for Sustainable Development Management”, at the request of the United Nations Economic and Social Council. Among these criteria were steps for TNCs to take to transfer sound environmental management techniques to host countries to enhance sustainable development. Among other things, corporations were encouraged to provide education and perform environmental audits of on-going activities, particularly those in developing countries, to verify that the criteria had been adequately considered. Sustainable development management criteria, as identified by the UNCTC, also included instituting research-and-development work on the reduction and/or elimination of industrial products and processes that generate greenhouse gases and arranging for environmentally safer technologies to be available to affiliates in developing countries without extra internal charges.

Agenda 21 has informed several instruments in its enterprise-specific pronouncements, including the recognition of environmental management as a high corporate priority (box 9).

Box 9. Agenda 21: selected references to TNC responsibilities with respect to environmentally sound management practices

Agenda 21 acknowledges the role that TNCs can play in mitigating environmental harm through the development and implementation of policies and operations that result in “more efficient production processes, preventive strategies, cleaner production technologies and procedures throughout the product life cycle” [30.2].^a Thus, TNCs are urged to “recognize environmental management as among the highest corporate priorities and as a key determinant to sustainable development” [30.3]. To this end, Agenda 21 encourages TNCs to:

1. aim to increase the efficiency of resource utilization, including increasing recycling and reducing waste discharge [30.6];
2. develop and implement methodologies for the internalization of environmental costs into accounting and pricing mechanisms [30.9];
3. report annually on their environmental records, and the adoption and implementation of codes of conduct promoting best environmental practices [30.10];
4. establish world-wide corporate policies on sustainable development and arrange for environmentally sound technologies to be available to affiliates owned substantially by their parent company in developing countries without extra external charges [30.22];
5. establish partnership schemes with small and medium-sized enterprises to help facilitate the exchange of experience in managerial skills, market development and technological know-how [30.23];
6. increase research and development of environmentally sound technologies and environmental management systems [30.25];
7. ensure responsible and ethical management of products and processes from the point of view of environmental aspects [30.26]; and
8. adopt and implement, wherever they operate, policies and standards of operation with reference to hazardous waste generation and disposal that are equivalent to or no less stringent than those in their country of origin [20.29].

^aSource: UNCTAD, based on UNCED, 1993.

Bracketed references are to the original Agenda 21 provisions.

The inclusion of sound environmental management in the 1991 OECD Guidelines was further recognition that it is an important component of sustainable development, and was increasingly being seen as both an opportunity and a responsibility for business, especially TNCs. The 1991 version in a section entitled “Environmental Protection” provided:

“Enterprises should ... take due account of the need to protect the environment and avoid creating environmentally related health problems. In particular, enterprises, whether multinational or domestic, should:

1. Assess, and take into account in decision making, foreseeable environmental and environmentally related health consequences of their activities, including citing decisions, impact on indigenous natural resources and foreseeable environmental and environmentally related health risks of products as well as from the generation, transport and disposal of waste;
2. Co-operate with competent authorities, inter alia, by providing adequate and timely information regarding the potential impacts on the environment and environmentally related health aspects of all their activities and by providing the relevant expertise available in the enterprise as a whole;
3. Take appropriate measures in their operations to minimise the risk of accidents and damage to health and the environment, and to co-operate in mitigating adverse effects, in particular:
 - a) by selecting and adopting those technologies and practices which are compatible with these objectives;
 - b) by introducing a system of environmental protection at the level of the enterprise as a whole including, where appropriate, the use of environmental auditing;
 - c) by enabling their component entities to be adequately equipped, especially by providing them with adequate knowledge and assistance;
 - d) by implementing education and training programmes for their employees;
 - e) by preparing contingency plans; and
 - f) by supporting, in an appropriate manner, public information and community awareness programmes”.

Environmental protection was given particular attention during the 1999/2000 review of the OECD Guidelines. This was primarily due to

the 1992 Rio Declaration with its Agenda 21 and the added reinforcement by several corporate codes, notable among which is the ICC Business Charter for Sustainable Development. This resulted in a much strengthened Environment Chapter (Chapter V) (box 10), especially with respect to environmentally sound management practices.

**Box 10. The environmental chapter of the 2000
OECD Guidelines
V. ENVIRONMENT**

“Enterprises should, within the framework of laws, regulations and administrative practices in the countries in which they operate, and in consideration of relevant international agreements, principles, objectives and standards, take due account of the need to protect the environment, public health and safety, and generally to conduct their activities in a manner contributing to the wider goal of sustainable development. In particular, enterprises should:

1. Establish and maintain a system of environmental management appropriate to the enterprise, including:
 - a) collection and evaluation of adequate and timely information regarding the environmental, health, and safety impacts of their activities;
 - b) establishment of measurable objectives and, where appropriate, targets for improved environmental performance, including periodically reviewing the continuing relevance of these objectives; and
 - c) regular monitoring and verification of progress toward environmental, health, and safety objectives or targets.
2. Taking into account concerns about cost, business confidentiality, and the need to protect intellectual property rights:
 - a) provide the public and employees with adequate and timely information on the potential environmental, health and safety impacts of the activities of the enterprise, which could include reporting on progress in improving environmental performance; and
 - b) engage in adequate and timely communication and consultation with the communities directly affected by the environmental, health and safety policies of the enterprise and by their implementation.
3. Assess, and address in decision-making, the foreseeable environmental, health, and safety-related impacts associated with the processes, goods and services of the enterprise over their full life-cycle. Where these proposed activities may have significant environmental, health, or safety impacts, and where they are subject to a decision of a competent authority, prepare an appropriate environmental impact statement.

/...

Box 10 (concluded)

4. Consistent with the scientific and technical understanding of the risks, where there are threats of serious damage to the environment, taking also into account human health and safety, not use the lack of full scientific certainty as a reason for postponing cost-effective measures to prevent or minimise such damage.
5. Maintain contingency plans for preventing, mitigating, and controlling serious environmental and health damage from their operations including accidents and emergencies; and mechanisms for immediate reporting to the competent authorities.
6. Continually seek to improve corporate environmental performance, by encouraging, where appropriate, such activities as:
 - a) Adoption of technologies and operating procedures in all parts of the enterprise that reflect standards concerning environmental performance in the best performing part of the enterprise;
 - b) Development and provision of products or services that have no undue environmental impacts; are safe in their intended use; are efficient in their consumption of energy and natural resources; can be reused, recycled, or at least disposed of safely;
 - c) Promoting higher levels of awareness among customers of the environmental implications of using the products and services of the enterprise; and
 - d) Research on ways of improving the environmental performance of the enterprise over the longer term.
7. Provide adequate education and training to employees in environmental health and safety matters, including the handling of hazardous materials and the prevention of environmental accidents, as well as more general environmental management areas, such as environmental impact assessment procedures, public relations, and environmental technologies.
8. Contribute to the development of environmentally meaningful and economically efficient public policy, for example, by means of partnerships or initiatives that will enhance environmental awareness and protection.”

Source: OECD, 2000a, pp. 5-6.

The coverage of the 2000 OECD Guidelines, the Commentary on which makes reference to the principles and objectives contained in, *inter alia*, the Rio Declaration and Agenda 21, has been broadened and deepened to include establishing and maintaining environmental management appropriate to an enterprise, even though essentially limited to the collection and evaluation of information and monitoring and the

establishment of measurable objectives and targets for improved environmental performance. Accordingly, managers of these enterprises are exhorted to “give appropriate attention to environmental issues within their business strategies” (OECD, 2000b, p. 8). “Sound environmental management”, as referred to in the 2000 OECD Guidelines, is to be interpreted “in its broadest sense, embodying activities aimed at controlling both direct and indirect environmental impacts of enterprise activities over the long-term, and involving both pollution control and resource management elements” (*ibid.*).

Thus, the environment chapter of the 2000 OECD Guidelines reflects several principles of sound management practices contained in Rio’s Agenda 21. It also reflects standards contained in such instruments as the International Organization for Standardization (ISO) Standard on Environmental Management Systems (ISO, 1998). In fact, the ISO has developed special standards for environmental management. While TNCs are not singled out as addressees, the so-called “ISO 14001” (box 11) has been developed as a series of tools encompassing standards for environmental management and guidelines for environmental performance analysis generally and, as such, clearly has a direct bearing on TNC management practices, both at home and abroad.

Box 11. ISO 14001 standards for environmental management systems

The ISO^a 14001, part of the ISO 14000 family of International Standards on environmental management, specifies the requirements for an environmental management system — the management of those processes and activities that influence environmental impact. An organization might implement ISO 14001 for the internal benefits it can provide, such as reduced cost of waste management; savings in consumption of energy and materials; or clarification of environmental responsibilities within the organization. In addition, the standard may be used as the basis for certification of the environmental management system by an independent “registration” or “certification” body. ISO itself does not carry out conformity assessment and does not issue ISO 14001 certificates. An ISO 14001-certified environmental management system is intended to provide confidence to external parties that an organization has control over the significant environmental aspects of its operational processes, that it has committed itself to comply with all relevant environmental legislation and to continually improve its environmental performance. Such independent certification is becoming an integral part of environmental management strategies: certificates of

/...

Box 11 (concluded)

conformity to ISO 14000 increased fifty-fold between the years 1995 and 1999.

Firms seeking certification are required to take the following steps:

- an initial review by management to identify environmental issues of concern (e.g. excessive use of polluting inputs; the potential for a serious environmental accident);
- establishment of priorities for action, taking into account local environment regulations and potential costs;
- establishment of an environmental policy statement, signed by the CEO, which includes commitments to compliance with environmental regulations, pollution prevention and continuous improvement;
- development of performance targets based on the policy statement (e.g. reduction of emissions by a set amount over a defined period);
- implementation of the environmental management systems, with defined procedures and responsibilities;
- implementation reviews, performance measurement and management audits.

Although fairly new, the bulk of the certificates that have been issued are for firms in developed countries. This reflects demand in these countries for environmentally responsible management. Developing countries are starting to obtain a greater share of the certificates being issued. TNCs have a role to play in assisting, first, developing countries to upgrade their abilities to have certification bodies, and, second, domestic firms, especially their own operations and suppliers, to meet the certification requirements.

Source: UNCTAD, based on ISO, 1998.

^a The International Organization for Standardization, based in Geneva, publishes voluntary standards for technology and business activity.

^b See ISO, 1999.

^c On the participation of developing countries in standard-setting bodies, see Krut and Gleckman, 1998.

As indicated previously, environmental protection is a vast subject that transcends the interface of FDI and IIAs. While stock has been taken of how the key issues have been addressed in IIAs and other relevant international instruments, two other developments deserve brief discussion.

The first notable development concerns an increasing awareness of and calls for studying and measuring the potential impact of production on the environment. This development, in its contribution to environmental awareness and protection, is closely linked to issues discussed

concerning environmentally sound management practices of TNCs. With respect to environmental assessment studies, one issue that arises in the context of FDI is the screening of investment projects. Despite the general trend towards providing incentives for TNC entry and moving away from screening of FDI, some IIAs do provide for pre-admission screening mechanisms on environmental grounds through the requirement of submission of environmental impact assessment studies. For example, in article 19(1) of Part IV of the ECT, “[t]he Contracting Parties agree that the polluter in the Areas of Contracting Parties, should, in principle, bear the cost of pollution, including transboundary pollution, with due regard to the public interest and without distorting Investment in the Energy Cycle or international trade. Contracting Parties shall accordingly ... [*inter alia*] ... promote the transparent assessment at an early stage and prior to decision and subsequent monitoring, of Environmental Impacts of environmentally significant energy investment projects; ...” (ECT, 1995).

The Convention on Environmental Impact Assessment in a Transnational Boundary Context is another instrument that directly affects investment projects through its requirement for environmental impact studies. Article 2(2) provides that:

“[e]ach Party shall take the necessary legal, administrative or other measures to implement the provisions of this Convention, including, with respect to proposed activities listed in Appendix I that are likely to cause significant adverse transboundary impact, the establishment of an environmental impact assessment procedure that permits public participation and preparation of the environmental impact assessment documentation described in Appendix II” (ICEL, 1995).²⁰

It is also important to point out that article 2(3) of the Convention on Environmental Impact Assessment in a Transnational Boundary Context requires that “[t]he Party of origin shall ensure that in accordance with the provisions of this Convention an environmental impact assessment is undertaken prior to a decision to authorize or undertake a proposed activity listed in Appendix I that is likely to cause a significant adverse transboundary impact” (*ibid.*). This provision in effect establishes an environmental screening mechanism with respect to FDI.

The issue has also been addressed in ancillary fashion — for obtaining investment insurance — by the World Bank Group’s

Multilateral Investment Guarantee Agency (MIGA). MIGA, informed by such national-level schemes as the United States' Overseas Private Investment Corporation (OPIC, 1999), requires an environmental assessment of proposed projects by any applicant for a guarantee (box 12). MIGA is particularly important for investors from developing countries because, contrary to virtually all developed countries, developing countries typically do not provide insurance for outward FDI. It is therefore normally the only investment insurance facility available to firms from these countries.

The second development concerns the issue of environmental reporting standards. It involves the inclusion of financial measurements of the impact of production on the environment in relevant reports, as well as non-financial information with respect to environmental impact of operations. Accounting and reporting for the environment has become increasingly relevant to TNCs. Some users of financial statements want to know the extent of a company's environmental exposure and how the company is managing its environmental costs and liabilities. In this connection, a technical position paper endorsed by UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has been put forward for the consideration of Governments, enterprises and other interested parties in order to contribute to both the quality of environmental accounting and reporting and its harmonization (United Nations, 1999a).

Environmental reporting with respect to non-financial information on the policies, practices and overall value statements of TNCs has been explicitly encouraged in chapter III of the 2000 OECD Guidelines. Here, enterprises are encouraged "to apply high quality standards for non-financial information including environmental... reporting where they exist" (OECD, 2000a, p. 4). In particular, enterprises are encouraged to report on "value statements or statements of business conduct intended for public disclosure including information on the ... environmental policies of the enterprise and other codes of conduct to which the company subscribes" (*ibid.*).

A few IIAs and a number of other international instruments address the linkage between the environment and FDI. The protection of the environment is generally referred to with respect to the responsibility of both Governments

and TNCs. There are various formulations, each depending on the scope of a given instrument and the purposes and objectives of its signatories. In addition, two specific issues relating to regulatory powers and practices of Governments are noteworthy. First, some IIAs provide that Governments retain their right to regulate. Second, parties to some IIAs undertake not to lower standards in order to attract FDI. Furthermore, a few contemporary IIAs and other relevant international instruments (in particular Agenda 21) expressly recognize the role of FDI in the transfer of environmentally sound technology and management practices, and urge measures on the part of both Governments and TNCs in this regard. Provisions in this respect may well acquire an enhanced legal and practical significance in future rule-making.

Box 12. MIGA: investment guarantees and environmental assessment

To achieve its objective of helping to ensure that it provides guarantees only to those projects that are environmentally sound and sustainable, MIGA requires evaluation of the potential environmental impacts of a proposed project. It seeks to use such assessments to improve project planning, design and implementation by preventing, minimizing, mitigating or compensating for adverse environmental impacts. MIGA will "favour preventive measures over mitigatory or compensatory measures, whenever feasible" (MIGA, 1999, paragraph 2). The environmental assessment of a proposed project includes the identification of the relevant obligations of the host country under international environmental treaties and agreements, and MIGA will not issue guarantees to projects that would contravene such obligations.

An initial screening of each proposed investment by MIGA determines the appropriate extent and type of environmental assessment. A proposed investment is classified into one of three categories (A, B and C) "depending on: the type, location, sensitivity, and scale of the project; and the nature and magnitude of its potential environmental impacts" (*ibid.*, paragraph 8). Specified criteria for classification of each investment include whether it:

- is likely to have significant adverse environmental impacts that are sensitive, diverse or unprecedented (category A)
- has impacts that are site-specific and reversible, for which, in most cases, mitigatory measures can be designed (Category B); and
- produces negligible adverse impacts on the environment (Category C).

An applicant is then advised on MIGA's environmental assessment requirements.

/...

Box 12 (concluded)

The types of reports that can be used to satisfy MIGA's environmental assessment requirements are listed and defined in annex B to MIGA's Operational Regulations (*ibid.*, paragraph 7 and "Definitions"). A report should provide "a clear understanding of the sponsor's approach to environmental mitigation and management" (*ibid.*, paragraph 7, footnote 5). It will also provide MIGA "with an adequate basis for a decision to offer a guarantee" (*ibid.*, paragraph 5), as well as "for requiring specific actions as conditions of a guarantee" (*ibid.*, paragraph 7, footnote 5). In some cases, this includes the requirement of public disclosure of the instrument, and consultations with "project-affected groups and local non-governmental organizations" (*ibid.*, paragraph 9).

When a guarantee contract is issued, MIGA requires the guarantee holders to operate in compliance with the host country's environmental and other related laws and regulations, MIGA's own environmental policies and guidelines, and any other specific requirements set by MIGA. Compliance is verified through warranties and representations, monitoring reports, site visits, or other necessary measures. Failure by the guarantee holder to cooperate with respect to these verification mechanisms, or to abide by the relevant laws, regulations, or specific requirements, entitles MIGA to terminate a guarantee. In addition, MIGA could also deny payment of a claim if a non-compliance is not corrected within a period set forth in the Contract of Guarantee.

Source: UNCTAD, based on MIGA, 1999.

Section III

Interaction with other Issues and Concepts

The issue of environment has a number of interactive effects with a number of the issues and concepts covered in the present volumes, but in most cases, this is not extensive (table 1). In six areas, however, interaction is extensive.

- **Admission and establishment.** A critical point of intervention for Governments to assess the potential impact of FDI — especially investments involving large-scale projects and pollution-intensive industries — on the environment is at the time of entry of a TNC. This is typically through screening mechanisms, especially environmental assessment studies.
- **Incentives.** There is generally a concern that countries, in their competition to attract FDI, might consider lowering their environmental standards to reduce costs for foreign investors.

IAs have sought to address this concern, as discussed earlier in this text.

Table 1. Interaction across issues and concepts

Issue	Environment
Admission and establishment	++
Competition	0
Dispute settlement (investor-State)	+
Dispute settlement (State-State)	+
Employment	+
Fair and equitable treatment	+
Home country measures	+
Host country operational measures	+
Illicit payments	0
Incentives	++
Investment-related trade measures	+
Most-favoured-nation treatment	+
National treatment	+
Scope and definition	+
Social responsibility	++
State contracts	0
Taking of property	++
Taxation	0
Transfer of funds	0
Transfer of technology	++
Transfer pricing	0
Transparency	+

Source: UNCTAD.

Key: 0 = negligible or no interaction.

+ = moderate interaction.

++ = extensive interaction.

- **Technology transfer.** Provisions in IAs that generally deal with the transfer of technology also include automatically the transfer of environmentally sound technology. Hence, the discussion of this broader topic is immediately relevant to the subject of this chapter.
- **Social responsibility.** Contributions by TNCs to the maintenance and promotion of environmentally sound policies, operational standards and practices, technologies and products are substantive standards of social responsibility, which are increasingly reflected in corporate codes of conduct and, indeed, are part of the Global Compact (UNCTAD, 1999b).
- **Taking of property.** Measures pertaining to the protection of the environment that result in the effective loss of management, use or control, or a significant depreciation of the value, of the assets of a foreign investor may fall under the category of "regulatory takings" (see chapter 9). Where a takings clause in an IIA encompasses such measures and provides for compensation to foreign investors, it might

have a chilling effect on the efforts of host countries to protect their environment.

- **Investor State dispute settlement.** As discussed earlier, the effects of investor-State dispute settlement arrangements in IIAs on environmental measures might require careful consideration, especially in light of recent experience in the context of NAFTA. (For a general discussion of investor-State dispute settlement, see chapter 12.)

Conclusion: Economic and Development Implications and Policy Options

From a sustainable development perspective, neither the need for the protection of the environment, nor the possibility of the contribution of FDI to environmental welfare, are controversial international issues. Low awareness of environmentally friendly products, technology and management practices and/or inadequate attention to such products and processes by producers and consumers, can impose high costs in terms of environmental degradation as well as natural resources depletion which, in turn, negatively affect national development. For its part, FDI — made, as it is, by firms with competitive advantages that enable them to overcome the disadvantage of operating in foreign locations — often hold the potential for the international transfer of environmentally sound practices and knowledge that contribute towards sustainable development.

However, with respect to the question of countries balancing the immediate economic impact sought from FDI, on the one hand, and environmental preservation, on the other hand, some controversy might exist. Although there is scant evidence to indicate its occurrence on any significant scale, some countries, especially those trying hard to attract FDI, might be tempted or induced to lower their environmental standards to increase their locational advantages for TNCs. Moreover, in the absence of deliberate policies and practices by TNCs with respect to the use and diffusion of environmentally sound technologies and management practices in all their operations — and especially where IIAs prohibit the imposition of performance requirements on investors covered by the agreements — the policy options for countries with scarce financial resources for the

acquisition of such technologies and know-how remain limited.

National policymakers and managers of TNCs could make a contribution to the protection of the environment, by promoting the transfer of environmentally sound technologies and management practices to foreign affiliates located in particular countries, especially host developing countries and to other local firms linked to them. This can contribute to long-term sustainable development in the country in question. At the same time, from a corporation's perspective, it can make good business sense to adopt environmentally sound policies and practices — in terms of minimizing potential liabilities, responding to consumer preferences and safeguarding the corporate image.

Traditionally, environmental concerns have been addressed through national laws as well as through codes of conduct adopted by corporations and industry groups. More recently, such concerns have been addressed in international arrangements related to the environment, as well as within the context of IIAs. Within this latter context, a number of questions arise. To what extent could IIAs in general contribute to environmental welfare in the light of specialized instruments dealing with environment? Where IIAs address environmental concerns, should standards be included? If so, how are these standards defined, to whom are they addressed, and should they be binding or non-binding? How would they interact with standards contained in specialized instruments on the environment? A discussion of these questions would also require a balancing of at least two sets of arguments. First, that the prescription of certain standards could in some circumstances amount to a form of disguised protectionism. Secondly, that the need to promote certain environmental standards may outweigh certain negative impacts on trade or investment growth or patterns and possibly, on intellectual property rights.

In the light of the discussion in the preceding sections, the following are a range of policy options that IIA negotiators could consider as regards environmental matters. As always in these volumes, the intention is not to advocate any of them, but to provide a range of alternatives:

Option 1: No reference to the environment.

As indicated before, most IIAs do not have specific provisions concerning the environment and its protection. In this option, national laws remain the principal means of

environmental protection and the ways and means of providing for a framework for ensuring the achievement of related preservation objectives, is seen as involving issues that go beyond those relating directly to FDI. Thus, it would be reasoned that specialized international environmental agreements — to the extent that national laws are not enough — are better suited than IIAs to address such issues.

Furthermore, it can be argued that autonomous efforts by TNCs to meet or surpass national or international environmental standards may be an adequate guide to policy development in this area. Proponents of this line of reasoning maintain that the focus of governmental action could be limited to the cultivation and encouragement of environmentally friendly corporate management cultures and strategies, including those related to the transfer of environmentally sound technologies and management practices. This might include the promotion of the establishment and enforcement of internal corporate or industry-wide codes of conduct.

However, given that environmental issues are important and to the extent that countries wish to address the commitments of the actors in FDI with respect to the protection of the environment in IIAs, further options present themselves. Again, it is emphasized that the litmus test for the effective protection of the environment is the implementation of relevant provisions.

Option 2: Non-binding or declaratory provisions related to the environment.

Countries might simply wish to confirm their commitment to environmental preservation. This could be limited to an exhortation that the parties should generally promote environmental welfare. In other words, they would — usually in the preamble section of an instrument — simply exhort the parties to take into account the preservation of the environment, which might be included with a string of other issues, such as social responsibility and consumer protection.

Alternatively, general references in IIAs could manifest the parties' consideration of and attention to, environmental welfare in general or, in particular, to other international environmental arrangements. A model for the latter approach is provided for in the preamble of the Energy Charter Treaty:

“Recalling the United Nations Framework Convention on Climate Change, the Convention on Long-Range Transboundary

Air Pollution and its protocols, and other international environmental agreements with energy-related aspects; and

Recognizing the increasingly urgent need for measures to protect the environment, including the decommissioning of energy installations and waste disposal, and for internationally-agreed objectives and criteria for these purposes, ...”

Moreover, parties could use declaratory statements to protect and promote the environment, as well as affirm their belief that their objectives under a given IIA could be achieved without compromising the environment or a lowering of environmental standards. Declaratory statements have recently been incorporated in a few IIAs. In particular one BIT concluded between Bolivia and the United States and another between Mozambique and the Netherlands, as well as the MAI Draft Negotiating Text.

Negotiating parties might also wish to provide for non-binding provisions that address certain aspects of environmental protection in more detail. The introduction of such provisions might reduce the indeterminacy of the effects of the inclusion of hortatory provisions in IIAs in terms of implementation, application or dispute settlement. This could also be accomplished by making reference to other agreements in the context of an IIA. A model for this approach is provided for in the MAI Draft Negotiating Text. In part X of the MAI entitled “Relationship to other International Agreements” incorporated the OECD Guidelines for Multinational Enterprises, which included recommendations on environmental protection, into the agreement and stated:

“2. The Contracting Parties ... are encouraged to participate in the Guidelines work ... in order to promote co-operation on the application, ... of the Guidelines

...

4. Annexation of the Guidelines shall not bear on the interpretation or application of the Agreement, including for the purpose of dispute settlement; nor change their non-binding character...”.

The MAI approach also points to a more general variation. IIAs are intergovernmental instruments and as such, their hortatory language typically refers to States. However, where parties to IIAs intend to address TNCs, as they did in the case of the MAI, then hortatory provisions on the protection of the environment, and the transfer and

use of environmentally sound technologies and management practices could also be included in an IIA.

Non-binding language might prove to be easier to negotiate than legally binding provisions. Furthermore, where there is concern that the establishment of legal obligations might potentially stifle initiatives to reach higher standards with respect to environmental protection, the inclusion of nonbinding provisions could provide a way forward. With respect to provisions addressed to States, it should also be noted that it is possible for States, through the implementation of “soft” international commitments, to create customary norms, which, in time, might become “hard” legal obligations, and thus become enforceable as customary rules of international law.

Option 3: Specific clauses on reservation of regulatory powers with respect to the environment.

The nature of the provisions and the commitments undertaken in IIAs might be (mis-)interpreted in a way that could hamper the ability of Governments to protect the environment effectively. This might particularly be the case, when measures taken in the interest of environmental concerns could be construed as expropriations. Another case could be that an IIA, without any provisions relating to environmental regulation, does not allow performance requirements and is further strengthened by mandatory, final and binding international arbitral procedures to settle investor-State disputes. Thus, parties to IIAs might find it necessary to clarify specifically that their obligations there under do not diminish their power to take measures to protect the environment. One approach could be a specific clause that encourages or requires the parties to take whatever measures necessary to ensure that covered investments conform to environmental standards in the host country. Countries might therefore prefer to introduce “carve-out” clauses for environmental measures.

One method of carving out environmental regulation from the ambit of the provisions of IIAs is the inclusion of general or specific exceptions that would provide a legal basis for justifying relevant measures that affect covered investments, which might otherwise be precluded in an IIA. The general exceptions model has been followed in GATT article XX. An example of the specific exception model is found in the raft MAI with respect to performance requirements. The

introduction of this type of carve-out clause establishes unequivocally that environmental measures are not included in the category of prohibited performance requirements, or that such measures, if within the normal scope of governmental regulatory activity, could not be submitted to an investor-State arbitral panel.

Another carve-out option that can be considered is with regard to the subject-matter jurisdiction of investor-State dispute settlement bodies. Here, the parties could include a provision to exclude claims arising from environmental measures that affect covered investments from being pursued through investor-State dispute settlement processes and instead, to leave such matters for State-to-State dispute settlement processes. Proponents of this technique might point out that, as both States share a common interest in regulating for environmental welfare, it would be more appropriate for such disputes to be handled between regulators, rather than through the narrower perspective that is created in a dispute between an investor and a host State.

Some IIAs, in particular those that are regional or plurilateral, or are wider in scope (such as economic integration agreements), might have a “positive list” or “negative list” approach with respect to their various obligations. In other words, parties to such agreements are allowed to “opt-in” or “opt-out” only specified industries of their economies, which will then be subject to (or excluded from) investment-related obligations undertaken in an IIA. Where this method is available, countries might choose to carve-out environmentally-sensitive industries from the coverage of some of the provisions of an agreement. It should be noted that this option may be useful only in certain cases, for example where, an IIA contains disciplines on performance requirements, the application of which a country might wish to exclude from those industries most sensitive to environmental stress. In most other cases, however, opting for an industry to remain immune to the important investment protection provisions of IIAs could place a country at a competitive disadvantage vis-à-vis countries that accept such obligations, but has strengthened its domestic regulatory framework with respect to environmental protection.

While most BITs condition the entry of foreign investment on conformity with relevant national legislation, some more recently negotiated IIAs have sought to extend general treatment standards to the pre-establishment stage.

In such cases, the screening of foreign investment might run counter to such standards, especially where they include environmental impact assessments. On the one hand, if environmental impact assessments were required on a non-discriminatory basis, a problem would not arise. On the other hand, where no general environmental regulatory framework exists and a country instead relies on a project-by-project screening method to ensure environmental protection, differential treatment might be unavoidable. Here, an option is to carve-out screening mechanisms intended to protect the environment, such as environmental impact assessments, either through specific clauses, or the modification of the treatment provisions in such a way as to provide for differential treatment in dissimilar circumstances.

Option 4: Specific clauses on no lowering of environmental standards.

A corollary to the right to regulate for environmental protection is the issue of the lowering of environmental standards as a means to attract FDI. Where parties consider that this possibility exists, and wish to address it in their IIAs, specific clauses to this effect could be included. In the context of negotiations on such issues, concerns could arise with respect to the necessity of ad hoc relaxation of environmental standards under circumstances that are not FDI related. These include, for example, the need to experiment with different levels of protection, temporarily raise standards to meet particular transitory environmental stresses, and issue individual waivers to help quickly resolve specific cases of damage to the environment. Such circumstances may need to be taken into account in clauses obliging countries not to lower their environmental standards.

A model that reflects a strongly formulated approach to the issue of the no lowering of environmental standards can be found in the MAI Draft Negotiating Text's proposal 3. Where binding language is preferred on this issue, negotiations might also address how a legal test could be devised so that clear cases of lowering of environmental standards intended to attract FDI could be distinguished from cases where such lowering is done for legitimate reasons, but may nevertheless have an incidental impact on FDI flows.

Option 5: Generally mandatory environmental provisions in IIAs.

Where environmental welfare is integral to the purposes of an IIA, parties might consider binding environmental clauses to advance their objectives. Thus, a further option for dealing with environmental concerns would be to enshrine certain principles and related standards into concrete provisions in IIAs. In this case, obligations would be undertaken by the parties, the breach of which would have consequences for them under international law. In addition to undertaking binding commitments as a matter of purely international legal obligation, the parties could go further in making their treaty provisions more effective and, depending upon the nature of the obligation, create directly effective rights under their respective national legal systems.

Such obligations could be phrased in general terms. Thus, for example, parties could agree to take all necessary measures to ensure that investment activities in their respective territories are carried out based on environmentally sound policies and practices. Alternatively, specific provisions could be formulated, which could be informed by domestic standards that are similar between the contracting parties, or internationally agreed environmental standards that are accepted by them. For example, there could be standards dealing with the use of certain products or production technologies, processes and practices. In addition, standards might provide for certification procedures, reporting requirements, testing and analysis undertakings, and insurance against environmental damage. They might also include environmental impact assessments and related accounting reports.

Instead of providing explicitly for mandatory provisions concerning the environment, the parties could also simply incorporate by reference certain standards from other legal systems and frameworks into their IIAs. This incorporation technique could provide for the inclusion of mutually recognised domestic or international environmental standards as reflected in, for example, multilateral environmental agreements. The consequence of this incorporation option is that obligations in the IIA would then mirror those under the incorporated domestic or international standards. Thus, the determination of the nature and scope of application of such obligations depends entirely upon the domestic

legal system or the international regime from which they are derived. NAFTA is an example of one model for this option, where, in its article 104 entitled "Relation to Environmental and Conservation Agreements", it provides:

1. In the event of any inconsistency between this Agreement and the specific trade obligations set out in:
 - a. the Convention on International Trade in Endangered Species of Wild Fauna and Flora, done at Washington, March 3, 1973, as amended June 22, 1979,
 - b. the Montreal Protocol on Substances that Deplete the Ozone Layer, done at Montreal, September 16, 1987, as amended June 29, 1990,
 - c. the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, done at Basel, March 22, 1989, on its entry into force for Canada, Mexico and the United States, or
 - d. the agreements set out in Annex 104.1, such obligations shall prevail to the extent of the inconsistency, provided that where a Party has a choice among equally effective and reasonably available means of complying with such obligations, the Party chooses the alternative that is the least inconsistent with the other provisions of this Agreement.
2. The Parties may agree in writing to modify Annex 104.1 to include any amendment to an agreement referred to in paragraph 1, and any other environmental or conservation agreement".

Equally, parties to IIAs could choose to address environmental concerns in side-agreements. Such agreements tend to be negotiated when issues arise after main negotiations have been concluded or near conclusion, or when the institutional and procedural arrangements on environmental matters vary substantially from those provided for in the IIA. The NAFTA side agreement, NAAEC, provides a model for this approach.

As in option 2, (binding) provisions can address States or TNCs.

It should be noted here that the foregoing options are not intended to provide a comprehensive listing of available options, but merely a possible range. Furthermore, while the options are presented individually, they are not necessarily mutually exclusive and indeed, hybrids

could be considered when addressing related environmental matters in the negotiation of IIAs.

Notes

¹ The activities of NGOs include field projects, training, education, research and publication in the area of environmental protection and conservation. With respect to publications that deal with the interface between FDI and the environment, see, for example, WWF (1999b). For other relevant WWF publications, see, <http://www.panda.org/resources/publications>.

² An example is a measure requiring a foreign investor to invest in (and transfer) technology to clean toxic seepage that was not caused by that particular investor. Although such measures usually provide for tax breaks, they are not incentives, given that there is no option on the part of the investor to refuse the mandatory clean-up requirement. Other examples include requiring, for the purposes of the renewal of operating licenses, the use of environmentally sound resource extraction techniques, which would reduce the profit margins of a foreign investor; changing land use regulations in such a way as to reduce the value of the property of a foreign investor significantly; and significantly reducing fishing quotas or revoking licenses to protect fisheries, flora or fauna. The issue of regulatory takings is relevant in this context.

³ Under this principle, measures are taken to counter potential environmental damage, the risk of which can not be accurately assessed due to scientific uncertainty or incomplete data. The principle and its implications under international law are beyond the scope of this chapter. For a detailed discussion offering different views, see Sands, 1995, and Bodansky, 1991.

⁴ See also Chudnovsky and López, 1999.

⁵ This chapter will only highlight those provisions in Agenda 21 that specifically address TNCs with respect to environmental protection, or are otherwise relevant to the interface between FDI and TNCs on the one hand and the environment on the other. It is recognized that Agenda 21 contains numerous articles, particularly in Chapter 30, that address actors in business and industry, which includes TNCs.

⁶ Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996a, 2000a, 2001a, 2002a and 2004c.

⁷ Such preambular language, even though not part of the "operative" text of an IIA, can nevertheless have an influence on the interpretation of a treaty's substantive obligations.

⁸ See footnote 3 of the Preamble to the MAI Draft Negotiating Text. For an NGO perspective on the MAI and environmental protection, see, WWF, 1998b.

⁹ General references, using binding language "shall", are found in provisions setting forth the

approach towards strategies aimed at realizing the objectives of the agreement (article 20), as well as the conditions for regional cooperation (article 30), institutional development and capacity building (article 33). A declaratory provision in article 42 acknowledges the importance of a clean marine environment in the area of marine transport development.

¹⁰ The specific areas mentioned are in fact very broad, and include tropical forests, fisheries resources, soils, biodiversity and ecosystems.

¹¹ Due to heightened awareness of environmental concerns since the earlier code movement, prompted in part by reactions to industrial accidents such as Bhopal, a chapter on the environment was added following the 1991 Review, which will be discussed below.

¹² The OECD Principles constitute a set of non-binding corporate governance standards and guidelines, prepared by an OECD task force in consultation with national Governments, relevant international organizations and the private sector. The Principles were approved by the OECD Council at the ministerial level on 26-27 May 1999.

¹³ Although article 2101 does not apply to NAFTA's Chapter 11 on investment, NAFTA does except, from its performance requirements prohibitions, national measures that require an investment to use a technology to meet generally applicable health, safety or environmental requirements (article 1106, paragraph 2).

¹⁴ For these reasons the MAI Chairperson recommended that the MAI Draft Negotiating Text be accompanied by yet another interpretative footnote, which would have indicated that "[the Parties] recognize that Governments must have the flexibility to adjust their overall health, safety, environmental or labour standards over time for public policy reasons other than attracting foreign investment" (UNCTAD, 2000a, vol. IV, p. 215).

¹⁵ Provisions relating to transfer of technology, in general terms, are included in a number of international instruments. The issue of technology transfers in the context of IIAs are dealt with in chapter 23. Here, only those provisions that address the transfer of environmentally sound technologies will be discussed.

¹⁶ Numerous provisions in Agenda 21 address the need for technology transfer in the latter context. Many of its chapters include articles that pertain to human resources development and capacity building with respect to transfer of environmentally sound technologies. These chapters include environmental infrastructure in

human settlements, energy efficiency and consumption, combating deforestation and desertification, sustainable agriculture and rural development, biological diversity, water resources, toxic and dangerous products, and hazardous wastes.

¹⁷ See the 1979 Long-Range Transboundary Air Pollution Convention, Art. 8(c) (ILM, 1979); the 1988 NO Protocol, Art. 3 (Exchange of Technology) (ILM, 1988); the 1991 VOC Protocol, Art. 4 (Exchange of Technology) (ILM, 1991b).

¹⁸ This is the Protocol to the Vienna Convention for the Protection of the Ozone Layer (ILM, 1987a). There have since been two amendments to the Protocol: one adopted at London "the 1991 London Amendment" (Montreal Protocol Parties: Adjustments and Amendments to the Montreal Protocol on Substances that Deplete the Ozone Layer) (ILM, 1991a), and the other adopted at Copenhagen, "the 1993 Copenhagen Amendment" (United Nations: Montreal Protocol on Substances that Deplete the Ozone Layer. Adjustments and Amendments) (ILM, 1993c).

¹⁹ Art. 10(1); see Annex VIII, Indicative List of Categories of Incremental Costs, UNEP/OzL.Pro.4/15, 25 November 1992, 51 and 735C6; on the Global Environmental Fund, see also Birnie and Boyle, 1995.

²⁰ A review of the list of activities in Appendix I reveals a closer connection between the Convention and FDI, as it includes operations that traditionally have involved TNCs. Activities include certain types of refineries, power stations, and chemical installations. Also included are groundwater abstraction activities; pulp and paper manufacturing; major mining, on-site extraction and processing of ores or coal; offshore hydrocarbon production; and, deforestation of large areas. In addition, infrastructure projects over a certain size are also included in the list. These are construction of motorways, railways, airports, oil and gas pipelines, seaports, waste-disposal installations, chemical treatment plants, large dams, and major storage facilities for petrochemical products. "Impact" means any effect caused by a proposed activity on the environment including human health and safety, flora, fauna, soil, air, water, climate, landscape and historical monuments or other physical structures or the interaction among these factors; it also includes effects on cultural heritage or socio-economic conditions resulting from alterations to those factors (article 1(vii) of the Convention).

Chapter 17. Employment*

Executive summary

The inclusion of employment issues into international investment agreements (IIAs) is a relatively new phenomenon. On the other hand, the development of international labour standards has a long pedigree dating back to the establishment of the International Labour Organization (ILO) in 1919. The main issues considered in this chapter are those specifically developed in international instruments in relation to transnational corporations (TNCs). The most important of these instruments are the 1977 ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (the ILO Tripartite Declaration) and the Chapter on Employment and Industrial Relations of the 1976 Organisation for Economic Co-operation and Development (OECD) Guidelines on Investment and Multinational Enterprises (OECD Guidelines) (which is part of a broader set of guidelines). Following what is covered by these instruments, the main issues concern general employment (including employment promotion, equality of opportunity and treatment, and security of employment), as well as human resources development, conditions of work and life, and industrial relations practices. In addition a category of emerging issues is covered, namely issues related to core labour standards and efforts to reflect these in international agreements through a “workers’ rights” or “social” clause. Many of the issues discussed in this chapter are also dealt with in instruments other than those mentioned here; however, these other instruments are not discussed in this chapter as its focus is on issues specifically concerning TNCs.

The chapter points out that employment promotion is a major goal pursued by Governments and that TNCs have an employment-generating potential that can be harnessed. At the same time, TNCs are called upon to promote equality of opportunity and therefore to base their employment policies on qualifications and skills. In this regard, they are also encouraged to invest in human resources development, especially in developing countries, so as to upgrade the human-capital base.

While recognizing that TNCs are generally progressive in terms of pay and conditions of work, IIAs can exhort them to maintain high standards, considering that the record of some foreign affiliates raises some concerns. Another important employment issue is that of industrial relations practices. The chapter illustrates how such related issues as the right of association, collective bargaining and consultation can be dealt with in an IIA. Finally, the chapter examines certain emerging issues, including expanding TNC specific IIA provisions to cover all core labour standards and efforts to ensure observance of such provisions through a social clause.

Employment issues interact with a number of other issues in IIAs. In particular, there are interactions with admission and establishment, as where investments are screened for their employment effects, and with host country operational measures, incentives and national treatment. For example, certain performance requirements may impose extra obligations on foreign investors, thereby requiring exceptions to principles of national treatment in IIAs. Further interactions arise in relation to issues of social responsibility and dispute settlement as employment policies are usually closely linked to a country’s obligations on these issues under an IIA. In some instances, interactions may also be with home country measures when home countries take measures aimed at affecting employment practices of foreign affiliates of their TNCs.

There are a number of options regarding clauses concerning employment that may be included in IIAs. At one extreme, an IIA may have no mention of employment issues. Secondly, an IIA could contain a general hortatory provision to the upholding of employment standards. Thirdly, an IIA could contain a commitment not to lower existing standards of protection to be found especially in the national laws of the contracting parties. Fourthly, an IIA could include a reference to the observance of employment issues contained in other IIAs or in international labour instruments generally. Finally, an IIA could include mandatory legal duties to observe certain employment standards.

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Introduction

The inclusion of employment issues into international agreements is at once an old and a new phenomenon. It is old in that the evolution of international standards in this field can be traced back to the work of the ILO, which has been at the forefront of the movement for the international regulation of employment issues since its inception in 1919 under Part XIII of the Treaty of Versailles (Israel, 1967). It is new in that specific consideration of employment issues in relation to foreign direct investment (FDI) and TNCs has occurred only since the mid-1970s. This chapter examines the treatment of such issues in the arena of FDI and TNCs.

Given the pre-eminence of some specialized international instruments in this field, section II provides some detail of their coverage as regards five main areas of TNC-related issues: employment promotion, opportunity and security of employment, human resources development, conditions of work and life and industrial relations (including freedom of association and the right to organize; collective bargaining and consultation; and examination of grievances and settlement of industrial disputes). Section II also examines to what extent IIAs have paid attention to emerging issues, such as the possible expansion of the scope of core labour standards to TNCs and the possible utilization of a social clause in this regard.

It is in the light of these issue areas that alternative approaches to the drafting of employment related clauses in IIAs are then examined. The varying relationship between employment issues and the aims and purposes of IIAs is reflected in the different approaches as regards clauses included in IIAs. These present a number of policy options which are further discussed in the conclusion.

Section I Explanation of the Issue

FDI generates employment in host countries directly and indirectly. Foreign affiliates of TNCs directly employ people in, for example, their natural resources projects, manufacturing plants and service industries. Estimates suggest that direct employment in foreign affiliates in developing countries numbered around 19 million at the end of the 1990s (UNCTAD, 1999b) (table 1).

Table 1. Estimated employment in TNCs
(Millions of employees)

Economy	Total employment in TNC ^a	Employment in affiliates in developed countries	Employment in affiliates in developing countries
All countries			
1985	65	15	7
1995	78	15	15
1998	86	17	19
Memo item:			
Employment in TNCs from:			
United States (1996)	26.4	4.9	2.7
Japan (1995)	5.6	0.8	1.4
Germany (1996)	..	2.0	1.0

Source : UNCTAD, 1999b, p. 265.

^a Including parent firms and foreign affiliates.

TNCs also generate indirect employment through enterprises that are suppliers, subcontractors or service providers to them; indirect employment created by foreign affiliates is larger than direct employment, amounting to between one and two times the number of jobs created directly in these affiliates (UNCTAD, 1999b). Much foreign affiliate employment is concentrated in manufacturing and modern services where the employment practices of TNCs often have a demonstration effect.

Given the growing integration of the world economy, the employment practices of TNCs come increasingly under international scrutiny. Besides the importance of their employment-generating potential, TNCs, as a major force in the transnationalization of the world's economies, can have significant impact in a number of key areas related to employment. Following the ILO and OECD approaches in this regard, five areas are traditionally identified as being of special importance and particular relevance to FDI and TNC issues. In addition, some new issues are emerging that bear on the subject of this chapter. This chapter thus deals with employment issues under six headings:

- **Employment promotion.** The issue of employment promotion is intricately connected with aspirations for economic development. It is particularly important for host developing countries where unemployment is most serious. The labour force in the developing world is growing each year at around two per cent (ILO, 1998b; World Bank, 1997a). Population growth and increasing labour force participation are

continuously adding new entrants to the work force. Thus, for example, in 1997, open unemployment ranged from 3 to 15 per cent in the urban areas of Latin America and 5 to 20 per cent in those in Africa; this in addition to a substantial amount of hidden unemployment (UNCTAD, 1999b). Increasing employment thus ranks high as a policy objective for developing countries. While there is no simple method of evaluating the impact of FDI flows on employment creation, in general “positive employment effects have been found to be associated with inward FDI” (UNCTAD, 1994, p. 169). Governments therefore pursue as a major goal the encouragement of TNCs to stimulate economic growth by promoting the growth of employment.

- **Opportunity and security of employment.** A fundamental right concerning employment issues is that of non-discrimination in employment matters whether on grounds inter alia of race, colour, sex, national extraction or social origin, religion or political opinion. Equality of opportunity in employment implies that TNCs should base their employment policies on qualifications and skills. A related issue is security of employment. Of particular relevance is the question of how to deal with changes of operations by firms and their effects on employment. This may, for example, require a set of duties to be observed by firms in the process of restructuring their operations.
- **Human resources development.** A third issue, which flows naturally from the second, concerns the education and training of workers. This issue has become especially significant in recent years as the effects of global economic integration have manifested themselves inter alia in changing patterns of employment both in developed and developing countries. Complex integration strategies of TNCs (UNCTAD, 1993) are likely to involve training programmes with different implications for host and home countries. The issue for many developing countries that host low-skill foreign affiliate manufacturers is how to move themselves towards skill upgrading, higher value-added activities and better quality FDI. The problem is how to change the mix of skills, and ensure that skilled workers find better remunerated employment that is commensurate with such skills while moving up from their established

base of competitiveness in low-skill activities. To put it another way, how can Governments “draw upon the resources offered by TNCs to upgrade their human-capital base while keeping their economy cost-competitive and attractive?” (UNCTAD, 1999b, p. 275). Of major importance, of course, is the question of the role of IIAs in this respect.

- **Conditions of work and life.** The main issues of concern here are, first, wages and benefits, and, second, safety and health matters. Considering their size, technological sophistication and origin principally in developed countries, TNCs are often expected to be better employers than domestic firms (UNCTAD, 1999b). Moreover, when it comes to these aspects, foreign affiliates generally have a great deal of autonomy in the determination of wages and working conditions and can therefore go beyond minimum national requirements (UNCTAD, 1994, 1999b). On the other hand, TNCs, like all private enterprises, are driven by the profit motive and thus, while generally progressive in terms of pay and conditions of work in host countries, the record of some foreign affiliates raises some concerns. This is especially the case in export processing zones (ILO, 1998c) and with respect to the conditions of work and life provided by sub-contractors of TNCs. Also of relevance to the issue of conditions of work and life is the issue of how to ensure that TNCs maintain high standards of safety and health.
- **Industrial relations practices.** Decisions affecting the quantity and quality of employment, human resources development and conditions of work and life are primarily the responsibility of management. But these decisions have to be taken in the context of national industrial relations and need to take account of workers’ views – hence the importance of trade unions and the right of association. The right of association connotes rights of collective bargaining and consultation, which ensure that workers representatives have access to employers for the purposes of not only bargaining but of consultation from which information relevant to the bargaining process (that may be only in the possession of employers) is conveyed to those representatives. Furthermore, it is important to ensure that workers’ grievances can be aired without prejudice to the workers

concerned and that appropriate procedures for the settlement of disputes are in place.

- **Emerging issues.** A new and rather controversial issue in the FDI/TNC context is that relating to the use of a “social clause” in an IIA. This issue has its origin in the context of trade negotiations. One mechanism put forward to link “workers’ rights” – and, in particular, certain core labour standards – and trade is the idea of including a social clause in trade agreements. It is characterised by two key elements. First, it would be based on already agreed and widely ratified international standards contained in ILO conventions. Second, it would ensure observance of core labour standards by linking them to market access.¹ The benefits of an agreement would thereby become conditional on the observance of certain workers’ rights by the contracting parties.² One of the issues that makes discussion on the use of a social clause rather controversial is the question of its potential scope. This is particularly relevant as employment issues concerning TNCs are increasingly discussed in a wider context. For example, certain core labour standards previously not covered by TNC specific provisions are finding their way into a number of international instruments (as will be indicated in section II). While the idea of linking certain core labour standards to FDI *per se* is not entirely new, what is new and could have wider implications, would be to expand the current scope of such standards.

Section II Stocktaking and Analysis

Employment and labour issues are relatively uncommon in IIAs. They have only appeared in the 1970s on the agenda of IIAs, predominantly on the regional or multilateral levels.⁴ The most comprehensive international instruments in this area remain the 1977 ILO Tripartite Declaration and the 1976 OECD Guidelines’ Employment Chapter (box 1).⁵

Since the ILO Tripartite Declaration and the OECD Guidelines’ Employment Chapter form what is the most comprehensive statement to date of the kinds of issues identified in section I, much of the following discussion focuses on them. Where other international instruments contain

relevant provisions, they are, of course, also brought into the discussion.

Box 1. Principal features of the ILO Tripartite Declaration and the OECD Guidelines’ employment Chapter

The Tripartite Declaration, adopted by the Governing Body of the ILO in November 1977, was the outcome of a decade of research and discussion on the relationship between TNCs and social policy (Günter and Bailey, 1992).^a The OECD Guidelines’ Employment Chapter is part of the more general OECD Guidelines on Investment and Multinational Enterprises (OECD Guidelines). It is less detailed than the ILO Tripartite Declaration. Some of the principal features to note about these two instruments are the following:

Legal status. The ILO Tripartite Declaration is addressed jointly to Governments, employers’ and workers’ organizations and to TNCs in both home and host countries. By contrast, the OECD Guidelines are addressed by OECD Governments and other adhering countries (at present Argentina, Brazil and Chile) to TNCs and all their entities operating in their territories. Neither the ILO Tripartite Declaration nor the OECD Guidelines are mandatory or legally enforceable. They are voluntary and promotional, but their application (or, better, follow-up) is monitored by the institutional machinery available in both cases.

Definition of TNCs. Both the Declaration and the Guidelines adopt a functional definition of the types of enterprise to which they are addressed. Thus by paragraph 6 of the ILO Tripartite Declaration, TNCs engaged in all types of activity are considered as falling under its provisions, irrespective of whether they are of public, mixed or private ownership or as to their type of activity, so long as there is cross-border economic management of entities established in various countries. Like the ILO Tripartite Declaration, the OECD Guidelines’ Employment Chapter applies to TNCs engaged in all types of activity regardless of their pattern of ownership or control. Moreover, the OECD Guidelines are addressed to the various parent companies and/ or local entities (paragraph 8) “according to the actual distribution of responsibilities among them on the understanding that they will co-operate and provide assistance to one another as necessary to facilitate observance of the Guidelines”.

Relevance to domestic firms. Both instruments provide that, where their recommendations are relevant to domestic firms, they should be considered as applying to them as well.

Scope. The OECD Guidelines are wider than the ILO Tripartite Declaration in that they cover general policies, disclosure of information, competition, financing, taxation, environmental issues and science and technology as well as employment and industrial

/...

Box 1 (concluded)

relations.^e The Guidelines are part of a package of international instruments that together seek to provide a balanced framework for dealing with international investment issues, including national treatment, incentives and disincentives and conflicting requirements. The Tripartite Declaration has four major areas: general employment issues; training; conditions of work and life and industrial relations.

Source: UNCTAD.

^a In 1987 the Governing Body approved an addendum to take account of relevant post-1977 ILO Conventions and Recommendations, and this was updated in 1995.

^b The OECD Committee on International Investment and Multinational Enterprises also issues clarifications where necessary to help clarify the meaning of the Guidelines.

^c One of the important proposed changes in the draft text of the revised Guidelines is that they encourage TNCs to observe the Guidelines wherever they operate.

^d Both instruments also use the terminology "multinational enterprise" rather than the United Nations terminology "transnational corporation". References to TNCs in this chapter are therefore equivalent to references to "multinational enterprises" as defined in both the ILO Tripartite Declaration and the OECD Guidelines.

^e For the proposed coverage of the revised Guidelines, see footnote 5.

A. Employment promotion

The instrument that gives the most detailed attention to this broad issue is the ILO Tripartite Declaration. It asserts (paragraph 13) that Governments should "declare and pursue, as a major goal, an active policy designed to promote full, productive and freely chosen employment", and (paragraph 16) that TNCs, "particularly when operating in developing countries, should endeavour to increase employment opportunities and standards, taking into account the employment policies and objectives of the governments, as well as security of employment and the long-term development of the enterprise".

To this general objective, paragraphs 17, 18 and 19 of the Declaration add specific duties:

- to consult with host country authorities and national employers' and workers' organizations in order to keep manpower plans in harmony with national social development policies;
- to give priority to the employment and promotion of host country nationals; and
- when investing in developing countries, to use technologies which generate employment.

Furthermore, paragraph 20 provides that, to promote employment in developing countries, supply contracts with local enterprises should be concluded whenever practicable, and TNCs should stimulate the use and the processing of local raw materials.

The OECD Guidelines' Employment Chapter does not espouse the broader goal of employment promotion. However paragraph 2 of the General Policies Chapter in the OECD instrument mentions the "creation of employment opportunities" as a matter to which TNCs should give due consideration.

Some IIAs make the optimal use of local labour an objective for the promotion of TNCs. For example, article 2 of the Charter on a Regime of Multinational Industrial Enterprises in the Preferential Trade Area for Eastern and Southern African States provides that the establishment and promotion of such enterprises shall, among other objectives, be governed by "the development of industries making optimal use of labour available locally and within the subregion". Yet other agreements emphasize reduction of unemployment. Article 101 (2)(v) of the Treaty Establishing the Common Market for Eastern and Southern Africa provides that the member States shall determine the conditions that shall govern the multinational industrial enterprises that "through their activities, provide substantial employment or reduce unemployment within the territories of the Member States ...". The Treaty for the Establishment of the Preferential Trade Area for Eastern and Southern African States uses the same exact wording in its article 2(a)(v).

Other IIAs make employment promotion a condition or advantage for the grant of incentives. Article 8 (2) of the Common Convention on Investments in the States of the Customs and Economic Union of Central Africa provides that the creation of employment and vocational training are among criteria for investments to qualify for a certain preferential schedule.

On the other hand, other IIAs emphasize that the treatment accorded to investors will contribute to their ability to create employment opportunities. In its preamble, the draft text of the OECD's Multilateral Agreement on Investment (MAI) provides:

"Recognising that agreement upon the treatment to be accorded to investors and their investments will contribute to the efficient utilisation of economic resources, the creation

of employment opportunities and the improvement of living standards...” (OECD, 1998b, p. 7).

B. Opportunity and security of employment

1. Equality of opportunity and treatment

Paragraph 21 of the ILO Tripartite Declaration states that “[a]ll governments should pursue policies designed to promote equality of opportunity and treatment in employment, with a view to eliminating any discrimination based on race, colour, sex, religion, political opinion, national extraction or social origin.”⁶ TNCs should be guided by the same principles throughout their operations but without prejudice to preferential treatment for host country employees or to governmental policies designed to correct historical patterns of discrimination. Equally, Governments should never encourage TNCs to pursue discriminatory policies.

The United Nations draft Code of Conduct on Transnational Corporations provides (Article 13) that, “[i]n their social and industrial relations, transnational corporations should/shall not discriminate on the basis of race, colour, sex, religion, language, social, national and ethnic origin or political or other opinion”. It also provides that TNCs should conform to Government policies “designed to extend equality of opportunity and treatment” (ibid.).

Some IIAs make a point of emphasizing that the employment related rights enjoyed by nationals are equally applicable to foreigners from all States party to the IIAs. Article 11 (a) of the Community Investment Code of the Economic Community of the Great Lakes Countries provides as follows:

“Workers who are Community nationals shall be governed by labour legislation and social laws under the same conditions as nationals. They may participate in trade union activities and belong to bodies defending employee rights. They shall be further governed by the general agreement on social security between the member countries of the Community”.

It should be noted that the ILO Tripartite Declaration accepts “affirmative action” on the basis of government policies. The OECD Guidelines’ Employment Chapter, too, recommends (paragraph 7) that enterprises should:

“Implement their employment policies including hiring, discharge, pay, promotion and training without discrimination unless selectivity in respect of employee characteristics is in furtherance of established governmental policies which specifically promote greater equality of employment opportunity”.

Neither code has raised significant issues of interpretation in this area. Most countries accept non-discrimination in employment as a principle. In this respect TNCs are subject to the same requirements and pressures as national enterprises. Much depends on the internal “management culture” and whether, regardless of legal rules, a moral principle of non-discrimination is observed (Muchlinski, 1999, p. 463).

2. Security of employment

Governments are encouraged by the ILO Tripartite Declaration to study the impact of TNCs on employment and develop suitable policies to deal with the employment and labour market impacts of TNC operations. In their turn, TNCs and national enterprises should, through active manpower planning, “endeavour to provide stable employment for their employees and should observe freely-negotiated obligations concerning employment stability and social security” (paragraph 25). Furthermore, TNCs, because of the flexibility they are assumed to have, are exhorted to assume a leading role in promoting security of employment, particularly in countries where the discontinuation of operations is likely to accentuate long-term unemployment. The Declaration further states that arbitrary dismissal procedures should be avoided, and that Governments, in cooperation with TNCs and national enterprises, should provide some form of income protection for workers whose employment has been terminated.⁷

Both the ILO Tripartite Declaration and the OECD Guidelines’ Employment Chapter accept that TNCs are free to change their operations, even if this results in major employment effects, as in the case of the closure of an entity involving collective layoffs or dismissals, or in a merger, takeover or transfer of production which results in employment rationalization. At the same time, as indicated later in this chapter on the discussion of industrial relations, changes of operations – including closing of firms or collective lay-offs – should not be used as a threat in collective bargaining.

The OECD Guidelines' Employment Chapter (paragraph 6) provides that in such cases TNCs should provide reasonable notice of the impending changes to the representatives of their employees, and to relevant governmental authorities, and should cooperate in the mitigation, to the greatest possible extent, of any adverse effects. This has been clarified by the OECD Committee on International Investment and Multinational Enterprises. The Committee observed that, in general, for notice to be reasonable, it should be sufficiently timely for the purpose of mitigating action to be prepared and put into effect. Furthermore, management should normally be able to provide notice prior to the final decision being taken (OECD, 1992a).

The United Nations draft Code of Conduct on Transnational Corporations requires (Article 44) annual employment information including the average number of employees.

C. Human resources development

On the issue of human resource development, the ILO Tripartite Declaration encourages Governments to develop national policies for vocational training and guidance, closely linked with employment. TNCs are encouraged to ensure that relevant training is provided for at all levels of employees in the host country to meet the needs of the enterprise as well as the development policies of the country. This should develop generally useful skills and promote career opportunities. Furthermore, in developing countries, TNCs are exhorted to participate in special programmes aimed at encouraging skill formation and development.

The OECD Guidelines' Employment Chapter provides for much the same approach. It states (paragraph 5) that TNCs, "[i]n their operations, to the greatest extent practicable, utilise, train and prepare for upgrading members of the local labour force in co-operation with representatives of their employees and, where appropriate, the relevant governmental authorities".

D. Conditions of work and life

Issues related to conditions of work and life can be divided between, on the one hand, wages, benefits and conditions of work and, on the other, safety and health matters. The ILO Tripartite Declaration covers all of them. The OECD Guidelines' Employment Chapter says little on the first set of

issues, simply asserting that TNCs should observe standards of employment no less favourable than those observed by comparable employers in the host country.

1. Wages, benefits and conditions of work

Like the OECD Guidelines' Employment Chapter, here, too, the ILO Tripartite Declaration applies a standard of equality of treatment, or non-discrimination, to these matters. Thus paragraph 33 of the Declaration provides that:

"Wages, benefits and conditions of work offered by multinational enterprises should be not less favourable to the workers than those offered by comparable employers in the country concerned".⁸

When operating in developing countries, where comparable employers may not exist, TNCs should provide the "best possible wages, benefits and conditions of work, within the framework of government policies" (paragraph 34). These should be related to the "economic position of the enterprise, but should be at least adequate to satisfy basic needs of the workers and their families" and where TNCs "provide workers with basic amenities such as housing, medical care or food, these amenities should be of a good standard" (*ibid.*).⁹

Finally, the Declaration exhorts Governments, especially in developing countries, to endeavour to adopt suitable measures to ensure that lower income groups and less developed areas benefit as much as possible from the activities of TNCs (*ibid.*).

2. Safety and health

The ILO Tripartite Declaration urges Governments that have not already done so to ratify ILO Conventions in the field of safety and health,¹⁰ while in paragraph 37 TNCs are required to maintain the "highest standards of safety and health, in conformity with national requirements, bearing in mind their relevant experience within the enterprise as a whole, including any knowledge of special hazards". Furthermore, TNCs are urged to make available information on safety and health standards relevant to their local operations, which they observe in other countries, to workers' representatives in the enterprise and, upon request, to the competent authorities and to workers' and employers' organizations in the countries in which they operate. In particular, special hazards and

related protective measures associated with new products and processes should be made known to those concerned. This part of the Declaration ends with exhortations to TNCs to cooperate in the work of international organizations in the preparation of international safety and health standards, and with national authorities and representatives of workers' organizations and specialist safety and health organizations. Where appropriate, matters relating to safety and health should be incorporated into agreements with workers' representatives and their organizations.

E. Industrial relations

There are several important issues under this heading: freedom of association and the right to organize, collective bargaining and consultation, examination of grievances and the settlement of industrial disputes. As far as the ILO Tripartite Declaration (paragraph 40) is concerned, each area is subject to the overriding general principle that TNCs "should observe standards of industrial relations not less favourable than those observed by comparable employers in the country concerned". The OECD Guidelines' Employment Chapter contains the same general principle (paragraph 4).

1. Freedom of association and the right to organize

Freedom of association and the right to join workers' organizations have been one of the central guiding policies of international labour instruments. In fact, as recently as 1998, the ILO Declaration on Fundamental Principles and Rights at Work reaffirmed freedom of association among the core labour standards (ILO, 1998a). The ILO Tripartite Declaration recognizes in paragraph 41 the right of workers to establish and to join organizations of their own choosing without previous authorization, and to enjoy adequate protection against anti-union discrimination in respect of their employment and makes reference to the Freedom of Association and Protection of the Right to Organise Convention No. 87, article 2 (1948) and the Right to Organise and Collective Bargaining Convention No. 98 article 1(1) (1949). The establishment, functioning and administration of such organizations should not be interfered with by other organizations whether representing TNCs or workers in their employment.

The ILO Tripartite Declaration enumerates certain specific policies that Governments should and should not follow in the furtherance of the freedom of association. They are urged:

- to ensure that workers in TNCs are not hindered in meeting and consulting with one another;
- not to restrict the entry of representatives of workers' and employers' organizations from other countries; and
- to permit workers' and employers' organizations which represent, respectively, the workers and the TNCs in which they work, to affiliate with international organizations of workers and employers of their choosing.

This last obligation, which is provided for in paragraph 44 of the ILO Tripartite Declaration, may be of importance in relation to the development of international collective bargaining, as it accepts the legitimacy of entering organizational structures that can facilitate this. Indeed, the OECD Guidelines' Employment Chapter includes, among "other bona fide organisations of employees" International Trade Secretariats as bodies entitled to represent workers (OECD Guidelines' Employment Chapter, paragraph 1 as interpreted in the 1986 Review of the OECD Guidelines). International Trade Secretariats represent affiliated national unions in the same, or similar, industries. They can offer co-ordinating facilities for the exchange of information and, in exceptional cases, they have acted as the organizers of international industrial action.

Governments are also urged not to offer any limitation of the workers' freedom of association, or of the right to organize and bargain collectively, as special incentives to attract FDI. Thus, the ILO Tripartite Declaration exhorts Governments not to engage in a "race to the bottom" over trade union rights.

2. Collective bargaining and consultation

With regard to the issue of collective bargaining and consultation, both the ILO Tripartite Declaration and the OECD Guidelines' Employment Chapter assert (in paragraph 48 and paragraph 1, respectively) that the employees of TNCs should have the right, in accordance with national law and practice, to have representative organizations of their own choosing recognized for the purpose of collective bargaining. What constitutes collective bargaining is a matter for

interpretation in the context of different national situations. The ILO Tripartite Declaration may offer some harmonization in this regard in that it recommends the taking of measures appropriate to national conditions for the encouragement and promotion of negotiations through collective agreements in accordance with ILO Convention No. 98, article 4. The ILO Convention may therefore provide a basis for identifying the common expectations that a system of collective bargaining should fulfil. The ILO Tripartite Declaration also seeks to encourage the development of systems for consultation between employers and workers and their representatives on matters of mutual concern. However, such consultations should not substitute for collective bargaining.

Both the ILO Tripartite Declaration and the OECD Guidelines' Employment Chapter expect TNCs to provide the facilities necessary for the development of effective collective agreements, and to provide workers' representatives with information required for meaningful negotiations on conditions of employment. Thus paragraph 54 of the ILO Tripartite Declaration provides that this should give a "true and fair view of the performance of the entity or, where appropriate, of the enterprise as a whole". The ILO Tripartite Declaration and the OECD Guidelines' Employment Chapter also recommend that the provision of information must accord with local law and practice. The ILO Tripartite Declaration urges Governments to help workers' representatives by furnishing them, where the law permits, with information about the industry in which the TNC concerned operates. It urges TNCs to observe any requests from Governments for relevant information on their operations.

Furthermore, the two instruments recognize the implications of the group structure of TNCs for effective collective bargaining. Each instrument demands that the authorized representatives of employees conduct negotiations with representatives of management who are authorized to take decisions on the matters under negotiation (ILO Tripartite Declaration, paragraph 51; OECD Guidelines' Employment Chapter, paragraph 9). Under the OECD Guidelines' Employment Chapter this requirement means that parent companies may be obliged to take the necessary organizational steps to enable their foreign affiliates to observe the Chapter, *inter alia*, by providing them with sufficient and timely information and ensuring that local managers are

duly authorized to take the decisions on matters under negotiation. Alternatively, the parent company may delegate a member of the decision-making centre to the negotiating team of the affiliate, or engage directly in negotiations, so as to achieve the same result. Furthermore, employees' representatives maybe entitled to information about the decision-making structure within an enterprise, but such a right of information is confined to the negotiating situations referred to in the Chapter. There is no general right to be informed about the decision-making structure within the enterprise. Additionally, negotiations should take place in a language understood by both sides.

Finally, both instruments also address the problem of unfair pressure being brought to bear upon negotiations with workers' representatives by TNCs as a result of the international scope of their operations. Thus the ILO Tripartite Declaration states in paragraph 52: "Multinational enterprises, in the context of bona fide negotiations with the workers' representatives on conditions of employment, or while workers are exercising the right to organise, should not threaten to utilise a capacity to transfer the whole or part of an operating unit from the country concerned in order to influence unfairly those negotiations or to hinder the exercise of the right to organise; nor should they transfer workers from affiliates in foreign countries with a view to undermining bona fide negotiations with the workers' representatives or the workers' exercise of their right to organise".

The OECD Guidelines' Employment Chapter contains essentially the same formulation in paragraph 8:

"Enterprises should, within the framework of law, regulations and prevailing labour relations and employment practices, in each of the countries in which they operate:

.....

In the context of bona fide negotiations with representatives of employees on conditions of employment, or while employees are exercising a right to organise, not threaten to utilise a capacity to transfer the whole or part of an operating unit from the country concerned nor transfer employees from the enterprises' component entities in other countries in order to influence unfairly those negotiations or to hinder the exercise of the right to organise".

It adds that "bona fide negotiations may include labour disputes as part of the process of negotiation. Whether or not labour disputes are so

included will be determined by the law and prevailing employment practices of particular countries". An important issue arising from this provision is the distinction between, on one hand, the legitimate provision of information and, on the other hand, threats designed to influence negotiations unfairly. A distinction should be drawn between giving employees information to the effect that a particular demand has serious implications for the economic viability of the enterprise, and the making of a threat. Furthermore, it is also important to note that, while the Employment Chapter was drafted to consider only operations involving existing plant and equipment, future investments (such as the replacement of equipment or the introduction of new technology) could be crucial to the survival of the enterprise in the medium to long term and thus might be of interest in this context. So, not only threats of withdrawal from current operations but also threats to run down an operation might be seen as "unfair", in the absence of information that justifies such a decision (Muchlinski, 1999, p. 479).

The OECD Guidelines' Employment Chapter also makes provision not to "import" strike-breaking employees from affiliates in other countries. This requirement was absent from the original formulation of the OECD Guidelines' Employment Chapter. However, it was inserted in 1979 as a result of the interpretation of the Chapter by the OECD Committee on International Investment and Multinational Enterprises in the light of such a case. The Committee observed that the transfer of employees from foreign affiliates could unfairly influence negotiations and was contrary to the general spirit and approach of the OECD Guidelines even if it did not contravene them. Consequently, this gap in the original formulation was remedied through the insertion of appropriate words.

3. Examination of grievances and settlement of industrial disputes

The ILO Tripartite Declaration also addresses the examination of grievances and the settlement of industrial disputes. Regarding workers' grievances, the following principle is recommended to TNCs (paragraph 57):

"... any worker who, acting individually or jointly with other workers, considers that he has grounds for a grievance should have the right to submit such grievance without suffering any prejudice whatsoever as a result,

and to have such grievance examined pursuant to an appropriate procedure."

This is seen as particularly important where a TNC operates in a country that does not abide by the principles of ILO conventions relating to freedom of association, the right to organize and bargain collectively and to forced labour.

The ILO Tripartite Declaration ends (paragraph 58) with a recommendation that TNCs should seek to establish, with the representatives and organizations of the workers whom they employ, voluntary conciliation machinery to assist in the prevention and settlement of industrial disputes. This machinery should include equal representation for employers and workers, and it should be appropriate to national conditions. It may include provisions for voluntary arbitration.

F. Emerging issues

Independent of what has been discussed above in reference to TNC specific provisions on employment issues in international investment instruments, increasing efforts have been made in the past decade to identify certain core labour standards. The ILO Declaration of Fundamental Principles and Rights at Work (adopted by the International Labour Conference at its 86th session on 18 June 1998 - ILO, 1998a) set out, in paragraph 2, four basic obligations, often referred to as core labour standards (box 2).

Among these core labour standards are two – freedom of association and non-discrimination –

Box 2. Core labour standards restated by the ILO Declaration of 1998

" [A]ll Members, even if they have not ratified the Conventions in question, have an obligation, arising from the very fact of membership in the Organisation, to respect, to promote and to realize, in good faith and in accordance with the Constitution, the principles concerning the fundamental rights which are the subject of those Conventions, namely:

- (a) freedom of association and the effective recognition of the right to collective bargaining;
- (b) the elimination of all forms of forced or compulsory labour;
- (c) the effective abolition of child labour; and
- (d) the elimination of discrimination in respect of employment and occupation".

Source: ILO, 1998a, p. 7.

that are addressed in the principal international instruments dealing with employment matters (see above). Two others, however – the elimination of forced or compulsory labour and the abolition of child labour – have crystallized in the ILO but have, until very recently, not been discussed specifically in the context of TNCs. But to the extent that they are standards of good behaviour for companies in general, they are also relevant to TNCs. This is reflected in the fact that some corporate codes explicitly refer to them.¹¹

Most recently, the identification of the two latter core labour standards has come up in connection with the revision of the OECD Guidelines. More specifically, the Draft Text and Commentary of the OECD Guidelines (OECD, 2000a) provides (paragraph 1(b) and (c) of Chapter IV) that:

“Enterprises should, within the framework of applicable law, regulations and prevailing labour relations and employment practices:

...

- b) Contribute to the effective abolition of child labour and, in particular, not engage in the worst forms of child labour in their operations;
- c) Contribute to the elimination of all forms of forced or compulsory labour and, in particular, not engage in the use of such labour in their operations ...”

As the review of the OECD Guidelines is not yet concluded, it remains to be seen whether this instrument is a step towards advancing certain workers’ rights.

The identification of certain standards as four labour standards focuses attention on them. Linking them – through the inclusion of a social clause – to international agreements makes obtaining the benefits of an agreement (e.g. market access) conditional on the observation of these core labour standards, especially where such agreements provide for sanctions in case of non-observance.

So far, the discussions of a social clause have focused on trade agreements. There are, however, signs that this approach is also beginning to find its way into IIAs. (It needs to be reemphasized, however, that some core labour standards are already included in traditional and -- employment-centred -- international instruments.) At the bilateral level, for example, the United States-Argentina bilateral investment treaty (BIT) (1991) (preamble, paragraph 5) speaks of promoting “respect for internationally recognized

worker rights” (ILM, 1992c, p. 128), but does not explain the phrase. Similarly, the United States-Bolivia BIT preamble makes provision for:

“Recognizing that the development of economic and business ties can promote respect for internationally recognized worker rights ...” (United States, State Department, 1992, p. 1).

While being vague may imply an unknown scope for the meaning of “internationally recognized worker rights”, it is important to note that this appears only in the preamble; its enforceability, if that were an issue, is therefore debatable.

In similar fashion, the draft MAI text made provision in its preamble for:

“Renewing their commitment to the Copenhagen Declaration of the World Summit on Social Development and to observance of internationally recognised core labour standards, i.e. freedom of association, the right to organise and bargain collectively, prohibition of forced labour, the elimination of exploitative forms of child labour, and non-discrimination in employment, and noting that the International Labour Organization is the competent body to set and deal with core labour standards world-wide” (OECD, 1998b, p. 9).

The issue is also pertinent to the operations of the Multilateral Investment Guarantee Agency (MIGA). Under its Environmental and Social Review Procedures, paragraph 16 provides that MIGA will not provide guarantees for certain types of business activities, including enterprises “involving slave labour or child labour inconsistent with internationally recognised norms” (MIGA, 1999).

The North American Agreement on Labour Co-operation (NAALC) (ILM, 1993d), which came into force in January 1994, is another example of linking a regional IIA arrangement with labour co-operation in industrial relations and worker rights. Although NAALC is a “side” agreement, rather than an integral part of the North American Free Trade Agreement (NAFTA), it is significant in that it links employment issues to the NAFTA through a binding dispute resolution mechanism and allows for the partial suspension of NAFTA benefits where a country is found to be in breach of its own labour laws and regulations and where the breach is trade-related (and, through the natural relationship between trade and investment, this implies investment related issues as well).¹²

Its preamble calls, among other things, for protecting, enhancing and enforcing basic workers' rights; strengthening labour-management co-operation; promoting higher living standards; and encouraging compliance with labour laws and co-operation in maintaining a progressive, fair, safe and healthy working environment. The objectives of the NAALC include the improvement of working conditions and living standards; the promotion of eleven guiding labour principles; and the promotion of compliance with, and effective enforcement of, labour laws. The obligations under the NAALC require that each government ensure that its labour laws provide for high labour standards (Article 2), promote compliance with and effectively enforce its labour laws (Article 3), and ensure access to tribunals through proceedings that are fair, equitable and transparent (Article 4 and 5).

Annex 1, incorporated by reference in Article 1 (b) of the Agreement, outlines the eleven guiding labour principles to which the parties commit to promote through their respective domestic laws: freedom of association and the right to organize; the right to bargain collectively; the right to strike; the prohibition of forced labour; labour protections for children and young persons; assurance of minimum labour standards; elimination of employment discrimination; equal pay for women and men; prevention of occupational injuries and illnesses; compensation in cases of occupational illnesses and injuries; and protection of migrant workers.

As can be seen from this review, few IIAs address directly employment and related issues. However, some IIAs deal with some or all of the issues identified above, either through a cross reference to other international instruments or by adopting a "no lowering of standards" clause.

As regards the former approach, most prominent is perhaps the United Nations draft Code. While emphasizing the role of national laws in dealing with labour relations, the United Nations draft Code refers to the ILO Tripartite Declaration, making it in fact the social chapter of the United Nations draft Code (Article 46):

"With due regard to the relevant provisions of the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy and in accordance with national laws, regulations and practices in the field of labour relations transnational corporations should/ shall provide to trade unions or other representatives of employees in their entities in each of the countries in which they operate, by

appropriate means of communication, the necessary information on the activities dealt with in this code to enable them to obtain a true and fair view of the performance of the local entity and, where appropriate, the corporation as a whole".

Paragraph (a) of appendix II of the Charter of Trade Union Demands for the Legislative Control of Multinational Companies takes an even stronger approach to the relationship between national laws and ILO standards. It requires that, if national laws conflict with ILO standards, the latter prevail. In effect, therefore, it takes a fundamental rights approach whereby ILO standards are at the minimum made applicable. It states as follows:

"Regarding employment and industrial relations the following obligations should be imposed on the multinational companies:

(a) multinational companies shall follow the laws, the rules and the practices of the host country regarding the labour market **only** if these are not inferior to the standards of the International Labour Organization in which case those of the ILO shall be followed".

On the issue of a "no lowering of standards" clause, certain IIAs contain a clause whereby the parties agree not to compete for inward FDI by lowering employment standards. In this connection, Article 1114 of NAFTA is of some relevance. It specifies that:

"... it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement".

Though limited to health, safety and environmental measures, the approach of this provision can be adapted to employment issues in general, as well as to other emerging issues.

Indeed, the draft MAI contains three alternative formulations for a no lowering of standards clause (box 3). They cover not only health, safety and environmental standards but also labour standards. The Chairperson's "Proposals on Environment and Related Matters and on Labour"¹³ include *inter alia* a binding "not

lowering measures” provision whereby a contracting party:

“shall not waive or otherwise derogate from, ... its domestic health, safety, environmental, or labour measures, as an encouragement to the establishment, acquisition, expansion, operation, management, maintenance, use, engagement and sale or other disposition of an investment of an investor”(OECD, 1998b, p. 144).

Box 3. Draft MAI formulations for a no lowering of standards clause

Alternative 1

[The Parties recognise that it is inappropriate to encourage investment by lowering [domestic] health, safety or environmental [standards][measures] or relaxing [domestic] [core] labour standards. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such [standards] [measures] as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.]

Alternative 2

[A Contracting Party [shall] [should] not waive or otherwise derogate from, or offer to waive or otherwise derogate from [domestic] health, safety or environmental [measures] [standards] or [domestic] [core] labour standards as an encouragement for the establishment, acquisition, expansion or retention of an investment of an investor.]

Alternative 3

[1. The Parties recognise that it is inappropriate to encourage investment by lowering domestic health, safety or environmental measures or relaxing international core labour standards.

2. A Contracting Party [shall] [should] accord to investors of another Contracting Party and their investments treatment no more favourable than it accords its own investors by waiving or otherwise derogating from, or offering to waive or otherwise derogate from domestic health, safety, environmental or labour measures, with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of an investment.

3. A Contracting Party [shall] [should] not take any measure which derogates from, or offer to derogate from, international health, safety or environmental laws or international core labour standards as an encouragement for investment on its territory.]

Source: OECD, 1998b, pp. 143-144.

It is interesting to note that the draft MAI text uses the phrase “shall not” whereas Article 1114 of NAFTA referred to above uses the phrase “should not”, implying that the latter is not legally binding.

In some cases, the no lowering of standards approach may be implied by IIA provisions that encourage the co-ordination of domestic labour legislation. For example, the Agreement on Arab Economic Unity provides in article 2 that:

“For attaining the unity mentioned in Article (1) the contracting states shall work for accomplishing ... [C]o-ordinating labour and social insurance legislation...”.

Some developing countries may regard a no lowering of standards clause as a form of reverse protectionism in that it prevents them from competing with more developed investment locations on legitimate cost grounds connected with a less regulated investment environment. Thus, an IIA may also attempt to impose an obligation on the investor’s home country not to engage in protectionism based on employment policies. Article VI, 2(a) of the 1972 International Chamber of Commerce Guidelines for International Investment has an interesting formulation in this regard. It provides that the investor’s country’s Government “[s]hould, in formulating policies aimed at securing full employment, rely on stimulating domestic demand through appropriate economic and social policies, rather than on restrictions on the outflow of direct investment”.

On this issue it is interesting to note that paragraph 6 in Chapter I of the draft revised OECD Guidelines provides that “Governments adhering to the *Guidelines* should not use them for protectionist purposes nor use them in a way that calls into question the comparative advantage of any country where multinational enterprises invest” (OECD, 2000a).

* * *

Section III Interaction with other Issues and Concepts

This section examines how employment issues – in whatever instrument or agreement they may be addressed – tend to interact with other issues and concepts covered by these volumes. Employment

issues are closely affected by their interaction with other aspects of international investment agreements (table 2).

Table 2. Interaction across issues and concepts

Issue	Employment
Admission and establishment	++
Competition	0
Dispute settlement (investor-State)	+
Dispute settlement (State-State)	++
Environment	+
Fair and equitable treatment	+
Home country measures	++
Host country operational measures	++
Illicit payment	0
Incentives	++
Investment-related trade measures	+
Most-favoured-nation treatment	+
National treatment	++
Scope and definition	+
Social responsibility	++
State contracts	0
Taking of property	0
Taxation	0
Technology transfer	+
Transfer of funds	0
Transfer pricing	0
Transparency	0

Source: UNCTAD.

Key: 0 = negligible or no interaction
 + = moderate interaction
 ++ = extensive interaction

- **Admission and establishment.** IIAs that allow for some discretion before investments are made enable Governments to direct TNCs to activities which have scope for creating more employment and which are also more likely to transfer and diffuse high levels of skills.
- **Incentives.** Such an objective can also be promoted through the use of incentives. A system of incentives (e.g. agreed tax deductions for training) may be used to attract FDI to areas of high unemployment and into skill-intensive technologies that offer opportunities for training and diffusion. Export incentives and facilities in export processing zones may, for example, lead to FDI in labour intensive activities. On the other hand, such zones may not promote a number of employment standards.
- **Home country measures.** Where home countries set standards that foreign affiliates of

their TNCs need to meet, there is a potential for interaction between such measures and employment issues. Some of the codes of conduct regarding the then apartheid South Africa are an example in this respect (box 4).

Box 4. Promoting employment standards through home country measures

Efforts to deal with international concern with the labour situation in the then apartheid South Africa exemplify home country measures in the area of employment. In 1977, the Ministers for Foreign Affairs of the States members of the European Community adopted a Code of Conduct for Companies with Subsidiaries, Branches or Representation in South Africa. The Code, which applied only to African employees, called on TNCs to: facilitate labour union organisation and activities; counter the effects of the migrant labour system; improve wage rates; promote policies of "equal pay for equal work"; take steps to improve the living conditions of employees, including housing, health, education and leisure; and desegregate places of work (UNCTC, 1986). The Code called for a reporting procedure. However, the Code was voluntary. In addition, there was no consistent reporting system. Moreover, some Governments issued public reports on its implementation but others did not. Furthermore, those member countries that reported on the implementation of the Code did not rate the performance of individual corporations.

Source: UNCTAD.

^a Similar efforts resulted in Canada's Code of Conduct Concerning the Employment Practices of Canadian Companies Operating in South Africa and the 1977 Sullivan Principles – a private undertaking by Reverend Leon Sullivan, a member of the Board of Directors of General Motors – which were designed "to promote racial equality in employment practices for United States firms operating in the Republic of South Africa" (UNCTC, 1986, p. 90).

- **Host country operational measures and national treatment.** The intermingling of these two issues underscores the importance of a coherent approach towards the goal of a host State's employment policies. Performance requirements may include priority for the employment of nationals, the promotion of local personnel, the use of local sub-contractors etc. Similarly, measures sought to enhance job growth in, and the development of human resources of, a host State may have been tailored in a manner that flexibility remains in an IIA to provide for some preferential treatment of domestic labour by foreign investors. Such measures might give rise to national treatment issues under an IIA if

they do not equally apply to nationals of the host country.

- **Social responsibility.** Contributions to the generation of employment and the ensuring of security and continuity of employment are substantive standards of social responsibility. There are mutually supportive effects between the two, where strengthening one strengthens the other.
- **Dispute settlement.** Where a specific measure that is intended to implement an employment policy standard runs counter to a host State's obligations under an IIA, a claim may be triggered that is dealt with in accordance with the dispute settlement provisions therein. In this connection, some IIAs incorporate the use of specialist institutions and/or their specific criteria to assist in the settlement of disputes.

Conclusion: Economic and Development Implications and Policy Options

The role that FDI might play in employment promotion, opportunity and security of employment, human resource development, improving conditions of work and life, promoting healthy industrial relations, and dealing with emerging issues related to labour standards, depend to a large extent on the amount and type of FDI that a country receives. But government policies can also have a significant impact on strategies to pursue specific employment objectives (UNCTAD, 1999b, ch. IX).

Traditionally, Governments, employers, employees and local trade unions and employer organisations have been the main actors in employment policy. The growth of international corporate production systems has added to this a transnational angle by emphasizing the social dimension of globalisation. This is reflected in the fact that employment issues enter international discussions on IIAs. This brings with it a number of questions. Should IIAs in general be used as instruments to promote employment issues, or should this be left for specialized labour instruments? Should such standards be binding or non-binding? How should these standards be defined? Should corporate codes of conduct be promoted instead of (or in addition to) governmental action? The discussion of these questions entails some political sensitivity. It requires a balancing of arguments that the

prescription of certain standards could in certain circumstances actually lead to a form of disguised protectionism on the one hand and those arguments that emphasize the need to promote certain minimum standards, on the other hand.

In light of the foregoing discussion, the following policy options present themselves:

Option 1: No specific provision on employment issues.

As indicated before, most IIAs have no specific provisions relating to employment and related issues. It is relevant to note in this connection that the approach of TNCs to employment issues often depends on their management culture and corporate strategies. In particular, TNCs may attempt on their own volition to meet labour and employment standards that are higher than national or international prescribed norms. This may be encouraged through corporate codes of conduct. Nevertheless, the increasing internationalization of the issue suggests that references to employment issues in IIAs could possibly become more common. Thus other options are discussed below.

Option 2: A general hortatory provision.

IIAs could limit themselves to a simple exhortation that the parties should promote or observe some or all of the employment conditions discussed above. In other words, they would simply exhort the parties to encourage employment promotion; opportunity and security of employment; human resources development; good conditions of work and life; and industrial relations rights. One could add to this emerging issues. Alternatively, the clause may not refer to any of the specific issues. Such an approach could serve the purpose of acknowledging that certain standards exist, but it does not spell out what these standards are nor whether the contracting parties need to observe any particular one of them. Thus this option would be attractive in cases where there is little consensus between the parties on the nature and content of what should be covered but where there is a recognition of the political significance of, and linkage between, employment issues and the promotion and protection of investors and their investments.

Option 3. No lowering of standards.

A "no lowering of standards" clause could be employed with the principal objective of ensuring that countries do not compete for FDI by deliberately lowering employment standards. Here the basic choices are between:

- a binding or non-binding provision; or

- a provision referring to domestic measures only or one that also (or in the alternative) refers to core international labour standards.

Option 4: Cross reference to other international instruments.

A number of international instruments exist that may be used to serve this approach. At the level of international agreements, these include:

Option 4 (a): Observance of TNC related employment issues.

This model could be based on the contents of the ILO Tripartite Declaration or the OECD Guidelines' Employment Chapter. The extensive and detailed contents of the ILO Tripartite Declaration and the more general contents of the OECD Guidelines' Employment Chapter offer two distinct options:

- a clause could be included that incorporates these ILO and OECD instruments into IIAs by reference thereto, without the text of the documents being reproduced;
- IIAs could contain an annex through which the ILO Tripartite Declaration and/or the OECD Guidelines' Employment Chapter is appended to an agreement.

Option 4 (b): Additional observance of ILO core labour standards.

This approach would have the implication that, in addition to the observance of TNC related employment issues as contained in the ILO Tripartite Declaration and the OECD Guidelines' Employment Chapter (before the January 2000 draft), IIAs would require that the ILO's fundamental principles and rights at work, set out in the ILO's Declaration of June 1998, become the subject of obligations of observance.¹⁴ Such an approach could be of interest to a country that wants to meet the demands of a more comprehensive labour standards programme that goes beyond those directly related to TNCs.

Option 5: Mandatory legal duties to observe employment provisions.

Another level of dealing with employment issues in IIAs would be to render the treatment of certain employment and related issues into a mandatory legal obligation for the contracting parties. This could be done as a matter of a purely

international legal obligation, for example, through a social clause, or it could go further and create directly effective rights under the national laws of the contracting parties. This would offer workers in those countries effective legal standards upon which to base their claims.

* * *

The inclusion of employment issues in IIAs has been – and is – a controversial matter. These issues have traditionally been the preserve of national laws and practices. However, the work of the ILO in this field, coupled with an increasingly integrated global economy and market- and production place, combine to put the debate on employment issues in the international arena. Given that TNCs, as the most prominent agents of international economic integration, are particularly visible as producers and employers around the world, the inclusion of clauses concerning corporate practices in the field of employment may increasingly be seen as consistent with the aims of IIAs. Whether or not, however, this will actually occur depends on the negotiating objectives and bargaining strength of the parties concerned.

Notes

- ¹ See for example TUAC, 1996 and ICFTU, 1998.
- ² For a fuller explanation of the position of the main advocate of this approach, see ICFTU, 1999. For arguments of the opposite view, see Anderson, 1996.
- ³ For further discussion of other relevant issues, see Hepple, 1997.
- ⁴ In parallel with employment policy instruments developed at national and international levels, a number of corporations, mainly TNCs, have developed and adopted individual or industry-wide principles that define what they consider to be acceptable standards for their employees to follow. These corporate codes of conduct usually address workplace and other employment-related issues. The motivations for the adoption of these codes include the recognition of – among other things – the existence of a certain social responsibility (UNCTAD, 1999b, chapter XII).
- ⁵ Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996a, 2000a, 2001a, 2002b and 2004c. The Guidelines were revised several times, lastly in 1991. At the time of writing of this chapter, the OECD Guidelines were in the process of being reviewed extensively and updated, with the draft text having become available during January 2000. This chapter is based on the existing text. The draft text of the revised version is divided into ten sections: Concepts and Principles, General Policies,

Disclosure, Employment and Industrial Relations, Environment, Combating Bribery, Consumer Interests, Science and Technology, Competition and Taxation. Where appropriate, reference is made to the draft text, although it must be underlined that it is a draft only, subject to changes. The draft Guidelines and the present implementation procedures can be consulted on the OECD's web site at <http://www.oecd.org/daf/investment/guidelines/newtext.htm>. Additional background information on the OECD Guidelines for Multinational Enterprises, as well as the other three instruments of the OECD Declaration on International Investment and Multinational Enterprises, may be found on <http://www.oecd.org/daf/investment/guidelines/declarat.htm>.

- ⁶ It also refers to the Discrimination (Employment and Occupation) Recommendation No. 111 (1958) and the Workers with Family Responsibilities Convention No. 156 (1981).
- ⁷ See ILO Tripartite Declaration, paragraph 27 and the Termination of Employment Convention No. 158 and the Maintenance of Social Security Rights Convention No. 157 (both 1982) and the Termination of Employment Recommendation No. 119 (1963) and the ILO Tripartite Declaration, paragraph 28.
- ⁸ In the draft OECD Guidelines under review, TNCs are encouraged to observe "standards of employment and industrial relations not less favourable than those observed by comparable employers in the host country" (paragraph 4 of the draft Employment Chapter). In the commentary to the text, it is stated that compensation and working-time arrangements are understood to be included in paragraph 4 of the draft text.
- ⁹ In that regard paragraph 34 makes reference to the Conditions of Employment of Plantation Workers Convention and Recommendation No. 110 (both 1958), the Workers' Housing Recommendation No. 115 (1961), the Medical Care Recommendation No. 69 (1944), the Medical Care and Sickness Convention No. 130 and the Medical Care and Sickness Recommendation No. 134 (both 1969).
- ¹⁰ Paragraph 36 specifically refers to the Guarding of Machinery Convention No. 119 (1963), the Benzene Convention No. 136 (1971), the Occupational Cancer Convention No. 139 (1974), the Working Environment (Air Pollution, Noise and Vibration) Convention No. 148 (1977), the Workers with Family Responsibilities Convention No. 156 (1981), the Occupational Safety and Health Convention No. 155 (1981), the Health Protection and Medical Care (Seafarers) Convention No. 164 (1987), the Occupational Health Services Convention No. 161 (1985) and the Asbestos Convention No. 162 (1986).
- ¹¹ See, for example, Levi Straus Business Partner Terms of Engagement: UNCTAD, 1994, p. 325, box VIII.6.
- ¹² Where Canada is the party complained against, the procedures set out in Article 41 providing for suspension of benefits do not apply. Rather, the procedures adopted under Annex 41A apply. These set out a system under which Canada's federal courts enforce fines filed against provinces of Canada that are bound by the Agreement.
- ¹³ It is notable that the Chairperson's Proposals on Environment and Related Matters and on Labour referred, in its preamble, to the ILO and noted that it is "the competent body to set and deal with core labour standards worldwide".
- ¹⁴ The draft revised OECD Guidelines also refer to all the core labour standards set out in the ILO's Declaration of June 1998.

Chapter 18. Social Responsibility*

Executive summary

The social responsibility of corporations, including transnational corporations (TNCs), is typically not addressed in most international investment agreements (IIAs). Nonetheless, it is a question that has been raised through the adoption, since the 1970s, of international codes of conduct for TNCs. More recently, it has been addressed in a number of international fora and the United Nations Global Compact. The concept of corporate social responsibility is potentially very wide and may encompass most matters pertaining to the economic and social impact of TNCs. However, a more specialized approach to this concept is emerging. As a result, a number of aspects — including development obligations, socio-political obligations and consumer protection — have received some attention, and others (especially corporate governance, ethical business standards and the observance of human rights) seem to be emerging issues. These matters constitute the focus of the present chapter. This is in addition to obligations particularly as regards the environment and employment issues, which are sufficiently developed in relation to their operation in international investment instruments to deserve separate study in other chapters in these volumes.

Given that the issues covered by this chapter are relatively new to IIAs, but that their content is already developed in other instruments and codes of conduct, the stocktaking in section II draws not only on IIA provisions but also on provisions in other instruments that offer examples of the types of provisions that may be used to operationalize social responsibility obligations.

Social responsibility obligations interact with a number of other concepts, including taxation, transfer pricing, competition, transfer of technology, employment, environment, illicit payments and transparency. These interactions are considered in section III. As such, social responsibility provisions interact with a great number of other issues to be found in IIAs.

The concluding section considers economic and development implications,

particularly policy options. The challenge is to balance the promotion and protection of liberalized market conditions for investors with the need to pursue development policies; social responsibility obligations are one way to move towards such a balance. Above all, social responsibility standards must be applied with sensitivity to the realities of local conditions in developing countries and should not be misused for protectionist purposes. In this light, the policy options discussed range from an absence of any reference to social responsibility in IIAs to the inclusion of non-binding standards through the reservation of regulatory powers in relation to social responsibility to the use of a no lowering of standard clause, home country promotional measures and, lastly, the inclusion of generally binding social responsibility provisions.

Introduction

Corporate social responsibility is a well-known concept in national law. Its origins can be traced to the rise of modern corporations whose shares can be freely traded on stock markets. This has necessitated a degree of protection for shareholders, who need sufficient and accurate information about the performance of companies as a guide to their investment decisions. This in turn has led to comprehensive laws on shareholder protection, both through the regulation of governance structures and disclosure regimes under company laws and through specialized securities laws that govern the trading of stocks and shares.

However, new issues of corporate social responsibility have emerged. No longer are companies regarded as being responsible to shareholders alone, although this concept still holds a central position in legal systems. For example, responsibility to employees and other “stakeholders” in a company is a concept that has gradually been gaining ground in national laws. Furthermore, wider issues, such as the need for companies to take active and responsible steps to minimize pollution, to protect consumer interests, to refrain from illicit practices or to observe

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fundamental ethical and human rights standards, have also inspired new regulatory initiatives.

These national trends are beginning to have an impact at the international level as well. The aim of this chapter is to examine how far issues of corporate social responsibility have found their way into the provisions of IIAs. Although not a central feature in most IIAs, social responsibility provisions seem to be increasingly in evidence, especially in relation to labour, environmental and consumer protection questions. However, as sections I and II will show, there are a number of other issues that come under the umbrella of social responsibility. Defining the boundaries of this concept is thus the first task of this chapter, and is addressed in section I.

Section II analyses existing provisions in IIAs that cover the defined field. These may take the form of non-binding or binding clauses; they may be addressed to Governments, to Governments and enterprises, or to enterprises alone, and may be generated by intergovernmental organizations, national Governments, TNCs, industry groups, employers' associations, or civil society groups acting through non-governmental organizations (NGOs) or trade unions. The implications of these alternative sources are considered. Section III looks at interactions between the concept of social responsibility and other IIA issues, while the concluding section outlines policy options for negotiators in this field.

Section I Explanation of the Issue

Corporate social responsibility is at the heart of the obligations that firms owe to the societies in which they operate.¹ This relationship is further accentuated and sensitized when the firms involved are foreign affiliates of TNCs. Such obligations can be seen as the *quid pro quo* for the protection of investors and investments under IIAs, should the negotiating parties to an IIA seek such a balance of rights and responsibilities for investors and their investments. However, it may also be argued that such responsibilities amount to corporate duties that should be discharged independently of the protection given by host countries to foreign investment.

What precisely is meant by social responsibility in the context of IIAs? This issue can

be considered in the broader context of the overall obligations of TNCs, and these can be drawn rather widely. For instance, the United Nations draft Code of Conduct on Transnational Corporations² (which was never adopted) lists the obligations of TNCs across a wide range of issues relating to such matters as respect for the sovereignty of the host State and its political system, respect for human rights, abstention from corrupt practices, refraining from using their economic power in a manner damaging to the economic well-being of the countries in which they operate, including observance of tax and anti-monopoly laws, and ensuring full disclosure concerning their activities. (A full listing of the matters covered by the United Nations draft Code of Conduct is given in box 1.) A similar list of obligations is to be found in the (voluntary) OECD Guidelines for Multinational Enterprises, which were revised in 2000 (box 2).

As may be apparent from this wide-ranging list of issues, the precise classification of corporate social responsibility standards is difficult, since the concept potentially covers all aspects of corporate behaviour. However, some typology is necessary so that negotiators can have a more focused view as to what issues fall under this general heading.

In this connection, the United Nations Secretary-General, Kofi Annan, in a speech to the World Economic Forum in Davos on 31 January 1999, challenged world business leaders to “embrace and enact”, both in their individual corporate practices and by supporting appropriate public policies, nine universally agreed values and principles derived from universally accepted United Nations instruments. He placed observance of human rights, labour rights and environmental protection at the heart of a socially responsible agenda for global business (box 3). This list was not designed as a code, but as a “framework of reference to stimulate best practices”, in order to bridge the legitimacy gap created by the rapidity of economic globalization outpacing “the ability of societies and their political systems to adjust to them, let alone to guide the course they take” (Annan, 1999). This is intended as an inter-agency activity of the United Nations (involving the International Labour Organization, the United Nations Environment Programme and the Office of the High Commissioner for Human Rights) (Kell and Ruggie, 1999).

Box 1. Principal obligations of TNCs in the United Nations draft Code of Conduct on Transnational Corporations

The draft Code of Conduct lists the obligations of TNCs under the general heading of “Activities of Transnational Corporations”, comprising three subheadings. Under the subheading “General and political”, the following are found:

- “respect for national sovereignty and observance of domestic laws, regulations and administrative practices;”
- “adherence to economic goals and development objectives, policies and priorities;”
- “review and renegotiation of contracts;”
- “adherence to socio-cultural objectives and values;”
- “respect for human rights and fundamental freedoms;”
- “non-collaboration by transnational corporations with racist minority regimes in southern Africa;”^a
- “non-interference in internal political affairs;”
- “non-interference in intergovernmental relations;”
- “abstention from corrupt practices.”

Under the subheading “Economic, financial and social” responsibilities come:

- the duty, by TNCs, to allocate their decision-making powers among their entities so as to enable them to contribute to the economic and social development of the countries in which they operate;
- observance of the balance of payments policies and financial transactions policies of such countries;
- avoidance of transfer pricing practices;
- avoidance of corporate structures and practices aimed to modify the tax base of the corporation contrary to national laws and regulations;
- observance of the principles concerning restrictive business practices and competition as contained in the Set of Multilaterally agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the General Assembly in resolution 35/63 of 5 December 1980;
- contribution to strengthening the technological capacities of developing countries in accordance with the practices and priorities of these countries;
- observance of national consumer protection laws and regulations and international standards;
- observance of environmental protection laws and regulations and international standards;
- take steps to protect the environment and make efforts to develop and apply adequate technologies for this purpose.

The third subheading concerns “Disclosure of Information” and urges TNCs to disclose to the public in the countries in which they operate, by appropriate means of communication, full and comprehensible information on the structure, policies, activities and operations of the TNC as a whole.

Source: UNCTAD, 1996a, vol. I. pp. 161-171.

^a The apartheid regime in Southern Africa has since been abolished.

Box 2. The OECD Guidelines for Multinational Enterprises

II. General Policies ^a

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

1. Contribute to economic, social and environmental progress with a view to achieving sustainable development.
2. Respect the human rights of those affected by their activities consistent with the host government’s international obligations and commitments.
3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise’s activities in domestic and foreign markets, consistent with the need for sound commercial practice.
4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees.
5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues.
6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices.
7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate.
8. Promote employee awareness of, and compliance with, company policies through appropriate dissemination of these policies, including through training programmes.
9. Refrain from discriminatory or disciplinary action against employees who make *bona fide* reports to management or, as appropriate, to the competent authorities, on practices that contravene the law, the *Guidelines* or the enterprise’s policies.
10. Encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the *Guidelines*. 11. Abstain from any improper involvement in local political activities.” The *OECD Guidelines* also have an implementation mechanism which, among other things, can make use of National Contact Points.”

Source: OECD, 2000a, pp. 3-4.

^a The remaining chapters include “Disclosure”, “Employment and Industrial Relations”, “Environment”, “Combating Bribery”, “Consumer Interests”, “Science and Technology”, “Competition and Taxation”.

Box 3. A compact for the new century

The Secretary-General asked world business to uphold the following:

1. The Universal Declaration of Human Rights

- support and respect the protection of international human rights within their sphere of influence; and
- make sure their own corporations are not complicit in human rights abuses.

2. The International Labour Organisation's Declaration on fundamental principles and rights at work

- freedom of association and the effective recognition of the right to collective bargaining;
- the elimination of all forms of forced and compulsory labour;
- the effective abolition of child labour; and
- the elimination of discrimination in respect of employment and occupation.

3. The Rio Declaration of the United Nations Conference on Environment and Development

- support a precautionary approach to environmental challenges;
- undertake initiatives to promote greater environmental responsibility;
- encourage the development and diffusion of environmentally friendly technologies.

Source: UNCTAD, based on Annan, 1999.

With regard to drawing up social responsibility provisions for IIAs, the key issues identified by the Secretary-General are by no means exhaustive (UNCTAD, 1999c and 2003a). Other issues of relevance to developing countries in particular (especially in the economic area) can be gleaned from the above-mentioned United Nations draft Code of Conduct and the OECD Guidelines for Multinational Enterprises. They include technology transfer, training of the local workforce, the importance of backward linkages and the promotion of local entrepreneurship. Equally, certain issues of interest to both developing and developed countries regarding the proper regulation of corporate behaviour are also present in the draft Code and the Guidelines. In particular, requirements regarding transparency through corporate disclosure, accountability through corporate governance structures to various stakeholder groups, and ethical responsibility in relation to such matters as illicit payments, advertising and product safety and quality could be included under the broad heading of social responsibility.

Thus, social responsibility may assume economic, social, political and ethical dimensions in that TNCs are expected to conduct their economic affairs in good faith and in accordance

with proper standards of economic activity, while also observing fundamental principles of good socio-political and ethical conduct. Although the latter issue has been dealt with in the past — as witnessed, for example, by the references to the observance of human rights and non co-operation with the apartheid regime in South Africa in the United Nations draft Code of Conduct — it is receiving renewed emphasis today, as shown by the Secretary-General's highlighting of these issues. Such a position is also taken in the General Policies section of the revised OECD Guidelines (box 2). On the other hand, responsibilities in respect of economic matters (which were prominent in earlier years) are receiving less attention, in line with a general inclination in the economic sphere to rely more on market forces. The rise of social, ethical and environmental concerns suggests, however, that, a certain re-balancing may eventually take place — if only because market pressures may seek to protect their brand names by behaving in a socially responsible manner and avoid being caught in a general impression that business is socially irresponsible because of the behaviour of firms.

Given the range of questions that come under the heading of “corporate social responsibility”, they can not all be covered in one chapter. Indeed, certain issues have generated sufficient IIA practice and/or are important enough in their own right to deserve being dealt with in separate chapters in these volumes. These include:

- environmental issues;
- employment;
- transfer of funds;
- competition;
- transfer pricing;
- taxation;
- technology transfer;
- illicit payments; and
- transparency and disclosure.

These matters will therefore not be discussed in the present chapter, although, brief references and illustrations taken from these other areas will be used where this adds to the clarification of the issues discussed here.

The present chapter focuses on certain specific questions of social responsibility that extend the coverage of IIAs to matters falling within the broad notions of development obligations, socio-political obligations, and the protection of consumers. These can be briefly introduced as follows:

- **Development obligations.** Such obligations arise as a result of TNCs potential impact on the economic development goals of the host countries in which they operate. In particular, countries seek to harness the economic resources of TNCs to help achieve such goals. On the other hand, there is a danger that their weight may be applied without due consideration of its effects on such goals. Consequently, certain development-oriented IIAs have addressed the issue by requiring enterprises to observe development policy goals in their operations. Equally, non-governmental instruments have stressed the need for TNCs to act in a manner consistent with development goals. As discussed earlier, development obligations cover a number of economic issues. Given their importance, they are dealt with in separate chapters. (See also chapter VI of UNCTAD, 2003a.) The discussion below therefore focuses only on the broader concept of development obligations.
- **Socio-political obligations.** Apart from employment issues, which (owing to their importance) are examined in a separate chapter,³ these cover such corporate responsibilities to host countries as non-involvement in a host country's political processes, observance of the sovereignty and cultural integrity of host countries, and cooperation in good faith with the economic and social policies of those countries. These obligations were included in various codes of conduct relating to TNCs developed during the 1970s, as a response to the perceived risk to host country sovereignty and independence posed by powerful TNCs.
- **Consumer protection.** With the growth of international business, consumer issues have, in their turn, taken on an increasingly international character, involving issues relating to, among others, marketing, product packaging, sales and safety. In response, a trend has developed in intergovernmental organizations dealing with specific consumer-oriented issues towards drawing up codes of conduct after consultation with experts, corporations, civil society and other interested parties, in areas that have become of central interest to society, given the potential (if not actual) harm that corporate activity could generate for consumers in the area concerned. The best-known example is the WHO Code of Breast-milk Substitutes. More general

initiatives have taken place at the level of the United Nations and the OECD. These will be examined further in section II below.

Three other areas are increasingly being addressed by firms in their own corporate codes and in national laws concerning corporate responsibilities, as well as in some international instruments. These *emerging issues* may well become important in relation to IIAs in the years ahead:

- **Corporate governance rules** have more recently been set out in an OECD instrument. Corporate governance, as defined in the OECD Principles, concerns primarily the relationships between a company's management, its board, its shareholders and its other stakeholders. In the main, these relationships involve the governance of a corporation for gain. However, the reference to "other stakeholders" introduces issues of corporate social responsibility, in that this term refers to other groups of persons interested in the operation of a corporation apart from its investors, namely employees, contractors, trade unions, consumers and consumer groups and the general public at large. Indeed, the OECD Principles assert, in the Preamble, that "factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long-term success of that company".
- **Ethical business standards** have hitherto generated numerous corporate, industry, governmental and intergovernmental codes dealing not only with industry-specific matters but also, more broadly, general policies of good corporate behaviour that seek to ensure an ethical approach to the conduct of business.
- **The observance of human rights** standards by TNCs has generated a number of codes and guidelines emanating from civil society groups, which require *inter alia* respect by TNCs for fundamental human rights in their relations with local communities in the countries in which they operate, avoidance of complicity in human rights abuses and violations by the Governments of countries of those countries, and ensuring that corporate security policies do not violate human rights.

In each case, new transnational standards of good corporate conduct may be developed which may qualify the scope of investor protection standards

in IIAs, especially as regards the issue of home or host country regulation.

The next section of this chapter provides a general survey of these more specific measures or provisions covering social responsibility areas that are not dealt with in other chapters in these volumes.

Section II Stocktaking and Analysis

Following on from the list of issues discussed in section I, this section analyses in more detail the substance of existing IIAs dealing with social responsibility. Overall, it needs to be noted that the subject matter of this chapter is conspicuous by its relative absence from IIAs. On the other hand, there are numerous voluntary codes of conduct developed by TNCs, industry groups, employers' organizations, NGOs and intergovernmental organizations that have produced standards in this area and may help in creating an environment that could promote the wider acceptance of their provisions by the international community. At the same time, however, care needs to be taken that social responsibility standards are not abused for protectionist purposes. While concentrating primarily on the provisions of IIAs, this section will also draw on those other sources as necessary so as to provide a more complete picture of the types of issues that may arise in connection with future IIAs.

A. Development obligations

Certain IIAs introduce positive, albeit voluntary, obligations upon enterprises to act in a manner consistent with the development goals and policies of the developing countries in which they operate. Thus the United Nations draft Code of Conduct on TNCs stresses, in paragraph 9, the need for TNCs to carry out their activities in conformity with the development policies, objectives and priorities set out by the Governments of the countries in which they operate. TNCs are, in addition, expected to work seriously towards the achievement of those objectives and to consult with those countries for that purpose. Similarly, the revised OECD Guidelines provide that enterprises should "contribute to economic, social and environmental progress with a view to achieving sustainable development" (OECD, 2000a, p. 3). This general commitment to sustainable development is accordingly echoed in the Guideline on the

environment, in which enterprises are required to take due account of the need to protect the environment, and public health and safety, and generally conduct their activities in a manner contributing to the wider goal of sustainable development (*ibid.*, p. 6). Likewise, the Guideline on Science and Technology exhorts enterprises to ensure that their policies in this area are compatible with those of the countries in which they operate and that they contribute to the development of local and national innovative capacity. In addition, where enterprises grant licences for the use of intellectual property rights, or otherwise transfer technology, they should do so on reasonable terms and conditions and in a manner that contributes to the long-term development prospects of the host country (*ibid.*, p. 8). Finally, in relation to the Guideline on Disclosure, the OECD Commentary on the revised Guidelines notes that enterprises may take special steps to make information available to communities that do not have access to printed media, for example poorer communities that are directly affected by the enterprise's activities (OECD, 2000b, p. 6, para. 17).

In contrast to the voluntary provisions outlined above, a particular type of a binding, development-oriented clause can be found in regional investment promotion agreements entered into by developing countries *inter se*. Typically, such agreements may offer preferential treatment for enterprises established by regional investors from more than one member country. Such treatment is made conditional upon observance, by the enterprise in question, of the development objectives of the member countries in which the enterprise operates. Failure to observe these objectives may lead to the withdrawal of privileged status for the enterprise.

Another source for development oriented social responsibility clauses can be found in instruments adopted by NGOs. Thus, for example, the International Chamber of Commerce's Guidelines for International Investment of 1972, under the heading "Investment Policies", state that investors should consult over the proposed investment and its "fit" with the economic and social development plans of host countries. Similarly, the Charter of Trade Union Demands for the Legislative Control of Multinational Companies drawn up in 1975 by the International Confederation of Free Trade Unions (ICFTU), lists in an Appendix on the Social Obligations of Multinational Companies, three development-specific obligations to be observed by such companies:

- to inform the authorities and trade unions of the home and host countries as to their ongoing or planned activities for the purpose of adjusting these to the economic and social planning of both countries;
- to use production methods and forms of cooperation that are in harmony with the economic and social conditions of the host country and contribute to a development consistent with that country's interests;
- to contribute to a development fund in developing host countries in which they operate.

Box 4. Development obligations imposed on regional multinational enterprises in investment promotion agreements between developing countries

- Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) (1982), Article 19: the authorized Community enterprise shall agree *inter alia* to “develop local resources; give priority of supply to CEPGL Member States in times of scarcity; give priority to exports to Member States of the goods produced”. The privileges of the enterprise may be revoked under the procedure outlined in Articles 50-53.
- Charter on a Regime of Multinational Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States (1990), Article 17: MIEs are obliged to implement a local value-added programme, an export programme and a training programme. Under Article 19 MIEs must contribute to “a Special Development Tax for the benefit of the less developed Member States of the Preferential Trade Area”. Under Article 20 the status of an MIE can be revoked for “a serious violation or a number of recurring violations of this Charter”.
- Agreement for the Establishment of a Regime for Caribbean Community (CARICOM) Enterprises (1987): Article 3 provides for a general power to determine the purposes and functions of such an enterprise. Article 11 (2c) allows for the revocation of such status where the enterprise carries out business in gross or persistent violation of the Agreement.

Source: UNCTAD, 1996a.

Finally, the Pacific Basin Charter on International Investments, issued by the Pacific Basin Economic Council in 1995, under the heading “Basic Principles”, asserts that:

“International investors, in pursuit of their business objectives, should proceed in ways which will contribute to economic and social

development, particularly in host economies, and they should maintain a sensitivity to changing domestic goals and aspirations in all economies with which they are concerned.”

There are also a number of instruments issued by NGOs that include provisions declaring that TNCs should observe the general development policies of the countries in which they operate. Thus:

- The draft NGO Charter on Transnational Corporations issued by the People's Action Network to Monitor Japanese Transnational Corporations Abroad (PAN), in its Code of Conduct for TNCs, asserts that TNCs should make every possible effort to help develop the economic and social independence of the host country.
- The Polaris Institute of Canada, in its discussion paper “Towards a Citizens' MAI ” includes within its “Operating Principles” a section on corporate responsibilities which highlights certain social responsibilities that corporations should meet in return for their right to invest. First, they must ensure that their investment is designed to serve the public interest by meeting performance requirements such as labour and environmental standards; second they must recognize the right and responsibilities of States to protect, preserve or enhance strategic areas of their economies and the commons. Third, they must contribute to revenues through taxation that can be used for social programmes, environmental projects, cultural initiatives and a variety of public services.
- The World Development Movement's Core Standards of 1999 include, under the heading “Sovereignty and development strategies ”, a section requiring TNCs to take account of countries' policy objectives, including development and social priorities. They should pay due regard to using technologies that generate employment and consider giving contracts to local companies using local materials and local processing.

Thus there are some significant models that may form the basis of future clauses aimed at promoting corporate social responsibility in the area of development. As noted earlier, a number of IIAs also deal with specific economic issues in terms of seeking to establish development obligations for TNCs. Given their importance, they are being dealt with in separate chapters.

B. Socio-political obligations

Under this heading, IIAs have considered what is perhaps the most politically sensitive question to have emerged from the relationship between TNCs and developing host countries in particular. It concerns the question of how far a TNC can, or should, become actively involved in the internal and external political processes of a host country, and how far it should respect the national, political, social, cultural and economic policy goals of that country. This raises questions as to the scope of clauses dealing with this issue. Do they aim to prevent TNCs from *any* involvement in the political processes of the countries in which they invest, or do they merely prevent improper involvement, e.g. where a particular activity is illegal under the law of the country concerned?

As noted in section I, the United Nations draft Code of Conduct contains a section addressing the “Activities of Transnational Corporations”. The standards for TNC’s activities which are stressed, in relation to social and political obligations, are the following:

- respect for national sovereignty and observance of domestic laws, regulations and administrative practices;
- review and renegotiation of contracts;
- adherence to socio-cultural objectives and values;
- non-collaboration by TNCs with racist minority regimes in southern Africa;
- non-interference in internal political affairs; and
- non-interference in intergovernmental relations.

Similarly, the OECD’s Guidelines for Multinational Enterprises are directly addressed to TNCs (OECD, 2000a). As can be seen in box 2, the revised Guidelines mention a number of general social obligations that should be observed by TNCs in their dealings with the countries in which they operate. Each obligation is subject to a general duty on enterprises to take fully into account established policies in the countries in which they operate, and to consider the views of other stakeholders. On the specific question of social and political obligations, point 11 of the General Policies Guidelines states that enterprises should “abstain from any improper involvement in local political activities”. This includes (point 6 of the section on “Combating Bribery”) that enterprises should “not make illegal contributions to candidates for public office or to political parties

or to other political organisations. Contributions should fully comply with public disclosure requirements and should be reported to senior management”. These norms re-emphasise the obligation of TNCs to respect legitimate forms of political behaviour. However the Commentary on the Guidelines is silent on the scope and meaning of this duty. Thus there is little guidance as to the effect of this provision.

In addition, another non-binding code, the Asia Pacific Economic Cooperation (APEC) Non-Binding Investment Principles, states, under the heading of “Investor Behaviour”:

“Acceptance of foreign investment is facilitated when foreign investors abide by the host economy’s laws, regulations, administrative guidelines and policies, just as domestic investors should”.

Apart from the above-mentioned codes, relatively few IIAs expressly include a provision on political or social responsibility. One example arises from the Agreement on Promotion, Protection and Guarantee of Investments Among Member States of the Organisation of the Islamic Conference (1981). Under Article 9 thereof:

“ The investor shall be bound by the laws and regulations in force in the host state and shall refrain from all acts that may disturb public order or morals or that may be prejudicial to the public interest. He is also to refrain from exercising restrictive practices and from trying to achieve gains through unlawful means.”

In addition, the Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) (1982), Article 21, provides that authorization for inclusion under its regime of advantages for Community enterprises does not exempt an authorized enterprise from compliance with the political, financial, fiscal and social legislation of the host country.

Certain codes developed by civil society groups also address the issue of social and political obligations of TNCs. Thus, the World Development Movement’s Core Standards include a section requiring TNCs to respect every State’s right to choose its own economic system and to regulate foreign investment and the activities of TNCs within its jurisdiction. Similarly, the PAN draft NGO Charter on Transnational Corporations requires that TNCs operate in harmony with the local economy and culture. This involves duties to observe strictly the laws, regulations and administrative practices of a country or international standards regarding pollution

controls, environmental protection, consumer protection and labour rights where that country's laws and regulations are not up to (or on par with) such standards; to respect the social and cultural values and customs of the locality where a TNC operates; and to refrain from political and illegal activity, such as bribery.

Finally, mention should be made of certain intergovernmental instruments that have imposed obligations on TNCs to refrain from doing business in host countries that are pursuing internationally unacceptable policies, such as systematic denial of human rights or discrimination. Of particular historical note in this regard are the various United Nations resolutions instituting an economic boycott of South Africa and other racist regimes in southern Africa that pursued apartheid policies. A similar approach was taken by the European Union which adopted a code of conduct concerning business with South Africa (European Community, 1985). At the non-governmental level, a number of significant initiatives were also taken, chief among these being, the Sullivan Principles (Sullivan, 1977).

C. Consumer protection

The growing internationalization of business has led to the creation of a transnational dimension to the already well-established issue of consumer protection. As business crosses borders in search of new markets and customers, problems of good corporate practice towards consumers follow. This issue can become more salient in the context of developing countries that may not have the resources or the regulatory structure to deal effectively with such matters. The result may be an enhanced risk of abuse of consumer rights. In these circumstances, a measure of co-ordinated international action may be necessary. Equally, a harmonization of consumer protection standards across national boundaries may be necessary on efficiency grounds, so that firms will need to observe only one universal set of standards, and as a stimulant to market integration, through the greater ease of compliance with national standards that follows from such harmonization.

In this connection, the European Union (albeit, admittedly, a special situation) has developed a number of instruments on consumer protection. These will only be discussed briefly in this section, but nonetheless they represent the most developed supra-national scheme of consumer protection in existence. The European

Union instruments are based on the terms stipulated in Article 153 of the Treaty establishing the European Community under title XIV, on Consumer Protection, which states that the Community shall "contribute to protecting health, safety and economic interests of consumers, as well as to promoting their right to information, education and to organise themselves in order to safeguard their interests" (European Commission, 1997, p. 109).

The European Union instruments on consumer protection can be divided between legislative directives dealing with the protection of economic interests of consumers and the protection of their safety, and non-legislative directives that are mostly made up of actions with budgetary consequences. More specifically, the European Union directives have concentrated on the following key areas:

1. Safety and liability.
2. Directives concerning the protection of economic interests such as:
 - misleading and comparative advertising;
 - price indication;
 - contracts negotiated away from business premises (doorstep selling);
 - package travel;
 - unfair contract terms;
 - timeshare contracts; and
 - distance contracts.
3. Financial services.
4. Access to justice.
5. Consumer representation, information and education.
6. Links of consumer policy with other European Union policies.

The United Nations has also developed a set of Guidelines for Consumer Protection. These Guidelines were adopted by the 1985 United Nations General Assembly (Resolution 39/248), in order to protect consumers, particularly those in developing countries. As a General Assembly resolution, the Guidelines were mainly drafted to advise Governments on how best to protect consumers. The language used in the Guidelines is therefore not mandatory.

The Guidelines' main objectives are:

- (a) "To assist countries in achieving or maintaining adequate protection for their population as consumers;
- (b) To facilitate production and distribution patterns responsive to the needs and desires of consumers;

- (c) To encourage high levels of ethical conduct for those engaged in the production and distribution of goods and services to consumers;
- (d) To assist countries in curbing abusive business practices by all enterprises at the national and international levels which adversely affect consumers;
- (e) To facilitate the development of independent consumer groups;
- (f) To further international co-operation in the field of consumer protection;
- (g) To encourage the development of market conditions which provide consumers with greater choice at lower prices”.

The General principles provided in the Guidelines are the following:

- (a) “the protection of consumers from hazards to their health and safety;
- (b) the promotion and protection of the economic interests of consumers;
- (c) access of consumers to adequate information to enable them to make informed choices according to individual wishes and needs;
- (d) consumer education;
- (e) availability of effective consumer redress; and
- (f) freedom to form consumer and other relevant groups or organizations and the opportunity of such organizations to present their views in decision-making processes affecting them”.

The development, implementation and monitoring stages of national consumer policies are left to Governments, which are urged to follow the standards contained in the Guidelines in order to achieve stronger protection policies.

The 2000 OECD Guidelines for Multinational Enterprises complement the United Nations Guidelines, in that chapter VII of the Guidelines deals with the responsibilities of TNCs with respect to the protection of consumer interests (box 5).

The first reference to consumer interests was made in the OECD Guidelines in 1984, which reflected the increasingly internationalised aspects of consumer protection policies and laws in terms of product packaging, marketing and sales, and product safety (OECD, 2000b). This development, coupled with the continuing recognition of the issue of consumer protection by TNCs (as manifested by the emphasis placed on it in corporate policies and management practices), led to the addition of the chapter in 2000.

Box 5. OECD Guidelines for Multinational Enterprises and the protection of consumer interests

“VII. Consumer Interests

When dealing with consumers, enterprises should act in accordance with fair business, marketing and advertising practices and should take all reasonable steps to ensure the safety and quality of the goods or services they provide. In particular, they should:

1. Ensure that the goods or services they provide meet all agreed or legally required standards for consumer health and safety, including health warnings and product safety and information labels.
2. As appropriate to the goods or services, provide accurate and clear information regarding their content, safe use, maintenance, storage, and disposal sufficient to enable consumers to make informed decisions.
3. Provide transparent and effective procedures that address consumer complaints and contribute to fair and timely resolution of consumer disputes without undue cost or burden.
4. Not make representations or omissions, nor engage in any other practices, that are deceptive, misleading, fraudulent, or unfair.
5. Respect consumer privacy and provide protection for personal data.
6. Co-operate fully and in a transparent manner with public authorities in the prevention or removal of serious threats to public health and safety deriving from the consumption or use of their products.”

Source: OECD, 2000a, p. 7.

The United Nations Guidelines can also be read alongside the Consumer Charter for Global Business of 1995, produced by the NGO Consumers International. It covers much of the same ground as the United Nations Guidelines and includes provisions on ethical business conduct carried out in the interests of consumers, fair competition, proper marketing practices, product standards and labelling. In addition, consumers have a right to expect appropriate information as to storage and disposal of products, the establishment of informal systems for the redress of complaints and the provision of proper guarantees. Other NGOs have also referred to the protection of consumers in their codes on TNC responsibilities (see PAN Draft NGO Charter on Transnational Corporations paragraph 12; Consumer Unity and Trust Society International Agreement on Investment Article 1.F; World Development Movement’s Core Standards “Consumer Protection”). In a similar vein, the ICC has issued

its own codes on marketing. These cover *inter alia* direct marketing, advertising practice, environmental advertising, sales promotion and sponsorship (ICC, 2000).

A further noteworthy development has been the adoption of certain issue-specific codes by intergovernmental organizations, designed to deal with issues of direct concern to consumers in the field under scrutiny. Such codes establish internationally agreed standards, usually aimed more directly at enterprises. A number of issue areas have been covered. These include:

- **Breast-milk substitutes.** Perhaps best-known is the WHO's International Code of Marketing of Breast-milk Substitutes. This Code was adopted by the Thirty-fourth World Health Assembly in 1981, after it had been discovered that the use of Western style breast-milk substitutes in the less hygienic conditions of developing countries could be harmful to the good health of infants, and after a concerted campaign by civil society groups targeted at the TNCs responsible for the marketing and sale of this product to mothers in developing countries. The Code recognized that the encouragement and protection of breast-feeding is an important part of the health, nutrition and other social measures required to promote healthy growth and development of infants and young children. Therefore, the aim of the Code, as stated in the first article, is to: "contribute to the provisions of safe and adequate nutrition for infants, by the protection and promotion of breast-feeding, and by ensuring the proper use of breast-milk substitutes, when these are necessary, on the basis of adequate information and through appropriate marketing and distribution. The Code applies to the marketing, and practices related thereto, of the following products: breast-milk substitutes, including infant formula; other milk products, foods and beverages, including bottle-fed complementary foods, when marketed or otherwise represented to be suitable, with or without modification, for use as a partial or total replacement of breast-milk; feeding bottles and teats. It also applies to their quality and availability, and to information concerning their use."

The United Nations Children's Fund (UNICEF) has been active in assisting with its monitoring, mainly by NGOs (Chetley, 1986; IBFAN, 1994).

- **Pesticides.** The Food and Agriculture Organization of the United Nations (FAO) has long been involved in developing technical standards and codes, several of which have important social and environmental aspects. Its International Code of Conduct on the Distribution and Use of Pesticides (adopted in 1985) established voluntary standards of conduct for all public and private entities involved with the distribution and use of pesticides, particularly in countries with national laws inadequate for regulating pesticides. The Code is based on the shared responsibility of all segments of society, and upon a co-operative effort between Governments of pesticide-exporting and importing countries. Initially, the Code was developed to address certain issues associated with the use of pesticides, particularly in developing countries where adequate regulatory infrastructures are frequently lacking. It was recognized, however: "that in order to remain relevant the Code must evolve in order to reflect changing needs of countries and that there was a need to monitor progress in the observance of the Code. The objectives of the Code are to set forth responsibilities and establish voluntary standards of conduct for all public and private entities engaged in or affecting the distribution and use of pesticides. The Code suggests how to distribute the responsibilities between government, industry and others. The twelve articles of the Code are supported by a set of detailed technical guidelines which provide guidance on their implementation" (FAO, 1990, p. 2).
- **Hazardous chemicals and pesticides.** Most recently, in conjunction with the United Nations Environment Programme (UNEP), FAO has developed the Convention on the Prior Informed Consent (PIC) Procedure for Certain Hazardous Chemicals and Pesticides in International Trade, agreed and opened for signature in September 1998 (UNEP/ FAO, 1998). Though addressed to Governments, this initiative aims to influence the conduct of TNCs. The PIC procedure is: "a means for formally obtaining and disseminating the decisions of importing countries as to whether they wish to receive future shipments of a certain chemical and for ensuring compliance to these decisions by exporting countries."

The aim is to promote a shared responsibility between exporting and importing countries in protecting human health and the environment from the harmful effects of such chemicals. The Convention contains provisions for the exchange of information among Parties about potentially hazardous chemicals that may be exported and imported and provides for a national decision-making process regarding import and compliance by exporters with these decisions ” (ibid., p. 2).

- **Tobacco.** More recently, the WHO has called for work to begin on a Framework Convention on Tobacco Control which would contain *inter alia* rules relating to issues that involve regulation of the activities of tobacco corporations, including tobacco advertising and promotion, especially in relation to young persons and children, agricultural diversification, smuggling, taxes and subsidies (WHO, 1999). The Framework Convention is meant to become an international legal instrument that will circumscribe the global spread of tobacco and tobacco products. It is being developed by WHO’s 191 member States, so as to ensure that their concerns are adequately reflected throughout the process. Protocols are envisaged as separate agreements to cover the substantive part of the Convention.
- **Food safety.** Brief mention should be made of the FAO and WHO Codex Alimentarius. Although not entirely uncontroversial, this extensive Code seeks to set global standards for the elaboration and establishment of definitions and requirements for foods, to assist in their harmonization and, in doing so, facilitate international trade. Not only are standard definitions of foods developed, but also standards concerning food labelling and principles of food hygiene. The Codex is expressly mentioned in paragraph 39 of the United Nations Guidelines for Consumer Protection as the source of consumer protection standards in the field of food policy. The WTO has recognized Codex standards as the international reference for settling disputes in relation to food safety issues. Though addressed to member Governments of the FAO and WHO, the Codex influences the conduct of TNCs in the food industry (FAO/WHO, 1999).
- **Electronic commerce.** Another initiative undertaken by the OECD was the adoption, in 1999, of the Guidelines for Consumer Protection in the Context of Electronic Commerce. This aims to assist Governments to formulate consumer policies for electronic commerce and outlines information disclosure requirements to protect consumers. In particular the Guidelines require that consumers who participate in electronic commerce should be afforded transparent and effective consumer protection that is no less than the level of protection afforded in other forms of commerce. To this end, the Guidelines recommend that businesses engaged in electronic commerce should pay due regard to fair business, advertising and marketing practices; provide accurate, clear and easily accessible information about themselves to allow for identification of their business, prompt, easy and effective consumer communication with the business, appropriate and effective dispute resolution, service of legal process and location of the business for regulatory purposes; offer sufficient information about the goods or services offered so as to enable consumers to make an informed decision about entry into a transaction; offer sufficient information about the terms, conditions and costs associated with the transaction; provide an effective confirmation process for the transaction in question; provide easy-to-use and secure payment mechanisms and information as to these mechanisms; and provide access to fair, timely and affordable alternative dispute settlement mechanisms. Furthermore, electronic commerce transactions should be carried out in accordance with recognized privacy principles. Finally, Governments are expected to carry out programmes of consumer education in this field, to review and promote self-regulation by private business, and to cooperate with other countries in the development of regulatory environments (OECD, 1999a).
- **Protection of personal data on consumers.** Closely linked to the development of standards in relation to electronic commerce are initiatives to secure privacy and security in relation to electronic data stored and processed by firms. Thus in 1981 the Council of Europe adopted a Convention for the Protection of Individuals with Regard to Automatic

Processing of Personal Data. The European Parliament and Council issued a Directive in this field in 1995 (Council of the European Union, 1995). For its part, the OECD issued in 1998 a Ministerial Declaration on the Protection of Privacy on Global Networks (OECD, 1998c).

- **Pharmaceutical products.** The International Federation of Pharmaceutical Manufacturers Associations (IFPMA) adopted, in 1981, a voluntary Code of Pharmaceutical Marketing Practices. Its aim is to “promote and support continuous development throughout the pharmaceutical industry of ethical principles and practices voluntarily agreed on” (IFPMA, 1994, p. 1). To this end, it sets standards for promotional material that seek to ensure its accuracy, fairness and objectivity so as to ensure not only conformity with legal requirements, but also adherence to high ethical standards and to good taste.
- **Quality assurance.** Apart from the above-mentioned codes, the series of generic technical standards developed by the International Standardization Organisation (ISO) are worthy of special note: ISO 9000, for quality assurance management (to ensure products conform to customers’ requirements), and ISO 14000 for environmental system management (to eliminate the harmful environmental impact of enterprise activities) (ISO 1999). However, these focus on management systems rather than measuring actual performance. Implementation is not the direct responsibility of ISO itself, but certification is carried out by its national member organizations, usually through accredited bodies. Though not specifically addressed to TNCs, these codes are relevant since they offer guidance to TNCs on the development of their quality assurance systems.
- **Social accountability.** The ISO approach has also been adopted by the United States based Council for Economic Priorities. It has launched “Social Accountability 8000” (SA8000), also as a management system standard. The SA8000 system is based on ISO 9000, which is widely used by companies to ensure quality control. The auditing techniques of ISO include:

“specifying corrective and preventive actions; encouraging continuous improvement; and focusing on

management systems and documentation proving these systems’ effectiveness. In addition, the SA8000 system includes three elements essential for social auditing:

- (a) Specific performance standards set with minimum requirements;
- (b) Auditors are required to consult with and learn from interested parties, such as NGOs, trade unions and, of course, workers; and
- (c) A complaints and appeals mechanism allows individual workers, organizations, and other interested parties to bring forward issues of noncompliance at certified facilities” (CEPAA, 2000, p. 3).

D. Emerging issues

Certain new issues are emerging in the practice of corporations, industry organizations, Governments and civil society that may influence the future content of provisions in IIAs on the social responsibility of corporations. They include, most importantly, corporate governance, ethical business practices and the need for TNCs and domestic firms to observe fundamental principles of human rights in their operations. Indeed, all three issues appear prominently in the General Policies chapter of the 2000 OECD Guidelines for Multinational Enterprises (box 2).

1. Corporate governance

The “Principles of Corporate Governance” were adopted by the OECD Council in May 1999. Expressed in general terms, these are aimed at providing guidance to Governments, public bodies and companies in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. The OECD Principles concentrate on:

“governance problems that result from the separation of ownership and control. Some of the other issues relevant to a company’s decision-making process, such as environmental or ethical concerns, are taken into account but are treated more explicitly in a number of other OECD instruments (including the Guidelines for Multinational Enterprises and the Convention and Recommendation on Bribery) and the instruments of other international organisations” (Preamble).

Against this background, the OECD Principles contain the following provisions on corporate governance that can be seen as relating to social responsibility:

- The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.
- The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding a corporation, including the financial situation, performance, ownership, and governance of the company. The disclosure framework of the OECD Guidelines on Multinational Enterprises is relevant in this context.
- Risks related to environmental liabilities should be disclosed.
- Information relating to human resource policies, such as programmes for human resource development or employee ownership plans, should be disclosed as these can communicate important information on the competitive strengths of companies to market participants.

2. Ethical business standards

The developments discussed in section I have given a new impetus to various types of corporate codes, some of which have a long history. Although such codes are voluntary rather than legally binding requirements, they are often the result of social pressures, and are adopted in response to real or perceived threats of social sanctions or legislative action. Furthermore, they may incorporate or refer to standards that have some legal status; they may be monitored or enforced by often sophisticated auditing procedures; and non-compliance may potentially entail harmful or damaging consequences, such as loss of contracts and damaging publicity. Codes may be formulated and adopted by an individual firm, but set standards of conduct to apply not only throughout a firm and its foreign affiliates, but also

to its entire supply chain, sometimes involving thousands of contractors and subcontractors, often in many countries. These can therefore have widespread effects if adopted, for example, by large retail trading firms, perhaps responding to consumer pressures. Industry codes may cover enterprises based in several home countries, as well as affiliates and contractual suppliers in many host countries.

Codes of this type have been adopted by companies in almost all OECD countries (Kline, 1985; Kolk, van Tulder and Welters, 1999; Gordon and Miyake, 1999; see also OECD, 1999b). Some schemes may spread by being adopted in many host countries, often through international action. Thus, the Responsible Care scheme originated by the Chemical Manufacturers Association in the United States was spread through the International Council of Chemical Associations into over 40 countries. In many respects, therefore, the emergence of codes laying down social responsibility standards seems to be an international phenomenon, linked to the trends of privatization, deregulation and liberalization of the present phase of globalization (UNCTAD, 1999b). Examples of such codes dealing generally with ethical business standards are listed in box 6.

Box 6. Examples of ethical codes of conduct

The following are examples of various codes. They are presented without examining their economic or other implications, merely as examples of what is emerging in this field.

Corporate codes:

- The General Mills Statement of Corporate Responsibility 1994 (UNCTAD, 1994, p. 317).
- The Caterpillar Code of Worldwide Business Product and Operating Principles 1992 (UNCTAD, 1994, p. 319).
- Levi-Strauss Business Partner Terms of Engagement and Guidelines for Country Selection 1994 (UNCTAD, 1994, p. 325).
- More recently, the United Kingdom food retailer J. Sainsbury & Co established a code for the monitoring of ethical business practices on the part of suppliers of its "own brand" goods (Fridd and Sainsbury, 1999).

Industry codes may be adopted by coalitions of firms, or by an industry association (sectoral and multisectoral):

- Some of these codes originate from concerns specific to an industry, such as the environmental impact of mining, the rights of indigenous people in relation to land use by agricultural or extractive industries, health and safety in chemicals production, the exploitation

/...

Box 6 (concluded)

- of children or other workers in clothing manufacture; privacy, intellectual property rights and ethical business practices in Internet commerce. But a code's content may extend beyond such direct concerns.
- Other codes are issued by general business associations, including international organisations, such as the International Chamber of Commerce. For example, it has drawn up ethical marketing codes such as its International Code of Environmental Advertising (ICC, 1991).

Third-party codes may be issued by public interest groups, or by trade unions (especially the international trade secretariats), sometimes working together. Thus, some International Trade Secretariats have negotiated codes focusing mainly, but not exclusively, on labour rights, either directly with TNCs, or jointly with NGOs and covering specific industries:

- The International Metalworkers' Federation has a Model Code of Conduct for TNCs, which is being discussed with individual firms through their World Union Committees (IMF, 1997). It is derived from the ICFTU/ITS Basic Code of Labour Practice (ICFTU/ITS, 1997).
- A Code on Clean and Safe Drinking Water has been established in a common effort of companies providing the public service of supplying clean and safe drinking water to communities, and trade unions organising water workers affiliated to the Public Service International (PSI), to address issues related to public service obligations, democratic regulation, environmental standards and fair labour practices (PSI, 1999).
- Following publicity about child labour used for stitching footballs to be used in the World Cup, the Fédération Internationale de Football Association (FIFA), in conjunction with international trade union bodies and other organisations, developed a code and agreement aimed at eliminating this practice (Kearney, 1999, p. 219).

Government codes. Governments have also often been involved in the encouragement of corporate codes. For example, the United States Apparel Industry Partnership was encouraged by the White House; the Governments of Australia and New Zealand have produced guides to the development of codes; and the Government of Canada has encouraged, through the Office of Consumer Affairs of Industry Canada, effective codes and implementation processes. One significant example of a governmental code on ethical business practices is the United Kingdom's Ethical Trading Initiative (ETI). This entails a commitment to a Base Code which has specifically-defined standards; these require wages and benefits to meet, at a minimum, the higher of national legal or industry benchmark standards; and an Appendix lists "relevant international standards", including ILO conventions (ETI, 1998).

Source: UNCTAD.

3. Observance of human rights

It was noted above that the United Nations draft Code of Conduct mentioned observance of human rights by TNCs among its substantive standards. More specifically, the draft Code mentions, in paragraph 13, the need for TNCs to respect human rights and fundamental freedoms in the countries in which they operate. However, no agreement was reached on whether this should be expressed as an obligation by incorporation of the word "shall" into the text or as a hortatory standard expressed by the word "should". Equally, the 2000 OECD Guidelines for Multinational Enterprises stress, as part of the General Policies to be observed by TNCs, "respect the human rights of those affected by their activities consistent with the host government's international obligations and commitments" (OECD, 2000a, p. 3).

Also more recently, the United Nations Sub-Commission on the Promotion and Protection of Human Rights has established a working group on the working methods and activities of TNCs and, through this body, is currently undertaking work towards the drafting of a Human Rights Code of Conduct for Companies. This code foresees that it would apply to foreign and domestic companies alike and would expect companies to respect, ensure respect for, and promote internationally recognised human rights within their respective spheres of activity and influence. It then goes on to elaborate more specific obligations in relation to a number of major areas of activity, including war crimes and crimes against humanity, non-discrimination, slavery, forced labour and child labour, respect for national sovereignty and self determination, fundamental labour rights and environmental rights (United Nations, 2000).

Most importantly, the United Nations Secretary General's Global Compact (box 1) stresses the need for business to observe the human rights contained in the Universal Declaration of Human Rights and the core labour standards contained in the ILO Declaration on Fundamental Principles and Rights at Work of 1998 (ILO, 1998a). Indeed, the clearest link between corporate social responsibility and the observance of human rights arises in the field of labour standards. Although an employment issue (see chapter 17), the relationship between fundamental human rights and labour rights must be mentioned in this chapter, given the central importance of this issue to the wider debate on the applicability of human rights obligations to TNCs.

The most comprehensive set of international agreements embodying social standards is the ILO's International Labour Code, which consists of both legally binding conventions and recommendations. Although ratification of the conventions is a matter for each State, they are regarded as aspirational in that membership of the ILO entails the obligation to establish at least basic labour rights, and members are required to report both on the implementation of ratified conventions and on the progress made in relation to those that embody fundamental rights. This has now been strengthened by the adoption of the Declaration on Fundamental Principles and Rights at Work.

Box 7. Human rights and labour rights

In accordance with the most central guiding policy of the ILO, the 1977 ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (UNCTAD, 1996a, vol. I, p. 89) recognizes the right of workers to establish and to join organisations of their own choosing without prior authorisation, and to enjoy adequate protection against anti-union discrimination in respect of their employment. This right appears to have the status of a fundamental human right. Thus, Article 22(1) of the International Covenant on Civil and Political Rights 1966 states: "Everyone shall have the right to freedom of association with others, including the right to form and join trade unions for the protection of his interests" (UNGA, 1976). Article 22(2) then enumerates certain public interest exceptions to this principle. These must be prescribed by law and may be necessary in a democratic society for the protection of those interests. However, Article 22(3) stresses:

"Nothing in this article shall authorize States Parties to the International Labour Organisation Convention in 1948 concerning Freedom of Association and Protection of the Right to Organize to take legislative measures that would prejudice, or apply the law in such a manner as to prejudice, the guarantees provided for in that Convention" (ibid).

This right is addressed primarily to States. As such, TNCs are not the object of the right. It is for the Government of a host state to ensure that freedom of association is observed in law and in fact. It is for TNCs to observe the law of the land. However, foreign firms may be in a position to take the lead in the removal of restrictions over the freedom of association, by encouraging trade unions in their plants, and by defending their right to exist.

Source: Muchlinski, 1999, p. 471.

The observance of human rights by TNCs is becoming an increasing object of discussion leading to new initiatives by NGOs. This issue is mentioned for example in:

- The draft NGO Charter on Transnational Corporations (paragraph 4) prepared by the People's Action Network to Monitor Japanese Transnational Corporations Abroad in 1998.
- So as to avoid the dilution of human rights standards by way of investor protection standards, Article 1.E of the Indian-based Consumer and Unity Trust Society's "International Agreement on Investment" asserts that a contracting party shall be free to adopt or continue, with or without modification, such measures as are required for securing conformity with international treaties, conventions and agreements relating to human rights.
- The Polaris Institute for the Council of Canadians, in its discussion paper "Towards a Citizens MAI" of 1998, makes it clear that investment by foreign-based corporations is welcome, provided that it observes *inter alia* regulations designed to enhance the economic, social and environmental rights of citizens. Equally, in case of conflicts, internationally agreed citizens' rights such as the Universal Declaration of Human Rights and its Covenants take precedence over the rights of corporations and investors.
- The "Core Standards" annexed to the World Development Movement's consultation paper "Making Investment Work for People" of February 1999 include the following obligations for TNCs: respect for the right to life and the right not to be tortured or subjected to cruel treatment or arbitrary arrest; the promotion of basic human rights, ensuring that they are universally and effectively observed; and ensuring that any security force working for them abide by basic standards.
- A notable recent example is the Amnesty International United Kingdom Business Group's "Human Rights Guidelines for Companies" (Amnesty International, 1998). These deal *inter alia* with general human rights standards as applicable to corporate operations, and with security issues in particular (box 8).

* * *

The preceding survey indicates that a number of IIAs have addressed development obligations, socio-political obligations and consumer protection obligations as a part of corporate social responsibility. Furthermore, new issues are emerging in relation to corporate governance, ethical

Box 8. Amnesty International Human Rights Guidelines for Companies

According to Amnesty International:

“Companies have a direct responsibility for the impact of their activities on their employees, on consumers of their products and on the communities within which they operate. This means ensuring the protection of human rights in their own operations. They also have a broad responsibility, embodied in the expectations of civilised society and in international protocols, to use their influence to mitigate the violation of human rights. This applies whether these violations are committed by governments, by the forces of law and order, or by opposition groups in the countries where companies have a presence.” The Amnesty International Guidelines go on to note that TNCs often also operate in countries with poor human rights records. In such cases, firms are urged to use their influence to promote respect for human rights, given that silence might increasingly be interpreted as providing support for oppressive regimes, which in turn might adversely influence a company’s reputation.

The Guidelines advocate the following principles as being of importance to companies:

- All companies should adopt an explicit policy on human rights which includes public support for the Universal Declaration of Human Rights
- All companies should ensure that any security arrangements protect human rights and are consistent with international standards for law enforcement.
- All companies should take reasonable steps to ensure that their operations do not have a negative impact on the enjoyment of human rights by the communities in which they operate.
- All companies should ensure that their policies and practices prevent discrimination based on ethnic origin, gender, sex, colour, language, national or social origin, economic status, religion, political or other conscientiously held beliefs. All companies should ensure that their policies and practices prohibit the use of chattel slaves, forced labour, bonded child labourers or coerced prison labour.
- All companies should ensure that their policies and practices provide for safe and healthy working conditions and products.

Source: Amnesty International, 1998, pp. 1-7.

business standards and the observance of human rights, indicating a growing concern about corporate social obligations not only among civil society groups but also among TNCs themselves. Further, there are intricate and, sometimes indeterminate, interrelationships between binding

and non-binding standards, and between international and national and private and public law. Thus, for example, a corporate code adopted by a TNC distributing consumer goods in developed countries, and applied in its relationships with a network of independent suppliers in developing countries, may incorporate references to ILO conventions, which may or may not have been ratified in the suppliers’ countries of operation. Even if the code is not formally regarded as contractually binding on the suppliers, their compliance may well be monitored as part of the normal process of supervision of product quality, backed up by some form of third-party social audit; and suppliers that fail to make improvements to ensure compliance could well lose their contracts (Fridd and Sainsbury, 1999, pp. 223-224). By such means, international standards, which may formally be non-binding or binding only on States, may effectively be enforced transnationally. It is this “soft law” element which emerges from voluntary initiatives that may have an impact on the evolution of international standards in the field of social responsibility.

Section III Interactions with other Issues and Concepts

This section examines how social responsibility issues — in whatever instrument or agreement they may be addressed — tend to interact with other issues and concepts covered by these volumes (table 1).

- **Taxation.** Taxation has a principal interactions with social responsibility in so far as there is a duty on TNCs to pay the taxes to which they are subject in the countries in which they operate (see chapter 21). Furthermore, in relation to taxation, the 2000 OECD Guidelines state that:

“It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their

operations and conforming transfer pricing practices to the arm's length principle" (OECD, 2000a, p. 8).

Table 1. Interaction across issues and concepts

Issue	Social responsibility
Admission and establishment	+
Competition	++
Dispute-settlement (investor-State)	+
Dispute-settlement (State-State)	+
Employment	++
Environment	++
Fair and equitable treatment	0
Home country measures	+
Host country operational measures	+
Illicit payments	++
Incentives	+
Investment-related trade measures	+
Most-favoured-nation treatment	+
National treatment	+
Scope and definition	+
State contracts	+
Taking of property	+
Taxation	++
Transfer of funds	+
Transfer of technology	++
Transfer pricing	++
Transparency	++

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

- **Transfer pricing.** As the preceding quotation indicates, particularly important aspect of corporate social responsibility for TNCs is to refrain from taking advantage of their transnational network of affiliates by engaging in the manipulation of intra-firm transfer prices so as to achieve a revenue shifting effect. Such practices may be especially damaging to the economies of developing countries in that they might be deprived of revenue on profits made within their territories. The taxable profits made by TNCs may be a vital contribution to the revenue base of such countries; thus any action designed to reduce such profits through transfer pricing manipulations will reduce that revenue base to the detriment of economic and social policy funding in the developing countries concerned, which in turn prejudices the welfare of local populations. Such action may, in addition, be regarded as an unfair abuse of corporate power

to the detriment both of local competitors who cannot engage in cross-border transfer pricing manipulations, and of local investors who obtain less than the full market return on the investment in that this would be calculated on the basis of the artificially lower returns declared by the TNC after it has shifted profits out of the jurisdiction in question (see chapter 19).

- **Competition.** The principal interaction between social responsibility and competition issues concerns the obligation for TNCs not to abuse their market power in a way that violates competition rules as this may undermine the competitive position of smaller firms operating in the local market and thereby adversely affect local employment, business interests and development. The control of anti-competitive practices has a further social dynamic in that it prevents the abuse of consumers through monopolizing pricing practices and the prevention of choice in markets through the erection of barriers to competition from other firms. Such regulation may be especially important in relation to developing countries whose ability to protect themselves from anti-competitive restrictive business practices may be hindered owing to inadequate resources (see chapter 24). Thus a regulatory gap could be reduced by way of cooperation and technical assistance in competition matters under the regime of any applicable IIA. The UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices may serve as a model in this regard.
- **Transfer of technology.** The principal interaction in this area concerns the transfer of socially useful technology to developing countries. This entails the transfer of technologies that can produce a positive impact on the productive situation in the host country. It has been said that the most appropriate technology for developing countries is labour-intensive technology as it permits the application of the major comparative advantage possessed by developing countries, a supply of cheap labour, to economic production (Helleiner, 1975). While this may have been true in certain countries at certain times in their economic history, contemporary concerns have moved on towards higher-value-added activities in developing countries, entailing a

transfer of higher-skilled work and its attendant technologies. Nonetheless, the effects of FDI on technology transfer have been uneven (see chapter 27). Thus TNCs should consider carefully how their investment in developing countries can provide the most useful technology for economic development purposes (see further UNCTAD, forthcoming b). Another factor in this regard concerns the need to transfer environmentally sound technology to developing countries (see chapter 16).

- **Employment.** The treatment of workers by TNCs is a core issue in the field of social responsibility. As noted at the beginning of this chapter, the rights of workers have been given a leading place in the development of international obligations to be observed by TNCs by the Secretary-General of the United Nations. This issue is further discussed in the separate chapter on employment (chapter 17).
- **Environment.** The observance by TNCs of environmental protection standards has also been given prominence by the Secretary-General of the United Nations. The responsibilities of TNCs in this regard can be listed as relating to the observance of sustainable development principles in the conduct of their operations, and to ensure the transfer of environmentally sound technologies and management practices, especially to developing countries. These matters are further discussed in the chapter on environment (chapter 16).
- **Illicit payments.** Another issue of social responsibility that has a long history is bribery and corruption. In the light of recent developments culminating in the Convention on Corruption drawn up by the Organization of American States and the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, it is clear that a major aspect of corporate social responsibility is for firms to refrain from the making of illicit payments to public officials. This issue is further considered in the chapter on illicit payments (chapter 20).
- **Transparency.** A crucial aspect in the effective regulation of corporate social responsibility is the provision of clear and transparent information about the activities of an enterprise. In developed countries, this may be ensured by a comprehensive code of

disclosure backed up by an administrative enforcement system and sanctions for non-compliance. In the context of developing countries, while formal legal rules may require full and fair disclosure, the resources may not always be available for enforcement. Accordingly, TNCs may have a strong social obligation to offer full and useful disclosure about their activities in accordance with the standards set in international instruments and in the domestic laws of the countries in which they operate. In particular, they should give adequate information about their corporate structure and organization, their principal product and geographical lines of business and any other information necessary for a full and true view of their activities to be obtained by relevant stakeholders. These issues are further discussed in the chapter on transparency (chapter 10).

Conclusion: Economic and Development Implications and Policy Options

Until relatively recently, IIAs rarely included references to social responsibility standards. Beginning with the voluntary codes of conduct for TNCs in the 1970s, social responsibility issues have continued to appear on the negotiating agenda of IIAs. The main issues were identified in sections I and II of this chapter. They represent a response to the growing awareness that the liberalization of international investment conditions requires a corresponding assumption by firms of certain responsibilities.

This evolution in the agenda of IIAs is not free from controversy and debate. Thus, from the perspective of developing countries, development obligations may be desirable, while, from the perspective of developed countries, they may be not, their preference being for market liberalization. On the other hand, developing countries may be concerned that the application of certain social responsibility standards to international business may be inimical to development, by imposing inappropriate levels of social or environmental protection, entailing unfair costs on poorer countries, or may be abused for protectionist purposes. It may well be the case that the concerns of consumers or other socially-concerned groups in developed countries stimulate unilateral initiatives, which may take little account

of the practical situation of those in developing countries whom they are intended to help. At the same time, the pressures of economic competition resulting from increasing global economic integration may result in the adoption of short-sighted business practices, imposing high social costs that are themselves inimical to development. Thus, for example, low business awareness of good environmental protection practices can impose high costs for energy generation, or environmental clean-up. Furthermore, the adoption of best practices is often good business: for example, producers of food or consumer products are more likely to build a favourable reputation in world markets by adopting high standards of safety and quality, as well as good terms and conditions of employment for their workforce. Nevertheless, it is important that social responsibility standards be applied in ways that permit sensitivity to local conditions. As noted in the OECD Guidelines on Multinational Enterprises, “Governments adhering to the Guidelines encourage the enterprises operating on their territories to observe the Guidelines wherever they operate, while taking into account the particular circumstances of each host country” (OECD, 2000a, p. 3). Finally, standards that are intended to operate internationally should be multilaterally agreed, monitored and applied through procedures that are themselves transparent, accountable and socially responsible. Implementation and monitoring are particularly important, if effectiveness is the objective.

In the light of the preceding discussion the following policy options present themselves and, as always in these volumes, they may be relevant at whatever levels IIAs are being pursued:

Option 1: No reference to social responsibility.

This approach is currently taken in the vast majority of IIAs, although some specific issues may be addressed. In particular, bilateral investment treaties (BITs) are largely restricted to issues related to the protection of investors and their investments. Social responsibility issues are seldom expressly mentioned although there may be an indirect impact of such issues on the content of investors obligations, to the extent that national laws of the contracting parties cover social responsibility questions. Given that most BITs contain a reference to the entry of investors and investments in accordance with the laws and regulations of the receiving contracting party, where such laws and regulations cover social responsibility issues they will extend to foreign

investors from the other contracting party as well, provided that they apply in a manner consistent with the non-discrimination provisions of an agreement. Thus both foreign and domestic investors would be equally subject to the social responsibility requirements of a host country’s laws. However, apart from such an indirect effect, BITs do not in general aim to introduce social responsibility issues into their express provisions.

Option 2: Non-binding social responsibility standards included in an agreement.

Where the parties to an IIA accept the need for a reference to social responsibility issues, but are not prepared to introduce binding rules in this area, one option is to introduce these issues into a non-binding section of the agreement. This was proposed in relation to the draft Multilateral Agreement on Investment (MAI) where the OECD Guidelines on Multinational Enterprises could have been included as a non-binding annex to the main agreement.

This has the advantage of avoiding possible negotiating problems that would arise in relation to binding rules. In particular, it might be easier for countries fearing the protectionist abuse of certain social responsibility standards to accept them if they were not legally binding. Equally, business fears of being subjected to legal accountability for their observance of certain social responsibility obligations would be allayed. Furthermore, the use of non-binding standards leaves open the possibility that a moral obligation to observe those standards would arise, perhaps because of monitoring by civil society groups. In this way “soft law” would be created and, eventually, might crystallize into “hard law”.

On the other hand, such an approach fails to meet the criticism that a pure investor/investment promotion and protection agreement is unbalanced since it fails to meet the legitimate social concerns generated by internationally mobile TNCs, while at the same time giving them rights and privileges in relation to the countries in which they operate.

Option 3: Reservation of regulatory powers in relation to social responsibility issues.

As investment liberalization and protection measures have increasingly been embodied in binding instruments, a variety of means have been used both to limit the restrictions they impose on national measures involving social responsibility and to permit or encourage the adoption and application of non-binding social responsibility standards. Thus, host countries may

seek to replace traditional investment scrutiny procedures with regulatory arrangements that are non-discriminatory or otherwise compatible with trade and investment treaties. This may entail the use of exclusions and exceptions from investor protection standards, which serve to protect a host country's discretion to regulate investors and investments in the light of social responsibility standards. The effects of general obligations in an investment agreement may be limited by the specific national exceptions that a party may be permitted to make. In the case of "top down" agreements, such as the draft MAI, these would have to be agreed in advance and explicitly listed, and be subject to "standstill" and "rollback" requirements.

An alternative approach is a broader general exceptions provision, along the lines of GATT Article XX, which exempts national state measures under a number of headings, provided they do not constitute arbitrary or unjustified discrimination or a disguised restriction on international trade (or, in this case, investment). GATT article XX includes exceptions allowing States to preserve their own social and environmental responsibility standards, notably the protection of public morals; the protection of human, animal or plant life or health; and the protection of national treasures of artistic, historical or archaeological value. However, the scope of such exceptions has proved uncertain or limited, since the GATT/WTO is reluctant to give *carte blanche* to a government to introduce measures that restrict trade on the basis of its unilateral standards of social or environmental protection. This has resulted in the elaboration of more detailed agreements, notably those on Government Procurement, Technical Barriers to Trade and Sanitary and Phytosanitary Measures (WTO, 1995a).

Option 4: No lowering of standards clause.

An alternative approach was adopted in the North American Free Trade Agreement (NAFTA), and proposed in the MAI, in response to concerns that the relaxation of controls on investment flows might lead to a deterioration of standards of social and environmental protection in host countries. Thus, NAFTA provides, in Article 1114 on Environmental Measures:

"1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its

territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement."

In the MAI negotiations, a similar clause was proposed, which referred also to labour standards (with proposed qualifications limiting it to "domestic" and "core" labour standards). It should be noted that these clauses refer to the non-lowering of standards in order to attract a *particular* investment, and thus do not cover a more generalized relaxation, or one applicable to a class of investors or a particular area such as a special investment zone.

There is no reason why this technique could not be extended to some of the other issues mentioned in sections I and II of this paper. In particular, a commitment not to lower consumer protection standards or rules on corporate governance are an option. On the other hand, this approach may not be well suited to more general social obligations imposed directly on TNCs. Examples include the duty not to interfere in socio-political affairs or the observance of fundamental human rights. The "no lowering of standards" option applies to those cases in which host countries may be tempted to lower their social standards so as to attract marginal inward investment. It does not apply to TNC behaviour as such. Countries may be opposed to such a clause on the grounds outlined in the introduction to this section. However, it should be made clear that this technique does not demand positive action to raise standards — only that countries refrain from lowering them. Thus a comparative advantage associated with a pre-existing level of social responsibility is unlikely to be interfered with.

Option 5: Home country promotional measures.

As part of an ongoing relationship of cooperation for development, the principal home countries of TNCs may seek to undertake positive obligations to promote good corporate social

responsibility on the part of their firms when operating in developing host countries (see chapter 22). These may be little more than non-binding “best efforts” commitments, although, negotiators may agree to make such commitments binding in appropriate cases. As noted in the introduction to this section, a non-binding hortatory approach is taken in the OECD Guidelines, which exhort the OECD home countries to encourage in their turn the observance of the Guidelines by their firms wherever they operate. Similarly, a precedent for home country social responsibility measures exists in relation to codes adopted to set standards for TNCs operating in southern Africa during the period of apartheid, of which the Sullivan Principles (Sullivan, 1977) and the European Union code are the most well known (European Community, 1985).

Alternatively, a binding commitment might be undertaken. The advantage of this approach is that firms are subjected to home country supervision. This is likely to entail high standards of social responsibility, where the laws and regulations of a home country maintain a comprehensive code of social responsibility rules. The main disadvantage of this approach rests in the associated extraterritorial extension of home country laws and regulations to a host country’s territory. This may often not be welcomed and may, in certain cases, be perceived as a threat to the sovereignty of a host country. It may also stoke fears of the protectionist use of higher OECD regulatory standards to hold back competition from less developed host countries. Furthermore, it does not address the related issue of whether the same approach would make sense if the home country of a TNC was itself a developing country, with social responsibility standards different from those found in OECD legal systems.

Option 6: Inclusion of generally binding social responsibility provisions into an agreement.

While rare, some regional integration agreements have begun to develop coordinated policies and to harmonize some standards and even laws relating to social policy. The European Union, especially, has developed an active programme of environmental protection laws and standards. Since the incorporation of the Social Charter into the Treaty of the European Union, employment rights and social policy more generally have begun to be the subject both of coordinated action and of some harmonization. Thus the most far reaching option for dealing with

social responsibility in an IIA would be to include a legally binding set of provisions covering some or a number of the major issues identified as falling within this concept, for example in the form of a detailed chapter on social responsibility. However, that might prove to be very difficult to negotiate.

Two further options present themselves:

- annexing existing instruments and/or international agreements to an IIA as binding provisions. This would raise questions of choice — which instruments and/ or agreements should be included? However, in the end the crucial element is the question of whether or not agreement can be reached on the substantive content of any standards.
- to establish linkages with other binding instruments. Relevant agreements standards could be associated with IIAs on an opt-in basis. States and enterprises could be encouraged to sign up to a range of agreements and codes as appropriate to their activities and circumstances. This would help to provide a higher visibility for positive regulatory standards, as well as helping to authenticate both those standards and their monitoring and compliance mechanisms.

* * *

The preceding discussion has concentrated on the principal techniques for dealing with social responsibility provisions in IIAs (limited as they are). It should not be forgotten, however, that — independently of what happens in relation to IIAs — work also continues on the *content* of social responsibility standards. In the international arena, that work has to date been mainly carried out by such regional bodies as the European Union and the OECD, or by specialized agencies, most prominently by the ILO. Of particular relevance is also the further development of social responsibility standards through the Global Compact (United Nations, 1999b). This allows not only a universal body of countries to be associated with this effort, but it also offers a multidisciplinary context for such discussions, in that a wider range of issues can be considered. Thus, following the lead given by the Secretary-General of the United Nations in his above-mentioned Global Compact, both the United Nations, its membership and specialized agencies, business and civil society can come together and develop a new agenda for social responsibility which may well influence the provisions of future

IAs. In addition to the substantive content of social responsibility standards, a further matter to be determined is whether, in future, IAs should address Governments only, leaving with them the responsibility to enforce social responsibility standards, or whether TNCs should be directly addressed, thereby imposing direct duties upon them. Such an approach has been taken in various non-binding codes discussed earlier in this chapter. It remains to be seen whether binding agreements will take this approach further.

Notes

- ¹ For a discussion of the concept of social responsibility and its implications, see UNCTAD, 1994, 1999b, ch. XII, and 2003a.
- ² Unless otherwise indicated, all instruments cited herein may be found in UNCTAD, 1996 and 2000b.
- ³ Particularly relevant here is the ILO's "Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy", adopted in 1977. In a sense, this instrument was one of the first "social responsibility codes"; it also included a follow-up mechanism.

Chapter 19. Illicit Payments*

Executive summary

The bribery of foreign public officials in the course of cross-border investment and international business transactions, i.e. transnational bribery, raises significant foreign direct investment (FDI)-related issues for host countries, transnational corporations (TNCs) and their home countries. This chapter examines the topic of transnational bribery in the context of international investment agreements (IIAs), as well as other international instruments that address issues related to the making of such illicit payments (“IIA related instruments”). The chapter focuses on how IIAs and IIA-related instruments have addressed the issue of combating transnational bribery through international obligations by States to criminalize such transactions within their national jurisdictions.

The chapter follows the development of efforts by Governments to combat corruption at the international level, while, at the same time, recognizing that these efforts would have to be undertaken at all levels and by all actors concerned with the problem, including TNCs and non-governmental organizations (NGOs). The chapter begins with the identification of the principal issues that arise in connection with establishing obligations to criminalize transnational bribery. Then it takes stock of how IIAs and IIA-related instruments have dealt with those issues, analysing how relevant provisions address illicit payments. The chapter continues by noting the interactions that arise between the present topic and those considered in other chapters in these volumes. The analysis then addresses the development and policy implications of illicit payments, and concludes with a discussion of some options that could be considered should parties choose to address this issue in IIAs.

The criminalization of the bribery of foreign officials entails the establishment of an offence that includes a legal definition that refers to a form of prohibited conduct, which is sanctioned in national penal codes. The issues that arise with respect to the legal definition are:

- What is the offence of bribery and its scope?

- Who is a “public official”?
- What is transnational bribery?

The definition of the offence of transnational bribery is developed in such a way as to avoid circumvention by including not only direct transactions between the principals concerned, but also indirect transactions through whatever intermediaries and means. In addition, issues arise as to how to overcome inconsistencies presented by the diversity of national legislation in this area and the lack of efficient international mechanisms for investigation, prosecution and enforcement of applicable sanctions against those involved in transnational bribery. In this respect, there are concerns that international rules should not create a competitive disadvantage for enterprises from one country *vis-à-vis* those of other countries not involved in anti-bribery initiatives. At the same time, other concerns exist with respect to ensuring that the different national legal systems function towards a common end, which is difficult, especially in view of issues relating to extraterritoriality. In this connection, the chapter discusses issues related to jurisdiction, international cooperation, enforcement and sanctions, as well as those dealing with the responsibility of TNCs.

Most IIAs or IIA-related instruments that deal with transnational bribery – and these are few – provide for a definition of the offence, either by giving a distinct definition or by establishing the scope of the offence of bribery in such a way as to include (or limit it to) its transnational dimension. In order to avoid circumvention, the offences target not only the principals in corrupt transactions, but also all those that are involved in its realization. This includes intermediaries, wherever they might be located, as well as those that are the actual recipients of the undue advantages, so long as such advantages are the *quid pro quo* for the improper act of a public official.

International anti-bribery agreements seek to obtain the maximum possible latitude for each State party to be able to exercise jurisdiction in the investigation and prosecution of instances of transnational corruption. Thus, they require

* The present chapter is based on a 2001 manuscript prepared by Giorgio Sacerdoti with inputs from S. M. Bushehri. The final version reflects comments received from Richard Gordon, Luis F. Jimenez, Joachim Karl, Eney Quinones and A.J.W. Vanderlinde. This chapter was finalized before the United Nations Convention Against Corruption had been adopted.

countries to establish their jurisdiction to prosecute such transactions on the basis of the concepts of territoriality (including the “effects doctrine”) and nationality, as well as any other basis that is available under their national legal systems. At the same time, IIAs or related instruments include provisions with respect to international cooperation to minimize conflicts of jurisdiction, in terms of both the simultaneous exercise of jurisdiction by two or more States and extra-territorial application of the laws of one State. Indeed, a particular feature of transnational bribery is that, in a given case, elements of a transaction take place in at least two, but quite possibly three or more countries. Thus, agreements in this area provide for international cooperation not only as regards conflicts of jurisdiction, but also with respect to the investigation and prosecution of alleged offences, extradition of the suspected perpetrators, gathering of evidence, and seizure and confiscation of the proceeds of a transaction. The touchstone of efforts to combat transnational bribery is in the enforcement and sanctions that are provided in related international instruments. In this respect, States that are party to such agreements are required to take all necessary measures to enforce their laws against corruption. At the same time, provisions are included to ensure that differing substantive or procedural standards between the various national legal systems are not applied in such a way as to result in the competitive disadvantage of their companies. Moreover, in order to increase the effectiveness of international anti-bribery agreements, criminal sanctions are typically complemented by non-penal measures that are addressed to TNCs. These include obligations on the part of TNCs concerning reporting of relevant information to shareholders, as well as reporting requirements concerning corporate accounts, bookkeeping and financial statements. Such rules are intended to make concealing illicit transaction more cumbersome and financial irregularities more easily detectable by auditors.

The topic of transnational bribery interacts with a number of other topics and issues that arise in discussions that relate to FDI and IIAs. Perhaps the most important interaction is with transparency, which is an important element in the efforts to prevent corruption. Governments’ efforts to increase the transparency of their activities include the areas of procurement, regulatory procedures and decision-making processes, and fiscal, monetary and financial policies and practices. Adequate accounting standards, both public and private, in home and host countries, coupled with

appropriate reporting and disclosure requirements, could increase the chances of uncovering illegal payments. Another interaction is with the standards of treatment in IIAs, as the failure of a Government to act against bribery could result in claims of its breach of such standards. Other interactions include taking of property, dispute settlement and social responsibility.

The lack of checks and balances on the power of officials, the high degree of discretion that public officials are permitted to exercise, and the lack of transparency, monitoring and accountability in administrative processes could contribute to an environment that is conducive to transnational corruption. It is generally considered that the higher the level of corruption, the lower the degree of legal security and predictability that investors feel in their dealings with Governments. In other words, the lack of confidence necessary to investment would hamper economic initiative. At the same time, corruption may reduce or even cancel the benefits expected from FDI for a host country, as it can distort the objective use of governmental powers in assessing investments from abroad for the public good in favour of private gains.

Thus, on the one hand, Governments seek to ensure that TNCs do not benefit from the protection afforded to them in IIAs while resorting to the making of illicit payments that could reduce the expected benefits from their investment to a host State. On the other hand, TNCs would need to be safeguarded from arbitrary, discriminatory or anti-competitive action that either results from bribery or may be directed towards them under an illegitimate funding that implicates them in a corrupt transaction. The policy options that present themselves for inclusion in IIAs would therefore need to be considered in view of these factors. The range of available options are from making no references to illicit payments in IIAs, on the one hand, to the inclusion of substantive provisions that address transnational bribery issues, on the other.

Introduction

Corruption in public service or private transactions is not a new phenomenon. It has many facets, one of which is illicit payments, or bribery, as it is more commonly called. Bribery is disapproved of on both normative and economic grounds. It raises political and larger systemic questions with respect to its effect on governance and the role of government in its cause and treatment.¹ Bribery

connected to public office is an important element of these larger questions. The normative issues encompassed in political, sociological and moral concerns with respect to corruption are, however, beyond the scope of this chapter. Rather, it focuses on the issue of illicit payments – in particular its transnational dimension – and the way it is addressed in IIAs and related instruments. It needs to be noted at the outset, however, that bribery is not a core element of IIAs and investment protection. Indeed, the issue is typically not addressed in such agreements.

Still, efforts to combat corruption are increasingly being pursued by Governments, TNCs and NGOs. More specifically, this chapter examines issues related to illicit payments that are relevant to IIAs. It first identifies the principal issues that arise. Then it takes stock of how IIAs and IIA related instruments have dealt with those issues, analysing how relevant provisions address illicit payments. Third, the chapter notes the interactions that arise between the present issue and those considered in other chapters in these volumes. Finally, the chapter examines the development and policy implications of illicit payments, and concludes with a discussion of some options that could be considered should parties choose to address this issue in IIAs.

Section I Explanation of the Issue

The globalization of the world economy increases the risk of transnational corruption and facilitates transnational bribery for a variety of reasons. First, the number and magnitude of, as well as the competition for, cross-border business transactions have risen, thus increasing the motive to engage in illicit payments. Secondly, Governments and, hence, public officials, often interact with foreign investors in large transactions either directly or by means of authorizations and incentives, which creates the opportunity for bribes. Some areas of public sector activities that could be particularly susceptible to transnational corruption, including the making of illicit payments, comprise for example; export/import controls, health safety controls, dispute settlement and legislative action relevant for FDI. A typology of public sector corrupt practices that seem to be particularly relevant in this framework is set out in table 1 below. Thirdly, the liberalization of financial operations renders international controls more difficult, especially in the light of the wide

availability of offshore tax and banking havens, which creates the means to hide or launder the proceeds of such illicit transactions.

Bribery can have important consequences for FDI, from the perspective of both Governments and TNCs. Corruption can distort FDI flows from areas identified by Governments as having development priority to those areas that would instead maximize only, or primarily, private gain. Additionally, bribery can create general allocation distortions, and the payment of bribes could ultimately increase the costs to host economies themselves in the form of inflated and excessive payments, either by the Government or consumers, for the purchase of goods, services or technology provided by foreign investors, thereby having negative effects for the society at large. In sum, there is ample reason for Governments to recognize that bribery could reduce the potential that FDI has to contribute to national development objectives. At the same time, such illicit transactions can reduce commercial predictability and create an uneven playing field for private enterprise. Since predictability and non-discriminatory standards of treatment are important components for international business with respect to FDI, especially where the latter involves substantial amounts in long-term projects, FDI is likely to be adversely effected.

Transnational corruption, including the bribery of foreign public officials, is an important subset of the larger issue of corruption, given that the substantial sums that are often involved in FDI increase the prospects for significant private gain. Yet, national efforts to combat corruption have typically not included the relationship between local enterprises and foreign public officials.² Thus, a double standard can be created where the bribery of a local official is outlawed, but illicit payments to a foreign public official are condoned. Additionally, the investigation of local corruption might require appropriate international mechanisms for mutual police and judicial assistance and cooperation. Such assistance and cooperation would need to take place between countries in which an enterprise offering a bribe, the financial intermediaries who may facilitate such an illicit transaction, and a public official who receives a bribe are located. Thus, the effective control of corruption requires addressing transnational bribery in a context that would provide national governments with appropriate tools to investigate and prosecute all parties involved in such transactions (Vogl, 1998). The argument about a double standard has been

Table 1. Typology of public sector corrupt practices

Primary area of public sector activity	Elements of activity open to corrupt practices
Public expenditure programmes.	The allocation of real, financial and administrative resources for public programmes, including the earmarking of resources across sectors and regions. Also includes the prioritization of expenditures and programme scheduling, determination of expenditure quality, and the distribution of goods utilised in the course of the programmes.
Public procurement.	Negotiation with domestic and transnational operators for the purchase of assets or services. Also includes the selection of suppliers, contractors and operators, as well as the pricing of procurement.
Government licenzng.	The selection of entities (especially if licenses are rationed), determination of supply levels, and the pricing of licenses for entities to undertake specific economic activities. This includes the import and export of particular products, production of specified goods or services, or exploitation of particular natural resources. Also includes licenses authorising trade in certain products or in certain regions of the country.
Centralized control of fiscal and financial policy measures.	The selection of recipients, determination of values of allocation, pricing of allocation and management of default situations, through centralised agencies such as central banks, for activities related to international finance ranging from the allocation of foreign exchange to financial credit under systems of non-market administered control.
The sale of public assets to private sector interests under programmes of privatisation.	Determination of asset valuation. Determination of terms and conditions of sale. Selection criteria of buyer
The management of private activities.	Determination of pricing. Controls on scale and location of operation. Environmental controls.
The administration of the tax revenue system (for both internal and international transactions).	Determination of liabilities and their collection.
The operations of the public enterprise sector, including the purchase and sale of goods and services.	Pricing and invoicing of imports and exports.

Source: OECD, 1997c, p. 52.

addressed by the actions of the countries of the Organisation for Economic Co-operation and Development (OECD) under their 1997 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (1997 OECD Convention).

Efforts to counter the bribery of foreign officials have increasingly involved action at both the national and international levels, by Governments, international business and civil society, including NGOs. Such efforts at the level of Governments can be classified into initiatives intended to *prevent* corruption and, more commonly, those designed to define and *criminalize* specific behaviour deemed to constitute

corrupt practices. With respect to the prevention of corruption, the main issue involves the reduction of the opportunity for, and the means of, bribery through commitments with respect to transparency, disclosure and accounting, and the reduction of the discretion of public officials in relation to transactions involving a Government.

Given that transparency is an important element in the efforts to prevent corruption, and yet it also involves other issues that go beyond corruption, the topic is covered separately in another chapter (see volume I). Hence, transparency will not be discussed in this chapter in detail. It should be noted, however, that governmental efforts to increase the transparency

of their activities generally encompass the areas of procurement, regulatory procedures and decision-making processes, and fiscal, monetary and financial policies and practices.³

Some efforts to prevent transnational bribery have also been made by a number of TNCs, mainly through internal processes and procedures that affect conduct of their employees and representatives, but also through the promotion of best practices in relevant industry groupings. NGOs have contributed to this effort by taking on the role of both pressure groups and watchdogs *vis-à-vis* Governments and international business. In this connection, NGO activities include promoting awareness of the problem of transnational bribery, publicizing its incidences and responses thereto, and advocating coordinated action to combat the phenomenon.

Traditionally, however, international efforts concerning transnational bribery have centred on its criminalization. This implies that the main actors in this area are Governments. The role of TNCs and NGOs would therefore be complementary to official efforts to investigate, prosecute and enforce criminal sanctions in cases in which transnational bribery is at issue. As indicated earlier, in many countries, including some developed countries, paying a bribe to a foreign public official is not a criminal offence. On the contrary, such a payment could even be considered as a legitimate deductible expense for the company disbursing it, thus reducing the cost of the payment from a business point of view.⁴ In countries in which anti-bribery laws have been enacted, vast differences exist in their application, sanctions and enforcement, usually due to differences in criminal legal systems.

Thus, international rule-making and cooperation have become necessary to overcome inconsistencies presented by the diversity of national legislation in this area, and the lack of efficient international mechanisms for investigation, prosecution and enforcement of applicable sanctions against those involved in transnational bribery. In this connection, two significant hurdles need to be overcome. First, countries might be concerned that international rules do create a competitive disadvantage for their respective enterprises *vis-à-vis* those of other countries not involved in anti-bribery initiatives; this means that major exporters and importers of international investment would need to be somehow linked to such initiatives. Second, effective international anti-bribery commitments

would entail that the different national legal systems function towards a common end, which is difficult, especially in view of issues relating to extraterritoriality.

Against this background, a number of issues related to the bribery of foreign officials can arise in the context of IIAs and related instruments. These include:

- **Definitions.** The criminalization of the bribery of foreign officials implies that a certain offence is established, which becomes the subject matter of legal definitions and refers to a form of conduct prescribed by international agreements or domestic law. The problem exists that legal definitions are by no means identical if one looks at the relevant laws of various countries, although a common core can be identified on a comparative basis.

1. **What is the offence of bribery and its scope?** Bribery connotes a transaction that provides the parties involved with undue payment (interpreted widely to include any property having financial and non-financial value) or other benefit or advantage. This includes a payment or advantage that is in consideration of (non) performance of that which is already due by virtue of the recipient's terms of service, or other commitments and obligations. It also includes payments in consideration for the receipt of information, services or other advantages that the payer would not otherwise be entitled to receive. In this connection, issues arise as to how to distinguish between legitimate, negligible or otherwise benign gifts that are customary in some cultures and those that would constitute a bribe.

The effectiveness of an anti-bribery law in part depends upon its scope. This is especially the case given that there is no direct victim and, therefore, there may be difficulties in detecting and investigating such offences. Thus, the issue arises as to how best to address this matter and impose penalties on all potential parties to a bribe, including third party intermediaries, regardless of whether a given party is soliciting, offering, facilitating or complying with a demand for a bribe. In this connection, the issue of circumvention arises. In order to avoid circumvention, not only direct, but also

indirect payments would need to be considered in the definition of the offence of bribery, including advantages in kind and payments to third parties where a principal actor in the transaction is an indirect beneficiary. Such payments could also encompass contributions to political parties, elections and campaigns.

2. **Who is a “public official”?** Generally speaking, illicit payments involve at least two individuals. In the general case of the bribery of a public official, it follows that one of them is a person entrusted with a public office or function. Issues arise within each legal system as to what is meant by “public function”. Typically, this would include a person acting in a public capacity on behalf and in the interest of a State entity or other public body, or performing what is defined as a public task or function in the country within whose system he or she operates. For example, persons holding legislative, administrative or judicial offices, as well as employees of State enterprises and international organizations, would typically be considered as public officials.
 3. **What is transnational bribery?** From the previous discussion, it follows that the bribery of a foreign official may simply be defined as bribery directed from businesspeople and companies of one country to public officials of another country. This would typically occur where the parties are seeking improperly to obtain an advantage in the conduct of international business, as in relation to an investment or a procurement or trade transaction.
- **Jurisdiction.** The uniformity and effectiveness of international action against transnational bribery also depends on the jurisdictional basis according to which signatories proceed to the application and enforcement of their respective obligations to prosecute the offence. Territorial jurisdiction is found in all legal systems and thus could be asserted with respect to local bribery issues. However, territorial jurisdiction can easily be avoided when transnational bribery is at issue by carrying out the transaction in a third country. In addition to territorial jurisdiction, countries can therefore also regulate the conduct of their nationals at home and abroad

under the concept of jurisdiction based on nationality. In order to reach effectiveness in international instruments that address transnational bribery, the issue arises as to how to extend – to the maximum extent possible in accordance with the constitutional system of each party – the jurisdiction of each country to investigate, prosecute and sanction those who contravene anti-bribery laws and conventions. In this connection, the issue arises as to how to address situations in which more than one party has exercised (or wishes to exercise) jurisdiction with respect to the same act of bribery.

- **International cooperation.** As indicated earlier, effective co-operation between countries with respect to the investigation and prosecution of transnational bribery is one of the central aims of international action in this area. In the absence of international agreements, the exchange of information, taking of evidence and supply of documents may be impossible. Even where conventions exist, co-operation may be cumbersome, and persons affected may legally obstruct compliance by the authorities of the requested country by having recourse to available judicial remedies. Moreover, evidence of transnational bribery – especially that contained in corporate and bank records – may not be kept either in the country of the public official, or in the country where the TNC involved has its head office. Rather, such evidence might be located in offshore countries. This makes effective treaty provisions in this respect essential, especially in terms of mutual legal assistance and extradition.

A connected issue is that of monitoring effective application of a given international instrument by its contracting parties. This is especially important when the regulation of the economy is at stake, because different levels of compliance result in different standards applied to companies of different national origins, to the detriment of their competitors and of host governments.

- **Enforcement and sanctions.** A number of issues arise with respect to the enforcement and sanctions associated with the offence of transnational bribery. While, as a general proposition, it might be acceptable to subject TNCs to anti-bribery laws in their international business dealings, lax

implementation of international commitments might result in the risk that, while companies are prosecuted by their national authorities, host governments would condone the action of the public officials involved. A second concern, as indicated previously, is the resulting competitive disadvantage of companies whose home countries are parties to anti-bribery conventions *vis-à-vis* their competitors whose home countries have not become parties to such conventions, or where different substantive or procedural standards might exist in different countries with respect to the same offence. This would include, for example, circumstances in which countries have different timeframes within which they could legally prosecute violations of laws on transnational bribery.

A related question arises when bribery takes place by or in the interest of corporations. To maximize the deterrent effects of anti-bribery laws, an issue is to what extent a corporation itself (and not just the managers or intermediaries responsible) could be subject to sanctions. This is problematic in many legal systems in which criminal liability concerns only individuals as opposed to legal persons. Even in such instances, however, non-criminal pecuniary sanctions are usually available, and may be imposed on corporations, in addition to any individual involved, or even if the individual responsible cannot be prosecuted or punished because of some factual obstacle or lack of jurisdiction.

With respect to sanctions, a further concern is the possible effects that penalties provided for in anti-bribery conventions would have on the rights and obligations of States as regards the treatment and protection of foreign investment in IIAs. For example, where sanctions mandated in conventions that prohibit transnational bribery include an administrative decision to annul any licenses that have been issued as a result of an illicit payment, such action might be challenged under a general expropriation clause in an IIA. This could subject the same offence to adjudication under a multiplicity of fora and, potentially, in accordance with differing legal standards. Indeed, should an IIA also include investor-State dispute resolution provisions, such a mechanism would in effect internationalize criminal proceedings that are typically, even

under instruments that address transnational bribery, a matter left for national authorities.

- **The responsibility of TNCs.** As indicated previously, TNCs play a crucial complementary role with respect to efforts to prevent and counter transnational bribery. In this respect, they could contribute to the control of transnational bribery by providing information and complying not only with anti-bribery laws, but also with requirements concerning financial reporting standards. Issues arise on how to prevent transnational corruption by dissuading TNCs and their managers from using bribery as a means of doing business. Typically, preventive rules that pertain to bookkeeping, accounting and disclosure standards could make deviations more cumbersome and easily detectable by auditors.

The issues identified in this section are not meant to be exhaustive. From a legal perspective, many other(sub)issues require consideration in the context of international negotiations. Differences in approach and formulations to the problematic of criminalization of transnational bribery in IIAs and related instruments depend, to a large degree, on the purposes and objectives of the parties involved, as well as their political, legal and administrative cultures. In the next section, stock will be taken as to how the main issues identified here have been addressed in IIAs and related instruments; to the extent possible, variations in approach and formulation will be highlighted and discussed.

Section II Stocktaking and Analysis

The idea that it is improper to offer inducements to influence public officials – and consequently to receive them – has longstanding roots. However, the translation of this idea into law has been inconsistent over time. In Europe, for example, criminal sanctions to punish illicit payments to public officials can be found only from the last century onward, beginning with the French Code of 1810. Moreover, the extent to which such laws are enforced and bribery prosecuted varies greatly. Transnational bribery can also be traced long before the current era of globalization, although now the motives, opportunities and means have increased significantly. Today, many governments are undertaking autonomous reviews of their

legislation concerning transnational bribery (UNGA, 2000). One of the first and most comprehensive national efforts to combat transnational bribery is the United States “Foreign Corrupt Practices Act of 1977”. The Act has made it illegal for United States companies, under criminal sanctions, to bribe foreign public officials (box 1). Similar efforts have been undertaken by countries that have enacted laws giving effect to international conventions, such as the 1996 Organization of American States Inter-American Convention against Corruption (Inter-American Convention).

Box 1. Summary of the United States Foreign Corrupt Practices Act of 1977

The Foreign Corrupt Practices Act (United States Code, 1977) makes it unlawful to bribe foreign officials to obtain or retain business. The anti-bribery provisions apply first to “domestic concerns”, defined as any individual who is a citizen, national or resident of the United States or any corporation, partnership or other organisation with its principal place of business therein. A similar prohibition applies with respect to payments to a foreign political party or a candidate for foreign political office. The Act also prohibits bribes paid by a domestic concern and its officials through intermediaries while knowing that all or a portion of the payment will be offered or given directly or indirectly to a foreign public official. The anti-bribery provisions apply also to certain issuers of securities, irrespective of whether they are United States or foreign companies, by requiring filing of periodic reports to the Securities and Exchange Commission.

The Act requires also that these corporations meet certain accounting standards, that is to maintain books and records that accurately and fairly reflect the transactions of the corporation and to design an adequate system of internal accounting controls. As amended in 1988 (*ibid.*, 1988) the Act provides an explicit exception to the bribery prohibition for “facilitating payments” for “routine governmental action”, that is for minor payments meant to facilitate the provision of permits, licences, visas, phone service, etc.

The United States Department of Justice is responsible for the criminal enforcement of the Act. Firms are subject to a fine up to \$2million; officers, directors and stockholders acting on behalf of a company are subject to a fine up to \$100,000 and imprisonment up to five years. While only a few criminal proceedings have been brought under the Act, and no offender has ever served jail terms, its preventive effect on corporate conduct by United States companies is generally considered as having been substantial. In particular, United States TNCs have introduced and enforced programmes of monitoring and compliance by their personnel in order to avoid violating the statute.

/...

Box 1 (concluded)

United States business also encouraged its Government to act in order that other countries, especially those in which their major competitors on the international market are located, introduce similar standards of behaviour in order not to be put at a competitive disadvantage. The efforts of the Government in this direction ultimately helped to produce the 1997 Convention on Combating Bribery of Officials in International Business Transactions, negotiated within the OECD. In order to enforce the OECD Convention of 1997, the Act was amended in 1998 (*ibid.*, 1998). Its jurisdictional provisions, both territorial and personal, have notably been expanded. They also now cover foreign persons and firms who commit a corrupt act in the United States, as well as United States persons and businesses, even if no territorial link exists with the United States.

Source: UNCTAD.

Efforts to combat transnational bribery at the national level have also been undertaken by TNCs, as well as NGOs. Some businesses have developed “codes of conduct” with respect to bribery. (The topic of corporate codes of conduct is more specifically discussed in chapter 18.) Such anti-bribery commitments have encompassed a broad range of approaches, from general statements prohibiting bribery to relatively detailed primers that address employee conduct with respect to payments to public officials (Gordon and Miyake, 2000). The civil society’s involvement in dealing with transnational bribery is illustrated by the activities of Transparency International in a number of countries (box 2).

While international efforts to address transnational bribery can be traced back to the 1970s, developments at the international level gained momentum in the 1990s, when it was realized that individual national efforts alone may not be sufficient in this area. As early as 1976, an *ad hoc* Intergovernmental Working Group and a Committee on an International Agreement on illicit payments was established under the auspices of the United Nations Economic and Social Council (ECOSOC) to address the issue of corrupt practices (ECOSOC, 1979a).⁵ NGOs also addressed bribery in business transactions at the international level, for example in 1976, with the establishment of an *ad hoc* Commission of the International Chamber of Commerce (ICC) to investigate the extent to which countries have effective legislation to prohibit extortion and bribery (ICC, 1977).⁶

Box 2. Transparency International^a

Transparency International (TI) is a non-governmental organization dedicated to increasing governmental accountability and curbing international and national corruption. It is the only global non-profit and politically non-partisan organization with an exclusive focus on corruption.

Founded in 1993, TI is active in more than 70 countries and in the international arena, with a small secretariat in Berlin. National chapters form its core. Among other things, they monitor national developments. National chapters are financially and institutionally independent and are called upon to observe the TI guiding principles of non-investigative work and independence from government, commercial and partisan political interests.

TI defines corruption as the abuse of public office for private gain. This effectively means the taking of decisions to serve private interests, rather than the public good. TI believes that combating corruption is only possible by involving all stakeholders in a society: the State, civil society and the private sector.

At the national level, TI promotes, through its national chapters, the concept of “integrity pacts” in order to curb corruption in the area of public procurement. Yet, corruption often transcends the national level and is beyond the reach of national governments alone. Therefore, TI works to ensure that the agendas of international organizations – both governmental and non-governmental – give high priority in their programmes to curbing corruption. TI also seeks to shape public policy discussions in various fora – such as the Council of Europe, the European Union and the Organization of American States – to criminalize transnational corruption in an internationally coordinated manner. It also strives to develop coherent international norms to fight and prevent corruption, e.g. in the fields of auditing or international finance.

Other initiatives undertaken by TI to tackle the problem of international corruption include the publication of “best practices” in the area of building and maintaining a country’s national integrity system in its TI Source Book and annual surveys of key themes in corruption and the fight against corruption in a report entitled the Global Corruption Report. The Report includes evidence of corruption, both by payers of bribes (Bribe Payers Index) and bribe recipients (Corruption Perceptions Index).

Source: UNCTAD, 1999a, p.142, based on information provided by Transparency International.

^a For more information, see Transparency International, 2001.

Against this background – and prior to taking stock of how the issues identified in section I of this chapter have been dealt with in IIAs and other relevant international agreements – one point needs to be clarified. It is recognized that not many international agreements on the promotion and protection of investment specifically address

transnational bribery and corruption, especially with respect to the criminalization of acts that would constitute such practices. Indeed, for example, bilateral investment treaties (BITs) do not directly address the issue. Therefore, in the remainder of this section, the analysis focuses on a discussion of the treatment of the issues related to transnational bribery in international instruments that are related to the operation of TNCs, i.e. those that address bribery in international business transactions, the obligations of TNCs in this regard, or related topics.

A. Definitions

The prohibition of certain conduct under the threat of criminal sanctions requires a clear description as to what acts would be punishable under the relevant laws. With respect to transnational bribery, some elements are typically included in international agreements to render a precise legal description for the act of bribery. They are:

- (1) an offer or demand (the following terms are typically used: the offering, promising, giving, soliciting, demanding, accepting or receiving);⁷
- (2) to or by a foreign public official;
- (3) of any payment (usually terms such as gift or advantage are included);
- (4) by a person or corporation (which are also referred to as natural and juridical persons); and
- (5) for undue consideration of (non)performance of duties.

1. The offence of bribery

The 1979 United Nations ECOSOC draft International Agreement on Illicit Payments (United Nations draft International Agreement on Illicit Payments) requires, in its article 1(1), each contracting party “to make the following acts punishable by appropriate criminal penalties under its national law:

- “(a) The offering, promising or giving of any payment, gift or other advantage by any natural person, on his own behalf or on behalf of any enterprise or any other person whether juridical or natural, to or for the benefit of a public official as undue consideration for performing or refraining from the performance of his duties in connection with an international commercial transaction.

- (b) The soliciting, demanding, accepting or receiving, directly or indirectly, by a public official of any payment, gift or other advantage, as undue consideration for performing or refraining from the performance of his duties in connection with an international commercial transaction.”⁸

Article 1(2) of the draft Agreement provides that the same acts should be made punishable when committed by a juridical person, i.e. a corporation. In the case of a State that does not recognize criminal responsibility of corporations, the same article requires a contracting party to “take appropriate measures, according to its national law, with the objective of comparable deterrent effects”. In order to avoid circumvention, the scope of article 1 is wide. The offence covers direct or indirect payments (and demands therefore by public officials) made by or on behalf of individuals or corporations. However, a question arises as to whether or not the offence is limited to instances where the payment is to or for the benefit of a public official, which, for example, could be at issue in the case of contributions to a political party. Furthermore, by limiting the scope of the offence to circumstances involving the performance of the duties of a public official that are in connection with an *international commercial transaction*, the draft Agreement essentially identifies the offence as transnational bribery. However, this does not imply that the scope is limited only to transactions that include TNCs on the one side and foreign public officials, on the other side. The scope would also cover instances where a domestic firm bribes a domestic public official for, say, the undue issuance of a permit to export a product whose export is otherwise restricted.

Article VI of the 1996 Inter-American Convention in its paragraphs 1(a) and (b) defines bribery, as a subset of corruption:⁹

“The solicitation or acceptance, directly or indirectly, by a government official or a person who performs public functions, of any article of monetary value, or other benefit, such as a gift, favor, promise or advantage for himself or for another person or entity, in exchange for any act or omission in the performance of his public functions;

“The offering or granting, directly or indirectly, to a government official or a person who performs public functions, of any article of monetary value, or other benefit, such as a

gift, favor, promise or advantage for himself or for another person or entity, in exchange for any act or omission in the performance of his public functions; ...”

Under the Convention, therefore, the (1) solicitation or acceptance and/or offering or granting; (2) by or to a government official or person who performs public functions; (3) of any article of monetary value, or other benefit i.e. (examples of which include a gift, favour, promise or advantage); (4) in exchange for any act or omission in the performance of his public functions, constitutes the offence of bribery. It is interesting to note, from a drafting perspective, that the provider of a bribe is not specifically included as an element of the definition of the act of bribery. However, the Convention does provide, in its article V, that each “State Party may adopt such measures as may be necessary” to prosecute its nationals for committing the offence, which would presumably include its own public officials and TNCs. With respect to the “article of value or other benefit” referred to in paragraphs (a) and (b), it is not specifically required that such consideration be related to *undue* performance of duties. Thus, a question might arise, for example, as to whether or not a payment made to *expedite* the performance of official functions would constitute bribery.

In general, the scope of the offence under the Convention is broad, as it covers direct or indirect demands for bribes by public officials and payments therefore that are made by or on behalf of individuals or corporations. The offence covers payments to a public official, either for her own benefit, or that of another. Finally, it is not limited to cover only the international dimension of bribery; transactions that are completely domestic are also included.

The 1996 United Nations General Assembly (UNGA) Resolution 51/191: “United Nations Declaration against Corruption and Bribery in International Commercial Transactions” includes two provisions, which together define the act of bribery. As provided in its articles 3(a) and (b), these are:

“The offer, promise or giving of any payment, gift or other advantage, directly or indirectly, by any private or public corporation, including a transnational corporation, or individual from a State to any public official or elected representative of another country as undue consideration for performing or refraining from the performance of that official’s or representative’s duties in connection with an

international commercial transaction; The soliciting, demanding, accepting or receiving, directly or indirectly, by any public official or elected representative of a State from any private or public corporation, including a transnational corporation, or individual from another country of any payment, gift or other advantage, as undue consideration for performing or refraining from the performance of that official's or representative's duties in connection with an international commercial transaction; ..."

The Resolution's definition of bribery follows closely the definition of the United Nations draft International Agreement on Illicit Payments, and contains the five typical elements. The scope of the definition is wide, as it includes direct and indirect solicitation and payment of bribes. The offence deals essentially with the classical instance of transnational bribery within the context of an international commercial transaction.

The 1997 OECD Convention provides for a definition in its article 1(1):

"Each Party shall take such measures as may be necessary to establish that it is a criminal offence under its law for any person intentionally to offer, promise or give any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business."

Its article 2 requires that the contracting States "take such measures as may be necessary, in accordance with its legal principles, to establish the liability of legal persons for the bribery of a foreign public official". The scope of the offence is limited only to instances of active bribery. Furthermore, it is limited to exchanges between individuals or companies, on the one hand, and foreign public officials, on the other hand, in the context of international business transactions. Hence, it deals with the classical case of transnational bribery. Within that context, however, the scope is potentially wide. The 1997 OECD Convention not only requires action against the principals involved in bribery, but also against accomplices to the offence. It should be noted that according to the 1997 Commentaries on the OECD Convention (OECD, 1997d),¹⁰ attempts, conspiracies, incitement, aiding and abetting of bribery are

punishable only to the extent that such acts are already punishable in the national legal system of a party to the Convention. Thus, on the one hand, there is no requirement for a party to make such acts punishable under its legal system. On the other hand, the Commentaries make plain that the parties to the Convention must aim at a functional equivalence between their laws in this area, allowing countries to work within their legal systems as long as they can achieve the results required by the Convention thereby aiming at reducing unequal application.

Moreover, the Commentaries clarify that certain circumstances are irrelevant to the question of whether or not a crime has been committed. For example, as provided for in article 1(4) of the Commentaries, in circumstances such as, for example, bidding for public projects, bribery is deemed to have been committed even if it is shown that the bribe payer was nevertheless the most qualified bidder and could properly have been awarded the project. Other factors that are regarded as having no bearing on the issue of the commission of the offence under the 1997 OECD Convention include in article 1(7) "the value of the advantage, its results, perceptions of local custom, the tolerance of such payments by local authorities, or the alleged necessity of the payment in order to obtain or retain...[an]... advantage." (*ibid.*, p.1).

Under the 1997 OECD Convention, the giving of any *undue* advantage in relation to performance of official duties in order to *obtain or retain business or other improper advantage* is prohibited. The question arises as to what constitutes an "undue advantage".¹¹ The view expressed in article 1(8) of the Commentaries is that "It is not an offence ... if the advantage was permitted or required by the written law or regulation of the foreign public official's country, including case law" (*ibid.*). On the other hand, it could be also argued that an advantage is undue if it is provided in order to obtain or retain something to which the party giving the bribe is clearly not entitled. In this connection, article 1(9) of the Commentaries provides that "[s]mall "facilitation" payments do not constitute payments made "to obtain or retain business or other improper advantage" ... and, accordingly, are ...not an offence" (*ibid.*). Such qualifications, as indicated in the Commentaries, seem to be, however, a setback to the goal of a wide scope for the offence.¹²

In the 1999 Council of Europe Criminal Law Convention on Corruption (Criminal Law Convention), the bribery of public officials is

extensively defined in terms of the relevant official that might be involved, at both domestic and international levels (box 3).

**Box 3. The Criminal Law Convention on
Corruption: defining bribery**

“Chapter II - Measures to be taken at national level

Article 2 - Active bribery of domestic public officials

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law, when committed intentionally, the promising, offering or giving by any person, directly or indirectly, of any undue advantage to any of its public officials, for himself or herself or for anyone else, for him or her to act or refrain from acting in the exercise of his or her functions.

Article 3 - Passive bribery of domestic public officials

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law, when committed intentionally, the request or receipt by any of its public officials, directly or indirectly, of any undue advantage, for himself or herself or for anyone else, or the acceptance of an offer or a promise of such an advantage, to act or refrain from acting in the exercise of his or her functions.

Article 4 - Bribery of members of domestic public assemblies

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to in Articles 2 and 3, when involving any person who is a member of any domestic public assembly exercising legislative or administrative powers.

Article 5 - Bribery of foreign public officials

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to in Articles 2 and 3, when involving a public official of any other State.

Article 6 - Bribery of members of foreign public assemblies

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to in Articles 2 and 3, when involving any person who is a member of any public assembly exercising legislative or administrative powers in any other State.

Article 9 - Bribery of officials of international organisations

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to

/...

Box 3 (concluded)

in Articles 2 and 3, when involving any official or other contracted employee, within the meaning of the staff regulations, of any public international or supranational organisation or body of which the Party is a member, and any person, whether seconded or not, carrying out functions corresponding to those performed by such officials or agents.

Article 10 - Bribery of members of international parliamentary assemblies

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to in Article 4 when involving any members of parliamentary assemblies of international or supranational organizations of which the Party is a member.

Article 11 - Bribery of judges and officials of international courts

Each Party shall adopt such legislative and other measures as may be necessary to establish as criminal offences under its domestic law the conduct referred to in Articles 2 and 3 involving any holders of judicial office or officials of any international court whose jurisdiction is accepted by the Party.”

Source: UNCTAD, 2000a .

The scope of the Criminal Law Convention is broad in that its articles 2 and 3, when taken together, address all potential transactions, whether direct or through third parties, between public officials and private entities. In order to avoid circumvention, the offence under the Criminal Law Convention covers cases in which a payment is in exchange for an act or omission by a public in the exercise of his or her functions, irrespective of whether the public official or an associated third party is the beneficiary of the transaction.

2. The “public official”

The definition of a public official determines, to some degree, the scope and effectiveness of the efforts to combat bribery. The narrower and more technical the definition, the easier it would be to circumvent the law. Thus, in most instruments, the definition of a public official goes beyond titular designations, and includes functional characterizations. For example, in article 2(a) of the United Nations draft International Agreement on Illicit Payments, "...‘Public official’, means any person, whether appointed or elected, whether permanently or temporarily, who, at the national, regional or local level holds a legislative, administrative, judicial or military

office, or who, performing a public function, is an employee of a Government or of a public or governmental authority or agency or who otherwise performs a public function; ...”.

The formulation used in the Inter-American Convention is somewhat different, as its definition includes both titular designations (public officials) and persons who perform public functions. Thus, its article provides that:

“ ‘Public function’ means any temporary or permanent, paid or honorary activity, performed by a natural person in the name of the State or in the service of the State or its institutions, at any level of its hierarchy. ‘Public official’, ‘government official’, or ‘public servant’ means any official or employee of the State or its agencies, including those who have been selected, appointed, or elected to perform activities or functions in the name of the State or in the service of the State, at any level of its hierarchy. ”

A more particular definition is included in the 1997 OECD Convention, which in its article 1(4) defines “foreign public official” to mean “any person holding a legislative, administrative or judicial office of a foreign country, whether appointed or elected; any person exercising a public function for a foreign country, including for a public agency or public enterprise; and any official or agent of a public international organisation; ...”.

Another formulation is provided for in the Criminal Law Convention on Corruption, which provides, in Chapter I, article 1:

- “a) ‘*public official*’ shall be understood by reference to the definition of ‘*official*’, ‘*public officer*’, ‘*mayor*’, ‘*minister*’ or ‘*judge*’ in the national law of the State in which the person in question performs that function and as applied in its criminal law;
- b) the term ‘*judge*’ referred to in subparagraph a above shall include prosecutors and holders of judicial offices; ...”.

Thus, this instrument defers to the applicable definitions of “public official” under the national laws of its contracting parties, rather than opting for harmonized definition under the Convention.

3. *Transnational bribery*

Transnational bribery could be defined separately as an offence in a relevant instrument. For example, article VIII of the Inter-American

Convention entitled “Transnational Bribery” provides:

“Subject to its Constitution and the fundamental principles of its legal system, each State Party shall prohibit and punish the offering or granting, directly or indirectly, by its nationals, persons having their habitual residence in its territory, and businesses domiciled there, to a government official of another State, of any article of monetary value, or other benefit, such as a gift, favor, promise or advantage, in connection with any economic or commercial transaction in exchange for any act or omission in the performance of that official’s public functions.”

It should be noted that, under the Inter-American Convention, the definition of transnational bribery includes the same general definition of bribery under its article VI, which is, in article VIII, fashioned to address specifically the international dimension of the general offence. The scope of the offence is, however, narrower than the general offence of bribery defined in the Convention. Transnational bribery under this Convention addresses *economic or commercial transactions*, i.e. the specific offence focuses on international business. In contrast, articles 5,6, 9-11 of the Criminal Law Convention (box 3), while also providing for specific references to bribery in a transnational context, cover the entire range of circumstances within which a public official acts in the exercise of his or her functions.

It is also possible to establish the scope of the general definition of bribery in such a way as to address the offence in its transnational context. Examples include, as previously discussed, the United Nations draft International Agreement on Illicit Payments and the 1997 OECD Convention.

* * *

The review of the foregoing international agreements leads to a number of general observations. First, the definition of the offence of bribery, including transnational bribery, includes a number of elements, namely: (1) an offer or demand (2) to or by a public official (3) of any payment or other benefit (4) by a person or corporation (5) for undue consideration of that official’s (non) performance of duties. Secondly, the definition of a public official includes both a subjective element in terms of qualifications and an objective element in terms of the exercise of public functions. Thirdly, the scope of the offence of bribery is usually wide, as it may cover direct and

indirect transactions, regardless of whether or not payments or advantages go to the principals or to third parties. Fourthly, in a number of cases, the instruments focus only on transnational bribery, i.e. on foreign public officials within the context of international business transactions.

B. Jurisdiction

The typical grounds upon which States can assert jurisdiction to address transnational bribery are based upon the principles of territoriality and nationality. Essentially, the territoriality principle stands for the proposition that a State can act, exclusively of other States, but within the bounds of international law, to regulate or otherwise address any matter that occurs within its territory. This ground of jurisdiction is sometimes extended to cover instances in which acts that do not originate within the territory of a State have, nevertheless, significant effects in its territory; this is known as the “effects doctrine”. The nationality principle, on the other hand, asserts that a State can regulate or otherwise address, within the bounds of international law, the conduct of its nationals, regardless of their location or the location where their conduct originate.

While all States base their criminal jurisdiction on territoriality (that is in respect of offences committed within their territory including in some cases those deemed to have been committed in their territory because of the effects caused therein), many States do rely also on nationality as a basis of jurisdiction, which makes it possible to prosecute nationals for offences committed by them abroad. Even those States that extend their jurisdiction over their nationals abroad in criminal matters tend to do so only in respect of certain crimes or in special circumstances.

Thus, article 4 of the United Nations draft International Agreement on Illicit Payments provides:

“1. Each Contracting State shall take such measures as may be necessary to establish its jurisdiction:

- (a) Over the offences referred to in article 1 when they are committed in the territory of that State;
- (b) Over the offence referred to in article 1 (b) when it is committed by a public official of that State;
- (c) Over the offence referred to in article 1, paragraph 1 (a) relating to any payment, gift or other advantage in connection with [the

negotiation, conclusion, retention, revision or termination of] an international commercial transaction when the offence is committed by a national of that State, provided that any element of that offence, or any act aiding or abetting that offence, is connected with the territory of that State.

[(d) Over the offences referred to in article 1 when these have effects within the territory of that State.]

2. This Agreement does not exclude any criminal jurisdiction exercised in accordance with the national law of a Contracting State.”

Thus, the draft International Agreement provides for territorial jurisdiction in article 4(1)(a), and splits nationality jurisdiction in sections (b) and (c) of article 4(1). Its article 4(1)(d) establishes jurisdiction on the basis of the “effects doctrine”. The provisions in article 4(1) suggest that, if either active or passive bribery is committed entirely, or has its effects, in the territory of a State, that State shall have jurisdiction to prosecute. Interestingly however, with respect to jurisdiction on the grounds of nationality, there is a distinction between public officials and other nationals of a State. Section (b) provides that a State shall establish jurisdiction over passive bribery offences that involve its public officials, presumably irrespective of where such offences have been committed. On the other hand, section (c) retains an element of territoriality by providing that for other nationals of a State – including international business actors – involved in active bribery, such jurisdiction shall be established in so far as any component of the offence is connected with the territory of that State. Thus, a narrower commitment seems to exist for a State to establish jurisdiction over its international business actors who are involved in active bribery, as compared to its public officials involved in passive bribery. Finally, article 4(2) provides for other grounds of establishing jurisdiction pursuant to national criminal laws of a State.

The Inter-American Convention also provides for jurisdiction on territoriality (including the “effects doctrine”) and nationality grounds in its articles IV and V (1) and (2). In its article V (4), the Convention preserves other jurisdictional grounds that result from “the application of any other rule of criminal jurisdiction established by a State Party under its domestic law”. An interesting additional requirement in this Convention (found also in article 10.3 of the 1997 OECD Convention) is that in article V (3), each State undertakes to

“adopt such measures as may be necessary to establish its jurisdiction over the offenses it has established in accordance with this Convention when the alleged criminal is present in its territory and it does not extradite such person to another country on the ground of the nationality of the alleged criminal”. In effect, this article provides a State with a choice either to extradite an alleged offender or, failing that, to establish jurisdiction to prosecute. Article V adopts a broad definition of jurisdiction in order to secure proper prosecution of the alleged criminals.

Article 4 of the 1997 OECD Convention provides for jurisdiction on the basis of the principles of territoriality and nationality. It states:

“1. Each Party shall take such measures as may be necessary to establish its jurisdiction over the bribery of a foreign public official when the offence is committed in whole or in part in its territory.

2. Each Party which has jurisdiction to prosecute its nationals for offences committed abroad shall take such measures as may be necessary to establish its jurisdiction to do so in respect of the bribery of a foreign public official, according to the same principles.”

It should be highlighted that article 4(2) of this Convention does not seem to require the establishment of a new basis of jurisdiction on nationality grounds to prosecute offences that have been committed abroad. This provision requires however any contracting State that relies on nationality jurisdiction in order to prosecute its nationals for criminal offences committed abroad, to do so also as to the offence of bribery of a foreign public official under the Convention, according to the same principles generally applicable to crimes committed abroad. These principles may typically refer to the requirements of dual criminality, of a minimum penalty as a threshold for prosecution, of a denunciation by the victim, etc. Article 4(4) of the Convention requires each contracting party to “review whether its current basis for jurisdiction is effective in the fight against the bribery of foreign public officials and, if it is not, shall take remedial steps”.

In the 1997 OECD Convention, it was recognized that, under some national laws, the exercise of jurisdiction with respect to the bribery of foreign public officials could be subject to the offence being charged within a prescribed time-period from the alleged date of its occurrence (statute of limitations). In such circumstances, article 6 of the 1997 OECD Convention provides

that “[a]ny statute of limitations applicable to the offence of bribery of a foreign public official shall allow an adequate period of time for the investigation and prosecution of this offence”.

The Criminal Law Convention provides for similar requirements to establish jurisdiction. Its article 17 stipulates:

“1. Each Party shall adopt such legislative and other measures as may be necessary to establish jurisdiction over a criminal offence established in accordance with Articles 2 to 14 of this Convention where:

a) the offence is committed in whole or in part in its territory;

b) the offender is one of its nationals, one of its public officials, or a member of one of its domestic public assemblies;

c) the offence involves one of its public officials or members of its domestic public assemblies or any person referred to in Articles 9 to 11 who is at the same time one of its nationals.

...

4. This Convention does not exclude any criminal jurisdiction exercised by a Party in accordance with national law.”

Section 1(c) is interesting in that it extends nationality jurisdiction to cover employees of international organizations. It should be noted however, that, on the one hand, nationality jurisdiction under this Convention could be limited by the contracting States through reservations, as provided for in its article 17(2). However, if a State makes a reservation with respect to its obligations under sections (b) and (c) of article 17(1), it is required, under article 17(3), to prosecute an accused individual if that State refuses to extradite the accused after having received a request from another contracting State. Finally, it should also be noted that article 16 of the Convention states that its provisions “shall be without prejudice to the provisions of any Treaty, Protocol or Statute, as well as their implementing texts, as regards the withdrawal of immunity”. Thus, the Convention does not directly deal with one potential obstacle to the exercise of jurisdiction to prosecute the higher level foreign public office holders who may enjoy certain immunities from prosecution. Instead, it defers to relevant rules provided for in other international instruments.

* * *

There may be situations in which more than one State exercise (or wish to exercise) their jurisdictions with respect to the occurrence of the

same act of bribery. For example, a State in which the actual transaction has occurred may wish to prosecute both its public official and an officer of a TNC involved in an illicit payment transaction. At the same time, however, the home country of the TNC involved may also wish to prosecute the accused officer. The issue will thus arise as to which country should prosecute the TNC officer charged with the same offence. The 1997 OECD Convention has addressed this issue in its Article 4(3): “When more than one Party has jurisdiction over an alleged offence described in this Convention, the Parties involved shall, at the request of one of them, consult with a view to determining the most appropriate jurisdiction for prosecution.”

Finally, there may be circumstances in which one State seeks to extend unilaterally the reach of its laws against transnational bribery over non-nationals or acts that have occurred outside of its territory. Such attempts to exercise extraterritorial jurisdiction were addressed in the United Nations General Assembly resolution 51/191, where it was stated:

“11. Actions taken in furtherance of the present Declaration shall respect fully the national sovereignty and territorial jurisdiction of Member States, ...;

12. Member States agree that actions taken by them to establish jurisdiction over acts of bribery of foreign public officials in international commercial transactions shall be consistent with the principles of international law regarding the extraterritorial application of a State’s laws.”

To summarize, relevant international agreements base the establishment of jurisdiction to prosecute corruption upon a number of factors. First, States are required to establish jurisdiction, possibly taking also into account the “effect doctrine”. Secondly, nationality jurisdiction may be required to be established, in addition to territorial jurisdiction, albeit under varying criteria. In some cases, States are required to establish nationality jurisdiction for bribery offences only to the extent that this basis of jurisdiction is recognized in principle, in their legal systems. Thirdly, in the context of transnational bribery, some instruments address the issue of conflicts of jurisdiction in cases that involve the concurrent exercise of jurisdiction by two or more States or the extraterritorial application of the laws of a State. This leads to issues of international

cooperation, which is dealt within more detail below.¹³

C. International cooperation

As indicated previously, due to the nature of the offence, which involves transactions between actors that are based in different countries, the effective investigation and enforcement of laws that are intended to combat transnational bribery depends, to a large degree, upon appropriate levels of international cooperation. Thus, one of the central aims of international action in this area is to agree on such cooperation, particularly as regards mutual legal assistance and extradition.

Article 9(1) of the United Nations draft International Agreement on Illicit Payments provides that the “Contracting States shall inform each other upon request of measures taken in the implementation of this Agreement”. The draft Agreement continues, in its article 10, to outline the areas of cooperation with respect to the exchange of information and, assistance in criminal investigations and proceedings related to the offence. It states:

“1. Contracting States shall afford one another the greatest possible measure of assistance in connection with criminal investigations and proceedings brought in respect of any of the offences [referred to in article 1/within the scope of this Agreement]. The law of the State requested shall apply in all cases.

2. Contracting States shall also afford one another the greatest possible measure of assistance in connection with investigations and proceedings relating to the measures contemplated by article 1, paragraph 2, as far as permitted under their national laws.

3. Mutual assistance shall include, as far as permitted under the law of the State requested and taking into account the need for preserving the confidential nature of documents and other information transmitted to appropriate law enforcement authorities [and subject to the essential national interests of the requested State]:

- (a) Production of documents or other information, taking of evidence and service of documents, relevant to investigations or court proceedings;
- (b) Notice of the initiation and outcome of any public criminal proceedings concerning an offence referred to in

article 1, to other Contracting States which may have jurisdiction over the same offence according to article 4;

(c) Production of the records maintained pursuant to article 6.

4. Contracting States shall upon mutual agreement enter into negotiations towards the conclusion of bilateral agreements with each other to facilitate the provision of mutual assistance in accordance with this article. ”

Article 10(5) of the draft International Agreement requires, among other things, that the information obtained be used “solely for the purposes for which it has been obtained” and otherwise be kept confidential.

With respect to cooperation on extradition matters, Article 11 of the draft International Agreement provides that:

“1. The offences [referred to in article 1/ within the scope of this Agreement] shall be deemed to be included as extraditable offences in any extradition treaty existing between Contracting States. Contracting States undertake to include the said offences as extraditable offences in every extradition treaty to be concluded between them.”

Sections 2 and 3 of article 11 propose ways by which contracting parties could eliminate the need for establishing the existence of an extradition treaty, or that the offence is considered extraditable *inter se*. The draft International Agreement also requires in its article 5(1) that unless a party extradites an alleged offender, it is obliged to prosecute “without exception”. The requirement that a party must either extradite or prosecute is not designed to resolve conflicts of jurisdiction; the purpose of this requirement (*aut dedere aut judicare*) is to ensure that crimes that are considered to be very grave do not go unpunished or, at any rate, unprosecuted.

The Inter-American Convention requires, in Article VII, that the parties “facilitate cooperation among themselves pursuant to this Convention”. Article XIII of the Convention provides for cooperation on extradition, and articles XIV through XVIII comprehensively provide for mutual assistance and cooperation (box 4).

Box 4. Inter-American Convention against Corruption: provisions on international cooperation

Article XIII

Extradition

“1. This article shall apply to the offenses established by the States Parties in accordance with this Convention.

2. Each of the offenses to which this article applies shall be deemed to be included as an extraditable offense in any extradition treaty existing between or among the States Parties. The States Parties undertake to include such offenses as extraditable offenses in every extradition treaty to be concluded between or among them.

3. If a State Party that makes extradition conditional on the existence of a treaty receives a request for extradition from another State Party with which it does not have an extradition treaty, it may consider this Convention as the legal basis for extradition with respect to any offense to which this article applies.

4. States Parties that do not make extradition conditional on the existence of a treaty shall recognize offenses to which this article applies as extraditable offenses between themselves.

5. Extradition shall be subject to the conditions provided for by the law of the Requested State or by applicable extradition treaties, including the grounds on which the Requested State may refuse extradition.

6. If extradition for an offense to which this article applies is refused solely on the basis of the nationality of the person sought, or because the Requested State deems that it has jurisdiction over the offense, the Requested State shall submit the case to its competent authorities for the purpose of prosecution unless otherwise agreed with the Requesting State, and shall report the final outcome to the Requesting State in due course.

7. Subject to the provisions of its domestic law and its extradition treaties, the Requested State may, upon being satisfied that the circumstances so warrant and are urgent, and at the request of the Requesting State, take into custody a person whose extradition is sought and who is present in its territory, or take other appropriate measures to ensure his presence at extradition proceedings.

Article XIV

Assistance and Cooperation

1. In accordance with their domestic laws and applicable treaties, the States Parties shall afford one another the widest measure of mutual assistance by processing requests from authorities that, in conformity with their domestic laws, have the power to investigate or prosecute the acts of corruption described in this Convention, to obtain evidence and take other necessary action to facilitate legal proceedings and measures regarding the investigation or prosecution of acts of corruption.

/...

Box 4 (concluded)

2. The Requesting State shall be obligated not to use any information received that is protected by bank secrecy for any purpose other than the proceeding for which that information was requested, unless authorized by the Requested State.

Article XVII

Nature of the Act

For the purposes of articles XIII, XIV, XV and XVI of this Convention, the fact that the property obtained or derived from an act of corruption was intended for political purposes, or that it is alleged that an act of corruption was committed for political motives or purposes, shall not suffice in and of itself to qualify the act as a political offense or as a common offense related to a political offence.

Article XVIII

Central Authorities

1. For the purposes of international assistance and cooperation provided under this Convention, each State Party may designate a central authority or may rely upon such central authorities as are provided for in any relevant treaties or other agreements.

2. The central authorities shall be responsible for making and receiving the requests for assistance and cooperation referred to in this Convention.

3. The central authorities shall communicate with each other directly for the purposes of this Convention.”

Source: UNCTAD, 2000a.

Paragraph 8 of the United Nations General Assembly resolution 51/191 provides, in similar fashion, that States should:

“cooperate and afford one another the greatest possible assistance in connection with criminal investigations and other legal proceedings brought in respect of corruption and bribery in international commercial transactions. Mutual assistance shall include, ...:

- (a) Production of documents and other information, taking of evidence and service of documents relevant to criminal investigations and other legal proceedings;
- (b) Notice of the initiation and outcome of criminal proceedings concerning bribery in international commercial transactions to other States that may have jurisdiction over the same offence;
- (c) Extradition proceedings where and as appropriate; ...”.

The resolution continues, in paragraph 10, that States should “ensure that bank secrecy provisions do not impede or hinder criminal investigations or other legal proceedings relating to corruption, bribery or related illicit practices in international commercial transactions, and that full cooperation is extended to Governments that seek information on such transactions”.

The first official OECD instrument that addressed the need for international cooperation on transnational bribery was the 1997 Revised Recommendation of the Council on Combating Bribery in International Business Transactions (OECD, 1997e).¹⁴ The Council recommended that member countries cooperate on investigations and other legal proceedings through sharing of information (spontaneous or upon request), provision of evidence and extradition (section VII). The members were urged to provide for such cooperation in their national laws and international agreements (ibid.). In the 1997 OECD Convention that followed, these recommendations were reflected in its articles 9 “Mutual Legal Assistance” and 10 “Extradition”. A unique feature of the Convention is cooperation on monitoring the implementation of the Convention by the contracting parties through the establishment of a specific follow-up mechanism. In this connection, article 12 of the Convention provides:

“Article 12 - Monitoring and Follow-up

The Parties shall co-operate in carrying out a programme of systematic follow-up to monitor and promote the full implementation of this Convention. Unless otherwise decided by consensus of the Parties, this shall be done in the framework of the OECD Working Group on Bribery in International Business Transactions and according to its terms of reference, or within the framework and terms of reference of any successor to its functions, and Parties shall bear the costs of the programme in accordance with the rules applicable to that body.”

Thus, in accordance to its mandate under Article 12, and its detailed terms of reference, the Working group is evaluating the compliance of the contracting parties with the obligations laid down in the text, as well as the adequacy of enforcement actions taken by them. For a number of member countries, this evaluation has already taken place and a second phase involving on site evaluation of enforcement of such laws is starting (OECD, 2000c).

Another initiative in this direction was taken by the Council of Europe in 1995, through the establishment of a Multidisciplinary Group on Corruption (GMC) (Council of Europe, 1999a) which instituted the “Group of States against Corruption” (GRECO) (Council of Europe, 2000).

GRECO's main task is the monitoring of member States' compliance with international legal instruments adopted in pursuance of the Programme of Action against Corruption of the Council (Council of Europe, 1999b) decided upon in 1994, through evaluation procedures, country visits by evaluation teams, and the adoption of reports.

Further examples are the follow-up mechanism setup by the States Parties to the Inter-American Convention against Corruption to consider the way States parties are implementing the Convention and the extensive treatment of the issues connected with international cooperation in the Criminal Law Convention (box 5).

Box 5. Criminal Law Convention on Corruption: provisions on international cooperation

“Article 21 - Co-operation with and between national authorities

Each Party shall adopt such measures as may be necessary to ensure that public authorities, as well as any public official, co-operate, in accordance with national law, with those of its authorities responsible for investigating and prosecuting criminal offences: (a) by informing the latter authorities, on their own initiative, where there are reasonable grounds to believe that any of the criminal offences established in accordance with Articles 2 to 14 has been committed, or (b) by providing, upon request, to the latter authorities all necessary information.

Chapter IV – International co-operation

Article 25 - General principles and measures for international co-operation

1. The Parties shall co-operate with each other, in accordance with the provisions of relevant international instruments on international co-operation in criminal matters, or arrangements agreed on the basis of uniform or reciprocal legislation, and in accordance with their national law, to the widest extent possible for the purposes of investigations and proceedings concerning criminal offences established in accordance with this Convention.

2. Where no international instrument or arrangement referred to in paragraph 1 is in force between Parties, Articles 26 to 31 of this chapter shall apply.

3. Articles 26 to 31 of this chapter shall also apply where they are more favourable than those of the international instruments or arrangements referred to in paragraph 1.

Article 26 - Mutual assistance

1. The Parties shall afford one another the widest measure of mutual assistance by promptly processing requests from authorities that, in conformity with their domestic laws, have the power to investigate or prosecute criminal offences established in accordance with this Convention.

/...

Box 5 (continued)

2. Mutual legal assistance under paragraph 1 of this article may be refused if the requested Party believes that compliance with the request would undermine its fundamental interests, national sovereignty, national security or order public.

3. Parties shall not invoke bank secrecy as a ground to refuse any co-operation under this chapter. Where its domestic law so requires, a Party may require that a request for co-operation which would involve the lifting of bank secrecy be authorised by either a judge or another judicial authority, including public prosecutors, any of these authorities acting in relation to criminal offences.

Article 27 - Extradition

1. The criminal offences established in accordance with this Convention shall be deemed to be included as extraditable offences in any extradition treaty existing between or among the Parties. The Parties undertake to include such offences as extraditable offences in any extradition treaty to be concluded between or among them.

2. If a Party that makes extradition conditional on the existence of a treaty receives a request for extradition from another Party with which it does not have an extradition treaty, it may consider this Convention as the legal basis for extradition with respect to any criminal offence established in accordance with this Convention.

3. Parties that do not make extradition conditional on the existence of a treaty shall recognise criminal offences established in accordance with this Convention as extraditable offences between themselves.

4. Extradition shall be subject to the conditions provided for by the law of the requested Party or by applicable extradition treaties, including the grounds on which the requested Party may refuse extradition.

5. If extradition for a criminal offence established in accordance with this Convention is refused solely on the basis of the nationality of the person sought, or because the requested Party deems that it has jurisdiction over the offence, the requested Party shall submit the case to its competent authorities for the purpose of prosecution unless otherwise agreed with the requesting Party, and shall report the final outcome to the requesting Party in due course.

Article 28 - Spontaneous information

Without prejudice to its own investigations or proceedings, a Party may without prior request forward to another Party information on facts when it considers that the disclosure of such information might assist the receiving Party in initiating or carrying out investigations or proceedings concerning criminal offences established in accordance with this Convention or might lead to a request by that Party under this chapter.

Article 29 - Central authority

1. The Parties shall designate a central authority or, if appropriate, several central authorities, which shall be

/...

Box 5 (concluded)

responsible for sending and answering requests made under this chapter, the execution of such requests or the transmission of them to the authorities competent for their execution.

2. Each Party shall, at the time of signature or when depositing its instrument of ratification, acceptance, approval or accession, communicate to the Secretary General of the Council of Europe the names and addresses of the authorities designated in pursuance of paragraph 1 of this article.

Article 30 - Direct communication

1. The central authorities shall communicate directly with one another.

2. In the event of urgency, requests for mutual assistance or communications related thereto may be sent directly by the judicial authorities, including public prosecutors, of the requesting Party to such authorities of the requested Party. In such cases a copy shall be sent at the same time to the central authority of the requested Party through the central authority of the requesting Party.

3. Any request or communication under paragraphs 1 and 2 of this article may be made through the International Criminal Police Organisation (Interpol).

4. Where a request is made pursuant to paragraph 2 of this article and the authority is not competent to deal with the request, it shall refer the request to the competent national authority and inform directly the requesting Party that it has done so.

5. Requests or communications under paragraph 2 of this article, which do not involve coercive action, may be directly transmitted by the competent authorities of the requesting Party to the competent authorities of the requested Party.

6. Each State may, at the time of signature or when depositing its instrument of ratification, acceptance, approval or accession, inform the Secretary General of the Council of Europe that, for reasons of efficiency, requests made under this chapter are to be addressed to its central authority.

Article 31 - Information

The requested Party shall promptly inform the requesting Party of the action taken on a request under this chapter and the final result of that action. The requested Party shall also promptly inform the requesting Party of any circumstances which render impossible the carrying out of the action sought or are likely to delay it significantly."

Source: UNCTAD, 2000a.

Efforts by Governments with respect to combating transnational bribery are noted, with approval, in the 1999 revised ICC Rules and Recommendations on Extortion and Bribery in International Business Transactions. The Recommendation provides, under the subheading "cooperation in law enforcement" that "Governments should agree, under appropriate

provisions for confidentiality, and in conformity with the OECD Convention, to exchange through law enforcement agencies relevant and material information for the purpose of criminal investigation and prosecution of cases of extortion and bribery. They should also continue to cooperate bilaterally on matters involving extortion and bribery, on the basis of treaties providing for assistance in judicial and penal prosecution matters". Moreover, particular attention is drawn to the role of international financial institutions in this respect. Thus, it is recommended that:

"International financial institutions, e.g., the World Bank, the European Bank for Reconstruction and Development, should aim to make a significant contribution to the reduction of extortion and bribery in international business transactions. They should take all reasonable steps to ensure that corrupt practices do not occur in connection with projects which they are financing. Similarly, in negotiating cooperation agreements with non-member countries, whether countries with economies in transition or developing nations, the governing or coordinating bodies of the European Union, NAFTA, ASEAN and other regional institutions, should seek to satisfy themselves that appropriate legislation and administrative machinery to combat extortion and bribery exists in the countries concerned."

* * *

The foregoing review of provisions relating to international cooperation shows that the scope of such cooperation is intended to be wide. Again, it should be noted that it is taking place in the wider context of provisions in treaties dealing with suppression of crime. With respect to extradition, the provisions in IIAs and other relevant international agreements require States to recognize bribery as an extraditable offence. They also provide grounds upon which States could forego the necessity of the existence of extradition treaties prior to honouring a request for extradition from another party. In addition, some agreements require that a State that refuses to extradite must then prosecute. With respect to other areas of cooperation, States undertake to provide information, either spontaneously or upon request, that might help another State in the initiation, investigation and prosecution of suspected cases of bribery. Moreover, States are required to render assistance to other States in the investigation of

alleged instances of bribery, as well as the gathering and confiscation of evidence. It should be emphasized, however, that most instruments provide that States must undertake such requirements for international cooperation only to the extent that they are able to do so under their own domestic laws. On the other hand, in most cases, States may not invoke their bank secrecy laws as a ground to refuse such cooperation. In some cases, States may refuse a request for cooperation on the basis that the request is contrary to its national interests or on some other similar grounds. Such limitations diminish, of course, the effectiveness of provisions intended to secure international cooperation on such matters.

D. Enforcement and sanctions

The credibility of any criminal law system is in its enforcement mechanisms and the effectiveness of its sanctions in terms of deterrence. With respect to transnational bribery, the issue requires careful analysis to ensure an even application of laws *vis-à-vis* all parties involved. Otherwise, countries might not wish to subject their nationals to criminal sanctions in a non-reciprocal fashion. Furthermore, standards that differ significantly between countries could place international business at a competitive disadvantage, depending on whether or not they are located in jurisdictions with tougher enforcement practices than their competitors.

Article 3 of the United Nations draft International Agreement on Illicit Payments requires its contracting parties to “take all practicable measures for the purpose of preventing the offences mentioned in article 1”. It is understood that this would include the enforcement of their criminal laws by way of prosecution of the offence of bribery, as criminal prosecution could have a considerable deterrent effect on future conduct. With respect to sanctions, article 8 provides:

“[Each Contracting State recognizes that if any of the offences that come within the scope of this Agreement is decisive in procuring the consent of a party to an international commercial transaction as defined in article 2, paragraph (b), such international commercial transaction should be voidable and agrees to ensure that its national law provide that such party may at its option institute judicial proceedings in order to have the international commercial transaction declared null and void or to obtain damages or both.]”

The Inter-American Convention, in its Article XV related to international cooperation, makes reference to sanctions in the form of “freezing, seizure and for feature of property or proceeds obtained, derived from or used in the commission of offences established in accordance with” the Convention. The manner in which forfeited property should be disposed is to be in accordance with national laws.

The United Nations General Assembly resolution 51/191 in its paragraph 1 urges countries to “pursue effective enforcement of existing laws prohibiting bribery In international commercial transactions, to encourage the adoption of laws for those purposes where they do not exist, and to call upon private and public corporations, including transnational corporations, and individuals within their jurisdiction engaged in international commercial transactions to promote the objectives of...” the Resolution. In its paragraph 4, the Resolution further exhorts countries to “deny, in countries that do not already do so, the tax deductibility of bribes paid by any private or public corporation or individual of a State to any public official or elected representative of another country and, to that end, to examine their respective modalities for doing so, ...”. Finally, Governments are requested in paragraph 10 to “ensure that bank secrecy provisions do not impede or hinder criminal investigations or other legal proceedings relating to corruption, bribery or related illicit practices in international commercial transactions, ...”.

With particular reference to the bribery of foreign public officials, the 1997 OECD Convention addresses, in its articles 3 and 5, enforcement and sanctions issues, as follows:

“Article 3 - Sanctions

1. The bribery of a foreign public official shall be punishable by effective, proportionate and dissuasive criminal penalties. The range of penalties shall be comparable to that applicable to the bribery of the Party’s own public officials and shall, in the case of natural persons, include deprivation of liberty sufficient to enable effective mutual legal assistance and extradition.
2. In the event that, under the legal system of a Party, criminal responsibility is not applicable to legal persons, that Party shall ensure that legal persons shall be subject to effective, proportionate and dissuasive non-criminal sanctions, including monetary

sanctions, for bribery of foreign public officials.

3. Each Party shall take such measures as may be necessary to provide that the bribe and the proceeds of the bribery of a foreign public official, or property the value of which corresponds to that of such proceeds, are subject to seizure and confiscation or that monetary sanctions of comparable effect are applicable.
4. Each Party shall consider the imposition of additional civil or administrative sanctions upon a person subject to sanctions for the bribery of a foreign public official. ...

Article 5 - Enforcement

Investigation and prosecution of the bribery of a foreign public official shall be subject to the applicable rules and principles of each Party. They shall not be influenced by considerations of national economic interest, the potential effect upon relations with another State or the identity of the natural or legal persons involved.”

The Convention addresses the issues in a relatively comprehensive fashion. In addition to covering natural persons, the sanctions provisions specifically address juridical persons. It is interesting to note that sanctions against the bribery of foreign public officials cannot exceed those against domestic officials. The consideration of national economic interests in the enforcement of the anti-bribery laws under the Convention is explicitly forbidden, as are considerations with respect to international relations or the identity and presumably, the status of an alleged offender. In a connected development, the OECD Recommendation of the Council on the Tax Deductibility of Bribes to Foreign Public Officials (OECD, 1996b) urges, in its paragraph I, that “Member countries which do not disallow the deductibility of bribes to foreign public officials re-examine such treatment with the intention of denying this deductibility. Such action may be facilitated by the trend to treat bribes to foreign public officials as illegal”.¹⁵

Article 19 of the Criminal Law Convention provides for sanctions that are rather similar to those in article 3 of the 1997 OECD Convention. An interesting provision in the Criminal Law Convention is the issue of the protection of informants, or “whistleblowers”, which is generally not explicitly mentioned in other IIAs. Thus, article 22 provides:

“Article 22 - Protection of collaborators of justice and witnesses

Each Party shall adopt such measures as may be necessary to provide effective and appropriate protection for:

- a) those who report the criminal offences established in accordance with Articles 2 to 14 or otherwise co-operate with the investigating or prosecuting authorities;
- b) witnesses who give testimony concerning these offences.”

Article 23 of the Criminal Law Convention requires parties to adopt measures in accordance with their laws to facilitate gathering of evidence, including bank records. Parties are also required under this article to adopt measures allowing the freezing and seizure of instrumentalities and proceeds of corruption. It further provides that bank secrecy laws should not be used to thwart investigations or the freezing and seizure of proceeds of corruption.

The 1999 revised ICC Rules and Recommendations on Extortion and Bribery in International Business Transactions provide, in part I, that “Governments, in conformity with their jurisdictional and other basic legal principles, should ensure:

- i) that adequate mechanisms exist for surveillance and investigation, and
- ii) that those who offer, demand, solicit or receive bribes in violation of their laws are subject to prosecution with appropriate penalties.”

As to civil remedies, the 1999 Civil Law Convention on Corruption of the Council of Europe (Council of Europe, 2001) provides for the annulment of contracts having bribery as their object. Under the Convention, a party to a contract is entitled to ask from a competent domestic court the annulment of the contract when its consent has been affected by bribery, without prejudice to a claim for damages.

* * *

The enforcement of criminal laws against transnational bribery, and imposition of sanctions that are intended to discourage such conduct are considered to be *sine qua non* for any framework international agreement to combat bribery. Therefore, such agreements usually carry with them obligations for States to ensure that those involved in bribery are subject to criminal prosecution. To this end, most instruments require States to provide, within the limits of their national

legal systems, adequate institutional capacity for the surveillance and investigation of transactions that provide the requisite context for bribery. Moreover, similarly to the case of international cooperation, States are proscribed from raising their bank secrecy laws as justification for their failure to investigate and prosecute instances of alleged bribery. In some agreements, there are innovative provisions that requires states to protect those who report violations of laws on bribery or testify in related prosecutions that may ensue. Furthermore, it is sometimes made clear that States may not be influenced by considerations of national economic interest or other similar issues when deciding on whether or not to investigate or prosecute an alleged case of bribery.

With respect to sanctions, States generally undertake to provide for effective, proportionate and dissuasive criminal penalties. However, to ensure that the enforcement of anti-bribery laws would not result in competitive disadvantages between enterprises, some agreements require that the relevant procedures and penalties be similar to those that are applicable a State's own nationals. Penalties that are considered as being effective include the deprivation of liberty and of property, the latter being subject to freezing, seizure, confiscation, nullification and ultimately, disposition, should it be found to represent the proceeds of a corrupt transaction. A related measure is to disallow expenses related to bribery that are claimed as a tax deduction. States also recognize that, in addition to sanctions that are criminal in nature, non-penal measures that impose obligations on business enterprises are also of fundamental importance in efforts to counter transnational bribery. This is discussed in some detail below.

E. The responsibility of TNCs

As discussed previously, enterprises, and particularly TNCs, have an important role to play in preventing transnational bribery. In this respect, in addition to refraining from offering or paying bribes to public officials, appropriate management practices need to be employed, including transparency in accounting and disclosure in relevant corporate reports.

Article 20 of the 1983 United Nations draft Code of Conduct on Transnational Corporations specifically addresses the obligation of TNCs with respect to the bribery of public officials. It provides:

“[Transnational corporations shall refrain, in their transactions, from the offering, promising or giving of any payment, gift or other advantage to or for the benefit of a public official as consideration for performing or refraining from the performance of his duties in connection with those transactions...”

The third paragraph of this article of the draft Code specifically refers to the United Nations draft International Agreement on Illicit Payments and provides that the principles set out in the latter should apply in the area of abstention from corrupt practices included in the former. Indeed, the way in which the offence is defined in article 20 is very similar to article 1.1(a) of the United Nations draft International Agreement on Illicit Payments.

The 2000 OECD Guidelines for Multinational Enterprises (The Guidelines) (OECD, 2000a) include a chapter that deals exclusively with the responsibility of TNCs in the fight against bribery (box 6).

In addition, paragraph 9 of chapter II of the Guideline urges TNCs to “[r]efrain from discriminatory or disciplinary action against employees who make *bona fide* reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the *Guidelines* or the enterprise's policies” (ibid.). As indicated in the commentary on the Guidelines, this provision is particularly relevant to efforts to combat bribery. Thus, the OECD anti-corruption agenda focuses on combating the “supply-side” of transnational bribery, i.e. it seeks to eliminate bribes to foreign public officials by requiring each member country to take responsibility for subjecting the relevant activities of its TNCs that occur in its territory to criminal prosecution under the OECD anti-bribery convention, while, at the same time, encouraging TNCs to comply with the standards contained in the Guidelines for Multinational Enterprises. The 2000 Guidelines not only recommend that enterprises refrain from paying bribes, but that they also abstain from other improper conduct in their dealing with public officials that could affect the latter's impartiality, as well as the transparency and legitimacy of the administrative and political processes of their countries.

A number of NGOs have also addressed the responsibility of TNCs in refraining from, and combating, bribery. For example, part II of the 1999 revised ICC Rules and Recommendations on Extortion and Bribery in International Business Transactions provides that TNCs should be guided

by the principle that “[a]ll enterprises should conform to the relevant laws and regulations of the countries in which they are established and in which they operate, and should observe both the letter and the spirit of these Rules of Conduct”. In addition, the ICC instrument provides, also in part II, a number of specific rules for TNCs with respect to transnational bribery (box 7).

Box 6. OECD Guidelines for Multinational Enterprises on bribery

“VI. Combating Bribery

Enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage. Nor should enterprises be solicited or expected to render a bribe or other undue advantage. In particular, enterprises should:

1. Not offer, nor give in to demands, to pay public officials or the employees of business partners any portion of a contract payment. They should not use subcontracts, purchase orders or consulting agreements as means of channelling payments to public officials, to employees of business partners or to their relatives or business associates.
2. Ensure that remuneration of agents is appropriate and for legitimate services only. Where relevant, a list of agents employed in connection with transactions with public bodies and state-owned enterprises should be kept and made available to competent authorities.
3. Enhance the transparency of their activities in the fight against bribery and extortion. Measures could include making public commitments against bribery and extortion and disclosing the management systems the company has adopted in order to honour these commitments. The enterprise should also foster openness and dialogue with the public so as to promote its awareness of and cooperation with the fight against bribery and extortion.
4. Promote employee awareness of and compliance with company policies against bribery and extortion through appropriate dissemination of these policies and through training programmes and disciplinary procedures.
5. Adopt management control systems that discourage bribery and corrupt practices, and adopt financial and tax accounting and auditing practices that prevent the establishment of “off the books” or secret accounts or the creation of documents which do not properly and fairly record the transactions to which they relate.
6. Not make illegal contributions to candidates for public office or to political parties or to other political organisations. Contributions should fully comply with public disclosure requirements and should be reported to senior management.”

Source: OECD, 2000a.

Box 7. ICC’s basic rules of conduct to combat extortion and bribery

“... ”

Article 2. Bribery and “Kickbacks”

- a) No enterprise may, directly or indirectly, offer or give a bribe and any demands for such a bribe must be rejected.
- b) Enterprises should not (i) kick back any portion of a contract payment to employees of the other contracting party, or (ii) utilize other techniques, such as subcontracts, purchase orders or consulting agreements, to channel payments to government officials, to employees of the other contracting party, their relatives or business associates.

Article 3. Agents

Enterprises should take measures reasonably within their power to ensure:

- a) that any payment made to any agent represents no more than an appropriate remuneration for legitimate services rendered by such agent;
- b) that no part of any such payment is passed on by the agent as a bribe or otherwise in contravention of these Rules of Conduct; and that they maintain a record of the names and terms of employment of all agents who are retained by the main connection with transactions with public bodies or State enterprises. This record should be available for inspection by auditors and, upon specific request, by appropriate, duly authorized governmental authorities under conditions of confidentiality.

Article 4. Financial Recording and Auditing

- a) All financial transactions must be properly and fairly recorded in appropriate books of account available for inspection by boards of directors, if applicable, or a corresponding body, as well as auditors.
- b) There must be no “off the books” or secret accounts, nor may any documents be issued which do not properly and fairly record the transactions to which they relate.
- c) Enterprises should take all necessary measures to establish in dependent systems of auditing in order to bring to light any transactions which contravene the present Rules of Conduct. Appropriate corrective action must then be taken.

Article 5. Responsibilities of Enterprises

The board of directors or other body with ultimate responsibility for the enterprise should:

- a) take reasonable steps, including the establishment and maintenance of proper systems of control aimed at preventing any payments being made by or on behalf of the enterprise which contravene these Rules of Conduct;
- b) periodically review compliance with these Rules of Conduct and establish procedures for obtaining appropriate reports for the purposes of such review; and
- c) take appropriate action against any director or employee contravening these Rules of Conduct.

/...

Box 7 (concluded)**Article 6. Political Contributions**

Contributions to political parties or committees or to individual politicians may only be made in accordance with the applicable law, and all requirements for public disclosure of such contributions shall be fully complied with. All such contributions must be reported to senior corporate management.

Article 7. Company Codes

These Rules of Conduct being of a general nature, enterprises should, where appropriate, draw up their own codes consistent with the ICC Rules and apply them to the particular circumstances in which their business is carried out. Such codes may usefully include examples and should enjoin employees or agents who find themselves subjected to any form of extortion or bribery immediately to report the same to senior corporate management. Companies should develop clear policies, guidelines, and training programmes for implementing and enforcing the provisions of their codes."

Source: UNCTAD, 2000a.

It should be noted that the introduction to part II indicates that these Rules of Conduct constitute "what is considered good commercial practice in the matters to which they relate but are without direct legal effect". The rules are intended to inspire, as provided for in article 7, company codes of conduct in this respect. As such, they "are intended as a method of self-regulation by international business, and they should also be supported by governments". The introduction also makes clear that in practice, the Rules of Conduct must be read *mutatis mutandis* subject to the individual national legal system within which a TNC operates, as the rules could not derogate from applicable local laws.

Pursuant to the sixth paragraph of the 1985 Global Sullivan Principles of Corporate Social Responsibility, enterprises that have endorsed the Principles will "not offer, pay or accept bribes" (IFESH, 1999a). Under the preamble, these enterprises undertake to "respect the law, and as a responsible member of society ... apply these Principles with integrity consistent with the legitimate role of business" (*ibid.*). They further commit to the development and implementation of company policies, procedures, training and internal reporting structures to ensure commitment to the Principles throughout their organization. Such reporting structures should include providing the secretariat of the Global Sullivan Principles with an annual letter that will provide examples of "[a]ctivities which demonstrate progress that the

enterprise has made in the previous calendar year to live up to its commitment to the Global Sullivan Principles" (IFESH, 1999b). "Focus areas and activities that are planned by the enterprise in support of the Global Sullivan Principles for the coming calendar year" should also be reported in that letter (*ibid.*).

Another NGO instrument that addresses TNC responsibilities in this area was compiled by the People's Action Network to Monitor Japanese Transnational Corporations Abroad. Part II of the 1998 draft NGO Charter on Transnational Corporations provides, in its paragraph 6 entitled "Ban on political and illegal activities such as bribes", that:

"The TNC shall not be involved in or conduct any political and illegal activity wherever it operates including bribes to local and/or national governments, to political or administrative figures, or to specific groups or organisations. It shall not unfairly purchase public or private entities for its own benefit."

It is interesting to note that the draft NGO Charter, according to its article 3 in part I, primarily aims at establishing criteria to monitor TNCs by concerned NGOs. In its part III, the draft NGO Charter provides a relatively specific set of procedures for NGOs to follow in their pursuance of the monitoring of TNC activities.

* * *

Transnational bribery is, in the final analysis, mostly carried out on behalf of companies through the use of their funds and to their advantage. At times, companies might be the instigators, whereas at other times, they might feel that they have no other option but to yield to illicit demand by public officials. Thus, the policing and sanctioning of both companies and public officials involved is the primary objective of international agreements in this area. Most agreements that deal with transnational bribery provide for a definition of the offence, either by providing a distinct definition or by establishing the scope of the offence of bribery in such a way as to include (or limit it to) its transnational dimension. In order to avoid circumvention, the offences target not only the principals in corrupt transactions, but all those who are involved in its realization. This includes intermediaries, wherever they might be located, as well as those that are the actual recipients of the undue advantages, so long as such advantages are the *quid pro quo* for the improper act of a public official.

An important provision, aimed at making enforcement more effective, is article 7 of the 1997 OECD Convention on the application of anti-money laundering legislation of all contracting States to bribe payments:

“ Each Party which has made bribery of its own public official a predicate offence for the purpose of the application of its money laundering legislation shall do so on the same terms for the bribery of a foreign public official, without regard to the place where the bribery occurred.”

International anti-bribery agreements seek to obtain the maximum possible latitude for each State party to be able to exercise jurisdiction in the investigation and prosecution of instances of transnational corruption. Thus, they require countries to establish their jurisdiction to prosecute such transactions on the basis of the concepts of territoriality (including the “effects doctrine”) and nationality, as well as any other basis that is available under their national legal systems. At the same time, international agreements include provisions with respect to international cooperation to minimize conflicts of jurisdiction, in terms of both the simultaneous exercise of jurisdiction by two or more States and extra-territorial application of the laws of one State. Indeed, a particular feature of transnational bribery is that, in a given case, elements of a transaction take place in at least two, but quite possibly three or more countries. Thus, international agreements in this area provide for international cooperation not only as regards to conflicts of jurisdiction, but also with respect to the investigation and prosecution of alleged offences, extradition of the suspected perpetrators, gathering of evidence, and seizure and confiscation of the proceeds of a transaction.

The touchstone of efforts to combat transnational bribery is in the enforcement and sanctions that are provided in related international instruments. In this respect, international agreements require States that are party to them to take all necessary measures to enforce their laws against corruption. At the same time, provisions are included to ensure that differing substantive or procedural standards between the various national legal systems are not applied in such a way as to result in the competitive disadvantage of their companies. Moreover, in order to increase the effectiveness of international anti-bribery agreements, criminal sanctions are typically complemented by non-penal measures that are addressed to TNCs. These include obligations on

the part of TNCs concerning reporting of relevant information to shareholders, as well as rules reporting requirements concerning corporate accounts, bookkeeping and financial statements. Such rules are intended to make concealing illicit transaction more cumbersome and financial irregularities more easily detectable by auditors.

Section III Interaction with other Issues and Concepts

In general, transnational bribery may be at issue whenever transactions with respect to both the carrying out of an investment and operations in the furtherance of an existing investment require a discretionary act of a public authority, such as an investigation, approval, or authorization. Other acts could include provision of a license, an exemption, or a decision that would implicate resource contributions by a government or simply result in abstention from intervention that may normally be provided for in official rules, procedures or practices. These acts could be in the context of, for example, the admission of foreign companies, granting of incentives, application or enforcement of environmental standards, granting of State contracts, and transfer of funds abroad, all of which are included in the issues and concepts covered in this Series. Although the issue of transnational bribery therefore touches upon a range of issues and concepts, the interactions involved are not extensive, as they do not raise concerns that need to be addressed in provisions in IIAs pertaining to them. In a number of areas, however, interactions are extensive (table 2).

- **Standards of treatment.** The standards of treatment that are typically provided for in IIAs are most-favoured-nation treatment and national treatment. In some cases, the standard of fair and equitable treatment is also included in IIAs. In general, these standards seek to protect an investor covered under an IIA from discriminatory and arbitrary governmental measures. Bribery of a public official leads to a decision by that official that is unfair and discriminatory, especially when the competitors of the bribe giver are thereby put at a disadvantage. Thus, to the extent that a decision arising from an illicit payment could be imputed to a Government as an official measure, such a measure would be prohibited by the relevant treatment standards of an

applicable IIA. However, a host country might argue that acts that are the fruits of illegality, such as decisions that are induced by bribery, could not be attributable to it, as such illicit transactions are manifestly beyond the scope and course of the employment of public officials. Implicit in this argument is that, even in cases in which there is a demand by a public official for a bribe, no foreign investor could reasonably believe that an official has authority to seek a bribe. On the other hand, this position might be difficult for a Government that systematically fails to prosecute corrupt transactions. In other words, it could be argued that the systematic inaction of a Government in enforcing its laws against bribery could be construed as a measure that is tantamount to a tacit endorsement of the bribery transaction, and hence imputable to the Government. Thus, the failure of a Government to take action against bribery could result in claims of its breach of the standards of treatment under an IIA.

Table 2. Interaction across issues and concepts

Issue	Illicit payments
Admission and establishment	+
Competition	0
Dispute settlement (investor-State)	++
Dispute settlement (State-State)	++
Employment	0
Environment	+
Fair and equitable treatment	++
Home country measures	+
Host country operational measures	+
Incentives	+
Investment-related trade measures	+
Most-favoured-nation treatment	++
National treatment	++
Scope and definition	0
Social responsibility	++
State contracts	+
Taking of property	++
Taxation	+
Technology transfer	0
Transfer of funds	+
Transfer pricing	0
Transparency	++

Source: UNCTAD.

Key: 0 = negligible or no interaction.
 + = moderate interaction.
 ++ = extensive interaction.

- **Social responsibility.** This is an area in which TNCs can make an important contribution to efforts to combat transnational bribery, not only by making their employees aware of the relevant laws, but also by going further and developing and implementing operational standards and practices that are considered to be substantive standards of social responsibility in this area.
- **Taking of property.** Certain circumstances could give rise to an interaction between illicit payments and takings of property. For example, a host country may revoke, seize or forfeit a right or property of a foreign investor as a result of a finding that the right or property was the proceed of a corrupt transaction. In this connection, it should be noted that, on the one hand, takings resulting from a violation of criminal laws are not generally considered to be expropriation. On the other hand, the legitimacy of a finding of corruption and the extent, scope or proportionality of a corrective measure may be issues that could require case-by-case analyses to determine whether or not a State has expropriated the property of a foreign investor.
- **Transparency.** Requirements that governmental action and TNC activities be subject to transparency standards provide for the most important interaction indicated in this section. Transparency is an essential element in efforts to prevent bribery in that it facilitates public controls and review of transactions. Adequate accounting standards, both public and private, in home and host countries, coupled with appropriate reporting and disclosure requirements, also decrease the risk that illegal payments could be made in a clandestine way. Such policies raise the transaction costs of transnational bribery.
- **Dispute settlement.** It should be noted that public officials include the judiciary; therefore, transactions with judicial officers are subject to anti-bribery laws. It is less clear whether or not arbitrators in dispute settlement panels provided for in IIAs are likewise considered to be public officials. On balance, most of the definitions of a “public official” are wide enough to include arbitrators. Consequently, the bribery of an arbitrator would, in all likelihood, render a decision of that arbitrator in a particular case null and void.

Conclusion: Economic and Development Implications and Policy Options

Certain aspects of a country's administrative and economic organisation may lend themselves to the spread of corruption. These include the lack of checks and balances on the power of officials, a high degree of discretion that public officials are permitted to exercise, and the lack of transparency, monitoring and accountability in administrative processes (OECD, 1997c). Higher levels of corruption, in turn, can adversely affect the level of investment, and particularly of FDI, in a country, possibly lowering it to below levels that would otherwise prevail (Mauro, 1995; Wei, 1997). The effects of bribery on other aspects of international business transactions and TNC activities are also deemed negative. However, it should be noted that the level of corruption is but one factor among the various host country determinants of FDI (UNCTAD, 1998b) and, therefore, its significance would depend upon the effect of all other relevant factors. It is also generally recognized that corruption causes competitive disadvantages between market actors – including TNCs, but especially small and medium-sized enterprises (SMEs) – and that it creates uncertainty in relation to their investments. This is of particular importance with respect to IIAs, as these are instruments that seek to contribute to a stable and predictable international investment environment.

In light of the foregoing discussion, the following are a range of policy options that negotiators of IIAs could consider with respect to the issue of transnational bribery:

Option 1: No reference to illicit payments.

The great majority of IIAs per se include no reference to combating illicit payments, although in a few, some specific issues have been addressed. Since most efforts with respect to transnational corruption focus on its criminalization, it could be argued that IIAs per se are not the appropriate instruments to deal with this issue. Rather, Governments would address the issue of transnational bribery in the context of related IIAs.

Option 2: Inclusion of a general provision on illicit payments.

Where the parties to an IIA agree to include a reference to transnational bribery to highlight its importance, but do not wish to address this issue more specifically, one option is

to introduce it through a general, hortatory clause in the agreement. The content could include, for example, an affirmation of the parties' commitment to prevent and combat transnational bribery, or agreeing that international cooperation in preventing or combating transnational bribery is important to the aims of their IIA. Such general statements could address the parties themselves or TNCs, or both. Example upon which such an approach could be based are article II of the Inter-American Convention section V(1)(a) of the ICC's 1972 Guidelines for International Investment.

Option 3: Provisions to clarify the effects of sanctions against illicit payments on obligations under an IIA.

As indicated previously, States undertake obligations to enforce laws that prohibit transnational bribery and take penal and non-penal measures against those engaged in such transactions. Some measures include the arrest, prosecution and incarceration of the individuals involved, which could presumably include foreign investors. Others include the seizure, confiscation and disposition of property that is considered to be the result of bribery, as well as the annulment of any right or advantage acquired through such illicit transactions, all of which could be considered to be a covered investment under an IIA. Thus, there may be instances in which the application of such measures against covered investors or investment might be considered contrary to a State's obligations under an IIA. Take, for example, the right to the unrestricted transfer of funds, which is guaranteed to foreign investors under some IIAs. A host country may, under the application of its criminal laws against transnational bribery, prevent a transfer of funds that were paid to a foreign investor under a State contract that was granted to that investor through its bribing a public official. The question would then arise whether a State would be in breach of its obligations under an IIA by taking such a measure. States that are parties to an IIA may wish to clarify the effects of these measures arising from the application of their laws against illicit payments on their obligations under the IIA and, where appropriate, provide for exceptions with respect to measures that arise from the application of such laws. For example, with respect to transfer of funds, article 6 of the model BIT of China provides that transfers shall be guaranteed, subject to the laws and regulations of the contracting parties, which might arguably include criminal sanctions. A clearer formulation is provided in

articles 1109 (1) and 4(c) of the 1992 North American Free Trade Agreement (NAFTA).

Option 4: Linkages to other international anti-bribery agreements.

States may wish to link their IIAs to international agreements dealing specifically with transnational bribery for a number of reasons. For example, in the context of the negotiation of IIAs, they may decide to incorporate therein certain provisions of other international agreements that address transnational bribery issues. It should be noted, however, that this would probably be relevant only in cases in which States wish to address non-criminal measures that are intended to prevent or expose bribery, such as reporting requirements for TNCs. Another example concerns the circumstances discussed under option 3, where potential conflicts might arise between IIAs, on the one hand, and anti-bribery agreements, on the other hand. States might wish to provide for a provision that would, through incorporating the relevant anti-bribery agreements, address any potential conflict by providing for a legal hierarchy between these agreements.

States could use two techniques to incorporate existing anti-bribery agreements into their IIAs. First, parties could choose to provide a provision that indicates that certain provisions of an anti-bribery agreement is incorporated, through the attachment of an annex to their IIA, into their IIA. Alternatively, a relevant provision in an IIA could simply refer to the applicable section(s) of an existing anti-bribery agreement, and incorporate the section(s) into the IIA by such reference. The consequence of this incorporation technique is that obligations in the IIA would then mirror those under the incorporated international agreements. Thus, the determination of the nature and scope of application of the attendant obligations depends entirely upon the regime from which they are derived.

With respect to the first example, the incorporation technique could be particularly helpful in cases in which the parties perceive that negotiations on such issues might be difficult. Equally, it could be used when the negotiating States are already party to international agreements on transnational bribery, as there would be no need to enter into new negotiations in this area. Moreover, in such cases, States might wish to forgo new negotiations on anti-bribery issues for prudential reasons, as the existence of two sets of rules might be a source of confusion and conflict due to inconsistent application. As

regards the second example, article 104 of the NAFTA incorporates other international agreements in an attempt to address potential conflicts.

In a combination of options 2 and 4, parties to an IIA could also include a provision on illicit payments in an IIA with a cross reference to obligations under international anti-bribery agreements, which would apply to those parties to IIAs that are also parties to the anti-bribery agreement, and would urge those that are not parties to become parties to the relevant conventions.

Option 5: Inclusion of substantive provisions on illicit payments.

States may wish to include in their IIAs substantive provisions that address transnational bribery issues. This might particularly be the case, for example, with respect to non-criminal measures that pertain both to their Governments and to their TNCs. An instrument in which this approach was hinted at is the 1984 Caribbean Community (CARICOM) Guidelines for use in the Negotiation of Bilateral Treaties. In a section entitled "Monitoring", the CARICOM Guidelines provide that a host country "should undertake to do all in its power to ensure" that its investors "be good corporate citizens in CARICOM host countries". Arguably, a component of good corporate citizenship would be abstinence from engaging in transnational bribery. It should be emphasized, however, that the provision is addressed to home countries, which implies that they should take measures to ensure that their TNCs act as good corporate citizens in host countries.

Another example of circumstances under which parties might wish to provide for substantive provisions related to transnational bribery is with respect to international cooperation concerning specific anti-bribery issues that might arise within the context of an IIA. A number of BITs currently include provisions that could be argued as providing the basis of cooperation in such matters. These include, for example, article 12 of the 1994 model BIT of China and article VIII of the 1994 model BIT of the United States. Such provisions in IIAs might fit in well with, and reinforce obligations under, international anti-bribery agreements, should the same countries be parties to both agreements.

Finally, as some international economic agreements, e.g. regional integration agreements, increasingly seek to extend their traditional subject

matters beyond the core issues of trade liberalization and investment protection, and in particular to include rights and benefits for TNCs that are enforceable by way of adjudication in international tribunals, Governments may consider it appropriate to embody certain core values and standards in their IIAs to form an essential part of a balanced package of rights and obligations that such instruments provide to host countries, TNCs and their home countries. An analogy might be the TRIPS agreement, which in essence has made the acceptance of basic intellectual property rights a requirement of participation in the WTO system. Moreover – and directly relevant to the issue of transnational bribery – the parties to the 1994 WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) have also accepted, in article 61, that criminal procedures and penalties should be applied to willful violations of protected intellectual property rights. In similar fashion, the prevention and prohibition of transnational bribery could be regarded as an essential component of IIAs, at least in terms of non-penal measures intended to prevent and expose related transactions. Related provisions could be formulated in non-compulsory terms or, as in the TRIPS agreement, they could include mandatory obligations on the part of their addressees. Such provisions could be applicable on the basis of reciprocal conditionality, which would provide flexibility. Thus, States could choose to extend investment protection benefits only to investors from States accepting such obligations. Conditionality could also be applied to enterprises, through an appropriate denial-of-benefits clause. This would permit a State to deny the benefits of investment protection to enterprises breaching specified anti-bribery or related standards. In addition, the inclusion of specific provisions prohibiting transnational bribery within a single framework would help to create public confidence that the benefits extended to investors by globalisation would be complemented by a strengthened framework of international cooperation to prevent abuse of the freedoms of the global market.

* * *

It should be noted here that the foregoing options are not intended to provide a comprehensive listing of available options, but merely a possible range. Furthermore, while the options are presented individually, they are not

necessarily mutually exclusive and, indeed, hybrids could be considered when addressing bribery matters in the negotiation of IIAs.

Notes

- ¹ A large literature exists on the general question of bribery. See, for example, Alesina and Rodrik, 1994; Andvig, 1991; Bardhan, 1997, Bernasconi, 2000; Eigen, 1996; Gould and Amaro-Reyes, 1983; Heidenheimer, 1970; Huntington, 1968; Johnston, 1998; Mauro, 1995 and 1997; OECD, 2000d; Rose-Ackerman, 1998; Sacerdoti, 1999; Tanzi, 1994 and 1998; Theobald, 1990; Kpundeh and Hors, 1998; Vincke, Heimann and Katz, 1999; and World Bank, 1997b.
- ² A notable exception are the efforts of the United States, which has addressed the specific issue of the bribery of foreign officials in its national law. Indeed, an increasing number of other countries have also, under the auspices of the OECD, undertaken to address this issue and have adopted changes in their respective laws.
- ³ These efforts have been made mostly in regional or multilateral international for a, and under the auspices of international organizations. Examples include the 1999 Asia Pacific Economic Cooperation (APEC) Non-Binding Principles on Government Procurement (APEC, 2000); the 1998 International Monetary fund (IMF) Code of Good Practices on Fiscal Transparency (IMF, 1998) and the 1999 Code of Good Practices on Transparency in Monetary and Financial Policies (IMF, 1999); the 1992 World Bank Guidelines on the Treatment of FDI and 1995 Guidelines for Procurement under IBRD Loans and IDA Credits (World Bank, 2001); the 1995 WTO Agreement on Government Procurement (WTO, 2001), and the 2000 OECD Guidelines for Multinational Enterprises (OECD, 2000a).
- ⁴ It should be noted however that, since the adoption of the 1996 OECD Recommendation of the Council on the Tax Deductibility of Bribes to Foreign Public Officials (OECD, 1996b), most member countries have changed their legislation in line with the Recommendation.
- ⁵ See ECOSOC document E/1979/104, "Report of the Committee on an International Agreement on Illicit Payments", with the text of the draft agreement as an annex. The draft included an article against payments to the apartheid regime of South Africa. This inclusion explains the use of the term "illicit payments" in the title of the agreement otherwise dealing exclusively with bribery under criminal law. The inclusion of that provision, objected to by most industrialized countries, and the link established between these negotiations and the one on a Code of Conduct on TNCs, were the main reasons for the failure of the negotiations which had been otherwise almost completed from a legal point of view.

- ⁶ The ICC ad hoc Commission prepared “the Recommendations to Combat Extortion and Bribery in Business Transactions”. The Commission presented its report to the ICC Council in November of 1977. After further negotiations, the Council adopted the code on 2 December 1977.
- ⁷ The offering, promising, or giving of a bribe is sometimes referred to as “active bribery”, and the soliciting, demanding, accepting or receiving of a bribe is referred to as “passive bribery”.
- ⁸ Unless otherwise indicated, all instruments cited herein may be found in UNCTAD, 1996a, or UNCTAD, 2000a.
- ⁹ The Convention also establishes, in articles VI(1)(c) and (d), that any “Act or omission in the discharge of his duties by a government official or a person who performs public functions for the purpose of illicitly obtaining benefits for himself or for a third party; ...”, or “The “fraudulent use or concealment of property derived from any of the acts...” defined in article VI, also constitute corruption.
- ¹⁰ The Commentaries were adopted by the Negotiating Conference on 21 November 1997. However, their weight in providing for authoritative interpretations of the Convention, as a part of the “context” of the Convention or *travaux préparatoires* under article 31 and 32 respectively of the 1969 Vienna Convention on the Law of Treaties (United Nations, 1969), is unclear. For the purposes of this chapter, they are offered to give guidance in understanding the scope of some of the provisions of the Convention.
- ¹¹ A related issue that might complicate the analysis is the inclusion, as an element of the definition, that the offence requires a person *intentionally* to offer any undue pecuniary or other advantage to a foreign public official. Conceptually, circumstances in which an offer of an *undue* advantage in exchange for the receipt of an improper advantage might not carry with it the requisite criminal intent are difficult to imagine and, therefore, its inclusion would seem to be superfluous. However, in a number of criminal systems, *mens rea* or a criminal intent is a necessary part of the elements of a crime.
- ¹² It could also be argued that this qualification concerning small facilitation payments is not a setback of the 1997 OECD Convention, since it reflects the reality that the Convention (which is aimed primarily at corruption in international business transactions) need not address all types of corruption, particularly those that do not involve a discretionary decision on the part of public officials as to whether or not to grant a business deal, contract, license, permit, etc. Many countries have in fact not made use of this exception and have decided to cover even facilitation payments in their national foreign bribery legislation.
- ¹³ It should however be noted that the issues of jurisdiction and international cooperation are not peculiar to the instruments discussed in this chapter. They are fairly common to most treaties that are devoted to the suppression of crimes.
- ¹⁴ The revised Recommendation was adopted by the Council of OECD on 23 May 1997.
- ¹⁵ The Recommendation was adopted by the Council of OECD on 11 April 1996.

Chapter 20. Transfer Pricing*

Executive summary

As the global integration of the world economy proceeds, more transnational corporations (TNCs) are considering new or increased foreign direct investment (FDI) and the establishment of affiliates abroad. This expansion necessitates the transfer of tangible and intangible assets (including services) between parent corporations and their foreign affiliates. One issue that arises in this context is how to establish prices for these cross-border transfers. Transfer pricing frameworks can, in principle, promote reasonable tax revenues for the countries involved and, at the same time, establish a fair tax liability on corporations. For these reasons, transfer pricing issues raise important and often contentious policy questions for host and home governments, as well as for TNCs, as transfer pricing methods directly affect the amount of profit reported in host countries by corporations, which in turn affects the tax revenues of both host and home countries.

International tax and other arrangements can address transfer pricing issues, including mutually acceptable transfer pricing methods, compensating adjustments to avoid double taxation, competent authority issues, and clauses for limitations on benefits and exchange of information. Such arrangements can also provide corporations with some assurance of dispute settlement and the elimination of double taxation while safeguarding countries' tax revenues and capital stock. Also, increased financial, accounting and tax disclosure by corporations can occur concurrently with the implementation of a transfer pricing framework to ensure the transparency of transactions and to deter income shifting and evasion of tax liabilities.

As the international operations of TNCs grow in developing countries, the issue of effective transfer pricing regulation becomes more pressing for them. Given the more limited skills and resources of such countries in the field of transfer pricing, it becomes increasingly important to consider to what extent international investment agreements can address this imbalance through, for example, increased transparency, information

sharing, co-operation and technical assistance provisions, thereby ensuring that developing countries derive full benefits from FDI without exposure to a potentially harmful diversion of revenues through transfer pricing practices.

Introduction

An important issue resulting from the globalization of economic activity and the associated increases in the international transactions of TNCs and the internationalization of a good part of international trade is how to establish prices for goods, services, know-how and intellectual property transferred across borders within corporate networks and especially between foreign affiliates and parent corporations. The prices at which such items are transferred determine the incomes for both parties and therefore the tax base of the countries involved. In theory, a properly calculated transfer price allocates profits from the transferred items reasonably to all involved parties so that tax authorities in the countries concerned receive their fair shares of the tax revenues from those profits.

In principle, therefore, transfer pricing frameworks should promote reasonable tax revenues for all countries involved while assessing a fair tax liability on TNCs. These two objectives highlight the desirability for each country's tax authority to develop and enforce appropriate transfer pricing regulations and treaty provisions that, among other things, mitigate double taxation, income shifting and tax avoidance. Understanding a TNC's FDI strategy is also important "because appropriate transfer pricing policies can sustain and guarantee the original investment decision" (Emmanuel, 1996, p. 3); inappropriate policies can discourage new or continued FDI in host countries.

Transfer pricing is one of the most important tax issues facing TNCs today (Ernst and Young, 1997) due to its direct effects on both TNC profits and host and home countries' tax revenues. There are also specific factors going beyond tax-related transfer pricing considerations that can

* The present chapter is based on a 1999 manuscript prepared by Susan Borkowski. The final version reflects comments received from Antonio Carlos Rodrigues do Amaral, Dali Bouzora, Bernard Damsma, Sylvain Plasschaert and Constantine Vaitsos.

motivate a TNC to manipulate transfer prices in a manner that adversely affects host or home countries, including the level of customs duties; repatriation policies; the extent of exchange risk; asset capitalization policies; anti-monopoly charges; dumping charges; and cost-sharing concerns (Plasschaert, 1994). As cross-border transactions are increasing in number, size and scope, more TNCs are engaging in transfers involving larger monetary amounts with affiliates located in more and more countries, as well as among these affiliates. The effects of transfer pricing are therefore increasingly important to both TNCs' profits and to each country's tax base. Developing countries, for example, "have long relied on corporate income taxes as a principal means of revenue. These taxes account for up to a third of revenue in some developing countries" (Cohen, 1995, p. 11).¹

Indeed, transfer pricing methods can directly affect the amount of profit reported in a country by a TNC, which in turn affects the tax revenues of that country (box 1). However, many developing countries (and especially least developed countries) do not have administrative frameworks that adequately codify and enforce regulations governing TNCs' transfer pricing practices. In addition, non-existent, unfair or ambiguous transfer pricing legislation can be a factor that discourages FDI inflows due to concerns about tax risks and legal protection. To avoid this outcome, countries can implement and enforce a transfer pricing framework that has broad support in the international community, from both the governmental and the corporate side. Its application needs to be flexible, but its effective implementation can be assured by a penalty system that distinguishes between good-faith errors and deliberate manipulations by firms to shift income and evade tax liabilities.

Section I

Explanation of the Issue

A. Transfer pricing in transnational corporations

For an understanding of the transfer pricing issue, it is important to describe briefly the use of transfer pricing by TNCs. Only then can the meaning of the regulatory standards employed in international agreements and national laws be fully grasped.

The pricing of transfers of goods, services or other assets within a TNC network creates

considerable management and accounting problems. This can be explained by the fact that, while the management of individual plants and divisions is often carried out on a decentralized

Box 1. How income can be shifted across borders

Scenario A: The parent TNC in the example is domiciled in a relatively high-tax (34 per cent) country, and it has a foreign affiliate in a lower-tax (10 per cent) host country. A component is produced by the affiliate in the host country at a cost of \$400, and sold to the parent in the home country at the (transfer) price of \$550, which becomes part of the parent TNC's cost of goods sold. The home country parent firm incurs an additional \$300 to complete the product which contains the transferred component. The product is sold at \$2000. Tax liabilities are calculated using the host affiliate's and parent firm's pre-tax income, resulting in total tax liabilities of \$226.

Transfers to income statement	Affiliate in low-tax country (10 per cent tax rate)	Parent in high-tax country (34 per cent tax rate)	Total TNC income
Revenue	\$550	\$2,000	\$2,000
Less costs of goods sold	\$400	(\$550* + \$300)	\$700
Gross margin =	\$150	\$1,150	\$1,300
Less operating expenses	\$100	\$500	\$600
Income before taxes =	\$50	\$650	\$700
Less tax expense	\$5	\$221	\$226
Net income	\$45	\$429	\$474

Scenario B: Income is shifted from high-tax to low-tax country when the component produced by the affiliate in the host country is sold by the parent in the home country at the (transfer) price of \$700. The result is that there is no effect on total revenues, costs and pre-tax income of the TNC. There is a net reduction of \$226-\$190=\$36 in the TNC's overall tax liability, resulting in \$36 increase in consolidated net income. When the results are consolidated, the affiliate's selling price cancels out \$550 of the parent firms' costs of goods sold. The net effect of any transferred good or service on a company's pre-tax profits is zero.

Transfers to income statement	Affiliate in low-tax country (10 per cent tax rate)	Parent in high-tax country (34 per cent tax rate)	Total TNC income
Revenue	\$700*	\$2,000	\$2,000
Less costs of goods sold	\$400	(\$700*+\$300)	\$700
Gross margin =	\$300	\$1,000	\$1,300
Less operating expenses	\$100	\$500	\$600
Income before taxes =	\$200	\$500	\$700
Less tax expense	\$20	\$170	\$190
Net income	\$180	\$330	\$510

* Because this amount is revenue for the affiliate but a cost for the parent company, it is calculated into the parent company's cost of goods but neutralized in the calculation of the total cost of goods which remains the same for the total TNC income.

Source: UNCTAD.

basis, and accounts are made out for each “profit centre”, the group enterprise as a whole may require a centralized financial strategy, to ensure an efficient co-ordination of the group’s transnational business operations. In order to achieve this, a TNC sets the transfer pricing of intra-firm flows of goods, services or other assets on a centralized basis, thereby taking control over pricing policy away from individual profit centres. This requires a mechanism for setting prices in a rational way that ensures the setting of optimal prices and which avoids the misallocation of resources or distortions in the final prices of products (Muchlinski, 1995, pp. 283-284; Plasschaert, 1994, pp. 6-7).

The achievement of optimal prices can be very difficult. One, seemingly straightforward, approach is to apply open market prices to intra-firm transactions. However, such prices may be inapplicable – or even non-existent – to the realities of TNC operations. First, profit centres may not be free to purchase inputs from the open market. Second, the relevant inputs may not be available on the open market. Indeed, the specialized productive technology or managerial know-how of a given TNC may be unique to the enterprise. The very advantage that the firm possesses may negate any alternative source. Thus an internally determined transfer price may be the best approximation of the value of the input concerned (Muchlinski, 1995, p. 285; Kaplan and Atkinson, 1994, pp. 134-135).

Accordingly, TNCs have developed mechanisms to determine internal transfer prices. Two basic methods are used, though with many variations. The first is the “cost-plus” method. This uses the basic cost of the item transferred, calculated according to one of a number of possible costing criteria, to which a percentage mark-up is added allowing a margin of profit to accrue each seller in the chain. The second is the “sales minus” or “resale price” method. Here, the price of the finished product is the starting point. From this, a percentage discount is subtracted, leaving the buyer with a margin of profit on the transfer based on the assumption that the affiliated buyer will add value to the product prior to resale at the final price (Muchlinski, 1995, p. 284; OECD, 1995). These methods are in themselves imperfect. Significant problems continue with the allocation of costs to different parts of a TNC’s system of production. Moreover, the sales minus approach may introduce distortions where the final resale price may reflect the monopolistic position of a TNC on its market, if applicable.

From the above, it is clear that the setting of transfer prices between the affiliates of a TNC is no easy matter. There is much uncertainty which, in turn, creates complexity for regulators who must balance between, on the one hand, ensuring a reasonable return to revenue from the operations of TNCs located in their territory and, on the other, allowing that the legitimate pricing practices of integrated business groups are not undermined as this could lead to the penalization of the efficiency gains of integrated international production systems.

B. Transfer pricing methods in tax regulation

Most developed countries derive their transfer pricing regulations from the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines (OECD, 1995; 1996a) and from the United States regulations in Section 482 of the Internal Revenue Code (hereinafter referred to as United States Section 482).²

Transfer pricing methods which are currently acceptable to most tax authorities are based on the arm’s-length principle. In non-technical terms, this principle means that a transaction should be valued at what company A would have charged company B in the market, if company B were an independent company not connected in any way with company A. (See box 2 for an example of a provision that applies the principle to taxation measures.)

Box 2. Applying the arm’s-length principle to taxation

“[When] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Source: OECD, 1997a, article 9.

The use of the arm’s-length approach is not without difficulties. Critics of this approach point to the fact that such an enquiry is likely not to achieve useful results where the transaction under review occurs between affiliates of an internationally integrated TNC. It fails to meet the reality of such an enterprise’s activity especially in relation to transfers of technology, whether as

intellectual property or know-how, or other firm-specific sources of value. Yet, national tax authorities and the OECD continue to prefer the arm's-length method, in part, because it accords better to a world of territorially based national tax jurisdictions. In practice, however, tax authorities have been pushed to recognize the realities of TNC transfer-pricing activities by using profit-based allocation methods. This, in turn, has led to lively debates on the nature and future of the arm's-length principle particularly between the United States, which is at the forefront of developing profit-based allocation methods, and the OECD, the principal supporter of the arm's-length principle (Muchlinski, 1995, pp. 293-295; Plasschaert, 1994, pp. 9-10; United States, Department of the Treasury, 1988; OECD, 1995).

Cross-border transfers may be priced using any of several traditional *transactional* and *transactional profit* methods, all of which adhere to the arm's-length principle. The methods can apply to both "tangibles" and "intangible property".

Tangibles include any goods, whether finished products or intermediate inputs, such as raw materials or components, that are transferred between affiliated enterprises. Intangible property includes such diverse categories as:

- patents, inventions, formulas, processes, designs or patterns;
- copyrights, literary musical or artistic compositions;
- trademarks, trade names or brand names;
- franchises, licenses or contracts;
- method programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- other intellectual property not listed above.

The definitions of transfer pricing methods used in this section are derived from the transfer pricing guidelines of the OECD (1995; 1996a) and from the United States Section 482 transfer pricing regulations (United States, Internal Revenue Service, 1994).

1. Transactional methods

The *comparable uncontrolled price* (CUP) method, also known as the market price method, compares the price for tangible goods transferred in a controlled transaction to the price charged for property or services transferred in a *comparable uncontrolled transaction* (CUT) in comparable circumstances, i.e. the market price. This comparison verifies that the comparable price for

the product transferred between TNC entities is the same as would have been charged if the product had been sold to a customer unconnected with that TNC, i.e. an arm's-length transaction. The difficulty for both tax authorities and (as noted above) TNCs lies in identifying an exact comparable product upon which to base the market price; hence, an adjusted, or inexact comparable market price, is more commonly used.

In an elaboration from the accounting practices of TNCs, the *resale price* method uses the price at which a product, that has been purchased from an associated enterprise (a TNC entity), is resold to an independent enterprise (an independent customer).

The resale price is reduced by the resale gross margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's-length price. The *cost plus* method uses the costs incurred by the supplier of a tangible product in a controlled transaction between TNC entities. An appropriate cost plus mark-up is added to this cost to allow for an appropriate profit in light of the functions performed and the market conditions, again arriving at an arm's-length price.

2. Transactional profit methods

The *profit split* method identifies the combined profit to be split for the associated enterprises from a controlled transaction (between TNC entities). Those profits are then split, or allocated, between the TNC entities based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's-length with an independent customer.

The *transactional net margin* method (TNMM) examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpaying TNC realizes from a controlled transaction with its affiliate(s). This method operates in a manner similar to the cost plus and resale price methods. The TNMM must therefore be applied in a manner consistent with the way in which the resale price or cost plus method is applied (OECD, 1995, paragraph 3.26).

The *comparable profits* method (CPM) determines an arm's length result using the amount of operating profit that the tested party (a TNC entity) would have earned on related party transactions with other TNC entities if its profit

level indicator were equal to that of an uncontrolled comparable transaction, i.e. the comparable operating profit the TNC entity would have earned in a transaction with an independent customer.

3. Formulary apportionment methods

Some tax authorities have suggested determining transfer prices based on the *global formulary apportionment* method. This approach “allocate(s) the global profits of a multinational enterprise group on a consolidated basis among the associated enterprises [TNC entities] in different countries on the basis of a predetermined formula” (OECD, 1995, p. G-4). It is, arguably, a method that more closely relates to the realities of international business integration by TNCs. To date, however, this method has not gained much support because it does not meet the arm’s-length principle. The practical application of formulary apportionment involves multiple tax authorities, guidelines, regulations, tax rates and tax bases in arriving at the tax revenues apportioned to each country. Reaching a global consensus on a so-called “predetermined formula” that would be required to allocate a TNC’s total profits to the countries involved is difficult to obtain. Such a formula would *inter alia* have to take account of the special economic situation of developing countries. Existing methods of formula apportionment may be unsuitable in view of their emphasis on economic criteria that result in higher proportions of taxable revenue being allocated to more economically developed taxing jurisdictions (Muchlinski, 1995, p. 307).

C. Cost-sharing arrangements

A cost-sharing arrangement is an agreement whereby two or more persons agree to share the costs and risks of research and development of new intangible property as these are incurred in exchange for a specified interest in any such property that is developed. Such arrangements can be used as a vehicle for the reallocation of costs and risks in the most tax-efficient way. Consequently, where such arrangements are entered into by affiliated enterprises, tax authorities have monitored them to ensure that they are not used simply as tax-avoidance devices. Thus only genuine allocations of costs and risks will be acceptable. The OECD (1997b) guidelines re-emphasize the arm’s-length nature of any cost-

sharing allocations, and the requirement of definite prospective benefits in order to participate in a cost-sharing arrangement.

D. Advance pricing agreements

Advance pricing agreements (APAs) are concluded between taxpayers, including TNCs and host and/or home country tax authority(ies); they can be unilateral, bilateral or multilateral. Their purpose is to reduce uncertainty and conflict among taxpayers and tax authorities. An APA “determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustment thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time” (OECD, 1995, p. G-1). Multilateral APAs reduce significantly the risk of transfer pricing audits, penalty assessments and double taxation when the tax policies of two countries differ regarding corresponding adjustments and acceptable transfer pricing methods. A shortcoming of unilateral APAs is that they are ineffective in resolving double taxation issues.

Section II Stocktaking and Analysis

A. Transfer pricing legislation: a historical perspective

A comparison of countries with well-developed transfer pricing legislation shows the influence of OECD guidelines and/or United States tax policy on those countries’ regulations. Further, most other transfer pricing legislation is based on concepts drawn from either or both sources. A discussion of both approaches is therefore necessary to understand their similarities and differences, and to analyse the conflicts between the two approaches and their effects on current global transfer pricing policies.³

While both the OECD and the United States tax authority fully support and are committed to the arm’s-length principle, they diverge in several important areas: the methods that are preferred, the profit-based methods that are acceptable, the depth of documentation requirements, the entity that bears the burden of proof, and the type and severity of penalties. These differences are clarified and illustrated below.

- OECD guidelines as implemented by selected developed countries.** The OECD began a substantive assessment of transfer pricing issues in its publication *Transfer Pricing and Multinational Enterprises* (OECD, 1979), which was supplemented by additional guidance in *Transfer Pricing and Multinational Enterprises: Three Taxation Issues* (OECD, 1984) and again in *Thin Capitalization* (OECD, 1987). Given the continuing relevance of this issue and multiple revisions of the United States regulations, the OECD responded to the needs of member countries for updated transfer pricing guidance relevant to the expanding globalization of TNC activity. The OECD revised transfer pricing guidelines (OECD, 1995; 1996a; 1997b) are designed to assist tax authorities and TNCs “by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict” and therefore costly litigation (OECD, 1995, p. P-5). The purpose of the updated guidelines is twofold: they are meant to serve as the foundation of a country’s transfer pricing regulations, and to provide direction to TNCs in choosing a transfer pricing method in accordance with the arm’s-length principle. They are characterized by flexible application, moderate documentation requirements, avoidance of double taxation and a non-adversarial relationship between tax authorities and the TNCs. Currently, the OECD guidelines are the source of most countries’ transfer pricing legislation, where such legislation exists (box 3). Transactional methods are preferable to transactional profit methods, according to these guidelines. The latter are to be used only as methods of last resort.
- United States.** The United States Internal Revenue Service (IRS) regulates transfer pricing through Section 482, which has been repeatedly revised during the last two decades, with significant changes occurring with almost every revision (United States, Internal Revenue Service, 1996). The most recent changes in 1994 allow a TNC the choice of any approved transaction-based or profit-based method to price transferred tangibles or intangible property. These methods include CUP, CUT, resale price, cost plus, profit split and CPM. Under this “best method” rule, however, the IRS can challenge a TNC’s

choice, placing the burden of proof on the TNC. Section 482 mandates that TNCs maintain extensive contemporaneous documentation, while Section 6662 provides for penalties in cases of understatement of taxable income, with no distinction between good faith errors made by TNCs and deliberate income manipulation.

Box 3. Transfer pricing legislation based on the OECD guidelines

- Canada.** Transfer pricing is regulated by Revenue Canada in Section 69 of the Canadian Income Tax Act. These regulations require that the method employed meet the arm’s-length standard in accordance with the OECD guidelines. While the application of Section 69 is flexible, Revenue Canada follows the OECD preference for transactional and then transactional profit methods, such as TNMM and profit split, but excluding the comparable profits method. In cases where a CUP cannot be determined, a functional analysis should be undertaken to identify the appropriate transfer pricing method.
- Japan.** The Japanese National Tax Administration regulates transfer pricing through Article 66-5 of the Special Taxation Measures Law and the Special Taxation Law relating to a Tax Treaty. These regulations are based on the OECD guidelines and are flexibly applied to eliminate income shifting and double taxation while easing the reporting burden of TNCs. The regulations also protect Japanese TNCs from audits and penalties assessed by the United States tax authority, as a result of enforcement of Section 482. Due to increasing audits of its TNCs, the Japanese tax authority has become more active in its own audits of non-Japanese TNCs.
- United Kingdom.** The Inland Revenue controls transfer pricing transactions through Sections 770-773 of the 1988 Income and Corporation Taxes Act. These regulations are based on OECD guidelines and assume a flexible interpretation of the arm’s length principle for both tangible and intangible transfers. The regulations have been strengthened by recently enacted legislative changes. These changes include a shift of some of the burden of proof for compliance with the arm’s-length principle to TNCs from the tax authority, and adoption of documentation requirements similar to OECD guidelines. At this time there is no formalized APA programme, although informal APAs will be considered.

Some developing countries have based their regulations on the OECD guidelines and variations thereof. The Republic of Korea and Mexico, for example, have relatively well-developed transfer pricing regimes. The Republic

of Korea regulates transfer pricing through Article 20 of its Corporation Income Tax Law and administrative regulations and guidelines issued by the Office of National Tax Administration in 1990. The arm's-length principle is upheld, with the CUP, resale, and cost-plus methods preferred. If these methods are not appropriate, only then can other reasonable methods be considered. Documentation may be requested from a TNC to check the correctness of the chosen transfer pricing method and application. The tax authority may audit TNCs that do not provide documentation when requested; these documentation requirements, updated in 1996, are more burdensome to TNCs than those suggested by the OECD. The tax authority may also recalculate profits by applying its own choice of an arm's-length method, and is actively pursuing TNCs which shift profits and avoid taxes (Lee, Lee and Donaldson, 1996).

Mexico addresses transfer pricing issues in the Tax Reform Act of 1992, and again in 1997 with its tax reform package adopting the revised OECD guidelines. The *Secretaria de Hacienda y Credito Publico* reviews transfer pricing transactions between related parties, using the arm's-length principle. Income adjustments may be made if a TNC is deficient in maintaining or providing pricing documentation, and multi-year APAs will be available. In order to follow OECD guidelines, existing safe harbour provisions will be gradually eliminated (Leavey and Amante, 1997).

B. Status of related tax treaty articles

Most tax treaties⁴ contain several articles related to transfer pricing issues. In most cases, it is not the articles themselves that pose problems for transfer pricing, but the fact that they appear in a patchwork of bilateral, multilateral and/or regional treaties, each of which may address one or all of the issues.

The United Nations Model Double Taxation Convention between Developed and Developing Countries (UNCTAD, 1996a, vol. I), originally adopted in 1979 and currently under revision, is very similar to the OECD Model Tax Convention (OECD, 1997a). Any differences are due to the former taking into account the specific needs of, and conditions in, developing countries, and addressing them in the Convention articles. The United Nations Model stresses source taxation, and is therefore favoured by capital-importing countries. The OECD Model is preferred by

capital-exporting countries because it emphasizes residence taxation.

The OECD Model Tax Convention on Income and on Capital, originally developed in 1963 (OECD, 1963a), has undergone periodic revisions during the past 35 years. It is the basis of most existing tax treaties, and the origin of many of the articles related to transfer pricing issues. Recently, the United States Department of the Treasury released its Model Income Tax Convention (1996), which is based on several models, including the OECD Model Convention, the prior 1981 United States model treaty, and existing United States tax treaties.

The following discussion of articles relevant to transfer pricing is drawn from both model conventions. The principle issues covered by these provisions are:

1. The application of the arm's-length principle

Article 9 (Associated enterprises) of the OECD Model Tax Convention (1963) is the source for the widely-accepted definition of the arm's-length principle upon which all acceptable transfer pricing methods are based, and is similar in both the OECD and United States models. This article also provides for the use of corresponding adjustments by competent authorities to eliminate or mitigate double taxation situations which may arise when cross-border transfers occur. This problem arises where the home tax administration of a TNC, in the exercise of its powers of re-allocation under transfer pricing regulations, increases the taxpaying enterprise's liability to home country tax. Unless the host country tax administration involved agrees to adjust downwards the amount it has already charged to tax from the local affiliate of the TNC, there will be an element of unrelieved double taxation. To avoid this eventuality, Article 9 (2) of the OECD Model Tax Convention recommends that the host country tax administration makes the necessary adjustment to the tax charged on the local affiliate's profits. However, this procedure is not compulsory and so no duty to adjust arises on the part of the host country.

To deal with such cases, both model treaties contain provisions on relief from double taxation (article 23) to address situations which may arise due to differences in host and home country transfer pricing regulations and requirements. Article 25 of the OECD Model

(Mutual agreement procedure) allows for the use of a competent authority to try mutually to resolve tax disputes and instances of double taxation between a TNC and a host country tax authority. The United States model sets no time limits within which a transfer pricing dispute may be brought to the competent authority, while the OECD model sets a three-year time limit beginning from the first notification of the dispute. The United States model also allows the use of advance pricing agreements as a means of settling transfer pricing disputes.

2. Deterrence of “treaty shopping”

The United States model treaty contains strong provisions in Article 22 (Limitation on benefits). This article is designed to deter treaty shopping, which is an attempt “by a third-country resident to obtain benefits from an income tax treaty for which it was not intended to qualify” (Brandt and French, 1995, p. 224). The OECD model does not specifically address this issue, but does contain language that allows a tax authority to deny benefits when a third country treaty is used to shift profits from one country to another. This article prevents a TNC from using an affiliate in a third country – that is not involved in the transfer pricing transaction – to act as a conduit for profits shifted between the involved TNC entities in the host and home countries.

3. Exchange of information

In its Article 26 (Exchange of information), the United States model treaty, while similar to the OECD Model, contains provisions which allow the tax authority access to usually inaccessible banking or financial information. The United States model is also explicit about the obligation of a contracting State to comply with requests for information, while this obligation is implied in the OECD Model. The United States model reflects the trend towards increased international cooperation between governments in sharing tax and other information to prevent income shifting and tax evasion.

In addition to the routine exchange of information provisions contained in many tax treaties, the OECD (Owens, 1997) suggests that other non-routine exchanges be explored, including a simultaneous examination agreement between two tax authorities. Such a

coordinated enforcement programme allows for both host and home tax authorities to concurrently examine a TNC in whom they share a mutual interest, and share information. In addition, some countries, particularly Canada, are actively advocating the increased use of simultaneous examinations. Simultaneous examination agreements are included in many tax treaties based on Article 26 of the OECD Model Tax Convention, in bilateral advance pricing agreements, and in the joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters.

Other avenues for gathering information include bilateral Tax Information Exchange Agreements (TIEA) with the United States, or such multilateral agreements as the Nordic Convention on Mutual Assistance and the EC Directive on Mutual Assistance. General industry-wide exchanges of information can be set up between the United States tax authority and other tax authorities under the Industry Specialization Programme. Data are limited to a particular industry, rather than specific TNCs.

C. Status of arbitration venues

Until recently, the competent authority as defined in existing tax treaties was a major factor in any settlement of double taxation and other transfer pricing disputes. However, this approach is very time-consuming and may require several years to reach a settlement, if indeed one is reached. In some cases, settlements are never reached, because, as noted above, the OECD and United States models do not require that a binding decision be made, only that an attempt to reach settlement be made. On the other hand, the Arbitration Convention (on the Elimination of Double Taxation with the Adjustment of Profits of Associated Enterprises) agreed to by European Community countries (EC, 1990), which entered into force on 1 January 1995, ensures the elimination of double taxation by forcing any disputes to arbitration if the competent authorities have not reached a settlement within two years. The arbitration commission then has six months to render a binding decision, after which the competent authorities either reach an alternative agreement within the next six months, or accept the Commission’s settlement.

D. Potential conflicts around procedural issues

While there is much agreement that the arm's length principle is appropriate when pricing tangibles and intangible property, there are differences of opinion on other issues, such as documentation requirements, penalties, burden of proof, and preferences concerning the TNMM versus the CPM methods.

Some tax authorities now require detailed documentation on how a TNC's transfer pricing method was chosen and how the transfer price was calculated in order to assess its compliance with the arm's length principle. The OECD guidelines suggest a flexible approach, recommending the maintenance of a level and detail of documentation that allows verification of compliance while not burdening firms with excessive time and cost demands. A more demanding approach is required by United States Section 6038, which sets forth the documentation and reporting requirements for TNCs: documentation should be contemporaneous and include all relevant information, including that discovered after the transaction has occurred. The level of detail, and the types of documentation required, are often considered onerous by TNCs in terms of detail and quantity. Assuming good-faith compliance, such detailed documentation is required by the tax authority for TNCs to escape penalties if there has been a significant under-reporting of tax liabilities due to pricing adjustments.

As with documentation requirements, the assessment and severity of penalties varies by tax authority. OECD guidelines do not suggest specific penalties to be applied at certain thresholds of tax liability in response to misstatements of liability by TNCs. The recommendation is for each country to set penalties, whether criminal or civil, such that "tax underpayments and other types of non-compliance are more costly than compliance" (OECD, 1995, p. IV-7). The other viewpoint is observed in United States Section 6662, which imposes transactional and net adjustment penalties for misstatements, even those resulting from good-faith errors. The specific accuracy – and fraud – related penalties are applicable at certain thresholds for under-reported profits.

Differences regarding burden of proof are highlighted by the divergence between the OECD and United States approaches to documentation and penalties (box 4). This difference may lessen due to recent calls by the United States Congress

for reform of the United States tax authority. These reforms include shifting the burden of proof from TNCs to the United States tax authority.

Box 4. Burden of proof

The following summarizes the philosophical differences between the United States and the OECD approaches to the issue of the burden of proof: "In the United States, the burden of proof lies squarely with the taxpayer, who must prove that his prices are charged at arm's length. In Europe, conversely, the burden of proof lies with the tax administration, which must prove that the prices are not arm's length [...] In the United States, the relationship [of TNCs with their respective tax authorities] is often adversarial, whereas in Europe corporations are more used to working in close cooperation with tax authorities to arrive at compromise solutions [...] The OECD guidelines concentrate on how prices are set (a subjective test that focuses on behavior), whereas the U.S. regulations require an arm's length result (an objective test that focuses on taxable income). The IRS's main concern is whether the tax base is correct."

Source: Tax Analysts, 1996, p. 2 and p. 8.

Based on OECD guidelines, some tax authorities (for example in Canada and Germany) have reservations and/or are strictly opposed to CPM as an acceptable transfer pricing method. In other countries, such as Japan, transactional methods are clearly the methods of choice, although the profit split and TNMM methods may be acceptable in certain specific circumstances. Recently, Japanese officials were said to have warned that "if the US insists on using the CPM too aggressively, it could provoke a 'taxation war' with Japan" (Coopers and Lybrand, 1997, p. 1). Opposition stems from the perception that "transfer pricing is a pricing issue, not an income issue, and TNMM deals with pricing, whereas CPM deals with income" (Tax Analysts, 1997, p. 4). TNMM is applied only to individual transactions and groups of transactions, while CPM can be applied not only to specific transactions, but to results of a TNC on a company-wide basis. If the latter occurs, then CPM is no longer considered a "transactional" method, and is unacceptable to most tax authorities in countries adhering to the OECD guidelines.

When the source of FDI is a TNC based in an OECD country, that country's transfer pricing regulations are generally based on the OECD guidelines and are characterized by flexibility and an assumption of good faith by both the TNC and the tax authority. If developing countries implement their own transfer pricing legislation

using similar approaches, disputes about double or unfair taxation and the frequency of arbitration, of audits and penalty assessment, and of income shifting, would all be minimized, provided sufficient resources are available for the effective operation of such laws.

Section III

Interaction with other Issues and Concepts

Several issues included in international investment agreements are related to transfer pricing (and are discussed in other chapters in these volumes and in previous sections of this chapter (table 1):

- **Investment-related trade measures (IRTMs).** Firms' transfer prices also become an issue in their relations with governments because of their implications for tariff revenues. Transfer pricing issues thus interact with IRTMs. In fact, for firms' individual transactions, there are sometimes conflicts in the incentives created by the relative magnitudes of the tax rates and the tariffs in

the importing country. For example, if the tax rate is relatively high, compared with the exporting country, firms have an incentive to set the transfer price high to shift income out of the importing country and into the exporting country. However, if the importing country also has a high tariff rate on the imported item, then a high transfer price will of course mean a higher tariff. The interaction of transfer pricing issues with tariffs as IRTMs, therefore, can be compounded by the interaction between transfer prices and taxes – and the relationship between taxes and tariffs.

- **Taxation.** Tax issues are obviously relevant to transfer pricing issues; indeed, as this chapter makes clear, transfer pricing is in substantial measure a tax issue. Although firms would need to set prices for intra-firm international transactions for their own internal financial and control purposes, their transfer pricing practices become such an important and contentious issue in their relations with host and home governments because of the tax implications of the prices. The sums at stake are substantial for all parties involved.

Table 1. Interaction across issues and concepts

Issue	Issues in this chapter		
	Tangibles	Intangible property	Advanced pricing arrangement
Admission and establishment	+	+	+
Competition	++	++	+
Dispute settlement (investor-State)	++	++	++
Dispute settlement (State-State)	++	++	++
Employment	0	0	0
Environment	0	0	0
Fair and equitable treatment	+	+	+
Home country measures	++	++	++
Host country operational measures	+	+	+
Illicit payments	0	0	0
Incentives	+	+	+
Investment-related trade measures	++	0	++
Most-favoured-nation treatment	+	+	+
National treatment	+	+	+
Scope and definition	+	+	+
Social responsibility	0	0	0
State contracts	0	0	0
Taking of property	0	0	0
Taxation	++	++	++
Transfer of funds	++	++	++
Transfer of technology	+	++	++
Transparency	++	++	++

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

- **Competition.** Competition issues and transfer pricing can interact significantly. One of the major “internalization” advantages of TNCs over domestic firms is their ability to manipulate transfer prices across tax jurisdictions offering a higher saving to tax than a domestic competitor can enjoy. This may figure as part of a strategy to drive weaker domestic competitors out of the market. Equally, abuses of transfer price manipulations can lead to the creation of barriers to entry as a result of the greater market power enjoyed by the TNC through its greater profitability (Muchlinski, 1995, p. 393).
- **Transfer of technology.** The transfer of intangible property, which includes technology transfers under the OECD guidelines, should be addressed by transfer pricing regulations. However, in many developing countries, such transfers are not addressed. This is a deterrent to TNCs which need assurance that such transfer will not be unduly taxed.
- **Home country measures.** Transfer pricing regulations administered by the TNC’s home country tax authority affect the distribution of income among the TNC and its affiliates, and therefore the tax revenues of the host and home countries. Inequitable distribution may lead to TNCs avoiding investment in certain countries whose tax authorities disagree with the distributions imposed by the home country authorities.
- **Funds transfer.** There are also extensive interactions with funds transfer issues – precisely because transfer prices inevitably affect the amounts of funds that are transferred between related entities of a TNC. Thus, if a host government imposes restrictions on funds transfers in the form of an affiliate’s profit remittances, a firm can raise the transfer prices of the goods and services being imported by the affiliate from the parent firm or affiliates in other countries, in order to circumvent the restrictions and thus move funds out of the host country. Of course, there can be serious legal consequences and other problems in relations with the host government if these practices are detected by the exchange control or other authorities of the government.
- **Transparency.** Because of the potential for manipulating transfer practices in contravention of government tax and tariff regulations and because of the potential for

using transfer prices to move funds internationally in circumvention of government restrictions on funds transfers, questions of transparency interact with transfer pricing issues. The transparency issues include not only the transparency of firms’ practices but also the transparency of governments’ tax, tariff and funds transfer policies. Furthermore, given the possibility of bribery in these domains of government policy, there are often serious issues about the transparency of TNC-government relations associated with transfer pricing practices.

- **Dispute settlement.** Provisions for the settlement of transfer pricing disputes provide TNCs with some assurance that an avenue exists to deal fairly with such issues. These provisions are often included as articles in bilateral tax treaties. When such provisions are lacking, or fail to succeed, arbitration procedures are the next approach available to TNCs.

Conclusion: Economic and Development Implications and Policy Options

There is widespread concern about transfer pricing issues among policy makers in both developed and developing countries, but especially in the latter group. This was reflected in the answers from respondents from developing countries who completed the 1995 UNCTAD *Questionnaire on current developments in the field of accounting and reporting by transnational corporations and other enterprises* (box 5).⁵ The following issues are particularly important.

A. Issues

1. Deficiencies in transfer pricing legislation

For 41 per cent of the developing countries in the UNCTAD survey noted above, their existing transfer pricing regulations, guidelines and/or administrative requirements did not address the issue of services. Furthermore, technology transfers were not addressed in the transfer pricing regulations of two-thirds of the developing countries. The effects of such non-existent or incomplete transfer pricing regulations in some developing countries are debatable. Some experts

argue that the presence of transfer pricing policies is a disincentive to FDI in that such policies unnecessarily restrict a TNC's freedom to structure its FDI to protect itself in a risky environment. Others argue that the lack, rather than the presence, of transfer pricing policies is the true disincentive. It may be that TNCs "weight profit allocations towards countries with aggressive transfer pricing policies, so as to minimise tax risk" (Price Waterhouse, 1997, p. 1).

Box 5. Transfer pricing policies: views from a developing country perspective

Because most TNCs are based in developed countries, and developing countries are mostly host countries, inequitable transfer pricing shifts wealth and resources from the latter to the former. The following are observations obtained in response to the UNCTAD questionnaire from one government official, observations that echoed those of many other respondents:

- * Recognize the right of governments of importing countries to question the pricing policies of TNCs.
- * Ensure an appropriate taxable profit is posted in the end consumer country, keeping in view the risk/reward criteria which propel multinational investment.
- * Recognize all taxes paid by the TNC in a host country including state or local authority taxation and withholding taxes, in determining the reward criteria for transfer price fixation.
- * Recognize the research and development costs of products and services, and the necessity of their recovery from product or service sales.
- * Recognize the relative cost base differentials between countries when determining profit splits between territories on any transfer pricing issues.
- * Recognize the validity of patents and trademarks, more specifically to develop different price fixation criteria for products under patent."

Source: Borkowski, 1997, p. 333.

If regulations are based on globally acceptable principles, such as the arm's-length principle, and are uniformly implemented by competent and knowledgeable tax authorities, TNCs should welcome the certainty of the investment environment, especially if this certainty is reinforced by tax treaties and APAs. As has been observed: "only formal public agreements can provide both the framework needed for systematic cooperation and a clear incentive to taxpayers to comply with the law" (Cohen, 1995, p. 23). In some developing countries, the existence of tax

incentives, such as tax holidays and tax credits, has postponed the need for transfer pricing policies. Other countries have relied on customs valuations in place of transfer pricing valuations to generate revenues.

In developing countries with basic transfer pricing regulations, problems arise from the lack of experience and/or expertise of accountants and auditors in analyzing complex transfer pricing situations. A lack of administrative experience may allow firms to take advantage of the situation and shift income, or to be unfairly taxed due to a misapplication of the regulations. The existence of monopolies within a country may affect the tenor of tax regulations so that those monopolies are protected from competition by TNCs wishing to tap into a captive market share. In some countries, "entry is arbitrarily regulated – often from regulatory authorities with vested interests in screening" (Bergsman and Shen, 1996, p. 346).

2. Income shifting

The extent and significance of income shifting by national and foreign TNCs in developing countries was assessed by the UNCTAD survey. Of the developing countries with sufficient evidence to make an assessment, 61 per cent estimated that their own national TNCs were engaging in income shifting, and 70 per cent deemed it a significant problem. The income-shifting behaviour of foreign-based TNCs was also appraised. Eighty-four per cent of the developing countries felt that the affiliates they hosted shifted income to their parent companies to avoid tax liabilities, and 87 per cent viewed the problem as significant.

Even in countries with sophisticated transfer pricing legislation designed to subvert income shifting and transfer pricing manipulations, the success of the tax authorities in these areas has to be weighted against the effort involved. In 1994 alone, the United States tax authority made income adjustments of \$2 billion and \$1.5 billion for 236 non-United States-controlled and 156 United States-controlled TNCs respectively (United States, GAO, 1995), based on the application of Section 482. Other countries, most notably Japan, are increasing the frequency and size of TNC income adjustments resulting from the misapplication or manipulation of transfer pricing. In the twelve month period ending June 1997, the National Tax Administration of Japan made 78 adjustments to reported income due to transfer

pricing assessments totalling \$330 million (Hielscher and Kaneko, 1998).

Income shifting is encouraged by cross-border tax and tariff differentials, and may lead to distorted competitiveness between resident and non-resident TNCs. Capital flight may occur via the opportunity for non-resident TNCs to withdraw funds from emerging market economies which could otherwise have been used for reinvestment in those countries. Tax underpayments caused by the movement of profits out of a country can result in shortfalls in government revenue and in foreign exchange reserves. Income shifting also leads to an undue reduction of the tax base in one country with a corresponding undue tax base increase in another. The curtailment of income shifting is hampered by the difficulty in obtaining physical evidence of transfer pricing manipulations. This situation has led many developed countries to include stricter documentation requirements and penalties in their transfer pricing regulations.

3. Repatriation of profits

While some developing countries set some limits on the outflow of funds, repatriation policies can sometimes be so stringent as to deter FDI. Such limitations are often considered part of the negotiations when encouraging major TNCs to commence or increase FDI. However, reservations can often be made for situations in which there are severe trade imbalances. Repatriation policies can be included in new tax and investment treaties and

agreements. An analysis of 19 existing regional, bilateral and multilateral FDI instruments by UNCTAD (1996b) shows that the transfer of funds and the repatriation of investment by TNCs are explicitly addressed in nine of those instruments.

4. Double taxation of profits

Double taxation of a TNC's profits may arise when there are differences in the transfer pricing policies of the countries involved. For example, the OECD guidelines mandate the use of TNMM only by transaction, or for a group of controlled transactions, and only as a last resort. The United States tax authority, however, allows CPM, its supposed counterpart, to be applied to a broader, and therefore less rigorous, range of transactions, and with no restrictions, only requiring documentation that it is the "best method" for the firm. These differences create the current situation where a tax authority using OECD-based transfer pricing regulations may reject a TNC's use of CPM and assess additional taxes and penalties. (The potential for double taxation and/or transfer pricing audits is detailed in table 2).

Such situations may be resolved by use of the competent authority procedure described in the OECD Model tax treaty. However, some developing countries do not have corresponding adjustments in their tax treaties, while others do not even have a tax treaty with the relevant home

Table 2. Transfer pricing method matrix of selected countries

Country	Transaction-based methods			Profit-based methods			Other methods
	CUP/CUT	Resale	Cost Plus	Profit Split	CPM	TNMM	Formulary apportionment
Brazil	Yes	Yes	Yes	No	No	No	Possible
Canada	Yes	Yes	Yes	No	No	Last resort	No
China	Yes	Yes	Yes	Deemed profit	No	Yes	No
Germany	Yes	Yes	Yes	Last resort	No	Last resort	No
Japan	Yes	Yes	Yes	Yes	No	No	No
Mexico	Yes	Yes	Yes	Yes	No	Yes	No
Korea, Rep. of	Yes	Yes	Yes	Last resort	No	Last resort	No
United Kingdom	Yes	Yes	Yes	Last resort	Last resort	Last resort	No
United States	Yes	Yes	Yes	Yes	Yes	No	No
OECD Guidelines	Yes	Yes	Yes	Last resort	No	Last resort	No

Source: Adapted from *Tax Management Transfer Pricing Report*, 1997, p. 18; and *Tax Notes International*, 17, 16 (10 October 1998), p. 1159.

country. The competent authority process has been characterized as “too costly ... time consuming ... simply inadequate” from a TNC perspective (Ernst and Young, 1995, p. 2). In addition, the use of the competent authority procedure does not guarantee the elimination of double taxation. From the viewpoint of tax authorities, there is concern that the current competent authority process is perceived by TNCs as inadequate to protect them against double taxation, and that the time factor to settle a case is excessive. The latter problem is important because the caseload for competent authorities is expanding, and will only increase the already considerable time delay in resolving cases.

Recent research (Borkowski, 1996) found that United Kingdom and United States TNCs experienced transfer pricing audits by both home and host country tax authorities significantly more often than Canadian, German or Japanese TNCs. One-half of TNCs from the United Kingdom with affiliates in the United States had been audited by the United States tax authority, while 29 per cent of those same TNCs had been audited by their home tax authority in the United Kingdom. Most audits of TNCs, regardless of home country, are conducted by the United States tax authority (table 3).

Table 3. Double transfer pricing audits of TNCs in selected countries^a
(Percentage)

TNC home country	TNCs audited by United States tax authority	TNCs audited by home country tax authority ^b
Canada	4	14
Germany	11	6
Japan	18	6
United Kingdom	50	29
United States	56	33

Source: UNCTAD, based on Borkowski, 1996, p. 30.

a 347 TNCs were covered in the study.

b Host country in the case of the United States.

5. Customs valuations

Conflicts of interest may arise between valuing a transferred good using an arm's length method, such as CUP, and valuing the same good for purposes of customs duties. Cogent arguments have been made for and against uniform valuation. Proponents of one valuation cite the value derived at arm's-length as objective; the need for one standard to avoid taxpayer confusion; the

consistent use of the arm's length standard in all tax situations; and problems if TNCs use one value to minimize tax liabilities while tax authorities use another value to maximize tax revenues. Opponents argue that the valuations serve different purposes; TNCs are not adversely affected; and the expectation that both TNCs and the tax authorities would choose the optimal valuation to maximize their positions (Masui, 1996).

In reality, complete uniformity is improbable given the complexities of the tax-trade cross-border relationships and regulations (Masui, 1996), and that transfer pricing valuations usually include costs that are omitted in customs duties valuations. By including an exchange of information provision in tax treaties, tax authorities and customs officials can ensure that differences in the declared values are indeed justified, and do not represent an attempt to evade either income taxes or customs duties. Such information exchange is supported by OECD guidelines.

6. Cost sharing

Cost sharing arrangements for the development of intangibles require careful monitoring to ensure that TNCs are not passing on undue costs of developing intangible property to their affiliates in developing countries which may receive minimal benefit from that property. Cost sharing techniques can be used to allocate research, development and other costs, leading to these advances, to developing countries on a basis disproportionate to the benefits actually enjoyed by those countries. However, in certain cases, in particular those of high research and development costs, including new product development, headquarters salaries and other corporate overheads, the affiliate concerned, often the parent firm, may be unable to meet all of the cost incurred. Yet, the overall benefit to the corporate group may require a degree of shifting in the overall distribution of costs across and among affiliates. Thus, legitimate cost sharing arrangements must be distinguished from those with a primary aim of tax avoidance.

7. Tax havens

Transactions performed in tax havens pose some problems to tax authorities, as do payments of interest through loan agreements entered into by related parties. These issues are discussed in more detail in the chapter on taxation in these volumes.

8. Advance pricing agreements

APAs might help to alleviate some transfer pricing problems for developing countries. However, TNCs typically appear uninterested in participating in APA programmes. One survey (Borkowski, 1996) found that, depending on the home country, the percentage of TNCs with no plans to pursue APAs with either their home or host country tax authorities ranged from 71 per cent to 96 per cent (table 4). Canadian TNCs cited the volume of information and/or documentation required and the cost of APAs exceeding their benefits. German TNCs ranked volume of information required and the difficulty of concluding multilateral APAs as the most important deterrents. Japanese TNCs were concerned with volume of information and confidentiality concerns, while United Kingdom TNCs cited cost and confidentiality concerns. United States TNCs ranked cost and volume of information required as the chief drawbacks to APAs.

Table 4. Advance pricing agreements in selected countries^a
(Percentages)

Home country	Have/plan to have APA with the United States	Have/plan to have APA with home country ^b
Canada	7	11
Germany	17	6
Japan	18	5
United Kingdom	29	21
United States	10	4

^aSource: UNCTAD, based on Borkowski, 1996, p. 30. 347 TNCs were covered in the study.

^bHost country in the case of the United States.

While the United States tax authority has been a leading proponent of the APA programme, TNCs based in the United States seem to be wary of the programme. Only 10 per cent of these TNCs have or plan to pursue an APA with their own United States tax authority, while only four per cent are considering APAs with host country tax authorities

B. Enhancing the development dimension

As noted above, developing countries have, and will continue to, experience significant direct and indirect effects from transfer pricing transactions.

This is true not only in cases of wholly-owned subsidiaries operated by TNCs. Other types of business organization employed by TNCs and which involve local investors, whether as minority shareholders or as partners in joint ventures, will also generate transfer pricing problems. Any resulting income diversion from local investors and/or, more generally, from the local economy may need to be regulated.

In responding to such matters developing countries face particular problems. Many such countries lack adequate financial resources and sufficient numbers of experts to administer an effective regulatory system. A related problem exists with the retention of experts after training—developing countries may be unable to compete with TNCs over terms and conditions of employment for such skilled personnel.

In addition, while laws regulating transfer pricing can be adopted, and, as shown above, significant models already exist for these, their practical application may create further issues. In particular the practical skills and resource needs in administering a regime for transfer pricing adjustments have to be met. These concern principally mechanisms for obtaining and sharing information, both internally among national regulators as well as regionally and internationally.

These dual concerns, skills and resources and information gathering and sharing, could be operationalized in international investment agreements through specialized clauses. In the first place, a transparency clause could be included that requires disclosure by TNCs of their transfer pricing practices. For example, the draft United Nations Code of Conduct on TNCs required, in paragraph 44, that TNCs should “disclose to the public in the countries in which they operate, by appropriate means of communication, clear, full and comprehensible information on the structure, policies activities and operations of the transnational corporation as a whole”. Listed among the non-financial information to be disclosed are “policies applied in respect of transfer pricing” (UNCTAD, 1996a, volume I, pp. 170-171). Similarly the OECD Guideline on taxation states:

“Enterprises should:

1. Upon request of the taxation authorities of the countries in which they operate provide in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in

connection with their operations, including relevant information concerning their operations in other countries” (UNCTAD, 1996a, volume II, p. 160).

Increased disclosure could serve to discourage income shifting by making transfer pricing activity more transparent to tax authorities in both developed and developing countries (box 6).

Box 6. Improving transparency

Considerable energy has already been expended on increasing disclosure, resulting in the International Accounting Standards Committee’s 1997 revision of IAS 14, “Reporting financial information by segment” (IASB, 1997) and the United States Financial Accounting Standards Board’s Statement 131, “Disclosures about segments of an enterprise and related information,” issued on 30 June 1997 (United States, FASB, 1997). Detailed recommendations for improved reporting have been suggested by UNCTAD (1996d), including increased disclosure about transfer pricing methods, tax liabilities, segment financial reporting, and related party transactions. In further standardizing reporting and allowing for comparisons of TNCs based in various countries, the IASB standards about depreciation, research and development, allowable expenses and related issues could help to improve comparable cross-border analyses.

Source: UNCTAD.

Notwithstanding an increase of transparency, problems concerning skills, resources and regulatory systems will continue for developing countries in particular. Here, technical assistance and co-operation clauses may help to ensure that positive assistance is given to developing countries, in particular by developed countries that have the resources and experience necessary to deal with transfer pricing practices effectively. An analogous technical assistance clause can be found in the TRIPS agreement (box 7). Such a clause could include assistance on information sharing (Lall, 1979), cooperation in the control of transfer pricing and advice and information on the development of effective regulatory frameworks. Furthermore recommendations for establishing a workable transfer pricing framework based on international guidelines have been made by a number of tax experts from developing countries (box 8). These indicate how special clauses aimed at assistance to developing countries could evolve.

Box 7. The TRIPS technical assistance clause

Article 67

Technical Cooperation

“In order to facilitate the implementation of this Agreement, developed country Members shall provide, on request and on mutually agreed terms and conditions, technical and financial cooperation in favour of developing and least-developed country Members. Such cooperation shall include assistance in the preparation of laws and regulations on the protection and enforcement of intellectual property rights as well as on the prevention of their abuse, and shall include support regarding the establishment or reinforcement of domestic offices and agencies relevant to these matters, including the training of personnel.”

Source: UNCTAD, 1996a, volume I, p. 368.

Box 8. Establishing a workable transfer pricing framework for developing countries

Below are suggestions adapted from a resolution of tax experts from Latin American countries which were approved at an international event, the “II Jornada Tributária do Mercosul” (Sao Paulo, 1997):

1. National laws, notably of the Southern Common Market (MERCOSUR) member-states, must be compatible with one another, so that the principle of tax coordination among the various jurisdictions involved prevails and harmful fiscal competition is avoided.
2. In view of the necessity of retaining international investment and to keep MERCOSUR member-states attractive for foreign capital, the rules for transfer pricing to be established by the respective domestic laws should follow the basic lines adopted by the OECD countries, taking into account national realities. The member-states should also adopt the interpretative orientation given under the OECD rules.
3. The economic methods to obtain a transfer price must be used in a consistent form and should be compatible with the applicable rules to the customs and VAT valuations.
4. For transfer pricing rules to be compatible with internationally adopted practices, fixed profit margins should not be established, nor should there be any utilization of legal fictions or absolute presumptions other than the “arm’s-length” method in the identification of the market value of a transaction.
5. The national tax authorities must bear the burden of proof that the prices adopted by the taxpayers do not reflect the applicable legal standards.
6. The rules for transfer pricing relating to intangibles (such as the rendering of services, utilization of rights, brands and patents, transfer of technology, technical assistance and cost-sharing agreements) must be fair and efficient and adopted in a realistic form, so that the economic methods adopted are adequately defined by the relevant legislation.

/...

Box 8 (concluded)

7. The network of international agreements should be increased to avoid double taxation and to allow for the exchange of information between the fiscal authorities from the various jurisdictions. It is recommended that the MERCOSUR countries establish a multilateral treaty, i.e. signed jointly by the member-states, to avoid double or multiple taxation.
8. The MERCOSUR member countries should adequately examine the structure of their respective taxes over the income and profit of taxpayers, including identifying tax havens and examining their taxable basis, rates and fiscal administration.
9. To apply adequately the rules of transfer pricing in the MERCOSUR countries, the establishment of a supranational organization to organize a large database (statistics) on economical activities relevant for international transactions is of importance, as long as the necessary commercial secrecy is preserved about the operations and business practices of taxpayers.
10. Due to relevant administrative and compliance costs arising from the application of transfer pricing rules, national legislation should allow for the possibility of advance pricing agreements, the existence of deviation margins, excluding methods of transfer pricing from operations that do not materially show outstanding taxes, and safe harbours.
11. It is essential to establish efficient channels of communication between public authorities and taxpayers, so that the introduction and application of pertinent rules on transfer pricing is done in a fair, adequate and reasonable way.
12. It is essential that the tax authorities of the MERCOSUR member-states act in a consistent form, in order to minimize the possibilities of starting expensive litigation between nations, because of diverging interpretations over transfer pricing rules in each of the jurisdictions, including the efficient application of the so-called corresponding or appropriate adjustment to avoid double or multiple taxation of the same income.

Source: do Amaral, 1998.

Box 9. Dispute settlement

Tax disputes and double taxation situations arising from transfer pricing disagreements are, to a certain extent, unavoidable, given the nature of rules in this area and their application. Mutual agreement procedures with competent authorities can help, but these are cumbersome. Perhaps competent authorities can utilize international APAs as part of tax treaties to settle current and avoid future transfer pricing disputes with TNCs. Article 25 of the OECD Model Tax Convention allows for the use of competent authorities, but does not set time limits on reaching a settlement,

/...

Box 9 (concluded)

and does not require that a solution be reached to avoid double taxation. Treaties could include a binding arbitration clause similar to that in the European Community Arbitration Convention (text box).

In some countries, TNCs use litigation in the tax courts to seek redress in instances of transfer pricing disputes. Litigation could be structured so that it is seen as the last, rather than first, resort of dispute settlement. Access to voluntary binding arbitration could be simplified and its cost-effectiveness stressed. While arbitration costs are less than litigation costs, total costs may be even lower if limits are set on discovery and on the use of expert witnesses.

Expansion of arbitration clause

“Article 25 [on dispute settlement] should be expanded to include mandatory arbitration to settle disputes within a reasonable timeframe if mutual agreement procedures fail ... When competent authorities fail to settle the dispute, it should be sent to an independent arbitration board whose decision is binding on all participants. The board should consist of transfer pricing, trade law, and tax experts from countries not involved in the particular dispute, or currently involved with one of the parties in another dispute. Board members should not be part of any tax authority or governmental unit. The integrity and independence of the arbitration board must be guaranteed in order for tax authorities and TNCs from the countries involved to accept the board’s decision as binding.”

Source: UNCTAD, 1996d, p. 21.

Source: Sansing, 1997.

Some more technical aspects of transfer pricing issues could also be addressed in relevant provisions of international tax agreements. These could include specific arbitration measures to settle disputes when the competent authority fails (box 9), and limitation-on-benefits clauses to prevent or deter treaty shopping (box 10). Tax treaties could also be a vehicle through which APAs are reached, allowing developing countries and TNCs a respite from annual tax audits, deficiency assessments and tax disputes.

By way of conclusion, it can be seen that transfer pricing practices require a specialized and flexible regime based on cooperation both within and between countries, and especially between developed and developing countries, if a development friendly regime for regulating transfer pricing is to be realized.

Box 10. Benefits clause

A limitation-on-benefits clause could be included in tax treaties to help curb transfer pricing abuses and prevent the pass-through of profits through a third party country. Treaties could also provide for compensating adjustments to avoid double taxation of TNCs, such as those presented in the OECD Model. In certain cases, such adjustments are not necessarily desirable because they may harm, rather than help, a developing host country, depending on its tax structure vis-à-vis a developed home country. An exchange-of-information clause, based on Article 26 of the OECD Model, could be included in treaties and identify relevant types of information, whether routine, specific or spontaneous. Language could be based on existing Tax Information Exchange Agreements.

Source: UNCTAD.

^a If such correlative adjustments are desired, the United States model does not guarantee protection from double taxation.

Notes

- ¹ A further, related, issue concerns the fact that transfer pricing may be used as a means of redistributing profitability entitlements among business partners as in the case of joint ventures or of other business arrangements with profit sharing implications. This may require a reallocation of revenues to ensure that a true and fair amount of profit is distributed to the non-TNC partner. This may be a particular problem in developing countries where local partners may not have the capacity or resources to identify the profit-shifting effect of transfer pricing manipulations.
- ² Harmony between the OECD and United States approaches is assumed unless otherwise specifically noted. Differences between, and the relative impact of, OECD and United States regulations are discussed below.
- ³ Lorraine Eden (1997) provides an in-depth discussion of OECD guidelines as implemented by Canada – versus United States regulations – and their relative effects on corporate income taxation and on TNC strategy.
- ⁴ For a discussion of the growth of tax treaties, see UNCTAD (1998b).
- ⁵ For detailed country-specific comments, see Borkowski (1997).

Chapter 21. Taxation*

Executive summary

The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by the entities of a transnational corporate system is allocated among countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, among other things, to set out detailed allocation rules for different categories of income. While international tax agreements deal foremost with the elimination of double taxation, they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution.

The process of globalization, including growing transnational investment and trade, has increased the potential for conflict between tax jurisdictions. At the heart of jurisdictional conflict lies the issue of the jurisdiction to tax. There are no restrictions under international law to a legislative jurisdiction to impose and collect taxes. In most countries, the jurisdiction to tax is based on the domestic legislative process, which is an expression of national sovereignty. States apply their jurisdiction to tax, based on varying combinations of income source and residence principles. This, together with mismatches in definition, accounting and income recognition rules, may result in double taxation or, in some cases, in a jurisdictional vacuum.

A jurisdictional conflict arises when a taxable event falls under the jurisdiction of two or more sovereign powers. These are generally the source country and the country of residence. Jurisdictional conflicts can be, and often are, relieved unilaterally under both international investment agreements (IIAs) and double tax treaties (DTTs). The bulk of such arrangements is represented by bilateral agreements dealing exclusively with tax matters. However, taxation is also dealt with by a host of multilateral comprehensive or specific tax agreements, or bilateral agreements not dealing specifically with taxation.

Tax provisions do not typically form a principal part of IIAs, partly owing to the existence of the tax-specific DTTs. One reason for the limited role of taxation provisions in IIAs is that

the inclusion of taxation matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion. There nonetheless exists a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of the responsibility of transnational corporations (TNCs) in the area of taxation; and as the basis for a taxation regime for regional multinational enterprises or supranational business associations. The final model involves a commitment in an IIA to avoid the double taxation of investors and/or investments. Such an agreement would be based on existing models, of which the OECD and United Nations model tax conventions are of special significance. The OECD Model Convention generally favours residence taxation, while the United Nations Model Convention generally favours source taxation. For developing countries, the OECD Model Convention may operate well under conditions of balanced economic relations such as exist between capital-exporting nations. However, it may not be as suited for the uni-directional capital flows that exist between most developed and developing countries.

DTTs themselves typically have clauses excluding national and most-favoured-nation (MFN) treatment from tax matters; and bilateral investment treaties, which provide for national and MFN treatment, typically exclude taxation from those provisions. This exemplifies the sensitive nature of the sovereign right of a State to tax.

IIAs and international tax arrangements have evolved a number of approaches in relation to the jurisdiction to tax:

- the exclusion of tax issues model;
- the qualified exclusion model;
- the tax incentives model;
- the TNC tax responsibility model;
- the regional multinational enterprise taxation model.

Even in cases where there is no double taxation to relieve (e.g. if there is no tax in one State or if the country of residence unilaterally

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avoids double taxation), a tax treaty can be useful as it generally offers greater and more comprehensive protection than that available under domestic rules, which can be modified at will. Indeed, the single most important advantage of a tax treaty is the relative legal certainty it offers to investors with respect to their tax position in both the source and residence countries. In addition, a country can create, through tax treaties, new business opportunities. Various efforts at multilateral agreements have been made, but with little success to date. Those that have experienced some success have been supplemented by bilateral arrangements among the various parties.

In taking into account all of the above considerations, the important issues to note are that countries that opt for the conclusion of international tax arrangements need to be aware of the tax system of the treaty partner and to draft an arrangement in such a way as to exploit all synergies with that tax system and preserve their tax base, or (and most importantly for developing countries) at least leave the opportunities open for implementing any source-based options.

Introduction

The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by associated entities of a TNC is allocated among countries, i.e. how appropriately to allocate business income between associated entities of a TNC and how equitably to divide or share the revenues from foreign affiliates between host and home countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, *inter alia*, to set out detailed allocation rules for different categories of income, for example, income (e.g. from real property) taxable without restriction in the source country, and income (e.g. interest income) subject to limited taxation in the source country (UNCTAD, 1998b).

Most countries assess taxes by reference to a connection between the taxpayer and/or the taxable transaction with their territory. International taxation issues have their origin in the framework of pure export/import activities between unrelated parties. Here the tax implications are more often than not restricted to indirect taxes such as customs duties and value-added tax. The mode of operation of such taxes is generally not conflict-prone, in that it does not involve a double imposition of taxes, since such taxes arise at the point of entry into, or

at the point of resale within, the taxing jurisdiction. Even indirect taxes, however, impact upon foreign direct investment (FDI) in that they have implications for direct taxes, since two or more States may at the same time consider that a connection exists between a taxpayer or a taxable event and their territories. Therefore, the same taxpayer or taxable event may fall under the fiscal sovereignty of two or more jurisdictions (double taxation), or may fully or substantially escape taxation in all jurisdictions involved. At the same time, the global integration of the world economy and the expansion of investment and trade conducted by TNCs has added a new dimension to taxation issues.

Many countries unilaterally avoid the concurrent exercise of taxing rights, whether in pursuit of economic policies (e.g. capital-export neutrality) or simply because they recognize limits to the enforcement of national tax laws beyond their territories. At the same time, an increasing number of countries, faced with the challenges of tax-base erosion, have extended their tax jurisdictions to persons and/or taxable events outside their territories. This often requires the negotiation of international tax arrangements. Because tax arrangements have a direct and indirect impact on the revenues of the contracting parties, the manner in which they are drafted and applied is of crucial importance to policy makers.

This chapter concentrates on how various international tax issues related to FDI have been addressed in IIAs and in international tax arrangements, as well as policy options for developing countries in this regard.

Section I Explanation of the Issue

Globalization and increased transnational investment and trade imply a potential conflict of tax jurisdictions or, in certain circumstances, a jurisdictional vacuum. Central to the question of jurisdictional conflict is the issue of the jurisdiction to tax: the sovereign right of two or more jurisdictions to levy tax on one and the same event or one and the same taxpayer. Where there are mismatches between national tax laws, the jurisdictional conflict can be exacerbated by improper conduct on the part of taxpayers. Jurisdictional conflicts can be, and often are, relieved unilaterally under national tax laws, or bilaterally - and sometimes even multilaterally -

under tax treaties, although the question as to which jurisdiction should bear the burden of relief is important and not uncontroversial, due to legitimate concerns about the erosion of the tax base. This is generally achieved through the elimination of definitional mismatches or the relief of double taxation.

A. The jurisdiction to tax

In most countries, the jurisdiction to tax is based on the domestic legislative process, which is an expression of national sovereignty, thus heightening the sensitivity of the surrounding issues. There are no restrictions under international law to the legislative jurisdiction to impose and collect taxes. In principle, international tax agreements do not restrict the contracting parties' legislative jurisdiction (although they may restrict the application of tax rules enacted pursuant to that jurisdiction). It is only in rare situations that such tax arrangements may impact directly on the legislative jurisdiction.¹

Nevertheless, the impact of a country's legislative jurisdiction is restricted by the obvious limitations on its enforcement powers beyond its own national boundaries (Sandler, 1998). In other words, the unrestricted exercise of the right to impose and collect taxes is rather limited if the resulting rules cannot be enforced outside the regulating state's own territory. Thus, most countries exercise their jurisdiction to tax by reference to factors that assume a sufficient connection between the relevant country and the taxable person and/or the taxable income.

Taxation systems based on a sufficient connection between the relevant country and the taxable person apply the principle of "residence-based taxation". Countries applying such a principle tax their residents (and sometimes their nationals) on their worldwide income, wherever derived. One method of assessing the allocation of income, which has been the subject of some controversy on jurisdictional grounds, is the "unitary taxation" method (box 1).

Taxation systems based on a sufficient connection between the relevant country and the taxable income apply the principle of "source-based taxation". Countries applying such a principle tax income derived from sources in their territory, regardless of the residence of the person deriving the income.

Box 1. Unitary tax

The unitary tax method rests on the assumption that it is too difficult to determine precisely what taxable income is being generated by any particular taxable person and, hence, what should be allocated to that person. Instead, a proportion of the worldwide income is allocated to the taxing jurisdiction, based on the relationship of assets, payroll and sales (or formulae taking into account several combinations of the same) of the taxable person (in the case of TNCs, the foreign affiliate) located within that tax jurisdiction to the TNC's worldwide assets, payroll and sales. In effect, this method pierces the corporate veil of foreign affiliates and treats all related affiliates as one corporation.

Critics of this method have argued, among other things, that the unitary tax method could have, as a side effect, deterrence potential as regards investment in States that choose to apply it. The method has been applied notably by certain States of the United States, in an attempt to avert possible distortive effects of transfer pricing. But a study conducted in 1982 by a large United States accounting firm showed that corporate taxation schemes do not play a definitive role in a corporation's locational decisions (Allen, 1984). The study notwithstanding, largely for the very fear of discouraging incoming investment or of encouraging disinvestment by foreign companies already established, most of the United States' States which originally adopted the unitary tax method have in fact abandoned it, and it has ceased to be a serious issue (Wallace, 2002).

It is nonetheless worth noting another criticism of the method, namely that unitary taxation assumes that profit is uniformly related to all stages in an integrated production system and that production costs are the same in different countries; in practice, however, this is not so in the majority of cases. Also, if the operations of a firm in a unitary taxation jurisdiction are more profitable (more efficient) than the rest of its worldwide operations, the affiliate company would be likely to pay lower taxes under that method than under a regular arm's-length method; conversely, if the local operations are less profitable (less efficient), the local company is likely to pay higher taxes under this method than under the arm's-length method. In effect, unprofitable firms would be more likely to pay more taxes in relation to their real income than profitable ones. To avoid those distortions, a complex analysis would be needed of the different functions of the various associated firms and the different risks and profit opportunities at various stages of production. Such calculations require complete information about all the activities of the TNC as a whole. In addition, a number of Governments and TNCs have argued that this approach runs counter to the internationally accepted arm's-length principle and exposes TNCs to double taxation (UNCTAD, 1993).

Source: UNCTAD.

Most countries apply a combination of residence-based and source-based taxation. Hence, residents (and sometimes nationals, whether or not resident)² are taxable on their worldwide income under what is generally referred to as an “unlimited tax liability”. In contrast, non-residents are taxable only on income derived or deemed to be derived from sources within the territory, under what is generally referred to as a “limited tax liability”.

1. Jurisdictional conflicts

A jurisdictional conflict arises when a taxable event falls under the jurisdiction of two or more sovereign powers.³ These are generally the source countries and the countries of residence. The source country is where the activity is exercised, where the payer is resident, or where the property producing the income is situated. The country of residence is where the persons deriving the income or the owners of the property producing the income have their residence or domicile.

The same occurrence may be regarded as a taxable event by the source country because it involves income sourced there from or property situated therein, but also by the country of residence because the income accrues to, or the property is owned by, one of its residents. For example, a company resident in country A conducting business through an affiliate in country B, could be taxed in country A on its worldwide income (including that derived through the branch) if country A has a residence-based taxation system. At the same time, the affiliate could be taxed by country B on the income derived through the affiliate if country B has a source-based taxation system. The concurrent exercise of their taxing rights by the country of residence (A) and the source country (B) leads to double taxation. Thus, double taxation can be defined, in a non-exhaustive way, as the imposition of comparable taxes by two or more sovereign countries on the same item of income of the same taxable person for the same taxable period (Rivier, 1983; Arnold and McIntyre, 1995; OECD, 1997f).

Double taxation most often occurs when both the source country and the country of residence concurrently exercise their taxing right without providing full relief for the other country’s tax. However, double taxation can also occur in various other situations, in particular as a result of definition and/or income classification differences between different taxing authorities. Hence, a

person considered as a resident by two or more States by virtue of different definitions can be taxed in each of the States involved. This can be the case for individuals maintaining habitual abode or conducting professional activities in two or more countries. It can also be the case for companies operating in countries with different corporate laws. For example, a company may be incorporated under the laws of country A which determines residence by reference to the place of incorporation (i.e. it considers as a resident any company incorporated under its laws). At the same time, the company may be effectively managed and controlled from country B which determines residence by reference to the place of effective management. Such a company would meet the residence test in both countries and can therefore be taxed as a resident by both countries A and B.

Likewise, two or more States which each deem, by their own definition, an item of income to arise from sources within their territory can concurrently tax the same item of income. Finally, double taxation can also result from mismatches in accounting standards or in the timing of income recognition.

Occurrences of double taxation are sometimes classified as “juridical” and sometimes as “economic”. Juridical double taxation occurs when one and the same person is taxed on the same income by two or more States. Double taxation is classified as economic when two separate persons are each taxed on the same income by two or more States (box 2).

Box 2. Juridical and economic double taxation

Juridical double taxation

Example 1:

Xco is resident in country A and operates an affiliate in country B. Xco is taxed in country A on its worldwide income (including that derived through the foreign affiliate). It is also taxed in country B on the income derived through its affiliate therein. There is juridical double taxation because one and the same taxpayer (Xco) is taxed on the same income (that of the affiliate) by two States (countries A and B).

Example 2:

Xco is resident in country A and is a shareholder in a company resident in country B. If the latter company pays dividends to Xco, such dividends can be taxed by country A pursuant to the residence principle and also by country B pursuant to the source principle.

/...

Box 2 (concluded)*Economic double taxation*Example 1:

Affiliate company Xco realizes \$100 of income and is taxed on that income in its country of residence A at 40 per cent. Xco distributes the after-tax income (\$60) to its parent company Yco which parent company is taxed in its country of residence A on the income received from Xco at 35 per cent. Ultimately, the income realized by Xco was taxed twice, a first time by country A at the level of Xco and a second time by country B at the level of Yco. The total tax would have amounted to 61 per cent.

Example 2:

Xco sells goods to its parent company Yco for \$100 which amount is taxable to Xco in its residence country A and deductible to Yco in country B. The tax authorities of country A determine that the price is too low and adjust it to \$150, while the tax authorities of B refuse to grant Yco a corresponding adjustment (i.e. an additional deduction of \$50). Therefore, the amount of \$50 is taxed twice, first as an additional income for Xco and then as a non-deductible expense for Yco.

Source: UNCTAD.

2. Jurisdictional vacuums

Overlapping tax jurisdictions can, as shown above, result in over-taxation, but can also give rise to under taxation or even effective non-taxation, stemming from mismatches between the national tax laws. Hence, if source country A grants an exemption to a specific item of income (e.g. in the framework of a tax incentive scheme), and residence country B relieves the double taxation of foreign income of its residents by applying the exemption method (see part B. 2. b, below), the item of income derived by a resident of country B from source country A will effectively escape taxation in both countries. Such situations may be exploited by both legitimate and illegitimate tax planning techniques. Many countries have designed rules to prevent the occurrence of such phenomena, in particular when it is expected that it may be aggravated by tax payers planning techniques that are not in conformity with policy intentions.

Within this context arises perhaps the major legal preoccupation in the area of taxation as it pertains to TNCs (for both Governments and TNCs themselves): curtailing tax evasion brought about by transfer pricing abuses. Transfer pricing practices are now considered one of the leading international tax issues (see chapter 19).

The term “transfer pricing” denotes that practice whereby a TNC, in its intra-enterprise transactions, can sometimes effectively modify the tax base on which its entities are assessed, or possibly avoid exchange controls where such exist. This is accomplished by “doing business” within the TNC corporate structure itself so as to reallocate costs and revenues in such a way that its profits are realized where the tax and exchange environment is the most favourable (Wallace, 2002). Even though, as with tax havens, the national legislation primarily addresses outbound transfers from the legislating State’s own parent companies to their foreign affiliates, this issue is of common international concern and is highly relevant to foreign investors conducting cross-border transactions within their corporate systems. Moreover, the control of transfer pricing abuses is rendered largely impracticable without cooperation between nation-States. It is particularly worthy of note that transfer pricing regulations are among the few aimed primarily at TNC operations, in that it is not a real issue within a strictly national context (ibid.). One additional issue which should be mentioned in conjunction with transfer pricing is the prevention of tax evasion and the role of international tax treaties, mutual assistance and information exchange in this connection.

B. Avoidance of double taxation

In order to avoid the situation of tax being levied twice on the same income, in the forms described above, and to address the question of jurisdictional overlaps in income allocation, various solutions have been sought to deal with the problem. They can be unilateral or international. Unilateral measures are not addressed in detail in this chapter. Generally, unilateral measures are dictated by economic policy choices. For example, many capital-exporting countries exempt the foreign-source income of their TNCs in order not to put them at a competitive disadvantage in third country markets vis-à-vis TNCs of other countries. On the other hand, for many capital-importing countries, the most obvious unilateral restraint is represented by tax incentives aimed at attracting FDI. Also, in order to attract capital, many countries exempt interest-remunerating bank deposits of non-residents. Sometimes unilateral restraint measures are simply dictated by restrictions on a country’s possible enforcement jurisdiction of its own laws outside its own territory.

International measures for the mitigation of double taxation problems can take various forms. Most important and most common among them are comprehensive DTTs. There are several reasons why tax treaties are useful and important. From the perspective of a capital-exporting country, a tax treaty is important in that it affords its own enterprises, to the extent possible, a level playing field in a given foreign market, in comparison with enterprises of other capital-exporting countries. At the same time, bilateral tax treaties also create possibilities for the exchange of information between capital-exporting and capital-importing countries and can support the prevention of fraud and abuse. The overwhelming majority of comprehensive double tax treaties is represented by bilateral agreements dealing exclusively with taxation matters in regard to income and, sometimes, capital. A limited number of multilateral instruments dealing exclusively with taxation matters have also been concluded. Additionally, various other types of bilateral agreements deal with some tax matters, whether exclusively or only in a very partial way. These include inheritance and gift tax treaties,⁴ air and/or sea transport agreements, investment promotion and protection agreements, consular and diplomatic conventions, and cultural, technical and scientific cooperation agreements.

The avoidance of double taxation does not mean granting the taxpayer the advantage of the lowest tax. Indeed, its only purpose is to avoid the accumulation of concurrent taxes. This is generally achieved through two simultaneous means:

- the elimination of definition mismatches; and
- the provision of relief for the tax borne in one of the contracting States.

1. Elimination of definition mismatches

One of the underlying causes of double taxation occurrences is definition mismatches. Indeed, as mentioned above, two or more countries can each consider the same taxpayer to be a resident pursuant to the definition of residence under their domestic laws, in which case the taxpayer could be taxed as a resident by each of the countries involved. Also, two or more countries can, in the application of their domestic laws, consider a given item of income to be connected to sources within their territories, in which case each of the countries involved would tax the relevant item of income.

Tax treaties eliminate such definition mismatches, to a certain extent, by providing for commonly agreed definitions. Hence, with respect to the determination of residence, treaties provide for the application of a number of criteria, such as:

- the availability of a home or permanent abode;
- the location of the taxpayer's centre of economic interest; or,
- for legal entities, the location of the statutory seat or of the place of effective management.

In case the application of these criteria does not resolve the residence determination issue, a so-called tie-breaker clause is applied to reach a solution. A tie-breaker clause could, for example, determine that a person is resident in the country of which it is a national, or in the country where effective management is located. In other circumstances, the clause could provide for the application of a mutual agreement procedure.

A treaty can also eliminate definition mismatches by providing agreed definitions of the concept of various types of income. For example, it can provide that income from profit-sharing bonds should be treated as a distribution of dividends rather than as interest payment, or that the concept of dividends does not cover constructive dividends. In most cases, however, the income definition clause also refers to the definition under the domestic law of the source country. For example, article 10 (3) of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model Convention) provides:

“The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident” (OECD, 1997f, p. M-21).

Because such a clause is referenced to domestic laws, the elimination of definition mismatches may be incomplete, since the other contracting party need not necessarily follow the definition determined under the domestic laws of the source country. However, in some cases (mostly related to older treaties), the definition does not refer back to domestic law so that the parties are bound by the definition contained in the treaty. For example, article VIII, paragraph 7, of the 1962 Austria-Egypt tax treaty provides that:

“In this Article, the term “dividends” includes in the case of the United Arab Republic profits distributed by a company to its founder shareholders as well as profits distributed to ... and in the case of Austria profits distributed by [a company with limited liability]” (IBFD, 1986-).

2. Relief from double taxation

Relief from double taxation generally follows one of three methods:

- the deduction method;
- the credit method; or
- the exemption method.

The least applied of the three is the deduction method. Under the deduction method, which is normally applied by the country of residence, the foreign tax is treated as a deductible expense so that the income is taxed net of foreign tax. This method is generally the least favourable to the taxpayer. It is usually used as a unilateral tool in the absence of a tax treaty. International tax arrangements, whether bilateral or multilateral, normally prevent double taxation through the credit method or the exemption method.

a. The credit method

Under the credit method, the country of residence taxes the foreign income of its residents but allows the foreign tax as a credit against its own tax. Generally, it does not refund excess foreign tax over its own tax. The ultimate tax liability of the taxpayer is, therefore, the higher of the domestic or foreign tax (box 3).

Box 3. Double taxation relief under the credit method

Xco is resident in country X (corporate tax rate 40 per cent) and operates an affiliate in country Y (corporate tax rate 30 per cent). The affiliate derives \$100 of income and pays \$30 tax in Y. The remainder (\$70) is remitted to X where it could be grossed up to \$100 and taxed at 40 per cent resulting in a corporate tax liability of \$40. However, since Xco is entitled to a credit for the tax paid in Y, it only pays \$10 of tax in X (i.e. 40 less 30). Its ultimate tax liability therefore amounts to \$40 (i.e. \$30 in Y tax and \$10 in X tax). If the corporate tax rates were reversed (i.e. 30 per cent in X and 40 per cent in Y), Xco will end up not paying any tax in X (since the tax credit is higher than X corporate tax and X does not refund excess foreign tax), but it would have paid in total \$40 in Y tax. Therefore, in both situations, the ultimate tax liability of Xco is the higher of the domestic or foreign tax.

A variation of the credit method is the “tax sparing” or “matching credit” method, under which the country of residence in effect grants a credit for a tax that is higher than the tax actually levied in the source country. The matching credit issue has been considered important by many developing countries and is addressed in greater detail under section II.

The credit method attempts to achieve full “horizontal equity” more effectively than the deduction or exemption method. Under the horizontal equity theory, resident taxpayers pay the same amount of tax regardless of whether they derive domestic-source or foreign-source income. However, the credit method is complex from both a compliance and an enforcement perspective, as the foreign income needs to be recomputed according to domestic rules. It may also discourage investments abroad or encourage the deferral (i.e. non-repatriation) of types of foreign income, such as dividends, which are normally not assessed for tax in the country of residence until actually received. Since the taxpayer’s ultimate tax liability is the higher of the country of residence and source country tax, the source country can manipulate the credit method to its advantage by increasing its own tax up to the amount of the country of residence tax without, on balance, aggravating the ultimate tax position of the investor.

b. The exemption method

Under the exemption method, the country of residence disregards the foreign-source income of its residents. The foreign tax is, therefore, the only tax burden borne by that income. This method is most favourable to the taxpayer if the source country tax is lower than the country of residence tax. It is also easily enforceable, fosters capital-import neutrality and, in principle, does not encourage deferral of income. However, it is more prone to abuse and can cause discrimination between residents, depending on whether they realize domestic or foreign income.

Normally, the exemption method is applied by the country of residence. For certain types of income, however, tax arrangements may require the source country to exempt the income. This is generally the case for passive income, including royalties and capital gains.

A variation of the exemption method is the “exemption with progression” method under which the foreign-source income, while exempt from tax, is taken into account in determining the rate of tax

applicable to the taxpayer's remaining income. This, of course, is relevant only when tax is levied at progressive rates.

Section II Stocktaking and Analysis

Taxation provisions have, to date, not played a major role in IIAs. This is explicable partly by the highly specialized nature of such issues and partly by the fact that, as a result, taxation experts and investment experts have not developed an extensive dialogue. Indeed, taxation may be seen as something of an expert "niche". This has been partially resolved by the creation of double taxation agreements with an investment component.

Despite the marginal treatment of taxation issues in IIAs, the proliferation of DTTs is one important indication that taxation has far-reaching implications for the conduct of FDI operations by TNCs. Thus, in this section of the chapter, not only are tax provisions in IIAs considered but also the investment-related provisions of tax agreements. A brief historical perspective helps to provide the proper context for the ensuing discussion.

A. An historical perspective

Various types of international agreements deal with taxation matters, either exclusively or partially. The most important of these are comprehensive DTTs which deal with taxes on income and, sometimes, capital. There are also a number of international tax agreements dealing with specific tax matters, such as mutual assistance and exchange of information. Treaties dealing exclusively with the elimination of double taxation with respect to inheritance and/or gift tax are numerous but are not addressed in this chapter.

International arrangements dealing exclusively with taxation matters with respect to income and capital can be divided into bilateral and multilateral arrangements. With over 2,300 arrangements concluded by the end of 2003 (UNCTAD, 2004b), bilateral DTTs represent the immense majority of all international tax arrangements.

Most international tax arrangements are drafted along a combination of the provisions of the OECD Model Convention (OECD, 1997f) and those of the United Nations Model Double Taxation Convention between Developed and

Developing Countries (United Nations Model Convention) (IBFD, 1986-).⁵

1. *Bilateral arrangements*

a. *The evolution of double tax treaties*

Many tax historians regard the France-Belgium agreement of 12 August 1843 on mutual administrative assistance (Convention pour régler les relations des administrations de l'enregistrement de France et de Belgique) (Parry, 1843) as the first international agreement dealing with tax matters (Gouthière, 1991). Nevertheless, the development of international taxation and of the study of the issues raised by double taxation started only soon after the beginning of the twentieth century.

In 1921, the Finance Committee of the League of Nations was entrusted with a study of the economic aspects of international double taxation. That work was concluded by the drafting of the first model at the Geneva conference of 1928 (LoN, 1928) in which 27 countries took part. In 1928, the League of Nations established a permanent fiscal committee which was entrusted with the formulation of rules governing the taxation of enterprises active in various countries. A draft convention was elaborated in 1935 and revised in Mexico in 1943 (LoN, 1945). However, the Mexico model was regarded by developed countries as too biased towards the source-country principle, and was amended at the London conference of 1946 (LoN, 1946a). In its turn, the London model was deemed too favourable to developed countries (LoN, 1946b). Negotiations between developing and developed countries stalled in 1954, and work on double taxation matters continued in two separate frameworks, namely the OECD and the United Nations.

In 1967, the Economic and Social Council of the United Nations (ECOSOC) stressed the need to conclude tax treaties between developed and developing countries (UN-ECOSOC, 1967). An ad hoc group of experts on international cooperation in tax matters was formed. The group, which consists of experts proposed by Governments but acting in their personal capacity, elaborated the United Nations Model Convention of 1980 (UN-ECOSOC, 1980) and the "Manual for the Negotiations of Bilateral Tax Treaties between Developed and Developing Countries" (UN-ECOSOC, 1979b). The group continued to meet regularly, including, for example, as a focus group

in March 1999, in order to discuss international tax developments and the possible need to update the model.

Developed countries have continued to coordinate their work on international tax issues in the framework of the Fiscal Committee of the OECD.⁶ One result was the elaboration of the 1963 draft model (OECD, 1963b), later revised as the 1977 model Convention (OECD, 1977).⁷ The 1977 model was revised in September 1992 and later published in loose-leaf form so as to facilitate updating the text and commentaries (OECD, 1992b).⁸

The great majority of the over 2,300 DTTs are now based on either the United Nations or OECD models (with variations that reflect the specifics of the bilateral relationship between the contracting parties).

Nevertheless, being bilateral agreements, DTTs rarely adopt the form of one model but rather tend to reflect a compromise between the positions of both parties.

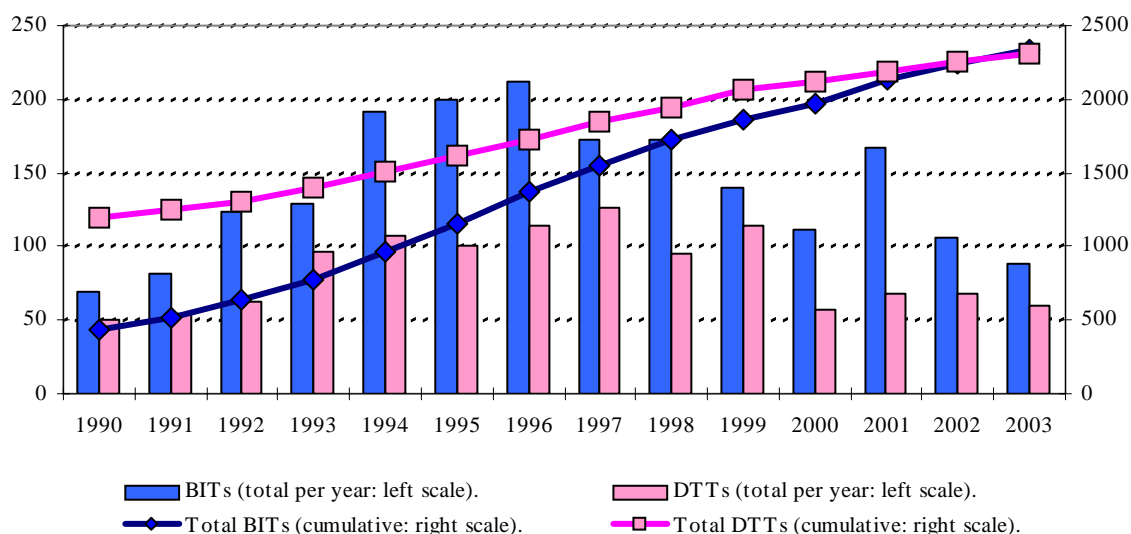
b. The universe of double tax treaties⁹

The number of DTTs has increased rapidly during the past four decades (figure 1). By the end of 2003, 2,316 treaties, covering 188 countries and territories, were in existence. This compares with 2,265 bilateral investment treaties (BITs) involving 176 countries at the end of 2003. Between 1980

and 2003, the rate of increase for DTTs held steady, while the rate of increase for BITs rose sharply in the late 1980s.

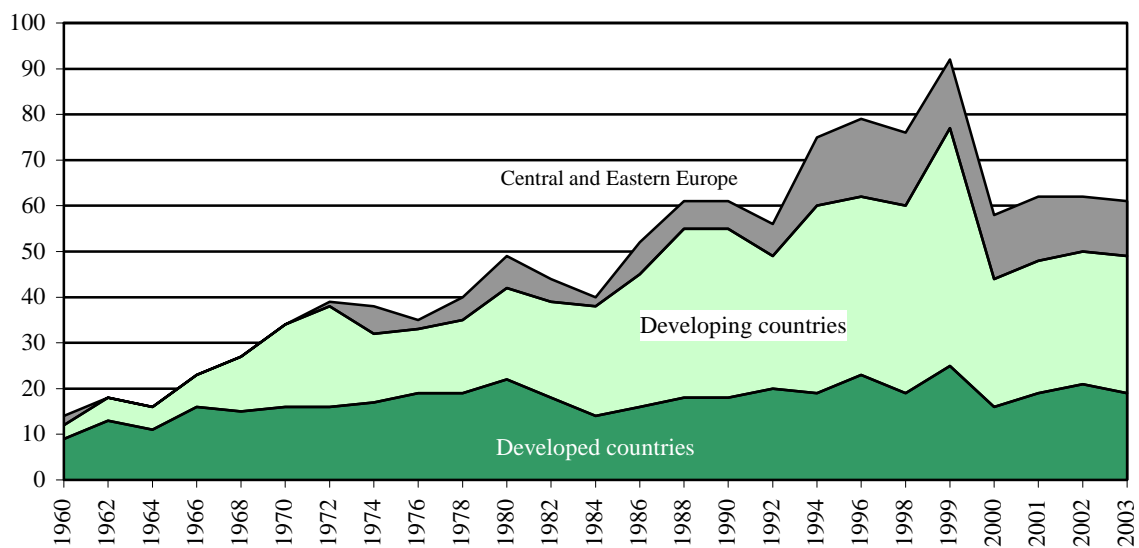
As developed countries were traditionally the principal home and host countries for TNCs, DTT issues arose primarily between these countries, explaining why most of the earlier DTTs were between developed countries. (BITs, on the other hand, were initially concluded primarily between developed and developing countries, as developing countries were seen to involve certain risks for investors.) Over the years, however, as first the developing countries and then the countries in Central and Eastern Europe became important host countries for FDI and also emerged as home countries, the universe of tax treaties expanded to include them (figure 2). As developing countries became outward investors, and a growing part of their investment was in other developing countries (especially in Asia), they also began to conclude both types of treaties. The increased participation of developing countries and – later – countries in Central and Eastern Europe has not been limited to concluding agreements with developed countries. Indeed, since the 1980s, DTTs are increasingly being concluded between developing countries *inter se*, and between countries in Central and Eastern Europe *inter se*, as well as between developing countries on the one hand and countries in Central and Eastern Europe on the other (figure 3).

Figure 1. BITs and DTTs concluded, cumulative and year to year, 1990-2003



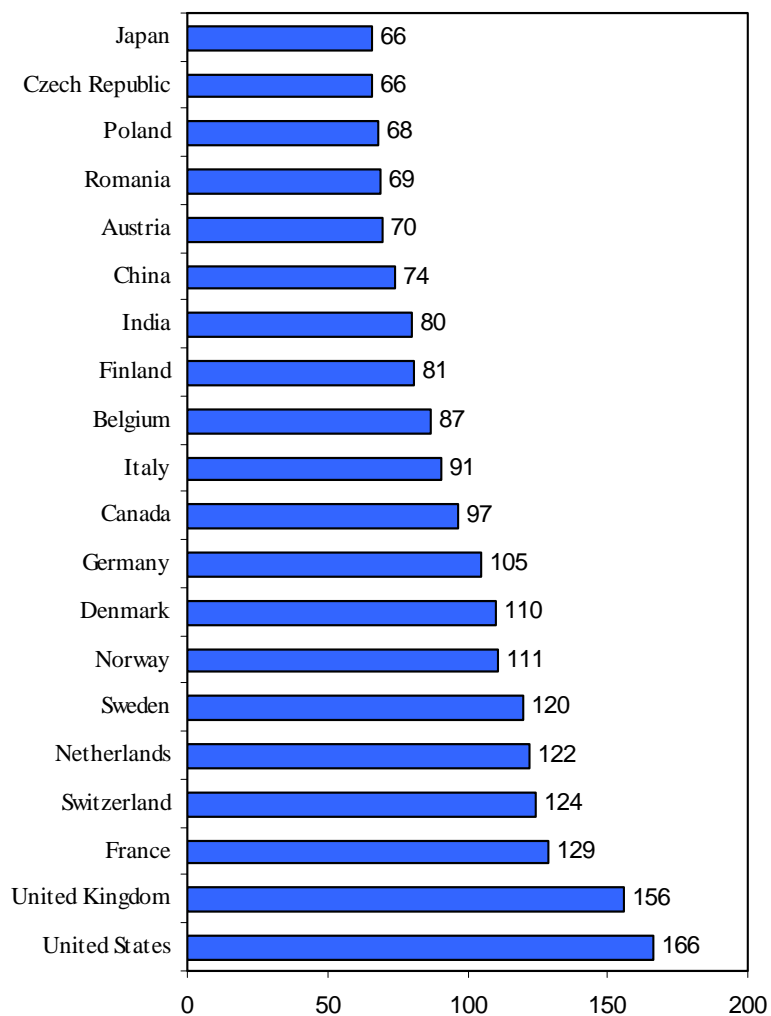
Source: UNCTAD, database on BITs and database on DTTs.

Figure 2. Number of countries and territories with DTTs, 1960-2003



Source: UNCTAD, database on DTTs.

Figure 3. Number of DTTs concluded: top 20, as of end December 2003

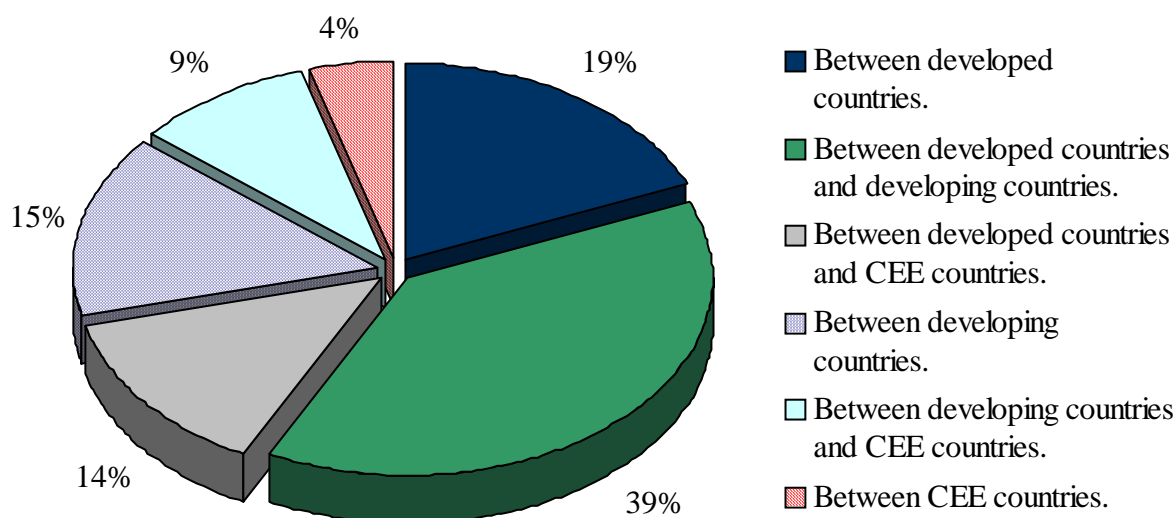


Source: UNCTAD, database on DTTs.

If the universe of DTTs is compared with the universe of BITs it needs to be kept in mind that both types of treaties have specific but distinct purposes. The principal purpose of DTTs is to deal with issues arising out of the allocation of revenues between countries; the principal purpose of BITs is to protect the investments that generate these revenues (and tax issues are excluded from their provisions). The two types of treaties are therefore

complementary. At the same time, the universes of BITs and DTTs, although having started from different points and for different — but complementary — purposes, are evolving in the same direction. The propensity to sign both types of treaties has increased, which is a reflection of the growing role of FDI in the world economy and the desire of countries to facilitate it.

Figure 4. DTTs concluded in 2003, by country group^a
(Percentage)



Source: UNCTAD, FDI/TNC database.

^a A total number of 60 DTTs were concluded in 2003.

2. Multilateral arrangements

While there was some initial discussion by the League of Nations on the possibility of developing a multilateral tax treaty only, a small group of academics (Lang et al., 1998) have recently discussed this option. Countries have, in general, preferred the bilateral form. In order better to appreciate this preference, it is useful to understand why a tax treaty has traditionally been essentially a bilateral exercise. Three main arguments supporting the bilateral form are:

- A bilateral treaty is necessarily based on the specific tax systems of the negotiating parties. Hence, one party may insist on levying a withholding tax on a given item of income because the other party exempts that item of income under its domestic laws (otherwise the relevant income would escape taxation altogether). The same reasoning is not necessarily valid in relation to a third country.

- A bilateral treaty is necessarily based on the economic relationship between the parties involved. The parties agree to reciprocal concessions on the premise that the tradeoff is globally balanced. Hence, one party may agree to a concession with respect to a given item of income on the premise that it gains with respect to another item of income. The same reasoning may not necessarily apply in relation to a third country, as the economic relationship and financial flows with that third country can be different.
- It is unclear how, in practice, a multilateral treaty would be negotiated with a large group of countries.

The main arguments in favour of a multilateral agreement are:

- A multilateral treaty helps to avoid competitive distortions by eliminating one additional – even if minor – obstacle that might exert a negative influence or even play a key role in the decision-making process as to

where to invest. Where the principal FDI determinants (UNCTAD, 1998b, ch. IV) are essentially equal, TNCs may direct their capital towards those countries where the most favourable treaty provisions afford them the greatest protection.¹⁰ This could actually lead to harmful tax competition to attract FDI (OECD, 1998d). A multilateral double taxation convention can neutralize the otherwise potentially distortive effects of differing bilateral arrangements and thereby avoid possible competitive advantages or disadvantages among host countries.

- A multilateral treaty helps to improve legal certainty by offering a more uniform interpretation of the various laws on taxation. Even though the commentary on the OECD Model Convention (OECD, 1997f) recommends that bilateral treaties resort to its interpretations whenever provisions of the OECD Model Convention are incorporated into bilateral treaties, only a multilateral convention can assure that the interpretation given to a given provision is applied equally among all treaty partners.
- In a multilateral treaty, the effect of treaty revisions is immediate. While the OECD Model Convention undergoes constant review and periodic revision, which then is ideally to be translated into corresponding adjustments to provisions in individual countries' bilateral tax treaties, revisions to a multilateral treaty are simultaneously applicable in all signatory States (Loukota, 1998).

Over the years, various attempts at reaching multilateral tax agreements have met varying degrees of success. The 1922 South-East European multilateral double taxation tax agreement (Convention pour éviter la double imposition) (L'Institut de Droit Public, 1934), signed between Austria, Hungary, Italy, Romania and the Kingdom of the Serbs, Croats and Slovenes, is one of the first multilateral DTTs ever concluded. This was followed by a number of unsuccessful attempts. In 1931, a sub-committee of the Fiscal Committee of the League of Nations prepared a "Draft Multilateral Convention for the Prevention of the Double Taxation of Certain Categories of Income" (LoN, 1931). In 1968, the European Commission prepared a preliminary draft for a multilateral DTT, which was ultimately abandoned. A year later, a working group of the European Free Trade Association (EFTA) made another effort to formulate a draft multilateral DTT, but this also

failed to be realized. However, the work undertaken by EFTA formed the basis of the Convention between the Nordic countries for the avoidance of double taxation with respect to taxes on income and on capital (Nordic Convention) (1983) (IBFD, 1986-), a multilateral tax treaty among the Nordic countries finally replaced by the treaty of 23 September 1996 (*ibid.*).

Of the limited number of multilateral comprehensive DTTs that were eventually concluded, it appears that the 1983 Nordic Convention is the only one that functions adequately (Mattsson, 1985), even if at the cost of additional complications. Other conventions have lost their substance (e.g. the 1973 Arab Tax Treaty concluded between members of the Arab Economic Unity Council (IBFD, 1986 --)¹¹ and the Council of Mutual Economic Assistance Convention (COMECON) between members of the former socialist countries (*ibid.*)),¹² often, as with the latter example, as a result of the decomposition of the ideological and/or regional settings that justified them in the first place. Therefore, whether or not they remain in force, they are largely irrelevant – other than, for example, in the case of COMECON where in certain cases two countries have specifically agreed between themselves to regard the agreement on a bilateral basis.

It should be noted, however, that non-comprehensive multilateral tax agreements dealing with specific issues have had a greater degree of success. Most of these deal with administrative assistance and include the Council of Europe / OECD Convention on Mutual Administrative Assistance in Tax Matters of 25 January 1988 (*ibid.*) and the Convention between the Nordic countries on mutual administrative assistance in tax matters of 7 December 1989 (*ibid.*). Exceptions include the EC Convention on the Elimination of Double Taxation with Connection to the Adjustment of Profits of Associated Enterprises of 23 July 1990 (Arbitration Convention) (*ibid.*) which deals with transfer pricing adjustments and the Nordic Convention for the avoidance of double taxation with respect to taxes on inheritances and gifts of 12 September 1989 (IBFD, 1986-). Agreements on the privileges and immunities of various international organizations also contain fiscal provisions.

The difficulties of concluding any multilateral treaty increase exponentially with the number of parties. Owing to the particular sensitivity of Governments with respect to

compromises in the sovereign right to tax, this difficulty appears to be exacerbated when it comes to the elaboration of multilateral DTTs. For this reason, although the OECD Fiscal Affairs Committee does not discourage the conclusion of multilateral conventions between specific sub-groups of member countries, it has traditionally considered that the conclusion of a multilateral DTT between its member countries is not yet practicable (OECD, 1997f).

There are, nonetheless, certain multilateral effects of bilateral tax treaties (box 4). Moreover, ever-changing economic conditions, in conjunction with the points mentioned above in favour of a multilateral approach, can provide new motivation for multilateral agreements in this field, as bilateral and multilateral agreements each have their respective advantages and are not, as exemplified by the Nordic Convention, mutually exclusive.

Box 4. Multilateral and MFN effects of bilateral tax treaties

One sub-issue that should be mentioned is whether bilateral tax treaties may produce a multilateral effect. In principle, a bilateral tax treaty is an international agreement which produces its effects between the contracting parties only. It does not bind a third non-contracting party. For example, the non-discrimination clause under the OECD Model Convention (article 24) is generally understood as a national treatment clause and not as a most-favoured-nation (MFN) clause. Thus, if State A concludes an agreement using the OECD Model Convention non-discrimination clause with State B, it undertakes to extend to nationals of B, who are in the same or substantially similar circumstances as its own nationals, a treatment which is not “other or more burdensome” than that of its own nationals. However, State A remains free to grant nationals of a third State a treatment which is other or less burdensome than that granted to its own nationals, and thus more favourable than that granted to the nationals of B. The only MFN inclination is contained in article 24(5) of the OECD Model Convention, the purpose of which is to ensure that a contracting party does not treat its own companies differently depending on whether their capital is held by nationals of the other contracting parties or by others (including nationals of other parties).

The commentary on the OECD Model Convention, in principle, disallows any MFN effect of bilateral tax treaties (OECD, 1997f). This position is explicable, since an MFN approach to bilateral tax treaties would not recognize three essential points:

/...

Box 4 (concluded)

- Differentiated withholding taxes under different treaties are not necessarily less or more favourable to the persons involved, because the ultimate tax position of the investor is shaped by an inevitable inter linkage between source and residence taxation. For example, assuming source country S has treaties with both residence countries R1 (credit country) and R2 (exemption country), if the S-R1 treaty provides for a 5 per cent withholding tax on dividends and the S-R2 treaty provides for a 15 per cent rate, it would appear that R2 residents are treated less favourably than R1 residents. Ultimately, however, when source and residence tax are taken into account, R2 residents are better off than R1 residents, so that extending to them the lower withholding tax under the S-R1 treaty would only increase their advantage.
- An MFN approach to double taxation could create difficulties for the symmetry of tax treaties (Hughes, 1997). The following example regarding royalties illustrates the point: country A has treaties with countries B (10 per cent rate) and C (0 per cent rate). All of country B’s other treaties provide for a 10 per cent rate. Under the MFN approach, A would be forced to extend the 0 per cent rate to residents of B, while B can continue to apply the 10 per cent rate to residents of A. It is clear that, bearing in mind such asymmetric result, countries would be reluctant to agree to reciprocal concessions.
- The MFN approach looks only at the tax treatment in the source country with no reference to the tax treatment in the country of residence. Because MFN treatment does not extend to the tax treatment of residents, the country of residence may continue to tax its own residents differently depending on the source of their income.

Source: UNCTAD.

B. The jurisdiction to tax

In the light of the foregoing discussion, IIAs and international tax arrangements have evolved the following approaches in relation to the jurisdiction to tax.

1. The exclusion of tax issues model

As mentioned earlier, the vast majority of IIAs have excluded taxation issues from their content. The majority of BITs¹³ make taxation matters exceptions to the MFN and national treatment principles. Such an exception permits a contracting party to provide favourable tax treatment to investment by investors of another

country without according the same treatment to investment by investors of third countries with which it has BITs (box 5).

For example, the 1991 BIT between the Republic of Korea and Mongolia states in its article 7 (b) that the MFN and national treatment provisions:

“shall not be construed so as to oblige one Contracting Party to extend to the investors of the other Contracting Party the benefit of any treatment, preference or privileges which may be extended by the former Contracting Party by virtue of ... any international agreement or domestic legislation relating wholly or mainly to taxation” (UNCTAD, 1998a, p. 63).

Box 5. Excerpts from model BITs

The following texts are excerpted from prototype BITs of several developed and developing countries (UNCTAD, 1996a, vol. III). They are representative of the present tendency to exclude, specifically or by implication, the application of the MFN and national treatment provisions to the tax regulations.

- Article 4(3) of the Chilean model BIT states: “If a Contracting Party accords special advantages to investors of any third country by virtue of an agreement establishing a free trade area, a customs union, a common market, an economic union or any other form of regional economic organization to which the Party belongs or through the provisions of an agreement relating wholly or mainly to taxation, it shall not be obliged to accord such advantages to investors of the other Contracting Party” (UNCTAD, 1996a, vol. III, p. 145).
- Article 3(3) of the Chinese model BIT states: “The treatment and protection as mentioned in Paragraphs 1 and 2 of this Article shall not include any preferential treatment accorded by the other Contracting Party to investments of investors of a third State based on customs union, free trade zone, economic union, agreement relating to avoidance of double taxation or for facilitating frontier trade” (*ibid.*, p. 153).
- Article 4 of the French model BIT states: “Ce traitement [MFN/national treatment] ne s’étend toutefois pas aux privilèges qu’une Partie contractante accorde aux nationaux ou sociétés d’un Etat tiers, en vertu de sa participation ou de son association à une zone de libre échange, une union douanière, un marché commun ou toute autre forme d’organisation économique régionale. Les dispositions de cet Article ne s’appliquent pas aux questions fiscales” (*ibid.*, p. 161).

/...

Box 5 (concluded)

- Article 3(4) the German model BIT states: “The treatment [MFN/national treatment] granted under this Article shall not relate to advantages which either Contracting Party accords to nationals or companies of third States by virtue of a double taxation agreement or other agreements regarding matters of taxation” (*ibid.*, p.169).
- Article 4(4) of the Swiss model BIT states: “If a Contracting Party accords special advantages to investors of any third State by virtue of an agreement establishing a free trade area, a customs union or a common market or by virtue of an agreement on the avoidance of double taxation, it shall not be obliged to accord such advantages to investors of the other Contracting Party” (*ibid.*, p.179).
- Article 7 of the United Kingdom model BIT states: “The provisions of this Agreement relative to the grant of treatment not less favourable than that accorded to the nationals or companies of either Contracting Party or of any third State shall not be construed so as to oblige one Contracting Party to extend to the nationals or companies of the other the benefit of any treatment, preference or privilege resulting from
...
(b) any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation” (*ibid.*, p. 189).

Source: UNCTAD, 1996a, vol. III.

The reasons for this exception in BITs are that:

- many countries prefer to address international taxation issues in separate treaties dealing specifically with such matters in order to maintain maximum fiscal sovereignty;
- the exception allows a country to conclude a tax treaty granting special tax treatment to investment from another country in return for concessions, without having to worry that other countries will have the right to the same treatment by virtue of the MFN provision in their BITs;
- the complexity of tax matters may render such matters unsuitable for inclusion in the kind of standardized provisions that are typical of BITs (UNCTAD, 1998a).

A similar approach to the exclusion of taxation issues is taken in the 1994 Protocolo de Colonia Para la Promoción y Protección Reciproca de Inversiones en el MERCOSUR (Intrazona), (Colonia Protocol) article 3(3) (UNCTAD, 1996a,

vol. II) and in the 1994 Protocolo Sobre Promoción y Protección de Inversiones Provenientes de Estados No Partes del MERCOSUR (Protocol on Promotion and Protection of Investments coming from Non-Party States) article 2(3)(6) (*ibid.*).

Not all exclusions are based on an MFN / national treatment provision. For example the Revised Basic Agreement on ASEAN Industrial Joint Ventures (1987) (Association of South East-Asian Nations) contains a general exception in article V which states:

“The provisions of this Agreement shall not apply to matters of taxation in the territory of the Contracting Parties. Such matters shall be governed by Avoidance of Double Taxation Treaties between Contracting Parties and the domestic laws of each Contracting Party” (*ibid.*, p. 296).

2. The qualified exclusion model

Certain IIAs that do contain a general exclusion of taxation issues then qualify it with references to specific taxation matters that materially affect the enjoyment, by an investor, of certain protective rights under the agreement. Thus, the Energy Charter Treaty (ECT) states in article 21(1) that: “Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties...” (*ibid.*, p. 563).

The ECT provision then deals with certain specific tax issues in subsequent sub-paragraphs (box 6). Of significance to the model under discussion, in addition to the general exclusion of taxation matters in article 21(1), sub-paragraph (3)(a) of article 21, is that it introduces the MFN exception with respect to tax advantages accorded by a contracting party pursuant to a taxation convention. Sub-paragraph (3)(b) excludes taxation measures aimed at ensuring the effective collection of taxes, though investors are protected against arbitrary discrimination in the application of such measures (*ibid.*). Article 21(2) extends a similar regime to article 7(3) of the ECT which accords national treatment to investors in relation to provisions concerning the treatment of energy materials and products in transit (*ibid.*). In addition, article 21(6) states that, for the avoidance of doubt, the guarantee for free transfer of funds in article 14 of the ECT “shall not limit the right of a Contracting Party to impose or collect a tax by withholding or other means” (*ibid.*, p. 565).

Box 6. Energy Charter Treaty

TAXATION

Article 21

- “(1) Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties. In the event of any inconsistency between this Article and any other provision of the Treaty, this Article shall prevail to the extent of the inconsistency.
- (2) Article 7(3) shall apply to Taxation Measures other than those on income or on capital, except that such provision shall not apply to:
- (a) an advantage accorded by a Contracting Party pursuant to the tax provisions of any convention, agreement or arrangement described in subparagraph (7)(a)(ii); or
 - (b) any Taxation Measure aimed at ensuring the effective collection of taxes, except where the measure of a Contracting Party arbitrarily discriminates against Energy Materials and Products originating in, or destined for the Area of another Contracting Party or arbitrarily restricts benefits accorded under Article 7(3).
- (3) Article 10(2) and (7) shall apply to Taxation Measures of the Contracting Parties other than those on income or on capital, except that such provisions shall not apply to:
- (a) impose most favoured nation obligations with respect to advantages accorded by a Contracting Party pursuant to the tax provisions of any convention, agreement or arrangement described in subparagraph (7)(a)(ii) or resulting from membership of any Regional Economic Integration Organization; or
 - (b) any Taxation Measure aimed at ensuring the effective collection of taxes, except where the measure arbitrarily discriminates against an Investor of another Contracting Party or arbitrarily restricts benefits accorded under the Investment provisions of this treaty.
- (4) Article 29(2) to (6) shall apply to Taxation Measures other than those on income or on capital.
- (5) (a) Article 13 shall apply to taxes.
- (b) Whenever an issue arises under Article 13, to the extent it pertains to whether a tax constitutes an expropriation or whether a tax alleged to constitute an expropriation is discriminatory, the following provisions shall apply:
- (i) The Investor or the Contracting Party alleging expropriation shall refer the issue of whether the tax is an expropriation or whether the tax is discriminatory to the relevant Competent Tax Authority. Failing such referral by the Investor or the Contracting Party, bodies called upon to

/...

Box 6 (continued)

- settle disputes pursuant to Article 26(2)(c) or 27(2) shall make a referral to the relevant Competent Tax Authorities;
- (ii) The Competent Tax Authorities shall, within a period of six months of such referral, strive to resolve the issues so referred. Where non-discrimination issues are concerned, the Competent Tax Authorities shall apply the non-discrimination provisions of the relevant tax convention or, if there is no non-discrimination provision in the relevant tax convention applicable to the tax or no such tax convention is in force between the Contracting Parties concerned, they shall apply the non-discrimination principles under the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development;
- (iii) Bodies called upon to settle disputes pursuant to Article 26(2)(c) or 27(2) may take into account any conclusions arrived at by the Competent Tax Authorities regarding whether the tax is an expropriation. Such bodies shall take into account any conclusions arrived at within the six-month period prescribed in subparagraph (b)(ii) by the Competent Tax Authorities regarding whether the tax is discriminatory. Such bodies may also take into account any conclusions arrived at by the Competent Tax Authorities after the expiry of the six-month period;
- (iv) Under no circumstances shall involvement of the Competent Tax Authorities, beyond the end of the six-month period referred to in subparagraph (b)(ii), lead to a delay of proceedings under Articles 26 and 27.
- (6) For the avoidance of doubt, Article 14 shall not limit the right of a Contracting Party to impose or collect a tax by withholding or other means.
- (7) For the purposes of this Article:
- (a) The term "Taxation Measure" includes:
- (i) any provision relating to taxes of the domestic law of the Contracting Party or of a political subdivision thereof or local authority therein; and
- (ii) any provision relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound.
- (b) There shall be regarded as taxes on income or on capital all taxes imposed on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, or substantially similar

/...

Box 6 (concluded)

- taxes, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
- (c) A "Competent Tax Authority" means the competent authority pursuant to a double taxation agreement in force between the Contracting Parties or, when no such agreement is in force, the minister or ministry responsible for taxes or their authorized representatives.
- (d) For the avoidance of doubt, the terms "tax provisions" and "taxes" do not include customs duties."

Source: UNCTAD, 1996a, vol. II, pp. 563-565.

A similar approach is taken in NAFTA, article 2103(1), which states: "Except as set out in this Article nothing in this agreement shall apply to taxation measures". Article 2103(2) states:

"Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency" (ILM, 1993a, p. 700)

However, paragraph 2 notwithstanding, NAFTA does extend national treatment and MFN to "all taxation measures, other than those on income, capital gains or on the taxable capital of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers and those taxes listed in paragraph 1 of Annex 2103. 4" (NAFTA, article 2103(4)(b)) (*ibid.*). Given the breadth of this list, few tax measures would appear to be caught by this provision. The provision continues by asserting that the non-discrimination provisions of NAFTA shall not apply:

- "(c)[to] any most-favored-nation obligation with respect to an advantage accorded by a Party pursuant to a tax convention,
- (d) to a non-conforming provision of any existing taxation measure,
- (e) to the continuation or prompt renewal of a non-conforming provision of any existing taxation measure,
- (f) to an amendment to a non-conforming provision of any existing taxation measure to the extent that the amendment does not decrease its conformity, at the time of the amendment, with any of those Articles,
- (g) to any new taxation measure aimed at ensuring the equitable and effective imposition or collection of taxes and that

does not arbitrarily discriminate between persons, goods or services of the Parties or arbitrarily nullify or impair benefits accorded under those Articles, in the sense of Annex 2004, or

- (h) to the measures listed in paragraph 2 of Annex 2103.4”(*ibid.*).

Thus NAFTA follows a rather complex structure in relation to taxation issues: first, all taxation matters are excluded, except as provided for in article 2103. Secondly, tax conventions are given priority over NAFTA in relation to the rights and obligations of any Party under such a convention. Thirdly, national treatment and MFN apply to all taxation measures other than those listed in paragraph 4(b) and the matters listed in paragraphs 4(c) to (h).

Some IIAs expressly link expropriation protection to tax measures so as to prevent direct or indirect expropriation of the assets of a foreign investor through the use of tax measures. One example is article 21(5) of the ECT (box 6). Another example occurs in the United States model BIT, article XIII (box 7), which excludes all taxation except where taxation results in an act of expropriation. NAFTA also includes taxation measures under its expropriation provision (see NAFTA, article 2103(6)) (ILM, 1993a).

Box 7. United States model BIT

Article XIII

1. No provision of this Treaty shall impose obligations with respect to tax matters, except that:
 - (a) Articles III, IX, and X will apply with respect to expropriation; and
 - (b) Article IX will apply with respect to an investment agreement or an investment authorization.
2. A national or company, that asserts in an investment dispute that a tax matter involves an expropriation, may submit that dispute to arbitration pursuant to Article IX(3) only if:
 - (a) the national or company concerned has first referred to the competent tax authorities of both Parties the issue of whether the tax matter involves an expropriation; and
 - (b) the competent tax authorities have not both determined, within nine months from the time the national or company referred the issue, that the matter does not involve an expropriation.

Source: UNCTAD, 1996a, vol. III, p. 204.

3. The tax incentives model

A common taxation provision in a significant number of regional investment agreements among developing countries aims at setting down a regime of tax incentives for investors from other member countries of the region. Commonly such provisions may reduce the overall level of taxation to be levied on investors who qualify for the preferential treatment, or protect the level of taxation charged on foreign investors by reference to the national treatment standard, or guarantee the free transfer of assets without special taxation or seek to harmonize tax rates across the region.

The following examples illustrate this approach and its variations:

- The Common Convention on Investments in the States of the Customs and Economic Union of Central Africa (1965) (UNCTAD, 1996a, vol. II), in Part III, offers:
 - reduced taxation for companies that are entitled to such treatment under the agreement;
 - a variety of schemes of tax reduction.
- The Agreement on the Harmonisation of Fiscal Incentives to Industry (Caribbean Common Market (CARICOM) (1973) (*ibid.*), offers a scheme of fiscal benefits to approved enterprises.
- The Unified Agreement for the Investment of Arab Capital in the Arab States (1980) (*ibid.*), in article 7, guarantees the freedom to transfer capital, without the transfer process incurring any taxes or duties. Articles 16-17 of the agreement, which deal with investor privileges, contain no mention of tax, but this may be implicit in the freedom granted to the contracting parties to offer privileges in excess of the minimum stipulated within the agreement.
- The Agreement on Promotion, Protection and Guarantee of Investments among Member States of the Organisation of the Islamic Conference (1981) (*ibid.*), in article 4, mentions tax incentives.
- The Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) (1982) (*ibid.*), in title II, offers extensive tax advantages to qualifying enterprises, especially in section III, articles 28-9 (tax advantages) and in chapter II, section I, articles 31-36 (tax advantages).

- The Fourth ACP-EEC Convention of Lomé (Lomé Convention) (1989), in part III, title III, chapter 5, section 6, mentions tax and customs arrangements (ILM, 1990).
- The CARICOM Agreement (UNCTAD, 1996a, vol. III), in article 40, introduces a programme for the harmonization of fiscal incentives.
- The Treaty Establishing the Latin American Integration Association (LAIA) (1980) (*ibid.*), in article 46, introduces the national treatment principle as regards, inter alia, taxes charged on products originating from the territory of another member country.

Many host countries offer tax incentives in various forms in order to attract FDI. The desirability and effectiveness of tax incentives is a much debated issue (UNCTAD, 1996c) but is outside the scope of this chapter. Assuming an investor would not have invested in the absence of an incentive, such schemes represent a budgetary sacrifice on the part of the host country. The latter consents to the sacrifice on the premise that the revenue losses could be recouped directly or indirectly (e.g. employment, technological upgrading).

The tax incentives approach is not universally advocated. Thus article III (9) of the Guidelines on the Treatment of Foreign Direct Investment (The World Bank Group, 1992) states that the use of tax exemptions as a means of providing incentives is not recommended. The use of reasonable tax rates is preferred (UNCTAD, 1996a, vol. I).

4. The TNC tax responsibility model

Several codes and declarations concerning the conduct of TNCs have included provisions on taxation. These provisions generally call for tax responsibility on the part of TNCs in that such firms are exhorted to cooperate with the tax authorities of the countries in which they generate taxable income by offering full disclosure of their profits and losses in accordance with national laws and practices, by not engaging in tax avoidance manipulations, particularly transfer pricing practices, and by paying all due taxes.

For example, the taxation guidelines, contained in annex 1 (“The Guidelines for Multinational Enterprises”) of the 1976 OECD Declaration on International Investment and Multinational Enterprises assert that enterprises should:

- “1. Upon request of the taxation authorities of the countries in which they operate provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
2. Refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm’s length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed” (UNCTAD, 1996a, vol. II, p. 190).

Similarly, the United Nations draft Code of Conduct on Transnational Corporations, paragraph 34, states:

“Transnational corporations should / shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm’s length principle, or other means, to modify the tax base on which their entities are assessed” (UNCTAD, 1996a, vol. I, p. 168).

As regards the payment of due taxes, illustrative provisions occur in Decision 24 of the Commission of the Cartagena Agreement (Andean Group, 1970) (UNCTAD, 1996a, vol. II), articles 9 and 10, whereby the assets resulting from the winding up of a foreign investment are deemed a capital gain and can only be remitted abroad after the payment of the taxes due. Similarly, any sum obtained by a foreign investor as a result of the sale of its shares, capital interest or rights can be remitted after the payment of taxes due.

5. The regional multinational enterprise taxation model

A specialized taxation provision can usually be found in agreements setting up a regional multinational enterprise or other supranational form of business association. Where such an enterprise or business association is established, the constitutive agreement must determine in what manner and in which place the entity in question will be taxed. Thus, for example, the enterprise maybe obliged to pay tax in the place where its

principal seat or place of incorporation is located. Alternatively it may be absolved from paying tax altogether where it is seen to be a vehicle of economic development for the region and where a degree of preferential treatment for the entity is deemed desirable.

For example, article 13 of the Agreement for the Establishment of a Regime for CARICOM Enterprises (1987) (*ibid.*) states that the corporate profits of a CARICOM enterprise shall be subject to tax. However, an exception is made where the equity capital is wholly owned by the Governments of the member States and they agree to exempt that enterprise from tax. Equally, dividends and other distributions paid to a CARICOM enterprise in respect of equity capital owned by Governments of any of the member States shall not be subject to tax. Furthermore, CARICOM enterprises that engage solely in the business of intra- or extra-regional transport and communications may have their taxes on profits waived by the mutual agreement of the Governments of participating States. Finally, CARICOM enterprises are eligible to benefit from fiscal incentives under the Scheme for Harmonisation of Fiscal Incentives to Industry.

On the other hand, this provision is silent as to the place where CARICOM enterprises should pay tax. However, other provisions of the agreement imply that the headquarters State, the State in which the CARICOM enterprise is established, and other member States in which the enterprise is registered, may have the right to tax. By article 5 of the agreement: "The incorporation, registration, operation, management, winding-up and dissolution of a CARICOM ENTERPRISE shall be governed by the provisions of this Agreement as well as the company law and other relevant laws of the Headquarters State and those other Member States in which the CARICOM ENTERPRISE is registered" (*ibid.*, p. 271). Though taxation is not expressly mentioned, it must be implicit in the reference to "other laws". This in turn raises difficult questions as to the allocation of revenues among the member States. In the absence of clear rules about these matters in the agreement, it must be assumed that the applicable national rules concerning the allocation of foreign earned income would govern the matter.

By contrast, the Council Regulation on the European Economic Interest Grouping (EEIG) (Council of the European Communities, 1985), a supranational form of business association formed by members from more than one European Union member State, states that the profits of the EEIG

shall be deemed to be those of its members and shall be shared among them in the proportions laid down in the contract establishing the EEIG. The members' profits shall be taxed in accordance with national tax laws.

Other provisions dealing with the taxation of regional multinational enterprises include the Charter on a Regime of Multilateral Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States (1990). Article 15(7) exempts the MIE and its branches and subsidiaries from the payment of taxes in any of the member States parties to this regime for five years after the first date on which the MIE first derives income from its operations (UNCTAD, 1996a, vol. II).

Finally, the Uniform Code on Andean Multinational Enterprises (AME) of the Andean Group (1991) (*ibid.*) states, in article 18, that the AME is entitled to the same tax treatment as national companies in respect of national taxes.

6. The avoidance of double taxation model

This issue is dealt with by both IIAs and double taxation agreements. The former may incorporate a provision encouraging the contracting parties to deal with the problem of double taxation as a part of their mutual obligations under an IIA. The modality of dealing with this issue may be specified through an obligation to conclude a double taxation agreement between the parties (see for example article 47 of Decision No. 24 of the Commission of the Cartagena Agreement) (*ibid.*). Such a commitment is present in article 161 of the Treaty Establishing the Common Market for Eastern and Southern Africa (1993) (COMESA):

"The Member States undertake to conclude between themselves agreements on the avoidance of double taxation" (UNCTAD, 1996a, vol. III, p. 109).

Alternatively, there may simply be a general commitment to avoid double taxation. Thus the APEC Non-Binding Investment Principles state that "Member economies will endeavour to avoid double taxation related to foreign investment" (UNCTAD, 1996a, vol. II, p. 537). Similarly, the Agreement on Arab Economic Unity (1957), article 2(7)(b), includes as an aim for attaining the unity mentioned in article 1: "Avoiding double taxation and duties levied on the nationals of the contracting parties" (UNCTAD, 1996a, vol. III, p. 26). The EU treaty (EU, 1995)

also contains a clause of this kind encouraging member states to start negotiations on the avoidance of double taxation, if necessary. But it is unclear what such a clause achieves and what the sanctions are.

As to international tax arrangements, these contain numerous clauses that are of direct relevance to the treatment of investors and investment and to the avoidance of double taxation in particular. Each will be considered in turn.

a. Tax arrangements and allocation of income

A primary objective of tax treaties, along with determining the appropriate allocation of revenues between countries, is the mitigation of double taxation through the elimination of definition mismatches and the allocation of exclusive or shared taxing rights to the contracting parties. Also, by providing rules for cooperation in the prevention of tax avoidance and, sometimes, for the collection of tax claims, a tax treaty can indirectly contribute to the treasury of the contracting parties.

As mentioned earlier, most bilateral tax treaties concluded to date are based on the OECD Model Convention, the United Nations Model Convention, or a combination of the two. The United Nations Model Convention is actually substantially based on the OECD Model Convention, and many clauses of the two models are virtually interchangeable. The main difference between the two models is that the OECD Model Convention generally favours residence taxation while the United Nations Model Convention generally favours source taxation. For this reason, capital exporting countries have traditionally preferred the OECD model and capital importing countries the United Nations model.

However, this classification is becoming increasingly blurred as

- net capital importers have become members of the OECD which model would, therefore, need to consider their interests;
- various developing countries have become to some extent countries of residence rather than just source countries;
- not all developing countries are equally satisfied by the United Nations Model Convention, in particular because of the absence of tax-sparing provisions therein.

(i) Source versus residence taxation

Most countries impose tax based on a combination of the source and residence concepts. In seeking the avoidance of double taxation, a tax treaty attributes exclusive or shared taxing rights to the source and/or residence countries.

Generally the OECD Model Convention favours exclusive taxation by the country of residence of the recipient of the income. This is most evident in article 12(1) of the OECD Model Convention which provides:

“Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner or the royalties” (UNCTAD, 1996a, vol. II, p. 79).

Similarly, there is a marked preference, in article 11 of the OECD Model Convention, for exclusive taxation of interest in the country of residence of the beneficiary. In both cases the model excludes the country of residence principle where the royalties or interest are earned through a permanent establishment (e.g. a branch or foreign affiliate) in the country where the activity is exercised. However, the model does not easily assume the existence of such a permanent establishment.

By contrast, the United Nations Model Convention favours non-exclusive source taxation. Thus, the corresponding articles on interest (article 11) and royalties (article 12), while not prohibiting taxation by the country of residence, stipulate that these taxable flows of income “may also be taxed in the Contracting State in which it arises and according to the laws of that State...”, followed by a percentage limitation on the amount of tax so chargeable if the recipient is the beneficial owner of the interest or royalties (UNCTAD, 1996a, vol. I, p. 119). Furthermore, the United Nations Model Convention assumes more easily than the OECD Model Convention the existence of a permanent establishment, so that an activity undertaken in the source country can more easily be taxed therein.

Both the residence and source principles may create problems for developing countries. To favour residence taxation may result in depriving a developing country, which typically is a source country, from much needed revenue. Equally, a major argument against the source principle is that it may be counterproductive for developing countries as it may effectively result in increased costs. The argument is that, if source tax is based

on the gross amount of the income, it cannot be fully credited in the country of residence which taxes the income on a net basis, and therefore it becomes an effective cost which needs to be reflected in the price (e.g. the royalty or interest rate) charged to the developing country. For example, if a company Xco resident in country X borrows money and lends it with a margin to a company Yco in country Y, the latter would impose withholding tax on the gross payment from Yco to Xco. However, because Xco is taxed in X only on the net margin, the foreign tax would exceed the tax due in X and therefore become an effective cost to Xco. As a result, Xco will increase the interest rate charged to Yco so as to reflect the effective cost of source country tax.

The argument is sound, albeit not in all circumstances. Source country tax need not lead to an effective tax cost in the country of residence if:

- the expenses deductible therein are too low (e.g. in case of royalties, if R&D expenses have already been substantially written off); or
- the recipient receives income from various sources and the country of residence does not apply “basket” or “per country” foreign tax credit limitations. In that case, indeed, high taxes of certain source countries can be averaged with low taxes of other source countries, so that, on balance, there is no excess foreign tax credit.

To avoid the risk of such a cost increase, a limited number of tax treaties put the burden on the (developed) country of residence. Hence, article 23(1)(b) of the 1993 France-Zimbabwe tax treaty reads:

“...where the amount of tax paid in Zimbabwe in accordance with the provisions of the Convention exceeds the amount of French tax attributable to such income, the resident of France receiving such income may represent his case to the French competent authority; if it appears to it that such a situation results in taxation which is not comparable to taxation on net income, that competent authority may, under the conditions it determines, allow the non credited amount of tax paid in Zimbabwe as a deduction from the French tax levied on other income from foreign sources derived by that resident” (IBFD, 1986-).

Such a solution, while limited because dependent on the discretionary judgement by the competent authorities of the country of residence, do nevertheless show that countries of residence may take a part in solving the issue.

(ii) Passive investment income

Depending on the form they take, investments can generate interest or dividends. In the case of interest income, both the United Nations Model Convention and the OECD Model Convention provide for shared taxation: the source country may levy a withholding tax at a rate not exceeding 10 per cent (OECD Model Convention) or the rate agreed to by the parties (United Nations Model Convention), and the country of residence taxes the income with a credit for the tax levied in the source country.

In the case of dividends, again, both the United Nations and the OECD model provide for shared taxation: the source country may levy a withholding tax at a rate not exceeding that set forth under the treaty and the country of residence may tax the income received but must grant a credit against its own tax for the withholding tax levied in the source country. In practice, however, many capital-exporting countries provide for a regime, generally known as the participation exemption, under which dividends received by a resident parent company are exempt from tax. In that case, the foreign withholding tax is generally not creditable since there is no tax against which it can be offset in the country of residence.

In order to prevent improper use of the participation exemption, a number of countries provide for a switch to the credit method where the income from which the dividends are paid was not (sufficiently) taxed in the source country. In that case, the dividends are taxed in the country of residence with a credit for the tax paid in the source country, if any. Depending on the way in which they are drafted, tax treaties can restrict to a certain extent the ability of the country of residence to switch from the exemption to the credit method (see below).

(iii) Capital gains

Portfolio investors in emerging markets are often more intent on realizing a capital gain on their investment than on receiving dividends. Indeed, for investments in growing firms, the potential for realizing a gain is greater than the potential for receiving a dividend.

The OECD Model Convention provides for exclusive taxation of capital gains on shares in the country of residence of the investor. The United Nations Model Convention follows suit, with the difference that it provides for shared taxation of gains on substantial participation:

Article 13(5) United Nations Model Convention provides:

“Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State” (UNCTAD, 1996a, vol. I, p. 122).

Generally, gains on shares are taxable in the country of residence, but many capital-exporting countries do extend the participation exemption to capital gains (e.g. Denmark, Luxembourg, Netherlands). Capital-importing countries may have valid reasons to exempt capital gains derived by non-residents. Nevertheless, the retention of the right to tax capital gains under a tax treaty can be helpful:

- the source country is not required to exercise effectively the right to tax attributed to it under the treaty. Indeed, it may choose to exempt such gains under its domestic law even though the treaty gives it the right to tax; and
- the source country may choose to tax certain types of gains. For example, it may wish to reserve the exemption to gains on shares held for a minimum period of time, so as to discourage speculative trading and extreme stock market fluctuations. The attribution of the right to tax exclusively to the country of residence prevents the source country from implementing such policy choices.

(iv) Other income

Tax treaties eliminate the potential for double taxation by, *inter alia*, providing for commonly agreed definitions. Income that cannot be classified under one of the income categories listed under the treaty is generally referred to as “other income” or “income not expressly mentioned”. Both the OECD and the United Nations models contain an “other income” clause (article 21 in both models) which provides that items of income not separately dealt within the foregoing articles of the convention are exclusively taxable in the country of residence of the beneficiary.

In contrast to the OECD Model, however, the United Nations model contains an additional provision (article 21(3)) which prescribes that “other income” may also be taxed in the country from which it arises (i.e. in the source country) (IBFD, 1986 --). Such a clause preserves the right of the source country to tax items of income

derived from its territory and not covered by the treaty.

(v) Credit and exemption

The double-taxation elimination clause in international tax treaties is usually expected to reflect the domestic laws of the contracting parties and, for that reason, is one of the least difficult clauses to negotiate. As mentioned above, in order to prevent a jurisdictional vacuum, various countries provide, under their domestic laws, for a switch from the exemption to the credit method if the foreign-source income is not adequately taxed abroad. Such positions are also sometimes confirmed by tax treaties. For example, article 19(B) of the 1989 France-United Arab Emirates tax treaty provides:

“Where a person who is a resident of the United Arab Emirates or who is established there is fiscally domiciled in France for the purposes of French domestic law or is a subsidiary directly or indirectly controlled for more than 50% by a company with its place of effective management in France, the income of that person shall be taxable in France notwithstanding any other provision of this Convention. In such event, for all income taxable in the United Arab Emirates by virtue of this Convention, France shall allow as a deduction from the tax attributable to that income the amount of tax levied by the United Arab Emirates” (IBFD, 1986 --).

Nevertheless, a strictly drafted clause can reduce the ability of the country of residence to apply its domestic legislation by, for example, switching from the exemption to the credit method. Point 6(a) of the protocol to the 1996 Germany-India tax treaty provides:

“The exemption provided for in sub-paragraph (a) of paragraph 1 of Article 23 is granted irrespective of whether the income or capital concerned is effectively taxed in the Republic of India or not” (IBFD, 1986 --).

This type of clause can be useful only when the relevant exemption is available pursuant to the treaty. If, instead, the exemption is available pursuant to the domestic laws of the country of residence without the treaty confirming such exemption, the clause will have no impact.

(vi) Tax sparing

The budgetary sacrifice represented by tax incentives offered by host countries, discussed above, may be made in vain if not matched by the

country of residence of the investor. This is particularly the case where the country of residence applies the credit method to relieve double taxation of its residents with respect to the relevant item of income. In such a case, the investor being taxed at the higher of the source country and country of residence rate, the tax incentive does not benefit the investor but is rather appropriated by the treasury of the country of residence. The problem can be further exacerbated if the country of residence applies foreign tax credit limitations, the effect of which is to prevent averaging the tax borne in high-tax jurisdictions with that paid in low-tax jurisdictions.

For this reason, many capital-importing countries insist on including a tax-sparing or matching-credit clause in their treaties. Under such a clause, the country of residence of the investor grants a credit for the tax which would have been levied by the source country in the absence of the tax incentive. In that way, the tax incentive is channeled to the investor and not to the treasury of its home country.

Traditionally, many capital-exporting nations have accepted the granting of tax-sparing credits (table 1). The United States, however, has always been an exception to this rule. In fact, the United States position is that tax benefits to United States persons may only be granted by United States law and not by tax treaties. Thus, the most the United States has been prepared to offer so far

Table 1. Examples of DTTs with tax-sparing provisions (non-exhaustive)

Australia - China (1988) Article 23
Australia - Vietnam (1996) Exchange of Notes
Canada - Argentina (1993) Article 23
Canada - China (1986) Article 21
Canada - Thailand (1984) Article 22
Denmark - Poland (1994) Protocol
Germany - Indonesia (1977) Article 22(1)
Germany - Turkey (1985) Article 23(1)
Japan - Bangladesh (1991) Article 23
Japan - Brazil (1976) Protocol
Japan - Bulgaria (1991) Article 23
Japan - Vietnam (1995) Article 22
The Netherlands - Bangladesh (1993) Article 23
New Zealand - Singapore (1993) Protocol
Spain - India (1993) Article 25
Sweden - Malta (1995) Article 22(2)
United Kingdom - Indonesia (1993) Article 21
United Kingdom - Mongolia (1996) Article 24
United Kingdom - Papua New Guinea (1991) Article 23

Source: OECD, 1998e.

in its tax treaties is a commitment to grant the same benefit to the treaty partner if it is ever granted to a third country. For example, the letter of submittal to the 1985 Tunisia-United States tax treaty stated as follows:

“[...] The United States delegation, while understanding the Tunisian position, [requesting a tax-sparing credit], is not prepared to agree to such a provision. I wish to assure you, however, that should the United States position change and we agree to include such a position in an income tax treaty with another country, we agree to reopen discussions with the Tunisian Republic with a view to extending the same benefit to investments in Tunisia” (IBFD, 1986-).

(a) Structuring of tax sparing credits

Tax-sparing credits are usually given for withholding taxes on interest, dividends and royalties. A number of treaties, however, grant the sparing credit for business income,¹⁴ or for both passive income and business income.¹⁵ Also, in certain cases, tax treaties between capital-importing countries do provide for the reciprocal granting of sparing credits.¹⁶ Interestingly, neither the OECD Model Convention nor the United Nations Model Convention contain tax-sparing provisions.

A number of treaties grant a sparing credit up to the amount of tax that the source country is allowed to levy under the treaty (i.e. if the treaty provides for a maximum 15 per cent rate for interest and the source country levies only 5 per cent or not at all, tax is deemed to have been paid at 15 per cent). For example, article 23(3) of the 1991 Netherlands-Nigeria tax treaty provides:

“Where by reason of the relief given under the provisions of Nigerian laws for the purposes of encouraging investment in Nigeria the Nigerian tax actually levied on interest arising in Nigeria or on royalties arising in Nigeria is lower than the tax Nigeria may levy according to [the Convention], then the amount of the tax paid in Nigeria on such interest and royalties shall be deemed to have been paid at the rates of tax mentioned in [the Convention]” (IBFD, 1986-).

Other treaties may grant a sparing credit for an amount higher than the rate of tax that the source country may charge under the relevant treaty. This is, for example, the case for French treaties with African countries of the former

French Communauté, which base the credit on a formula whereby the sparing credit becomes higher as the source country tax becomes lower (IBFD, 1986-).¹⁷

Tax-sparing clauses under older treaties rarely contain limitations as to the time period for which they apply or the tax incentives pursuant to which the country of source does not levy (or levies a reduced) tax.

(b) Recent trends

Many developing countries consider tax sparing as an integral part of the elimination of the double taxation process. Until recently, many developed countries accepted the granting of tax-sparing credits. There are, however, indications of a restrictive trend on the part of capital-exporting countries (OECD, 1998e).

From the perspective of developed countries, the arguments against tax sparing range from potential abuse to the determination that it actually represents foreign aid which should be granted through other more appropriate channels. Another major issue appears to be that the party granting a tax-sparing credit accepts that its foreign tax credit policy becomes to some extent dictated by the policies of the capital-importing treaty partner.

Recent treaties tend therefore to contain restrictions as to the scope of application of tax sparing, from the perspective of both the duration and type of incentive. For example, the 1998 Albania-Norway treaty (IBFD, 1986-) restricts the tax-sparing credit to a period of five years from the date on which the treaty becomes effective. Also, article 23(4) of the 1996 Canada-India tax treaty (*ibid.*) provides for a tax-sparing credit for certain types of income benefiting from tax incentives under the India's 1961 Income Tax Act, "but not the part dealing with ships or aircraft" (*ibid.*). The exclusion of incentives dealing with ships and aircraft was not included in the old 1985 Canada-India treaty (*ibid.*).

In any case, while of utmost important in many cases, there are instances in which tax-sparing credits lose all or part of their significance:

- There is little significance if the country of the investor applies the exemption method to the relevant type of income.
- Tax sparing is useful only when the income is distributed to the investor. If the income is retained or reinvested in the source country, there is no tax in the country of residence

(except under controlled-foreign-company (CFC) or other anti-deferral rules) and tax sparing is, therefore, irrelevant. Since source countries should encourage the reinvestment of the income (rather than its repatriation to the country of residence), it can be argued that tax sparing, by encouraging the repatriation of income, is in fact counterproductive.

- The usefulness of tax sparing is modified when the country of residence of the investor applies no foreign tax credit limitations. In that case, indeed, difficulties arising from the imposition of domestic tax over foreign low-tax income can be mitigated by tax credits attached to foreign high-tax income.

b. Tax arrangements and non-discrimination rules

As noted earlier, non-discrimination clauses in many international arrangements, such as commerce treaties and investment promotion agreements, usually carve out taxation, although older arrangements are sometimes drafted in general terms so that they can apply to tax matters as well.¹⁸ Most tax treaties therefore contain a non-discrimination clause based on article 24 of the OECD Model Convention. A limited number of countries, notably Australia and New Zealand, generally do not include non-discrimination clauses in their tax treaties.¹⁹

As mentioned earlier (box 4), the non-discrimination clause under article 24 of the OECD Model Convention is generally understood as a national treatment clause and not as an MFN clause. Its first objective is to prohibit a treaty partner from granting to nationals of the contracting party a treatment which is other or more burdensome than that granted to its own nationals, provided the former are in the same or a substantially similar situation as the latter. Its second objective (article 24(5)) is to ensure that a contracting party does not treat its own companies differently depending on whether their capital is held by nationals of the other contracting party or by other persons.

Article 24 does not imply an obligation for the extension of MFN treatment. Nevertheless, various tax treaties do contain MFN clauses whereby a contracting party commits itself to extend to the other contracting party any more favourable treatment granted (later) to another country. This issue is further discussed in section III below.

In principle, the non-discrimination clause applies to all nationals of the contracting parties, whether or not actually covered by the treaty, and to all taxes applied by the contracting parties, whether or not covered by the treaty.

Various tax treaties contain restrictions as to the extension of certain tax reliefs to non-residents. This is generally the case for deductions and reliefs with respect to family allowances and social security premiums.

c. Tax arrangements and prevention of tax evasion

Tax treaties are concluded not only for the elimination of double taxation but also for the prevention of tax evasion. This aim is generally achieved through two mechanisms:

- Exclusion from treaty benefits; and
- Mutual assistance and exchange of information.

A number of tax arrangements also provide for assistance in the collection of taxes.

(i) Exclusion from treaty benefits

Tax treaties apply to residents, meaning persons covered by the treaty and who are liable to tax in the contracting country where they have their domicile, residence, place of management or any other criterion of a similar nature.

In international tax planning, certain structures are sometimes sought to obtain treaty benefits which are not otherwise available (so-called treaty shopping). Hence, a person not covered by a treaty may interpose another person covered by the relevant treaty in order to indirectly obtain treaty benefits. Also, a person covered by a treaty may prefer to obtain the benefits of a more favourable treaty, in which case various tax planning techniques are used to derive indirectly the benefits of the more favourable treaty.

In principle, the beneficial ownership clause in a tax treaty, under which treaty relief is granted only if the recipient is the beneficial owner of the income, should be sufficient to exclude nominees and other interposed persons from treaty benefits. However, some treaties take other specific approaches to exclude potential beneficiaries.

First, many treaties include specific clauses that provide for detailed eligibility tests or exclude specific persons from treaty benefits. Detailed eligibility tests are especially found in United States tax treaties, under which they are generally known as limitations on benefits clauses.

Under some of the United States treaties, the limitations-on-benefits clause is of extraordinary length and detail.²⁰

Secondly, other treaties simply exclude specific persons from treaty benefits. For example, article VI, protocol of 18 July 1995 to the Malta-Netherlands tax treaty states:

“This Agreement is not applicable to companies or other persons which are wholly or partly exempted from tax by a special regime under the laws of either one of the States” (IBFD, 1986-).

A third approach found in a number of treaties is the inclusion of clauses which authorize the contracting parties to apply “thin capitalization rules”, notwithstanding any treaty provision. Thin capitalization rules are domestic law provisions whereby the deduction of interest paid to shareholders (e.g. to a parent company) is disallowed if the debt/equity ratio of the debtor exceeds certain limits. The rationale behind the rules is to discourage financing companies through debt (the interest remuneration of which is normally deductible for the debtor), rather than through equity (the dividend remuneration of which is not deductible for the payer). However, since the rules generally do not apply to interest paid to domestic shareholders, their application to non-resident shareholders only can be in conflict with the non-discrimination clause under tax treaties. For this reason, preventive clauses are sometimes included in tax treaties.

A fourth exception (found in particular in Canadian and French treaties) is the authorization of the contracting parties to apply CFC legislation. CFC rules are domestic law provisions pursuant to which a country taxes its own residents who control a foreign entity (the “controlled foreign company” or CFC) benefiting from a privileged tax regime (typically a “tax haven”) on any income and gains realized by that foreign entity. Ordinarily, pursuant to a long-established principle of international tax law, the resident shareholders would not be taxed in the country of residence until the income or gains realized by the CFC are distributed to them. However, in order to discourage the deferral (i.e. non-repatriation) of income in tax havens, various residence countries (eighteen in 1999, including two non-OECD countries) tax their residents currently on the CFC income without waiting for an actual distribution. Because the compatibility of CFC rules with tax treaties is still an open issue,²¹ a number of treaties contain preventive clauses that authorize the

contracting parties – or one of them – to use their (its) CFC legislation notwithstanding any other treaty provisions.

For example, article 27(2) of the 1991 Canada-Mexico tax treaty states:

“Nothing in the Convention shall be construed as preventing a Contracting State from imposing a tax on amounts included in the income of a resident of that State with respect to a partnership, trust or controlled foreign affiliate, in which the resident has an interest” (IBFD, 1986-).

Such measures can impact negatively on developing countries, for example (though not the only impact), if they target tax incentives. Given the unclear outcome of the ongoing debate on the compatibility of CFC rules with tax treaties, various countries insist on the inclusion of specific clauses that would allow them to use their CFC legislation notwithstanding other treaty clauses.

(ii) Mutual assistance and exchange of information

Tax treaties generally authorize the tax authorities to exchange information and lend each other assistance in carrying out the provisions of the treaty.²² Pursuant to article 26 of the OECD model, the exchange of information can operate simultaneously or on demand but is generally not construed to entail an obligation to:

- carry out administrative measures at variance with the laws and administrative practice of the relevant contracting party;
- supply information that is not obtainable under the laws or in the normal course of the administration of the relevant contracting party; or
- supply information that would disclose any trade, business, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Besides bilateral tax treaties, the Council of Europe and the OECD have the 1988 Convention on Mutual Administrative Assistance in Tax Matters. The Convention is in force between the limited number of member countries that ratified it.

d. Arbitration and conflict resolution

The settlement of disputes in the framework of international taxation is more akin to the settlement of differences of interpretation and application. This mechanism is essentially based

on the mutual agreement procedure under tax treaties. (See, for example, article 25 of the OECD model; OECD, 1997f). But the use of other means is steadily increasing.

Under the mutual agreement clause, taxpayers who consider that the actions of one or both contracting States result for them in taxation which is not in accordance with the convention, may present their cases to the residence country authorities. The latter are required to strive, if the cases appear justified and a unilateral solution is not possible, to resolve the cases by mutual agreement with the authorities of the other State. Furthermore, the clause requires the competent authorities of both States to endeavour to resolve by mutual agreement any difficulties or doubts that arise as to the interpretation or application of the convention.

In both cases, however, the tax authorities are merely required to endeavour to find a solution. They are by no means required to reach a solution. Furthermore, if a solution is reached, the taxpayer is, in general, not required to be bound by it.

Outside a mutual agreement clause, the essential means of reaching a solution is arbitration. The textbook example is the Arbitration Convention mentioned earlier. Also, more recent tax treaties do sometimes contain an arbitration clause. Most such clauses are restricted to transfer-pricing arrangements (e.g. France-Germany tax treaty), but they are sometimes of a general application (e.g. arbitration board under article 26(5) of the Mexico-United States tax treaty). There are no indications to date on whether arbitration clauses under tax treaties have indeed been effectively applied.

Another dispute settlement procedure is the conclusion of joint advance pricing agreements ("APAs") with regard to the transfer pricing practice of specific taxpayers. This procedure, however, is aimed more at the prevention rather than at the settlement of disputes.

* * *

This section has examined a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of TNC responsibility in the area of taxation; and as

the basis for a taxation regime for regional multinational enterprises or supranational business associations. The final model involves a commitment in an IIA to avoid the double taxation of investors and/or investments. This may extend to an obligation among the contracting parties to conclude a double taxation agreement among themselves. Such an agreement would be based on existing models, of which the OECD and United Nations models are of special significance. It would cover the principal issues that have been discussed above.

Section III Interaction with other Issues and Concepts

The taxation issue has important interactive effects with many of the issues and concepts covered in these volumes (table 2).

Table 2. Interaction across issues and concepts

Issue	Taxation
Admission and establishment	+
Competition	+
Dispute settlement (investor-State)	+
Dispute settlement (State-State)	+
Employment	+
Environment	+
Fair and equitable treatment	+
Home country measures	+
Host country operational measures	+
Illicit payments	++
Incentives	++
Investment-related trade measures	+
Most-favoured-nation treatment	++
National treatment	++
Scope and definition	+
Social responsibility	+
State contracts	0
Taking of property	++
Technology transfer	++
Transfer of funds	+
Transfer pricing	++
Transparency	+

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

- **Incentives.** The question of incentives is of central importance to tax issues, as many countries have introduced special tax regimes to attract FDI. This has heated up the competition between nations and sometimes even between various parts of the same (federal) country. The effectiveness of tax

incentives is not addressed in this chapter. A measure that often accompanies tax incentives is “tax sparing” which is discussed in section II.

- **National and MFN treatment.** The interaction between national and MFN treatment on the one hand and taxation on the other is exemplified by the existence of clauses that explicitly exclude taxation from the application of such treatment.²³ National treatment and MFN provisions are generally explicit in this regard. The imposition of taxes being a sovereign right, countries are free, within the constraints of their own legal systems and international obligations, to design any revenue-raising measures they deem necessary. The non-discrimination clause in tax treaties requires a treaty partner to extend to the nationals of the contracting party a treatment that is not other or more burdensome than that granted to its own nationals, provided the former are in substantially the same circumstances as the latter; or, as in the equivalent NAFTA language: “in like situations” (box 4).
- **Transfer pricing.** Of all the issues covered in the series, transfer pricing is the most closely related to taxation, as the transfer prices of intra-group transactions (which represent one-third of world trade) impact directly on the taxable base. In fact, over the past years, transfer pricing has become one of the most important issues in international tax matters.
- **Technology transfer.** While not the most important factor, taxation can be used to encourage or discourage the transfer of technology. From a tax perspective, the approaches of developed and developing countries are dissimilar on two points. Firstly, most developed countries apply exclusive residence taxation and rarely apply the exemption method with respect to royalties. This position is opposed by developing countries on grounds of the unbalanced one-way character of payments for the use of technology. One of the arguments used against source taxation is that the source tax would be reflected in, and thus increase the price charged by, the licensor. (This, however, need not necessarily be the case, as discussed in section II.) Secondly, there is a slight difference with regard to technical assistance fees. Under both the OECD and the United Nations models, technical fees can be taxed in

the source state but only if attributable to a permanent establishment in that State. A number of developing countries, however, prefer the inclusion of technical fees under the royalty definition, since such would allow them to impose a withholding tax on the gross amount of the fee. Other developing countries, while accepting the exclusion of technical fees from the royalty definition, reject their taxation on a net basis, as should be the case with any permanent establishment income.

- **Illicit payments.** The problem presented by illicit payments can be aggravated by their taxation treatment in the home country of the payer. (They are by definition undisclosed in the country of the recipient.) Such payments have not been illegal in many home countries, and have even been accorded tax deduction, causing (among other things) a competitive disadvantage to those countries where such payments were illegal and (by definition) non-deductible. Although non-deductibility only increases the effective cost of illicit payments, this is one of the few tax measures that can deal with this phenomenon with any measure of effectiveness. Traditionally, however, the general view was that illicit payments are a moral and political problem, and that tax law should not be based on moral or ethical considerations. Under general tax principles, tax is imposed on net income, i.e. after deduction of related expenses. Whether or not such expenses are ethically acceptable was not considered to be a matter for tax law.
- **Taking of property.** Generally, of course, taxation does not amount to a taking; but a tax, when unreasonable or discriminatory, can constitute an expropriation (“creeping expropriation”). The question remains, however, to what extent and under what conditions the imposition of certain taxes could constitute expropriation. Thus, there is a need to define expropriation with respect to tax measures.

Conclusion: Economic and Development Implications and Policy Options

This chapter has shown the variety of tax issues raised by the activities of TNCs, and the types of provisions that have emerged in IIAs and double tax treaties to deal with them. It has been shown

that taxation provisions have played only a minor role in IIAs and that there are several reasons for this. First, double tax treaties are the major legal instruments used between States to deal with tax matters. Secondly, the inclusion of taxation matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion. This may be particularly important in cases in which the negotiating parties are at different levels of development. Hence the limited role for taxation provisions in IIAs and for the conclusion of separate tax treaties.

The necessity of tax treaties has been a much debated issue (IFA, 1990). It would appear that a treaty is not necessary where there is no double taxation to relieve (e.g. if there is no tax in one State or if the country of residence unilaterally avoids double taxation). However, even in that case, a tax treaty can be useful, as it generally offers greater and more comprehensive protection than that available under domestic rules which can be modified at will. Thus it can be argued that, while there is no conclusive evidence as to their absolute necessity, evidence of the usefulness of tax treaties is beyond doubt, and, like domestic tax laws, they can play a complementary role in attracting FDI if other factors are satisfactory. Of course the usefulness of a treaty is not always evident where direct business relations between the two contracting parties are minimal. In addition, a country can create, through tax treaties, business opportunities which it would not have otherwise attracted.²⁴

Indeed, the single most important advantage of a tax treaty is the relative legal certainty it offers to investors with respect to their tax position in both the source and residence countries.

Outside the few cases of treaty override, the discretionary power of the contracting parties to impose taxes is restricted by the framework agreed to under a treaty. This legal certainty is often greater in the source country than in the country of residence. A source country may decide under its domestic legislative process to increase the rate of dividend withholding tax or to impose tax on capital gains derived by non-residents. However, non-residents covered by a tax treaty can be protected from such domestic law changes, as the source country may not tax them beyond the level agreed under the treaty.²⁵ In contrast, changes in the domestic law of the country of residence may affect the investor, regardless of the existence of the treaty. For example, if a treaty provides for

the elimination of double taxation through the credit method, an increase in the general tax rates of the country of residence affects the investor, notwithstanding the treaty.

When considering the importance of bilateral tax treaties, it is important to recall that the development of regional integration groupings, especially among capital-importing countries, has an important impact on the negotiating position of capital-importing third countries. In principle, bilateral double tax arrangements do not have an MFN impact nor can they apply to non-signatories. Nevertheless, the integration process leads member States of a regional grouping to consider, in their negotiations with third countries, the position of residents of other member States. Thus, the negotiating member State could insist on obtaining a treatment that is not less favourable than that granted to another regional grouping member State, while at the same time being reluctant to grant to the third country a treatment which is more favourable than that which it grants to a fellow member State.

The challenges posed by tax competition (UNCTAD, 1998b; OECD, 1998d) have also forced many capital exporting countries to adopt rules that would allow them to extend their taxing jurisdiction to income and persons not connected to their territory. One of such measures, as discussed in section II, is CFC legislation, which allows a country to tax its own residents on income and gains realized through controlled foreign entities and retained abroad.

For most developing countries, more often host than home countries to FDI, a critical issue is whether an IIA uses a source or residence tax concept.

For developing countries, the OECD Model Convention, which generally favours residence taxation, may well operate under conditions of balanced economic relations such as exist between capital-exporting nations. However, it may not be suited for the overwhelmingly unidirectional capital flows that exist between developed and developing countries.

Again for developing countries, the retention of source taxation is important even if the developing country effectively foregoes the exercise of its taxation right. This is particularly important if the attribution of the taxation right to the source country is exclusive and matched by a treaty-confirmed exemption in the country of residence. In such cases, the source country may choose effectively to forego its right to tax (for

example by providing tax incentives that will not be undercut by residence taxation), or may, without being encumbered by a treaty, adopt policy options that allow it to tax on a selective basis (for example by reserving the exemption for capital gains only to shares held for a minimum period of time). In this respect, it is important to take into account that source country taxation is sometimes counter-productive, as the tax cost it may entail can be charged to the same country in the form of a higher price, fee, royalty or interest rate. A well drafted tax treaty can again limit this by involving the country of residence in resolving the issue.

In taking account of all these considerations, the important issues to note are that countries which opt for the conclusion of international tax arrangements need:

- to be aware of the tax system of the treaty partner; and
- to draft the arrangement in such a way as to exploit all synergies with that tax system and preserve their tax base, or (and most importantly for developing countries) at least leave the opportunities open for implementing any source-based options.

In the light of the foregoing discussion, the following options arise in relation to the treatment of taxation issues in IIAs:

Option 1: exclusion of taxation matters from an agreement

There are at least three variants that can be used:

Option 1 (a): a general exclusion

The contracting parties exclude taxation issues completely from an IIA. They can do so through a general, all embracing, exclusionary clause. This approach could be taken where the contracting parties already have a well developed system of double taxation agreements in place. However, this approach may leave open the possibility that the benefits of existing tax arrangements could be claimed by contracting parties to the IIA who are not themselves parties to such arrangements, on the basis of the MFN principle, unless there is an explicit partial or total exclusion from MFN and/or national treatment obligations.

Equally this approach can be taken by countries that simply wish to avoid linking tax and investment issues.

Option 1 (b): partial exclusion for national treatment / MFN

The contacting parties partially exclude taxation issues from an IIA. For example, a treaty

could state that nothing in the national treatment / MFN provision shall prevent the adoption or enforcement by the contracting parties of any measure which differentiates treatment between taxpayers that are not in the same circumstances, or is aimed at preventing the avoidance or evasion of taxes. Or it could qualify the application of national treatment to disallow the effect of extending fiscal advantages granted by the contracting parties on the basis of any international agreement or arrangement by which it is or may be bound.

Option 1 (c): specific exclusion through a national treatment/MFN provision

The most common technique of excluding taxation issues from an IIA is through the use of a specific exclusion of taxation matters in the national treatment / MFN clause. This avoids the risk of the “free rider” problem described in option 1 (a). On the other hand, it may not permit certain specific tax questions, which have a direct bearing on the rights of investors under the agreement, from being fully dealt with.

Option 2: qualified exclusion of taxation matters

This approach offers the benefit of excluding taxation issues in general from an IIA while at the same time ensuring that investors’ rights are not unduly interfered with by the use of taxation measures. Thus the use of tax measures as a means of expropriation is expressly prohibited in certain agreements, notably the ECT and NAFTA. From a development perspective, such an approach can help to reinforce the protection of investors under the IIA, though it does restrict the discretion of the host country in the use of tax measures as an instrument of economic policy. Much here depends on how an expropriation is defined in the IIA and on whether a distinction is made between legitimate taxation measures and those whose effect is the economic neutralisation of the investment with the aim of expropriating it (further, chapter 9).

Option 3: provisions concerning the tax responsibility of TNCs

Provisions on this matter may be included in an IIA where the contracting parties wish to include investor responsibilities alongside investor rights in order to ensure “good corporate citizenship” from investors. This approach can serve to reinforce existing national legal obligations on taxpayers, by requiring TNCs to observe those obligations. On the other hand, such provisions may add little to those national rules unless they are themselves legally binding, other

than acting as hortatory statements of desired practice.

Option 4: reference to avoidance of double taxation

An IIA may include a clause that encourages, or in the alternative obliges, the contracting parties to deal with the problem of double taxation as part of their obligations under an agreement. This may include an obligation to conclude double taxation agreements containing the kind of provisions described and analyzed in section II.

Option 5: taxation regime for regional multinational enterprises

This is a specialized option of relevance to any IIA whose purpose is to establish a regional multinational enterprise or other business association. The clarification of certain basic taxation issues, as discussed in section II, is an essential aspect of such a regime and must be addressed in the agreement.

This approach would not be required where the contracting parties already have a comprehensive network of double taxation agreements in place. On the other hand, it would be a useful course of action for contracting parties to an IIA where some, or all, of them do not already have such a network in place. In this regard an IIA can be used as a spur to effecting a new legal framework for dealing with double taxation issues. This would be a suitable policy choice for countries that are in the process of attracting increased levels of FDI but have, as yet, had no occasion to conclude double taxation arrangements.

This approach could include specific provisions relating to the conditions upon which tax incentives are offered to investors. It is an approach restricted to regional economic integration agreements among developing countries. The main advantage of specifying tax incentives is that it can ensure preferential tax treatment for investors from within the regional parties. However, such incentives can be criticized as distorting the operation of the market through state intervention. Much depends on the specific conditions for capital formation in the region concerned and whether special incentives are thought to be necessary to ensure regional economic integration.

Option 6: IIA dealing with the avoidance of double taxation

Although no example of this approach exists in practice, it is in theory possible to

conclude a comprehensive code on the avoidance of double taxation for inclusion in an IIA. The obstacles to this approach, however, would be considerable: the agenda for negotiation could become overloaded; the “free rider” problem might not be able to be successfully addressed, since an MFN exception could not exist alongside commitments to avoid double taxation (although, if all parties agree to such a course of action, presumably the “free rider” problem would cease to be an issue); and the discretion to offer special concessions typical of bilateral tax agreements would be lost if the number of contracting parties to the IIA was considerable. Finally, it should be noted that multilateral regimes on taxation, as noted in section I, are very difficult to agree upon. This option is generally seen by tax experts as not feasible.

It would be possible to create a mix of approaches based on options 1 to 6. In particular options 3, 4 and 6 could appear alongside other options where specific circumstances warrant.

Where IIAs do include a taxation provision, the development dimension can be enhanced by the inclusion of specialized clauses operationalizing transfer pricing adjustments, transparency guidelines and mechanisms for information sharing. Technical assistance and tax sparing clauses are similarly inclusions aimed at supporting the development objective.

The development dimension can also be served by a provision similar to that in the TRIPS agreement, that assures technical and financial cooperation in favour of developing and least-developed countries. Such cooperation could extend to assistance in the preparation of laws and regulations on taxation matters as well as on the prevention of their abuse, and could include support regarding the establishment of reinforcement of domestic offices and agencies relevant to these matters, including the training of personnel.

Of relevance to all IIAs involving developed and developing countries, is the fact that a commitment to such double taxation arrangements requires a sufficient level of resources to be able to administer a national revenue gathering system effectively and to carry out the cooperative activities required under double taxation arrangements. Thus, where developing countries are involved, additional provisions concerning cooperation and technical assistance

from developed countries on taxation matters may be required. Furthermore, the mutual assistance and information exchange provisions in any resulting double taxation arrangement could include special elements to ensure that the developing country party benefits from the institutional arrangements without undue prejudice to its own resources. In addition, skills transfer and training obligation in the field of tax administration may be needed on the part of developed country parties. Such modifications could be introduced via the IIA itself, thereby creating a specific development orientation into the practical operation of the double taxation arrangement. At the same time, if it is felt that rules for the avoidance of double taxation are needed, a better solution might be to conclude a separate regional double taxation convention.

Notes

- ¹ This is, for example, the case under the 1963 France-Monaco tax agreement which requires Monaco to introduce and levy a tax on profits pursuant to a taxable base and a tax rate determined by the agreement. Also, within the European Union, directives and regulations may have a direct effect in the member States and may impact on their legislative jurisdiction (IBFD, 1986 -).
- ² A limited number of countries, such as the Philippines and the United States, determine their jurisdiction to tax on the basis of nationality.
- ³ The use of the term “jurisdiction” refers to sovereign States. Conflicts arising from the application of concurring taxing rights by political or territorial subdivisions of the same State are not addressed in this chapter.
- ⁴ Inheritance and/or gift tax treaties are fewer in number than comprehensive income tax treaties, but their number is increasing (for example, 6 such treaties for Italy, 7 for Austria and the Netherlands, and 35 for France). The texts of all such treaties are reproduced in the IBFD’s tax treaties CD ROM (IBFD, 1986-).
- ⁵ Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996a.
- ⁶ Specific sub-groups also coordinate their (international) tax policies in the framework of other fora. This is in particular the case for coordination within the European Union. Representatives of France, Germany, the United Kingdom and the United States (“Group of four”) meet regularly to exchange views and coordinate policies with respect to tax matters. Regular similar meetings are also held between representatives of Belgium, France, Germany,

Luxembourg, the Netherlands and the United Kingdom (“Group of six”).

7 The OECD also elaborated a Model Double Taxation Convention on Estates and Inheritances and on Gifts (3 June 1982) (OECD, 1983) and, in collaboration with the Council of Europe, the 1988 Convention between the member states of the Council of Europe and the member countries of the OECD on mutual administrative assistance in tax matters (Convention on Mutual Administrative Assistance in Tax Matters) (IBFD, 1986 --).

8 The latest update was made on 1 November 1997.

9 This section updates UNCTAD, 1998b, ch.III.

10 Indeed, substantial amounts of FDI flow to tax heavens -- without, however, actually being invested there in productive capacities.

11 Egypt, Iraq, Jordan, Kuwait, Sudan, Syria and Yemen.

12 There were two COMECON conventions, one of 22 May 1977 (COMECON (CMEA) multilateral convention with respect to the avoidance of double taxation on income and net wealth of individuals) and one of 19 May 1978 (COMECON (CMEA) multilateral convention for the avoidance of double taxation with respect to income and capital of legal entities) (IBFD, 1986--).

13 Unless otherwise noted, the texts of the BITs mentioned in this chapter may be found www.unctad.org/iia.

14 See, for example, article 24(3) of the Albania-Norway tax treaty of 14 October 1998 (IBFD, 1986--).

15 See, for example, article 23(2) of the Pakistan-Sweden tax treaty of 22 December 1985 (IBFD, 1986--).

16 See, for example article 23(2) of the Spain-Tunisia tax treaty of 2 July 1982, and article 23(3) of the India-Russia tax treaty of 25 March 1997 (Tax Analysts, 1995-1999).

17 The formulae used is $[100 - (t + 25) \div 2]$, whereby t is the foreign tax. Therefore, the lower the foreign tax is, the higher the sparing credit becomes.

18 For example, the French Supreme Court ruled that the non-discrimination clause of the France-Panama establishment treaty of 10 July 1957 does not explicitly exclude, and therefore does apply to,

tax matters. (Decision of 15 November 1994, (Lexis, 1987 - 1995)). This required France to conclude an agreement with Panama to specifically exclude the application of the non-discrimination clause to tax matters (France-Panama agreement of 17 July 1995, (Tax Analysts, 1995 - 1999)). The agreement states that the nondiscrimination provisions of the France-Panama establishment treaty of 10 July 1953 and investment promotion agreement of 5 November 1982 do not apply to fiscal matters

19 An exception for both countries is found in their respective tax treaties with the United States which contain a non-discrimination clause.

20 See, for example, the clause under the Netherlands-United States tax treaty of 18 December 1992 (IBFD, 1986--).

21 There are, to date, only three lower court decisions in France and one appeals court decision in the United Kingdom on the compatibility of CFC rules with tax treaties. The French decisions reached diametrically opposed conclusions although they dealt with the same France-Switzerland treaty. The United Kingdom decision held that the rules are compatible with the Netherlands-United Kingdom treaty.

22 A notable exception is found in Swiss treaties which generally do not contain an exchange-of-information or mutual-assistance clause.

23 See chapter 6, section II(b)(2)(a).

24 While this possibility is increasingly threatened by modern anti-abuse and limitation-on-benefits clauses, the examples of the Mauritius treaty with India, Cyprus treaties with Eastern European countries, and the Netherlands tax arrangement with the Netherlands Antilles are edifying. Indeed, because of their favourable tax treaties with the countries mentioned, Mauritius, Cyprus and the Netherlands Antilles have been used by investors to channel investments in a tax-efficient way.

25 On the other hand, if a source country instead reduces its taxes or introduces certain exemptions, such reductions or exemptions apply to the non-resident investor regardless of the existence of the treaty – again a positive result for the foreign investor.

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