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**ADMISSION AND ESTABLISHMENT**

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on issues in international investment agreements**



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## NOTE

UNCTAD serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment and transnational corporations. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). In 1993, the Programme was transferred to the United Nations Conference on Trade and Development. UNCTAD seeks to further the understanding of the nature of transnational corporations and their contribution to development and to create an enabling environment for international investment and enterprise development. UNCTAD's work is carried out through intergovernmental deliberations, research and analysis, technical assistance activities, seminars, workshops and conferences.

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The following symbols have been used in the tables:

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

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

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

A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

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

Reference to "dollars" (\$) means United States dollars, unless otherwise indicated.

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## *IIA Issues Paper Series*

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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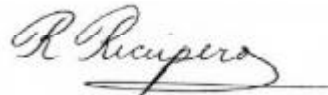
## Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view towards assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups of civil society and the preparation of a series of issues papers.

This paper is part of this series. It is addressed to government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant and Pedro Roffe, and including Victoria Aranda, Anna Joubin-Bret, John Gara, Assad Omer, Jörg Weber and Ruvan de Alwis, under the overall direction of Lynn K. Mytelka; its principal advisors are Arghyrios A. Fatouros, Thomas L. Brewer and Sanjaya Lall. The present paper is based on a manuscript prepared by Peter T. Muchlinski. The final version reflects comments received from Padma Mallampally. The paper was desktop published by Teresita Sabico.

Funds for UNCTAD's work programme on a possible multilateral framework on investment have so far been received from Australia, Brazil, Canada, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as India, Morocco and Peru also have contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.



Rubens Ricupero  
Secretary-General of UNCTAD

Geneva, December 1998



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## Executive summary

This paper analyses the legal and policy options surrounding the admission and establishment of foreign direct investment (FDI) by transnational corporations (TNCs) into host countries. This topic raises questions that are central to international investment agreements in general. In particular, the degree of control or openness that a host country might adopt in relation to the admission of FDI is a central issue. The purpose of this paper is to describe and assess the kinds of policy options that have emerged from the process of FDI growth and host country responses thereto in national laws and, more importantly, in bilateral, regional, plurilateral and multilateral investment agreements.

A discussion of the inter-relationship between the issue of admission and establishment and other concepts covered in this series shows that the extent to which rights of entry and establishment are accorded to investors in an agreement is affected particularly by such matters as: the definition of investment; the relationship between rights of entry and establishment and the nature of post-entry treatment; the transparency of regulatory controls; exceptions and derogations to treaty-based rights of entry and establishment; dispute settlement as it relates to host country rights to control entry and establishment; and investment incentives as an aspect of entry and establishment decisions.

The economic and development implications of different policy options depend on a number of variables concerning the nature and location advantages of a host country, the motives for, and nature of, the foreign investment a host country attracts, and the bargaining relationship between a particular investor and the host country. The mix of such variables in a given situation is likely to shape the approach that policy makers take when formulating and implementing policies regarding admission and establishment.



## INTRODUCTION

States have traditionally reserved to themselves absolute rights, recognised in international law, to control the admission and establishment of aliens, including foreign investors, on their territory. However, in today's world economy, the issue of more open policies regarding the entry and establishment of foreign investors is receiving increased attention. This may be based on a variety of concepts and standards, including adapted and evolved versions of non-discrimination standards commonly met in international trade treaties, notably national treatment (NT) and most-favoured-nation treatment (MFN).

However, while there is some pressure on States to liberalize conditions of entry and establishment for foreign investment, actual practice has moved in a variety of directions. At the national level, while policies offering greater market access are on the increase, national laws reveal continuing State control and discretion over entry and establishment, even in more "open-door" economies. At the international level, although market access provisions in investment agreements are common, they do *not* uniformly display provisions that offer foreign investors completely unrestricted or full rights of entry and establishment.

Country approaches to entry and establishment may be seen as falling into five major categories or models:

- the "investment control" model, which preserves full State control over entry and establishment;
- the "selective liberalization" model, which offers limited rights of entry and establishment, i.e. only in industries that are included in a "positive list" by the agreement of the contracting States;

- the “regional industrialization programme” model, which offers full rights of entry and establishment based on national treatment for investors from member countries of a regional economic integration organisation only for the purposes of furthering such a programme;
- the “mutual national treatment” model, which offers full rights of entry and establishment based on national treatment for all natural and legal persons engaged in cross-border business activity from member countries of a regional economic integration organization;
- the “combined national treatment/most-favoured-nation treatment” (NT/MFN) model, which offers full rights of entry and establishment based on the better of NT or MFN, subject only to reserved “negative” lists of industries to which such rights do not apply.

In practice, the first model is most widely used, albeit in a wide variety of forms, while the last model is increasingly favoured by States seeking to establish a liberal regime for entry and establishment in an international framework for investment.

The models suggest the following policy options:

- \* **Option 1:** To accept complete State discretion through the investment control model, thereby preserving the general power to screen proposed investments.
- \* **Option 2:** To liberalize cautiously through the adoption of the selective liberalization model, opening up one or more industries at a time.
- \* **Option 3:** To follow the regional industrial programme model and encourage the establishment of regional multinational enterprises, thereby setting up a supranational form of business organization aimed at encouraging intraregional economic development.
- \* **Option 4:** To grant full liberalization of entry and establishment on the basis of mutual national treatment, thereby allowing such rights to exist between States

that see a common interest in regional integration, but which are not necessarily committed to full multilateral liberalization.

- \* **Option 5:** To follow the full NT/MFN model and open up entry and establishment for investors from the contracting States on the basis of the better of these two standards, subject only to a "negative list" of reserved activities, industries or applicable policies. The existence of a negative list of excepted industries emphasizes that certain strategic industries may be beyond the reach of liberalization measures.
- \* **Option 6:** To follow a mix of models bearing in mind that some of the options appear to be incompatible or difficult to combine. The economic effect of these hybrid options would be to offer more specialized alternatives that may be more compatible with the mix of location advantages enjoyed by particular host countries.

All of these options focus narrowly on the question of admission and establishment; they do not address the extent to which States subsequently pursue policies aimed at, for instance, increasing the benefits associated with FDI and minimizing any negative effects.



## Section I

### EXPLANATION OF THE ISSUE

The issue underlying this paper is best introduced by making reference to the State's sovereign right, under customary international law, to control the entry and establishment of aliens within its territory.<sup>1</sup> Such entry is a matter of domestic jurisdiction arising out of the State's exclusive control over its territory (Brownlie, 1998, p. 522). Accordingly, a host State has a very wide margin of discretion when deciding on whether and under what conditions to permit the entry of foreign investors (Wallace, 1983, pp. 84-85).<sup>2</sup>

The regulation of entry and establishment of TNCs has taken the form of controls or restrictions over the admission and establishment of foreign investors including the acquisition of interests in local businesses (box 1), and limitations on foreign ownership and control (box 2). Such measures may consist of absolute restrictions or limits on foreign presence, or may involve discretionary authorization, registration and reporting requirements (UNCTAD, 1996b, pp. 174-177). Measures short of exclusion may also affect the conditions of entry for foreign investors. Examples include performance requirements such as local content rules, technology transfer requirements, local employment quotas, or export requirements. Equally, incentive regimes materially affect the conditions under which an investment is made (UNCTAD, 1996b, pp. 178-181). The effects of the various measures have been considered in detail in a number of recent studies (UNCTAD and UNCTC, 1991; Shihata, 1994; Muchlinski, 1995; UNCTAD, 1996c), and some of them are the subject of separate papers of this series.

A few words of explanation regarding the measures listed in boxes 1 and 2 are appropriate here:

- The measures listed vary in the degree of restriction involved. The most restrictive policies involve prohibitions on foreign investment, either in the economy as a whole - a practice not currently followed - or in certain activities or industries, a practice widely used even in the most "open-door" economies to protect strategic industries from foreign domination. By contrast, limiting the percentage of foreign shareholding in local companies and/or the requirement to form a joint venture with a local partner would not prohibit FDI in the sector concerned, but would place limits on its participation in that activity.
- The use by host countries of screening procedures suggests the desirability of FDI but the scrutiny of individual projects ensures their economic and social utility to the host country. This approach may result in the stipulation of performance or other requirements (to the extent permitted under international agreements) deemed necessary to ensure such utility. Hence it is useful to distinguish between prohibitions and restrictions over entry itself and the conditions that may be placed on entry that is in principle permissible.

### **Box 1. Measures relating to admission and establishment**

#### **1. Controls over access to the host country economy**

- Absolute ban on all forms of FDI (e.g. controls in some former centrally-planned economies prior to the transition process).
- Closing certain sectors, industries or activities to FDI for economic, strategic or other public policy reasons.
- Quantitative restrictions on the number of foreign companies admitted in specific sectors, industries or activities for economic, strategic or other public policy reasons.
- Investment must take a certain legal form (e.g. incorporation in accordance with local company law requirements).
- Compulsory joint ventures either with State participation or with local private investors.
- General screening/authorization of all investment proposals; screening of designated industries or activities; screening based on foreign ownership and control limits in local companies.
- Restrictions on certain forms of entry (e.g. mergers and acquisitions) may not be allowed, or must meet certain additional requirements).

/...



- Specialized regulatory regimes may be developed to meet the characteristics of particular types of FDI, leading to specific conditions being set according to the activity or industry involved, or to the development of new forms of FDI such as the build-operate-transfer (BOT) system.

**(Box 1, concluded)**

- Investment not allowed in certain zones or regions within a country.
- Admission to privatization bids restricted, or conditional on additional guarantees, for foreign investors.
- Exchange control requirements.

**2. Conditional entry into the host country economy**

*General conditions:*

- Conditional entry upon investment meeting certain development or other criteria (e.g. environmental responsibility; benefit to national economy) based on outcome of screening evaluation procedures.
- Investors required to comply with requirements related to national security, policy, customs, public morals as conditions of entry.

*Conditions based on capital requirements:*

- Minimum capital requirements.
- Subsequent additional investment or reinvestment requirements.
- Restrictions on import of capital goods needed to set up investment (e.g. machinery, software) possibly combined with local sourcing requirements.
- Investors required to deposit certain guarantees (e.g. for financial institutions).

*Other conditions:*

- Special requirements for non-equity forms of investment (e.g. BOT agreements, licensing of foreign technology).
- Investors to obtain licences required by activity or industry specific regulations.
- Admission fees (taxes) and incorporation fees (taxes).
- Other performance requirements (e.g. local content rules, employment quotas, export requirements).

*Sources* UNCTAD, 1996b, p. 176; Muchlinski, 1995, ch. 6.

## Box 2. Measures relating to ownership and control

### 1. Controls over ownership

- Restrictions on foreign ownership (e.g. no more than 50 per cent foreign-owned capital allowed).
- Mandatory transfers of ownership to local firms usually over a period of time (fade-out requirements).
- Nationality restrictions on the ownership of the company or shares thereof.

### 2. Controls based on limitation of shareholder powers

- Restrictions on the type of shares or bonds held by foreign investors (e.g. shares with non-voting rights).
- Restrictions on the free transfer of shares or other proprietary rights over the company held by foreign investors (e.g. shares cannot be transferred without permission).
- Restrictions on foreign shareholders rights (e.g. on payment of dividends, reimbursement of capital upon liquidation, on voting rights, denial of information disclosure on certain aspects of the running of the investment).

### 3. Controls based on governmental intervention in the running of the investment

- Government reserves the right to appoint one or more members of the board of directors.
- Restrictions on the nationality of directors, or limitations on the number of expatriates in top managerial positions.
- Government reserves the right to veto certain decisions, or requires that important board decisions be unanimous.
- "Golden" shares to be held by the host Government allowing it, for example, to intervene if the foreign investor captures more than a certain percentage of the investment.
- Government must be consulted before adopting certain decisions.

### 4. Other types of restriction

- Management restrictions on foreign-controlled monopolies or upon privatization of public companies.
- Restrictions on land or immovable property ownership and transfers thereof.
- Restrictions on industrial or intellectual property ownership or insufficient ownership protection.
- Restrictions on the use of long-term (five years or more) foreign loans (e.g. bonds).

Source: UNCTAD, 1996b, p. 177.

- Even in an open-door environment, host countries may wish to maintain a certain control over the investor or the investment. Hence, various techniques for the supervision of FDI have been developed, including limits on foreign shareholding with reserved shares or special voting rights for the host Government or local private investors to ensure local control over important management decisions, registration requirements and disclosure and reporting rules. These powers are not normally incompatible with rights of entry and establishment, but co-exist with such rights.

The underlying rationale for granting rights of establishment for foreign investors is to allow the efficient allocation of productive resources across countries through the operation of market forces by avoiding policy-induced barriers to the international flow of investment. In this sense it can be said that rights of establishment attempt to avoid discriminating between foreign and domestic investors and/or investors from different home countries.

In contrast, host countries have sought to control the entry and establishment of foreign investors as a means of preserving national economic policy goals, national security, public health and safety, public morals and serving other important issues of public policy (Dunning, 1993, ch. 20; Muchlinski, 1995, ch. 6). Such controls represent an expression of sovereignty and of economic self-determination, whereby Governments judge FDI in the light of the developmental priorities of their countries rather than on the basis of the perceived interests of foreign investors.

The State's right to control entry and establishment may be contrasted with increasing pressures for market access and rights of establishment arising out of the process of globalization. Given the absolute nature of the State's right to control the entry and establishment of aliens, there is no compulsion in law upon a prospective host State to grant such rights to foreign investors. On the other hand, countries that seek to encourage FDI may restrict their wide area of discretion both through unilateral liberalization of entry and establishment conditions in national laws and through international agreements, by the inclusion of a clause embodying rights of entry and establishment for foreign investors.

At the outset it should be stressed that these rights are treaty-based rights and not rights based in customary international law. Indeed, they operate as exceptions to the general customary law principle that recognizes the right of States to admit or exclude aliens from the territory of the State. Examples of such provisions will be analysed in section II below, where it will be shown that such provisions may vary widely in the extent to which they offer rights of admission and establishment, emphasizing the State's continuing control over the granting of such rights.

Prior to that it is necessary to explain some conceptual issues inherent in rights of admission and establishment (UNCTC, 1990a). These rights need to be distinguished. Rights of admission deal with the right of entry or presence while rights of establishment deal with the type of presence that may be permitted. The right of admission may be temporary or permanent. Temporary admission may be sufficient where a foreign enterprise seeks a short-term presence for the purposes of a discrete transaction, but would be insufficient for the purposes of a more regular business association with the host country. Should the host Government wish to encourage that association, a permanent right of market access may be granted. This would allow the enterprise to do business in the host country, but would not necessarily include a right to set up a permanent business presence. Market access rights may be sufficient where a foreign enterprise is primarily involved in regular cross-border trade in goods or services, or where business is carried out by way of electronic transactions, obviating the need for a permanent presence in the host country.

On the other hand, where some form of permanent business presence is preferred, a right of establishment ensures that a foreign investor, whether a natural or legal person, has the right to enter the host country and set up an office, agency, branch or subsidiary (as the case may be), possibly subject to limitations justified on grounds of national security, public health and safety or other public policy grounds (UNCTC, 1990b, pp. 192-195). Thus, the right to establishment entails not only a right to carry out business transactions in the host country but also the right to set up a permanent business presence there. It is therefore of most value to investors who seek to set up a long-term investment in a host country.<sup>3</sup>

Rights of establishment can be articulated through a variety of concepts and standards. In particular, issues concerning the avoidance of discrimination as between foreign and domestic investors and/or investors from different home countries have arisen. The former type of discrimination may be addressed by granting NT upon entry, while the latter can be addressed by granting MFN:

- National treatment can be defined as treatment no less favourable than that accorded to nationals engaged in the same line of business as the foreign investor. This standard is of particular relevance in the post-entry treatment of foreign investors (OECD, 1993). However, as will be shown in section II below, it has also been used as a means of granting rights of entry and establishment on the basis of mutual rights granted to States participating in a treaty regime granting such rights.
- Most-favoured-nation treatment can be defined as treatment no less favourable than that accorded to other foreign investors in the same line of business. The MFN standard ensures that any more favourable terms of investment granted to investors from one home country are automatically extended to investors from another home country.

These standards may be used separately or in combination with one another, whichever offers the higher standard of protection (see, for example, the United States model bilateral investment treaty (BIT), 1994, article II (1), in UNCTAD, 1996a, vol. III, p. 197); they are discussed in more detail in separate papers of this series. Other concepts and standards, such as an expansive definition of market access encompassing all forms of market presence, may also be adapted and developed to articulate a right to establishment for foreign investors. Moreover, in the case of highly integrated groups of countries, the possibility of evoking the notion of an absolute right of establishment, or even a right to invest, for foreign investors within the group cannot be excluded a priori.

Finally, it must be stressed that the granting of a right to establishment is only one approach among many to the issue under discussion. As the next section will show, actual practice has developed not only models for the liberalization of entry and establishment but also models for the preservation of the State's sovereign right

to control such matters. In this respect the grant of full rights of entry and establishment can be seen as the most open-door policy choice among the various options.

### Notes

- 1 For a detailed analysis of the concepts and principles of customary international law applying to foreign investment, see Fatouros (1993).
- 2 This is stressed in the Organisation for Economic Co-operation and Development (OECD) Draft Convention on the Protection of Foreign Property of 1962, which states in article 1 (b): “The provisions of this Convention shall not affect the right of any Party to allow or prohibit the acquisition of property or the investment of capital within its territory by nationals of another Party” (UNCTAD, 1996a, vol. II, p. 114).  
Unless otherwise noted, all instruments cited herein may be found in UNCTAD (1996a).
- 3 For a detailed analysis of the various degrees of market presence in the area of services, see UNCTAD and the World Bank (1994).

## Section II

### STOCKTAKING AND ANALYSIS

#### A. National legal approaches

In recent UNCTAD surveys regarding the direction and nature of liberalization of FDI entry and establishment, a number of findings have emerged (UNCTAD, 1994; 1995; 1996b; 1997; 1998a).<sup>1</sup> Traditionally, controls of FDI upon entry have centred on one or more of the following types of restrictions: prohibitions of FDI in specific activities or industries; foreign ownership limits in specific activities or industries; and screening procedures based on specified economic and social criteria.<sup>2</sup> Reforms have taken place through reductions in the number of activities/industries closed to FDI, usually by revising the lists of such activities/industries in negative lists which specify those activities/industries that are closed, leaving all other areas open to FDI;<sup>3</sup> reduction or removal of foreign ownership and control limits in previously controlled activities/industries; and the liberalization or removal of screening procedures. In this last area there has been a general move from substantive screening for the evaluation of investment projects towards more streamlined procedures such as registration requirements. The process of privatization has also increased the number of activities now open to FDI, though such processes may involve elaborate approval procedures for privatization bids from potential investors. However, it would be wrong to see liberalization of entry and establishment as a uniform process. Numerous controls remain, reflecting the different approaches taken by Governments to economic and social policy in the field of FDI. Moreover, as liberalization proceeds, more and more countries are introducing screening and review procedures for international mergers and acquisitions (M&As) to ensure that the removal of policy obstacles to FDI is not replaced by anti-competitive private practices (UNCTAD, 1997).

## B. Recent international agreements

Entry and establishment provisions can be found in BITs (UNCTAD, 1998b), regional and plurilateral instruments as well as multilateral agreements dealing with investment. The present paper identifies five models or approaches in this area (see the Introduction above). Each represents a point along a continuum -- from complete State control over entry and establishment at one extreme, to entry and establishment rights subject to limited exceptions at the other extreme.

- **The investment control model.** This model is followed in most BITs, although some exceptions exist, notably the BITs signed by the United States and, more recently, Canada. It recognises the restrictions and controls on the admission of FDI stipulated by the laws and regulations of the host country. Indeed, this model does not offer positive rights of entry and establishment, leaving the matter to national discretion. Such an approach is also favoured by certain regional instruments.
- **The selective liberalization model.** This approach offers selective liberalization by way of an agreed "opt-in" on the part of the host State, resulting in a "positive list" of industries in which rights of entry and establishment may be enjoyed. Such rights may be subject to restrictions that the host State is permitted by the agreement to maintain. In addition, signatory States may make commitments to undertake further negotiations over liberalization in specific industries at an agreed future date.
- **The regional industrialization programme model.** Certain regional groups have experimented with supranational investment programmes. These involve regimes for the encouragement of intraregional investment, including the setting up of regional enterprises with capital from more than one member country. Such regimes may or may not specify rights of entry and establishment. Nonetheless, such regimes have such rights implicit in their policies, as they endeavour to encourage cross-border investment by way of regionally integrated enterprises and projects.



- **The *mutual national treatment model*.** This arises out of the practice of certain regional economic integration organizations where rights of entry and establishment are offered only to investors located in member States, who either possess the nationality of such a State and/or are resident for business purposes in a member State. The aim is to establish a common regime for entry and admission for investors from member States. MFN treatment for investors from non-member States is not normally available. This model differs from the previous model in that a right of establishment is generally available and is not dependent on the adoption, by investors, of a particular form of industrial programme or joint enterprise.
- **The *combined national treatment/most-favoured-nation treatment model*.** This is exemplified by United States BIT practice. The United States model BIT stipulates NT and MFN, whichever is the more favourable to foreign investors from the States parties, at pre-entry (as well as post-entry) stages of investment. The aim is to widen entry and establishment rights as far as possible, thereby enabling investors from States signatories to obtain the same rights of access as the most favoured third country investor. However, MFN treatment for investors from third countries is normally not available. Exceptions to these rights are also part of the understanding, but these must be specified and included in country-specific schedules annexed to the treaty, creating a negative list of protected activities or industries.

Each approach is illustrated below by examples from bilateral, regional, plurilateral and multilateral treaty practice. It should be stressed that each model is an ideal type which is often modified in practice through negotiation to achieve a balance of interests between the parties involved regarding the extent of liberalization and the extent of control required.

### ***1. The investment control model***

BITs are the most frequent international investment agreements. With some notable exceptions, as a matter of law, they do not accord positive rights of entry and establishment to foreign investors from the other contracting party. Such treaties have, in general,

expressly preserved the host State's discretion through a clause encouraging the contracting parties to promote favourable investment conditions between themselves but leaving the precise conditions of entry and establishment to the laws and regulations of each party (Dolzer and Stevens, 1995, pp. 50-57; UNCTAD, 1998b).<sup>4</sup>

Turning to regional agreements displaying the use of this approach:

- The Agreement on Investment and Free Movement of Arab Capital among Arab Countries of 1970, reasserts, in article 3, each signatory's sovereignty over its own resources and its right to determine the procedures, terms and limits that govern Arab investment. However, by articles 4 and 5, all such investments are accorded NT and MFN once admitted (UNCTAD, 1996a, vol. II, pp. 122, 124).
- Controlled rights of entry and establishment can be found in the Unified Agreement for the Investment of Arab Capital in the Arab States of 1980 (UNCTAD, 1996a, vol. II, especially articles 2 and 5, pp. 213, 214).
- This approach is also followed in article 2 of the Agreement on Promotion, Protection and Guarantee of Investments among Member States of the Organisation of the Islamic Conference of 1981 (UNCTAD, 1996a, vol. II, p. 241).
- The 1987 version of the Association of South-East Asian Nations (ASEAN) Agreement for the Promotion and Protection of Investments follows the general practice in BITs and applies only to "investment brought into, derived from or directly connected with investments brought into the territory of any Contracting Party by nationals or companies of any other Contracting Party and which are specifically approved in writing and registered by the host country and upon such conditions as it deems fit for the purposes of this agreement" (article II, in UNCTAD, 1996a, vol. II, p. 294). Amendments made in 1996 introduced provisions on the simplification of investment procedures, approval processes and increased transparency of investment laws and regulations. However, the Framework Agreement on the ASEAN Investment Area (1998) offers a radical departure from this model.<sup>5</sup> It displays

elements of a mutual national treatment model and, after a period of transition, a combined NT/MFN model. These elements will be considered further below.

- In the framework of the Southern Common Market (MERCOSUR), each member State agrees to promote investments of investors from non-member States in accordance with its laws and regulations (Decision 11/94 of the Council of MERCOSUR of 5 August 1994; in UNCTAD, 1996a, vol. II, p. 527). This commitment is subject to each State making best efforts to ensure that all relevant licences and administrative procedures are properly executed once an investment has been admitted (UNCTAD, 1996a, vol. II, p. 529).
- The first and most extensive inter-State investor screening regime was Decision 24 of the Agreement on Andean Subregional Integration (ANCOM).<sup>6</sup>
- In Africa, the Common Convention on Investments in the States of the Customs and Economic Union of Central Africa (UDEAC) of 1965 sets up a common system of investment screening for undertakings from the member countries that leads to preferential treatment in accordance with the agreement for any approved activity listed in the Preferential Schedules in Part II thereof (see UDEAC Treaty, articles 6-14, in UNCTAD, 1996a, vol. II, pp. 90-92). An approved undertaking may be the subject of an "establishment convention" which grants to it certain guarantees and imposes certain obligations (UDEAC Treaty, chapter IV, in UNCTAD, 1996a, vol. II, pp. 96-97).
- The World Bank Guidelines on the Treatment of Foreign Direct Investment accept the investment control model used in the majority of BITs (UNCTAD, 1996a, vol. I, p. 247). Thus Guideline II affirms that each State maintains the right to make regulations to govern the admission of foreign investments. Furthermore, States may, exceptionally, refuse entry on the grounds of national security, or because an industry is reserved to a State's nationals on account of the State's economic development objectives or the strict exigencies of its national interest. Restrictions applicable to national investment on account of public policy, public health and

environmental protection can equally apply to foreign investment.

Today, the investment control model is the most widely used. The number of BITs that have followed this approach and the wide geographical distribution of regional agreements applying the investment control approach show a broad acceptance of its underlying rationale by many States, namely, that FDI is welcome but remains subject to host State regulation at the point of entry. The adoption of this model in preference to more liberal models in the World Bank Guidelines is also significant in view of the fact that the Guidelines were drawn up to express general trends in international treaty practice in the field of FDI promotion and protection.

## *2. The selective liberalization model*

This approach is illustrated by the General Agreement on Trade in Services (GATS): a right of establishment exists where a member of GATS makes specific commitments on market access under article XVI. This provides that, in industries for which a member undertakes market access commitments, that member is prohibited from imposing certain listed limitations on the supply of services, unless it expressly specifies that it retains such limitations. These limitations include measures that would affect access through, *inter alia*, FDI. Thus, in the absence of an express reservation, the member cannot restrict or require, for example, specific forms of legal entity or joint venture through which a service could be provided, nor impose limits for the participation of foreign capital drawn up in terms of limits on maximum foreign shareholding or total value of individual or aggregate foreign investment (article XVI (2) (e)-(f)).

The wording of article XVI makes clear that the receiving State has considerable discretion in determining the extent of its market access commitments, and that it may expressly reserve powers to limit the mode of supply; there is no general obligation to remove all barriers concerning the entry and establishment of service providing firms. Each member of GATS is obliged to do no more than set out the specific market access commitments that it is prepared to undertake in a schedule drawn up in accordance with article XX of the GATS. Thereafter, members shall enter into subsequent rounds of negotiations with a view to achieving progressively higher levels of liberalization (article XIX(1)).

This model is useful where States do not wish to liberalize across the board but wish to follow controlled and industry-specific liberalization in exchange for equivalent action by other States, where, after negotiation, it appears useful to do so.

### 3. *The regional industrialization programme model*

The oldest example of this approach is offered by ANCOM: the Cartagena Agreement (concluded in 1969, codified in Decision 236 of the Commission of the Agreement, UNCTAD, 1996a, vol. III, p. 27), provides for the progressive integration of the economies of the member countries. This is to be done, *inter alia*, through “industrial programmes and other means of industrial integration” (article 3), which include industrial integration programmes aiming at the participation of at least four member countries, and which may involve the location of plants in countries of the subregion (article 34). Thus, while not including an express provision on the right of establishment, such a right is implicit in the very mechanisms of the industrial policy behind the Cartagena Agreement. Along similar lines, the creation of “Andean Multinational Enterprises” has been provided for since 1971 (see Decision 292 (1991), UNCTAD, 1996a, vol. II, p. 475). These are corporations established in a member country by investors from two or more member countries, which are accorded rights of entry on the basis of national treatment in all member countries.

Other agreements have followed a similar path:

- An industrial integration model has been adopted by the Treaty Establishing the Common Market for Eastern and Southern Africa (COMESA Treaty, article 101, in UNCTAD, 1996a, vol. III, p. 103; Protocol on Co-operation in the field of Industrial Development, article 4, in UNCTAD, 1996a, vol. III, p. 111).
- The revised Treaty of the Economic Community of West African States (ECOWAS) also provides for a policy on intra-regional cross-border joint ventures (article 3(2)(c) and (d)(f) ECOWAS Revised Treaty, 1993, ECOWAS, 1996).
- ASEAN uses this approach for intraregional investors in the Revised Basic Agreement on ASEAN Industrial Joint Ventures

of 1987 (UNCTAD, 1996a, vol. II, p. 281) and in the ASEAN Framework Agreement on Enhancing ASEAN Economic Cooperation (ASEAN, 1992) which, in article 6, encourages cooperation and exchanges among the ASEAN private sectors. The ASEAN Industrial Cooperation Scheme (AICO) of 1996, which replaces the Basic Agreement on Industrial Joint Ventures, and the 1988 Memorandum of Understanding on the Brand-to-Brand Complementation Scheme, offers a preferential regime for products produced or used in cooperative arrangements involving companies from different ASEAN countries. To qualify, companies must be incorporated and operating in any ASEAN country, have a minimum of 30 per cent national equity and undertake resource sharing, industrial complementation or industrial cooperation activities (WTO, 1998, p. 30).

More generally, this approach is typical of regional economic integration groups, and is not often used outside such contexts. It is arguable, however, that treaties creating public international corporations offer a variant in that a special purpose transnational commercial regime is set up between two or more States, and that the resulting legal entity has rights of establishment within the several founding States (Muchlinski, 1995, pp. 79-80).

#### *4. The mutual national treatment model*

The most significant and influential examples of this approach are to be found in the Treaty Establishing the European Community (EC) and in the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations of the OECD:

- The EC Treaty ensures that restrictions on the freedom of establishment, or the freedom to supply services, are removed for natural and legal persons possessing the nationality of a member State (EC Treaty, articles 52-66; UNCTAD, 1996a, vol. III, pp.9-14; European Commission, 1997; Wyatt and Dashwood, 1993, ch.10; Muchlinski, 1995, pp. 245-247). These rights can be enjoyed by a company formed in accordance with the law of a member State and having its registered office, central administration or principal place of business within the EC. This is wide enough to cover the

EC-based affiliates of non-EC parent companies. However, the EC Treaty does not guarantee these rights to companies that have no legally recognized EC presence. The above-mentioned rights are subject to exceptions, in accordance with article 56 of the EC Treaty, which allows differential treatment of foreign nationals on grounds of public policy, public security or public health. Such exceptions, however, are construed strictly.

- This approach is followed in the agreements concluded between the European Union and associated Central and East European States (WTO, 1998, p. 9). However, the Partnership and Co-operation Agreements between the European Union and the States of the Commonwealth of Independent States limit rights of establishment to the setting up of subsidiaries or branches and do not extend to self-employed persons (WTO, 1998, p. 10).
- The two OECD liberalization codes (UNCTAD, 1996a, vol. II, p. 3 and p. 31, respectively)<sup>7</sup> contain a duty to abolish any national restrictions upon the transfers and transactions to which the codes apply. This is reinforced by a positive duty to grant any authorization required for the conclusion or execution of the transactions or transfers covered, and by a duty of non-discrimination in the application of liberalization measures to investors from other member States. The codes permit members to lodge reservations in relation to matters on which full liberalization cannot be immediately achieved.<sup>8</sup> Furthermore, a member is not prevented from taking action that it considers necessary for: "(i) the maintenance of public order or the protection of public health, morals and safety; (ii) the protection of essential security interests; (iii) the fulfilment of its obligations relating to international peace and security". Members can also take measures required to prevent evasion of their laws or regulations. Moreover, where the economic and financial situation of a member justifies such a course, the member need not take all the measures of liberalization provided for in the codes. Similarly, where the member has taken such liberalization measures, it may derogate from those measures where these result in serious economic and financial disturbance or where there exists a seriously deteriorating balance-of-payments situation.

- In 1984 the OECD Code of Liberalisation of Capital Movements was extended to include rights of establishment. Thus annex A states:

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

This definition of the right of establishment is wide enough to cover most policies that restrict, or make conditional, access to non-resident investors, subject to the above-mentioned public policy exemptions to the Code.

This model has also been adopted by several regional organizations established by developing countries:

- Rights of establishment are specifically mentioned in Article 35 of the Treaty Establishing the Caribbean Community (CARICOM); (see UNCTAD, 1996a, vol. III, pp. 44-45). This provision was amended by a protocol adopted in July 1997 which prohibits new restrictions on rights of establishment of nationals of other member States and obliges member States to remove existing restrictions in accordance with the programme to be determined by the Council of Trade and Economic Development, which will set the procedures and timetables for their removal and will specify activities which are exempt from rights of establishment (WTO, 1998, pp. 10-11).
- Similar provisions appear in the Treaty for the Establishment of the Economic Community of Central African States (ECCAS) (article 40, ECCAS Treaty, in UNCTAD, 1996a, vol. III, p. 65), and the 1972 Joint Convention on the Freedom of Movement of Persons and the Right of Establishment in the Central African Customs and Economic Union (Part III, in UNCTAD, 1996a, vol. II, pp. 157-159).



- The Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) of 1987 also contains provisions for rights of entry and establishment (CEPGL article 6, in UNCTAD, 1996a, vol. II, p. 254). However, these are preceded by a detailed regime for what are termed “joint enterprises” and “Community enterprises” (CEPGL articles 2-5, in UNCTAD, 1996a, vol. II, pp. 252-254). Such classes of enterprise are subject to an authorisation process, without which they will not benefit from various advantages offered under the Code (CEPGL Articles 14-42, in UNCTAD, 1996a, vol. II, pp. 256-263). Thus, this agreement also displays aspects of the regional industrialization programme and the investment control models.
- Certain economic cooperation agreements in Africa make commitments to offer rights of establishment to investors from signatory States at a future date through the conclusion of additional protocols. These include the COMESA Treaty (article 164), and the 1991 Treaty Establishing the African Economic Community (article 43) (WTO, 1998, p. 11).
- The ECOWAS Revised Treaty of 1993, in articles 3 (2) and 55, commits member States to the removal of obstacles to the right of establishment within five years of the creation of a customs union between member States (ECOWAS, 1996, p. 660).
- The Framework Agreement on the ASEAN Investment Area (1998) contains a commitment to national treatment for ASEAN investors by 2010, subject to the exceptions provided for under the Agreement (article 4 (6)).

This model is, like the previous model, peculiar to regional economic integration groups, based as it is on preferential rights of entry and establishment for investors from other member States. The two models should be kept distinct, however, because the former deals with specific industrial integration programmes, including the setting up of regional multinational enterprises/joint ventures, while the present model offers general rights of entry and establishment to all investors from other member States. Particular agreements may, of course, combine more than one model. The European Union/Commonwealth of Independent States agreements are distinct in that they are limited for the present to corporate investors,

displaying the characteristics of a transitional regime aimed at eventual full mutual national treatment along the lines of the European agreements with Central and East European States.

### *5. The combined national treatment and most-favoured-nation treatment model*

This model has its origins in United States BIT practice. The United States model BIT states in article II (1):

“With respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of covered investments, each Party shall accord treatment no less favorable than that it accords, in like situations, to investments in its territory of its own nationals or companies (hereinafter “national treatment”), or to investments in its territory of nationals or companies of a third country (hereinafter “most favored nation treatment”), whichever is most favorable (hereinafter “national and most favored nation treatment”)” (United States model BIT 1994, in UNCTAD, 1996a, vol. III, p. 197; and UNCTAD, 1998b).

This provision makes entry into the host State subject to the NT/MFN principle and, to that extent, the host State accepts to limit its sovereign power to regulate the entry of foreign investors. However, this general commitment is made subject to the right of each party to adopt or maintain exceptions falling within one of the activities or matters listed in an annex to the BIT (United States model BIT, 1994, article II (2)).<sup>9</sup> In addition, under article VI performance requirements must not be imposed as a condition for the establishment, expansion or maintenance of investments.

The most significant example of the NT/MFN model is the North American Free Trade Agreement (NAFTA) (UNCTAD, 1996a, vol. III, pp. 73-77):<sup>10</sup>

- Article 1102 of NAFTA grants NT to investors and investments of another contracting party with respect to “the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.”

- Article 1103 extends the MFN principle to investors and investments of another contracting party on the same terms as article 1102.
- Under article 1104, investors and investment from another contracting party are entitled to the better of national or MFN treatment.
- Article 1106 prohibits the imposition of performance requirements in connection with, *inter alia*, the establishment or acquisition of an investment in the host State contracting party.
- Article 1108 permits reservations and exceptions to be made to the above-mentioned Articles for any existing non-conforming measures. These are to be placed in each party's schedule to the Agreement.

Other agreements contain similar provisions:

- The 1994 Treaty on Free Trade between Colombia, Mexico and Venezuela (Article 17-03) accords NT and MFN treatment to investors of another party and their investments subject, *inter alia*, to the right of each party to impose special formalities in connection with the establishment of an investment and to impose information requirements.<sup>11</sup>
- In MERCOSUR, investments of investors from other MERCOSUR member States are to be admitted on the basis of treatment no less favourable than that accorded to domestic investors or investors from third States, subject to the right of each member State to maintain exceptional limitations for a transitional period, which must be detailed in an annex to the Protocol. (Decision 11/93 of the Council of MERCOSUR of 17 January 1994; UNCTAD, 1996a, vol. II, p. 513 and p. 520, for listed exceptions.)
- The Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles are reminiscent of the United States model BIT as they advocate rights of establishment based both on the MFN and NT principles (UNCTAD, 1996a, vol. II, p. 536). However, the APEC instrument is not legally binding,

and its provisions represent “best efforts” only. Also, the NT provision is more restrictive than in the United States model BIT in that it makes non-discrimination subject to domestic law exceptions (Sornarajah, 1995).

- The Framework Agreement on the ASEAN Investment Area of 1998 extends NT to all investors, not only ASEAN investors, by 2020 subject to exceptions provided for under the Agreement (article 4 (b), 7). Furthermore, all industries are opened for investment to ASEAN investors by 2010, and to all investors by 2020, subject to exceptions provided for in the Agreement (article 4 (c), 7). However, the MFN principle extends only to investors and investments from other member States (Articles 8 and 9). This makes clear that investors and investments from non-member States cannot benefit from measures aimed at investors and investments from member States.

The combined NT/MFN model is not as widespread as the investor control model; it is followed in the draft text of the Multilateral Agreement on Investment (MAI) which has been under negotiation.<sup>12</sup>

### Notes

- <sup>1</sup> See also Muchlinski, 1995, chapters 6 and 7; and WTO, 1996, pp. 33-34.
- <sup>2</sup> On national regulatory frameworks for foreign investment see Rubin and Wallace (1993).
- <sup>3</sup> For instance, Nigeria Investment Promotion Commission Decree, 1995, sections 18 and 32; Ghana Investment Promotion Centre Act, 1994, section 18 and Schedule (ICSID, 1995, updated looseleaf, vol. III). Bulgaria Law on Business Activity by Foreign Nationals and Protection of Foreign Investment, 1992, article 5 (3), (ICSID, 1992, updated looseleaf, vol. I); Kazakhstan Law on Foreign Investment, 1991, article 9 (ICSID, 1994, updated looseleaf, vol. IV).
- <sup>4</sup> Typical of this type of provision is article 2(1) of the Barbados-United Kingdom BIT of 1993: “Each Contracting Party shall encourage and create favourable conditions for nationals and companies of the other Contracting Party to invest capital in its territory, and, subject to its right to exercise powers conferred by its laws, shall admit such capital.” Similar provisions can be found in model treaties; see, e.g., article 3, Chilean model BIT 1994; article 2, Chinese model BIT; article 2, French model BIT; article 2, German model BIT 1991; article 3, Swiss model BIT; and article 3, African-Asian Legal Consultative Committee model 1985 (UNCTAD, 1996a, vol. III; UNCTAD 1998b).

- 5 [http://www.asean.or.id/economic/aem/30/frm\\_aia.htm](http://www.asean.or.id/economic/aem/30/frm_aia.htm).
- 6 This was repealed and replaced by subsequent decisions of ANCOM. The current position is contained in Decision 291 of 21 March 1991 which effectively abandoned a common ANCOM policy on FDI regulation. Decision 291 devolves this question to the level of the member countries' national laws, taking the issue out of ANCOM jurisdiction.
- 7 The codes are regularly updated by Decisions of the OECD Council to reflect changes in the positions of members. The updated codes are periodically republished. (For background to the codes, see OECD, 1995; Muchlinski, 1995, pp. 248-250.)
- 8 These reservations are set out in annex B to each code. They offer a good periodic indicator of how far liberalization has actually progressed among the OECD members.
- 9 See further Pattison, 1983, pp. 318-319, for a discussion of the United States-Egypt BIT in this respect.
- 10 See further Eden, 1996, and Gestrin and Rugman, 1994, 1996. See also the Canada-Chile Free Trade Agreement, 5 December 1996, chapter G, Articles G-01 to G-08, for similar provisions (Canada and Chile, 1997).
- 11 [http://www.sice.oas.org/Trade/G3\\_E/G3E\\_TOC.stm](http://www.sice.oas.org/Trade/G3_E/G3E_TOC.stm).
- 12 <http://www.oecd.org/daf/cmismai/negtext.htm>.



## Section III

### INTERACTION WITH OTHER ISSUES AND CONCEPTS

The meaning and scope of admission and entry provisions can be significantly affected by their interaction with other issues addressed in international investment agreements (see table 1). In particular, the actual extent of regulation should be viewed from at least two perspectives:

- (i) the extent to which treaty-based rights of entry and establishment are enhanced and/or limited by other provisions in an investment agreement; and
- (ii) the degree to which the treaty provisions concerned actually affect the operation of the internal laws of the host country.

In relation to these issues, the following matters are of special importance:

- **Definition of investments.** The definition of investment in an instrument that limits the powers of the host State to control, restrict or impose conditions on the entry of FDI (i.e. that grants entry and establishment rights to foreign investors) may bear on the scope of the host country limitations. A broad definition that covers a wide variety of categories of investment (e.g. one which covers both direct and portfolio investment) would limit more extensively a State's powers (Dolzer and Stevens, 1995, pp. 26-31; Energy Charter Treaty, 1994, article 1(6), in UNCTAD, 1996a, vol. II, pp. 548-549). A more restrictive definition would have the effect of covering a smaller range of operations and transactions

over which the powers of the host State are limited by an agreement, thereby allowing greater discretion to the host State with respect to categories of investment not covered.

- **Exceptions and derogations.** No existing investment agreement offers absolute and unconditional rights of entry and establishment. The range of exceptions and derogations has already been indicated earlier, where it was shown that most

**Table 1. Interaction across issues and concepts**

Concepts in other papers	Admission and establishment
Scope and definition	++
Incentives	++
Investment-related trade measures	+
Most-favoured-nation treatment	++
National treatment	++
Fair and equitable treatment	+
Taxation	+
Transfer pricing	+
Competition	+
Transfer of technology	+
Employment	+
Social responsibility	++
Environment	+
Home country measures	+
Host country operational measures	+
Illicit payments	+
Taking of property	+
State contracts	+
Funds transfer	+
Transparency	++
Dispute settlement (investor-State)	++
Dispute settlement (State-State)	+
Modalities and implementation	+

*Source:* UNCTAD.

*Key:*

- 0 = negligible or no interaction.
- + = moderate interaction.
- ++ = extensive interaction.



investment instruments accept legitimate exceptions to such rights on the basis of national security, public health and public policy concerns and for specific activities or industries. Equally, temporary reservations for balance-of-payments and exchange-rate protection have been accepted in agreements at all levels. Furthermore, there is always the possibility of a contracting State to “opt out” by making reservations to provisions that it feels go beyond what it is willing to accept as a restriction on its sovereign power to exclude aliens. Finally, a complicating problem involves sub-national entities in that States may be unable to guarantee compliance with entry and establishment provisions on the part of these authorities, should the national constitution require their consent to such limitations on their sovereignty and such consent is not forthcoming. Thus exceptions for sub-national authorities may be included in a liberalization measure.

- **Incentives.** A further issue related to entry and establishment rights is that of investment incentives (UNCTAD, 1996c). In some instances, the administration of incentives by a host country duplicates the investment control model, in that a set of specific criteria is applied by a government service, although with a view to according the promised incentives, rather than approving the admission or establishment of an investment. As a result, problems and disputes concerning the granting of incentives may often be quite similar to those relating to admission and establishment.
- **Post-entry national treatment and most-favoured-nation treatment.** The application of NT and MFN treatment standards to the post-entry treatment of foreign investors ensures that the original decision to admit an investor is not rendered commercially ineffective by subjecting the investor to discriminatory practices prejudicial to its business interests. In the absence of such treatment it is arguable that rights of entry and establishment can become worthless. Such problems may arise as a result of “hidden screening”, namely the control of inward investment through procedures applied by host authorities as part of their internal regulatory order. Specialized authorization and licensing procedures for specific operations related to the investment (e.g. purchasing of land) that are separate from the original entry decision may be

of special concern. Indeed, such restrictions can exist even in an open-door environment. In this connection, it is useful to have all decisions on entry and establishment centralized in a single screening agency (Wint, 1993).

- **Social responsibility.** Interactions between admission and establishment issues and wider issues of social responsibility can be considerable. In particular, it is at the point of entry that a host country may require certain commitments from a foreign investor. For example, some countries may require a particular legal form to be taken by the foreign investment, such as an incorporated company or a joint venture with local interests, which has as its purpose the furtherance of the host country's policy on corporate governance and accountability. Another example may be the imposition of an obligation to provide for consultation with workers through a workers' council. Furthermore, social responsibility goals could be achieved through the imposition of appropriate performance requirements at the point of entry.
- **Transparency.** The extent to which the regulatory environment in a host country is transparent will materially affect the capacity of foreign investors to gauge the degree of regulatory control and restrictions to which they will be subject. This concept is mentioned in the United States model BIT (article II (5), UNCTAD, 1996a, vol. III, p. 198), but not in other model treaties, though it may be implicit in the concept of "fair and equitable treatment". On the other hand, the concept is frequently found in plurilateral and multilateral investment agreements (Energy Charter Treaty, article 20, in UNCTAD, 1996a, vol. II, p. 562; GATS, article III, in UNCTAD, 1996a, vol. I, p. 289). The practical effect of such a clause is hard to determine, as the obligation it entails may be easily discharged through, for example, the promulgation of relevant laws and regulations in the official bulletin and the regular updating of investment promotion literature. Whether it would be effective in dealing with "hidden screening" is more open to question. In any case, clear treaty entry and establishment language would help to ensure that investors know in advance where State control over such matters remains.

- **Dispute settlement.** Dispute-settlement provisions can enhance rights of entry and establishment by offering effective means for raising claims to investors who feel that a host contracting State has not acted in accordance with its treaty obligations with respect to entry and establishment. However, with respect to agreements in which investors do not have enforceable rights in pre-investment situations, host-country disputes would concern issues arising in later stages of an investment. Therefore, disputes over admission and establishment are likely to involve allegations about State conduct inconsistent with the State's treaty commitments or with its own laws and regulations concerning entry of FDI.



## CONCLUSION:

### ECONOMIC AND DEVELOPMENT IMPLICATIONS AND POLICY OPTIONS

The effects of FDI on a host country's economy, in particular its growth and development prospects, are of special interest to developing countries (UNCTAD, 1995, 1997, 1998c; and UNCTAD, 1992). Concerns in this respect have sometimes led to controls over admission and establishment -- for example, under foreign exchange regulations. Several other, strategic and socio-economic considerations have also regularly figured in host government limitations on admission and establishment; these include defence capabilities, employment effects, technology transfer, and environmental and cultural effects. Host government policies in this respect emerge from the specific mix of political and economic circumstances characterizing particular countries. However, they tend to reflect the following policy options (discussed above), or a combination of them:

- (1) To accept complete State discretion through the investment control model;
- (2) To liberalize cautiously through the adoption of the "opt-in" approach of the selective liberalization model;
- (3) To follow the regional industrial programme model and encourage the establishment of regional multinational enterprises;
- (4) To follow the mutual national treatment model and only allow full liberalization in the framework of a regional economic integration organization;

- (5) To follow the full NT/MFN model and further open up entry and establishment, subject only to a negative list of reserved activities/industries;
- (6) To follow a mix of models bearing in mind that some of the options appear to be inconsistent or difficult to combine.

### A. Option 1: State discretion/investment control

This approach is often preferred by countries that are uncertain about the benefits that may flow from a liberalized policy on entry and establishment. Arguments in favour of such an approach include the possibility that foreign investors engage in business activities that are not desirable -- such as uncompetitive M&As or restrictive practices -- requiring a degree of pre-entry control to assess the overall costs and benefits to the host economy of a proposed investment and to impose specific limitations on such practices. The retention of screening procedures may not deter inward FDI, though it may create an unfavourable image for the host country.<sup>1</sup> Moreover, the use of screening may offer a “once-and-for-all” determination of the right to enter the host State and the added attraction of possible protection against competitive investment by rival firms.

Preferences for screening and restrictions over entry differ according to the industry or activity involved (Conklin and Lecraw, 1997). Thus host countries may prefer to protect infant industries and domestic producers deemed not strong enough to compete with foreign firms. Such restrictions may only be removed where effective competition with foreign investors becomes possible - - or, indeed, necessary -- to ensure the further development of the indigenous industry, as was the case, for example, in the liberalization of foreign entry conditions to the Brazilian informatics industry. Land and natural resources may be subject to screening controls and ownership restrictions to protect what is considered to be part of the natural wealth and resources of the host country. Ownership and establishment restrictions may be more prevalent in certain services industries (e.g. financial services) than in manufacturing owing to the pivotal role these industries play in the national economy and thus the consequent need for effective prudential supervision. Liberalization in this area has thus proceeded at a slower pace. They are prime candidates for an “opt-in” approach

as described under option 2 below. It is also conceivable that restrictions over foreign ownership of infrastructure in a host country are motivated by a desire to regulate a natural monopoly in the public interest. Another justification for controls over foreign entry and establishment is the protection of small and medium-sized enterprises. Finally, controls over foreign access to cultural industries may be justified to protect the cultural heritage of the host country. However, technological change -- including the rise of satellite and digital broadcasting and the widespread use of the Internet -- has thrown into doubt the ability of States to apply effective national controls in this area (Conklin and Lecraw, 1997, p. 18).

## B. Option 2: Selective liberalization

A less restrictive option -- to allow for selective liberalization of entry and establishment in specific activities or industries -- may have the advantage of making liberalization commitments more sensitive to the real locational advantages of a host country, and to permit the country more control over the process of negotiating liberalization measures, given the "stepped" approach to this goal that such a policy entails through the establishment of a positive list of industries in which FDI is allowed. It may be useful for developing countries that fear full liberalization, but would not be opposed to such a policy in activities where they are able to compete on more or less equal terms with foreign investors. It may also be an option which would allow a host country to enhance its future development and competitiveness through the introduction of investment that can stimulate the production of more complex goods and services. To the extent that this option, too, involves an element of loss of sovereignty, it is a gradual and controlled loss offset by the prospects of future economic development.

The circumstances in which a host country may be willing to liberalize a specific activity will echo the explanations given above as to why a specific host country may wish to restrict entry and establishment. Thus, different industries or activities may be more or less amenable to liberalization; liberalization in manufacturing and services may be easier than in natural resources (Conklin and Lecraw, 1997), though even in manufacturing and service industries, national interest may dictate protection.

Finally, it should be noted that the preamble and a number of provisions of the GATS relating to developing countries stress the right of countries to regulate the supply of services within their territories in order to meet national policy objectives. Equally, article IV (1) encourages the negotiation of specific commitments by different members relating to the strengthening of the domestic services capacity of developing countries, their efficiency and competitiveness through, *inter alia*: access to technology on a commercial basis; the improvement of developing country access to distribution channels and information networks; and the liberalization of market access in sectors and modes of supply of export interest to developing countries. Furthermore, developed country members are encouraged, under article IV (2), to establish contact points designed to facilitate service suppliers from developing countries in obtaining relevant commercial and technological information. Thus, GATS does not subject developing countries to immediate liberalization and, in addition, offers certain general commitments to ensure that service suppliers from developing countries can compete in international markets.<sup>2</sup> However, these commitments do not impose positive duties to open up markets for such suppliers.

### C. Option 3: Regional programmes

This approach is a variant of the economic integration model favoured by regional integration groups, applied to a specific policy which seeks to set up a supranational form of business organization aimed at encouraging intraregional economic activity. As such, it offers a vehicle for regional economic development. However, the practical results of such a policy may prove to be mixed. It assumes that local regional capital exists and possesses sufficient technical and managerial skills to be able to perform economic functions without investment from outside the region. This policy may ignore the fact that technology and capital are unevenly spread both within and across regions. On the other hand, such a policy can be useful as a means of breaking down structural barriers to intraregional integration where sufficient resources exist within the region to make such enterprises viable.



#### **D. Option 4: Mutual national treatment**

This approach involves a greater commitment to full liberalization than do those discussed above, though it requires a joint commitment to this process by the States participating in a regional economic integration organization. Consequently, liberalization may proceed between States that see a common interest in regional integration, but which are not necessarily committed to full multilateral liberalization. One major issue in this case is whether the effect of such a commitment is to enhance intraregional investment (and trade) without creating a diversion away from trade with non-members. Importantly, regional integration can offer a larger geographical area within which globally competitive industries can be established.

#### **E. Option 5: National treatment and MFN with negative list of exceptions**

This is the approach preferred by firms and countries that are supportive of liberalization, as it offers the best access to markets, resources and opportunities. It allows investment decisions to be determined on the basis of commercial considerations, by reducing entry controls that create barriers to the integration of production across borders, a strategy increasingly pursued by TNCs (UNCTAD, 1993).

However, the extension of the NT/MFN model to the pre-entry stage is not without its problems. This was vividly illustrated in the negotiations leading up to the Energy Charter Treaty (Dore, 1996, pp. 143-153; Konoplyanik, 1996; Waelde, 1996, p. 277). The principal advocates of such an approach sought to incorporate national treatment into the pre-investment phase so that the Treaty would reflect a standard of protection similar to that of article II of the United States model BIT. All delegations prepared negative lists for the purpose of negotiations on the pre-investment stage, but countries in transition requested a grace period in which to finalize national legislation. As a result, a compromise position was reached whereby the contracting parties would "endeavour" to accord national treatment at the pre-investment phase and would negotiate a supplementary treaty on the issue (Energy Charter Treaty, article 10 (2)-(4) in UNCTAD, 1996a, vol. II, p. 555). While

agreement has been reached on this supplementary treaty along the NT/MFN model with negative lists of existing legislation and the process of privatization, the Charter conference has not yet adopted the text (UNCTAD, 1998a).

The fact that the NT/MFN model allows for negative lists of excepted industries or activities is significant, since it makes clear that this approach recognizes that certain strategic industries may be beyond the reach of liberalization measures. However, it must be emphasized that such lists are difficult to negotiate and compile and may result in a lengthy and complex final text, as NAFTA exemplifies. In countries in which competition is a desired policy goal, such reservations may be of special importance in relation to infant industries that may not be able to withstand the vagaries of open international competition, or as a means of protecting natural resources against uncontrolled foreign ownership. On the other hand, care needs to be taken that such measures are not used to protect inefficient domestic monopolies against competition that may encourage a more efficient use of resources and improvements in consumer welfare.

### F. Option 6: Hybrid

This approach combines elements of more than one of the five basic models. The economic effects of these hybrid options would be to offer more specialized alternatives that may be more compatible with the mix of locational advantages enjoyed by particular host countries. The following combinations are examples:

Option 1 can be coupled with option 2 and/or 3 to produce a policy of investment screening with sectoral liberalization and/or regional industrial development programmes. Option 1 can also be coupled with option 4 so long as option 1 is restricted to investments originating in States that are not members of the relevant regional economic integration organization. Option 1 is incompatible with option 4 as regards investments originating in other member States of a regional economic integration grouping. This hybrid approach would suit a host State that is opposed to full multilateral liberalization on NT/MFN principles but which sees benefits in gradual regional integration. Such combinations are exemplified by

the Arab regional agreements, and the earlier ASEAN agreements mentioned in section II.

Option 4 may be coupled with options 2 and/or 3 to produce a policy of mutual national treatment coupled with sectoral "opt-in" policies for gradual liberalization vis-à-vis non-members of a regional economic integration grouping and/or regional industrial development programmes. This hybrid approach is useful to a host country that wishes to achieve full regional liberalization with its neighbours as a long-term goal but which may want to control that process through gradual sectoral liberalization and which may perceive a need to enhance regional industrial integration through specific projects. The history of European Community market integration is an example of this approach.

Option 5 can be combined with option 2 to produce a policy of general NT and MFN, coupled with a negative list subject to "opt-in" sectoral liberalization at a future date. This approach would suit a host country that wants liberalization on the basis of NT/MFN principles, but prefers gradual liberalization in specific activities. NAFTA is a good example of this approach. Option 3 is not used outside a regional economic integration context and is unlikely to be combined with option 5.<sup>3</sup> Option 5 and option 1 appear, at first sight, to be incompatible. However, the MERCOSUR agreements attempt a reconciliation by using option 1 in relation to non-MERCOSUR investors, and option 5 for MERCOSUR-based investors. Option 4 would be difficult to combine with option 5 except to the extent that special clauses are used (Karl, 1996). It is arguable that the Framework Agreement on the ASEAN Investment Area of 1998 attempts a combination of options 4 and 5 by extending NT and MFN to ASEAN investors first and then extending NT to non-ASEAN investors by 2020. However, MFN is only extended to ASEAN-based investors. Thus a transitional phase approach is used from one option to another.

An important final consideration relates to the types of exceptions and reservations on admission and establishment provisions that may be appropriate for countries in order to pursue their development objectives. Reservations and exceptions to rights of entry and establishment provisions in investment agreements

indeed offer a compromise option for host States that wish to make those rights compatible with their development priorities, so as to avoid having imposed on them blanket commitments to the granting of such rights. The consequences for national laws of having an agreement that protects rights of entry and establishment depend to a large extent on the nature of the derogations and reservations available under that regime. In particular, it has been noted that national security and public health/public policy concerns, including of countries that pursue option 5, are frequently the subject of such measures. Furthermore, in relation to certain specific economic and social issues, States are likely to reserve some degree of flexibility, including: the discretion to approve or disapprove privatization proposals;<sup>4</sup> control of access on the grounds of prudential supervision in the financial services sector; controls over entry and establishment for environmental protection purposes; and restrictions on strategic industries or activities based on economic development considerations.

### Notes

- 1 See, for example, Kudrle, 1995, on Canada, and South Centre, 1997, pp. 60-64, on East Asia.
- 2 The OECD recommends the liberalization of services in developing countries as a positive stimulus to development (OECD, 1989).
- 3 Indeed, a multilateral regional integration programme is a contradiction in terms. However, multilateral industrial development programmes are not inconceivable and could take the form of a public international corporation or an intergovernmental agency of which the Multilateral Investment Guarantee Agency (MIGA) may be an example (see Muchlinski, 1995, pp. 79-80, 515-519).
- 4 There may be differences between States over the extent to which they may seek to guard this discretion (see Muchlinski, 1996; and de Castro and Uhlenbruck, 1997).

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8. If you have read more than the present publication of the UNCTAD Division on Investment, Enterprise Development and Technology, what is your overall assessment of them?

Consistently good  Usually good, but with some exceptions

Generally mediocre  Poor

9. On the average, how useful are these publications to you in your work?

Very useful  Of some use  Irrelevant

10. Are you a regular recipient of *Transnational Corporations* (formerly *The CTC Reporter*), the Division's tri-annual refereed journal?

Yes  No

If not, please check here if you would like to receive a sample copy sent to the name and address you have given above