

Towards A Southern Agenda on International Investment: Discussion Paper on the Role of International Investment Agreements

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Introduction

International investment is an important and complex phenomenon. Research on international investment to date has focused on a limited number of topics, such as the factors that influence investment decisions and the impact of foreign direct investment in selected developing countries. Until recently, other topics have received less attention, notably the universe of international investment agreements (IIAs) and their role in relation to development and sustainable development.

This paper addresses this relationship. It identifies some of the key developments in relation to IIAs, and articulates a number of issues specifically relating to development and sustainable development that require further attention.

This paper should be understood as part of the larger project within which it falls: the development of a Southern Agenda for international investment agreements. It is noted below that the first call for international negotiations with a specific focus on transnational investment was actually in the Havana Charter of 1948. The absence of any effective international processes between developed and developing countries on this issue has left a complex web of bilateral investment treaties and regional trade agreements that include investment in different ways.

IISD believes that a proper negotiation of international investment can only begin when all participants have a sense of what the goals ought to be, rather than what traditional structures say they should be. The issue, in reality, is not whether we have international rules on investment or not: they already exist in various places. Rather, the issue is whether these rules are, or can be made, relevant to the development and sustainable development goals of the global community. The articulation of a developing country agenda is seen as one element that can assist in this process.

1. History of International Investment Agreements

International investment has a very long history but international investment agreements (IIAs) are a relatively recent phenomenon. The Havana Charter of 1948 was intended to form the basis of a universal trade agreement to complement the Bretton Woods institutions.¹ This is the agreement that, for example, spawned the General Agreement on Tariffs and Trade, the GATT. Articles 11 and 12 of the Charter both foresaw the future negotiation of an agreement on transnational investment.² Article 12 set out some parameters for such a negotiation. It recognized that host states have the right, in particular:

- (i) to take any appropriate safeguards necessary to ensure that foreign investment is not used as a basis for interference in its internal affairs or national policies;
- (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 reasonable requirements with respect to existing and future investments;

These negotiating guidelines were not intended to be legally binding. They did, however, recognize the tension between private rights and public goods, and between the movement of capital and the development of domestic economies, that is inherent in any investment. Article 12 of the Charter, whether fortuitously or presciently, suggested the use of bilateral investment agreements, bound by the same principles, if the international process did not generate the anticipated results.

The host-state centred approach of the Havana Charter is far removed from the investment agreements that were actually concluded, beginning with a bilateral agreement between Germany and Pakistan in 1959.³ The principal difference is the narrowing of the focus of IIAs to investor rights and away from the rights of

¹ Havana Charter for an International Trade Organization, at: <http://www.globefield.com/havana.htm>. Article 11 called for international negotiations on an investment agreement. Article 12 sets out set specific guidelines for such negotiations.

² For example, Art. 12 states that “the interests [of investor home and host countries] may be promoted if such [countries] enter into bilateral or multilateral agreements relating to the opportunities and security for investment.”

³ The first BIT was between Germany and Pakistan in 1959, followed by a German-Dominican Republic BIT a month later. See the ICSID list of bilateral investment treaties, 1959–1996, at <http://www.worldbank.org/icsid/treaties/i-1.htm>

host states, details of which are considered below. One impetus for this may be the process of decolonization, which began with Indian independence in 1947 and continued for 20 tumultuous years. Nationalization by means of expropriation was a constant threat. Governments were determined to do everything in their power to protect the rights of their nationals who had invested at a time when the colonies were, to them, little more than a projection of the home country. Powerful countries could and did use the threat of force to protect the foreign assets of their domestic investors, a process that helped develop the early international law on the protection of aliens. Weaker countries had to seek help from international institutions and the formalization of relations. In 1959, Germany was a large weak country with a burgeoning economy. IIAs that focus on investor protection gradually became attractive to countries with large volumes of foreign investment and no credible means to protect them, as well as to host governments eager to avoid the need for gunship diplomacy. Following the conclusion of the Uruguay Round (UR), the negotiation of an international investment agreement appeared like a natural next step, with little focused thought or analysis to support this assumption.

The narrow scope of the issues addressed by foreign investment agreements was also partly consistent with the narrow scope of analysis of foreign investment as being an activity largely related to trade. Indeed, much investment was originally ancillary to trade: colonial investment was designed to exploit natural resources for export, and new investments in “developing” countries were designed to capture local markets that had previously been supplied through trade or to benefit from host country endowments—natural resources and cheap labour—to strengthen competitive positions in international markets. Investment rules came to be based, in large measure, on the trade regime rather than on an analysis of the complex set of relations between an investment and the host state that all required attention if balanced and, therefore, equitable international investment rules were to be drafted.

This narrow vision may have also been reinforced by the fact that one of the common goals of any IIA is to ensure non-discrimination, a concept that is at the core of the GATT. It was but a short step from the articulation of this goal to the assumption that the disciplines that had served the GATT well—most-favoured nation treatment, national treatment, and a measure of transparency—should be the same types of rules applied to transnational investments, and would, therefore, achieve the right approach to non-discrimination in an investment regime.⁴ This in turn obscured the complex institutions employed at national

⁴ von Moltke, Konrad, *Investment, Non-Discrimination, and the Environment*. Paper prepared for the OECD Environment Directorate, 2000.

levels to maintain a balance between investor rights and public goods— institutions that needed to be mirrored or at the very least respected by any IIA.

It would be an exaggeration to describe the conclusion of IIAs between unequal partners as a negotiation: for the most part the putative home country, the one with capital for investment, was almost always able to dictate the terms of these agreements to host countries that were short of capital and desperate to attract more. A large number of IIAs were concluded without real negotiations, giving a false sense of legitimacy to the approach that they represented. In light of these many layers of misunderstanding, it is hardly surprising that the negotiation of IIAs between increasingly equal partners has now become a minefield.

The basic premise and promise of the current model of IIA was that they would be a precursor to the attraction of significant amounts of foreign investment. Recent analysis by the World Bank⁵ and other agencies has shown this premise to have no clear empirical foundation and that this promise remains unfulfilled.⁶ It is not unreasonable, therefore, to argue that IIAs represent one of the great failures of international economic policy of the past few decades. At a minimum, they appear to represent one of the great missed opportunities by failing to recognize and address the broader international goals and domestic relationships associated with foreign investment.

While IIAs have not been of much help, investment remains vital to any market economy and absolutely essential to rectify existing structural shortcomings from the perspective of sustainable development. In basic economic development terms, without continued investment, an economy has no future. In sustainable development terms, economies would be condemned to remain stuck in a condition that is by now widely recognized as being destructive to the essential requirements of a sustainable planet. Literally hundreds of billions of dollars in investments are needed to move unsustainable industrial, energy and natural resource practices to sustainable practices. While this may appear like a daunting figure, it is important to remember that this is not the same as a cost. Investments—including investments that promote sustainability—must generate

⁵ World Bank, *Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities*, 2003, (World Bank, Washington, 2003), p. 129; Mary Hallward-Driemer, *Do Bilateral Investment Treaties Attract FDI? Only a bit... and they could bite*, World Bank, June 2003, http://econ.worldbank.org/files/29143_wps3121.pdf

⁶ The best it seems that can be said of the utility of IIAs to attract investment is that, in some cases, a planned or anticipated investment may not take place without a contractual equivalent. But this does not mean the agreements have served as an attraction point for investors.

returns, including the cost of replacing the investment when needed. Consequently, an approach to sustainable development that focuses on investment actually represents a dramatic reduction in the presumed costs to meet the requirements of Agenda 21 that have been cited ever since the United Nations Conference on Environment and Development.⁷

In the past decade, there has been a dramatic increase in international investment. There is little doubt that foreign direct investment (FDI) will play a significant role in the search for sustainable development, though the positive or negative direction of this role still remains unclear. IISD believes that IIAs that recognize the full panoply of issues can contribute to the transformation of a global economy that is known to be unsustainable into one that has a more hopeful future.

2. Current Status of International Investment Agreements

The number of IIAs is large, yet until quite recently, there have been relatively few studies that seek to assess their form and effectiveness.⁸ It is possible to classify IIAs in terms of the number of parties involved as bilateral, regional or multilateral.⁹

2.1 Bilateral Agreements

Bilateral investment treaties (BITs) have been negotiated since the late 1950s, with upwards of 2,200 having been concluded as of this writing.¹⁰ The agreements were developed as a solution to the long-standing uncertainty as to the applicable international law standards governing the treatment of foreign property and property-owners.¹¹

⁷ The figure most frequently cited is \$625 billion.

⁸ Sornarajah, M., *The International Law on Foreign Investment*, (Cambridge University Press, 1994). A major body of analytical work has been produced by the United Nations Conference on Trade and Development (UNCTAD, www.unctad.org) and the Organisation for Economic Cooperation and Development (OECD, www.oecd.org). The publication policies of the OECD are more restrictive than those of UNCTAD.

⁹ The term "multilateral" is used in the same manner that it has become accepted to speak of the "multilateral trade regime." It denotes an investment agreement that is open to all countries that meet certain requirements and is increasingly synonymous with the concept of universality.

¹⁰ UNCTAD, *World Investment Report 2003*, p. 21.

¹¹ M. Sornarajah, *The International Law on Foreign Investment*, (Cambridge University Press, 1994).

Although provisions included in these agreements differ, at a minimum they typically guarantee foreign investors a right to repatriate their profits and other investment-related funds; a right to most-favoured nation (MFN) treatment and, almost as often, national treatment; a right to compensation in the event of nationalization, expropriation or indirect forms thereof; a guarantee of minimum international standards of treatment (e.g., fair and equitable treatment); and dispute settlement on a state-to-state and investor-to-state basis.

The 1990s saw the most dramatic surge in the volume of these treaties, with their numbers quintupling in that decade.¹² As the WTO's Doha Round of trade negotiations has faltered, many countries have accelerated the negotiations of bilateral free trade agreements.

A growing minority of international investment agreements have supplemented investor protections with commitments designed to liberalize foreign investor access. The context of such provisions, in theory at least, is to establish a continual process of reducing barriers to the acceptance of foreign investment. Typically, this will consist of an undertaking whereby treaty signatories will permit foreign investors to establish or acquire investments on the same basis as domestic investors, or on a national treatment basis. Such undertakings are usually given for specific sectors (those that are "listed-in" in the agreement) or on a broad basis subject to sectors that are "listed-out." In investment law and policy, this is known as "pre-establishment rights" or "rights of establishment." On occasion, pre-establishment commitments may be less generous and extended on an MFN basis, that is, where a host state permits investors of a third state to acquire or establish investments in its territory then the investment treaty accords the same treatment to investors of the other treaty party.¹³

The United States is a force in this shift towards pre-establishment commitments since it includes such commitments in its own treaties. Once a country has concluded such an investment agreement with the United States, it is more likely to embrace this more ambitious template as the new floor for further agreements with third countries. For example, Chile's FTA with Korea that came into force

¹² UNCTAD, "Number of Bilateral Investment Treaties Quintupled During the 1990s," Media Release TAD/INF/2877, available at: <http://r0.unctad.org/en/press/pr2877en.pdf>

¹³ See, for example, the Canada-Venezuela Foreign Investment Promotion and Protection Agreement, available on-line at: <http://www.dfait-maeci.gc.ca/tna-nac/documents/FIPA/VENEZUELA-E.PDF>

on April 1, 2004, models itself after the U.S.-Chile FTA concluded the year before.¹⁴ Likewise, following Canada's conclusion of the North American Free Trade Agreement (NAFTA) with the U.S. and Mexico, which includes pre-establishment commitments, Canada has pursued such commitments in its own stable of investment treaties. The European Union has been much more careful about commitments in this area.¹⁵

It is very difficult to determine the impact of these more than 2,000 agreements. For one thing, not only have the covered issues evolved, the language used to do this is surprisingly variable. Formulations of standard treaty protections may vary somewhat from treaty to treaty and this has given rise to diverging interpretations of their meaning.¹⁶ Even where formulations are very similar, tribunals are not bound to interpret the provisions in a standard light—and in one notable instance, two tribunals offered broadly contradictory readings whether a given set of facts amounted to a breach of key treaty provisions.¹⁷

A growing number of investor-state disputes based on BITs could suggest that they are effective at least in providing investors valuable protection but the evidence is clouded by the lack of transparency associated with the arbitration procedures that are being used. It is literally impossible to know how many disputes have been initiated or how many have been decided—let alone with what results and on what legal basis. While there is suggestive evidence indicating a wide range of outcomes—and even some contradictory results—there is no way to determine what the overall universe looks like. Thanks to the characteristics of some of the common rules of arbitration, a portion of the arbitral iceberg remains hidden from view.

No clear evidence has emerged to show that BITs have made a difference, for example, by increasing investment flows between parties.¹⁸ Yet a number of concerns have been documented. While the BITs seek to establish basic rules of

¹⁴ Peterson, Luke Eric, "Korea-Chile FTA enters into force; contains significant investment commitments," *INVEST-SD News Bulletin*, March 5, 2004, available on-line. at http://www.iisd.org/pdf/2004/investment_investsd_mar5_2004.pdf

¹⁵ See below for the issues that have arisen concerning U.S. BITs with EU accession states.

¹⁶ Peterson, Luke Eric, "Investment Treaty Tribunal Looks Under the Umbrella," *INVEST-SD News Bulletin*, February 16, 2004.

¹⁷ Peterson, Luke Eric, "Research Note on Emerging BITs Disputes," April 2003, available at: http://www.iisd.org/pdf/2003/investment_investsd_note_2003.pdf

¹⁸ World Bank, *Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities*, 2003, (World Bank, Washington, 2003), p. 129.

governmental behaviour for the host countries, they do not themselves meet the most essential standards of transparency and accountability. They do not contribute to the institutional development of host countries to enable them to meet requirements of due process, nor do they ensure that scarce resources are well allocated, in particular when disputes siphon off funding from agencies in developing countries that are under-funded in the first place.

2.2 Regional Agreements

There are no independent regional investment agreements, yet investment is part of most regional trade and economic integration agreements. Since these regional agreements differ widely in their purpose and coverage, the reasons for the inclusion of investment also differ widely.

*2.2.1. European Union.*¹⁹ The European Union (EU) is, among other things, a customs union that involves a significant process of economic and political integration. Citizens of the EU have a right of establishment in all EU countries and there is a guarantee of free movement of capital. The result is an unparalleled degree of openness to investment between member states. “Investment” is so integral to the EU that it is not covered as a separate issue in the EU treaties, which provide for freedom of establishment and free movement of capital between member states. Unlike most investment agreements, the EU embraces the principle of free movement of labour within its borders, even though the implementation of this principle continues to require significant effort.

The EU has an elaborate institutional structure that permits the creation and implementation of new laws at the international level without need for subsequent ratification procedures by member states. As such, it can achieve a balance between private rights and public goods that is beyond the reach of any other international regime. By this means, the EU has created a large and growing body of legislation on environment and sustainable development that serves as a framework for the development policies of the EU and its member states, including any investment between them. Indeed, at least one arbitration under a bilateral investment treaty between Argentina and Spain made express reference to the importance in Europe of environmental impact assessment law

¹⁹ The European Union includes the European Community, which represents the economic integration process. In keeping with widespread practice, no distinction is made here between the European Union and the European Community, even though this may be technically appropriate.

as a principal prerequisite for all investments to proceed.²⁰ This may represent an ideal solution for FDI from a theoretical perspective but it is one that cannot, at present, be duplicated by any other international regime. Yet, it illustrates the range of issues that need to be addressed when investment is opened up at the international level.

The extraordinary range of EU legislation concerning investment and the right of establishment has recently created a conflict between the EU and the U.S. approach to BITs. In the early 1990s, the United States concluded BITs with many of the economies in transition. When eight of these decided to become members of the EU, it became evident that the provisions of the U.S. BITs are incompatible with the investment regime that exists within the EU. The pre-establishment provisions of these BITs would have provided open access of U.S. investors to all EU member states, by way of the freedom of establishment rules. Moreover, the EU has special rules governing investment in transport, energy, agriculture and audio-visual industries that would have been circumvented. It is not an exaggeration to state that the U.S. BITs with the accession states conflicted with the internal development priorities of the EU. As a result, the U.S. BITs with eight accession states have been renegotiated to render them more compliant with EU requirements.²¹

2.2.2. *North American Free Trade Agreement (NAFTA)*. NAFTA is a comprehensive trade and investment agreement between Canada, Mexico and the United States. Unlike the EU, it does not include a customs or monetary union or other political and economic integration elements. In institutional terms, therefore, NAFTA follows a more traditional bilateral agreement model with no single secretariat or institutional home. The governance is provided by the Free Trade Commission, simply a forum for the three trade ministers.

NAFTA's Chapter 11 addresses investment between the three NAFTA parties. It incorporates the disciplines until recently considered appropriate to international investment agreements: national treatment, most-favoured nation treatment, minimum standard of international treatment, rules on expropriation and performance requirements, and state-state and investor-state dispute settlement. It covers both pre- and post-establishment phases of investment. At the time of its conclusion, it was widely considered the most advanced investment agreement

²⁰ Emilio Agustin Maffezini v. The Kingdom of Spain (ICSID Case No. ARB/97/7), Award, November 13, 2000, para. 67.

²¹ "U.S., E.C. Sign Bilateral Investment Understanding for Accession Countries," <http://www.useu.be/Categories/US&EUEnlargement/Sept2203BITsUnderstanding.html>

and was the template on which the draft multilateral agreement on investment (MAI) was subsequently modelled.²²

NAFTA Chapter 11 has become the forum in which many of the problems of the traditional model of international investment agreements are being argued. It has generated a large analytical literature and the governments have twice resorted to interpretative statements in an attempt to correct some of the more egregious shortcomings of the agreement.²³ None of the provisions of NAFTA Chapter 11 has proven entirely unproblematic, with the precise policy implications of most provisions yet to be clearly elucidated.²⁴ The reliance upon existing international institutions for dispute settlement led to a lack of permanent and open institutions of investor-state dispute settlement. This has, in part, meant that the investment provisions may have increased rather than reduced uncertainty in the application of the investment rules. While this uncertainty is in the direction of expanded rights for investors, it is especially problematic for host states that have yet to be able to assess the limitations of NAFTA on the exercise of traditional governmental decision-making.²⁵ The vagaries of the dispute settlement system continue to make predictions about the interpretation of the texts uncertain.

2.2.3. *Mercosur*. Mercosur, including Argentina, Brazil, Paraguay and Uruguay, with Chile and Bolivia as associate members, is characterized by contradictory tensions: the framework for the agreement is a customs union and the institutional structure is modelled on the EU, yet its practices more closely resemble those of traditional trade agreements. Development of the Treaty of Asunción, which established Mercosur,²⁶ occurs by means of protocols that require ratification by the member states. Some of these protocols, including

²² See below.

²³ See the NAFTA Parties July 31, 2001 Interpretive Statement (<http://www.dfait-maeci.gc.ca/tna-nac/NAFTA-Interpr-en.asp>); October 7, 2003 statements: Statement of the Free Trade Commission on Notices of Intent to Submit a Claim to Arbitration, Statement of the Free Trade Commission on Non-Disputing Party Participation; and a bilateral statement from Canada and the United States of America on commitments to have public proceedings in Chapter 11 arbitrations. The agreed statements can be found at <http://www.dfait-maeci.gc.ca/nafta-alena/celeb2-en.asp> and at <http://www.ustr.gov/>

²⁴ Mann, Howard, "Review of Investment Disputes Arising from NAFTA and BITs: A Preliminary Assessment of Implications for Developing Countries." Paper prepared for the United Nations Conference on Trade and Development (UNCTAD), 2004.

²⁵ Cosbey, Aaron, Howard Mann, Luke Eric Peterson and Konrad von Moltke, *Investment and Sustainable Development: A Guide to the Use and Potential of International Investment Agreements*, IISD, Winnipeg, Manitoba, 2004.

²⁶ For Mercosur texts: http://www.sice.oas.org/agreemts/Mercin_e.asp.

three on investment, are taking a long time to ratify.²⁷ Only portions of the Protocol of Montevideo (on services) have been put into force. Consequently, there is currently no Mercosur investment regime in force.

2.2.4. *ASEAN*. The Association of South-East Asian Nations (ASEAN) originated as a defensive alliance of countries that feared the effects of the Vietnam conflict. In 1998, the countries of ASEAN concluded an investment agreement that has a number of unique characteristics.²⁸ The goals of the agreement are clearly articulated: to increase investment flows and to enhance competitiveness. The definition of investment is broad, however, it excludes portfolio investment and services. In addition, there is a precise definition of “ASEAN investors,” one of the few attempts to define the concept of home state. The agreement does not accord rights to investors directly, nor does it provide for investor-state dispute settlement. It establishes obligations for member states to create specified conditions for investment, including national treatment and most-favoured nation treatment. These rights are to be accorded to all ASEAN investors by 2010 and to all investors by 2020, subject to a list of exceptions. In addition, the agreement provides for investment promotion measures to be undertaken by each country with an added structure to promote cooperation. The agreement includes a general safeguard provision as well as a specific provision for balance of payments. It also includes a list of exceptions that are modelled on—but not identical with—GATT Art. XX. The resulting investment regime can only be properly assessed on the basis of detailed knowledge of the promotional measures taken by member states and the steps that have occurred to promote their joint implementation.

2.2.5. *Energy Charter Treaty*. The Energy Charter Treaty was concluded in 1994 to create a framework for investment by most OECD countries in the energy industry of the former Soviet Union.²⁹ The Treaty contains standard investment provisions and investor-state dispute settlement, however, it does not include

²⁷ Protocol of Colonia for the Promotion and Reciprocal Protection of Investments in Mercosur, January 17, 1994. Mercosur Protocol for the Promotion and Protection of Investment of Third States (Buenos Aires Protocol), August 5, 1994. Protocol of Montevideo on Trade in Services in Mercosur, December 15, 1997. See Maryse Robert, Pierre Sauvé, Karsten Steinfatt – “Negotiating Investment Rules: Possible Scenarios for an EU-Mercosur Agreement,” in Paolo Giordano (ed.), *An Integrated Approach to the European Union-Mercosur Association*. Chaire Mercosur de Sciences Po, Paris 2002, pp. 245–265.

²⁸ Framework Agreement on the ASEAN Investment Area. Available at: <http://www.aseansec.org/6466.htm>

²⁹ Walde, Thomas, ed., *The Energy Charter Treaty. An East-West Gateway for Investment and Trade*. The Hague: Kluwer Law International, 1996. Kene Omalu, Mirian, *NAFTA and the Energy Charter Treaty. Compliance with, Implementation and Effectiveness of International Investment Agreements*. (NAFTA Law and Policy Series, Vol. 5). The Hague: Kluwer Law International, 1998. <http://www.encharter.org>

pre-establishment commitments; the latter are the subject of negotiations on a separate protocol that has yet to be concluded. The level of investment in the relevant sectors of the economies in transition has indeed been impressive but there is no way to determine whether or how the Energy Charter Treaty has impacted this process. The investment rules of the Energy Charter Treaty are largely ancillary to the broader purpose of opening up the energy sectors to Western markets, a goal that is pursued through a range of substantive provisions of the treaty. Several investor-state disputes that are available under the Charter, have raised questions about the substantive meaning of the treaty norms. But these disputes have not been made public and there is insufficient information about resulting interpretations and levels of awards to understand their implications.³⁰

2.3 Multilateral Agreements

Negotiating multilateral agreements on investment has been a minefield. The Havana Charter to establish the International Trade Organization included provisions on investment that were considered extremely controversial at the time³¹ and contributed to making it unacceptable to the United States Senate. Fifty years later, negotiations between OECD countries to conclude a Multilateral Agreement on Investment (MAI) collapsed after it attracted a great deal of resistance from numerous groups in civil society including, in particular, the French audio-visual industry. At about the same time, efforts to put investment on the agenda of the World Trade Organization (WTO) at its first Ministerial Meeting led to its being tabled, along with other “Singapore Issues.” A further attempt to revive these negotiations through the Doha Ministerial Declaration formed part of the issues that caused negotiations to collapse two years later in Cancun. No other issue of international economic policy seems to have a comparable history of negotiating failures.

These difficulties are all the more surprising as there has been a steady increase in the negotiation of BITs over the period when multilateral investment negotiations repeatedly failed, and most proposals for a multilateral agreement were modelled on existing bilateral and regional texts. This can only be explained if moving from the bilateral and regional to the multilateral level in some way represents a qualitative change or if, by their size and complexity, the multilateral negotiations revealed flaws in the accepted approach that never became evident through less comprehensive processes and the attendant lack of public scrutiny.

³⁰ As one example of such a case, see Luke Eric Peterson, “Swedish firm wins Energy Charter Treaty case against Republic of Latvia,” December 19, 2003.

³¹ Drache, Daniel, “The Short but Significant Life of the International Trade Organization: Lessons for Our Time,” Centre for the Study of Globalization and Regionalism Working Paper No. 62/00, University of Warwick, 2000, p. 20. (<http://www.warwick.ac.uk/fac/soc/CSGR/wpapers/WP6200a.pdf>)

One qualitative change that generated much resistance is the fact that a multilateral agreement will create obligations between developed (OECD) countries, whereas BITs generally linked an OECD country and a non-OECD country.³² Certainly, the MAI negotiations generated a surprisingly large number of claims for exceptions from countries seeking to maintain protections against foreign investment in certain sensitive sectors—indeed it was disagreement about one such protection, for audio-visual industries, that became the straw that broke the camel’s back and doomed the process. Yet the inevitable question is why problems found to exist in the negotiations between developed countries are not liable, indeed likely, to also exist between these and developing countries.

There is still no agreed approach to the development of a universal investment regime. The MAI was modelled on NAFTA’s investment provisions, concluded a few years before the MAI negotiations began and, at the time, considered the most highly developed agreement. The universe of BITs is highly varied. The differences between regional investment agreements are even more pronounced. The United States, Canada and Japan, promote BITs that include pre-establishment rights. The member states of the EU do not, and the investment provisions of EU bilateral trade agreements tend to be even more prudent. The debate about investment negotiations in the WTO did not lead to agreed “modalities,” that is an agenda for negotiation that seemed capable of attracting a consensus, even though the aspirations of the countries promoting such an agreement tended to become more modest as time went on.

Only two multilateral investment agreements currently exist, and they are both part of the World Trade Organization (WTO): the General Agreement on Trade in Services (GATS) and the Agreement on Trade Related Investment Measures (TRIMs). They take a very indirect approach to the problem of investment. The GATS incorporates a limited set of rules on investment, aimed primarily at ensuring most-favoured nation treatment and certain levels of transparency for services that are provided through a local presence (referred to as a “commercial presence” in the legal texts) in the foreign country. Rights of market access for foreign service providers, however, are governed by specific commitments “listed in” in schedules by each WTO Member. The TRIMs agreement, on the other hand, addresses a limited set of specific issues related to trade in products produced or used by an investment.

This difference of approaches adopted in the GATS and TRIMs Agreements reflects differences in the relationship between investment rules and trade in services on the one hand, and trade in goods on the other. As trade in services

³² In more recent times this is changing, with an increasing number of south-south BITs being concluded.

often involves some form of investment, the investment rules of the GATS are there because they are needed. The relationship between investment and trade in goods, however, is much more tenuous. Clearly foreign direct investment (FDI) and trade in goods are related. Yet the fact that they are related does not lead to any clear conclusions: it means neither that trade and investment should be treated in essentially the same manner nor that investment negotiations must necessarily be conducted in the trade regime. Indeed, a simple assumption on either of these points would ignore the vastly different types of linkages to the local environment and ecosystem, labour, human welfare and human rights, and political, legal and administrative institutions that an investment in a community and country have, as compared to trade in a product.

The word “investment” occurs but twice in the GATS: in Article XVI (on Market Access).³³ This is because the investment provisions that are part of the GATS are subsidiary to its service-trade liberalizing provisions and are designed to avoid hidden protectionism and to protect investments that are an integral part of services such as banking and transport. As such, it should be noted, these investment provisions are subject to Article XII (Restrictions to Safeguard the Balance of Payments) and Article XIV (General Exceptions).³⁴ By contrast, many IIAs do not include such safeguards.

The investment implications of the GATS are largely derived from the key definition of Article I.2, which identifies the “modes” by which services can be supplied. Several of these imply a significant presence in the country where the service is provided, and provide the basic protections of the GATS to the investments that are an integral part of this presence. Consequently, the investment provisions of GATS bear little or no resemblance to the provisions that are typically found in investment agreements and in the TRIMs agreement in particular.

The TRIMs Agreement is a fairly constrained document, resulting from the desire of some countries to go much further in the direction of a multilateral agreement on investment and the resistance of other countries to any agreement on investment within the framework of the WTO. Its operative provisions are

³³ Investment is mentioned first in a provision prohibiting quantitative limitations—in sectors where market-access commitments are undertaken—on the participation of foreign capital; and again in an annex on financial services.

³⁴ The OECD Codes of Liberalization have “classic” exceptions for public order or the protection of public health, morals and safety, essential security interests, and the fulfillment of obligations relating to international peace and security. The draft MAI had much more restrictive exceptions, pertaining to security and disarmament. NAFTA Chapter XI and most BITs have no such exceptions.

contained in a single sentence of Art 2.1: “Without 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.” These are, respectively, the provisions obliging states to provide national treatment for trade in goods, and the provisions prohibiting quantitative restrictions on imports or exports. The Agreement is notable for its lack of any reference to most-favoured nation treatment, and for the lack of a specific definition of either “investment” or “trade-related investment measure.” Rather, an Annex provides an illustrative list of TRIMs that are inconsistent with Article III or Article XI of the GATT. In the terminology of international investment agreements, the measures that are listed in the Annex are “performance requirements,” such as requirements that investors purchase inputs from domestic suppliers.

Based on these provisions, it has been argued that “investment is already in the WTO and that the proposal to negotiate further on investment does not represent a major departure. Yet the attempt to agree modalities failed, contributing to the breakdown of negotiations at the Cancun WTO Ministerial Conference. Indeed, the limited investment provisions in the current WTO Agreements address practically none of the numerous issues that have proven controversial in other investment agreements.

3. Issues Related to Investment Agreements and Development

Research on international investment agreements is surprisingly limited, certainly when compared to the extensive literature on trade agreements. This may have to do with the fact that no robust economic theory underpins international investment in the manner in which the theory of comparative advantage underpins trade policy. On the one hand, investment is a core economic activity, without which no market economy can function. On the other hand, international investment is about the acquisition of complex rights in foreign countries, ranging from the ownership of property to the rights to hire and fire or to use natural resources and to emit waste into the environment. This combination of economic and legal dimensions, combined with a profound institutional dimension, makes international investment one of the ultimate interdisciplinary topics, not unlike the environment: difficult to analyze, even more difficult to manage successfully, yet essential for the functioning of society.

The relationship of investment to development and sustainable development is self-evident. Without investment there can be no development. Increasingly, this investment is made based on a capacity to move capital globally. Whether or not foreign investment is an absolute economic requirement for all countries to be

able to pursue sustainable development opportunities, it is clear that the capacity for foreign investment to contribute positively or negatively is a critical issue in economic globalization. The challenge is, however, not only to promote investment and the diversity of investment into less developed countries, it is to promote private investment that advances essential goals of public policy: creation of employment, technology transfer, environmental improvement and poverty reduction. This is a demanding task, vastly more complex than trade liberalization. Indeed, it has little to do with “liberalization” since it requires a careful balancing of private rights and public goods at all levels (including the international level) in a manner that is legitimate, transparent and accountable.³⁵

The United Nations Conference on Trade and Development (UNCTAD) has assumed an important role in relation to investment. This grew out of its concern for development but the striking fact is that there are no other organizations within the UN system that laid claim to the issue. “Through its programme of Investment, Technology and Enterprise Development, UNCTAD analyses trends in foreign direct investment and their impact on development; helps countries to promote international investment and understand the issues involved in international investment agreements; devises strategies for the development of small and medium-sized enterprises; identifies policy options and implements capacity-building programmes to encourage the use of new technologies.”³⁶

The Organization for Economic Cooperation and Development (OECD) “covers financial issues related to banking, securities and institutional investors, promotes liberalization in financial services and the development of international financial best practices. It promotes co-operation among governments concerning FDI and other capital movements, helping to improve the domestic policy environment for attracting and reaping the full benefits of FDI.”³⁷

The World Bank group deals with investment. From its beginnings, it has sought to provide loan funds for public investment to create conditions for economic development. Private investment is much different: it is driven by the absolute need to generate revenues to cover the cost of investment—the cost of capital, depreciation and a reasonable profit—and by the relationship between risk and return. “The World Bank’s Investment Climate Program provides analysis and

³⁵ Cosby, Aaron, Howard Mann, Luke Eric Peterson and Konrad von Moltke, *Investment and Sustainable Development: A Guide to the Use and Potential of International Investment Agreements*, IISD, Winnipeg, Manitoba, 2004.

³⁶ <http://www.unctad.org/Templates/Page.asp?intItemID=1533&lang=1>

³⁷ http://www.oecd.org/topic/0,2686,en_2649_37467_1_1_1_1_37467,00.html

advice to countries considering reforms to accelerate growth and employment. Such reforms are bolstered by objective information on the conditions facing firms making investment decisions. Investment climate surveys yield information that helps quantify these obstacles and their impact on firm productivity, employment and investment.”³⁸ The World Bank also created the International Center for the Settlement of Investment Disputes (ICSID), one of the principal institutions for investor-state dispute settlement.³⁹ The level of transparency of ICSID arbitrations has been enhanced thanks to efforts of individual governments, in particular in the NAFTA countries, and the Center continues to be the most acceptable of the available arbitral institutions. The World Bank has further established the Multilateral Investment Guarantee Agency (MIGA) to promote FDI in developing countries.⁴⁰

The range of items and institutional structures these major international actors point to highlights the fact that the research and policy agenda on international investment agreements is indeed substantial and has not yet developed as might be expected. Among the issues that require attention are issues that revolve around the provisions of existing agreements, the dynamics of FDI and the conditions under which it may contribute to development and sustainable development. Some of the issues that have emerged recently are discussed in the following sections.

3.1 The Impact of Provisions in Existing IIAs

A number of provisions are to be found in many existing IIAs. They may appear to be uncontroversial. Yet, following the experience with NAFTA, a remarkable number of issues have arisen surrounding these provisions, many of which appear to have caught policy-makers unawares, suggesting that the existing agreements have not been negotiated as carefully as they deserve.

3.1.1. National Treatment. Productive investments are frequently highly specific. Even facilities that are replicated many times, for example fossil fuel fired power plants, exhibit a remarkable degree of variation in practice. The principle of national treatment depends on a determination, which investments are to be considered to be comparable, or “in like circumstances.” The corresponding GATT principle revolves around the concept of “like” products that must be accorded national treatment. Determining which products are indeed “like” has

³⁸ <http://iresearch.worldbank.org/ics/jsp/index.jsp>

³⁹ <http://www.worldbank.org/icsid>

⁴⁰ <http://www.miga.org>

proven difficult, in particular from the perspective of environment and sustainable development. Most IIAs refer to “like circumstances,” increasing the scope for interpretation. The seemingly straight-forward standard is rendered more complex still by time factors in investment: new facilities cannot readily be compared to facilities that have existed for ten or more years.

3.1.2. *Most-Favoured Nation Treatment.* The principle of MFN is likewise adopted from the GATT. Like the principle of national treatment, it revolves around the concept of “likeness.” In addition, however, the existence of a crazy-quilt of IIAs has left doubts as to the extent of MFN. Can investors “cherry-pick” all investment agreements signed by a country? Can they at least seek out other agreements when specific issues are formulated in ways that appear more attractive to them? Some IIAs now contain provisions limiting the application of MFN—a precaution that implies that agreements lacking such provisions are subject to extensive interpretation.

3.1.3. *Transparency.* Together with national treatment and MFN, the safeguarding of a measure of transparency is an essential institution to achieve non-discrimination. Investors must be able to determine what rules apply to their investment and those made under like circumstances in the host country. Yet, the achievement of transparency relative to investments represents a vastly more complex undertaking than for goods, because investment is a more complex phenomenon than trade. In addition, the paradoxical situation has arisen where the IIAs themselves suffer from fundamental defects when it comes to transparency and accountability of the investor-state dispute settlement process.⁴¹

3.1.4. *International Standards of Treatment.* Ensuring “fair and equitable treatment” or some such standard of treatment appears a reasonable goal for an IIA. Yet, the application of the appropriate standard would require the existence of a robust body of analysis and interpretation such as underpins the application of the law in most countries. In the absence of such a literature, significant uncertainty remains as to the meaning and reach of this principle—leading to one of the interpretative statements under NAFTA that does not, however, evacuate all uncertainties.

3.1.5. *Expropriation.* The protection of investors from expropriation without due process and fair compensation again appears as an almost self-evident provision. Where an investor is deprived of his property, as in the expropriation of real estate, most countries recognize the need for compensation and provide elaborate institutional means to ensure that it is provided. Investors in most countries are

⁴¹ See below.

often dissatisfied with the outcome of such procedures and can have recourse to appeals. Where those rights have been curtailed, international protection for foreign investors provides them with a forum for appeal that is not available to domestic investors. Yet, to the extent that manifest injustice has been done, this does not argue in favour of depriving some investors of recourse. The issue of expropriation has, however, become intensely controversial as the text of some IIAs has included measures “tantamount to expropriation,” and the interpretation of others has gone in a similar direction. Not only does this create significant uncertainty for investors and public authorities, it creates a risk that legitimate regulatory action in the public interest may be found to be tantamount to expropriation. Unlike the underlying concept of expropriation, the putative extension of this concept into regulatory areas is highly controversial and raises many concerns.

3.1.6. Regulation and Exceptions. Initially, in response to environmental pressures, drafters of IIAs have sought solutions to the “right to regulate” problem, that is the right of public authorities in host countries to regulate investments in the public interest. Turning once again to the GATT, and its exceptions in Art. XX that have played a central role in avoiding conflicts between trade and environment, a range of texts have emerged articulating public interest exceptions to the principles of national treatment and non-discrimination. The problem with this approach is that legitimate regulatory actions are not the exception—they represent public authorities doing what they are authorized to do and addressing them as exceptions represents an immediate distortion of the relationship between investors and host states.

3.1.7. Dispute Settlement. No aspect of IIAs has created more controversy than the investor-state dispute settlement process. Fundamentally, the existence of such a process appears to be an appropriate, perhaps even a necessary, aspect of IIAs. Individuals invest, not states, so disputes will arise between investors and host states and an international forum to settle such disputes appears desirable. The general practice, however, to use the institutions of commercial arbitration for this purpose has created a situation where the investor-state dispute settlement process generally does not meet basic requirements in terms of legitimacy, transparency and accountability.⁴² The process of interpreting the numerous provisions of IIAs that require elucidation cannot get under way, leaving uncertainty to be exploited by investors and their lawyers on the one

⁴² von Moltke, Konrad and Howard Mann, “Misappropriation of Institutions: Some Lessons from the Environmental Dimension of the NAFTA Investor-State Dispute Settlement Process,” *International Environmental Agreements*, vol. 1 no. 1 (January 2001), pp. 103–123.

hand, and weigh on public officials confronted by an unpredictable dispute settlement process on the other hand.

3.2 IIAs and Investment Flows

The most widespread assumption about international investment agreements is that they promote investment by limiting risk. Little empirical evidence has emerged to support the contention that the treaties stimulate new and additional flows of foreign direct investment. There is no recognizable relationship between IIAs and investment flows. Some countries that are party to no IIAs receive significant investment and many countries that are party to numerous IIAs receive almost none. Some countries that receive investment are indeed party to IIAs but the investment does not follow the pattern of agreements in any discernible manner.⁴³

The inescapable conclusion is that investment decisions are conditioned by other factors that outweigh any advantages conferred by IIAs. The identification of these factors is important as a source of direction for public policy. A number of issues have been identified thus far.⁴⁴

3.2.1. *Markets.* Investments can only be made where there is a market for the products or services produced by the investment at prices that cover its costs and promise a reasonable profit. These markets can be local, national or international. One of the factors promoting investment in Mexico post-NAFTA appears to have been the access it provided to North American markets, rather than the nature of the Mexican market. One of the major limitations of investment in certain public services, such as water supply and sanitation, is the ability of local markets to support the costs associated with making and upgrading those investments. Understanding markets and ensuring that they function in a satisfactory manner is important to promoting investment flows.

3.2.2. *Labour.* The availability of (skilled) labour is frequently critical for investment. Numerous examples are known where investments are made to capture low labour costs with a view to utilizing output from the investment within global product chains. The appropriate framing of this issue is one of the

⁴³ Hallward-Driemer, Mary, *Do Bilateral Investment Treaties Attract FDI? Only a bit... and they could bite*, World Bank, June 2003, http://econ.worldbank.org/files/29143_wps3121.pdf

⁴⁴ Balasubramanyam, V.N., "Foreign Direct Investment in Developing Countries: Determinants and Impacts," paper prepared for OECD Global Forum on International Investment, Mexico City, Nov.26-27, 2001, p. 13.

more challenging tasks of the sustainable development debate. On the one hand, low labour costs are a critical source of comparative advantage for producers in developing countries; on the other hand, it is important that fundamental labour rights are respected, including the payment of a living wage. Where skilled labour is not available locally, the ability to move qualified persons in and out of the host country becomes important, in addition to the need to control certain key appointments in relation to investments that are integrated into an international product chain, whether these are filled from the host country or elsewhere.

3.2.3. *Natural Resources.* Numerous foreign investments are made to ensure access to important natural resources. Indeed, certain resources are so critical that investments are made almost irrespective of conditions in the host country. Investors in oil supply have little choice: they must invest where the oil is and do not have the luxury of choice. They have consequently struggled with issues relating to sustainable development and the respect for the rights of indigenous populations.

3.2.4. *Infrastructure.* The existence of key infrastructure—transport, communications, energy and environmental services in particular—is critical to many investments, whether to produce goods or services. In some instances, such as the exploitation of natural resources, investors are willing to create necessary infrastructure as part of their overall investment.

3.2.5. *Public Institutions.* Foreign investors are dependent on the institutions of governance of the host country. They need timely, impartial and effective administration of the rules and regulations governing their activities, including a process of review and appeal. While the existence of good governance alone does not guarantee the flow of investments, all other things being equal, the quality of governance can have a decisive impact on investment decisions. The absence of the institutions of good governance has frequently been the reason for the development of IIAs. The paradox is IIAs themselves have now been shown not to meet essential criteria of good governance—and recourse to them can contribute to undermining efforts to establish appropriate institutions in the host country.

3.2.6. *Private Institutions.* Investments do not exist in an institutional vacuum. They require a range of private institutions to provide necessary support, mostly in the form of services: banking, legal advice, insurance at a minimum, and frequently also technical support and other forms of consultative services. Investment risk rises rapidly in the absence of such institutions. No IIAs have thus far been designed that can reduce those risks.

This list of issues illustrates that investment is a complex economic and social phenomenon with numerous implications for sustainable development. An adequate understanding of the full agenda of investment is a condition for fashioning successful international investment regimes.

3.3 The Interests of Host State and Home State

The rights that IIAs confer are formally reciprocal. In this they reflect the assumptions that underpin trade agreements. In fact, the relationships are much more complex, reflecting a much wider range of interests and issues that need to be taken into consideration when it comes to investment. Until recently, countries party to BITs were typically either host state or home state but rarely both—it has already been noted that few BITs or regional agreements exist strictly between OECD countries. Thus, in practice, the formal reciprocity hid the non-reciprocal relationship of capital exporters and capital importers. To date, the real change here is the growing number of IIAs between developing countries. The ASEAN investment agreement, while not yet fully developed, is possibly the most carefully reciprocal of all IIAs and reflects this fact in a number of characteristic provisions that are not replicated in other agreements, in particular, by shifting its emphasis from formal non-discrimination to joint promotion of investment.

The objectives of capital importing and capital exporting countries are often different. Countries that export capital have a range of interests relating to security of investment and the ability to repatriate profits. Frequently, such countries need secure access to commodities, energy supplies in particular. Moreover, countries with aging populations may need to invest in countries with labour surplus not only to benefit from the lower wage levels but also to contribute to palliating their social security deficits. Yet, for investments in other countries to serve social security needs it is essential that they offer long-term stability and that exchange rate risks can be managed successfully.

Host countries typically seek not only to alleviate their own shortage of capital but to ensure that investments contribute to the numerous unmet needs of their economy and populations: strengthening institutions and infrastructure, providing public services, combating poverty, transferring technology and protecting public goods such as the environment—in short, sustainable development.

In addition, there may also be international interests in investments shared by home and host country—security, development and the protection of international public goods, including environmental goods.

IAs need to reflect the full range of host country, home country and shared interests in a manner that ensures that all parties benefit. Carefully-crafted IAs can presumably achieve this purpose, but such agreements would need to look quite different from most existing IAs.

3.4 Development and Sustainable Development

Investment is the engine of development and required to make a more sustainable global economy possible. Yet, investment has not moved to the center of the debate about sustainable development. This may be due in part to the complexity of the investment process. On the one hand, investments depend on a range of public goods and services—as outlined above. On the other hand, private capital is at risk and consequently public authorities have a circumscribed role to play in relation to such investment decisions. Finding a balance between private rights and public interests is difficult. Moreover, different countries that have market economies and that trade vigorously with each other still have strikingly different approaches how they deal with issues of investment. There is no ready international consensus on how or where to strike the balance that must be found. Moreover, two of the major actors in international economic negotiations, the U.S. federal government and the EC Commission, have limited direct involvement in decisions where investments are being considered, either by the investor or the regulating level of government.

The U.S. federal government does not itself exercise many of the competences that come into play when governmental decisions concerning specific investments in the United States are taken. Frequently, these powers lie with the states, perhaps circumscribed by federal legislation. Not only does the federal government have little control over these processes, it has no expectation of being able to give them a particular direction, whether towards sustainability or some other desired goal of public policy. The U.S. approach to economic policy has been articulated as the “Washington Consensus,” a vision of international economic policy modelled on U.S. practices at the federal level. This has, on occasion, made it difficult to effectively communicate the priorities of sustainable development, essentially a paradigm that represents the principal current alternative to the Washington Consensus, to federal policy-makers in the United States.

In the European Union, the role of the Commission and member states in relation to investment is shifting. While investment has largely been the domain of member states—negotiations for the MAI were conducted without Commission participation and the EU has signed no BITs. Yet the draft EU Constitutional

treaty, if adopted, will add foreign direct investment to the international economic policy issues that fall under the former Art. 233—giving the Commission a larger measure of control. With the blessing of the member states, investment already has for some time been included in all bilateral and inter-regional trade negotiations conducted by the EU, negotiations that follow a different internal path than those at the WTO. Like the U.S. federal government, the EC Commission does not participate directly in the kinds of decisions that are required in relation to individual and specific investments.

Differences in approach to the issue of investment did not matter as long as capital remained within the confines of a single country. In an increasingly open global economy, differences matter, in particular the practices of major actors such as the United States and the European Union. While both adhere to the same economic principles, their approaches to the application of these principles differ significantly. Third countries are confronted with a fairly confusing picture that is increasingly mirrored in IIAs. The U.S. model, with variations that reflect the ability of partners to introduce their own priorities, is based on a limited view of government. Issues relating to development or sustainable development do not penetrate. The EU model, incorporated in bilateral free trade agreements, has been evolving steadily, seeking to find ways to embrace the imperatives of sustainable development or at least to avoid outright conflicts with them. At the same time, EU Member states continue to conclude BITs, creating a jumble of provisions and obligations that have become virtually impenetrable.

At the present time, it is not possible to articulate more than the need for robust debate about IIAs and sustainable development as well as the most appropriate provisions to include in new agreements that may be negotiated. The current agreements differ widely in terms of their sensitivity to development considerations. On occasion, they may reference development objectives in their preambles or contain express exceptions designed to exempt government assistance pursuant to a national development plan or policy,⁴⁵ or provide for sectoral exceptions for certain sensitive industries or services.⁴⁶ However, the overwhelming bulk of these agreements give no attention to the special development needs of the lesser-developed treaty party. Moreover, even in those rare instances where treaties do provide for express development flexibility, questions arise as to the suitability of ad-hoc arbitration tribunals to interpret and apply those provisions. This concern is discussed more fully below.

⁴⁵ See, for example, the U.K.'s 1990 agreement with Morocco for an example of the latter.

⁴⁶ Japan's 2003 investment agreement with Vietnam provides an example of an agreement which provides for extensive sectoral exceptions, as well as lengthier phase-in of some commitments.

3.5 Pre-establishment Commitments and Development Priorities

The issues surrounding sustainable development and IIA's are in sharpest focus when new investments are under consideration—what has come to be known as the pre-establishment phase. In this phase, prospective investors are seeking a range of decisions and measures by policy-makers. These policy-makers are seeking to attract investment, possibly to meet certain priorities, for example, with regard to regional development, promotion of the rights of disadvantaged groups or even environmental concerns.⁴⁷ Once an investment has been accepted or made, a series of rights and obligations come into focus—sometimes through the iteration of specific legal instruments (licenses, contracts, etc.). More generally, the investor then becomes an economic citizen of the host country.

For the most part, past IIAs have left to host states decisions about the entry of individual investments or the acquisition by foreigners of existing domestic investments. At times, this will be explicit—as for example, where treaties note that capital shall be admitted subject to the rights of states to exercise powers conferred by their laws—more often it will be implicit.⁴⁸ Increasingly, however, some capital exporting nations, including the United States, Canada, Mexico, Korea, Singapore and Japan are seeking pre-establishment commitments in the IIAs to which they are party. As already noted, such commitments oblige host states to accord foreigners comparable footing to domestic investors when it comes to the establishment or acquisition of an investment. Where such commitments are undertaken, it will be critical for treaty signatories to conduct an assessment of their own economies and development priorities in order to lodge appropriate exceptions and limitations. In practice, developing countries are not always well-equipped to undertake such a sweeping assessment—and, while Western governments may enter a raft of detailed exceptions, the developing country party may enter far fewer, sometimes out of fear of losing the agreement altogether. Accordingly, pre-establishment commitments can be a sleeper issue which may have implications only down the road. While opening of many sectors to foreign investment may be a salutary step for a given country, doing so by virtue of binding international legal commitments will leave little wriggle-room in the event that unforeseen complications arise down the road. Indeed, the intent of this area of negotiations is to make the commitments irreversible and seek ongoing commitments to future liberalization.

⁴⁷ Organisation for Economic Cooperation and Development (OECD), Checklist for Foreign Direct Investment Policies. Paris: OECD, 2003.

⁴⁸ For an example of the former, see article 2 of the U.K.-Malaysia Investment Promotion and Protection Agreement.

3.6 Performance Requirements

So-called performance requirements may encompass a wide range of duties or obligations applied to foreign investors; these may run the gamut from obligations to transfer technologies and requirements to generate local employment, to source local inputs.

The imposition of certain of these requirements may be prohibited under the terms of an investment agreement, or they may be permitted only where they are conditioned upon the extension of some incentive to the given foreign investor. The WTO TRIMs agreement proscribes a series of performance requirements, but in a strictly limited context. A small, but growing, number of investment agreements also prohibit wider categories of performance requirements, including ones related to employment of locals, transfer of technologies, mandatory levels of research and development, sourcing of local supplies and others.⁴⁹

This practice is on the rise, notwithstanding the fact that the literature on such requirements remains mixed. Some authors have cautioned that the use of certain performance requirements may be inefficient and a deterrent to new investment. At the same time, a recent study by UNCTAD notes that a number of performance requirements “seem to have played a positive developmental role” and suggests that this should argue against further restrictions on their use.⁵⁰ UNCTAD observes that host governments may be best placed to assess, in a particular instance, whether a given requirement might serve to dissuade FDI, and “to weigh these costs and risks against the expected development gains.”

A further concern which is raised by treaty prohibitions on performance requirements is that they may interfere with efforts by host governments to impose social obligations on businesses (both foreign and domestic) designed to further broader goals of racial or ethnic equality. Both South Africa and Malaysia have used a series of policy measures designed to redress economic imbalances between ethnic groups. However, measures such as preferential hiring of persons from disadvantaged groups, or sourcing of material and services from local

⁴⁹ See, for example, the 2003 Japan-Vietnam Agreement for the Liberalization, Promotion and Protection of Investment which prohibits all of these, and a number of others. Some of these requirements are permissible under the Japan-Vietnam treaty provided that they are accompanied with incentives to the affected foreign investor.

⁵⁰ United Nations Conference on Trade and Development (UNCTAD), *Foreign Direct Investment and Performance Requirements. New Evidence from Selected Countries*. Geneva: UNCTAD, 2004.
<http://www.unctad.org/Templates/webflyer.asp?docid=4378&intItemID=1397&lang=1&mode=toc>

minority firms, might constitute violations of common treaty prohibitions against employment or content rules. Indeed, some such measures have been criticized by some business representatives on these grounds.⁵¹ For this very reason, some parties have endeavoured to ensure that treaty prohibitions against performance requirements are caveated by exceptions for such social programs and measures. In the U.S.-Chile Free Trade Agreement, both parties entered exceptions respecting “the right to adopt or maintain any measure according rights or preferences to socially or economically disadvantaged minorities.”⁵² Likewise, Chile also created an exception which protects its right to accord special rights or preferences to “indigenous peoples.” However, other parties accepting disciplines on performance requirements have not always displayed such foresight. A failure to anticipate the need for such exceptions could complicate subsequent efforts to impose such social obligations on foreign investors.

3.7 Technology Transfer

There has been a vigorous debate about the prospects for technology transfer in connection with FDI. The evidence remains ambiguous. Foreign investors frequently employ technologies that are new to the host country, including investors in services. These technologies can be a source of significant competitive advantage for the foreign investment. Foreign investors frequently need to be able to send foreign staff to fill top management positions. Yet, they also generally employ local workers who receive training as needed. In this manner, knowledge and skills may be transmitted. Similarly, local suppliers may acquire new technologies, from the foreign investor, or as a condition of being used as suppliers, and these may spread further into the economy. Nevertheless, attempts to be more specific about technology transfer or to move beyond individual cases to identify structural processes have not been particularly successful. Even when technology transfer occurs, this can be the consequence of a general process of opening a country to international markets and trends, of which FDI is a part.

The desire to promote technology transfer, to strengthen an economy or to support sustainable development, are reasonable goals of public policy. Yet, the means of achieving this goal are not entirely clear. The availability of skilled local workers, and hence the infrastructure of training and innovation, is an important

⁵¹ Peterson, Luke Eric, “South Africa’s Black Economic Empowerment Plans an Obstacle to a U.S. FTA?,” *INVEST-SD News Bulletin*, July 8, 2003.

⁵² U.S.-Chile Free Trade Agreement, Annex II, Schedule of Chile, pg. II-CH-6 and Schedule of United States, II-US-3.

factor. It is intuitive that the use of performance requirements in this context can be advantageous, yet this must occur in a manner that respects competitive processes in the market and is not viewed by investors as putting proprietary knowledge or intellectual property rights at risk. It has been argued that a reliable system of IPR protection will contribute to this outcome, but again the evidence is not as clear as one would like for purposes of proposing specific policy measures.

It is clear that instances of *mandatory* technology transfer are increasingly rare.⁵³ Rather, host governments are more likely to seek to induce such transfers through the use of targeted incentives. The success of such transfers will be critically dependent upon the absorptive capacities of the host country and, particularly, its labour force. Viewed in this light, prohibitions against mandatory technology transfer in investment treaties seem marginal, geared to investor interests and certainly not designed to stimulate enhanced volumes of technology transfer—which remains the over-riding policy objective of many developing country host states.

3.8 Foreign Investment and Services

The liberalization of trade in services has been a vital area of negotiation and is assumed to be a source of economic growth in some countries. It remains, however, too complex a phenomenon to model so robust estimates of the impact of liberalization are hard to generate. The process of services liberalization is spearheaded by the WTO General Agreement on Trade in Services (GATS). Additional details are being agreed in the context of regional and sometimes even bilateral negotiations. For example, a series of new free trade agreements negotiated by the United States have tended to increase market access in the services sector in the treaty partners of the United States; the United States itself has tended not to make additional commitments beyond those it made under the GATS.

The process of services liberalization is unlike the process of liberalization of trade in goods, for the simple reason that trade in services generates a distinctively different set of economic outcomes, and interests are differently distributed when it comes to services. The approach to services liberalization is based on the distinction between four “modes” of service delivery and a process of request and commitment in which one country makes requests for

⁵³ UNCTAD, *Foreign Direct Investment and Performance Requirements*, p. 30.

liberalization that may or may not be met by another. Each country develops a positive list of services and modes on which commitments have been made. While the generally unquestioned goal may be universal liberalization of all services, the result for the foreseeable future is a patchwork. This reflects the complex pattern of advantage in services liberalization since one country is the likely provider while the other is a host. Like investment, services liberalization is difficult to categorize in simple terms.

Mode 3 of the GATS—delivery of services through commercial presence⁵⁴—involves investment in the host country. Such investments are also protected by the GATS agreement, but without any institutional means to enforce such protections beyond the traditional WTO institutions of dispute settlement and transparency. The standard for use of the Dispute Settlement Understanding (DSU) is failure “to carry out ... obligations or specific commitments under this Agreement” and nullification or impairment of benefits by measures not in conflict with the GATS. These are standards that apply to states and not to individual investors.

Following the development of a growing list of committed services, it is increasingly obvious that even where commitments have been made, domestic regulation can have a dramatic impact on the opportunities for trade in services. Many services are subject to tight regulation in all countries to ensure quality and to maintain a balance of competition. Such regulation represents another instance where private rights and public goods need to be balanced against each other and the negotiations to develop rules governing such regulation are correspondingly difficult.

3.9 Regulatory Chill

An argument that is frequently made in support of IIAs is the need for investors to have legal certainty. This is a desirable goal, yet the question remains just what is required to achieve it—and how to balance the desire for legal certainty with the regulatory functions of governments. The European Union addresses this relationship in a statement on investment: “We believe that the two objectives of improving legal certainty for FDI and respecting the right to regulate of host countries are compatible and can be pursued through international agreements.”⁵⁵ However, poorly drafted international agreements may achieve neither. Drafters of these agreements do not appear to have been fully aware of

⁵⁴ Actually GATS Art. 1.2(c).

⁵⁵ http://europa.eu.int/comm/trade/issues/sectoral/investment/index_en.htm

the complexities of achieving balance between investor rights and public goods, resulting in texts that risk producing undesirable results. This dimension has, thus far, been explored most fully in relation to NAFTA, but the lack of consistency between BITs suggests strongly that major issues of interpretation exist and the shortcomings of the dispute settlement procedure leave their resolution in the hands of a process that is singularly unsuited for this purpose.

The most serious potential result is a phenomenon that has been called “regulatory chill.” Regulators may prove hesitant to adopt measures because of uncertainty surrounding possible disputes that may follow. The result may be that necessary measures are delayed or not adopted at all.

3.10 Dispute Settlement

Investor-state dispute settlement has long been a feature of IIAs, and for good reason: disputes concerning investments are not between states but between individual investors and the states that are host to the investment. If IIAs are about a balancing of investor rights and public goods, disputes are liable to concern the relationship between these two. Turning an investor’s complaint into a state-state dispute means that one state represents the interests of an individual investor while the other stands for public welfare—not a desirable situation, and one that guarantees that only well-connected investors will get a full hearing.

The problem with existing investor-state dispute settlement is that, with the exception of the ICSID facility, the processes that are being used were never designed for this purpose.⁵⁶ In no circumstances do the rules of arbitration provide for full transparency of proceedings, or the resolution of disputes by permanent judges without any financial stake in the outcome.

The issue of transparency is fundamental. Without information on the grounds for a dispute, pleadings and decisions it is impossible for the legal doctrines surrounding FDI to develop in an orderly manner. More seriously, the disputes frequently impact on matters of public welfare; it is among the most fundamental of democratic principles that the public has a right to know about such proceedings.

⁵⁶ von Moltke, Konrad and Howard Mann, “Misappropriation of Institutions: Some Lessons from the Environmental Dimension of the NAFTA Investor-State Dispute Settlement Process,” *International Environmental Agreements*, vol. 1 no. 1 (January 2001), pp. 103–123.

Under the current model of dispute settlement, lawyers who practice on behalf of corporate clients who are potential complainants in such disputes are often appointed to serve as arbitrators. The resulting conflicts of interest are particularly difficult to manage since they do not involve the personal integrity of the lawyers themselves but are a structural feature that draws them into a complex web of relationships.

It is possible to design appropriate international institutions that are transparent, accountable and legitimate for resolving disputes which arise between investors and states. Given that such institutions will review the actions of all parts of government: legislative, administrative and judicial, they must meet the same standards as the review of government actions in any democratic context. In other words, they must act within a framework of law; their actions, including hearings and pleadings, must be transparent; and they must be free of any taint of conflict of interest. In all likelihood, acceptable investor-state dispute settlement will also require an appeals process.

3.11 Good Governance

“Good governance” has become shorthand for a range of practices that are widely accepted as necessary for the proper functioning of markets in general and for the promotion of sustainable development in particular. The agenda of good governance remains quite fluid but it is highly congruent with the need for legitimacy, transparency and accountability that is critical for addressing issues of investment. While the debate about good governance has largely focused on practices within countries, at national, regional or local levels, the requirements apply with equal force at the international level when matters relating to public goods are at stake. The fact that IIAs, the manner in which they are concluded, often without adequate discussion or negotiation, the ambiguities and contradictions that have been created by insufficiently careful drafting (itself a consequence of incomplete negotiation), and their dispute settlement institutions in particular, do not meet the most basic standards of good governance is deeply disturbing.

There are calls for good governance in relation to IIAs, but these calls have largely been confined to national practices. Indeed, in the most recent bilateral trade negotiations that included investment provisions, Australia successfully argued that the existence of good governance in the two countries (Australia and the United States) obviated the need for international investor-state dispute settlement. This raises the question whether IIAs should show a degree of deference to the institutions of domestic governance that is conditional on the existence of good governance.

Improving domestic governance is, or at least should be, a more important goal of international policy than the introduction of international institutions that preempt domestic actions. IIAs that are not drafted with sufficient prudence create a situation where allowing investors to circumvent domestic institutions has the presumably unintended effect of removing incentives for the development of good governance at domestic level. The opposite is required: IIAs that contribute to the promotion of good governance not only through their textual provisions but through robust commitments, including financing, to institutional development and capacity building wherever it is needed.

3.12 Corporate Social Responsibility

The debate about the obligations of foreign investors towards host states has existed since IIAs began to be negotiated. This debate has now crystallized around the concept of Corporate Social Responsibility (CSR).

A number of non-binding codes of conduct have emerged, including the OECD Guidelines for Multinational Corporations. The International Finance Corporation (IFC), a branch of the World Bank Group, has developed the Equator Principles⁵⁷ that have been signed by most large banks and now cover all investment supported by these banks. There is debate concerning the desirability of a voluntary standard developed by the International Organization for Standardization (ISO). The central dilemma has always been how to ensure respect for these codes and how to link them with IIAs.

The UN Centre for Transnational Corporations (UNCTNC) sought to negotiate a binding international agreement on investor obligations. These negotiations failed and UNCTNC was closed for its pains. More recently, the UN Human Rights institutions have worked to elaborate a set of norms on the conduct of transnational corporations and other business enterprises. A specialized working group has drafted a set of norms which have been submitted for consideration by the UN Commission on Human Rights, however these norms have become the subject of a heated behind-the-scenes debate between governments, business representatives and non-governmental human rights agencies.⁵⁸

⁵⁷ <http://www.ifc.org/equatorprinciples>

⁵⁸ Peterson, Luke Eric, "UN Human Rights Commission Handed Hot Potato on Corporate Responsibility," *INVEST-SD News Bulletin*, April 13, 2004, at: http://www.iisd.org/pdf/2004/investment_investsd_april13_2004.pdf

While the success of these efforts has been minimal, mainstream investment negotiations have done even less to balance corporate rights with corporate responsibilities. Investor obligations are exceedingly rare in IIAs;⁵⁹ indeed, it is more common for treaties to *prohibit* governments from imposing certain obligations upon investors—e.g., employment obligations, technology transfer and other so-called performance requirements. The draft MAI referenced the (non-binding) OECD Guidelines without linking them formally to any part of the proposed agreement. Other IIAs have not even attempted to make such a linkage. Part of the difficulty lies in the different character of IIAs and CSR codes. IIAs are binding agreements between countries; they confer limited rights on individuals. CSR codes address the behaviour of individuals and, in this instance, corporations. While the translation of obligations between states into obligations for individuals has always been tricky, it has been done in areas such as human rights and genocide, and there are techniques available for creating obligations on states to adopt new domestic laws as well. The issue, ultimately, is not the availability of legal tools, but of political will and consensus on corporate conduct obligations.

3.13 The Role of Official Development Assistance

The increasing role of FDI in economic development creates a number of new challenges and opportunities for official development assistance (ODA). Historically, much ODA has sought out projects that could be shown to be desirable investments, whether for infrastructure or energy supply or more specific objectives of economic development. Where ODA included a loan element, whether bilateral or multilateral, an effort was made to demonstrate that the economic benefits justified taking on the loan obligations. Yet, none of these projects entailed an acceptance of financial risk by the donor (or lender) agency, the essential characteristic of private investment.

Projects that have a positive economic rate of return are increasingly the object of private investment. Projects that do not attract private investors are, almost by definition, not viable as investments so that ODA is left to fund “uneconomical” activities. That has made loan financing increasingly problematic, even though

⁵⁹ Peterson, Luke Eric, “International Human Rights in Bilateral Investment Treaties and Investment Treaty Arbitration,” a research paper prepared by the International Institute for Sustainable Development for the Swiss Department of Foreign Affairs, April 2003, at: http://www.iisd.org/pdf/2003/investment_int_human_rights_bits.pdf

loan volumes have generally kept up as lenders have sought to avoid writing off loans (which would entail budgetary consequences) or finding themselves in a situation where net flows from poor countries turned negative, a particular problem for the World Bank with its limited grant funds.

Several critical functions have emerged for ODA in relation to FDI: the promotion of good governance, including capacity building to support this process; the creation of necessary infrastructure; and, the support of investment activities in projects that would not attract private investment without some measure of public participation. The resulting relationships between ODA and private investment require careful monitoring to ensure that risks and benefits are appropriately distributed and, more particularly, that governments do not substitute the economic judgment of private actors who also are exposed to financial risk.

The integration of trade and foreign direct investment with ODA represents one of the primary challenges of current development assistance activities. It is essential to ensure that trade and investment agreements recognize sustainable development as one of their primary objectives and include appropriate provisions that will help to ensure satisfactory outcomes. Similarly, the rules concerning ODA need to recognize the importance of trade and investment and ensure that adequate funding is available to meet the institutional and capacity-building needs of recipient countries that are increasingly enmeshed in a complex web of international economic policy obligations.⁶⁰

⁶⁰ The Cotonou Partnership Agreement (CPA) between the European Union, its Member states, and a group of African, Caribbean and Pacific (ACP) countries clearly enunciates these issues. There is insufficient evidence to judge whether its implementations meets the high aspirations that have been articulated by the treaty texts. von Moltke, Konrad, *A Cotonou Investment Agreement*, Report prepared for the Commonwealth Secretariat. Also at <http://www.iisd.org/trade/pubs.htm>. von Moltke, Konrad, *A Road Map for a Cotonou Investment Agreement*, Report prepared for the Commonwealth Secretariat. Also at <http://www.iisd.org/trade/pubs.htm>. von Moltke, Konrad, *Implications of the Cotonou Agreement for Sustainable Development in the ACP Countries and Beyond*. Report for the Swiss Agency for Development and Cooperation (SDC). December 2003. Available at <http://www.iisd.org/trade/pubs.htm>

4. Conclusion: Setting Priorities

The issues outlined above are daunting. Policy-makers may take comfort in the fact that FDI is flowing. This could suggest that the system is functioning. Nothing could be further from the truth. The existing IIAs represent a jumble of provisions that have little consistency—and provisions that were thought to be uncontroversial are proving to be much more difficult to interpret than anticipated. A large number of additional issues require urgent attention if the large flows of FDI are to promote sustainable development, the frequently stated goal of public policy. Some of these issues may flow into new IIAs; some may require the development of complex international regimes that include the necessary institutional, financial and human resources. Working out what needs to be done, and in what order, is not a simple task.

The regimes for FDI will require an exceptional level of public/private co-operation at the international level, just as the promotion of sustainable development has been recognized to need. While there are signs that this co-operation is beginning, it will still need careful nurturing to ensure that essential criteria of investment risk and good governance are met, in particular that binding decisions are taken in a legitimate, transparent and accountable manner.

Despite the increased flows of FDI, the core challenges of sustainable development remain unmet: ensuring poverty alleviation and ecological integrity. These will themselves require investment, and designing international rules that promote such investment is an urgent priority. This also entails the identification of solutions to one of the core dilemmas of FDI: that current flows are distributed in an extremely uneven manner that does not correspond to the needs of development. In particular, numerous smaller developing countries are hobbled by their lack of investment, including some that meet most criteria of good governance.

Not all the issues outlined above can be tackled simultaneously. This will require a process of priority-setting and some means of burden-sharing.

An immediate priority is to ensure that new IIAs do not increase problems of sustainable development and to rectify defects in existing IIAs. This will inevitably involve a process of international debate that is unlikely to be easy. The controversies surrounding the MAI, the Cancun WTO Ministerial and the negotiations for a Free Trade Area of the Americas are emblematic of this difficulty but, thus far, the debate has not extended to the process of negotiating BITs and regional agreements, as it must.

A further priority is to promote the better integration of policies relating to FDI and the actions of development agencies. The latter have long struggled with many of the problems now confronting the former. It is likely that these two communities will achieve more together than apart, as they currently operate.

The lack of analytical attention to FDI and IIAs needs to be corrected. One of the reasons for the difficulties of the current policy debate concerning FDI and development is the lack of sufficient critical input. Thus far, even the key hypotheses have not been identified, let alone appropriate methods to elucidate them. That is why studies like the analysis of NAFTA by the International Institute for Sustainable Development or the World Bank study showing little correlation between BITs and investment flows can cause such consternation.

Individual countries, whether host countries or home countries, cannot undertake all the tasks that need to be tackled. To some extent, this is a justification for multilateral action. Host countries must set priorities, identify the most important and promising areas of investment and work to stimulate a satisfactory flow of funds into them. Similarly, home and donor countries need to develop an approach to the issue of international investment that permits each country to work in areas that are particularly promising in terms of its resources and abilities. This can only occur in the framework of appropriate, robust, widely-supported international regimes.