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THE DEVELOPMENT DIMENSION OF FOREIGN DIRECT INVESTMENT: POLICIES TO ENHANCE THE ROLE OF FDI, IN THE NATIONAL AND INTERNATIONAL CONTEXT – POLICY ISSUES TO CONSIDER

Note by the UNCTAD secretariat

Executive summary

This note addresses a non-exhaustive set of issues that deserve careful consideration in exploring the development dimension of foreign direct investment, especially in the context of negotiating international investment agreements. More specifically, it focuses on issues related to, first, the role of FDI-related host country policies in encouraging synergies between inward FDI and the domestic enterprise sector; second, the potential role of home country policy measures in this context; and, third, how the design and implementation of IIAs can reflect in a balanced manner the interests of home and host countries, taking into account the development policies and objectives of host Governments as well as their right to regulate.

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CONTENTS

INTRODUCTION

1. The Commission on Investment, Technology and Related Financial Issues, at its sixth session on 21–25 January 2002, decided to hold an "Expert Meeting on the Development Dimension of FDI: Policies to Enhance the Role of FDI in Support of the Competitiveness of the Enterprise Sector and the Economic Performance of Host Economies, Taking into Account the Trade/Investment Interface, in the National and International Context".

2. The topic chosen is particularly relevant in light of the call for policy analysis in the area of investment as stated in the Ministerial Declaration from the meeting of the World Trade Organization in Doha, and given the need for inputs into the discussion on the "development dimension" of negotiations on international investment agreements (IIAs), regardless at what level.

3. Foreign direct investment (FDI) can play a significant role in the development process of host economies. In addition to capital inflows, FDI can be a vehicle for obtaining foreign technology, knowledge, managerial skills, and other important inputs; integrating into international marketing, distribution and production networks; and improving the international competitiveness of firms and the economic performance of countries. At the same time, neither inflows of FDI nor the benefits from such inflows are automatic.

4. Governments need to consider what role they want inward FDI to play in the development process of their economies, and then design their FDI policies accordingly. Thus, the broad policy objectives are to attract especially investment that is in line with the identified development objectives; to maximize the potential benefits derived from FDI; and to minimize negative effects (e.g. balance of payments problems, crowding out, transfer pricing, abuse of market power, labour issues and environmental effects). Government intervention (by host or home countries) may be motivated by two primary types of market failures: information or coordination failures in the investment process; and the divergence of private interests of investors (foreign and/or domestic) from the economic and social interests of host economies. To optimize the impact of inward FDI (UNCTAD, 1999), Governments need to address the following four sets of issues:

- Information and coordination failures in the international investment process;
- Infant industry considerations in the development of local enterprises, which can be jeopardized if inward FDI crowds out those enterprises;
- The static nature of advantages transferred by transnational corporations (TNCs) in situations where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in improving the relevant capabilities (an issue that is particularly relevant in the context of linkages between foreign affiliates and local firms); and
- Weak bargaining and regulatory capabilities on the part of host country governments, which can result in an unfavourable distribution of benefits from the perspective of the society (e.g. negative effects on competition or the environment).

5. In general, developing countries and economies in transition differ from developed countries with regard to the role and impact of FDI in their economies. First, the former are typically net importers of FDI, whereas developed countries in most cases present a more balanced pattern of inward and outward flows of FDI.[1] Thus, in the context of FDI and IIAs, the primary focus for most developing countries and economies in transition is on issues related to their ability to attract inward FDI and benefit from it. In contrast, questions related to improving access to foreign markets for outward investment are of secondary importance, at least for the vast majority of developing countries.

6. Second, the technological gap between domestic and foreign enterprises is generally more accentuated in developing countries and economies in transition. On the one hand, this suggests that these economies should be particularly interested in attracting FDI that can bring much-needed capital, technology and knowledge. On the other hand, weak domestic capabilities hamper the ability to fully reap the benefits of inward FDI. Similarly, whereas inward FDI in countries with relatively unproductive domestic enterprises may provide valuable examples of desirable practices, leading to a rise in productivity, it may also risk crowding out domestic players and may encourage anti-competitive behaviour resulting in welfare losses.

7. International agreements in general involve binding commitments, which may lead to the convergence of national policies and can limit the policy autonomy of the parties to an agreement. It is therefore important for developing countries to deepen their understanding of what policies and policy tools are most important from a development perspective; how international rules in the area of investment would affect them; and what commitments can be sought from home countries to support their development objectives. The overall question is how IIAs can help developing countries and economies in transition to attract FDI, while allowing sufficient policy space for these countries to regulate in the interest of benefiting as much as possible from such investment.

8. In this context, the terms of reference of the Expert Meeting identified four specific questions, namely:

- How can host country policies encourage synergy between FDI and domestic enterprises, to support the competitiveness of the latter, in the national and international context?
- What measures can home countries take to contribute to such an outcome?
- How can the interests of home and host countries be balanced, taking into account the development policies and objectives of host Governments as well as their right to regulate in the public interest?

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[1] The stock of outward FDI from developing countries increased rapidly during the late 1990s and stood at $776 billion in 2001. However, the 10 largest developing-economy sources – with Hong Kong (China), Singapore, Taiwan Province of China and the Republic of Korea in the top four positions – accounted for more than 85 per cent of these investments. Only 15 developing economies and economies in transition reported outward stocks of more than $10 billion in 2001. In 70 countries, outward FDI stocks were below $10 million (UNCTAD, 2002).

- How can safeguards be introduced to ensure that domestic enterprises are not adversely affected?

9. This note is a brief overview of a non-exhaustive set of issues that deserve consideration in exploring the development dimension of FDI in the context of negotiating IIAs. *Chapter I* discusses the role of FDI-related host country policies in encouraging synergies between inward FDI and the domestic enterprise sector. *Chapter II* looks at the potential role of home country policy measures in this context. *Chapter III* recognizes that IIAs discipline the use of policies undertaken by the parties involved and addresses the role of safeguards and the right of host governments to regulate.

I. HOST COUNTRY POLICY MEASURES

10. Host countries have various policy tools at their disposal to enhance the developmental impact of FDI. Some are of a general nature and aim at enhancing the attractiveness of the business environment (policies aimed at creating political and macro-economic stability and improving infrastructure and human resources; trade policy; science and technology policies; labour laws; etc.). Such policies can be nationwide or specific to sectors or regions. Another set of policies is geared to the development of enterprise capabilities, especially small and medium-size enterprises (SMEs). Finally, there are policies that consist of rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them and the functioning of the markets in which they are active (UNCTAD, 1996a). While this note concentrates on the last set of policies – since it is most directly related to FDI – it is clear that such policies need to be well integrated into the overall development strategy of a country.

11. Countries are scaling up their efforts to attract FDI. This can be seen from the ongoing liberalization of FDI policies involving the opening up of sectors and industries (UNCTAD, 2002). Countries at all levels of development are also continuing to enter into bilateral investment treaties (BITs) and double taxation treaties (DTTs). At the close of 2001, a total of 2,099 BITs and 2,185 DTTs had been concluded (UNCTAD, 2002). While the general trend is in the direction of FDI liberalization, simply opening up an economy is often no longer enough to attract sustained flows of FDI and to ensure that FDI brings the expected developmental benefits. TNCs’ investment decisions are primarily driven by economic fundamentals (such as market size, the costs and efficiency of production, the quality of infrastructure and access to skills). In response to growing competition for FDI, and to overcome information failures, more and more countries are actively promoting their locations to potential investors. In addition, countries are increasingly adopting a more targeted approach to FDI promotion. Such an approach, while not without risk, has been found to increase the chances of attracting the type of investment that can advance a country’s development objectives (UNCTAD, 2002).

12. Absent an enabling policy environment, TNCs tend to focus on the existing comparative advantages of host countries, especially low labour costs and logistical

considerations, when locating their export-oriented activities in developing countries. Capitalizing fully on static benefits and transforming them into dynamic and sustainable advantages therefore requires proactive government intervention. The development of domestic skills and enterprise capabilities is particularly important for attracting quality FDI and ensuring that the necessary absorptive capacity is present to benefit fully from knowledge transfers.

13. In terms of the core FDI policies, host countries have implemented, or are implementing, various "host country operational measures" (HCOMs) that aim at influencing the operation of foreign affiliates inside their jurisdictions (UNCTAD, 2001a). HCOMs can cover all aspects of investment (ownership and control, hiring of personnel, procurement of inputs, etc.) and usually take the form of either restrictions or performance requirements. They are often adopted to influence the location and character of FDI and, in particular, to increase its benefits. HCOMs can be divided into three categories (table 1): "red-light" HCOMs, which are explicitly prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs) because of their distorting effect on international trade; "yellow-light" HCOMs, which are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements; and "green-light" HCOMs, which are not subject to control through any IIAs.

Table 1
Three categories of HCOMs

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

Source: UNCTAD, 2001a, p. 3.

14. At the multilateral level, the TRIMs Agreement prohibits not only TRIMs that are mandatory in nature but also those that are linked to the receipt of an advantage. It applies only to investment measures related to trade in goods and not trade in services.[2] While such measures frequently arise in the context of foreign investment policies, the Agreement applies equally to measures imposed on domestic enterprises. For example, a local content requirement imposed in a nondiscriminatory manner on domestic and foreign enterprises is inconsistent with the TRIMs Agreement because it involves discriminatory treatment of imported products in favour of domestic products.

15. Some regional agreements also address these and additional performance requirements. The North American Free Trade Agreement (NAFTA), for example, forbids local equity requirements (Art. 1102(4)). Article 1106(1) proscribes the imposition or enforcement of mandatory requirements and the enforcement of any undertakings or commitments to (a) export a given level or percentage of goods or services; (b) achieve a given level or percentage of domestic content; (c) purchase, use or accord a preference to goods produced or services provided in the territory of a party or to purchase goods or services from persons in its territory; (d) relate the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with investment; (e) restrict sales of goods or services produced or provided by an investment in a party's territory by relating such sales to the volume or value of exports or foreign exchange earnings of the investment; (f) transfer technology, a production process or other proprietary knowledge; or (g) act as the exclusive supplier of the goods produced or services provided by an investment to a specific region or world market.[3]

16. Similar provisions are also found, for example, in the 1997 Canada-Chile Free Trade Agreement (Article G-06), the 1997 Mexico-Nicaragua Free Trade Agreement (Article 16-05), and the 2000 Free Trade Agreement between Mexico and El Salvador, Guatemala and Honduras (Article 14-07). Article 13 of the 1985 United States-Israel Free Trade Agreement forbids the use of local content and export performance requirements. A prohibition of a wide range of performance requirements is also contained in the 2002 Agreement between Singapore and Japan for a New Age Economic Partnership. On the other hand, the 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico explicitly allows the imposition of requirements to locate production, generate jobs, train workers or carry out research and development (Article 17-04).

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[2] Measures concerning service industries are addressed by the General Agreement on Trade in Services (GATS), which does not contain explicit rules dealing with TRIMs, although these may be subject to specific negotiated commitments. Article XIX.2 of the GATS explicitly grants appropriate flexibility to developing countries to attach conditions when making access to their markets available to foreign service suppliers, provided these conditions are aimed at achieving the objectives set out in Article IV of the GATS (increasing participation of developing countries in world trade).

[3] Requirements (a) and (b) refer only to goods, and (d) and (e) are also prohibited if applied as conditions for the receipt of an advantage (Article 1106(3)). However, parties are free to make receipt of an advantage conditional on compliance with requirements, in connection with an investment, to locate production, provide a service,

17. The usefulness of various performance requirements remains an area in need of more research. While some studies question the effectiveness of performance requirements, others argue that current IIAs go too far in curtailing the ability of host governments to improve the quality of FDI in line with their development objectives.[4] As regards future negotiations of IIAs, there may be a need for further assessments of the impact of existing agreements at the bilateral, regional and multilateral levels on the use and impact of performance requirements.

18. To avoid deterring FDI, performance requirements have normally been tied to some kind of advantage, often in the form of incentives. Most developed countries offer locational incentive packages to both domestic and international investors. Developing countries also offer tax breaks and locational packages to attract foreign investors. However, their packages are much smaller, and these countries typically rely relatively more on fiscal measures, whereas financial incentives are more common in developed countries (UNCTAD, 1996b; UNCTAD, 2000). In developing countries, incentives have been used especially to attract export-oriented FDI, often in the context of export processing zones (EPZs). In light of restrictions under the WTO Agreement on Subsidies and Countervailing Measures (the SCM Agreement), developing-country WTO members (other than those mentioned in Annex VII of the SCM Agreement and with the exception of those that obtain an extension of the transition period) will have to eliminate export subsidies (related to goods) as required under the SCM Agreement by 1 January 2003. Even those obtaining an extension of the transition period cannot increase the level of their export subsidies, are subject to the prohibition with respect to particular products if they achieve export competitiveness in such products, and will need to consider what to do once the transition period expires (UNCTAD, 2002).

19. At the same time, it is worth reflecting on the legal regime for development-related subsidies. For instance, subsidies to foreign affiliates and/or domestic firms that engage in linkage development activities in developing countries, involving the provision of technology, technical assistance and training to local suppliers and their personnel, may be an important policy tool. A case could be made for, under specified conditions, making certain types of such development-oriented subsidies to foreign affiliates non-actionable under WTO rules (UNCTAD, 2001b; UNCTAD, 2002).

20. In terms of the four principal issues mentioned in paragraph 4 above, incentives and performance requirements have been used in combination with other policy measures to optimize the impact of FDI. In countries in which such measures have played a role in efforts to promote inward FDI, they have typically complemented a range of other measures such as those aimed at enhancing the level of skills, technology and infrastructure. If the business environment is not made more conducive to investment, upgrading and linkages, the risk increases that investors will leave once an incentive expires.

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train or employ workers, construct or expand particular facilities, or carry out research and development on their territories (Article 1106(4)).

[4] See, for example, Caves, 1996; Hackett and Srinivasan, 1998; Moran, 1998 and 2001; Kumar, 2001; OECD, 1998; UNCTC, 1991; and WTO, 1998 for a discussion of the role of performance requirements.

21. Partly as a result of the liberalization of regulations governing the entry of foreign investors, regulatory policies to ensure the smooth functioning of markets become more important. They may involve the adoption of competition rules, merger reviews, environmental laws and stricter financial accounting standards. For many developing countries and economies in transition, the transition from more interventionist policy approaches (at the point of FDI entry) to the regulation of markets is difficult because of a lack of financial and human resources.

22. In light of the above, experts may wish to consider the following questions:

(a) What host country government policies are particularly important for enhancing the ability of developing countries and economies in transition to *attract* and *benefit from* FDI in line with their development objectives?

(b) How do international agreements at the bilateral, regional and multilateral levels affect the ability of countries to use these policies?

(c) To what extent have various performance requirements helped countries meet their development objectives?

(d) What “yellow-light” HCOMs have been particularly useful in this regard?

(e) How would developing countries benefit from making the use of such requirements more (or less) restrictive?

II. HOME COUNTRY POLICY MEASURES

23. Host country policies can be supported by home country measures (HCMs). Home countries influence FDI flows in various ways, including the likelihood that their TNCs will select certain locations.[5] The overriding question in this section is therefore how HCMs, in the context of IIAs, can help developing countries and economies in transition to attract and benefit from FDI. This is of particular relevance given the noted discrepancy between developed and developing countries in terms of the balance between inward and outward FDI.

24. Developed countries have removed most national restrictions on outward FDI, but policy declarations aimed at encouraging outward FDI are seldom linked to any specific commitments in IIAs (UNCTAD, 2001c). Most assistance remains at the discretion of each developed country and is commonly shaped to serve a home country’s own business interests along with general development objectives. This home country perspective is especially evident in the design of many financial or fiscal assistance programmes as well as preferential market access measures. The weak link between the explicit needs of developing countries and the design and execution of HCMs, as well as the often uncertain commitment to the

[5] An UNCTAD Expert Meeting on Home Country Measures was held in Geneva from 8 to 10 November 2000. The meeting’s outcome is outlined in UNCTAD, 2001c.

duration of assistance, may diminish the beneficial impact such programmes can have on development.

25. Relevant HCMs can, for example:

- Aim at improving the economic fundamentals of host countries – for example, through developing human resources, building institutional capacity and assisting in the design and implementation of adequate framework conditions in relevant policy areas;
- Help to reduce the types of information failures in the investment process alluded to above by assisting in the dissemination of investment opportunities in developing countries and economies in transition;
- Improve market access and facilitate export flows from developing countries;
- Provide investment guarantees and insurance;
- Provide risk and venture capital;
- Support linkage promotion programmes; and
- Commit to transfers of technology.

26. Most developed countries (and a number of other countries) engage in some of these activities, albeit largely on an autonomous basis and in a rather uncoordinated fashion. (For example, there are at least 12 European development finance institutions providing long-term financing for private-sector development in developing and transition economies; see e.g. http://www.edfi.be.) Other institutions providing financial assistance at the international level include the World Bank Group, regional multilateral development banks, the Commonwealth Private Investment Initiative and various privately sponsored investment funds (Hughes and Brewster, 2002). An example of an internationally agreed approach is the Cotonou Agreement (box 1).

Box 1
Investment and private-sector development support in the Cotonou Agreement

Article 74
"Cooperation shall, through financial and technical assistance, support the policies and strategies for investment and private-sector development as set out in this Agreement."

Article 75: Investment promotion
"The ACP States, the Community and its Member States […] shall:

(a) implement measures to encourage participation in their development efforts by private investors […];

(b) take measures and actions which help to create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate;

(c) encourage the EU private sector to invest and to provide specific assistance to its counterparts in the ACP countries under mutual business cooperation and partnerships;

(d) facilitate partnerships and joint ventures by encouraging co-financing;

(e) sponsor sectoral investment fora to promote partnerships and external investment;

(f) support efforts of the ACP States to attract financing, with particular emphasis on private financing, for infrastructure investments and revenue-generating infrastructure critical for the private sector;

(g) support capacity-building for domestic investment promotion agencies and institutions involved in promoting and facilitating foreign investment;

(h) disseminate information on investment opportunities and business operating conditions in the ACP States;

(i) promote […] private-sector business dialogue, cooperation and partnerships […]."

Article 76: Investment finance and support

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

(a) grants for financial and technical assistance to support policy reforms, human resource development, institutional capacity-building or other forms of institutional support related to a specific investment, measures to increase competitiveness of enterprises and to strengthen the capacities of the private financial and non-financial intermediaries, investment facilitation and promotion and competitiveness enhancement activities;

(b) advisory and consultative services in creating a responsive investment climate and information base to guide and encourage the flow of capital;

(c) risk capital for equity or quasi-equity investments, guarantees in support of domestic and foreign private investment and loans or lines of credit […];

(d) loans from the Bank's own resources. […]."

Article 77: Investment guarantees

"[…] 2. Cooperation shall offer guarantees and assist with guarantees funds covering the risks for qualified investment. Specifically, cooperation shall provide support to:

(a) reinsurance schemes to cover foreign direct investment to eligible investors; against legal uncertainties and the major risks of expropriation, currency transfer restriction, war and civil disturbance, and breach of contract. […]

(b) guarantee programmes to cover risk in the form of partial guarantees for debt financing. […]

(c) national and regional guarantee funds, involving, in particular, domestic financial institutions or investors for encouraging the development of the financial sector.

3. Cooperation shall also provide support to capacity-building, institutional support and participation in the core funding of national and/or regional initiatives to reduce the commercial risks for investors […].

4. […] The ACP and the EC will within the framework of the ACP-EC Development Finance Cooperation Committee undertake a joint study on the proposal to set up an ACP-EC Guarantee Agency to provide and manage investment guarantee programmes."

Source: UNCTAD, 2001d, pp. 452–54.

27. As the transfer of technology is a central element in many IIAs, capacity-building has often as its objective enabling developing-country parties to comply with their commitments under the instruments addressing technology issues. Many technology-related provisions rely on HCMs for their implementation.[6] For example, Article 66.2 of the TRIPS Agreement stipulates that developed countries "shall provide incentives to enterprises and institutions in their territories" in order to promote and encourage transfer of technology to LDCs to "enable them to create a sound and viable technological base". Though this provision leaves great leeway to member States to determine what kind of incentives to apply, it does require the establishment of some system encouraging transfer of technology to LDCs. It also provides a general objective that may help to assess the appropriateness of such incentives, since they should enable LDCs "to create a sound and viable technological base".[7]

28. The practical effectiveness of HCMs is likely to increase in proportion to the strength of the policy commitments contained in IIA provisions, running along a continuum from hortatory declarations to binding obligations accompanied by detailed implementation plans (backed by financial resources) and monitoring mechanisms. Some IIAs include for this purpose a provision for the establishment of a "Supervisory Committee" to ensure the proper implementation of what has been agreed.[8]

29. A related policy area is that of the social responsibility of corporations.[9] The concept of corporate social responsibility is potentially very broad and may encompass most matters pertaining to the economic and social impact of TNCs. In a more narrow sense, a number of aspects – including development obligations, sociopolitical obligations and consumer protection – have received some attention, and others (such as corporate governance, ethical business standards and the observance of human rights) are emerging. Issues related to corporate social responsibility are typically not covered by IIAs but are receiving increased attention in various international agreements and forums.[10] The challenge is to balance the promotion and protection of liberalized market conditions for investors with the need to pursue development policies. Social responsibility standards must be applied with sensitivity to the realities of local conditions in developing countries and should not be misused for protectionist purposes.

30. In light of the above review, experts may wish to consider the following questions:

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[6] An Expert Meeting on International Arrangements for Transfer of Technology: Best Practices for Access to and Measures to Encourage Transfer of Technology with a View to Capacity-Building in Developing Countries, Especially in Least Developed Countries, was held in Geneva from 27 to 29 June 2001. Its outcome was an input for policy considerations at the sixth session of the Commission on Investment, Technology and Related Financial Issues, held from 21 to 25 January 2002 (TD/B/COM.2/ L.16, 29 January 2002).

[7] For a compilation of provisions in international arrangements for the transfer for technology, see UNCTAD, 2001e.

[8] See e.g. Chapter 1, Article 8 of the Agreement between Japan and the Republic of Singapore for a New Age Partnership.

[9] For a discussion of this concept, see e.g. UNCTAD, 1999, pp. 345–70, and UNCTAD, 2001f.

[10] Examples include nonbinding recommendations in the OECD Guidelines for Multinational Enterprises, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, the United Nations Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices and the Global Compact of the United Nations Secretary-General.

(a) What HCMs are particularly important for enhancing the ability of developing countries and economies in transition to attract and benefit from FDI in line with their development objectives?

(b) How do international agreements at the bilateral, regional and multilateral levels affect the use of such measures?

(c) What are past experiences with the provisions related to investment promotion, investment finance and support, investment guarantees, and other HCMs in IIAs?

(d) To what extent have intergovernmental organizations so far been able to address satisfactorily the issue of corporate social responsibility?

(e) What are the pros and cons of various policy options ranging from making no reference to social responsibility in IIAs to the inclusion of generally binding social responsibility provisions, with other intermediary options in between these two extremes?

III. THE RIGHT TO REGULATE AND SAFEGUARDS

31. The Doha Ministerial Declaration, in the context of the relationship between trade and investment, stated in paragraph 22: “Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host Governments, as well as their right to regulate in the public interest.”

32. International agreements, like other legal texts, are specifications of legal obligations, which as such limit the sovereign autonomy of the parties. As international legal obligations generally prevail over domestic rules, a tension is created between the will to cooperate at the international level through binding rules and the need for Governments to discharge their domestic regulatory functions. Such tension is generally captured by the notion of the “right to regulate”, which is central to the question of preserving the national policy space for Governments to pursue their development objectives.[11]

33. There are various ways to address the issue of the right to regulate. Some of these, with regard to both trade and investment agreements, are reviewed below. In all cases the ability of signatories to regulate the domestic economy is a governing concern. Insofar as this concept is restated in an agreement – for instance, in its preambular language – it also serves an interpretive function vis-à-vis the provisions of the agreement. Furthermore, whenever countries enter into standard-of-treatment obligations, such as fair and equitable treatment, prohibition of arbitrary and discriminatory measures or most-favoured-nation treatment (MFN) and national treatment, various kinds of exceptions, reservations, derogations, waivers or transitional arrangements ensure that signatories retain their prerogative to apply nonconforming domestic regulations in certain areas. These can be general (e.g. for public

[11] The need to balance the public interest pursued through regulation and private rights is also common at the national level.

order or national security), subject-specific (e.g. the so-called “cultural exception”) or country-specific (e.g. as in the case of GATS schedules of commitments, with regard to commercial presence).

34. Various safeguards are also used to preserve the right to regulate, as in the case of transfer-of-payments and balance-of-payments safeguards. Furthermore, time-bound safeguards are often allowed as a measure to enable a country to safeguard its domestic production against a surge of imports.[12] It is necessary to examine to what extent such a concept of “safeguards” could also be used in the area of investment. As the terms of reference for this Expert Meeting suggest, this issue could, for example, be relevant in the context of ensuring that domestic enterprises are not adversely affected.

35. The issue of the right to regulate has been dealt with largely in international agreements on trade, and useful concepts and approaches that have been defined in this context have also been used in the context of IIA. In the area of *trade*, the issue has been debated and litigated at length in the GATT/WTO system, where the dispute settlement process has been frequently used to police domestic regulatory measures that have an impact on trade. The main instrument for policing regulatory activities in the WTO comes from the 1947 GATT and is found in Article III’s nondiscrimination (national treatment) obligation as complemented by the exceptions contained in Article XX. The general national treatment rule contained in Article III provides that internal taxes and regulations must not treat imports less favourably than domestic products. If a domestic regulatory measure is found to discriminate against imports, the regulating government may attempt to justify the discrimination by proving that it is necessary to achieve some legitimate purpose. Article XX of GATT defines these exceptions to include those necessary to protect public morals; to protect human, animal and plant life or health; and relating to the conservation of exhaustible resources. It should be noted that this list of policies that can justify measures otherwise considered in violation of national treatment is “closed” and thus provides limited scope for claiming an exception in many areas where countries may want to pursue regulatory action.

36. A justification for *de jure* discrimination (that explicitly distinguishes goods by origin) is particularly demanding since the country claiming the exception has to prove that there is no less burdensome alternative to the measure in question. In the case of *de facto* discrimination (not based on the origin of the goods), the central issue is that imports are treated less favourably than “like” domestic products. For a regulation to produce a difference in treatment, it must divide products into two or more categories. It is generally assumed that product distinctions that can be recognized under Article III relate to the qualities and physical properties of the products themselves or to characteristics of the production processes (e.g. hygiene) or of the producers (e.g. certification that they meet certain standards) that directly affect product qualities. Likeness is also traditionally determined in

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[12] For instance, in the framework of the WTO Agreement on Safeguards, if a production sector in a country suffers because of increased imports, the country is authorized to restrict imports temporarily by imposing higher tariffs or by directly limiting import quantities under certain conditions (“as to cause or threaten to cause serious injury to the domestic industry that produces like or indirectly competitive products”). The main rationale for this provision is that the particular sector in the country should be allowed time to adjust itself to the new situation of competition from imports.

light of factors such as physical similarity, tariff classification, interchangeability by consumers and end uses. In general, likeness indicates that products are competitive and thus that discriminatory treatment has an adverse effect on the competitiveness of the less favoured product.

37. The WTO Agreement on Technical Barriers to Trade explicitly calls for an integrated examination of the *purpose* of the measures in question and its *trade-restricting effects*. The Agreement clearly requires a balancing of the degree of trade restriction against the regulatory purpose of the disputed measure. Furthermore, the analysis of the regulatory aim is part of the review of the legality of the measure itself, with an illustrative (not closed) list of legitimate objectives. In this context, there is no need to first establish a violation (which requires a conclusive determination of likeness), followed by a review of the regulatory justification by way of exception. The balancing analysis also calls for an appreciation of the trade effects in light of existing less restrictive alternatives and of the risk of nonfulfilment of the regulatory objectives.

38. The GATS deals extensively with commercial presence of service providers, and thus its provisions are particularly relevant in the area of *investment.* GATS in its preamble recognizes “the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right.”

39. The services sector is highly regulated in many countries for the purpose of consumer protection, security, protection of public morals and prudential measures. While the GATS recognizes the sovereign right of a country to regulate services for legitimate purposes, Article VI seeks to prevent the use of administrative decisions to disguise protectionist measures. Generally applied measures that affect trade in service sectors for which a country has made commitments must be applied reasonably, objectively and impartially. Applications to supply services under such commitments must receive a decision within a reasonable period of time. The Council for Trade in Services is called on to develop rules to prevent requirements governing qualifications for service suppliers, technical standards or licensing from being unnecessary barriers to trade.[13] Until such multilateral rules are ready, governments are to follow (in sectors in which they have undertaken specific commitments) the same principles in applying their requirements and standards, so that these do not nullify or impair specific commitments (on market access and national treatment) they have made.

40. The GATS, in Article XVII on national treatment, does not limit the distinction between services and service providers only to the characteristics of the product, as is the case under GATT Article III. Other *regulatory distinctions* of otherwise “like” services and service providers are available. Obviously, origin-specific discrimination is forbidden. With regard to origin-neutral regulatory distinctions, these can create a disproportionate burden for

[13] A separate Ministerial Decision has launched this programme by establishing a GATS working party to prepare rules for the requirements that governments impose on professional service suppliers. The first disciplines to be drawn up apply to technical standards, qualification and licensing requirements for accountancy services.

foreign services and service suppliers and thus be challenged as *de facto* discrimination. The market effect is part of the analysis, as Article XXVII(3) states that "Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member."

41. The determination of likeness does not appear to be easier under the GATS than under the GATT. Probably the most meaningful element is that of "end use", along with the related concepts of direct competitive and substitutable services. Once likeness is determined and less favourable treatment found, then, rather as with the GATT, a general exception under Article XIV can be invoked. The key additional element in the GATS is that the national treatment obligation does not apply across the board but only "In the sectors inscribed in [the WTO Member's] Schedule, and subject to any conditions and qualifications set out therein" (i.e. the member's specific commitments). Thus, each member first decides which services sector will be subject to the GATS national treatment discipline, and then exempts those measures that it wishes to keep in place even though they represent a violation of national treatment. The exact content of the national treatment obligation under the GATS and any limitation on regulatory action are therefore determined not only by the interaction of the national treatment provision and the general exceptions but, and perhaps more importantly, by the extent of the limitations inscribed in each member's schedule.

42. Issues related to the right to regulate first arose in the context of investment protection agreements, with regard to the issues of expropriation and nationalization. Some regional agreements and virtually all bilateral investment treaties include broad language covering measures "tantamount" or "equivalent" to expropriation. Hence, they can also apply the expropriation provisions to "indirect expropriations" or "regulatory takings", namely, when a host country takes an action that substantially impairs the value of an investment without necessarily assuming ownership of the investment. Furthermore, a number of BITs and regional investment agreements are also understood to apply the expropriation provision to "creeping expropriations" – that is, expropriations carried out by a series of legitimate regulatory acts over a period of time, whose ultimate effect is to destroy substantially the value of an investment. They generally impose certain conditions on expropriation if it is to be considered lawful, by adopting some variation of the traditional rule of international law that a State may not expropriate the property of an alien except for a public purpose, in a nondiscriminatory manner, in accordance with due process of law and upon payment of compensation. Concerns have been expressed with regard to the impact that an expansive use of expropriation claims may have on sovereign governments' right to regulate. In the context of the NAFTA, the three member countries in 2001 adopted some Notes of Interpretation of Certain Provisions of the investment chapter to clarify the provision governing the minimum standard of treatment to be accorded to foreign investors. They determined that the NAFTA's standard is the customary international law minimum standard of treatment.

43. Moving to the area of *national treatment***,** the NAFTA, for example, subsequently followed by a number of FTAs, took an approach similar to that of the GATS. Each Party is required to accord the better of national treatment (and MFN) treatment to investors of another Party, and to investments of investors of another Party "in like circumstances", with

respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments (Articles 1102–1104). However, the Agreement's investment provisions, including those governing national treatment, are determined by the *exceptions* and *reservations* provided for in Article 1108 and contained in the annexes to the Agreement. Furthermore, the Agreement provides that nothing in the Investment Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure, otherwise consistent with the Chapter, "that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns" (Article 1114). The NAFTA also incorporates by reference the provision of GATT Article XX (Article 2101) and provides for a general national security exception (Article 2102).

44. BITs similarly limit the coverage of national treatment by including qualifications, exceptions or derogations (UNCTAD, 1998). As in the context of trade, MFN or national treatment provisions are often limited to investments that are "in the same circumstances" or "in like situations" or that are made by a "similar enterprise". Such provisions, however, do not identify the criteria by which similarity or likeness is to be established. The determination might depend, for example, on whether the two investments are in competition with each other. In OECD country practice, for example, the specific criteria to be taken into account include whether the two enterprises are in the same industry, the impact of policy objectives of the host country in particular fields and the motivation behind the measure involved. Another question that arises is whether the MFN or national treatment obligation applies to special treatment granted to certain individual investors or to all investors of a particular nationality (UNCTAD, 1998).

45. *General exceptions* are often agreed for reasons of "public security and order, public health and morality". Exceptions can also apply to the treatment accorded under international treaties or domestic legislation relating to taxation. In other words, the exception permits a country to provide favourable tax treatment to investment by national companies without according the same treatment to investment by foreign companies, or vice versa. Finally, a few BITs allow exceptions from national treatment on the basis of development provisions. An example of such an exception is found in Protocol No. 2 of the BIT between Indonesia and Switzerland, which allows derogation from national treatment of Swiss investors "in view of the present stage of development of the Indonesian economy."[14] Development considerations seem also to play a role in the case of Germany's approach in BITs to national treatment, insofar as the country has accepted certain exceptions to the national treatment principle provided that these are undertaken for development purposes only (e.g. to develop small-scale industries) and that the measures do not substantially impair investments by German investors (UNCTAD, 1998).

46. Concerning exceptions to *transfer of payments*, the possibility for a government to intervene is generally provided, with a number of qualifications. In a regional context, for instance, the 2000 Free trade Agreement between Mexico and El Salvador, Guatemala and Honduras provides for the possibility of introducing temporary exchange controls in the event

[14] However, Indonesia, pursuant to the terms of the treaty, would grant "identical or compensating facilities to investments and nationals of the Swiss Confederation in similar economic activities."

of a serious balance-of-payments disequilibrium. However, measures have to be compatible with internationally accepted criteria. In the context of the Economic Partnership Agreement between the European Union and Mexico, the Parties agreed that in case of serious balance-of-payment difficulties, restrictive measures with regard to payments, including transfer of proceeds from the total or partial liquidation of direct investment, could be adopted on a nondiscriminatory and time-bound fashion. The NAFTA provides for the possibility of adopting measures that restrict transfers in case of serious balance-of-payment difficulties, subject to a series of conditions (such as avoiding unnecessary damage to the commercial, economic and financial interests of another Party, not being more burdensome than necessary to deal with the difficulties, and being temporary and nondiscriminatory).

47. Many BITs allow exceptions to the obligation of free transfer of payments only during periods when foreign currency reserves are at exceptionally low levels. Such clauses generally allow the transfer to be delayed temporarily. Sometimes they are subject to one or more other conditions. Another approach confers the right to make monetary transfers, but subject to the exchange control laws of the host country. Some BITs guarantee the right to transfer only a fraction of the earnings of wages of nationals of the other contracting party to that home country.

48. In conclusion, while international rules obviously imply a measure of restriction on domestic regulatory autonomy, several techniques have been used to strike the right balance. The GATT, the Agreement on Technical Barriers to Trade (the TBT Agreement) and the GATS all use different approaches and may provide useful reference models for any future rule-making in the area of investment. With regard to both regional and bilateral IIAs, it is necessary to examine to what extent the right to regulate goes beyond "regulatory takings" and similar issues of investment protection to encompass the way other areas covered in IIAs can be reconciled with the necessary preservation of policy space for development.[15]

49. In light of the above review, experts may wish to consider the following questions:

(a) To what extent do existing agreements provide enough policy space for Governments to apply domestic regulatory measures in the public interest, especially in pursuit of development objectives?

(b) What might be the most appropriate approach to preserving the right to regulate in the area of investment? What role should special and differential treatment play in this context?

(c) Is an approach based on general and specific exceptions preferable to one that would assess the acceptability of a regulatory measure by balancing the investment's restrictive effect with the regulatory purpose pursued?

[15] The issue was also discussed at the UNCTAD Expert Meeting on Bilateral and Regional Approaches to Multilateral Cooperation in the Area of Long-Term Cross-Border Investment, Particularly Foreign Direct Investment. The Report of the Expert Meeting notes: "Finally, the question was raised whether the right to regulate would go beyond expropriation issues and cover performance requirements and other conditions imposed on foreign investors" (TD/B/COM.2/EM.11/3, para. 18(g)).

(d) What specific development exceptions and safeguards could be considered in the context of IIAs?

(e) What should be the objective criteria for transition periods and development exceptions, in particular to national treatment?

(f) In practice, what have the experiences been in the application of exceptions and safeguards?

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